

# **STABILITY PACT**

## **SOUTH EAST EUROPE COMPACT FOR REFORM, INVESTMENT, INTEGRITY AND GROWTH**



### **CROATIA**

### **ENTERPRISE POLICY**

### **PERFORMANCE ASSESSMENT**

Prepared by

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT  
AND EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT**

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**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

**The Stability Pact for South Eastern Europe** is a political declaration and framework agreement adopted in June 1999 to encourage and strengthen co-operation among the countries of South East Europe (SEE) and to facilitate, co-ordinate and streamline efforts to ensure stability and economic growth in the region. (see [www.stabilitypact.org](http://www.stabilitypact.org))

**The South East Europe Compact for Reform, Investment, Integrity and Growth (“The Investment Compact”)** is a key component of the Stability Pact under Working Table II on Economic Reconstruction, Development and Co-operation. Private investment is essential to facilitate the transition to market economy structures and to underpin social and economic development. The Investment Compact promotes and supports policy reforms that aim to improve the investment climate in South East Europe and thereby encourage investment and the development of a strong private sector. The main objectives of the Investment Compact are to:

- Improve the climate for business and investment.
- Attract and encourage private investment.
- Ensure private sector involvement in the reform process.
- Instigate and monitor the implementation of reform.

The participating SEE countries in the Investment Compact are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Moldova, Romania and Serbia and Montenegro. Building on the core principle of the Investment Compact that “ownership” of reform rests within the region itself, the Investment Compact seeks to share the long experience of OECD countries. It provides region-wide peer review and capacity building through dialogue on successful policy development and ensures identification of practical steps to implement reform and transition.

The work of the Investment Compact is actively supported and financed by seventeen OECD member countries: **Austria, Belgium, Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Norway, Sweden, Switzerland, Turkey, United Kingdom and United States.** (see [www.investmentcompact.org](http://www.investmentcompact.org))

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This report has been jointly produced by the OECD Investment Compact Team and the EBRD Office of the Chief Economist in cooperation with expert regional consultants. It draws on the extensive experience and work of both organisations in transition economies including the countries of South East Europe. The Enterprise Policy Performance Assessment process, highlighting feedback from SMEs as a key element of the analysis and assessment, was instigated by Declan Murphy, Programme Director of the Investment Compact (OECD) with support from Antonio Fanelli, Principal Administrator (OECD, Investment Compact) and Ricardo Pinto (Administrator, OECD).

Background research and information was provided by Dr. Nevenka Cuckovic (lead consultant, Institute for International Relations, Zagreb, Croatia) and Dr. Will Bartlett, Dr. Drago Cengic, Dario Cziraky, Dr. Kresimir Jurlin, Dr. Sanja Tisma, Dr. Maja Vehovec, who prepared the first draft of the report. The analysis, assessment and preparation of the final report were undertaken by Ricardo Pinto (OECD), Francesca Pissarides (EBRD) and Maria Vagliasindi (EBRD) with advice from other colleagues in the OECD and EBRD. The final editing was undertaken by Declan Murphy, OECD and Georgiana Pop, OECD. The assessments and views expressed in this report are those of the Investment Compact Team of the OECD secretariat and the EBRD Office of the Chief Economist and do not necessarily reflect the views of the institutions participating in preparing this report or of OECD and EBRD member countries.

## FOREWORD

Starting a business in today's environment brings opportunities and challenges. Changing lifestyles demand greater choice of products and services. New technologies and better access to global markets have provided increased business opportunities. At the same time increased competition, insistence on quality and unremitting pressure for lower costs, just to mention some issues, represent major challenges for business. For Small and Medium-sized Enterprises (SMEs) the challenge is greater. They lack scale, resources and the capacity to handle complex business management. Typically, less than half survive more than five years and only a small proportion go on to become large companies. Entrepreneurship and enterprise development are important elements in creating dynamic market economies. SMEs are a vital source of new jobs, exports and economic contribution to countries. How to ensure the growth of the SME sector – a fundamental feature of all developed and growing economies – is a major policy challenge for all countries.

This Enterprise Policy Performance Assessment (EPPA) of Croatia seeks to help address that challenge. The South East Europe (SEE) Compact for Reform, Investment, Integrity and Growth (Investment Compact), a key component of the Stability Pact, has consistently affirmed that the economic revitalisation of South East Europe is primarily dependent on private sector investment. Through the Investment Compact process, Stability Pact partners support and promote the structural policy reforms that will improve the climate for private enterprise and increase investment. Progress has been achieved in various areas. For example, the institutional framework is fairly comprehensive, the budget for small enterprise development is among the most generous in the SEE region and access to finance is improving. Nevertheless, the report shows that the environment for creating and sustaining businesses remains underdeveloped in Croatia. For example, the level of government-business consultation could be enhanced and the business environment could be further simplified. Reforming and improving the environment for entrepreneurship remains a priority.

The EPPA draws on the practical experience and views of Croatian SME representatives, expert advisors and the complementary experience and skills of the Organisation for Economic Co-operation and Development (OECD) and the European Bank for Reconstruction and Development (EBRD), two Stability Pact partner organisations that have been closely involved in the reform process in transition countries.

The analysis and assessments in this report provide valuable insights into the key issues confronting SME owners and managers in Croatia, and the challenges for policy makers. The Investment Compact for South East Europe, will continue to contribute to establishing this framework in Croatia and in the region as a whole through regular up-dates of the information contained in this report.



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## SUMMARY CONCLUSIONS AND RECOMMENDATIONS

### 1.1. Summary Conclusions

Over the last ten years, the SME sector in Croatia has played an increasingly important role in generating new employment and has been able to offer employment opportunities to some of the many workers that have been laid off by large enterprises, following an extended period of downsizing. In 1991 large enterprises employed 75% of the labour force, a figure that had dropped to 37% by 2000. During the same period, SMEs, including the craft sector, increased their share of employment to 63% (Ministry for SMEs, 2001).

This impressive performance was still not sufficient to prevent unemployment rising to levels in excess of 16% by 2000. The data on firm formation in Croatia suggest that there was very low rate of new firm formation in 1997-2001 period resulting in an unsatisfactory job creation rate (Cuckovic, 2003), although unemployment fell to approximately 14% in 2002. The financial position of the SME sector has been weak, with significant problems of liquidity due to late payments of bills by both large enterprises and the state. The financial crisis in the banking sector in the late 1990s indirectly hit the SME sector and resulted in a sharp fall in the share of profits attributed to small firms. The general level of the grey economy decreased since the mid-1990s from 25% to around 10% of Gross Domestic Production (Institute of Public Finance, 2002). The operation of small businesses is still affected, as it represents unfair competition to legitimate SMEs and undermines their financial position. Small firms have grown but have not been able to fulfil their full potential in terms of investment, exports, productivity improvement and growth. For this reason the government has introduced a series of policy measures designed to redress this imbalance and give priority support to the SME sector such as:

- Adoption of the “*Small Enterprise Development Programme (2001-2004)*” in 2001 with policies and incentives to assist the medium-term growth of SMEs.
- Creation of the Ministry of Crafts, Small and Medium Enterprises in 2000.
- Strengthening the SME sector in June 2002, through the formation of the Agency for Small and Medium Business (HAMAG).
- Adoption of the Law on Stimulating Small Enterprise Development in March 2002.

This Enterprise Policy Performance Assessment (EPPA) highlights a number of issues, grounded primarily on insights from SME owners and managers and builds on the recently published reports (EBRD, 2002). It identifies a number of actions needed in order to build further on the progress already made in improving the policy environment for SMEs.

In overall terms, the study finds that good progress has been made by the Government of Croatia in setting out and beginning implementation of new policies to support the growth and development of SMEs. A stronger outreach and partnership with SMEs is needed if the opportunities for growth of the sector are to be maximised.

In line with experience in other countries at a similar stage of transition to a market-based economy, there are some issues emerging relating to policy implementation. It will take a persistent and

determined effort to ensure that implementation is kept on track and momentum maintained. The best way to do this is with regular progress reviews to obtain feedback to identify areas requiring renewed focus.

The main issues identified in this assessment can be summarised as relating to the practicalities of:

- Communicating and consulting effectively with SMEs spread throughout the country.
- Co-ordinating the activities of the various bodies working to support SME development.
- Reducing complexity and ensuring coherency and consistency in policy, laws, regulations, procedures and support programmes, particularly between fiscal and developmental policies.
- Avoiding unnecessary changes in laws, regulations and programmes to facilitate planning of investments.
- Focusing on measures to support potential growth companies and their export levels, competitiveness and technology.

### 1.2. Summary Recommendations

#### ***Institutional Framework***

##### *Co-ordination*

- Co-ordinate SME policy and strategy at State, regional and local levels. Croatia has a highly developed institutional framework for the development and implementation of enterprise policy, however, it is not achieving its full potential due to inadequate co-ordination amongst the relevant institutions. It is the role of the Ministry for Crafts and SMEs to ensure that gaps and overlaps are avoided through regular co-ordination of all the SME stakeholders, including business sector representatives. The Ministry should work with the organisations active in the SME field, co-ordinate national efforts to develop SMEs by building effective co-operation between the key SME stakeholders and disseminate information through web sites and forums to ensure that SMEs are aware of the latest developments and can provide feedback.
- Activate the Agency for SMEs (HAMAG) as soon as possible. In order to accelerate the process of small enterprise policy implementation, HAMAG should ensure that it co-ordinates its activities closely with the Ministry for SMEs as well as other SME stakeholders.
- Implement an Inter Ministerial Group on SME policy. This should be chaired by the Ministry for Crafts and SMEs, including key Ministries such as Finance, Economy, Tourism, Employment, etc. to ensure that the needs of small enterprises are fully considered in national policy-making. The disparate nature of SME policy-making and the limited degree of co-ordination that takes place make this an important issue to tackle.
- Improve co-ordination among different activities of key national and local institutions as well as international organizations that support development of SME sector in Croatia, in order to increase synergies and avoid overlaps.

##### *Consultation*

- Initiate regular and effective dialogue between Government and the business community. Regular consultation has been largely non-existent and SMEs currently feel unable to influence SME legislation and policy in a timely manner. In policy spheres such as tax policy, new legislation and regulations affecting businesses etc. there is an urgent need to introduce regular mechanisms for dialogue between government and the enterprise sector in a manner that is representative of the SME policy community.

##### *SME Development Strategy*

- Apart from focusing on easing the new SME start-ups, it is important to create the institutional environment that would also enable the increase of the survival rate of small businesses, which is currently fairly low. Further strengthening of the capacities for SME development would be beneficial for job creation, competitiveness and technological development of SME sector.

**Local and Regional Government: SME Capacity**

- Strengthen the capacity of regional and local administrations (as well as the Chamber of Commerce) to support SMEs through provision of technical assistance and resources to enhance the capacity of staff in areas such as customer relations, research, policy formulation and implementation focusing on the current needs of small businesses, etc.

**Regulatory Environment****Company Registration**

- Introduce the 30-day maximum rule for company registration and ensure that it operates effectively. Although this measure was announced in 2002 it has not yet been implemented, suggesting a need for further public administration reform to ensure success (e.g. computerisation of commercial courts, land registry, etc.). Some countries in SEE are able to register companies in fewer than 30 days.
- Ensure a greater focus on a “proactive” and “enabling” approach by introducing the principle of “silence is consent” as soon as practical (“silence is consent” is where if the relevant public body fails to answer within a prescribed period, it will be deemed that consent has been given).
- Evaluate the possibility of introducing “one-stop-shop” initiatives with a view to establishing such a system throughout the country, as in the case of other parts of SEE such as Romania (see OECD-EBRD, 2002).
- Introduce on-line registration of enterprises via the e-Government programme.
- Introduce a single reference number for each enterprise, in order to save time and costs to entrepreneurs submitting the same basic information to different bodies.
- Publish, evaluate, and simplify the regulatory regimes that affect the setting-up phase of businesses, as well as the procedures for re-registering and terminating enterprises. This could significantly ease formation of new enterprises in Croatia.

**Business Simplification**

- Evaluate the effectiveness of the Ministerial Task Force on Removing Administrative Barriers and its Action Plan for Reducing Business Barriers, with the active involvement of the Ministry for Crafts and SMEs and HAMAG, once it is established.
- Consider introducing private sector representation in the Task Force, since it consists mostly of civil servants from ministries and other government bodies. This would help raise its visibility to the small enterprise sector and its effectiveness.
- Improve the quality and regularity of consultations between the government and the private sector on draft business legislation. SME stakeholders should be consulted before proposals are converted into law. The Task Force requires sufficient resource and capacity to recommend reforms and monitor implementation.

