Croatia
Integrated State-Owned Enterprises Framework (iSOEF) Assessment

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Abbreviations and Acronyms

CEE	Central and Eastern Europe
CERP	Center for the Restructuring and Sale
CFRS	Croatian Financial Reporting Standards
COVID-19	Coronavirus disease 2019
CSB	Croatian Statistics Bureau
EBRD	European Bank for Reconstruction and Development
EU	European Union
FINA	Financial Agency
GCR	Global Competitiveness Report
GDP	Gross Domestic Product
HAC	Hrvatske autoceste
HRK	Croatian Kuna
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
INTOSAI	Organization of Supreme Audit Institutions
iSOEF	Integrated State-Owned Enterprises Framework
JSC	Joint-Stock Companies
LLC	Limited Liability Companies
MAIC	Multi-Annual Infrastructure Contract
MoF	Ministry of Finance
MPPCSA	Ministry of Physical Planning, Construction and State Assets
MSTI	Ministry of the Sea, Transport and Infrastructure
MSP Law	Law on the Management of State Assets
OECD	Organization for Economic Co-operation and Development
POE	Privately Owned Enterprises
PPA	Public Procurement Act
ROA	Return on Assets
ROE	Return on Equity
SAO	State Audit Office
SOE	State-Owned Enterprises
TFP	Total Factor Productivity
ULC	Unit Labor Cost
VAT	Value-Added Tax
WB	World Bank
WBG	World Bank Group

Executive Summary

This report applies the new World Bank integrated SOE Framework (iSOEF) to assess Croatia´s state-owned enterprises sector and its current reform trends. The report provides one of the first comprehensive applications of the World Bank's new integrated SOE framework (iSOEF) in Europe. Based on firm-level data, it provides analytical arguments indicating underperformance of the Croatian SOE sector, which ultimately stems from corporate governance deficiencies. As the report points to areas where reforms are of utmost importance and gives actionable policy recommendations, it is intended to be used for deepening the policy dialogue in the area of SOEs with Croatian authorities. The analysis covers non-financial companies with central government ownership of at least 50 percent. Short analysis of local government SOEs is given in Annex 1.

Croatian state-owned enterprises (SOEs) play a significant role in economic activity. While the number of companies owned by the state has been continuously falling since the 1990s when the country embarked on its transition path from planned to market economy, the SOEs sector continues to be relatively large in international perspective. It is estimated that SOEs owned by the central government account for approximately 4 percent of total employment and 5 percent of value added generated in the entire economy. If local government SOEs were also considered, these ratios would both increase to 7 percent, which is in terms of employment higher than in Central and Eastern Europe (CEE) countries, as well as many OECD countries.

In this context, Croatian authorities have confirmed their commitment to reduce the SOEs portfolio and improve their corporate governance framework, especially in the case of SOEs considered as of "special state interest". Long-term state asset management reform efforts intensified after 2013 with the intention to improve the SOEs management and reduce their fiscal burden. Also, two reforms were introduced in 2017, pertaining to the restructuring of the Central State Office for State Asset Management into the Ministry of State Assets, intended to foster a more coordinated approach and give impetus to the restructuring and privatization of SOEs; and the adoption of a new Corporate Governance Code. As of 2020, the Ministry of State Assets was merged with the Ministry of Construction and Physical Planning, and these reforms are yet to yield desired effects in terms of SOEs´ efficiency and return.

Main findings of this report indicate that SOEs in Croatia have higher labor costs, and also lower productivity and profitability as compared to private-sector firms. It was found that labor costs are consistently higher in SOEs than in private companies, while labor productivity is consistently lower.

Also, SOEs lag private companies in terms of technical efficiency. Furthermore, average return on assets and equity in SOEs are lower than in private firms, and the spread between these two groups has been increasing over time. Finally, the average employment cost to turnover ratio is almost double in SOEs as compared to private firms. These findings hold for the economy as a whole as well as for most sectors where SOEs operate. However, it has to be kept in mind that if market activities of SOEs cannot be monitored separately from their activities related to public policies, performance indicators and comparisons to private sector peers need to be analyzed with caution. In that sense, international comparisons to similar SOEs operating in other countries are warranted.

Fiscal costs and risks of SOEs

Available data indicate that SOEs had a small positive (direct) net impact on the government budget over the past three years. During 2017-2019, SOEs paid on average 0.7 percent of GDP in taxes and 0.2 percent of GDP in dividends, annually, while subsidies from the government budget to SOEs amounted 0.5 percent of GDP. Most subsidies went to SOEs in industries showing elements of natural monopoly and market failure, such as the transport sector, road companies and postal services. At the same time, subsidies to SOEs in competitive sectors such as manufacturing and tourism were minimal.

However, fiscal risks were also identified —explicit and implicit— largely stemming from SOEs´ debt. The stock of non-financial SOEs debt was around 12 percent of GDP in 2019, and three quarters of this debt was concentrated in fifteen largest SOEs. Around 80 percent of this amount is already included in general government debt, thus covering the risk of increased public debt in the event of SOEs debt servicing default, but this would imply liquidity pressures on the budget. Moreover, while for most SOEs debt riskiness does not seem high, earnings ratios of around ten percent of SOEs do not seem high enough to cover interest expenses, suggesting that they may face servicing difficulties. In addition, the unexpected shock due to the COVID-19 pandemic has put significant pressure on performance of public companies linked to tourism, such as transport and road management companies.

Assessing the full fiscal impact of SOEs in Croatia requires better data. Besides subsidies, taxes and dividend payments, other transactions between the central government and SOEs such as budgetary net on-lending, tax deferrals and payment arrears, for which data is not readily available, can also have an impact on the government budget. However, the lack of information on these transactions hinders a more thorough analysis for assessing the full fiscal impact of SOEs in Croatia.

Corporate Governance and Accountability Mechanisms

2017-2019

SOEs paid on average / annually

0.7% of GDP in taxes

0.2% of GDP in dividends

Subsidies from the government budget to SOEs

0.5% of GDP / annually

Despite improvements over the recent years, the SOEs governance framework remains weak and Croatia still lacks a consistent approach towards state ownership in line with international standards. Corporate governance is a broad topic, covering a complex system of relationships between a diverse range of stakeholders. This report follows the iSOEF methodology for addressing SOE corporate governance and focuses on the state's ownership function and the legal framework governing SOEs. Overall findings indicate a departure from internationally accepted OECD principles in several key areas of corporate governance.

The SOE ownership function in Croatia has been traditionally fragmented among various government bodies, which impairs a proper oversight of the sector, and undermines accountability. Croatia's fragmented approach to state ownership creates a conflict of interest between line ministries' responsibility for setting sectoral policies and for managing SOEs day-to-day businesses. The Ministry of Finance is not entrusted with key SOE ownership responsibilities, and the oversight role over SOEs of special state interest, assigned to the new Ministry of Physical Planning, Construction and State Assets (MPPCSA), is also shared with line ministries. Besides, while the number of SOEs has been continuously falling, further efforts over the next years will be needed to assess the efficiency of subsidized SOEs in providing their services and to obtain further progress through the on-going privatization process.

These issues continue to prevail, despite a recent reinforcement of the SOE legal and regulatory framework. The Law on the Management of State Assets (MSA Law) from 2018 is the main pillar of the current SOE legal framework in Croatia, providing a general regulatory framework for the management of Croatian state assets. However, the Law focuses on the management of different types of state assets, rather than on the regulation of SOEs' functioning. The Parliament also approved in 2019 the Strategy for Management of State Assets 2019-2025 (MSA Strategy), which lacks specific objectives and indicators, and thus fails to provide a good roadmap for the implementation of the MSA Law. Overall, these and other significant recent reform actions such as the adoption of the new Code of Corporate Governance have proven so far insufficient to provide a sound SOE ownership policy and a reinforced SOE corporate governance structure.

The Croatian state remains a relatively passive owner, without an effective monitoring system that would keep SOEs´ board and management accountable for their performance. Many Croatian SOEs unilaterally define their mandates and objectives, including financial targets, capital structure targets, and risk tolerance levels, without prior approval or consultation with their line ministries. Since 2018, SOEs must report —on a quarterly and annual basis— on their financial performance and strategic plans to the MoF, MPPCSA and CERP by using the so-called *"Guidance for the Preparation and Submission of Business Plans and Reports of Companies and Legal Entities that represent State Assets".* However, SOEs are not required to submit such documents to their respective line ministries.

SOEs supervisory board practices have been reinforced through recent legislation, but challenges remain. A new framework was established by a recent government decree in 2019 to improve the board nomination process for SOEs of special state interest, which previously was lacking transparency and favored political appointees. According to this new framework, SOE board and management candidates must have adequate educational background, professional experience, and no conflicts of interest. However, the nomination of independent or non-executive members in SOEs continues being a rare practice, and SOE Boards are frequently performing as formal bodies with little influence on strategic decision-making processes and the appointment of management, as suggested by international corporate governance standards.

Current laws and regulations for the functions of accounting and disclosure of Croatian SOEs accounts are in line with EU standards. SOEs are required to submit their annual financial statements and consolidated statements with the respective accompanying auditor's reports to the Financial Agency (FINA) for statistical and other purposes and for public disclosure. Besides, financial statements and other reports of SOEs are controlled by several external and internal bodies, including state bodies, internal audit and control units of SOEs, and independent external auditors. The highest audit institution in Croatia is the State Audit Office (SAO), autonomous and independent in its work. During SOEs audits, a particular attention is paid to the application of good governance and internal control mechanisms. Large SOEs and those of special interest are also required to have an external statutory audit, under the coordination of an audit committee.

However, several aspects related to this practice still require improvements. The accounting standards applied to SOEs in Croatia are either the Croatian Financial Reporting Standards (CFRS) or the International Financial Reporting Standards (IFRS). While the elaboration of annual reports and public disclosure appear as adequate, significant departures from the IFRS are often found in practice, justified by special laws (Lex Specialis) as in the case of transport-sector SOEs. Also, while the Croatian Audit Law is in compliance with the European Union (EU) standards and directives, the quality of SOE financial statements external audits is uneven, since audit firms are sometimes selected on the basis of lowest cost only, without considering quality aspects. The quality control of external audits is carried out by the Ministry of Finance, and the disclosure of these data is limited.

Key Reform Agenda

Suggested policy options and reforms for the government's consideration are focused on the ownership function and the relation between the state and SOEs, transparency, the privatization program, and fiscal risk management. The proposed changes intend to improve public sector fiscal management and accountability, as well as align SOE corporate governance practices with internationally accepted standards.

Ownership Function

Ownership policy.
It should clearly define state ownership rationale with explicit criteria and expectations for all parties involved, including SOE shareholders, boards, management, auditors and other key stakeholders and clearly allocate responsibilities. The ownership policy should also define the criteria for establishing and terminating state ownership, and set out the roles and responsibilities of SOEs, which can be used to guide decision-making and help on protecting them from political interference.

Ownership institution.
The exercise of state ownership rights on SOEs should be clearly identified within the state administration, either through a centralized model with a single ownership entity or through the consolidation of a dual model where the ownership function is adequately shared by a central-level body and corresponding line ministries. In that sense, the role of the coordinating body, currently assigned to MPPCSA, could be strengthened through a clear and focused mandate with a high degree of autonomy, improved capacity and accountability, and effective SOE oversight. In the short-term,

the capacity of the line ministries to effectively oversee the SOEs within their portfolio should be strengthened through adequate training.

Privatization Program

Follow up of the government´s Privatization Program.
Privatization initiatives should be resumed based upon both the results of the efficiency analysis of subsidized SOEs, and the new state ownership rationale for SOEs.

Efficiency Analysis and Fiscal Risk Management

Carry out an efficiency analysis of government subsidized SOEs.
An in-depth analysis is needed to evaluate the efficiency of subsidized SOEs in providing their services and achieving appropriate value for money.

Development of an SOE fiscal risk management framework.
This framework—prepared and disclosed by the MoF—should identify the major risks to the budget emanating from SOEs; assess their size and probability of occurrence; identify any policy or other measures to mitigate these risks; and disclose the fiscal risks to enhance awareness of fiscal policy trade-offs and bring transparency to the entire budgeting process. The framework should take into consideration both direct and contingent liabilities, as well as explicit and implicit obligations.

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Introduction

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Introduction

1. **This report applies the new World Bank integrated SOE Framework (iSOEF), developed by the Equitable Growth, Finance and Institutions (EFI) practice group, to assess Croatia's SOE sector comprehensively and its current reform trends.** The report provides one of the first comprehensive applications of the World Bank's new integrated SOE framework (iSOEF) in Europe, by providing first a landscape of SOEs in Croatia, and then addressing key aspects for assessing SOEs, namely: "Fiscal impact" and "Corporate Governance and Accountability Mechanisms". This multidimensional assessment looks at the interrelationships of the challenges and opportunities faced by Croatian SOEs to propose holistic and sequenced recommendations to strengthen their governance and performance.

2. **The main objective of this iSOEF report is to identify ways to strengthen the corporate governance of SOEs and consequently improve its performance.** The primary audience of the iSOEF is the Government of Croatia, in particular the MoF, the Ministry of Physical Planning, Construction and State Assets (MPPCSA), the Ministry of the Sea, Transport and Infrastructure (MSTI) and other relevant stakeholders.

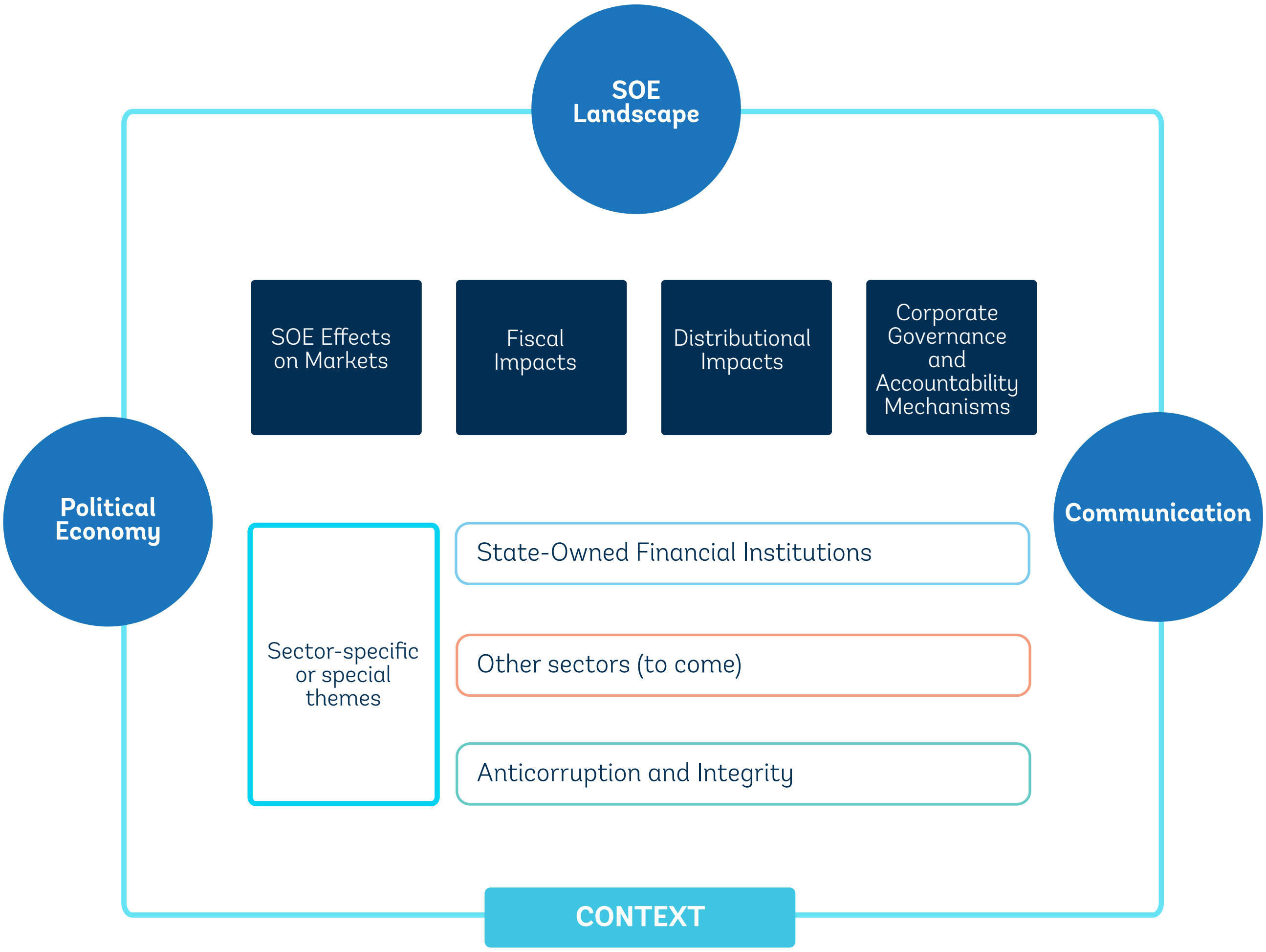
Data Availability

3. **Reliable financial data and selected economic indicators for SOEs in Croatia are readily available on an annual basis. However, SOE transactions with the central and local government budgets lack full transparency.** All companies in Croatia, both limited liability companies and corporations, that pay profit tax, are obliged according to the Law on Accounting to submit annual financial statement the Financial Agency (FINA). These statements are standardized and contain detailed data from the balance sheet, profit and loss account, cash flow statement, statement of changes in equity as well as economic indicators such as employment, composition of investment, etc. However, SOE level data on transactions with the central and local government budgets lack transparency. Namely, data on outstanding state guarantees by firms are not publicly available, nor are the information on tax arrears, deferred taxes, tax credits and, in most cases, intercompany lending between SOEs. Also, while information on subsidies received from the budget are collected and published by FINA, dividend payments to the budget by company can only be found in annual reports of some companies. Finally, data on recapitalizations of SOEs and privatization are not readily available.

Methodology

4. **The report followed the new World Bank integrated SOE Framework (iSOEF) and its respective guidance notes.** As mentioned, the report relies on iSOEF conceptual modules for assessing SOEs. In particular, it covers an overall landscape of the SOE sector and provides an analysis based on two iSOEF modules capturing key aspects of the SOE sector: "Fiscal Impact" (iSOEF Module 2), which offers an assessment of main fiscal costs and risks from the SOEs sector in Croatia; and "Corporate Governance and Accountability Mechanisms" (iSOEF Module 4).

Figure 1
Integrated SOE Framework (iSOEF)



Structure of the Report

5. **The report structure is organized in the following 5 chapters:** After the introduction in Chapter 1, the overview of the SOEs landscape in Croatia is given in Chapter 2. iSOEF Module 2 on fiscal costs and risks related to the SOEs sector is covered in Chapter 3, followed by the iSOEF Module 4 on corporate governance and accountability mechanisms in Chapter 4. Finally, Chapter 5 gives an action plan for an improved SOEs sector with a series of options for reforms, focusing on a set of sequenced realistic measures that could be implemented in the short and medium term, aimed to improve SOEs corporate governance, while obtaining a more effective oversight over their associated fiscal costs and risks.