**Corruption**

- Evaluate the effectiveness of The Office for Preventing Corruption and Organised Crime (USKOK), and its associated action plan even though the levels of corruption are not as significant in Croatia.
- Task USKOK with preparing a report for the Cabinet every six months, charting progress in implementing the action plan. The reports should be subsequently published in order to improve the quality, effectiveness and visibility of the government programmes for reducing administrative barriers, and for reducing corruption.
- Evaluate the effectiveness of the Inter Ministerial Task Force on Grey Economy in order to improve information on the implications for economic development. Private sector should be involved more in this process in order to improve transparency.

**Tax Policy for Small Businesses****Policy Principles**

- The Ministry of Finance, in co-operation with Ministry for SMEs and the SME policy community, should work together to ensure that:

- Simplicity, stability and clarity are achieved in tax policy with respect to SMEs.
- The fiscal administration is made more sensitive to the needs of the SME sector for example how the tax system can negatively affect their cash flow situation.
- Tax laws and regulations are consistently and fairly enforced, regardless of firm size.
- Consultation with SMEs or their nominated representatives on tax issues is carried out regularly.
- SMEs are able to obtain regular, simple and up-to-date information explaining the tax system.

### *Tax Filing*

- Allow small firms to file a simplified tax return without the need to comply with complex accounting standards, thus reducing the compliance burden.
- Enable enterprises to submit tax returns electronically through the Internet.

### *Tax Arrears*

- Strengthen efforts to collect tax arrears, regardless of firm size.

### *Consultation and Communication on Tax Policy*

- Improvement of Government communication strategy on tax policy issues in order to increase awareness and knowledge about tax rates and incentives.

### ***Financial Instruments for Fostering New and Small Businesses***

#### *Type of Government Intervention*

- At present the State is attempting to deal with the lack of long-term bank finance through direct provision of SME finance, using a number of subsidised schemes designed for different segments of the market. This approach is overly bureaucratic, distorts potential competition and provides incentives for rent-seeking behaviour. It is also an inefficient use of public funds and not self-sustainable.
- Provision of finance to the enterprise sector, regardless of size, is best left to private commercially based financial institutions, as this would guarantee the most efficient allocation of savings. Direct provision of government finance to SMEs should be gradually replaced by a lighter touch regulation, including programmes of advice, training, consultancy and networking support, which would enable SMEs to approach the banks as reliable and low-risk business partners to whom the commercial banks would be interested to offer long-term loan capital.

#### *Improving Banks' Lending to Small Clients*

- Commercial banks are increasingly moving into the provision of short-term lending to SMEs. However, banks still favour larger companies on an even larger scale than prior to the last financial crisis. After the crisis and completion of privatisation and bank restructuring, banks have naturally become more risk averse and thus prefer to deal with larger clients. Two suggestions may be made to deal with this issue.
- The smaller local and regional banks have an important role to play in the provision of loans to SMEs, however, they lack SME credit assessment skills. In this respect, the state could take an active role in fostering training opportunities in this field.
- Second, in order to deal with the increased risk aversion of the privatised and restructured banking sector, the state could support the private enterprise sector in setting up mutual guarantee schemes of the type used in OECD countries such as Italy and Germany. These could facilitate SME access to bank loans by overcoming the stringent collateral requirements imposed by banks.
- Financial support to knowledge-based and innovative technology companies should also be easier to access.

#### *Introduce Commercially Based Micro-finance Institutions*

- There are a number of innovative initiatives in the field of micro-credit and credit unions. These are a valuable tool for development of SMEs in high risk, war-affected areas and should continue to receive development support from the state and from international institutions. However, as they

stand they are not commercially based and have little prospect of reaching sustainability. Initiatives in this area should be further developed along commercial criteria.

### ***Advisory Services Supplied to New and Small Businesses***

#### ***Financial Sustainability***

- Continue to prioritise the support to SMEs through national policy focusing on subsidised business support services, especially targeting start-ups. In the longer term, competitive private provision of business advisory services may reduce the need for government or donor-funded initiatives to address market failure, however, this will only happen if there is a greater focus on achieving financial sustainability of the existing initiatives.
- Extend the network of business support services to areas of the country that are currently not covered.

#### ***Quality and Accreditation***

- Introduce a system of certification and accreditation of advisory bodies to set quality standards and improve confidence in the benefits of services. A credible representative body should perform this role.
- Encourage business advisory centres to specify and publish customer charters and to provide specialised services, setting out the range of services provided and the standards they undertake to adhere to. Entrepreneurs need to understand the potential benefits of receiving professional advice before they become more willing to pay for them.

### ***The Implementation of Business Incubators***

#### ***Policy***

- Promote business incubators by disseminating good practice information to entrepreneurs.
- Secure national and international resources in order to promote business incubators effectively.
- Assess the possibility of using business incubators to support enterprise activity in economically depressed regions.
- Evaluate the criteria for entry and exist from business incubators, as well as governance structures, in order to secure greater transparency in their operation.
- Develop training and education programmes for business incubator managers in order to ensure greater compliance with best practice in transition and OECD members countries.
- Ensure that incubators provide more than a physical infrastructure for micro enterprises and SMEs, i.e. in conjunction special advisory, mentoring, training and business consultancy services should be networked as part of the Incubator support framework. Such “soft” services could extend to practical assistance on production methods, quality systems, business development, export marketing, access to loan finance, etc. and could be provided on commercial terms when there is substantial time and input provided.



## *Chapter 2.*

### **INTRODUCTION**

Private investment by Small and Medium-sized Enterprises (SMEs)<sup>1</sup> is a key generator of economic growth and social change in OECD member country economies. In most countries, over 90% of all enterprises are SMEs. It is now widely accepted that the contribution of SMEs to new jobs, exports, innovation and regional development is vital to national development. How to benefit from and maximise this contribution is a continuous challenge for all countries. This Enterprise Policy Performance Assessment seeks to help address that question for Croatia and highlight issues that require attention and priority action.

The State has a fundamental role to play in providing a favourable framework and environment for private sector development in OECD member countries. In the transition economies of South East Europe (SEE), where private investment levels lag behind those of developed countries, the necessity to create an enabling environment for SMEs and private investment is more urgent. Reform of the business and investment environment leading to the creation of a dynamic entrepreneurial culture is crucial to drive the process of change in industrial structures and the transition to market economy structures.

The OECD and the EBRD have undertaken a series of Enterprise Policy Performance Assessments (EPPAs) in SEE countries in order to monitor the development of policies and infrastructures to support the SME sector. Substantial emphasis has been placed in eliciting the views of private SMEs on their experience and perception of the key barriers to business and new investment and their assessment of progress in implementing policies to encourage the development of SMEs.

Previous OECD research has identified six broad dimensions of the framework and environment supporting SME growth and development, which are particularly important for governments to get right:

- Institutional framework for SME policy.
- Rule of law and the regulatory environment.
- Tax policy for small businesses.
- Financial instruments for fostering small businesses.
- Advisory services supplied to new and small businesses.
- Implementation of business incubators.

Croatia has gone through an intense period of democratic, economic and social transition. The Investment Compact, endorsed by the countries of SEE including Croatia, explicitly acknowledges that the revitalisation of region must rely primarily on private sector development and investment (Investment Compact Charter, OECD, 2001). This EPPA captures private sector insights measured against the above six dimensions of good practice. They present views on performance and progress made on the basis of good practice indicators developed for transition economies. They take into account other OECD and EBRD studies (e.g. see EBRD Country Strategy, 2002).

The EPPA research provides a qualitative “snap-shot” of the SME perceptions of the business and investment environment. It highlights issues in need of policy attention and indicates a number of

recommended actions. This report is presented as a contribution to enhance policy dialogue between the key SME representative associations and the supporting State institutions. It will be up-dated on an annual basis, thus allowing a fuller picture to be developed over time.

The methodology employed in the EPPAs is set out in Box 2-1.

#### **Box 2-1. EPPA Methodology**

- I. The EPPA methodology has been designed to provide insights and assessments of the performance in the implementation of policies to improve the investment environment for business. The EPPAs have been conducted on a standard basis in all countries of the region and provide a benchmark for (a) highlighting key reform issues (b) measuring private sector insights and assessments of the business environment (c) assessing progress on a country by country basis and (d) comparative cross-country review for the SEE region.
- II. The main components of the EPPA undertaken in Croatia are as follows:
  - A question template derived from extensive case study work on good practice in transition economies and OECD country experience (OECD-UNIDO, 1999) was used in the research.
  - Country-based experts/consultants were selected for their enterprise policy knowledge and experience.
  - Focus group research: group discussions were held with SME representatives.
  - Individual SME interviews: to validate the focus group research and to provide insights on key issues.
  - Expert interviews: to cross reference information from the focus groups and contribute to views.
  - Desk research: examination of existing reports, databases, documents, etc.
  - Expertise from OECD, EBRD and experts from OECD countries.
- III. Under the guidance of OECD, the focus group research with the private sector in Croatia was carried out by local consultants, *Institute for International Relations (IMO)*, using a structured brief and template of questions developed by OECD and EBRD. The focus group research commenced in September 2002 and other interviews and desk research extended to early 2003. It focused on six dimensions of good practice in the following policy areas:
  - The Institutional Framework for SME policy.
  - Rule of Law and the Regulatory Environment.
  - Tax Policy for Small Businesses.
  - Financial Instruments for Fostering New and Small Businesses.
  - Advisory Services Supplied to New and Small Businesses.
  - The Implementation of Business Incubators.
- IV. In addition to the focus group discussions, individual interviews with SMEs and local experts were carried out during 2002. Representatives of small business associations, advisory agencies, universities as well as central, regional and local administration in charge of small business development (Ministry of Crafts, Small and Medium Entrepreneurship; Croatian Bank for Reconstruction and Development; Croatian Chamber of Commerce; Croatian Association of Business Consultants (CROATEH); Technology Park "TEHNOPARK"; Faculty of Economics, Rijeka; Faculty for Tourism and Hotel Management, Rijeka; Business Incubator PORIN, Rijeka; Centre for SME Development, Rijeka Municipality; Technology Innovation Centre, Rijeka; Office for Economic Development, Primorsko-Goranska County; Centre of Entrepreneurship

Medjimurje, Cakovec; The Chamber of Crafts, Cakovec; The Croatian Employment Bureau, Cakovec; The Sector for Economic Development, Medjimurje County Administration; and the Financial Agency (FINA), Cakovec) took part in the research, allowing for a wider perspective than the focus group discussions. The same template of questions/ratings was employed as for the focus group research.

- V. The findings from the focus groups and interviews obtained through the procedure detailed above were complemented with additional information provided by the EBRD. The EBRD's Office of the Chief Economist has assessed progress in structural and institutional reform across the region since 1994. The EBRD jointly with the World Bank launched the Business Environment and Enterprise Performance Survey (BEEPS) in 1999. The BEEPS asks enterprises to evaluate economic governance and state institutions and assess the extent to which the business environment creates obstacles to the operation and growth of their businesses. In 2002, a second stage of the BEEPS was undertaken, surveying close to 6,000 firms across 26 countries of the region.
- VI. The analysis in this EPPA is based on the methodologies described above (focus group research, expert interviews and secondary data collection) and is complemented by the EBRD assessment and the BEEPS 2002 results. The information has been analysed by the OECD and EBRD, resulting in the assessment presented in this EPPA.

## NOTE

1. The notations SME and small enterprise in this report also includes micro-enterprises, which according to the EU definition ([http://europa.eu.int/comm/enterprise/enterprise\\_policy/sme\\_definition/index\\_en.htm](http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/index_en.htm)) are independent enterprises with up to 9 employees and whose turnover or balance sheet asset value are  $\leq$  €2 million. Small enterprise are likewise defined as having between 10 and 49 employees and turnover or balance sheet asset value of  $\leq$  €10 million and medium sized companies as having between 50 and 250 employees and turnover of  $\leq$  €50 million or balance sheet asset value of  $\leq$  €43 million.