The SOE Landscape in Croatia

2

2. The SOE Landscape in Croatia

2.1. Background and Recent Developments in the SOE Sector

6. **Since Croatia's independence in 1991, the state footprint in the economy through SOEs was significantly reduced but remains elevated.** The main privatization process took place during 1990s as the country embarked on its transition path from planned to market economy. The adoptions of the Law on the Transformation of Social Ownership in 1991, that facilitated conversion of companies into joint stock companies or limited liability companies, marked the beginning of this process. In this initial phase, close to 2900 out of 3600 companies were sold, often under preferential arrangements to employees of respective companies. [1] The privatization of many of the largest companies, except those deemed to be of strategic or special state interest, was conducted in the late 1990s and early 2000s. However, divestment process has not been finalized [2] and a large number of companies is still directly controlled by the government. The central government currently holds a majority stake in more than 100 companies, [3] either directly or indirectly, including SOEs' subsidiary companies and companies established by independent entities like universities or institutes, while localgovernments hold around 800 companies.

7. **SOEs owned by the central government play a significant role in terms of economic activity, but there are concerns regarding their performance, fiscal impact and corporate governance.** SOEs owned by the central government, which are the main focus of this report, account for approximately 4 percent of total employment and 5 percent of value added generated in the entire economy. If we were to include the local government SOEs, these ratios would both increase to 7 percent, which is in terms of employment higher than in other countries in the Central and Eastern Europe (CEE). [4] Also, OECD (2017) shows that most OECD countries have notably lower shares of SOEs in total employment compared to Croatia. SOEs commonly lag behind private sector firms in terms of productivity, labor efficiency and productivity, and some are considered as a source of significant fiscal costs and risks. This is compounded by the existence of weak SOE corporate governance practices, departing from internationally accepted standards.

[1] According to Druzic et al. (2003).

[2] The Center for Restructuring and Sale —institution responsible for the management of shares and business stakes in SOEs not considered of special interest for the Republic of Croatia— continues to hold public calls, public tenders or direct sales of companies under its management.

[3] Additionally, central government holds between 25 and 50 percent of shares in 20 companies and less than 25 percent in around 270 companies.

[4] See IMF (2019).

8. **In this context, Croatian authorities have confirmed their commitment to reduce the SOEs portfolio and improve the corporate governance framework in SOEs of special state interest.** Long-term state asset management reform efforts intensified from 2013 and intended to improve SOE management and reduce the fiscal burden. The focus of the reforms was: (i) centralizing the asset management function by establishing the Central State Office for State Asset Management; (ii) building a central state asset registry; (iii) developing annual plans to operationalize the integrated 5 year asset management strategy; (iv) taking an integrated approach by forming part of the National Reform Program (NRP) documents (EU strategic document) and country-specific recommendations (EU semester), and reporting progress on a quarterly basis against the targets set out in the NRP; (v) developing an information system for state asset management - ISUDIO (the development and conceptual upgrade of the existing Central state asset registry data model and IT applicative solution). Two reforms were introduced in 2017 to improve SOE management by streamlining the state asset portfolio and to achieve better utilization and higher returns from state assets: (i) The restructuring of the Central State Office into the Ministry of State Assets, intended to foster a more coordinated approach and give impetus to the restructuring and privatization of SOEs; [5] (ii) the adoption of the new Corporate Governance Code, intended to improve the corporate management of SOEs by introducing stricter criteria for supervisory board memberships in larger corporations and incentivizing share-holder participation. As of 2020, the Ministry of State Assets was merged with the Ministry of Construction and Physical Planning, in the process of streamlining the number of ministries in the Government, and many of these reforms are yet to yield desired effects in terms of efficiency and return.

9. **The State Asset Management Strategy for the period 2019-2025 sets long-term goals and guidelines for the management of state assets and it is operationalized through annual state asset management plans [6].** In that sense, the Annual Plan for 2020 clearly stated that one of the strategic objectives of the state asset management remains the continuation of the privatization of SOEs and the improvement of management of SOEs and other legal entities of special interest to the Republic of Croatia. The State Asset Management Strategy, however, still needs to be aligned with Croatia's 2030 National Development Strategy which was recently adopted by the Government, providing strategic guidance to all development policies and lower-ranking strategic planning documents. Strong commitment of the authorities was confirmed by including the SOEs reform agenda in the ERMII Action plan and the list of so-called post-entry commitments in the context of Croatia's adoption of the euro as a national currency.

[5] Established by the Law on the Organization and the Scope of Ministries and Other Central Government Bodies (Official Gazette 93/16 and 104/16) on November 13th, 2016. Previously, the management of state properties was under the mandate of the Central State Office for State Asset Management. The Central State Office was Established by the Law on Management and Use of Asset Owned by the Republic of Croatia (Official Gazette 94/13). The Law also established the Center for Restructuring and Sales (hereinafter CERP), and in January 2014 the State Office founded State Asset ltd.
The Strategy was approved by the Parliament in October 2019.

[6] The Strategy was approved by the Parliament in October 2019.

Croatia has committed itself to intensifying the sale of shares and stakes of companies that are not listed as companies of special state interest and publish tenders for the sale of shares/stakes in at least 90 companies in the period between July 2019 and June 2020. The latest report by the Center for Reconstructing and Sale shows that in 2019 the Government sold its share in 80 companies [7], mostly via public tenders or on the capital market, bringing HRK 300 million or 0.1 percent of GDP in receipts for the state budget. Furthermore, Croatia has committed to conduct a Review of Corporate Governance of Croatian SOEs, a gap analysis of the existing corporate governance regulation and practices in SOEs with respect to best practices in line with OECD Guideline on Corporate Governance in SOEs and implement the recommendations for improvement. In that context, Croatia has applied for technical assistance through the Structural Reform Support Program of the European Commission with the main aim to facilitate business efficiency and improve corporate governance. [8]

2.2. SOE Portfolio

10. **For the purpose of this analysis, SOEs are defined as non-financial companies with central government ownership of at least 50 percent (as of 2019).** [9, 10] Following this criteria, a total of 121 state-owned enterprises (SOEs) were identified as currently operational. [11, 12] Information about the ownership structure is taken from two key data sources in the following order of priority: the Croatian Statistics Bureau (CSB) classification and FINA classification. FINA ownership data is less reliable than the CSB data, as the former is provided by the business entities themselves, whereas the CSB is responsible for conducting its own ownership classification following the official CSB rules and principles. [13] Additionally, we include in our dataset a number of firms that are classified as part of the general government sector according to the official CSB ownership classification. [14] Finally, all companies that according to FINA database are in liquidation or had no employees in 2019 have been excluded from the analysis.

[7] The number of companies in CERP portfolio fell by 29 reflecting partial sale of shares as well as the fact that 29 companies have been added to the state portfolio due to the termination of privatization contracts for companies sold under preferential arrangements during 1990s following irregularities found in the privatization processes.

[8] Five projects have been approved, three of which are still ongoing, delivered by the European Bank for Reconstruction and Development (EBRD) and the OECD. The approved projects included: (i) Improving Governance of SOEs in Croatia, (ii) SOE restructuring, (iii) Enhancing competences of supervisory board and audit committees in state-owned enterprises, (iv) Activation of non-operating assets in state-owned enterprises, and (v) Improving the corporate governance of state-owned enterprises.

[9] Short performance analysis of the SOEs owned by the local government units is given in Annex 1.

[10] The dataset is based on firm-level annual (unconsolidated) financial statements collected by the Croatian Financial Agency (FINA) for the period 2003-2019. Throughout the report SOEs are compared to the private sector nonfinancial enterprises (POE) established as either joint stock companies or limited liability companies. The annual FINA databases are comprised of all business entities registered in Croatia, but legal entities classified as crafts and freelancers and financial institutions are excluded from this analysis.

The report also analyzes a subset of SOEs, the so-called commercial SOEs. Contrary to sectors with elements of natural monopoly and market failure, such as some segments of transport sector, road companies and postal services which exhibit high entry barriers, and for which there is strong economic rationale for government provision, commercial sectors are considered those in which entry barriers are small and production activities do not generate externalities. The division of sector in the paper was done in line with Dall'Olio et al. (forthcoming). This subsample counts 81 companies. [15]

11. **The portfolio of privately-owned firms in this analysis counts 83 thousand companies.** It also includes companies that operated as state-owned enterprises before 2019, but have been privatized, as the analysis primarily focuses on assessing the performance of companies currently owned by the state and comparing them to the rest of the economy. For example, a hotel group company that was majority owned by the state but privatized in 2018 is for the purpose of this report considered to be a privately-owned company in the entire period analyzed.

12. **The 121 centrally-owned SOEs being the main focus of this report account for a significant share of economic activity in Croatia.** Although the SOEs footprint has been on a declining trend for years, centrally-owned SOEs still make up around 4 percent of employment and close to 5 percent of value added (Figure 2a). The share of SOEs in value added and employment of all non-financial companies in Croatia is high in energy, postal services agriculture and transport sector (Figure 2b). High government presence in most of these activities can, to some extent, be explained by *network industry* [16] features of these companies, strategic reasons and/or market failure. By contrast, SOE presence is marginal in trade, mining, manufac- turing and tourism. A high share of SOEs in the agriculture sector, usually not seen in developed countries, reflects the presence of the company Hrvatske šume which is responsible for managing forests owned by Republic of Croatia. Finally, significant SOEs share in construction can be explained by the fact that the largest road and highway operators

[11] Out of 121, 33 are classified as of special state interest, 19 are in the portfolio of Center for Restructuring and Sale (CERP), 8 in the bankruptcy procedure and the rest are subsidiary companies of other SOEs or companies established by independent entities like universities or institutes.

[12] There are currently 39 legal entities of special state interest and the state as a majority share in 38 of them (Government holds 44.8 percent of national oil company INA d.d.). In addition to INA d.d., three financial companies (Croatian Bank for Reconstruction and Development (HBOR), State Agency For Deposit Insurance And Bank Rehabilitation (DAB) and FINA), CERP and Hrvatske vode established as institutions are not included in the analysis.

[13] If the two sources do not match or when a firm is not listed in the CSB database, we also use publicly available data sources, including companies' official Internet sites and the webpage https://www.fininfo.hr/ (which contains information about the ownership structure for the majority of firms registered in Croatia), and others.

[14] Jadrolinija, Hrvatska radiotelevizija, Hrvatske autoceste (HAC), Hrvatske ceste, Autocesta Zagreb-Rijeka, HŽ Infrastruktura, Dalmacijavino and a limited number of smaller SOEs.

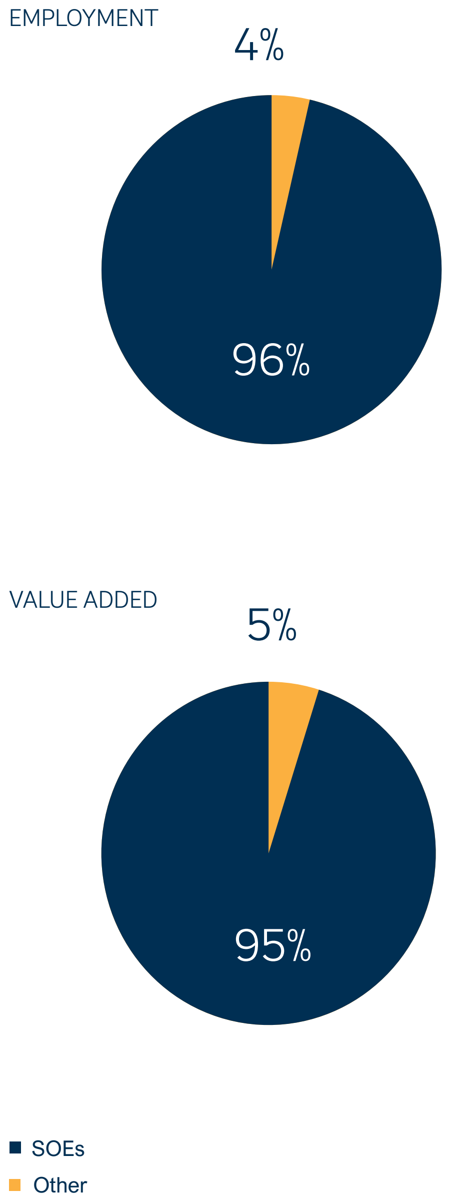
[15] Throughout the report, including charts and tables, *SOEs* always refers to this portfolio of 121 companies, while *SOEs Commercial* refer to 81 companies.

[16] Network industries are defined as those industries in which a fixed infrastructure is needed to deliver the goods or services to end users, e.g. telephone or electricity cables and wires, railtrack, and airport runways.

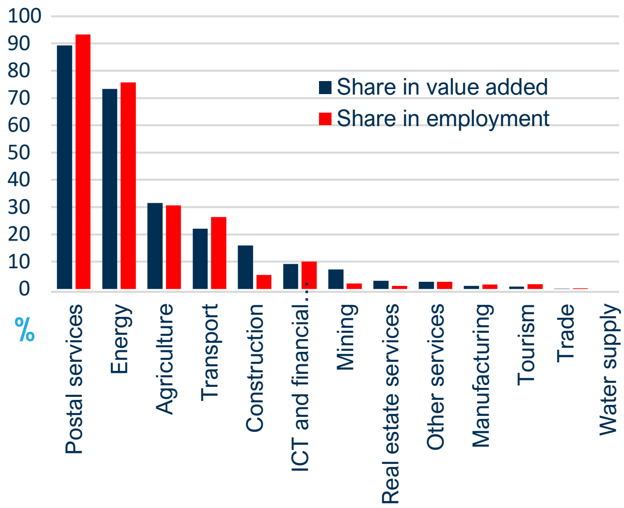
in Croatia, Hrvatske autoceste, Hrvatske ceste and Autocesta Rijeka-Zagreb,[17] are registered and therefore accounted for as construction firms in official statistics, both national accounts and business statistics.

Figure 2 **SOEs account for a significant share of economic activity**

(a) Share of SOEs in total employment and GVA



(b) Share of SOEs in total employment and GVA by sectors



Note: Panel (a) is calculated as a ratio of GVA and employment of SOEs taken from the FINA database and GVA and employment for the total economy from the national accounts. Panel (b) only takes into account data from the FINA database.
Sources: FINA, CBS.

[17] As of 2021 merged with Hrvatske autoceste.

13. **The SOEs sector is dominated by several large companies, mostly operating in network industries.** In terms of revenues, the largest companies include the national electricity company HEP with several of its subsidiary companies, the national motorways company HAC, the national forestry company Hrvatske šume, as well as the national postal company Hrvatska pošta and the national air carrier Croatia Airlines. According to the most revent data (2019), fifteen largest companies account for almost 90 percent of revenues, 70 percent of employment and 75 percent of debt of all centrally owned SOEs.

Table 1. **Largest SOEs in Croatia (2019)**

Rank (by revenue)	Firm name	Sector	Type of legal entity	Revenue (HRK mn)	Employment	Assets (HRK mn)	Debt (HRK mn)	Taxes (HRK mn)
1	**HRVATSKA ELEKTROPRIVREDA - GRUPA**	**Energy**	**Group**	**15,515**	**10,901**	**35,107**	**3,737**	**758**
2	**HRVATSKE AUTOCESTE D.O.O.**	**Construction**	**D.O.O.**	**2,223**	**2,707**	**38,858**	**20,358**	**203**
3	**HRVATSKE ŠUME D.O.O.**	**Agriculture**	**D.O.O.**	**2,023**	**7,885**	**2,545**	**171**	**227**
4	**HP - HRVATSKA POŠTA D.D.**	**Postal services**	**D.D.**	**1,640**	**9,281**	**1,909**	**278**	**239**
5	**CROATIA AIRLINES D.D.**	**Transport**	**D.D.**	**1,600**	**949**	**1,258**	**529**	**67**
6	HRVATSKA RADIOTELEVIZIJA	ICT and financial services	Statutory Entity	1,302	2,833	1,520	158	111
7	HRVATSKA KONTROLA ZRAČNE PLOVIDBE D.O.O.	Transport	D.O.O.	799	745	1,361	152	149
8	AUTOCESTA RIJEKA ZAGREB D.D.	Construction	D.D.	700	38	4,031	5,083	14
9	JADROLINIJA D.O.O.	Transport	D.O.O.	692	2,162	1,652	184	71
10	JADRANSKI NAFTOVOD D.D.	Transport	D.D.	669	370	4,624	5	82
11	HRVATSKA LUTRIJA D.O.O.	Other services	D.O.O.	622	1,347	339	0	48
12	HŽ CARGO D.O.O.	Transport	D.O.O.	465	1,430	1,288	425	46
13	ZRAČNA LUKA SPLIT D.O.O.	Transport	D.O.O.	445	459	1,367	294	58
14	ZRAČNA LUKA DUBROVNIK D.O.O.	Transport	D.O.O.	420	558	2,352	249	57
15	PLINACRO D.O.O.	Transport	D.O.O.	349	272	4,522	1,142	27
	Other national SOEs			**4,612**	**18,951**	**112,561**	**12,242**	**690**
	Total			**34,075**	**60,888**	**215,293**	**45,007**	**2,844**
	Share of TOP-15 SOEs in total (%)			**86**	**69**	**48**	**73**	**76**

Note: Companies are ranked by size of revenues from sales. Data for Hrvatska Elektroprivreda – Grupa is an estimation based on FINA database and revised consolidated financial statements of overall HEP Group and includes financial data of group members which are registered as legal entities in Croatia.
Sources: FINA.