## INSIGHTS FROM SME OWNERS, MANAGERS AND REPRESENTATIVE BODIES

### 3.1. Introduction

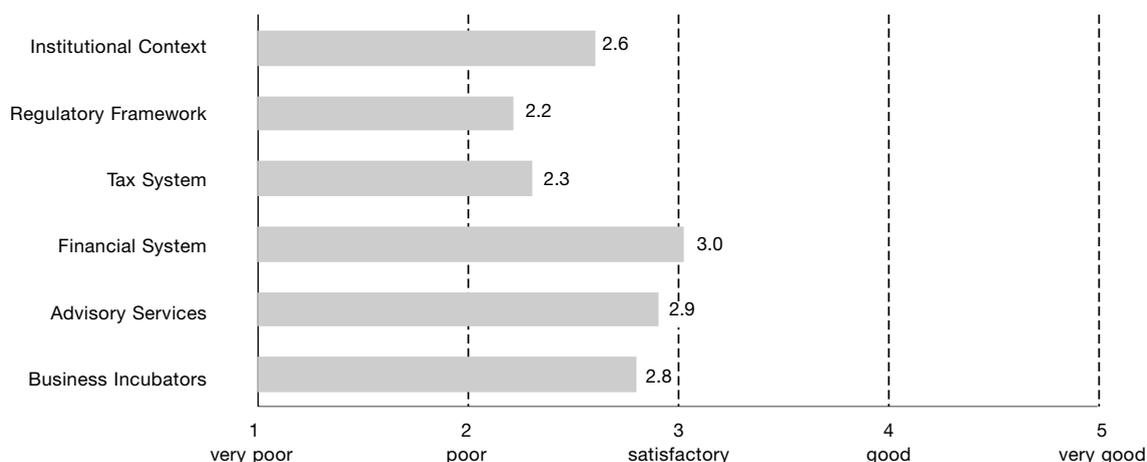
The analysis of the results of the research with the SME focus groups is presented under six framework dimensions of good practice for the business environment:

- Institutional framework for SME policy.
- Rule of law and the regulatory environment.
- Tax policy for small businesses.
- Financial instruments for fostering small businesses.
- Advisory services supplied to new and small businesses.
- Implementation of business incubators.

The analysis highlights the main issues arising from the discussion with the private SMEs participating in the EPPA research. The key questions dealt with in the focus group research are summarised at the beginning of each section. The average ratings used to represent the views of the entrepreneurs range from 1 to 5 and can be read as follows: 1 = very poor, 2 = poor, 3 = satisfactory, 4 = good and 5 = very good.

The average ratings per dimension of good practice are highlighted in figure 3-1. In general, the ratings are poor, with the Regulatory Framework (2.2) and the Tax System (2.3) rated poorest of all (i.e. just above “poor”). The Financial System and Business Advisory Services obtained average ratings at or close to the “satisfactory” point (i.e. 3.0).

Figure 3-1. Average Ratings of the Six Dimensions of Good Practice by SME Owners and Managers



The main points made by the participants during the focus groups are reported verbatim and the quotations most relevant to the analysis are highlighted. Each section concludes with a summary of the issues emerging from the research.

In addition, this chapter presents selected analysis of the Business Environment and Enterprise Performance Survey (BEEPS) 2002 survey. The BEEPS is a survey of 187 Croatian enterprises and, like the focus groups, was carried out in 2002. Of these, 158 were considered to be SMEs (of which 54% micro, 25% small and 21% medium-sized) according to the EU definition for employment (i.e. they had less than 250 employees). The results presented in this document refer only to the responses provided by the SME sub-sample. The BEEPS research is based on a sample survey and is not directly comparable with the focus group research. The BEEPS analysis is presented in separate text boxes (for example, see box 3-1. below) and a summary of main results is contained in Appendix 1.

**Box 3-1. Obstacles to Doing Business (BEEPS, 2002)**

The entrepreneurs were asked to rate the severity of obstacles pertaining to several aspects of the business environment (the scores can be interpreted as follows: 1 = no obstacle; 2 = minor obstacle; 3 = moderate obstacle; 4 = major obstacle). Three areas of analysis overlap with the areas investigated through the focus groups methodology: regulation, taxation and provision of finance. On average they are rated respectively between minor and moderate obstacles. A direct numerical comparison between the two types of analysis is not possible due to the very different formulations of questions asked, however, the results emerging from both sources are broadly consistent. It should be noted that the BEEPS included other areas of investigation in which obstacles of greater severity were identified, such as crime, land (title and access), labour regulations etc.

**3.2. Institutional Framework for SME Policy**

The issues researched under this heading:

1. Clear assignment of organisational responsibility for the development of SME policy.
2. The effectiveness of organisation/s in developing an environment to encourage entrepreneurship and the development of SMEs.
3. The quality and effectiveness of the SME development strategy.
4. The local and regional governments' mandate and resources (funding, people and skills) to promote SME development.
5. The information provided and awareness by business people of the government's institutions, policy and programmes to support new entrepreneurs and develop existing SMEs.
6. The quality and regularity of consultation between government and the private sector on SME policy and its performance and assessment.

**Organisational Responsibility**

1. Has the government assigned clear <b>organisational responsibility</b> for the development of SME policy?	Yes
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Both SME owners and managers participating in the focus groups and the experts that were interviewed believe that the government has assigned clear organisational responsibility for development of SME sector in Croatia by establishing the Ministry of Crafts, Small and Medium Entrepreneurship in the year 2000. However, more than 40% of respondents have reservations about how this is working out in practice and argue that there are many overlapping responsibilities existing at national, regional and local levels:

***“The Ministry [of Crafts, Small and Medium Entrepreneurship] was formed because clear responsibility was lacking since it was spread among several ministries and other institutions. However, the Ministry has not entirely solved the problem of poor co-ordination between different government institutions, where there is often strong competition.”***

***“The existing institutional framework ... is very dispersed ... it often amounts to a lot of uncoordinated individuals who do not co-operate on the implementation of SME programmes.”***

The SME respondents tend to be more critical of government, however, the experts participating in the research suggest that Government has assigned a clear responsibility with regard the development of the SME sector.

**Issues:** Government has assigned clear organisational responsibility for SME policy. However, the policy co-ordination could be improved since there still exists much overlapping of activities, for example, of SME programmes among key institutional players at the central, regional and local levels.

### Effectiveness of the Organisation/s

2. Rating given to the <b>effectiveness of the organisation/s</b> in developing an environment to encourage entrepreneurship and the development of SMEs	2.5
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Both SME and expert respondents assess the effectiveness of the relevant organisations in developing an environment that is conducive to the growth of small business as being less than “satisfactory”. Most of the focus groups discussants consider that the governmental organisations in charge of this task are still struggling to efficiently implement programmes that really encourage entrepreneurship and the development of the SMEs. In elaborating their ratings during group discussion, respondent stated:

***“It is not only important to assign tasks to certain organisations, but it is crucial that they implement the programmes efficiently, and that those at whom the policies are targeted [private small business] participate in the creation of future plans and incentives.”***

***“It is clear that the Ministry cannot solve all the problems with ‘top-down’ policies. Decentralised efforts remain uncoordinated and information is not efficiently disseminated among the small business community.”***

Several focus group discussants stated that:

***“Although the Government launched several interesting employment initiatives such as ‘From University to Work’, its implementation and the realisation of the incentives offered is rather slow and inefficient at the local level. For SMEs it is really hard to wait three months or half a year until we can employ someone under preferential terms.”***

**Issues:** The perception of effectiveness of the SME support organisations is not yet “satisfactory” and could be improved if the dialogue with the private sector is intensified. Top-down initiatives should be reduced and more efforts made to decentralise, including co-ordination of the central, regional and local initiatives.

### SME Development Strategy

3. Rating given to <b>the quality and effectiveness</b> of the SME development strategy	2.7
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Generally, the quality and effectiveness of the present government's strategy for development of the SME sector is assessed as being close to "satisfactory" by SME respondents. Most of the focus group discussants view positively the fact that Government adopted the Strategic Programme for Development of Small Businesses and consider this an acknowledgement of the importance of this sector to the economy.

However, several of respondents had various comments on its content and quality:

***"This strategy seems to favour weak and less developed SMEs, in particular small ones at the expense of already successful and developed enterprises which need additional expansion and technological development in order to cope with growing international competition. All government incentives target small and weak firms [i.e. start-ups]. What we need is technological development that will help us to grow and be competitive, especially in relation to large companies."***

***"We cannot prosper if the emphasis is not to help front-runners and winners but second-rate players."***

**Issues:** The existing strategy for SME development is broadly "satisfactory". In order for the strategy to become more encompassing, there is a perception that it needs to pay greater attention to the needs of established firms with growth potential. More attention should also go towards creating the conditions that could increase the survival rate of the newly formed SMEs.

#### Local and Regional Governments

4. Rating given to the <b>local and regional governments' mandate and resources</b> (funding, people and skills) to promote SME development	2.5
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The focus group discussions give a useful insight into how respondents assess specific elements of the institutional framework and the government's SME policy. Local and regional government resources for SME support in Croatia, their mandate, funding, people and skills are rated between "poor" by entrepreneurs and "satisfactory" by the experts. The entrepreneurs acknowledged that the availability of funding has been increasing, but that the staff skills are poor at the local level:

***"There are still a lot of differences among local and regional administration, in particular regarding the availability of skilled personnel and good programmes for enhancing SME growth. Good role models include the Istrian and Primorsko-Goranska counties. Other counties should follow a similarly pro-active approach in enhancing the entrepreneurship programmes in their areas."***

The focus group discussants pleaded for intensive education and training of local and regional government staff, as this would enable them to better assess the local entrepreneurship development needs and develop appropriate measures and instruments for their achievement. There is a perception that a greater degree of partnership between enterprise sector and local and regional authorities is needed.

**Issues:** The mandate and resources available to support enterprise development were assessed close to "satisfactory". Nevertheless, there is a need to further strengthen and develop the capacity of regional and local development staff, including partnership with the private sector and SMEs.

#### Information and Awareness

5. Rating given to the <b>information provided and awareness</b> of the government's institutions, policies, programmes to support new entrepreneurs and develop existing SMEs	2.7
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Both the SME respondents and the SME experts consider that information is increasingly available on the various activities to support the SME sector. However, the general awareness among the business community of the existence and the sources of specific information is not yet "satisfactory":

***“Information is available, but still not disseminated well to all those interested, particularly at the local level and the war-affected regions. The responsible government organisations should put more effort into finding ways of enhancing awareness of their support and programmes for SMEs.”***

***“Despite significant promotional activities and information campaigns by the Ministry [of Crafts and Small and Medium Entrepreneurship], in particular with regard to their Internet home-page which is [apparently] one of the most visited web sites in the country, there is still a lack of awareness in the small business community and entrepreneurs about the programmes and projects launched and institutional and financial support available at the central, regional and local levels.”***

**Issues:** Efforts are being made to increase visibility and access to information, however, the dissemination of information could be further improved, for example, in order to have wider reach in the less economically dynamic regions of the country.

### Consultation between Government and the Private Sector

6. Rating given to the <b>quality and regularity of consultation</b> between government and the private sector on SME policy and its performance	2.4
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The quality and regularity of consultation is the least satisfactory aspect of the government's policy performance, according to the SME owners and managers participating in the research. These elements of the institutional framework are generally rated as being more “poor” than “satisfactory”.

The focus group discussions with SME owners and managers reflected their dissatisfaction with the present level of interaction between Government and the small business community. They argued that the present level of communication is mostly on an ad hoc basis, for instance when the new SME support programmes are launched or when new laws are enacted. They feel that regular communication mechanisms between two sides are still absent:

***“The consultations between the government and the private sector about SME policy are not practised on a regular basis. We are often not consulted when major policy changes are being adopted by the Government, yet they always expect our enthusiastic support.”***

***“What is lacking is a sense of partnership between the private sector and the Government, rather than a centralised approach to solving problems. The government should remember that we [the entrepreneurs] are the major stakeholder in the process and that our voice should be heard.”***

There was also a more cynical view of what constitutes consultation in Croatia at present in that some SME participants suggested that communication with Government was only good when payment of taxes was sought.

**Issues:** Consultation with the enterprise sector, including the SME sector, is either absent or ad hoc at present. SMEs argue that there is a need to improve the regularity of dialogue and also more proactively include private sector representatives before finalising and implementing new policies and programmes.