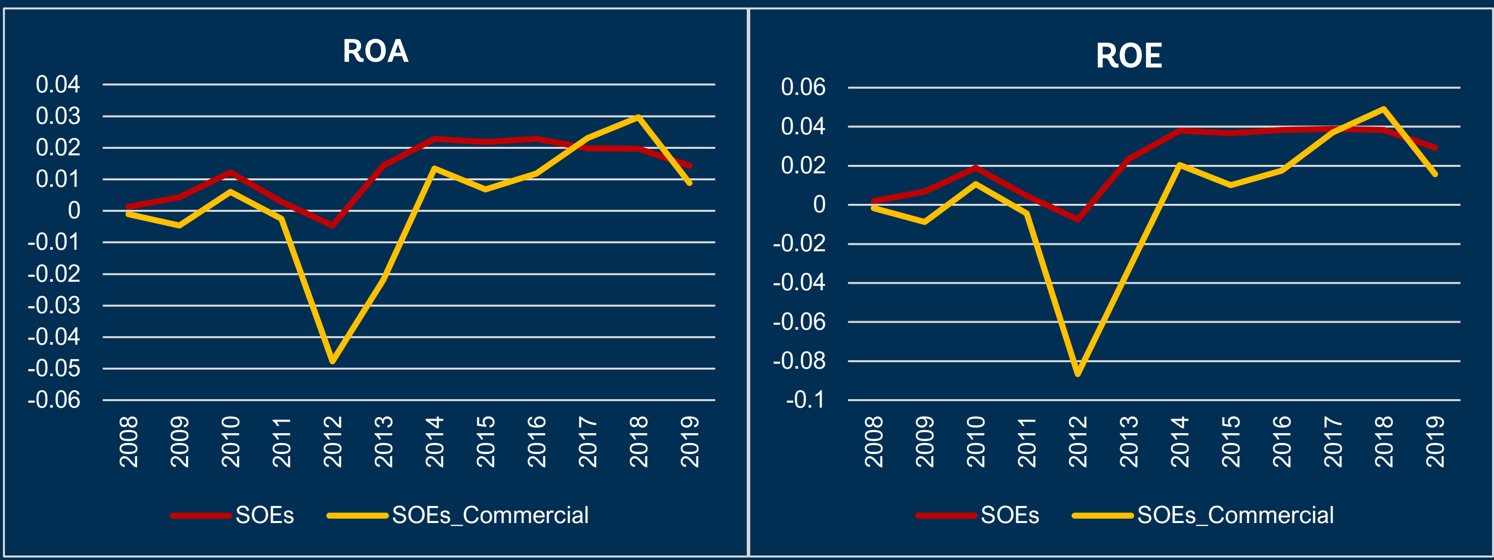
2.3. Performance of the SOE Sector

2.3.1. Financial Performance

14. **SOE profitability was generally low over the past decade, improving in 2013-2015 period, and coming to a halt since 2017.** Böwer (2017) found that in 2012-2014 the profitability of Croatian SOEs ranked worst or second to worst in Central and Eastern Europe. According to available data (Figure 3), SOE profitability started improving in 2013, partly as a consequence of national economy recovery after 6 years of recession. This improvement was spread across several major SOEs, particularly from the energy, transport and construction sectors. However, profitability ratios came into a new halt in 2017, and declined marginally in 2018 and 2019. A subset of SOEs counting 81 firms that compete on the market with private sector companies (i.e. SOEs operating in commercial sectors) have displayed lower profitability in almost the entire period, as compared to the full portfolio of 121 SOEs.

Figure 3:

Evolution of SOE profitability (2003-2019)



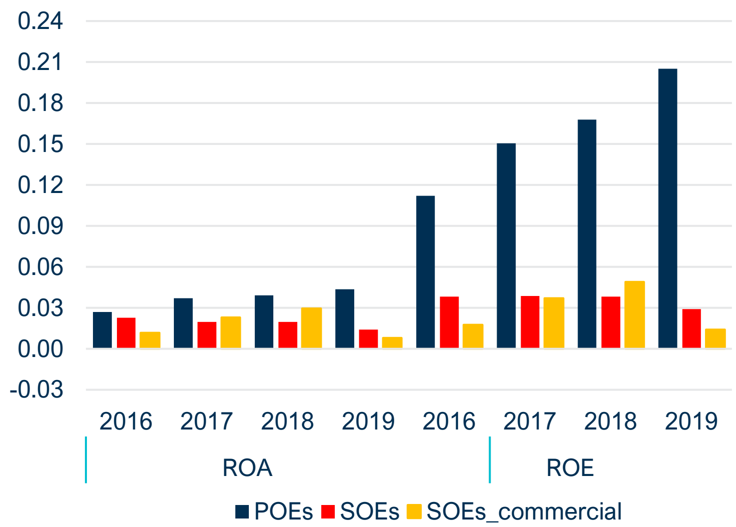
Note: ROA: return on assets; ROE: return on equity
Sources: FINA, World Bank staff calculations.

15. **While recent data available indicate that profitability is lower in SOEs than in private sector firms across nearly all sectors, this needs to be interpreted with caution.** While key profitability indicators support this conclusion (Figure 4) one must consider that for many SOEs strategic goals often go beyond profit maximization objectives. Furthermore, as the largest SOEs operate in natural monopoly sectors they are not exposed to direct private sector competition and their provision of public goods could affect their pricing decisions. Therefore, lower profitability of SOEs compared to private sector companies does not necessarily mean they are poorly managed but can point to the fact they are sometimes responsible for conducting public policies and need to compromise profit maximization objective in order to achieve them.[18] That makes any comparison between the public and the private sector less meaningful. International benchmarking against similar natural monopolies is warranted in these cases (see Annex 2). However, focusing only on Croatian SOEs operating in commercial sectors, the conclusion on lower profitability still holds and the gap has recently increased. Moreover, this has been verified across nearly all economic sectors. As shown in Figure 4b, the ROA is lower for these SOEs in comparison to private firms. Also, among top 10 loss making SOEs three quarters of losses are generated by SOEs operating in commercial sectors, as shown in Table 2.

Figure 4:

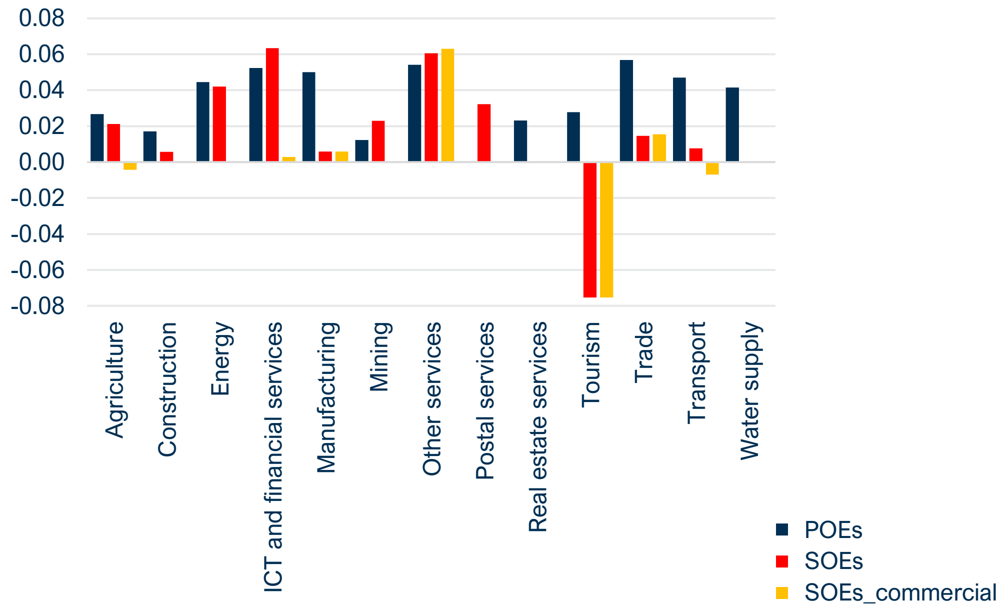
Private firms are more profitable than SOEs in almost all sectors

(a) ROA-ROE (2016-2019)

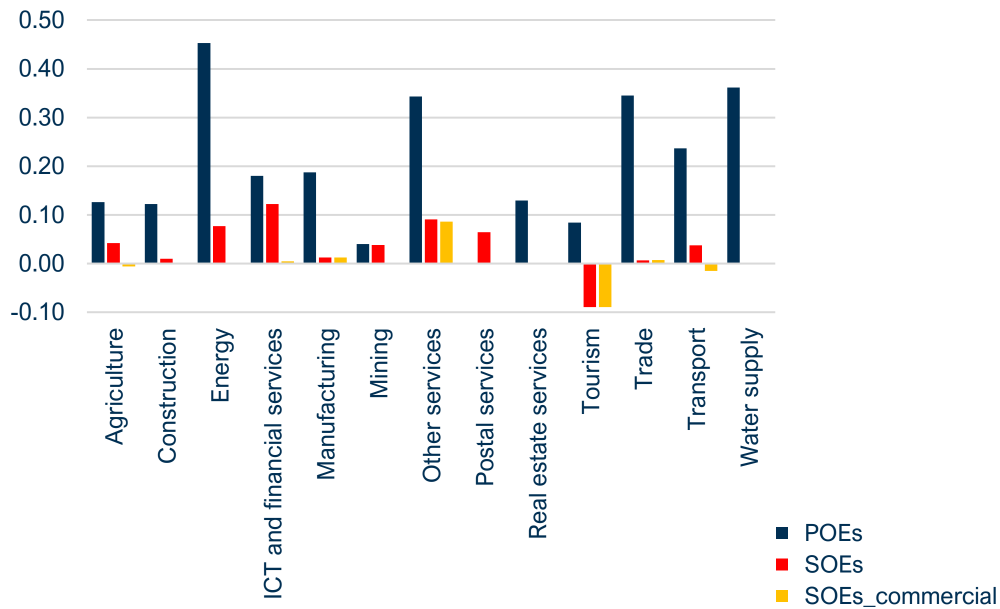


[18] On the other hand, SOEs suboptimal performance can sometimes be linked to their soft budget constraint and political interference, that can be interlinked. Namely, for SOEs operating in strategic sectors, the state will provide support in case of a failure, especially if the management of the company was politically appointed. This can lead to moral hazard and distort incentives for the management to control costs, be more efficient and improve performance of the company they operate.

b) ROA-2019



b) ROE-2019



Note:: POEs denotes privately owned enterprises. In panel (b) and (c) outliers for commercial SOEs in construction and real estate sector have been removed from the sample.
Sources: FINA, World Bank staff estimates.

Table 2. **Top loss-making SOEs (2019)** [19]

Rank	Company name	Sector	Taxonomy of sectors	EBIT (2019, in HRK mn)	ROA (2019)	ROE (2019)
1	JADROPLOV D.D.	Transport	javno-javno	-264	-0.59	-3.23
2	HŽ CARGO D.O.O.	Transport	javno-javno	-125	-0.10	-0.12
3	CROATIA AIRLINES D.D.	Transport	javno-javno	-55	-0.04	-0.20
4	VSI VODOVOD BUTONIGA D.O.O.	Water supply	0	-35	-0.16	-17.73
5	SERVISNI CENTAR TROGIR D.O.O.	Manufacturing	0	-33	-0.19	-0.48
4	HEP-TOPLINARSTVO D.O.O.	Energy	javno-javno	-31	-0.02	-0.31
5	3. MAJ TIBO D.D. U STEČAJU	Manufacturing	javno-javno	-29	-128.87	-0.92
6	HT PRODUKCIJA D.O.O.	ICT and financial services	javno-javno	-18	-0.24	-0.74
9	VODOOPSKRBA I ODVODNJA D.O.O.	Water supply	0	-16	0.00	-0.01
10	VODOVOD IMOTSKE KRAJINE D.O.O.	Water supply	0	-15	-0.08	-4.25
7	PANEX D.D.	Manufacturing	javno-javno	-13	-0.89	-0.83
8	DALMA D.D.	Other services	javno-javno	-11	-0.11	-0.02
13	VINKOVAČKI VODOVOD I KANLIZACIJA D.O.O.	Water supply	0	-10	-0.01	-0.03
14	VODOPRIVREDA ZAGREB, DD	Construction	0	-10	-0.11	-0.25
15	UPRAVLJANJE SPORTSKIM OBJEKTIMA	Other services	0	-10	-0.55	-98.53
16	VODOPRIVREDA DARUVAR D.D.	Construction	0	-9	-0.25	-0.73
9	OV-ODRŽAVANJE VAGONA D.O.O.	Manufacturing	javno-javno	-8	-0.06	-0.81
10	HEP UPRAVLJANJE IMOVINOM D.O.O.	Tourism	javno-javno	-8	-0.04	-0.08

Sources: FINA

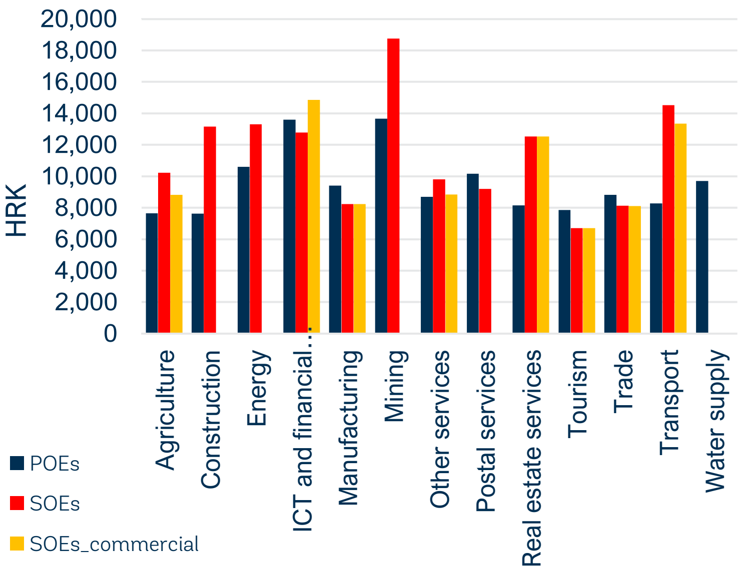
16. **Low profitability of SOEs can be partly attributed to high labor costs, and partly to low labor efficiency.** Notably, average wages in SOEs are higher than in the private sector. [20] In fact, particularly large wage differentials are observed in transport, trade, real estate services, agriculture, energy and construction (Figure 5a). However, differences are smaller if only commercial SOEs are taken into account. Moreover, while wages are higher, labor efficiency is lower in SOEs than in the private sector firms. On average, employee costs relative to turnover in 2019 were about twice as high in SOEs than in private sector firms (Figure 5b). [21] However, as already noted one needs to be cautious with the interpretation of these results as the turnover in SOEs that mostly provide public goods may not reflect the full value of production. In these cases, SOEs may report lower turnover relative to employee costs, without necessarily indicating poor labor efficiency.

[19] Company Panex has been privatized at the end of 2019 so was still marked as an SOE in the database for 2019.
[20] Comparison in wages does not take into account the differences in the nature of work. (e.g. education level, tenure, etc).
[21] Turnover in SOEs that mostly provide public goods may not reflect the full value of production, which warrants further analysis —for example, in some cases transport services are subsidized. As a result, SOEs may report low turnover relative to employee costs, without necessarily indicating poor labor efficiency.

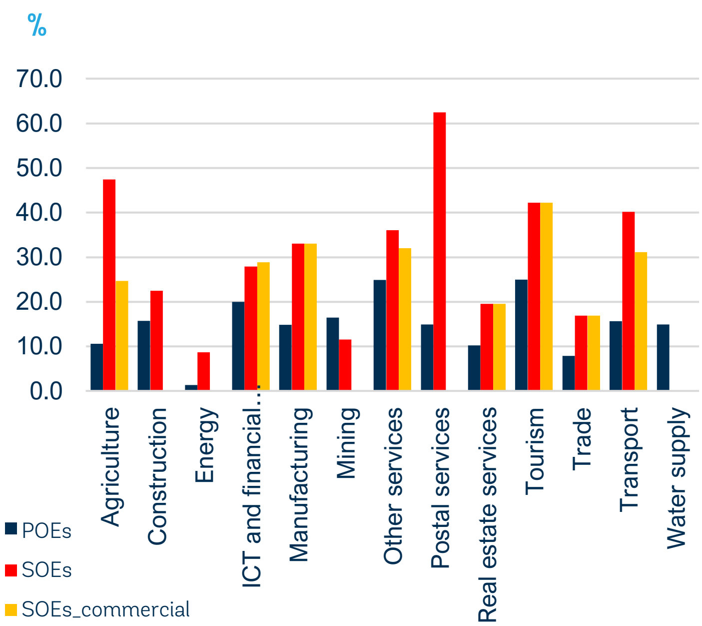
Figure 5:

Labor costs are higher in SOEs than in private firms (2019)

(a) Average monthly cost per employee



Sources: FINA



(b) Employment cost/Turnover

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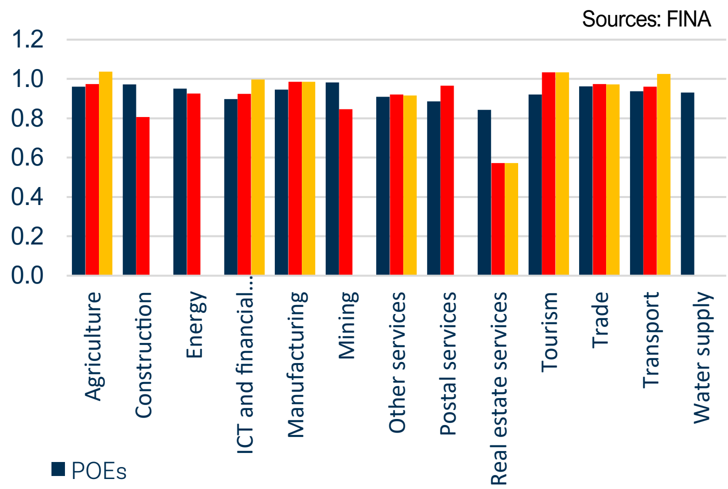
2.3.2. Operational Performance

17. **Technical efficiency of SOEs is lower compared to private companies in most sectors.** First, operational efficiency is calculated as total operating expenses divided by total operating revenues, as an indicator of the efficiency of firms' internal business processes. The sectoral disaggregation suggests that spending efficiency is particularly poor in SOEs in postal services, manufacturing and tourism (Figure 6). [22] Also, SOEs operating in commercial sectors are again less efficient than their peers in private sector but also compared to the rest of the SOEs sector.

Figure 6:

SOEs tend to be less efficient than private firms

Operating expenses/operating revenues (2019)



18. **Average productivity levels are higher in private firms than in SOEs.** Whether measured in terms of output per worker, output per unit of capital, or total factor productivity, average productivity levels of private sector firms exceeded that of SOEs from 2005 to 2018 (Figure 7).

2.3.3. Service Delivery Performance

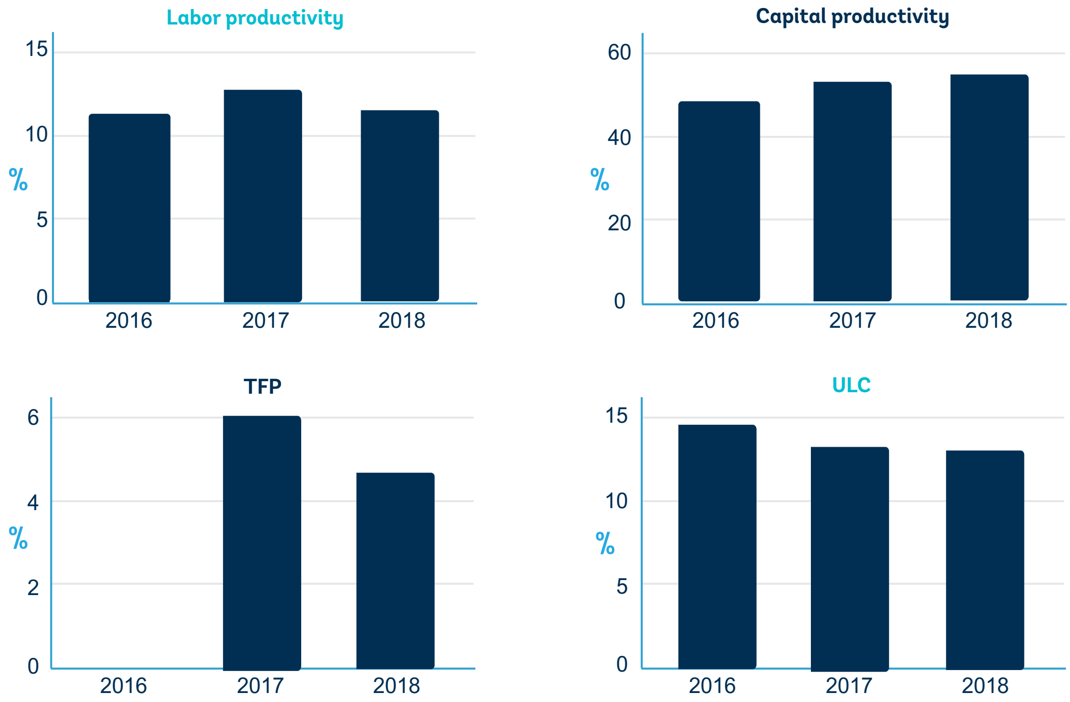
19. **Quality of service provision by SOEs varies considerably among different activities.** The current section reviews the quality of services that are mainly or entirely provided by SOEs in Croatia. While large investment and operational and financial restructuring in the road sector companies over the last two decades have

[22] This may be a result of strong competition that the SOEs in these sectors are faced with (except for the water supply sector) the SOEs are exposed to strong competition. In sectors that provide public goods, such as water supply and some transport SOEs revenues may not reflect the full value of services. Subsidies and other transfers from the government are included in revenues, which helps to ameliorate this problem, although it cannot be known whether these transfers fully compensate for the revenues foregone to lower the cost of services.

resulted in significant improvement in the quality of road infrastructure and financial sustainability of their business model, railways continue to exhibit inefficiencies in service provision and the quality gap to best performers is on a rise. Water and waste management practices also remain inefficient, with large water losses and low recycling rates. On the other hand, electricity supply is of good quality despite occasional interruptions during the main tourist season, while the postal company has been successfully coping with market transformations induced by digitalization.

Figure 7:

Productivity of SOEs was consistently lower than that of privately owned firms (premia of privately-owned enterprises compared to state-owned enterprises)



Sources: World Bank staff estimates

20. **Croatia's transport infrastructure shows significant contrasts in terms of quality.** According to World Economic Forum's 2019 Global Competitiveness Report (GCR) Croatia's road network is in the top five in the EU and was ranked 13th out of 141 countries surveyed. Such outcomes reflect substantial investments in highways in the 2000s. However, despite the quality of the road network, the rate of accidents and fatalities is higher than the EU average. More recently, authorities have made additional efforts in strengthening prevention of adverse outcomes by increasing penalties for risky driving and effectiveness of traffic surveillance programs. The efficiency of railway

services is, on the other hand poor, and Croatia was ranked 87th. The defining features of Croatia's current railway network is that it is old and slow. Significant underinvestment, with priority on routine maintenance, combined with difficulties in modernizing the governance of publicly owned railway companies has brought the railway infrastructure in Croatia in a very poor technical status, with huge backlog of rehabilitation works. Inadequate and excessively complex and costly infrastructure creates inefficiencies compared to road-based modes and low speeds on Croatia's railway network. This is reflected in utilization of passenger transport which is very low by European standards and falling. With additional investment Croatian railways have the potential to support the transition to greener mobility for both passengers and freight.

Box 1: **Rebalancing fiscal priorities of SOEs which support environment-friendly mobility**

Croatia's railway SOEs have the potential to underpin greener mobility for both freight and passenger transport. However, they currently do not achieve this as competition from road transport networks deprives the railway of demand. Approximately 84% of land-based passenger-kilometers travelled in Croatia and 82% of tonne-kilometers for freight move via road-based modes. Railways connectivity with neighboring countries remains poor and only 5% of Core TEN-T railways network lines in Croatia have been completed. Road-dependent transport accordingly accounts for 96% of Croatia's transport sector CO2 emissions.

Croatia's own Transport Development Strategy (2017-2030) identifies rail transport as critical to achieving objectives around environmentally sustainable transport, public mobility, international connectivity, and integration with the EU single market. However, the Government of Croatia's fiscal policy has historically prioritized road investment over "greener" railway investment since independence. Between 1995-2017 Croatia invested approximately EUR 11.7 billion in its road network vs. EUR 1.6 billion in its railway network (7 times less in rail). On average, between 2011 and 2016, EU member states invested EUR 110,349 per km of railway network whereas Croatia invested EUR 23,065 (4.7 times less per km). This large and historic imbalance of investment between roads and rail has understandably achieved the exact opposite of the Transport Development Strategy's stated objectives. There is an acute need to rebalance fiscal priority towards rail sector SOEs if those objectives are to be met.

A potential starting point would be to gradually reallocate a larger share of proceeds from Croatia's fuel tax to the SOE assigned to managing railway infrastructure (HŽI). In 2019, fuel tax provided about HRK 3.1 billion (EUR 411 million) in revenues. At present, HŽI receives 1/6th of fuel tax proceeds (about EUR 70 million) with the balance allocated to roads sector SOEs. Gradually scaling up HŽI's portion and / or allocating HŽI the proceeds from increasing fuel tax

Source: Wold Bank Analysis of International Transport Forum Data and European Union Greenhouse Gas Inventory as submitted to the United Nations Framework Convention on Climate Change (UNFCCC) further would support Croatia to achieve the objectives in its Transport Development Strategy (2017-2030) and EU Green Deal objectives.

Obsolescence is the foremost constraint on effectiveness and efficiency of Croatia's railway SOEs. Approximately 58% of railway track-kilometres predate Croatia's independence in 1991. Approximately 30% of track kilometres date from pre-1980. Only about 10% of Croatia's network has been rehabilitated since EU accession. The current railway includes excessively complex and costly infrastructure configurations that no longer serve an operational thesis. Obsolescence drives high requirements for labor and correspondingly high fiscal costs that constrain the railways potential. Most notably, obsolete signaling and traffic control requires more than 2,500 additional staff to operate (i.e. manually) infrastructure at an extra fiscal cost of EUR 45-50 million per year. This single cost category accounts for more than 1/3 of the operating subsidies that Croatia's infrastructure manager SOE (HŽI) receives from the Government of Croatia.

There is need to both scale up and strengthen governance of capital programs that SOEs manage. A key step would be to activate a Multi-Annual Infrastructure Contract (MAIC) between Croatia's infrastructure manager SOE (HŽI), the Ministry of Sea, Transport, and Infrastructure, and the Ministry of Finance. This would provide the framework for governing a multi-annual approach to funding and implementing large scale capital programs needed to address obsolescence. The current approach of annualized capital funding and project-by-project planning is catastrophic for assets that require long develop lead times and a long-term approach to maintenance.

A function of the MAIC would be increasing certainty of resource allocation while providing accountability for results. Reducing resource uncertainty is critical for capturing efficiencies from the supply chain for railway goods and services – which tends to be long and complex. Using longer duration contracts and providing suppliers with secure multi-annual pipelines can enable investment along the supply chain. This in turn can help railway SOEs to capture ≈ 10-20% efficiency savings in the capital programs. A new MAIC would also enable the Government of Croatia to link the forthcoming National Railways Strategy and National Railways Infrastructure Development and Management Plans with actions, key performance indicators, and a long-term resource allocation needed for sector modernization and reform – all of which would strengthen governance and effectiveness across SOEs.

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21. **Croatia's electricity coverage and supply quality are high, but transmission and distribution losses could be further reduced and costs for new businesses lowered.** According to the 2019 GCR, Croatia ranked among top performing countries in terms of coverage of households having initial access to sufficient electricity. However, based on available evidence there are still some populated rural areas where access to electricity for households is limited. Supply quality is also high but there is room for improvement compared to other EU members states with respect to electric power transmission and distribution losses. The World Bank's 2020 "Doing Business" report paints a similar picture. It shows relatively high reliability of electricity supply and transparency of tariffs, but also indicates that it is relatively expensive for a new business to get electricity in Croatia.

22. **Progress towards a circulr economy and efficient wastewater management is slow, despite large importance of natural capital for Croatia's economy and significant pressure on local capacities created by tourism.** National and local authorities have made some efforts on waste management policies, but recycling rates remain well below the EU average and waste is still being mostly landfilled. Furthermore, while the coverage of water services is high, the supply network needs to be rehabilitated and upgraded. The average age of water pipes is more than 40 years, and the system suffers from maintenance backlogs. This poses a threat to water security due to high water losses, which undermine the financial sustainability of the system both in terms of increased cost of production and forgone revenues.

23. **Trends in the postal sector suggest that Croatian postal service company - Hrvatska pošta, which is the only provider of universal postal services in Croatia, has been successful in adapting its business model and service delivery performance to transformations induced by digitalization and increased competition.** Technical progress led to a decrease in letter post volumes and in an increase in e-commerce parcel around the EU. In response to these developments, postal operators have been innovating their business models and national postal regulations have changed substantially (EC 2015). According to available data, the share of Hrvatska posta in total postal services provided has been steadily increasing in recent years, suggesting that modernization and refocus from traditional services has been successful (Naletina et al. 2019). However, there is no information that would allow to assess users' satisfaction with the services provided and whether they meet their needs.

Assessment of Fiscal Costs and Risks from the SOE Sector

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3. Assessment of Fiscal Costs and Risks from the SOE Sector

3.1. Fiscal Costs of SOEs

24. **This section looks at the fiscal costs of SOEs by quantifying transactions between the state and SOEs.** Direct transfers from the state to SOEs include subsidies, equity injections and payments of called guarantees issued to SOEs. On the other hand, revenues increasing transactions for the budget include payments of taxes, dividends and profit shares of SOEs. Indirect budget state support includes deferred taxes, tax credits or tax arrears, non-payment of dividends and any other kind of preferential treatment. Capturing both direct and indirect state support is equally important for measuring fiscal costs of SOEs. However, this chapter covers only direct transfers, due to a lack of publicly available data on indirect support.

25. **According to available data, SOEs had a small positive (direct) net impact on the general government budget over the past three years.** Budget revenues in the form of taxes and dividends paid by 121 SOEs analyzed in this report surpassed direct transfers to SOEs. Over the last three years, SOEs have paid on average 0.7 percent of GDP in taxes and 0.2 percent of GDP in dividends, annually. On the other hand, the companies have received subsidies worth on average 0.5 percent of GDP. Therefore, the effect on the government budget was on average only 0.3 percent of GDP annually in 2017-2019 period (Table 3). This can be considered rather small, especially if one considers that SOEs´ total assets represented around 50 percent of GDP in 2019. On taxes, twenty largest taxpayers account for more than 65 percent of all taxes paid by the SOEs sector. Largest amounts of taxes are paid by companies in the transport sector in the form of personal income tax and social contributions, reflecting a high level of employment in these companies. On the other hand, companies in the energy sector that are highly profitable also pay large corporate income tax. Data on net on-lending are not readily available and therefore are not included in the analysis of direct transfers between the budget and SOEs.

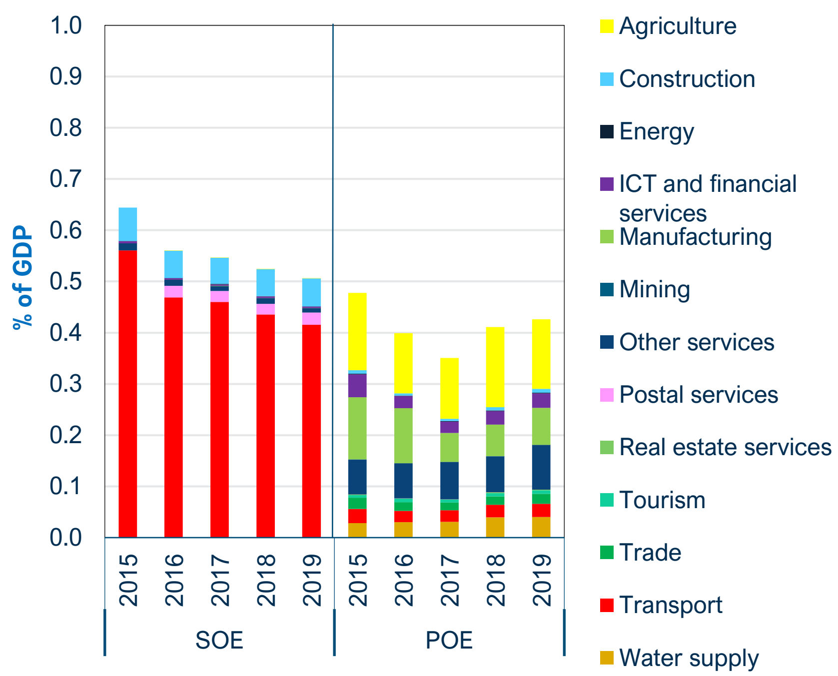
Table 3. **Direct net impact on the general government budget**

in % of GDP	2017	2018	2019
1. Total taxes	0.7	0.7	0.7
2. Dividends	0.3	0.1	0.1
3. Total subsidies	0.5	0.5	0.5
4. Recapitalizations	0.0	0.0	0.0
5. Payment of issued guarantees	0.1	0.1	0.1
6. Net impact (1+2-3-4-5)	**0.4**	**0.3**	**0.3**

Sources: FINA, and government reports.

26. **Subsidies to SOEs included in the analysis showed a gradual decline over the last ten years and were mostly directed to companies in transport, construction and postal services sectors.** Subsidies equaled roughly 0.5 percent of GDP in 2019, a decline of 0.2 percentage point compared to 2009, which can be in part connected with restrictions set by EU regulations for granting state support. Companies in the transport sector received the largest amount of subsidies over the last two years (Figure 8), and were followed by road companies in the construction sector. Most of the subsidies in the transport sector are directed to railways companies for maintaining and servicing the large network with mostly unprofi- table lines. National ferry service company, and to a smaller extent national air carrier, also receive significant amounts for servicing unprofitable lines between the islands and the mainland as well as between largest cities in the country via air transport. Hrvatska posta also receives substantial transfers from the state budget in the form of subsidies for covering the cost of providing postal services throughout the country.

Figure 8 **Subsidies are large, albeit declining over time**



Sources: FINA, CSB

27. **The amount of payments from profits paid to the budget by SOEs averaged 0.2 percent of GDP during 2017-2019.** [23] At the same time, the number of companies required to pay out profits and dividends declined by about a third. The number of companies required to pay a share of profits averaged 27 over this period. SOEs have generally paid less than the obligation set by the government, which is on average about 55 percent of the realized profit, depending on the share of the Republic of Croatia in their ownership. The main reasons for the failure to pay the obligated amounts are to cover losses from previous years or to retain profits in reserves. Companies succeed in reducing their payments below obligated amounts in part because of the system´s shortcomings for determining which SOEs are obligated to pay profit remittances to the budget, and for tracking and enforcing payment.

[23] Data on dividend and profit share payment are available only on the aggregated level. Therefore, the analysis as well as data in Table 4 reflect all payments made to the budget and not only by the companies in the sample.

Table 4. **Profit payments from SOEs to the budget**

	The number of companies required to make a payment from profit, as decided by the government	Realized profits of the companies required to make a payment from profit (HRK million)	Estimated payment obligation as decided by the government, (HRK million)	Profit paid to government to meet obligations from previous year (HRK million)
2016	32	3,478	1,936	699
2017	27	3,680	1,752	1,154
2018	22	2,430	1,047	725
2019	15	2,464	1,503	1,145

Sources: World Bank staff calculations according to Decisions on the amount, manner and deadlines for payment of funds of companies of special interest to the Republic of Croatia, Official Gazette NN 45/2016, NN 50/2017, NN 48/2018, NN 63/2019 and FINA data.

28. **Largest capital injections and payments of called guarantees issued to SOEs by the state budget have been concentrated to a few companies.** Based on the available data, the most significant amount of funds has been provided to SOEs operating in the transport sector (railways, airlines),[24] especially during 2012-2015, with the aim to strengthen their equity base (Table 5). More recently, it was decided to again financially support state-owned airline company Croatia Airlines d.d. as part of its restructuring process, and HRK 250 million was planned to be invested in 2020. As the company was hit hard by the COVID-19 pandemic given downturn in air transport activity the amount of financial injection in 2020 was increased to HRK 600 million.

Table 5. **Largest capital injections and payments of called guarantees**

in mil. HRK	2012	2013	2014	2015	2016	2017	2018	2019
Capital injections								
Croatia Arlines d.d.	862.2	206.3						
HŽ Cargo d.o.o.	190.0			168.2				
HŽ Putnički prijevoz d.o.o.	190.0		278.4	796.7				
Paid gurantees issued to SOEs								
HŽ Infrastruktura d.o.o	35.3	55.8	135.5	138.6	227.7	216.2	212.0	201.7
HŽ Cargo d.o.o.	7.3	108.0	213.6	81.5				
HŽ Putnički prijevoz d.o.o.		21.1	41.2	13.3	8.6	8.5		
Croatia Airlines d.d.	165.0	160.1						

Source: MoF

3.2. Fiscal Risks from SOEs

29. **Fiscal risks are factors that may cause fiscal outcomes to deviate from expectations or forecasts.** Fiscal risks emanating from SOEs can be organized in the following broad categories:

[24] Before EU entry, the government also assumed shipyards' debt of more than 3 percent of GDP as a part of their restructuring and privatization process. Also, in 2014 and 2018 the government has also recapitalized two SOEs - ĐURO ĐAKOVIĆ HOLDING d.d. and PETROKEMIJA d.d. - which have been privatized. This data is not shown in the table.

- *Explicit liabilities* are those for which the state has contractual obligations. These can be further divided into:
  (i) direct (e.g., subsidies); and
  (ii) contingent, which depend on the occurrence of an event, such as for example an SOE defaulting on a loan guaranteed by the state,

- *Implicit liabilities* are those for which there is a moral or political obligation for the government to respond, even in the absence of a contractual obligation, to meet public expectations. Such implicit liabilities can also be divided into:
  (i) direct (e.g. the government assuming the cost of social security payments for SOE staff); or
  (ii) contingent (e.g., bankruptcy, expenses related to the sale/privatization of an SOE, etc.).

Table 6. **A Framework for Mapping SOEs Related Fiscal Risks**

STATE LIABILITIES	DIRECT	CONTINGENT
Explicit Obligations (direct government liability under law or contract)	Subsidies (0.5% of GDP) Long term debt for financial restructuring of road companies (2.6% of GDP)	State guarantees to non-financial SOEs classified as part of central government sector (4.5 % of GDP) State guarantees to non-financial SOEs classified outside central government sector (0.05 % of GDP)
Implicit Obligations (moral obligation to meet public expectation or political pressure)		Total debt of non-financial SOEs classified as part of central government and not covered by guarantees (4.6 % of GDP) Total debt of non-financial SOEs classified outside central government sector and not covered by guarantees (2.1 % of GDP) Unexpected SOE liabilities associated with adverse shocks (e.g. COVID-19 pandemic)

Source: World bank staff estimates

30. **There are substantial fiscal obligations – both explicit and implicit, largely stemming from SOEs significant debt, but potential impact on the level of public debt is mitigated by the fact that large amount of SOEs' debt is already part of general government debt statistics.** Fiscal risks emanating from budget transfers are relatively small because, as mentioned above, explicit budget subsidies to SOEs are matched by taxes and dividends from SOEs. On the other hand, SOEs debt obligations are relatively large, and although most of them are already included in central government debt due to European System of Accounts (ESA) 2010 rules, SOEs potential financial issues would lead to liquidity pressures for the central government´s budget.