### 3.3. Rule of Law and Regulatory Environment

The issues researched under this heading:

7. The procedures for new company registration.
8. The procedures for obtaining licenses, permits and certificates necessary for business operations.
9. The existence of a government approved programme for reducing the legal / administrative barriers for business and rating of the quality and effectiveness of the programme.

10. The efficiency of the programme for reducing the impact of corruption.
11. The quality and regularity of consultation between government and the private sector / SME policy community on draft legislation and regulations that affect business.

### Company Registration

7. Rating given to the <b>company registration</b> procedure	2.7
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Within the generally “poor” assessment of the regulatory framework, by far the most favourable assessment, verging on “satisfactory”, is given to the new company registration procedure. This appears to reflect the recent improvements in the administrative procedures (such as opening the account, registering at the statistical office, registration with tax authorities and pension funds, etc.) and some reductions in the administrative fees to new business entrants (such as easing the procedure and costs of registration for micro enterprises and crafts). Notable comments included the following:

***“The registration of the new firms [in accordance with the present regulations] is relatively easy, however, it could be significantly cheaper, in particular when it comes to paying administrative fees for different permits, licences etc.”***

***“The main hindrance is not regulation but slow, complicated and rather inflexible administration which often operates on ‘discretionary’ rather than professional merits...”***

Nevertheless, there are some differences of opinion. Some of the respondents still consider the registration procedure to be in need of major streamlining:

***“Company registration still involves too many steps, it takes too long and it costs too much when compared with advanced transition countries. ‘One-stop-shops’ would be useful for that purposes. Furthermore, the government should also consider the possibility of on-line enterprise registration, like in some EU countries.”***

***“The registry of enterprises at the commercial courts should be improved, especially in the economically depressed regions [where] ... the shortage of judges can slow down the process.”***

One of the group discussant felt that the 30-day registration limit is not effective at present:

***“Automatic registration within the one month limit would have been a good thing, if it were enforced at the local level. However, I do not have the feeling that our local administration complies with this.”***

**Issues:** The respondents were well aware of the recent improvements made in the process of registration and rated it positively. However, the automatic registration of companies within the fairly high threshold of 30 days is not enforced by law, thus introducing inefficiencies in the process. The commercial court registry offices (and land offices) could be reformed to allow for reduced administrative barriers. There was also a feeling that consideration should be given to the introduction of Internet on-line registration through the e-Government programme.

### Licenses, Permits and Certificates

8. Rating of procedures for obtaining <b>licenses, permits and certificates</b>	2.4
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Both SMEs and experts perceive the procedures for obtaining licenses, permits, and certificates required for business operations as being unsatisfactory and time consuming. The SME owners and managers feel that their quality is very much dependent on where the firm is located:

***“The procedures for obtaining licences, certificates and permits are still not clearly defined and, therefore, particularly in smaller and more remote municipalities and places, very much depend on the arbitrary and discretionary power of the local administrator.”***

The respondents argue that the procedures are also not standardised for all the sectors, an issue that also applies to more advanced economies:

***“Some business sectors and activities, such as transport, health and financial services are over-regulated with respect to obtaining licences and permits, while others are not regulated at all and anybody could start a business. There should be more balance in the market.”***

Obtaining different licences and permits is also perceived to contribute considerably to the high costs of registration:

***“The capital requirements for establishing a company are not the problem. In the past we had much lower capital requirements, but it was not very helpful for dealing with company liabilities later on. The registration costs build up because of administrative fees for licences and permits at various stages of the registration procedure. They are sometimes accompanied by various indirect costs, for instance to comply with licences and permits requirements [e.g. education certificates and location permits].”***

Further business regulation issues identified in the BEEPS survey are referred to in box 3-2.

#### Box 3-2. Business Regulations (BEEPS, 2002)

According to the BEEPS, the aspects of the business environment for SMEs pertaining to regulation (labour regulations, customs and trade regulations, title or leasing of land, access to land and business licensing and permits) are considered to be a less severe obstacle than the focus groups analysis suggests. However, the rating of various aspects of the regulatory environment is rather high, with issues related to business licensing seen as the most difficult for entrepreneurs, followed by customs and trade regulations, labour regulations, issues related to titles or leasing of land and to access to land.

**Issues:** The process of obtaining licenses and permits remains complicated and allows too much scope for interpretation. There is a need to improve the clarity and precision of the procedures in order to streamline the process and curb arbitrary decision-making by local administrators.

#### Simplification Programme

9. Rating given to the efficiency of the programme for reducing administrative barriers for business	1.9
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A less favourable assessment relates to the quality and effectiveness of the government programme for reducing business barriers. The reason for this is quite simply that most of the entrepreneurs responding were not familiar with the Action Programme for Reducing Business Barriers, or indeed aware of the fact that a Government Task Force was established in 2001 to implementing the programme:

***“I did not know that the Government had adopted an Action Programme... It may be helpful for newcomers [start-ups], but it was not helpful for my own business. There was nothing of the kind at that time.”***

***“It is too soon to build an informed opinion about the programme’s success in reducing business barriers ... I do not have the relevant information.”***

**Issues:** Entrepreneurs are not very much aware of the existence of either the Task Force or the associated Action Programme for Reduction of Barriers. There is a need to intensify the Task Force's activities and visibility, perhaps by increasing the involvement of the SME sector and to improve information dispersal and communication with key players.

### Anti-Corruption Programme

10. Rating given to the quality and effectiveness of the <b>Government's programme for reducing the impact of corruption</b>	1.8
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The quality and effectiveness of the government programme for reducing corruption and organised crime is also assessed as "poor". This may, in part, be explained by the fact that many of the SME respondents were largely unaware of the government programme for suppressing corruption and organised crime, undoubtedly accentuated by the fact that the relevant national institution (USKOK) has not been fully operational. There has been a delay in appointing its head, it is reportedly understaffed, and the visibility of its operations is not high:

***"So far, the effects of the anti-corruption work are not visible. We do not feel its benefits."***

***"At the local level you can still 'grease' some stages of establishing your company or its business operations by bribing civil servants. Not all SMEs operate on an equal footing. Winning contracts sometimes depend on how much you can pay to obtain privileged information or services."***

One of the interviewed experts maintained that:

***"The government's anti-corruption programme is too general. What is missing is a concrete programme... with specific actions, as well as clearly defined responsibilities for implementing the programme."***

The constantly changing regulatory environment contributes to this situation by creating ambiguity and uncertainty, thus generating scope for rent-seeking activities (see also box 3-3.).

#### Box 3-3. Corruption (BEEPS, 2002)

Evidence of corruption affecting the SME sector also emerged from the BEEPS analysis. It found that SMEs pay 0.6% of total annual revenues in unofficial payments/gifts to public officials. This percentage is the same as in the 1999 BEEPS. Yet, a smaller percentage of firms is affected by corruption with respect to 1999, according to the same sources. In 1999, 17.7% of those interviewed admitted to having made frequent bribe payments, whereas in 2002, 12.9% of firms did so. Corruption is the sixth most severe obstacle to doing business (out of 21) .

**Issues:** The enterprise sector deals with the issue of corruption on a day-to-day basis. The efforts of the national programme to fight corruption appear to be neither visible nor successful enough for the small business community. Entrepreneurs call on Government for make renewed efforts to deal with this issue.

### Consultation between Government and the Private Sector

11. Rating given to the <b>quality and regularity of consultation</b> between government and the private sector on draft legislation and regulations that affects business	2.2
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The quality and regularity of consultations between the government sector and the private sector on draft regulations and legislation that affect business is assessed as “poor” by the SME respondents, and only marginally better (rating: 2.5) by experts taking part in the research. The respondents frequently remarked:

***“The consultations between small businesses, the government and the union representatives should be intensified in order to produce a better regulatory framework.”***

In this context, the BEEPS survey examined two related aspects of interest. Box 3-4 deals with issues to do with contractual rights and changes to the legal system.

**Box 3-4. Legal System: Contractual Rights and Impact of Unforeseen Changes (BEEPS, 2002)**

Entrepreneurs were asked to what degree they agree with the following statement: “I am confident that the legal system will uphold my contract and property rights in business disputes”, mostly tended to agree as can be seen from the table below.

	%
Strongly disagree	12.0
Disagree in most cases	11.4
Tend to disagree	10.1
Tend to agree	32.9
Agree in most cases	22.2
Strongly agree	5.7
Don't know	5.7

Also relatively more entrepreneurs felt that an unforeseen change in laws and regulations would occur in 2003 and would have a significant impact on their business. The following table shows the specific results for the SMEs interviewed.

	%
Extremely unlikely	8.9
Highly unlikely	21.5
Fairly unlikely	23.4
Fairly likely	18.4
Highly likely	14.6
Extremely likely	7.6
Don't know	5.7

In voicing the views of industry to the Government one of the respondents from Rijeka felt that:

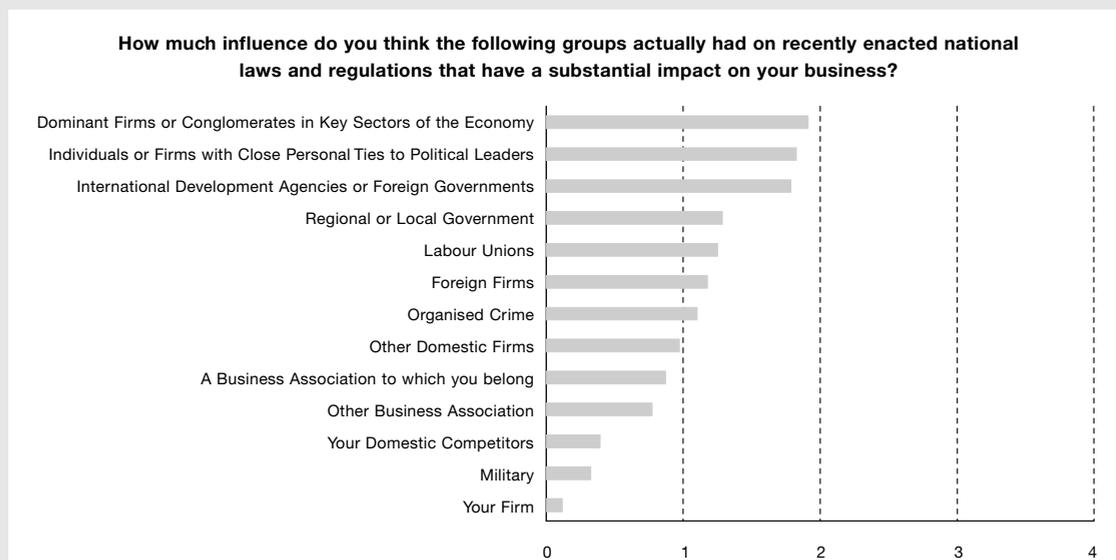
***“Presently the Croatian Employers’ Association has the leading role in voicing the interests of the business firms in the Tripartite Economic Council formed by the government in order to co-ordinate and implement key economic reforms. However, other associations, such as the Chamber of Commerce and***

***Chambers of Crafts, should have a more profound role in this process ... These business associations could perhaps better represent our interests.”***

Box 3-5. examines the private sector's perceptions of the lobbying power of various organisations on the making of laws and regulations. The entrepreneurs interviewed in the BEEPS believe that SMEs and their business associations have almost no impact on the making of laws and regulations.

#### **Box 3-5. Private Sector Perception of Lobbying Power of Various Entities (BEEPS, 2002)**

The entrepreneurs were also asked about the link (in terms of lobbying power) between the legislative powers and regulatory authorities with various organisations and economic agents (the scores can be interpreted as follows: 0 = no impact; 1 = minor influence; 2 = moderate influence; 3 = major influence; and 4 = decisive influence). As can be seen from the chart below, large firms and conglomerates in key sectors of the economy, firms with ties to political leaders, international development agencies and regional or local government are believed to be able to exercise, to a minor degree, some sort of lobbying power on the legislative and regulatory authorities.



**Issues:** The entrepreneurs believe that the quality and regularity of consultation between government and SME sectors needs to be improved through different forums and organisations, in order to better represent the SMEs' interests when new legislation and key economic reforms are being considered.