[25] The lower the ICR ratio, the more the company is burdened by debt expense relative to earnings. An ICR of less than 1 implies that the firm is not generating sufficient revenues to service its debt without making adjustments, such as reducing operating costs, drawing down its cash reserves, or borrowing more.

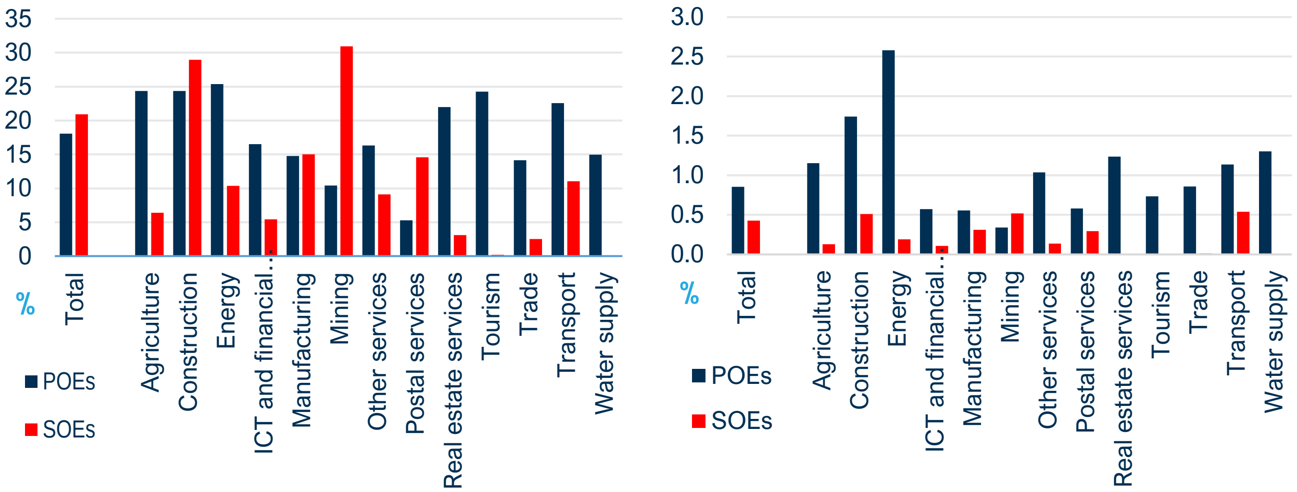
31. **Main explicit risks are related to loans provided to road companies as a part of their restructuring process and issued guarantees.** The financial restructuring of road companies started in November 2017 under a World Bank loan whose aim was to support the strategy for their financial optimization. By the end 2018 more than EUR 3.6 billion commercial financing have been mobilized. Part of the debt was refinanced with the direct help of the government, which issued a bond on the international market and then these funds were on-lent to road companies. The overall impact of the operation in terms of saved interest payments for the sector is expected to exceed EUR 400 million over the next 10 years. The government also provided significant guarantees to SOEs. However, less than 0.1 percent of GDP of issued guarantees to SOEs pertains to SOEs that are classified outside the general government sector, meaning that only a small amount might affect the level of public debt in case of non-payment.

32. **Implicit risks can be related to remaining SOE liabilities as the government was usually inclined to cover SOE losses.** Non-financial SOEs´ debt not covered by government guarantees stood close to 6.7 percent of GDP in 2019 —of which around two thirds are part of general government debt), with only 20 SOEs accounting for around 95 percent of overall debt.

33. **Financial leverage does not seem excessive for most SOEs and debt riskiness is in most sectors lower compared with private sector companies (Figure 9:** Financial indicators / a) Debt/Assets / b) Debt/Equity**)**. However, around ten percent of SOEs may face debt servicing difficulties as their interest coverage ratio (ICR) [25] is less than one, indicating that earnings are not high enough to cover interest expenses. Their total debt amounts to 2.9 percent of GDP and it is mostly concentrated to one company in construction sector - Hrvatske ceste, and three companies in transport sector - HŽ infrastruktura, Croatia Airlines and HŽ Cargo. The latter two companies also seem to be the most vulnerable among the companies with the highest debt. In some sectors the share of vulnerable debt in total sectors debt is relatively high but overall sector's indebtedness is low, like in manufacturing (Table 7).

Figure 9 **Financial indicators**

a) Debt/Assets b) Debt/Equity



Note: Outliers that are driven by small SOEs are not shown on the graph.

Table 7. **Share of vulnerable debt**

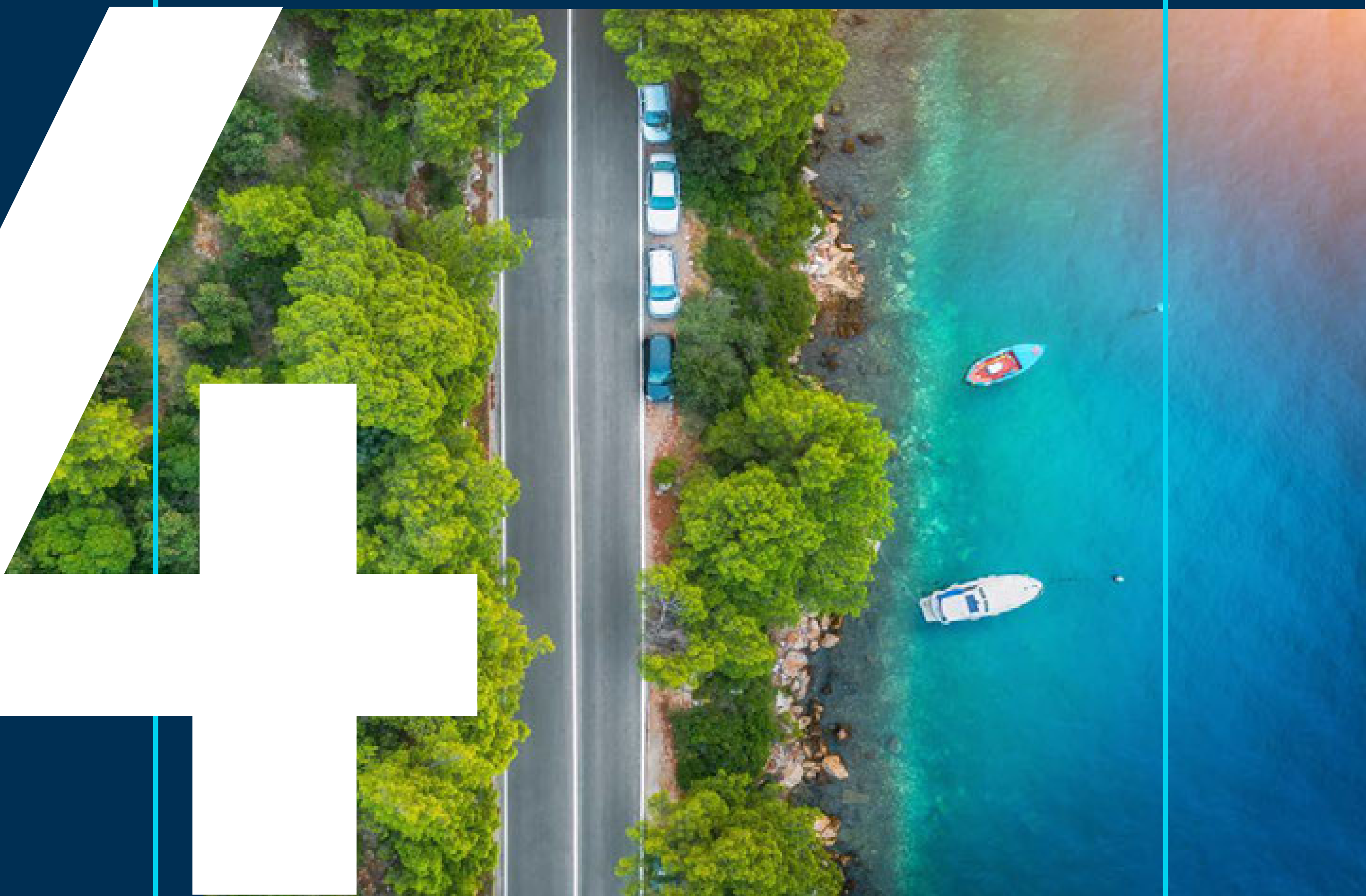
	Vulnerable debt of state SOEs (ICR<1)			Vulnerable debt of all POEs (ICR<1)		
	% of total #firms	% of debt	*% of vulnerable debt in GDP*	% of total #firms	% of debt	*% of vulnerable debt in GDP*
TOTAL	**13,2**	**26,0**	**2,9**	**4,0**	**31,3**	**12,0**
Agriculture	33.3	9.6	0.0	5.7	17.1	0.3
Construction	25.0	26.8	2.3	3.7	44.6	2.3
Energy				5.1	29.4	0.3
ICT and financial services				1.9	86.4	2.2
Manufacturing	42.1	77.5	0.1	5.2	18.5	1.3
Mining				3.6	13.6	0.0
Other services	5.6	13.0	0.0	3.1	38.3	1.6
Postal services				2.8	1.5	0.0
Real estate services				4.3	33.9	1.1
Tourism				5.7	24.5	1.2
Trade	14.3	100.0	0.0	3.8	16.0	1.0
Transport	15.0	40.7	0.5	6.2	32.8	0.6
Water supply				7.9	32.8	0.1

Source: FINA

34. **Additional support by the government might be required for the most affected SOEs in 2021, especially if COVID-19 pandemic is not controlled during the first half of the year.** Unexpected shock of the pandemic has put additional pressure on performance of some SOEs, especially those relying on revenues from tourism, requiring state budget support. Companies in transport sector including road companies have been hit especially hard, given decline in tourist arrivals. As mentioned above, the government has in 2020 provided large capital injection to Croatia Airlines, which was facing financial difficulties even before the pandemic. Further budgetary support might be required in 2021 if the pandemic continues and tourism does not recover.

Corporate Governance and Accountability Mechanisms

4



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4. Corporate Governance and Accountability Mechanisms

35. **Good corporate governance is the foundation for stable, financially healthy SOEs sector.** Compared with private sector companies, SOEs face distinct governance challenges that directly affect their performance. These challenges include multiple principals, competing goals and objectives, excessive protection from competition, undue political interference, and low levels of transparency and accountability. There is a wide perception that SOEs are poorly managed and inefficient, mainly due to politicization of management and suboptimal employment practices. [26] Therefore, effective improvements on corporate governance can lead to higher returns on equity and greater efficiency of Croatian SOEs. [27]

36. **Following the iSOEF methodology, this chapter assesses five dimensions of Croatia´s SOEs corporate governance:** legal and regulatory framework, ownership and oversight function, performance monitoring, board of directors, and transparency and disclosure. The analysis presented below focuses on SOEs related to the central level of government.

4.1. Legal and Regulatory framework

37. **In Croatia, SOEs operate mainly as joint-stock companies (JSC) or limited liability companies (LLC).** A small number of SOEs are statutory corporations, legal entities with public authority, established by a particular statute. [28]

38. **Croatia has reinforced its legal and regulatory framework for SOEs in recent years.** The Law on the Management of State Assets (2018), hereafter named as (MSA Law), is the main pillar of the current SOE legal framework, providing a general regulatory framework for the management of Croatian state assets. It defines key concepts, states the principles of asset management, outlines a plan for implementing them, and establishes the conditions under which state shares may be sold. The Law transposes in the legal system of the Republic of Croatia the provisions of the Directive 2014/42/EU of the European Parliament and of the Council of 3 April 2014 on the freezing and confiscation of cases and proceeds of crime in the EU. As such, the Law focuses on the management of different types of state assets, rather than on the regulation of SOEs' functioning.

[26] Sonje and Petrovic (2016).
[27] Claessens and Yurtoglu (2012).
[28] Out of a total number of 121 fully or majority-owned enterprises: 81 operate as LLCs; 28 as JSCs (out of which six are listed on the Zagreb Stock Exchange); and 12 are statutory entities.

39. **In 2019, the Croatian Parliament also approved the State Assets Manage- ment Strategy 2019–2025, which, however, fails to provide a good roadmap for implementation of the MSA Law.** The Strategy addresses all areas covered by the MSA Law. However, it lacks specific measures and anticipated outcomes to achieve its predefined objectives—for example, continuation of the SOE privatization process, as well as performance indicators to track progress. Also, some of the MSA Strategy's objectives, such as "strengthening business efficiency" or "strengthening the Croatian economy" are too general and are not accompanied by specific guidance for implementation. While the Strategy refers to the OECD principles and materials, it fails to use them as a starting framework on which to build clearer and more quantifiable goals. The Strategy describes the areas where state ownership is desirable, including areas of special national interest where the public interest cannot be precisely defined, areas subject to a high degree of complexity of different interests, areas where the public interest is not satisfied or depends on one company, or areas of infrastructure requiring significant capital investments. However, the Strategy does not outline the concrete way these requirements are transposed in a clear state-ownership rationale. Similarly, the Strategy presents provisions of the 2017 Corporate Governance Code for SOEs but fails to provide clear and concrete directions for its implementation.

Table 8. **Main regulatory framework for SOEs in Croatia**

Law / Regulation	Date of Approval	Key Provisions
Companies Act	November 1993	The law provides general rules regarding the appointment and remuneration of the Supervisory Board and Management Board in line with the OECD principles. The Company Law was revised in 2019 to implement EU Directive 2017/828 (amendment of the EU Shareholder Rights Directive).
Accounting Act	January 2016	The Act regulates the accounting practices, bookkeeping documents and business books, the application of financial reporting standards, annual financial statements, the audit and public disclosure of financial statements of all companies, including SOEs.
Decision on adopting the Code of Corporate Governance in which the Republic of Croatia has shares or equities	December 2017	The Code is designed mainly for SOEs of strategic interest for the Republic of Croatia, but the guidelines are recommended for all SOEs. The Code contains high-level corporate governance recommendations for the parties involved.
Law on the Management of State Assets	May 2018	The Law stipulates the management of the assets owned by the Republic of Croatia and the powers of the role and responsibilities of the Ministry of State Assets and Center for Restructuring and Sales.
Government Decision on Legal Entities of Special Interest for the Republic of Croatia	August 2018	The Decision contains a list of 39 SOEs and other legal entities declared of special interest for the Republic of Croatia. No criteria to define 'legal entities of special interest' are provided.

Decree on the conditions for Election and Appointment of the Members of Supervisory Boards and Management Boards of legal Entities for the Republic of Croatia	January 2019	The Decree set the conditions and the procedure for election and appointment of the members of supervisory boards and management boards of legal entities for the Republic of Croatia.
Strategy for the Management of State Assets for the period 2019-2025	October 2019	The Strategy is adopted in accordance with Article 18 of the Law on State Asset Management and it sets long term guidelines for the management of state assets.
Decision on criteria for determining legal entities of special interest to the Republic of Croatia	February 2020	The decision is an improvement of the Decision on Legal Entities of Special Interest for Republic of Croatia adopted in August 2018. However, the criteria are rather unclear, and allow for a rather discretionary approach towards state ownership.
Act on Internal Organization and Scope of State Administration Bodies	2020	The Act regulates various issues related to state ownership at the level of line ministries. The line ministries are responsible for proposing to the Government to appoint members of general meetings, supervisory boards and management boards, and for general guidance and training of the SOEs management.

Source: WBG staff consolidation.

40. **In addition, the Government adopted a Decision on the criteria for determining SOEs and other legal entities of special interest in February 2020.** This Decision is considered as a step forward in addressing the rationale for state ownership, as compared to the previous one from August 2018. Nevertheless, the criteria included in the Decision, which are referred to 39 central government SOEs and other legal entities, are not following the international practice (OECD), and are not clearly defined.

4.2. Ownership and Oversight Function

41. **Despite a recent attempt to enhance the role of the former Ministry of State Assets, the ownership function of SOEs in Croatia remains fragmented among different institutions, with an active role of line ministries.** The attributions of the former Ministry of State Assets were taken over by the new MPPCSA, established in July 2020. Together with line ministries, the MPPCSA exercises ownership rights over SOEs of special interests. However, its role is mainly confined to regular monitoring and reporting on the management of state-owned assets, including the monitoring of financial targets and capital structure objectives of SOEs. It is also responsible for maintaining a dialogue with external auditors.

42. **The line ministries are responsible for representing the state and exercising voting rights at the General Assembly and are involved in different degrees in appointing and monitoring the activity of board members of the SOEs in their portfolio.** The relevance of line ministries was inherited from the former centrally planned economy, where they were responsible both for providing the products or services and for developing sectoral policy. Their role is currently regulated by the Act on Internal Organization and Scope of State Administration Bodies adopted in 2020 (see Box 2 for an example). However, their ownership rights may overlap with regulatory functions as most ministries must develop industrial, regional, and sectoral policies according to government priorities. The number of SOEs that a line ministry manages may vary considerably: some have ownership rights over many enterprises such as the Ministry of the Sea, Transport and Infrastructure and Ministry of Economy and Sustainable Development, while others have only one SOE under their purview, such as the Ministry of Interior. Furthermore, it is not fully clear how many employees are actively engaged in overseeing the activity of SOEs. Namely, staff responsible for SOEs oversight is assigned to different organizational units and is usually engaged in other tasks as well. The exception is the MSTI, where one advisor to the minister is responsible only for the SOEs in the ministry's portfolio.

43. **The MSA Law from 2018 entrusts the MPPCSA with the management of state assets**. The Law defines the management of state assets as systematic and coordinated activities and good practices by which the state rationally, transparently and publicly manages state assets and related liabilities, on behalf and for the account of citizens for the sustainable development of the Republic of Croatia. In practice, this can take the form of: (i) exercising ownership rights and assuming ownership obligations for state assets; (ii) concluding legal transactions resulting in the transfer, alienation or limitation of these ownership rights and obligations; and (iii) determining the use of such assets. According to the Law, MPPCSA must manage state assets efficiently and reasonably, with the care of a competent owner, following the principles of accountability, publicity, economy, and predictability. In practice, however, the Ministry does not have clear responsibilities related to SOE's corporate governance in terms of setting objectives for SOEs, or for selecting, appointing, and monitoring the activity of board members. The MPPCSA is also responsible for drafting key policy papers, annual reports, and other state assets publications such as the State Asset Management Strategy and the criteria for defining special interest enterprises, amongst other aspects. [29] Lastly, the Ministry must also perform administrative tasks related to physical planning, construction and housing; asset valuation; utility management; and energy efficiency and renovation in the buildings sector, per the Act on the Organization and Scope of State Administration Bodies.

[29] Additionally, MPPCSA exercises direct ownership over Državne nekretnine d.o.o (the SOE in charge of managing the government's real estate) and CERP.

44. **The MoF is not entrusted with key SOE ownership responsibilities in Croatia.** The MoF bears the responsibility to track and analyze annual and quarterly financial reports of all 39 special-interest enterprises. It is also involved in adopting the annual state dividend policy decisions and participates in all decisions and procedures that have a fiscal impact on the Treasury, including the issuance of state guarantees for SOE loans. However, the MoF has no role in setting objectives for these SOEs, or in analyzing their performance against predefined objectives and indicators set elsewhere within the government. The Ministry monitors the achievement of planned targets and other policy effects by receiving performance reports that present a set of financial indicators, such as liquidity, activities, profitability, indebtedness, among others. The only other privy entities to these indicators are the MPPCSA and the Center for the Restructuring and Sale (CERP). These reports take the form of Excel tables that include numerous sheets of financial analyses extracted from the basic financial statements. They are protected by code that can be accessed only by the MoF, MPPCSA, and CERP.

45. **Overall, the current fragmented approach to SOE ownership in Croatia can lead to inefficiency and poor oversight.** Political considerations can undermine SOE efficiency, as line ministries are tempted to restrict or bypass the board and control day-to-day operations, particularly when CEOs are appointed directly by the government, which is a common practice. In competitive markets, having line ministries serve as owners and be responsible for policy making for the sector as a whole can create disadvantages for private sector companies or lead to allegations of bias in pricing and procurement decisions. In addition, the fragmentation of responsibility for ownership and monitoring of SOEs across several different agencies can lead to a lack of adequate oversight of the SOE sector as a whole.

46. **Globally, ownership arrangements have been evolving from a decentralized or dual model toward greater centralization in order to strengthen ownership and governance.** While a degree of centralization still varies across countries (see Annex 4), the underlying institutional arrangement is common: a well-coordinated mechanism across all SOEs. The state has increasingly become an active and professional owner of its assets, while giving SOEs operational independence and managerial discretion. With that, SOEs are insulated from political influence and interference in their day-to-day operations, keeping at arm's-length from the state. Under centralized ownership arrangements, countries either establish a central holding company for an important portfolio of SOEs, or appoint a central coordinating agency, often charged with monitoring performance or coordinating governance practices across the SOE sector (for more detailed examples of well-established centralized systems see Annex 5). [30]

[30] Corporate Governance of State-Owned Enterprises in Europe and Central Asia, A Survey; World Bank, July 2020.

4.3. Performance monitoring

47. **Croatian state, as the owner, has not yet established an effective monitoring system to keep SOEs´ board and management accountable for their performance.** SOEs unilaterally define their mandates and objectives, including financial targets, capital structure targets, and risk tolerance levels, without prior approval or consultation with their line ministries (see Box 2 for an example). Nevertheless, they tend to take into consideration the strategic plans issued by their respective line ministry. Since 2018, SOEs must report on their financial performance and strategic plans using the so-called "Guidance for the Preparation and Submission of Business Plans and Reports of Companies and Legal Entities that Represent State Assets", —developed as part of an EU-funded project with the assistance of the EBRD. The SOEs report their performance to the MoF, MPPCSA and CERP through quarterly and annual reports [31] ; they also submit yearly and mid-term plans. However, it should be noted that SOEs do not need to submit such documents to their respective line ministries, as, according to available information, these institutions do not actively monitor SOE performance, except for the Ministry of Sea, Transport and Infrastructure, which has developed its own monitoring system, requiring SOEs to submit bi-annual reports.

Box 2 HRVATSKE ŠUME – an SOE with high technical standards but suboptimal business model reflecting weaknesses of the national corporate governance framework [32]

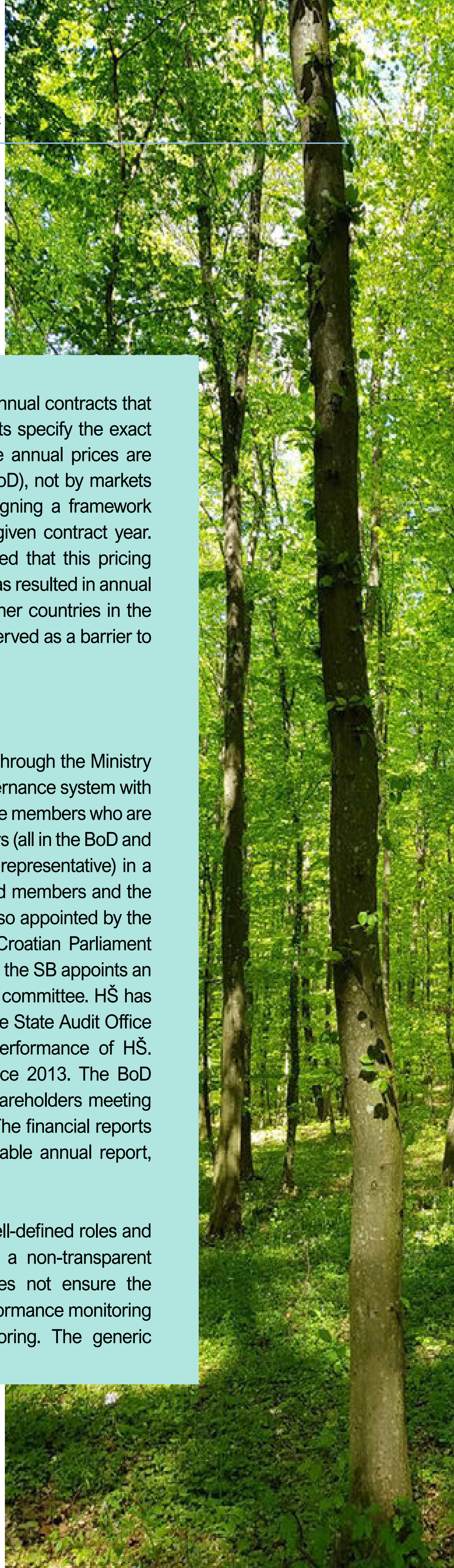
Hrvatske šume and the Croatian forest industry

Forests are among Croatia's most valuable natural resources and they are largely state owned. An SOE Hrvatske šume d.o.o., HŠ (Croatian Forests Ltd) a state owned-enterprise, is responsible for the management of 97 percent of state-owned forests and forestland in Croatia, making it by far the largest industrial roundwood supplier in the country. The forest sector is a significant part of the national economy and source of employment in Croatia, especially in rural areas. In total there are approximately 53,000 people employed in the sector, including 35,000 in the wood processing industry. Through its roundwood sales, the enterprise has a huge impact on the functioning of the whole Croatian forest-based economic sector. 93 percent of total HŠ's sales of roundwood goes to processing and manufacturing industry mostly through long-term (up to ten years) supply contracts. [33]

31 SOEs reporting to dedicated government bodies was first initiated in 2014 based on the Guidance for the Preparation and Submission of Business Plans and Reports of Companies and Other Legal Entities of Strategic and Special Interest for the Republic of Croatia.

32 This case study is based on the report Functional review, corporate governance, and benchmarking of the Croatian State Forest Enterprise, Hrvatske Šume, World Bank, forthcoming.

33 The policy objectives of the timber sales system are defined, among others, as creating economic growth and employment; ensuring creation of new value addition industries; contributing to the development of cooperation and competition among wood industries; investment in new technologies and innovative products; contributing to a circular economy (incl. rural small and medium enterprises); and ensuring the economic, social, and spatial cohesion of Croatia with the EU. Contribution of public revenue or overall efficiency are not mentioned as objectives of the system.

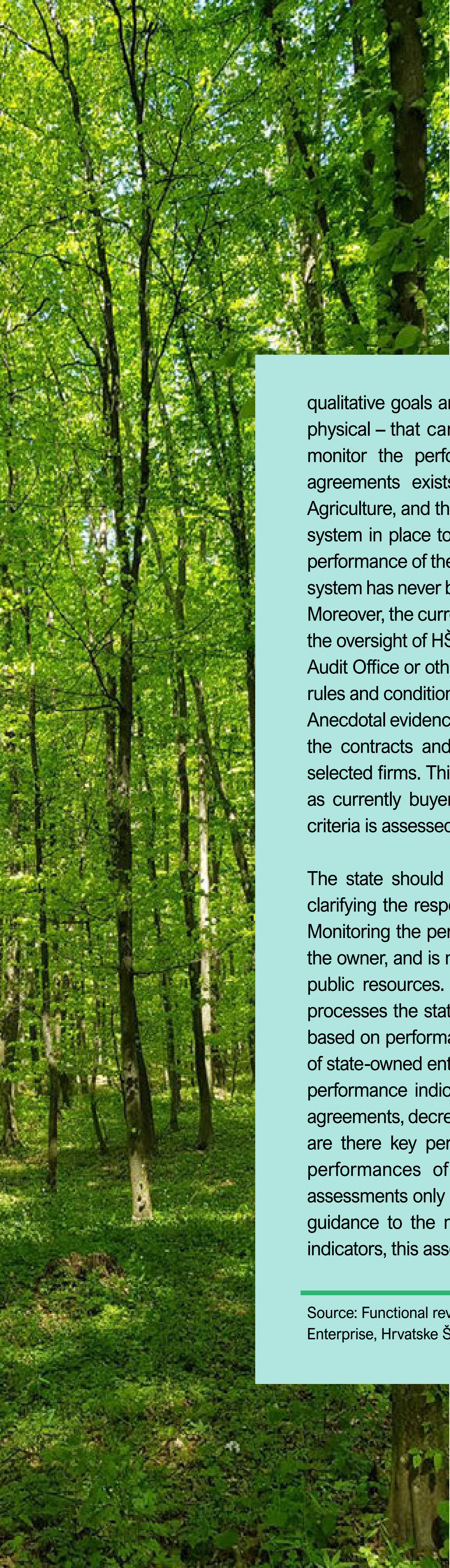


During the length of the contract, the companies are obliged to sign annual contracts that regulate the quantities and prices of roundwood. The annual contracts specify the exact types and quantities of roundwood traded between the parties. The annual prices are formed by an administrative decision of the HŠ board of directors (BoD), not by markets and the principles of price setting are not publicly disclosed. By signing a framework contract, the contract parties accept the listed prices, valid for the given contract year. While market conditions differ between countries, it can be estimated that this pricing system, combined with a regularly changing wood allocation regime, has resulted in annual revenue losses of EUR 40–50 million compared to wood prices in other countries in the region. It has also hindered competition among wood industries and served as a barrier to market entry, specialization, investment and innovation.

Corporate governance in HŠ

HŠ is a liability limited company, owned 100% by the state of Croatia through the Ministry of Agriculture. The enterprise operates under a two-tier corporate governance system with a Supervisory Board (SB) consisting in 5 members and a BoD with three members who are on HŠ payroll. The Minister of Agriculture nominates the board members (all in the BoD and two out of three in the SB while the remaining SB member is a staff representative) in a rather non-transparent manner, and there are concerns that the board members and the department heads are politically appointed. The Director General is also appointed by the Ministry of Agriculture. The HŠ management board reports to the Croatian Parliament through the Ministry of Agriculture. For the oversight of internal control, the SB appoints an audit committee. The internal audits report to the SB and to the audit committee. HŠ has been audited by an external local private firm external auditor. Also, the State Audit Office has the general mandate of auditing the financial activities and performance of HŠ. However, the Office has not audited HŠ financial performances since 2013. The BoD prepares the financial reports, which are approved by the general shareholders meeting (Minister of Agriculture) and published on the enterprise's webpage. The financial reports are subject to internal audits, and HŠ also prepares a publicly available annual report, including the external audit report.

HŠ corporate governance is weakened by several factors: i) lack of well-defined roles and responsibilities for the two boards which govern the company; ii) a non-transparent nomination process for the members of both Boards, which does not ensure the appointment of the most qualified candidates; iii) the absence of a performance monitoring system for the management, including targets setting and monitoring. The generic



qualitative goals and mandate of HŠ are not operationalized into indicators – financial or physical – that can be continuously monitored. The Ministry of Agriculture does not monitor the performance of HŠ management (SB and BoD), as no performance agreements exists between the state shareholder, represented by the Ministry of Agriculture, and the management of HŠ. Consequently, the management does not have a system in place to regularly monitor the operational, financial, social, and environmental performance of the company. Even the complex and rather bureaucratic roundwood sales system has never been independently audited to assess how the official objectives are met. Moreover, the current roundwood sales system is affected by a number of shortcomings in the oversight of HŠ. There is only limited oversight by the Ministry of Agriculture, the State Audit Office or other supervisory bodies responsible for ensuring HŠ compliance with the rules and conditions agreed with the buyers and stipulated in applicable legal frameworks. Anecdotal evidence from the processing firms indicate that the enterprise is not respecting the contracts and that there are cases of undue collusion between HŠ officials and selected firms. This situation is aggravated by the lack of an independent external review, as currently buyers/ partners compliance with the agreed roundwood sales rules and criteria is assessed only by HŠ employees.

The state should exercise in a responsible and active manner its ownership role, by clarifying the responsibilities of the management bodies and monitor their performance. Monitoring the performance of state-owned enterprises is a core function of the state as the owner, and is needed to ensure transparency, accountability and the adequate use of public resources. A performance-monitoring system should cover the institutions and processes the state uses to monitor the financial and non-financial performances of HŠ, based on performance agreements or contracts between the state and the management of state-owned enterprises that include the objectives to be achieved and the relevant key performance indicators. Currently, there are no performance provisions (e.g. contracts, agreements, decrees) between the Ministry of Agriculture and the management of HŠ. Nor are there key performance indicators (KPI) to monitor the financial and non-financial performances of the enterprise. The State Audit Office conducts performance assessments only every 4 to 5 years, which is not frequent enough to provide operational guidance to the management. In the absence of agreed objectives and performance indicators, this assessment does not have a clear baseline.

Source: Functional review, corporate governance, and benchmarking of the Croatian State Forest Enterprise, Hrvatske Šume (2020), European Forest Institute.

4.4 Boards of Directors and Management

48 **In line with the provisions of the Companies Act, Croatian companies can be organized under a unitary or two-tier management system.** SOEs tend to have predominantly two-tier management system, with supervisory boards consisting of 3 to 7 members and management boards of one or more members. Based on available information, 21 percent of board members are state officials and 19 percent are employee representatives.

49. **The rules for nomination and appointment of SOE board members are specified in the Companies Act, the (CG Code), and the 2019 Government Decree for SOEs of "special interest".** While the Companies Act and CG Code include general principles regarding board members' nomination (such as appointment by the shareholders meeting, general competencies, etc.), the 2019 "Decree on the Conditions for Election and Appointment of the Members of Supervisory Boards and Management Boards of Legal Entities of Special Interest for the Republic of Croatia" sets the specific framework for SOEs. According to this Decree, only management board positions are subject to open competition. For management and supervisory boards of SOEs of special interest, line ministries are required to follow a specific procedure for selecting candidates. The procedure consists in conducting an interview and publishing the names publicly for public consultation lasting approximately 15 days. Line ministries are required to send the proposal, including the relevant documentation and analysis, for the selection of candidates to the Government of Croatia. The board members are appointed by line ministries at the proposal of the Government of Croatia, and their name must be published on the website of the competent authority. This new framework was established in 2019 to improve the nomination process which was previously lacking transparency, with positions in SOEs boards being restricted to a pool of candidates favoring political appointees.

50. **The 2019 Decree provides for the requirements that candidates to the supervisory board must fulfill. According to this, a candidate must be a university graduate (or have completed an equivalent study program in a relevant discipline) with knowledge of corporate governance, finance, and accounting.** Furthermore, the candidate must have at least five years of professional experience gained in management positions for special-interest entities which the government is a majority shareholder of and whose consolidated revenue in the preceding financial year is below HRK 750 million. Alternatively, he/she must ten years of professional experience gained in management positions for special-interest entities, which the government is a majority shareholder of and whose consolidated revenue in the preceding year exceeds HRK 750 million. The successful candidate must have no conflicts of interest, per the rules of

the Corporate Governance Code for Companies in which the Republic of Croatia holds shares or interests. Similar criteria apply to candidates applying for a position to the management board (for example, the candidate must have at least ten years of professional experience in jobs that require an appropriate qualification level, of which at least five years in management positions).

51. **Nominating independent or non-executive members in SOEs is a rare practice.** Only listed SOEs are required to have an independent board member, per the provisions of the Code of Corporate Governance of the Zagreb Stock Exchange, which requires most board members (including the chairperson and deputy chairperson) to be independent. To be deemed independent, a director must have no conflicts of interest, such as being a significant shareholder (or the spouse or close relative of one), having been a member of the company's management board or any related companies within the previous three years. Moreover, an independent director must not have been an auditor, employee, or business partner of the company within the last three years.

52. **The duties and responsibilities of SOE boards and management reflect unclear corporate governance arrangements.** They are defined in the Companies Act in general terms in line with internationally accepted corporate governance practices. However, in practice, the management board has a much stronger role, including the responsibility to define the strategy, which is then presented to the board. In most cases, the SOE board is rather a formal body with little influence in decision-making processes, and no influence on the appointment of management members, as required by international corporate governance standards.

4.5. Accounting, Reporting, Transparency and Disclosure

53. **Croatian SOEs are subject to several laws regulating preparation and disclosure of financial statements and management reports, as well as the controls performed by various external and internal bodies.** The Accounting Act applicable from January 2016 and subsequently amended regulates the accounting practices and related instruments, the annual financial statements, annual report, consolidation, the report on payments to the public sector, as well as the audit and public disclosure of these reports. Annual financial statements must be signed by the chairman of the board and all directors. SOEs must also prepare annual management reports, which also include non-financial information on development, operational performance, position and impact of its activity on environment, social and worker matters, respect for human rights, anti-corruption and bribery matters.

54. **SOEs are required to submit their annual financial statements and consolidated statements with the respective accompanying auditor's reports to the Financial Agency (FINA) for statistical and other purposes and for public disclosure.** FINA keeps the register of annual statements of SOEs (as well as other business entities) in electronic form, which is publicly accessible on FINA's website. Furthermore, FINA is required to inform the MoF on which enterprises published their non-financial management report, and which did not, and this information is made available on the MoF's web site. In addition, according the Law on State Asset Management, SOEs are required to submit a quarterly financial statement, annual plan, annual report mid-term plan, mid-term report and other ad hoc reports as requested by the MoF, MPPCSA and CERP. During 2016-2018, the MPPCSA published annually an aggregate report for the SOEs of special interest, which however did not include the main financial information of entire portfolio of these SOEs.

55. **SOEs are controlled by several external and internal bodies, including state bodies, internal audit and control units of SOEs, and independent external auditors.** The highest audit institution in Croatia is the State Audit Office (SAO), autonomous and independent in its work. The tasks of the State Audit Office are prescribed under the Act on the State Audit Office (2019) and include: review of documents, reports, internal control systems, accounting, financial and other procedures that are subject to audit. During SOEs audits, a particular attention is paid to the application of good governance and internal control mechanisms. The SAO also assesses the activity of internal audit and audit committee (see below) and verifies the observance of the requirements included in the Anti-corruption Program. The state auditor reports directly to the Croatian Parliament, the audited entity, and any irregularities are passed on to the prosecutor's office. Furthermore, the SAO is making its reports publicly available on its website. The SAO audits are conducted in compliance with the standards of the International Organization of Supreme Audit Institutions (INTOSAI).