#### **3.4. Tax Policy for Small Businesses**

The issues researched under this heading:

12. Whether the present tax policy encourages new enterprise and rating of the tax system in terms of the encouragement, support and ease of use that it provides to new and existing SMEs.
13. The stability and transparency of the tax system for small enterprises.
14. The consultation and communication between government and the private sector on tax rates and incentives for enterprises.
15. Co-ordination of tax policy with other government policies.

## Encouragement of Enterprises

12. Rating given to tax policy in terms of the <b>encouragement, support and ease of use</b> that it provides to new and existing SMEs	2.2
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Both SMEs and experts regard the present tax system as “poor” in terms of the encouragement that it provides to the new and existing SMEs. There are various reasons why the SMEs participating in the research think so, the main one being the perception that the tax burden for SMEs is excessive. It should be noted that it is not unusual for entrepreneurs to complain about this issue:

***“The present tax policy is not stimulating the growth of the SME sector. On average almost a half of the net profit goes to pay taxes and that is not easy to bear.”***

The discussion did not simply reflect a criticism of the rates associated with the present tax system. There were also proposals as to how the tax system could stimulate the growth of small business:

***“A gradual increase in the corporate tax rate for new firms would allow faster growth of SMEs.”***

***“New businesses should be granted tax incentives, such as 100% tax exemption on income and profit for the first year in business, reduced to 50% in the second year of business and 25% in the third year.”***

It should be noted that some of the SME representatives did recognise that this gradual phasing in of taxation for new businesses had the drawback of reducing the corporate tax revenue for the state, as the life-span of SMEs could either naturally or artificially be made to coincide with the time-span of the tax incentives. Other SME discussants noted that this sort of tax incentive existed in Croatia and that previous experience shows that incentives are not as crucial as the stability and predictability of the tax system.

Both groups of respondents assess the ease of use of the tax system as being less than “satisfactory”. In particular the administration associated with the VAT tax is mentioned as causing difficulties. The respondents recommend certain actions to ease the situation for small enterprises:

***“The VAT tax threshold [85,000 Kuna per annum or about €11,333] should be raised for SMEs.”***

***“Small ... companies should be offered the opportunity to pay VAT, not on the basis of invoices, as is currently required, but upon receiving payment for goods and services sold. These enterprises are vulnerable when their customers do not pay. Taxing them at the moment of invoice affects their fragile liquidity.”***

**Issues:** The SME representatives do not consider the tax system to be easy to use or to encourage SME development at present. Apart from reducing the perceived high tax rates, they encourage the government to consider tax incentives to assist new companies. The administration of VAT could be reviewed in order to encourage greater cash-flow flexibility for small enterprises.

## Stability and Transparency

13. Rating given to the <b>stability and transparency</b> of the tax system for small enterprises	2.6
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Experts assess the stability and transparency of the tax system as being “satisfactory” (rating: 3.1), while SME owners and managers participating in the focus groups do not quite consider them to be “satisfactory” (rating: 2.6). The main concern relates to the lack of stability arising from changes to the tax system, however, views here are somewhat divergent. Some entrepreneurs feel that there is a sense of stability of the tax system:

***“The changes were not very frequent and do not occur without notice. Although this has its advantages as it makes our business predictable, we would welcome changes in the tax policy that would bring further incentives for the small business.”***

Others maintain a different perspective:

***“The tax system changes frequently. Every new government seems to have its own perceptions about the tax system. Tax rates change in different directions. I do not consider it stable, particularly as the government announced future changes, for instance in income tax base, introduction of new rates, etc.”***

There is a perception among most of the SME group discussants that the tax system is not transparent enough to be considered “satisfactory”:

***“... tax incentives offered, for instance for the newly employed categories of population such as war veterans, invalids, graduates, are not very clear to us.”***

***“The Government should make more effort to distribute information about tax [rates and] incentives, so that they are clear to everyone who is interested.”***

During the focus groups, there were animated discussions among the SME respondents about future direction of changes in the tax policy and tax rates. Some argue that the tax system should be simplified and the same rates should apply to all enterprises in the interest of transparency and fairness. Others plead for special rules and incentives targeted only at the SME sector.

**Issues:** Further stability and simplification of the tax procedures for micro and small enterprises is demanded. Other than this, there is little uniformity in how the respondents believe the tax system could be improved to assist the development of the sector.

#### Consultation and Communication on Tax Policy

14. Rating given to the <b>communication between government and the private sector</b> on tax rates and incentives for enterprises	2.0
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The participants in the focus groups regard the Government’s communication with SMEs on tax rates and on incentives for enterprises as being “poor”. The main reasons include the perception of inadequate responsiveness to proposals coming from SME community and that the incentive programmes and drafts of the new laws are not adequately presented for discussion and comment before being adopted. The SME group discussants feel in particular, that they are not well represented and that large firms dominate discussions on tax policy. There is also a strong perception that factors such as those relating to stimulating start-ups and fragile new firms predominate in the policy-making process, to the exclusion of other issues such as supporting technological growth and innovation. Finally, there is a perception among SME representatives that other “big” economic development issues dominate the tax policy debate, taking precedence over the concerns of small business:

***“The Government is only concerned about its budget, IMF fiscal policy requirements for reducing the fiscal burden and harmonisation with EU tax legislation and standards. It shows far too little interest in how to help develop SMEs by responding to our needs.”***

**Issues:** Consultation with the small business community regarding the new tax rates and incentives is currently not viewed as being a Government priority, as compared with for example, fiscal requirements and harmonisation with EU rules and regulations. There is a strong perception that large enterprises are better placed to influence tax policy and that the small enterprise sector does not currently have an adequate “voice” in the debates.

## Co-ordination of Tax Policy

15. Rating given to the tax policy <b>co-ordination with the overall government policy</b>	2.2
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The SME discussants were also critical of the lack of co-ordination of tax policy with the other government policies. The prevailing perception is that the present tax policy should work “hand-in-glove” with other policies aiming at strengthening economic development and integration with the EU. The discussions reveal a degree of dissatisfaction with the role played by the present tax policy in strengthening possibilities for SME development, since they are not considered to be stimulating in nature and are much more tailored to the needs of large enterprises:

***“Co-ordination with other Government policies should be strengthened... there is an almost insurmountable gap between our wish to lower tax rates and the need to increase state funding to support infrastructure for small business development.”***

According to the 2002 BEEPS, the two aspects of the business environment for SMEs pertaining to taxation, tax rates and tax administration are rated at 2.6 and 1.9 respectively on the BEEPS scale, indicating moderate/minor obstacles to doing business.

**Issues:** Tax policy is not perceived to be co-ordinated very well at present and supportive of SME development. It is viewed as being more geared to the needs of the large enterprises, than the vast majority of firms belonging to the small enterprise sector.

### 3.5. Financial Instruments for New and Small Businesses

The issues researched under this heading:

16. The stability, competitiveness and services of the banking system.
17. The commercial banks' interest in extending credits to the SME sector and lending attitude with respect to the SME sector.
18. The SME access to the following main sources of finance:
  - Own/family capital.
  - Micro finance.
  - Venture capital/Equity.
  - Repatriation capital (from family / friends abroad).
  - Commercial banks.
  - Leasing.
  - Credit reference sources.
  - Bank personnel skills.
  - Others (e.g. credit unions).
19. The availability of finance for SMEs at local and regional level.
20. The availability of funding for all sectors including technology companies.

### Stability, Competitiveness and Services

16. Rating given to the <b>stability, competitiveness and services</b> provided by the banking system	3.3
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The survey respondents consider that the banking system's stability (rating: 3.3), competitiveness (rating: 3.3) and provision of services (rating: 3.2) is generally “satisfactory”, one of the best ratings in the SEE region. There is a general perception that since 2002 there has been an increased degree of stability in the banking sector, as well as greater levels of competition among banks. These have had a positive knock-on effect on the range of banking services available. The SME group discussants attribute this to

the entrance of major foreign banks into the banking sector via the privatisation process, which has had a beneficial influence, banking services being delivered to clients. There is awareness among the participants that the banking sector in Croatia is largely (more than 90%) owned by foreign investors. The discussants emphasise that this influence is felt through a general lowering of interest rates and an increase in the availability of funding, including resources for small business development. The SME experts were even more positive about these developments and rate them between “satisfactory” and “good” (rating: 3.6). The following points illustrate the improvement in the banking sector:

***“The general stability of the banking sector has increased since 1999. There have not been further crises in a sector that most SMEs heavily depend on. The consolidation of banking industry increased tremendously with take-overs by foreign-owned banks. This has also generated new standards of service.”***

***“The interest rates dropped considerably when compared to the late 1990s. This makes a great difference if you plan to start a business. No one could have achieved a profit rate of 15-18% in the first year of business operation. That was the minimum required if you wanted to meet the loan costs.”***

**Issues:** The banking sector is rated as being broadly “satisfactory” in terms of its stability, competitiveness and the services on offer. Much of this appears to be a result of new players and foreign direct investment. The associated increase in competition and liquidity in the banking sector is expected to be reflected in further reductions of interest rates for commercial loans, as well as increases in lending and the range of services provided to SMEs.

#### **Banks’ Interest / Attitude to SMEs**

17. Rating given to the commercial banks <b>interest in developing SMEs and their lending attitude</b> to the SME sector	2.6
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The SME experts feel that commercial banks are interested in developing the SME sector by extending credit to small businesses, rating this as “satisfactory” (3.0), while the rating from the SME owners and managers participating in the focus groups was slightly lower (2.6). There has been an impressive improvement in the delivery of SME finance by the banking system in recent years. The discussants refer to the availability and affordability of bank loans as a result of increased liquidity and a reduction of the level of the interest rates. Nevertheless, it would appear that the SMEs still experience a degree of discrimination in the financial services provided through commercial banks. There is a perception that banks, not unnaturally, rely heavily on their experience with established clients, however, this tends to discriminate against new clients since there is limited information about their ability to repay loans.

The entrepreneurs’ concerns as regards the availability of bank loans concentrated on the process of assessing credit applications:

***“The commercial banks still fail to assess good business ideas and plans ... Instead, in approving loans, their decision is primarily based on collateral, such as outstanding mortgages on real estate. Small entrepreneurs without property to guarantee loans have virtually no chance of obtaining funds from commercial banks.”***

***“The banks should work more closely with the Ministry [for SMEs] for the provision of guarantees for loan repayment since very few new entrepreneurs can provide adequate property as collateral for banks.”***

One of the SME experts notes the possibility for developing mutual guarantee schemes:

***“Consideration should be given to the development of private associations/consortiums of local SMEs that would serve as mutual credit guarantee funds providing guarantees to banks for either a member or undertaking new initiatives considered to be important from a local economic development perspective. There***

***is a lot of experience, for instance in Italy, that we could learn from ... it would also demonstrate that we do not need to rely on the Government all the time.***

The SME owners and managers recognise that the general situation has improved and, with it, SMEs' access to finance. The general perception of the SME discussants in the focus groups is that the commercial banks' lending attitude is much more positive than during the 1990s:

***“The competition generated by foreign banks has brought higher accessibility to credit ... It was unimaginable, even 3-4 years ago, that the interest rates for small business loans would drop to 7-8%. That is remarkable.”***

**Issues:** The commercial bank approach to SMEs is perceived to be much more positive than in the late nineties, however, entrepreneurs believe that banks should enhance their SME lending operations by focusing more on the quality of the business plans and ideas, rather than just on established relationships and asset backed lending. They suggest that attention should be given to developing state credit guarantee schemes, as well as mutual credit guarantee schemes in order to assist small enterprises.

### Access to Finance

18. Rating given to the <b>access to key sources of finance</b> and guidance on financial matters to small businesses	2.5
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The most accessible form of finance, as in other countries, is capital from family/friends/own capital. The group discussions reveal that most entrepreneurs start their businesses on the basis of these types of funds. The respondents argue that prior to 2000, commercial bank loans for start-ups were very unfavourable and most SMEs would not have coped with payment schedules, with the consequence that there was little choice but to use other forms of start-up capital. This source of finance, in particularly family savings, is still considered by the respondents to be much more attractive when seeking to expand business operations:

***“I would still rather rely on assistance from family members or borrow from a friend than go to a bank... this might sound conservative, especially now that banks are offering better credit terms.”***

Access to leasing services is rated as being close to “satisfactory”. Most of the SME group discussants were aware of this potential source of capital and that it can assist them to develop their businesses. They feel that the availability of leasing sources has increased in the last 3-4 years, especially when it comes to the leasing of sophisticated production equipment such as electronic machines and computers, as well as company vehicles.