56. **Large SOEs and those of special interest for the Republic of Croatia are required to have an external statutory audit, under the coordination of an audit committee.** The Accounting Act stipulates that public interest entities, large and medium enterprises as well as entities which fulfill at least two of the following conditions namely (i) value of assets exceeding HRK 15 million (ii) revenues exceeding HRK 30 million or (iii) minimum annual number of employed is 25, are subject to statutory audit. [34] The selection of an independent auditor should take place at least three months before the end of the reporting period to which statutory audit refers. [35] In addition to this, certain large-sized

34 Article 20, Law on Accounting (Official Gazette 78/15, 134/15, 120/16, 116/18, 42/20, 47/20).

35 Article 41, Paragraph 1, Law on Audit (official Gazette Article 68127/17).

public interest entities [36] are required to engage 2 independent audit firms, which will jointly issue an audit report and provide an opinion on the financial statement. [37] The audit committee is responsible for selecting an external auditor, monitoring the external audit of financial statements, as well as verifying the independence and objectivity of the external auditor.

57. **The accounting standards applied to SOEs in Croatia are either the Croatian Financial Reporting Standards (CFRS) or the International Financial Reporting Standards (IFRS).** Micro, small and medium sized enterprises are encouraged to use CFRS whereas large and special interest SOEs are expected to report using the IFRS. SOEs are required to submit their annual financial statements for statistical and other purposes by the end of April of the current year. Additionally, they have to publish their annual reports and annual financial statements for the previous fiscal year (whether audited or not) by the end of June of the current year. While the filling of the annual reports and public disclosure appear as adequate, in practice, significant departures from the IFRS are often evident. These departures are justified by special laws (Lex Specialis) governing this subject matter and overruling the general law, as in the case of transport sector SOEs.

58. **The Croatian Audit Law is in compliance with the EU standards and directives.** The Croatian Law on Audit complies with the European Parliament Regulation No 537/2014 [38] and of the Council dated April 16, 2014 that regulate the specific requirements regarding the statutory audit of public-interest entities (repealing the Commission Decision 2005/909/EC). However, in practice, the quality of the SOE financial statements external audits is mixed. At times, audit firms are selected only on the basis of the lowest cost, without considering quality aspects.

59. **Starting in 2018, the function for ensuring the quality of external audits has been transferred from the Audit Chamber to the MoF.** [39] Within the MoF there is an independent unit in charge of controlling quality by issuing work approvals and supervising all certified auditors and audit firms. Quality control is done at least once every three years for public interest entities auditors and audit firms and at least every six years for other entities. The ministry's website publishes the following supervisions reports carried out during 2020: [40] (i) decisions on ordinary direct supervision, (ii) decisions on direct extraordinary supervisions and (iii) decisions on indirect supervisions. No data is available for 2019 financial year and the 2020 data is incomplete as of the issuance of this report.

36 The PIE which employ more than 5,000 employees and have assets exceeding HRK 5 billion.
37 Article 43, Law on Audit (official Gazette Article 68127/17).
38 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R0537.
39 Law on Audit (official Gazette Article 68127/17).
40 https://mfin.gov.hr/istaknute-teme/revizija/nadzor/rjesenja-o-izrecenim-nadzornim-mjerama/3059.

60. **Internal audit requirements are defined by the Law.** [41] In Croatia, any publicly owned commensal company or legal entity employing more than 50 staff and earning more than HRK 400 million in revenues, needs to establish an internal audit unit. [42] The internal audit unit may be limited to having a single internal auditor or establishing an independent internal audit unit with more staff. It is also possible for several entities to establish a common internal audit unit by mutual agreement in order to jointly perform internal audit activities. If there is an audit committee in place, the internal audit needs to report to this committee; alternatively, the unit reports to management.

4.6. Procurement

61. **The public procurement legal framework in Croatia has been continuously improved since EU access in 2013.** The legal framework consists of the Public Procurement Act (PPA), the Act on the State Commission for Supervision of Public Procurement Procedures, the Concessions Act, and the Act on Public-Private Partnerships.

62. **SOEs and their subsidiaries must comply with PPA, regardless of their commercial orientation.** PPA was initially adopted in 2011 and most recently amended in 2016 (OG 120/16) in line with relevant EU legislation on public procurement – Directive 2014/24/EU, Directive 2014/25/EU. PPA primarily establishes the rules regarding public procurement. This legislation applies to transactions amounting to HRK 200,000 (VAT excluded) for goods and services or HRK 500,000 (VAT excluded) for infrastructure projects. PPA defines majority state-owned and fully corporatized SOEs as sectoral procurers who can apply the Act as mentioned above. SOEs' subsidiaries must also be in line with the Public Procurement Act's provisions if they qualify as public or sectorial procurers.

63. **Croatia has a centralized electronic public procurement system operated by the National Gazette – the Electronic Public Procurement Classifieds of the Republic of Croatia.** The electronic submission of tenders has been mandatory in Croatia since January 1, 2016. E-procurement in Croatia was fully implemented in April 2018, when the use of e-ESPD became mandatory. Consequently, Croatia observes the OECD principle regarding the integrity in public procurement which states that governments should provide an adequate degree of transparency in the entire procurement cycle to promote fair and equitable treatment for potential suppliers.

41 Law on Internal Controls System in the Public Sector i Rulebook on Internal Audit in the Public Sector, Official Gazette 78/15, 102/19 enacted November 2, 2019.

42 Rulebook on internal audit in the public sector, Official Gazette 42/16 i 77/19.

64. **The OECD principle regarding the public's ability to scrutinize public procurement is also respected.** PPA requires that before launching an open or restricted procurement procedure for public works contracts or public supply contracts and public service contracts above the EU thresholds, contracting authorities must conduct market consultations for a minimum period of five days with the interested economic operator on the draft procurement documents, in particular for the subject matter of the tender, technical specifications, criteria for qualitative selection, contract award criteria and special conditions relating to the performance of a contract.

65. **The Act on the State Commission for Supervision of Public Procurement Procedures regulates the State Commission's competence to supervise public procurement procedures and other issues relating to the State Commission's activities.** Any competing party, bidder, or economic entity interested in obtaining a particular public procurement or framework agreement has the right compalin to with the State Commission. This right applies both to entities that have been or could potentially be harmed. Complaints can be filed with the State Commission either directly or by registered mail. This is in line with the OECD principles regarding public procurement, that require governments to ensure that potential suppliers have adequate and timely access to review systems of procurement decisions and that these complaints are promptly resolved.

The Key Reform Agenda

5

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5. The Key Reform Agenda

66. **Suggested policy recommendations and reforms for the government's consideration are focused on the ownership function and the relation between the state and SOEs, transparency, the privatization program, and fiscal risk management.** The proposed changes intend to improve public sector fiscal management and accountability, as well as align SOE corporate governance practices with internationally accepted standards.

Ownership Function

67. **Ownership policy.** It should clearly define state ownership rationale with explicit criteria and expectations for all parties involved, including SOE shareholders, boards, management, auditors and other key stakeholders and clearly allocate responsibilities. The ownership policy should also define the criteria for establishing and terminating state ownership, and set out the roles and responsibilities of SOEs, which can be used to guide decision-making and help in protecting them from political interference.

68. **Ownership institution.** The exercise of state ownership rights on SOEs should be clearly identified within the state administration, either through a centralized model with a single ownership entity or through the consolidation of a dual model where the ownership function is adequately shared by a central-level body and corresponding line ministries. In that sense, the role of the coordinating body, currently assigned to MPPCSA, could be strengthened through a clear and focused mandate with a high degree of autonomy, improved capacity and accountability, and effective SOE oversight. In the short-term, the capacity of the line ministries to effectively oversee the SOEs within their portfolio should be strengthened.

Transparency

69. **Ensure a consistent public disclosure of SOE financial information and strengthen the external audit practice.** While the completion of the annual reports and public disclosure appear as adequate, there are significant departures from the IFRS that are justified by special laws (Lex Specialis). Also, the MoF, currently in charge of the external audit quality control function, could enhance the transparency and disclosure of information.

Privatization Program

70. **Follow up of the government´s Privatization Program.** Privatization initiatives should be resumed based upon both the results of the efficiency analysis of subsidized SOEs, and the new state ownership rationale for SOEs.

Efficiency Analysis and Fiscal Risk Management

71. **Carry out an efficiency analysis of government subsidized SOEs.** An in-depth analysis is needed to evaluate the efficiency of subsidized SOEs in providing their services and achieving appropriate value for money. Only based on high-quality data and clear criteria for state ownership, a decision can be made whether an SOE should indeed remain owned by the state.

72. **Development of an SOE fiscal risk management framework.** This framework — prepared and disclosed by the MoF — should identify the major risks to the budget emanating from SOEs; assess their size and probability of occurrence; identify any policy or other measures to mitigate these risks; and disclose fiscal risks to enhance awareness of fiscal policy trade-offs and bring transparency to the entire budgeting process. The framework should take into consideration both direct and contingent liabilities, as well as explicit and implicit obligations.

ANNEX 1: Performance of SOEs owned by the local government units

Local government units currently hold a majority share in close to 800 companies, that account for around 30 percent of the value added and roughly 40 percent of employment of the entire SOEs sector in Croatia. The concentration in terms of economic significance is less pronounced compared to the central government level as fifteen largest locally owned SOEs account for around 40 percent of revenues and 30 percent of employment (Table A.1). However, there is much higher concentration of debt as only three companies (Zagrebački holding, Vodoopskrba i odvodnja and Zagrebački električni tramvaj) account for almost 70 percent of debt of all locally-owned SOEs. Also, there is a much greater sector concentration as more than 500 companies are registered in water supply and other services sectors often including local utility companies but also sport clubs, development agencies or landscape design companies. Therefore, analysis of locally owned SOEs in Croatia warrants a much deeper analysis that goes beyond the scope of this report.

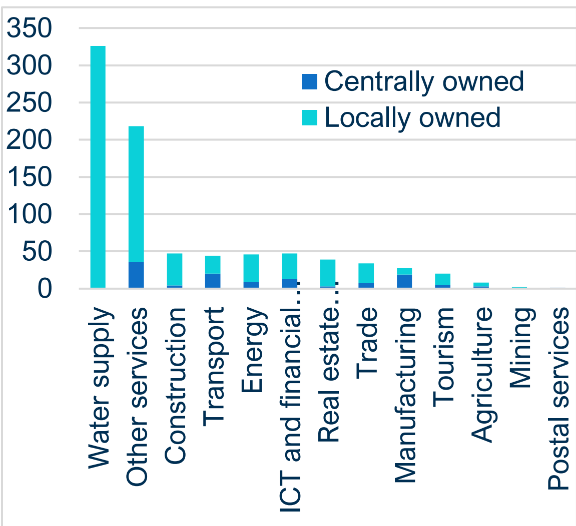
Table A.1 **Largest locally owned SOEs in Croatia**

Rank (by revenue)	Firm name	Sector	Type of legal entity	Revenue (HRK mn)	Employment	Assets (HRK mn)	Debt (HRK mn)	Taxes (HRK mn)
1	**ZAGREBAČKI HOLDING D.O.O.**	**Real estate services**	**D.O.O.**	**1,749**	**5,082**	**12,241**	**3,973**	**159**
2	**GRADSKA PLINARA ZAGREB - OPSKI**	**Energy**	**D.O.O.**	**952**	**122**	**378**	**29**	**6**
3	**VODOOPSKRBA I ODVODNJA D.O.O.**	**Water supply**	**D.O.O.**	**454**	**1,178**	**4,796**	**13**	**40**
4	**ZAGREBAČKI ELEKTRIČNI TRAMVAJ**	**Transport**	**D.O.O.**	**400**	**3,807**	**2,663**	**494**	**139**
5	**GRADSKA LJEKARNA ZAGREB**	**Trade**	**Statutory entity**	**334**	**342**	**303**	**0**	**22**
6	LJEKARNA SPLITSKO DALMATINSKE Ž	Trade	Statutory entity	276	224	130	9	16
7	TERMOPLIN D.D. VARAŽDIN	Energy	D.D.	205	104	231	0	6
8	MEDIMURJE-PLIN D.O.O.	Energy	D.O.O.	201	66	234	0	3
9	GRADSKA PLINARA ZAGREB D.O.O.	Energy	D.O.O.	197	407	1,089	29	23
10	LJEKARNE SRCE	Trade	Statutory entity	179	165	57	0	7
11	HNK HAJDUK Š.D.D.	Other services	Š.D.D.	164	73	267	16	6
12	VODOVOD I KANALIZACIJA D.O.O. SPI	Water supply	D.O.O.	127	460	2,677	30	14
13	LJEKARNE ZAGREBAČKE ŽUPANIJE	Trade	Statutory entity	126	96	38	0	6
14	ISTARSKI VODOVOD D.O.O.	Water supply	D.O.O.	126	293	661	0	10
15	VODOPRIVREDA VINKOVCI D.D.	Construction	D.D.	123	90	69	5	2
	Other local SOEs			**8,407**	**28,928**	**38,957**	**2,164**	**770**
	Total			**14,019**	**41,437**	**64,792**	**6,761**	**1,230**
	Share of TOP-15 SOEs in total (%)			**40**	**30**	**40**	**68**	**37**

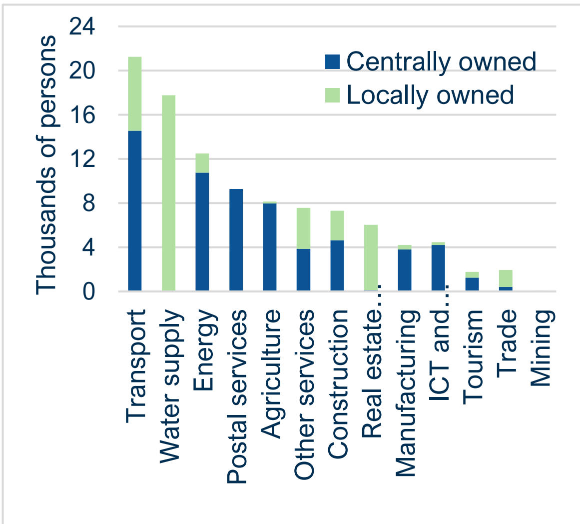
Sources: FINA

Figure A.1: The participation of centrally versus locally owned SOEs varies by sector (2019)

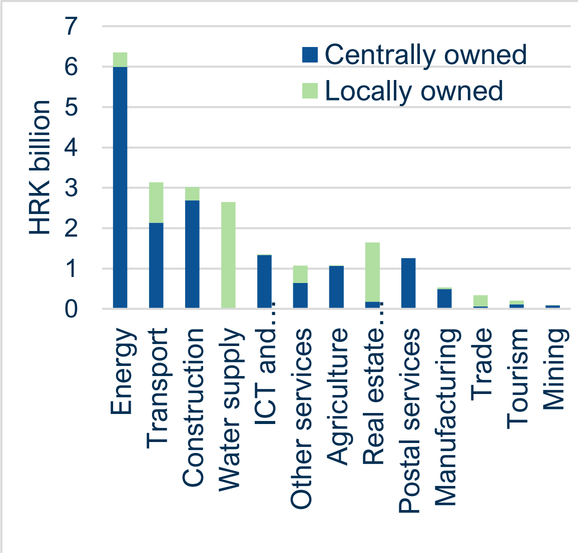
a) No. of SOE firms by sectors



b) SOE employment by sectors



c) Value added by sectors



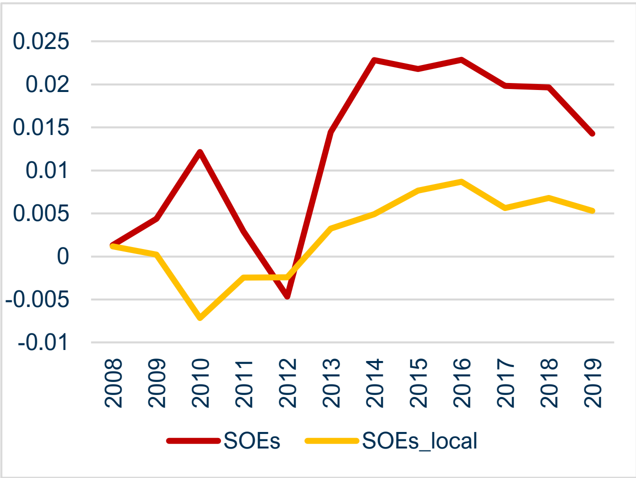
Source: FINA

Similar to centrally owned companies, local SOEs that pay profit tax, are obliged according to the Law on Accounting to submit annual financial statement to Financial Agency (FINA). Therefore, standardized financial data are available, as well as data on tax payments and subsidies received. As regards the latter, in 2019 local SOEs received subsidies in the amount of 0.3 percent of GDP, of which around half was directed to one company in transport sector - Zagrebački električni tramvaj d.o.o.. At the same time, local SOEs paid similar amount of taxes into the budget, meaning that their net impact on general government fiscal balance was broadly neutral. However, data on other possible sources of government support are not readily available and substantial effort would be required to collect these data from annual financial reports of companies (with no guarantee of success).

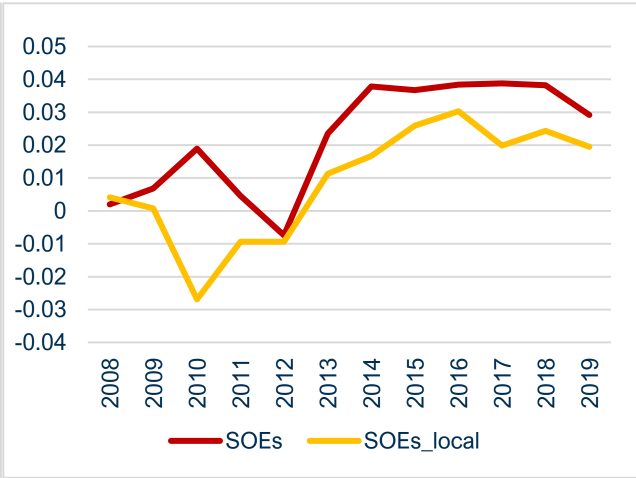
Available data suggests that locally owned SOEs lag behind performance of centrally owned SOEs. Since 2013, local SOEs profit was continuously lower compared to centrally owned SOEs and the gap remained broadly unchanged (Figure A1, panels a and b). Moreover, operating efficiency is in most sectors below centrally-owned SOEs although their labor costs are on average lower (Figure A1, panels c and d). Financial leverage seems high for some companies which may hinder investment capacities and lead to liquidity issues. This can be in particular observed in real estate service sector reflecting indebtedness of Zagrebački holding d.o.o. and in transport sector due the debt of Zagrebački električni tramvaj d.o.o. (Figure A2, panels a and b). Finally, around 12 percent of overall local SOEs have interest coverage ratio less than one but their total debt is not large (Table A2).