Table 3-1. Relative Importance of Main Financial Sources Accessed by SMEs

Financial Sources	Rating	Ranking
Family or own capital	3.5	1
Leasing	2.9	2
Commercial Banks	2.7	3
Micro-finance Funds	2.4	4
Credit Unions and Other Sources	2.2	5
Repatriation Capital	2.2	6
Venture/Equity Funds	1.7	7

Note: The ratings used to represent the views of the entrepreneurs range from 1 to 5 and can be read as follows: 1 = very poor, 2 = poor, 3 = satisfactory, 4 = good and 5 = very good.

Access to commercial bank credit is rated as “satisfactory” by the SME experts (rating: 3.5), but less so by the SME respondents (rating: 2.7). Although access to finance is not as great a problem for SMEs in Croatia as elsewhere in SEE, there is some way to go before the situation improves for small enterprises:

***“Yes, the availability of commercial bank lending to small entrepreneurs has really improved but it is not yet satisfactory. In my everyday contacts with banks, I cannot easily persuade them to finance the expansion of my business. What I need is a bank officer who is more sensitive to good business ideas, not someone who primarily thinks about how to make a safe profit for a bank.”***

Box 3-6 examines the sources of finance for SMEs’ needs.

#### Box 3-6. Sources of Finance for SMEs’ Needs (BEEPS, 2002)

According to the BEEPS, the two aspects of the business environment for SMEs pertaining to finance (cost of and access to capital) are rated between modest and moderate obstacles to doing business. They are ranked eight and seventh in the set of 21 potential obstacles to doing business. Overall, the survey results highlight that the relative severity of the financial obstacles appears to be secondary to economic policy uncertainty and macroeconomic instability, functioning of the judiciary, corruption, high tax rates and anti-competitive practices. Supporting this finding, an analysis of the sources of finance used by the Croatian entrepreneurs in the past to finance both their working capital needs and new investments shows a far smaller reliance on internal funds and loans from family and friends than in the other countries of the region (59.1% for working capital and 52.4% for new investments). Local banks and equity providers play a modest but significant role in relative terms. However, only 66% of enterprises interviewed manages to find any type of funds (be they internal or external) to make new investments, against 92% of firms finding finance for working capital needs. The following table presents the relevance of sources of finance used by interviewed entrepreneurs for working capital needs and to finance new investments in percentage of total.

Source of Working Capital		Source of New Investment	
Internal funds	55.5%	Internal funds	50.0%
Equity	10.4%	Private local banks	9.7%
Private local banks	8.3%	Other	7.6%
Other	6.9%	State-owned banks	6.3%
Supplier credit	4.4%	Equity	6.2%
State-owned banks	3.6%	Leasing	5.3%
Family/Friends	3.6%	Foreign banks	5.2%
Foreign banks	2.6%	Government	2.7%
Leasing	1.9%	Supplier credit	2.7%
Government	0.9%	Family/Friends	2.4%
Credit cards	0.8%	Money lenders	1.3%
Money lenders	0.7%	Credit cards	0.5%
Customer credit	0.4%	Customer credit	0.0%

Respondents rate access to more specialised sectors of the finance market, such as micro-finance, as being less than “satisfactory”. The micro-finance sector is not well established in Croatia, with the exception of a few well-known schemes such as: Credit Union Alliance, CRS/MIKRO PLUS and NOA. These are considered to be fairly limited in scope, not least as they tend to be targeted mainly at the economically depressed and underdeveloped regions (mostly war-affected areas and focusing on agriculture and crafts) and the maximum loan is 35,000 Kuna (€4,660).

Credit unions have a presence in the agricultural sector but they are not widespread, a feature which may account for the difference in views over access to this instrument between the small entrepreneurs and the experts participating in the group discussions. Unlike the latter, the former rates access to credit union finance as being more “poor” than “satisfactory”. Similarly, access to repatriation capital was rated as “poor”. Venture capital is considered an area of SME finance that needs improvement.

Box 3-7. analyses the SMEs’ perception of the ease of obtaining bank loans.

**Box 3-7. SMEs Perception of Ease of Obtaining a Bank Loan  
for Working Capital/Investment Needs (BEEPS, 2002)**

A question was asked regarding the entrepreneurs’ perception of the ease with which they would be able to obtain a loan from a commercial bank for both working capital needs and for financing a new investment. Despite the very positive results in the questions regarding sources of finance used, the answers to this question still point to difficulties in dealing with the banking sector. Only 54% of entrepreneurs think it would be easy to obtain a bank loan for working capital needs and fewer than 39% are of the same opinion as regards obtaining finance for new investments. It is worth noting that SMEs believe that accessing bank loans for the financing of new investments is relatively more difficult than accessing working capital loans from banks. The entrepreneurs’ responses to this question are presented below in percentage of total.

Accessing Bank Loans for	Working Capital	New Investment
Impossible	7.0%	6.3%
Very Difficult	10.8%	17.7%
Fairly Difficult	16.5%	24.1%
Fairly Easy	33.5%	22.8%
Very Easy	20.3%	15.8%
N/A	12.0%	13.3%

The respondents were generally satisfied with the quality of guidance on financial matters from credit reference sources and from bank personnel, although the experts’ responses tend to be more positive.

The overall situation with regard to access to finance is encapsulated by the following view:

***“The menu of financial sources available to small businesses has improved greatly in Croatia. The critical issue is no longer the availability of financial sources, but the inappropriate assessments of the quality of business proposals, particularly on the part of banks which seek to insure themselves against risk by insisting upon very strict collateral requirements from entrepreneurs.”***

**Issues:** Although access to finance has improved and is considered to be satisfactory, the range of sources of finance could be further improved. SME respondents wish to have greater access to venture capital funds, micro-finance and guarantee funds (of both mutual and traditional type). They also demand a more business development approach and less risk-averse approach in bank lending as regards high collateral requirements.

**Access at Local and Regional Levels**

19. Rating given to the access to finance at <b>local and regional levels</b>	3.3
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Access to financial sources at the local/regional levels is generally rated above “satisfactory”. The respondents feel that the availability of funding has been substantially increased in the last few years with the establishment of several regional and local development agencies focusing on SMEs, which are funded either from state or county / municipality budgets. However, the SME entrepreneurs trying to drawdown these resources consider that there is still scope for improvement:

***"Access to finance for the SME sector is available at local and regional level, however, the funds assigned for this purposes are still insufficient."***

***"More small business alliances, such as clusters, are needed at the regional level ... to promote more intensive links between large and small enterprises. Such initiatives could also have more success in obtaining funding."***

**Issues:** Regional and local funding has increased in Croatia, but remains at relatively modest levels. Initiatives such as inter-regional clusters, sub-contracting schemes and cross-border initiatives offer potential for business development.

### Access by sectors

20. Rating given to the access to <b>financial sources for all sectors</b> including technology companies	3.1
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There is a broadly favourable response to the issue of whether there is access to financial sources for all economic sectors of activity, including technology companies. The respondents regarded this as “satisfactory”. The SME owners and managers were slightly more critical than the SME experts (3.3) regarding the general access to the financial sources. What is lacking, according to the focus group discussions, is a greater recognition by banks, venture capital funds and government of the potential offered by fast-growing SME technology companies and appropriate policies and funds to support initiatives such as industrial clusters and business networks focusing on such areas as information technology, electronics and machinery.

**Issues:** Financial sources are perceived to be available for all sectors, however, more could be done to assist high growth SMEs including knowledge-based and innovative technology oriented companies in certain sectors. Both government policy and the financial means to support these initiatives are considered to be under-developed in Croatia.

### 3.6. Advisory Services for New and Small Businesses

The issues researched under this heading:

21. Satisfaction with the range and quality of advisory services available to new entrepreneurs and SMEs and rating of the present services and comment on the changes needed.
22. Efficiency of advisory services operations.
23. Responsiveness of advisory services provided to demand and the needs of enterprises.
24. The skills, experience and quality of the staff providing business advisory services.
25. The continuity of business advisory services available.

#### Range of Advisory Services

21. Rating given to the satisfaction with the <b>range of advisory services available</b> to new entrepreneurs and existing SMEs	2.9
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In contrast to the other dimensions of good practice in this report, the SME owners and managers tend to be more positive in their evaluations of the advisory services on offer than the experts. The SME respondents rated all aspects of the advisory service provision as (or close to) “satisfactory”.

For example, the range of advisory services available and being provided is assessed as being close to “satisfactory”. Nevertheless, there is still a widespread opinion that advisory services are not yet meeting entrepreneurs’ needs. Some experts hold that: **“... consultancy services are better in larger cities than in small ones”** or indeed in the rural areas, where the provision is either rudimentary or non-existent.

Although the respondents assess the range of advisory services to be broadly satisfactory, they still maintain that the business advisors/consultants within the advisory/business centres require more skills and training in order to broaden the scope of the services. For example, the respondents from Medimurje County were satisfied with the range of advisory services, but not with the degree of specialisation:

***“The production of business plans and investment studies is quite good, however, specialist services such as finance and tax consulting are missing. That is why we need to invest more in specialist services than we do today.”***

**Issues:** Although the range of services provided is generally seen as fine, further geographic spread and skill specialisation is needed. Knowledge of issues such as production and technological development, risk management, debt refinancing etc. is considered to be lacking in the advisory agencies.

#### Efficiency of Advisory Services

22. Rating given to the <b>efficiency of advisory services</b> available to SMEs	3.0
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The efficiency of the advisory services in Croatia is perceived to be “satisfactory”, however, the SME respondents also state that there are problems with such services:

***“Advisory services operate very much according to the mentality of their staff. Private services are expensive and those that are publicly-provided tend to be scarce, vague and not well targeted.”***

***“No effective advisory network exists, although there have been some efforts to create an ‘umbrella’ network. Advisory services are polarised and a well functioning network at national level is lacking.”***

***“What we need in order to develop an effective advisory service is good information about all the services available, be they privately or publicly-provided. A place where we could come, state what we need and obtain assistance to find an appropriate adviser.”***

There is also a perception that business consultants’ charges for their services are high:

***“While access the basic information is mainly free, all other levels provision of information and advice to SMEs are relatively expensive.”***

Associated with this, the SME discussants also had some views on the quality of the business consultants:

***“A certifying procedure for advisory services should be introduced in order to ensure that those who provide advice to the SMEs comply with minimum criteria and standards, such as the level of education.”***

There was discussion of the role of the Chambers of Commerce exemplified by the following comment:

***“The Chambers [of Commerce] must retrain their staff to provide consultancy services to their members ... the state should develop the level of professionalism of individual business consultants and improve their networking links.”***

**Issues:** Although the efficiency of advisory services is considered to be “satisfactory”, more could be done to improve the standards of the advisory services, public and private, in order to improve their capacity and quality through, for example, introduction of minimum standards for bodies providing business services to enterprises.

### Responsiveness to Demand

23. Rating given to the <b>responsiveness of advisory services</b> to demand and needs	2.5
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Both the experts and SME owners and managers regard the services provided to them to be only partly responsive to the needs of enterprises. They argue that this is particularly acute in small towns and less developed areas, such as Eastern and Western Slavonija, the Dubrovnik area, Banovina region etc.:

***“Only the advisory centres in the cities have adequate business services. In smaller places, this type of assistance to small businesses is still very poor. Even the Chambers of Commerce and Chamber of Crafts lack adequate advisory services, so the State administration should seek to support the development of independent business consultancies as a profession in this country.”***

The general perception of demands and needs regarding advisory services can be summarised in a statement by an SME representative:

***“I think the demand for specialised advisory services is much higher than what is actually available. It is hard to obtain assistance with issues such as: how to find new markets for our products and services, how to improve company management, how to cut expenses, how to improve financial management, how to refinance old loans, how to obtain funding for good projects, how to make better use of human capital, how to find funding for technology development, etc. So we all improvise ... There really is a need for more sophisticated advisory services than those that operate on general, basic information.”***

**Issues:** The existing advisory services are perceived to be partly responsive to enterprises’ needs, though the geographical coverage is uneven, with more remote places lacking such support. There is a strong perception of the need to move beyond the provision of basic business advisory services to specialised services with the capacity to add significant value to companies’ operations.

### Human Capital

24. Rating given to the <b>skills, experience and quality of the staff</b> providing advisory services	3.0
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Regarding the skills, experience and quality of the staff providing business advisory services, SME respondents consider them as “satisfactory”, although the perception does vary according to personal experience and on the stage of development of the provision of advisory services:

***“The market is very mixed. I have met superb consultants as well as real ‘comedians’. There are also some very average foreign consultants operating in Croatia. We should select business consultants more carefully in future!”***

As far as the general quality of the local staff is concerned, there is a recurring theme about the need to upgrade skills and to move beyond the provision of basic enterprise-oriented services:

***“Apart from certified consultants, who are fairly scarce, most advisory agencies are short of really skilled staff.”***

***“The consultant I need is not one who knows how to obtain a loan from a bank, but one that can help me develop a successful business project, that can help me to grow technologically and financially. I need someone who really knows my branch, its products, the market needs, etc. I would say that further specialisation and education are the most important directions for the advisory sector in Croatia.”***

Some experts were of the opinion that the need for further training applies doubly so to publicly funded services:

***“Most public sector business advisors are in need of additional training or they should serve as a link between clients and private consultants [rather than attempting to provide the services themselves]. They should seek to improve their communication skills with clients considerably.”***

**Issues:** A system of continuous education and training is expected, in due course, to lead to the kinds of services that are increasingly being demanded by SMEs. This applies also to the public provision of such services, where there is also a perception of a need to improve the communication skills with client, especially at the local and regional level.

### Continuity of Provision

25. Rating given to the <b>continuity of advisory</b> services available	3.1
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The continuity of provision of advisory services is perceived as “satisfactory“ by SME owners and managers, in particular in the capital city and Medjimurje county, where business advisory centres are known to be better established and experienced. It is argued that some business consultants are better qualified than others, particularly members of the Croatian Network of Consultants (HMK) or holding some other form of international professional certification. It is argued that it is difficult to assess quality without some degree of professional certification, which does not yet exist in Croatia. The problem of securing continuity of provision is acknowledged to be partly related to the relatively short-term strategies of international donors and International Financial Institutions (IFIs), and their associated funding regimes.

Entrepreneurs in Medimurje County also evaluated this aspect as being “satisfactory” in their area, however, this is also considered to be problematic in the economically depressed areas:

***“We are lucky. The Centre for Entrepreneurship Development is one of the oldest centres in the country and is continuously extending its services and links with both domestic and international networks ... but I doubt this is the case in underdeveloped regions.”***

**Issues:** The continuity of provision of advisory services is difficult to secure, particularly when related to internationally funded provision. There is a need for a greater focus on securing the longer term financial sustainability of business advisory services. Continuity of provision is considered to be particularly difficult to secure in economically disadvantaged or more remote locations.

### 3.7. Business Incubators

The issues examined under this heading were:

26. Experience with business incubators and importance to new entrepreneurs and existing SMEs.
27. The efficiency of the government policy and programme encouraging business incubators.
28. The state of the business incubators’ governance structures.
29. The locations, the infrastructure and facilities of business incubators.
30. The extent to which the business incubators’ activities are focussed on the needs of the local entrepreneurs.
31. The extent to which the operating conditions, services and charges are transparent and clear.

### Experience of Business Incubators

26. Rating given to the business incubators’ <b>importance</b> to new entrepreneurs and existing SMEs	3.3
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Business incubators were first established in Rijeka and the participants in the focus group from that region have the most extensive knowledge of business incubators. By contrast, those from Medimurje County have limited knowledge and experience of such institutions, but are fully aware of their importance. Generally speaking, the interviewees from Rijeka believe that business incubators produced very good results in the last few years. However, the experts from the Technology Innovation Centre (TIC) stress that their impact on entrepreneurship is quite limited, mainly because of a lack of suitable follow-up infrastructure such as offices, land and facilities. An expert reinforces this view:

***“... they are valuable, but need to develop sound plans for clients vacating at the end of contract period. Labin incubator is the best in this respect.”***

According to the Ministry for SMEs, business incubators are considered to be an important tool for enterprise development and can have a positive impact on new and existing entrepreneurs, especially in the provision of office and production space needed in the early years following the establishment of firms:

***“There are eight (active) incubators in Croatia and the Ministry for SMEs supported their activities in 2002. We see problems with certain issues, such as the quality of incubator office/production space, the unsystematic selection criteria for entrepreneurs and other issues to do with follow-up.”***

Another view related to the significance of business incubators in the context of regional development:

***“Business incubators should be implemented in all regions, for example in unused state-owned property ...[or in property belonging to] bankrupt companies.”***

Overall, the respondents argue that further business incubators should be created but there is a need to market them and the potential benefits to SMEs since:

***“There is still a rather limited number of business incubators and the entrepreneurs are sometimes not well informed about the main purpose of these organisations.”***

**Issues:** Business incubators are known to be a potentially valuable policy tool for enhancing start-ups and early growth firms. There is a perception that they could be better established and promoted, for example in economically depressed regions and by converting unused State property into business incubators.

### Government Policy

27. Rating given to the <b>efficiency of the government policy</b> encouraging business incubators	2.5
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The Government’s policy in relation to encouraging business incubators is not considered to be “satisfactory”. As discussed above, the Ministry for SMEs seeks to support the development of business incubators, however, the resources available to support business incubators are not substantial (€125,000).

One of the main issues discussed in the focus groups with respect to the policy and programme for encouraging business incubators, relates to the necessity to have the skills to make them work:

***“The problem is not establishing incubators. If they are to work, the human factor becomes important. We lack good business incubator managers, as well as the mentors to support them.”***

***“The existing business incubators... need experts with a broad education and very specific skills within the field of entrepreneurship. Qualified incubator managers and better state [financial] support are the most essential factors for future programmes encouraging business incubators.”***

Some discussion focused on who is best placed to take the lead in developing business incubators:

***“The initiative [for the establishment of business incubators] came from the local authorities, not from central government. This is natural, since they know best about the scope and conditions for the development of small business. A ‘bottom-up’ policy approach is much more efficient than a ‘top-down’ one in this respect.”***

**Issues:** The government has developed a policy to assist the development of business incubators, however, this is currently not well funded. Entrepreneurs argue that Government should assess ways of providing additional infrastructure suitable for the establishment of business incubators. A key issues raised in the discussions is the necessity for the human capital to be developed in order to assist the effective implementation of business incubators.

### Governance Structures

28. Rating given to the business incubators’ <b>governance structures</b>	2.3
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The SME focus group respondents consider that a key issue for the further development of business incubators is the improvement of their governance structures. This is currently assessed as being “poor” and it was noted that business incubator managers require training and education on governance issues, especially from successful transition countries and OECD member countries.

### Locations, the infrastructure and facilities

Due to the lack of specific knowledge by participants no feedback was obtained on this question.

### Focus on Needs

30. Rating given to the extent to which the business incubators’ activities <b>satisfy the local entrepreneurs’ needs</b>	3.0
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The experience of business incubators is generally regarded as “satisfactory”. One of their main strengths is perceived to be the way they help satisfy the needs of local entrepreneurs through provision of business space, equipment and offices at reduced rents. But there is also a degree of criticism with regard to what is on offer:

***“Although incubators provide cheap or free office space, in particularly in the first year of the firms’ operation, such spaces tend to be rather old and inadequately equipped with regard to the basic facilities needed such as computers, faxes, copy machines, etc.”***

***“Only a few business incubators in Croatia are fully functional. Interested entrepreneurs are not always well informed about their main purpose or the facilities on offer.”***

**Issues:** Incubators are perceived to satisfy local entrepreneurs’ needs, not least because they assist start-ups when they are most vulnerable. There is a perception that the facilities available tend to be fairly low in quality and that potential new entrepreneurs need to be made more aware of the benefits of using a business incubator.

### Transparency

31. Rating given to the extent to which the operating <b>conditions, services and charges</b> are transparent and clear?	3.1
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The respondents consider that the degree of transparency of such factors as operating conditions, services and charges made by business incubators in Croatia are generally “satisfactory”. This perception is mainly based on information publicly available in their respective regions, rather than on first-hand experience. Nevertheless, there are also critical perspectives on this issue:

***“Business incubators only partially satisfy entrepreneurs’ needs for business space. The criteria for the allocation of business space [are] ... neither clear nor transparent. In particular, the rental rules can be very different ... some entrepreneurs stay in the business incubator permanently, even though its prime purpose is to facilitate new entrants into business.”***

***“...sometimes the decision on enrolment into the incubator is arbitrary, and the established conditions are secondary ... the conditions are sometimes rather flexible.”***

**Issues:** The discussions suggest that the policy, the strategy, the operating conditions and the transparency of rules for business incubators could be improved, for example, with respect to both entry to and exist from business incubators.

## Chapter 4.

### ANALYSIS AND ASSESSMENT

This chapter presents the OECD-EBRD analysis and assessment of the six dimensions of good practice for the business environment to complement the analysis of the discussions with the owners and managers of SMEs presented in the preceding chapter of this report. It reviews the current situation in each of these areas; takes into account other OECD and EBRD studies and analyses of good practice; and the private sector views, based on the qualitative research with the owners and managers of SMEs. The assessment leads to a series of recommendations by the OECD and EBRD, presented in chapter 1.

#### 4.1. Implementation of the Institutional Framework for SME Policy

##### *The Situation on the Institutional Framework*

The institutional framework for the development of the SME sector in Croatia consists of various organisations at national, regional and local level that are responsible for articulating and implementing the SME development policy, and proposing changes to the legislative and regulatory framework affecting this sector.

At the state level, the institution in charge of the development of policy for the SME sector is the *Ministry for Crafts, Small and Medium Enterprises (MCSME)* which was established in February 2000. Previously, the key institution was the Division for SME Development at the Ministry of Economy, but in recognition of the importance of SME development to the economy, the government established a separate Ministry to give additional institutional momentum to this field. The government also singled out strengthening SME entrepreneurship as one of its developmental priorities for 2002-2004 (Developmental Priorities of the Republic of Croatia, 2002-2004, 2001, p.11).

In March 2002, the government passed a *Law on Stimulating Development of Small Entrepreneurship*, based on the *Programme for Development of Small Entrepreneurship in Croatia, 2001-2004* setting out its strategic goals for enhancing SME development in the medium-term. The main strategic goals of the programme are to:

- Increase the share of small business in the total economic output.
- Increase the share of small businesses in industry, agriculture, tourism and other service sectors.
- Enhance financial stability and provide more effective sources of finance.
- Accelerate technological development, competitiveness and the opening-up of new markets.
- Increase the number of small businesses and the number of new employees of SMEs.
- Support the small business development institutions and create entrepreneurial support infrastructure (business centres, business incubators, business zones, etc.).
- Educate and train entrepreneurs through focused educational programmes.
- Form networks and clusters of small business organisations.
- Develop contacts with neighbouring countries to exchange experience.

In June 2002, the *Croatian Guarantee Agency (CGA)*, the key government support institution since 1996, was transformed into the *Croatian Agency for Small Business (HAMAG)* in order to co-ordinate the various incentives for SME development, as defined in the Law on Stimulating the Development of Small

Entrepreneurship (March 2002). HAMAG is funded by the state budget, international loan schemes and other sources. It is expected to play a crucial role since it is in charge of implementing the short and medium term plans for the development of small business and co-ordinating all financial incentives to SMEs. Its prime goals include:

- Enhancing the operation and development of micro-, small- and medium-sized enterprises.
- Stimulating investment in the small business sector, including credit lines and other forms of financial support, such as credit guarantee schemes, subsidies for interest payments, etc.
- Selling, awarding concessions and leasing of real estate and other infrastructure in accordance with the Programme for Enhancing the Small Business Development.
- Monitoring, reviewing and reporting the results of the incentives adopted.
- Supporting job creation, education and training, retraining and the acquisition of additional skills and knowledge in small business.
- Supporting productive innovation and the introduction of modern technologies.
- Supporting participation at the international fairs and exhibitions in Croatia and abroad.
- Providing advisory services to small businesses and promoting entrepreneurship.
- Co-operating with other agencies and small business support institutions in Croatia and abroad.

It is too early to adequately assess how well HAMAG is performing the functions stipulated by the law. HAMAG is not yet fully operational, since its staff has yet to be appointed. It is important to accelerate the process of implementation of this organisation.