Figure A1. **Performance of local SOEs lags behind centrally-owned SOEs**

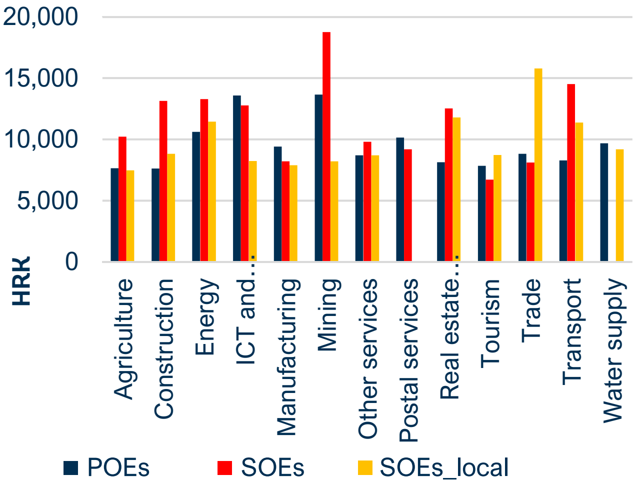
a) ROA



b) ROE



c) Average monthly costs per employee (2019)



d) Operating expenses/operating revenues (2019)

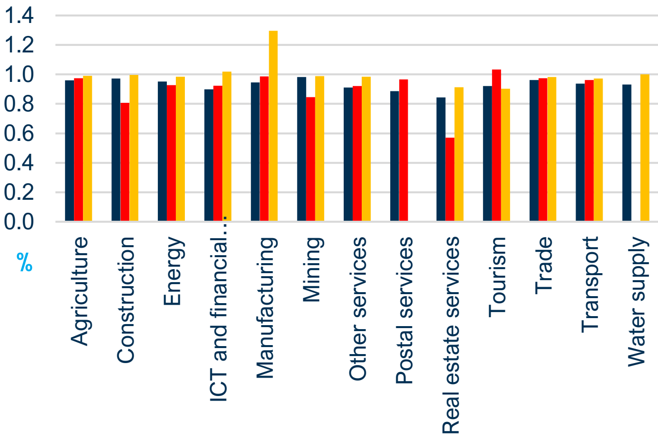
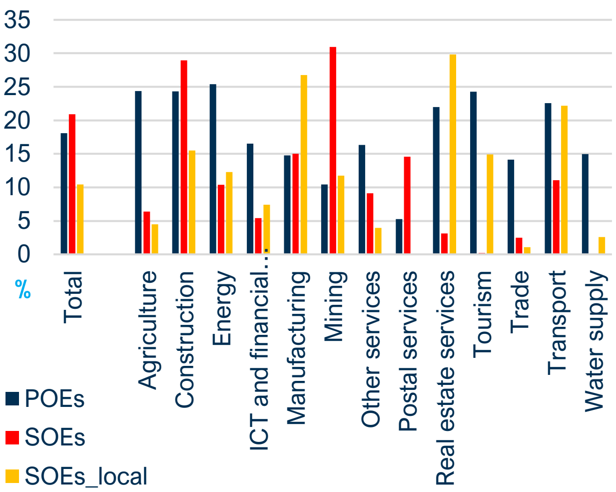
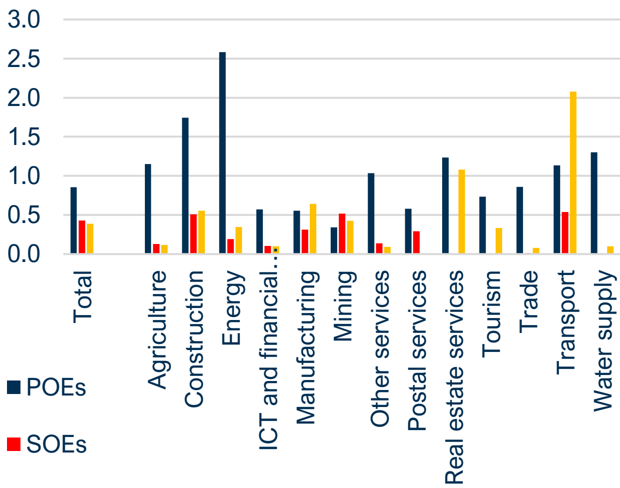


Figure A2. **Financial leverage of most locally-owned SOEs is not excessive**

a) Debt/Assets (2019)



b) Debt/Equity (2019)



Source: FINA

Table A2. **Share of vulnerable local SOEs debt**

	Vulnerable debt of local SOEs (ICR<1)		
	% of total #firms	% of debt	*% of vulnerable debt in GDP*
TOTAL	**13.4**	**12.9**	**0.2**
Agriculture	20.0	39.4	0.0
Construction	9.3	44.4	0.0
Energy	10.8	13.3	0.0
ICT and financial service	2.9	0.3	0.0
Manufacturing	22.2	97.9	0.0
Mining			
Other services	6.6	31.1	0.0
Postal services			
Real estate services	2.8	0.0	0.0
Tourism	6.7	0.2	0.0
Trade			
Transport	16.7	26.4	0.1
Water supply	21.2	39.7	0.1

Source: FINA

ANNEX 2: International benchmarking of selected SOEs in Croatia

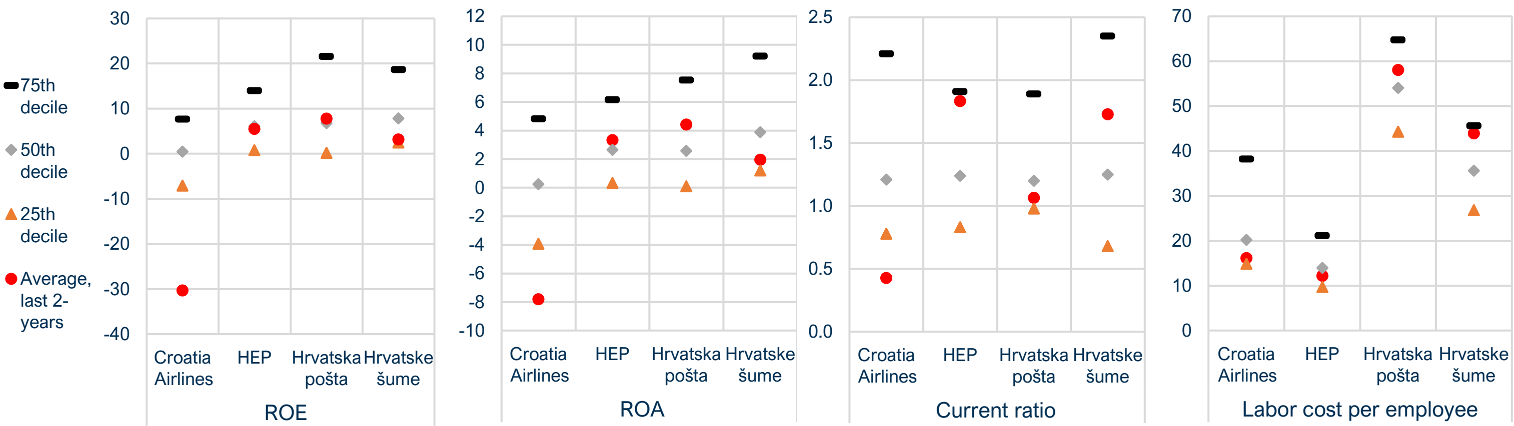
Performance comparison of selected SOEs with their sectoral peers in other countries indicates that in certain cases there is an ample space for their improvement. Such conclusions are based on the tool developed by IMF for monitoring performance and risks assessment of SOEs at the firm level (Baum et al., 2020). The tool includes two blocks, one for static benchmarking analysis and the second one for risk analysis based on forecasts of key macroeconomic indicators. Benchmarking block provides a set of financial indicators calculated at the sectoral level and separately for a group of developed and developing countries allowing one to compare selected SOEs financial indicators with those of its sectoral peers in other countries. However, in some cases comparison is limited by relatively high level of sectoral aggregation, like for road companies.

Against this backdrop, and limiting the analysis to most important sectoral SOEs, benchmarking was done for four Croatia's SOEs; Croatia Airlines d.d., Hrvatska elektroprivreda d.d., Hrvatske šume d.o.o., and Hrvatska pošta. What can be noticed is that:

- State-owned airline is in difficult financial position. As indicated by ROA and ROE indicators the company is unprofitable and has one of the worst performances when compared to sectoral peers in developed countries. In addition, its liquidity (the current ratio) is well below one and appear very weak. On the other hand, its labor cost per operating revenues seems adequate. Due to low profitability and lack of liquidity the government was planning to support the company in 2020 by granting capital injection of HRK 250 million, which was increased to HRK 600 million due to a dramatic revenue fall caused by COVID-19 pandemic. However, the company will continue to pose significant fiscal risks for the budget.

- Remaining companies are profitable, but Hrvatske šume significantly lags behind their sectoral peers in terms of ROA and ROE and are close to bottom decile of profitability distribution. Furthermore, while liquidity and solvency of these three companies seems adequate, in case of Hrvatske šume [43] and Hrvatska pošta, labor cost per operating revenues are comparably high.

Figure A: **Performance benchmarking**



Note: Benchmarks are represented by the median, top 75th and bottom 25th percentile of the distribution of each indicator across developed countries in the sample (except for Hrvatske šume where full sample was used due to lack of data) and for the respective sector. Red dots represent average performance of Croatia's respective SOEs over the last two years. Using the median, upper and bottom percentiles, allows to assess how the SOE compares to the average and against the best and worse group of performers, while reducing the influence of outliers (Baum et al., 2020). Source: IMF, World Bank staff calculations.

[43] See Box 2 in chapter 4 on a discussion of corporate governance practices in Hrvatske šume.

ANNEX 3: The system for obtaining profit remittances from SOEs requires improvement

By June 30 of each year, the government issues a decision on which SOEs are deemed of "strategic and of special interest", and for these, the amount of payment that should be paid to the government out of profits realized in the previous calendar year. June 30 is the official deadline for the final submission of companies' financial statements, including their profit distribution plan, to FINA. For example, companies are required to submit their decisions for profit distribution to FINA by the end of April of current year, while in 2019 a government decision for tax year 2018 was issued on June 27, 2019, only 3 days before the final deadline for the submission of financial statements. Although companies can alter their profit distribution decisions after the April deadline, they usually don't. Thus, the system of payment of profits to the budget does not enable timely planning of payments for companies and transparent monitoring of payments by public companies.

The government decisions state that the schedule of payments shall be fixed between the MoF and the individual company concerned by the decision. This terminology leaves room to adapt the timing of payments by each company so that the obligation to pay does not jeopardize its liquidity. However, the lack of a deadline by which all the required profits must be paid into the budget impairs control of the process.

Furthermore, while the MOF conducts regular analyses of SOEs financial performance and determines companies that are obliged to make payments into the budget, conditions for exemptions are not publicly disclosed. Some of the SOEs listed in these decisions as "strategic and of special interest" are exempted from profit payment requirements. In fact, any decision relating to the obligation to pay a share of profits to the budget includes a list of the companies that are exempt from that obligation, usually without explanation. Frequent changes are made in the list of companies required to pay out of profits; the list was amended every year during the 2015-2018 period analyzed. And the list of SOEs exempted from profit obligations (based on the previous year's profits) is typically increased after the decision is issued. For example, in the second half of 2016 the government exempted three additional companies from having to pay the budget out of profits realized in 2015.

All in all, the systems for managing profit payments to the budget are poorly monitored, insufficiently regulated and strongly subject to arbitrary changes in the list of payers, without clearly defined rules governing when and under what conditions companies can be exempted from the obligation to pay profits.

ANNEX 4: Types of ownership model structure

Ownership model	Main features	Countries
Centralized model	One government institution carries out the mission of shareholders in all companies and organizations controlled by the state. This institution can be either a specialized ownership agency of a designated government ministry. It sets up the financial, operational and technical objectives, determines the relevant key performance indicators, and monitors the performance of the SOEs. Board members are appointed centrally.	Finland, France, Sweden and Slovenia
Dual model/twin track	The ownership function for each SOE is shared by two government institutions – in most cases one-line ministry and the finance ministry. Typically, one ministry sets financial objectives and another ministry formulates operational strategy.	Czech Republic, Estonia, Germany, Italy
Coordinating agency	Specialized government units act in an advisory capacity to other shareholding ministries on technical and operational issues; their most important mandate is to monitor SOE performance. Additionally, these agencies may assist in policy-making, assist in privatization, advise line ministries, and ensure disclosure of SOE information, including an aggregate annual SOE sector report.	Latvia, Lithuania
Decentralized	No one single institution or state actor acts on the responsibilities of the ownership function. The public often perceives line ministries to be de facto running the SOE as an extension of their ministerial powers.	Romania, Croatia

Source: OECD (2018).

ANNEX 5: SOE ownership and governance practice across the OECD countries

In recent years, there has been a growing trend across the OECD countries towards establishing mechanisms for ensuring transparency and accountability of the state's exercise of ownership rights including developing a clear rationale for state enterprise ownership, a centralized or coordinated state enterprise ownership function, and regular and publicly disclosed aggregate reporting on the SOE sector. Many OECD countries have now explicit ownership policies defining the overall objectives of state ownership. Many have also adopted a centralized model for state ownership, Many have also adopted a centralized model for state ownership, established a central holding company for an important portfolio of SOEs, or established a central coordinating agency, often charged with monitoring performance or coordinating governance practices across the SOE sector. See, for example, examples for Austria and Sweden below. However, many others still maintain a decentralized model.

Austria

Since 1967 Austria has managed its SOEs through a single ownership entity, which has undergone several transformations required to accommodate its mission: from managing the first wave of privatisations (1987) to portfolio management starting in January 2019. Austrian Holdings AG (ÖBAG) is a public holding company managing 11 SOEs accounting for almost 4 parcent of Austria's gross domestic product and generating EUR 13.7 billion euro in gross value added, while securing over 135,000 jobs. These include listed companies such as OMV AG, Telekom Austria AG and Österreichische Post AG. Verbund AG, which is also listed, is managed by ÖBAG on behalf of the MoF.

ÖBAG mission is to perform "active investment management in the best interests of all Austrians. It takes targeted steps to promote growth and innovation and consolidate Austria's position as a place to do business."
ÖBAG provides a constructive partner for its companies in the fields of strategy and further investment and manages its portfolio with the utmost professionalism.

ÖBAG underlines the critical role of good governance. ÖBAG website clearly states its duty to "comply with all legal regulations and to increase trust in the Austrian capital market and in Austria as a place to do business through transparent governance."

Sweden

State-owned enterprises make up a significant part of the business sector in Sweden. The Government has a mandate from the Parliament (Riksdag) to actively manage state-owned enterprises to ensure the best possible long-term value performance and, where relevant, to ensure that specifically adopted public policy assignments are performed well.

As stated in the State Ownership Policy revised in 2020, "it is of the utmost importance for the Government that state-owned enterprises are actively and professionally managed with long-term value creation as an overall objective. State-owned enterprises have to take a long-term approach, be efficient and profitable, and be given the capacity to develop. To promote long-term sustainable value creation in state-owned enterprises, sustainable business is integrated into corporate governance. This means that state-owned enterprises have to act in an exemplary way in the area of sustainable business, and otherwise act in such a way that they enjoy public confidence. If state-owned enterprises are to contribute to economic efficiency and competitiveness throughout the country, the State has to apply good corporate governance. "

The Swedish government's management principles mainly follow the OECD Guidelines on Corporate Governance and Anti-Corruption and Integrity in State-Owned Enterprises, which provide a predictable framework both for the State as owner and for the state-owned enterprises.

Most of the enterprises are managed by the Ministry of Enterprise and Innovation, which has a special investment management organisation for state-owned enterprises. The Ministry of Enterprise and Innovation is also responsible for questions concerning the state ownership of enterprises that require a unified ownership policy. Therefore, OECD's principles for active management and governance of state-owned enterprises cover all state-owned enterprises.

To ensure active and professional investment management, the Government Office has developed a number of tools and processes for their work. As part of this investment management role, the Government Offices nominates directors, sets targets and tracks and evaluates the enterprises' operations. In the State Ownership Policy, the Government sets out mandates and objectives, applicable frameworks and important matters of principle relating to the governance of the state-owned enterprises. The State Ownership Policy is applied in all enterprises with majority state ownership. In other enterprises, i.e. those with minority state ownership, the state engages in a dialogue with the other owners to have this ownership policy applied. Enterprises administered by government agencies other than the Government Offices have to apply the State Ownership Policy in a corresponding way.

The Government presents an annual report on state-owned enterprises to the Parliament. The report is intended to describe state ownership and the value in state-owned enterprises and to provide an account of how the management of state ownership has developed during the year. The report also sets out how the enterprises are achieving their targets and complying with the Government's principles for state-owned enterprises.

Across these countries procedures for creating an SOE are set forth either in laws on the establishment of SOEs, or in the legal instrument establishing a specific SOE. The procedures for terminating SOE ownership or divesting state shares are often of a similar nature. To create an SOE, governments need to provide a rationale for the need for state enterprise ownership (often the Parliament). In some cases, they need to come up with a framework for operationalizing the new business. To terminate ownership, governments usually must demonstrate that the rationale for ownership no longer applies.

On performance monitoring, the emerging trend across OECD countries seems to be moving towards promoting transparency and disclosure. Countries are increasingly producing and disclosing online some form of aggregate reporting on SOEs. Most of them include all, or the majority of, SOEs in the reports.

ANNEX 6: Performance evaluation and management of SOEs

In SOEs, effective performance management must adopt elements from both public and private sector best practices. The OECD, through its corporate governance guidelines, has provided extensive suggestions regarding performance monitoring and management. Its fundamental principle is that the state must act as an informed and active owner, thus ensuring that SOEs' governance is transparent and accountable, with a high degree of professionalism and effectiveness. From this principle, further responsibilities of the state derive, such as:

1. setting and monitoring the implementation of broad mandates and objectives for SOEs.
2. creating monitoring systems that allow the ownership entity to audit and assess SOE performance.
3. establishing a board remuneration policy that will advance the long-and medium-term interests of the enterprise while attracting qualified professionals;

The first two are fundamental to performance management as a discipline, as they concern the setting and monitoring operational objectives. The latter relates to how the ownership entity must incentivize the boards of directors by requiring the fulfillment of performance criteria.

Best practices for performance evaluation and management of SOEs Include:

Formalizing performance evaluation systems through performance contracts and performance indicators. Performance contracts (or equivalents such as agreements or memorandums) outline yearly performance targets and should be concluded between the boards of directors and executive management. However, in a number of countries (OECD, 2016) performance contracts are concluded between the ownership entity and executive management, departing from the OECD Guideline II.B. that stipulates the state should “allow SOEs full operational autonomy to achieve their defined objectives and refrain from intervening in SOE management”. Performance indicators should be clearly defined and cover both financial performance and non-financial performance such as the delivery of public service obligations.

Auditing and reporting on performance. Reporting regularly on SOE performance at both the company level as well as the sector level through aggregate reports is critical for strengthening the accountability of the state as the owner and leads to improved performance. A good practice to ensure the quality of reporting and accuracy of information included in financial statements and annual report is to set up an internal audit function and appoint an external auditor that report directly to the Boards of Directors.

Linking evaluation of performance to executive incentives. In line with SOE Guidelines, the SOE board should be responsible to oversee and incentivize the management. Explicit and published pay-scales linked to performance allow for increased transparency and enhance SOEs capacity to attract and retain appropriate managerial capacity.

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