In 2001 financial support to SMEs through the MCSME amounted to HRK 120 million (€16 million), but was reduced to €12 million in 2002 partly due to the pressures to reduce the national fiscal deficit. In pursuit of its policy goals, the MCSME co-ordinates a range of institutions (not least the Croatian Bank for Reconstruction and Development, SME business development centres, regional development agencies, business incubators, free business zones, business associations, regional and local administration, etc), which mediate between banks and entrepreneurs, provide consultancy services, elaborate business plans and assist in searching for investment funds. Its work is backed-up by the initiatives of other ministries and state agencies that have SME support programmes, self-employment initiatives, sectoral activities, etc. The *main organisations* that have an important role to play are the Ministry of Tourism, Agriculture, Science and the Croatian Employment Bureau, through the Ministry of Finance and the Ministry of Economy.

The other key *support institutions for SMEs* at the national level include:

- Croatian Bank for Reconstruction and Development (HBOR).
- Croatian Chamber of Economy.
- Croatian Chamber of Crafts.
- Croatian Association of Cooperatives.
- Association of Croatian Institutions for Enhancing Entrepreneurship (UHIPP).

These organisations provide support to small enterprises but also co-operate with MCSME in order to diffuse information on their programmes for SMEs. There is scope for considerable improvement with regard to the quality of their service and advice provided to SMEs, in particularly when it comes to further education and training of the staff and funding for the programmes, as well as the promotion of SME development.

There are 21 counties in Croatia. Most run a *regional business support centre* organised and financed by the regional bodies in charge of economic development. There are also 123 towns and cities and 420 municipalities, some of which host the 35 existing local business support centres. These local and regional institutions also have a role in the implementation of the Programme of Small Business Development in terms of decentralisation of government funding and supporting and customising the programme to the needs of local entrepreneurs. The quality tends to vary according to the level of economic development,

the magnitude of funds assigned for SME development, as well as the skills and expertise of personnel of these centres. Zagreb, Medimurje, Primorsko-Goranska and Istrian County have launched a number of SME development and support programmes and have assigned significant funding to them. They could be considered dynamic regions with functioning regional and local bodies supporting SME development. Presently there are six regional development agencies.

The *counties and municipalities*, especially in the regions affected by the previous war, have few SME development centres. Funding is not the major problem since there are various programmes to assist these regions. On the other hand, the counties and municipalities appear to lack the absorption capacity, expertise and skills to develop such centres, as well as an entrepreneurial dynamic. It is expected that the counties, cities and municipalities will become more active in developing favourable conditions for SME development in future.

### **Assessment**

The research reveals that the institutional framework for SME support at state, local and regional level is generally perceived as “satisfactory”. The respondents believe that the government has assigned a clear organisational responsibility for the development of the SME sector in Croatia by establishing MCSME and HAMAG. The strategy for small business development and the general improvement of the availability of information are assessed favourably. Encouraging progress is also noticed in the support structures that exist at local and regional level, especially regarding their mandate and funding.

This amounts to a fairly comprehensive institutional framework, nevertheless, the focus group research suggests that weakness remain. Most of the areas of the institutional framework covered by the survey are rated as less than satisfactory. One of the main weaknesses of the institutional framework lies in the area of the quality and regularity of consultation between the government and the enterprise sector especially established firms with growth potential. Although numerous institutions exist, they are characterised by a “top-down” approach to policy making, even though such policy is largely delivered at the local and regional level. It remains a bureaucratic model and lacks adequate involvement of the private sector in the formulation and evaluation of policy.

Furthermore, the fact that a very comprehensive institutional framework has been created, involving the Ministry, Croatian Agency for Small Business (HAMAG), various Ministries, etc. means that effective policy implementation may be impaired unless the relevant institutions co-ordinate their work in order to ensure that they are informed of each other’s activities and that these do not overlap, for example, SME programmes among key institutional players at the central, regional and local levels.

The policy approach favoured in Croatia relies heavily on the capacity of local and regional bodies to implement enterprise policy initiatives. The mandate and resources available to support enterprise development are assessed as being fairly “satisfactory”, however, there is a need to further strengthen and develop the capacities of regional and local government staff dealing with private sector development, including SME support.

## **4.2. Implementation of the Rule of Law and the Regulatory Environment**

### ***The Situation on the Rule of Law and the Regulatory Environment***

Building a regulatory framework that is conducive to the growth of entrepreneurship and a competitive market economy has been a key goal of the economic transition since 1990s. Although significant progress has been made in adopting a number of laws, as well as various codes and practices designed to provide a framework for market behaviour, problems remain relating to such issues as enforcement, inconsistency, over-regulation and frequency of changes.

Most of the regulatory framework refers to all enterprises, particular when it comes to registration and operation of businesses. The legislation that regulates the operation of small business includes the:

- Law on Crafts (Official Gazette no. 77/93; 90/96, 64/01).
- Law on Commercial Companies (Official Gazette no. 111/93, 34/99,121/99,52/00).
- Law on Co-operatives (Official Gazette no.36/95).
- Law on Enhancing Small Business Development (Official Gazette no.29/02).

Micro enterprises and SMEs are most affected with regulations and procedures for company registration, start-up requirements such as licenses, permissions, and land acquisition procedures but also the associated corruption in the grey economy. There are high compliance costs in attempting to conform to the overly bureaucratic and costly regulatory framework applying to the small business sector.

The legislative procedures concerning *company registration* are broadly in line with EU practices and are not considered to present legal or administrative barriers to business start-ups (FIAS, 2002). However, due to an overburdened commercial court system, registration is still a much more time-consuming process than in EU countries, as well as in the most advanced transition countries. A FIAS study on administrative barriers to foreign investment (2002) found out that the total time taken for all procedures for registering a company is 45 days and that obtaining building and location permits (for building new business premises) takes a minimum of three months. Through the *Action Plan for Reducing Business Barriers* (see below), the Government has recommended a time limit of 30 days for company registration, after which the registration is automatic. However, this time limit has not been stipulated by law as an obligation and the requirement is not being implemented. The Government is also seeking to reduce the costs of various procedures of company registration, especially for small business and crafts start-ups.

The costs of registering new firms depend on the legal form. To establish a *limited liability company*, the minimum capital requirement is HRK 20,000 (about €2,600). Apart from this, potential entrepreneurs are required to pay registration costs amounting to at least 6,500 HRK (€860), covering fees for several registry requirements (including registration announcement in Official Gazette and national daily papers, court registry fees, certificates for minimum capital, opening bank accounts, company seal, etc.). The requirements for registering a *craft firm or co-operative* are significantly lower. The certificate fee for crafts is about 500 HRK (about €66), but there are discounts for persons starting crafts in the war affected zones, living on islands or unemployed persons, for whom the costs are reduced to 200 HRK (about €26). Unemployed people over the age of 45, those with at least 20 years of working experience, and former war veterans are fully exempted and the court registry fee amounts to 270 HRK (about €36).

According to the FIAS study (2002) *land acquisition, registration and site development* are the most complicated parts of starting a new business in Croatia and constitute impediments to a greater inflow of foreign investment. The procedures are bureaucratic and time-consuming but the key issue relates to the land registry, which is now progressing with World Bank and EC assistance.

The *Inter-Ministerial Task Force on Removing Administrative Barriers* to investment was established in 2001 in order to actively contribute to simplify barriers and reduce costs to start-ups, especially “green field” foreign investments. It is headed by the Vice-Prime Minister of Economy, whose Ministry co-ordinates the work of the Task Group. The Task Force consists mostly of civil servants from ministries and other government bodies and focuses only on some of the most urgent issues identified in the FIAS study, such as the reform of land registry.

The Transparency International Corruption Perception Index (Transparency International, 2002) placed Croatia on 51st place as opposed to 49th (the score deteriorated from 3.9 in 2001 to 3.8 in 2002 on a scale of 0-10, where 0 represents a high degree of corruption) in the year 2001, meaning that its situation has deteriorated relative to the other countries assessed. The *Office for Preventing Corruption and Organised Crime (USKOK)* was established in 2001 in order to deal with some of the most serious economic crimes, such

as money laundering, financial fraud, abuse of official position, fictitious capital investments, illegal capital drain, etc. that are eroding public trust in the market economy and its institutions.

The *grey economy* was estimated to account for 25% of Gross Domestic Product (GDP) between 1991-1996, reducing to 10% between 1996-2000 (Institute of Public Finance, 1997, 2002). The main causes of this significant reduction in the levels of the grey economy are attributable to: faster economic growth and increases in GDP levels during the period, changes in the structure of consumption, improvements in the recording and statistical system, the introduction of VAT, the stabilisation of the large retail systems and the entry of the foreign firms and banks into the Croatian market (Ott, 2002).

Nevertheless, the Government has established an *Inter Ministerial Task Force on the Grey Economy* in order to co-ordinate measures aimed at creating a better regulatory framework, as well as creating incentives to formalise the grey economy. The work of the Task Force focuses on public information on the causes and effects of the grey economy on economic development. The Task Force's representation could be enhanced by more active involvement of private sector representation.

### **Assessment**

Based on the research with SME entrepreneurs, a number of issues are apparent: the overall regulatory and legal framework is assessed as being "poor"; respondents perceive the procedures for obtaining licenses, permits, certificates etc. required for business operations as "unsatisfactory" and time consuming; and the quality and regularity of consultations between the government sector and the private sector on draft regulations and legislation that affect business is similarly seen to be "unsatisfactory".

The regulatory environment facing entrepreneurs in Croatia remains overly bureaucratic. Despite recent improvements, there remain significant costs and delays in starting-up a business. The rule that companies shall be registered within 30 days unless otherwise informed, does not currently appear to be working successfully and may need to be introduced by law, as in other countries such as Hungary. Likewise, the procedures for obtaining licenses and certificates necessary for business operations, in common with the results of other reports such as FIAS (2002), are still perceived as being far from "satisfactory". The government appears to be aware of this problem and has created an Inter Ministerial Task Force on Removing Administrative Barriers and has introduced an Action Plan for Reducing Business Barriers. However, the costs of establishing a new business are high and it remains to be seen how effective the Action Plan will prove to be. Similar to many OECD countries a system that allows Internet online registration might be considered.

The Task Force consists mostly of civil servants from ministries and other government bodies. It may be very advantageous to introduce greater private sector representation. Given that the Task Force was created in 2001, there is a need to evaluate its effectiveness and assess whether the timescales for the simplification of administrative procedures and removal of remaining barriers are appropriate. The Task Force presently focuses only on some of the most urgent issues identified in the FIAS study (2002), such as the reform of land registry. Consideration should be given to whether more resources are required in order to tackle the remaining issues identified in the study such as simplification of firm registration procedures and licences, improvement of construction permit and related procedures in order to promote the establishment of a greater number of companies, especially based on "green field" foreign investments.

By introducing the time limit of 30 days for company registration, after which the registration is automatic, Croatia would effectively start working towards the implementation of the principle of "silence is consent" under which if the relevant public body fails to answer within a prescribed period, it will be deemed that consent has been given. The extension of this principle would work towards streamlining and reducing compliance costs for various company registration and licensing procedures. Allied to the above, consideration should be given to the possibility of creating a "One-Stop-Shop" system, as in the case of other SEE countries such as Romania (see OECD-EBRD, 2002).

Corruption is a phenomenon that affects the business environment and is of vital concern to SMEs. The efforts to tackle corruption are welcome, though the evidence is that the situation may be deteriorating. SMEs are not really aware of the Government focus on this issue and want to see beneficial effects “on-the-ground” if they are to be convinced of the Government’s seriousness in addressing this issue. USKOK was established in 2001, however, its effectiveness appears to be affected by delays in appointing its director, and the organisation appears to be understaffed since its regional offices often comprise one employee. Only recently have its activities been intensified and scope exists to enhance its operation and activities, especially with regard to the adoption of a precise action plan for reducing corruption, with private sector involvement in the process (see SELDI, 2002; Bejakovic, 2002).

The level of grey economy activity has reduced significantly in recent years although entrepreneurs are still concerned about the degree of unfair competition vis-à-vis registered firms. An Inter Ministerial Task Force on the Grey Economy exists but the entrepreneurs participating in the research were neither aware of it nor of its activities. The Task Force’s visibility and effectiveness could be enhanced through more active involvement of representatives from the enterprise sector, small and large. The Government would benefit from such a partnership, since certain areas of the grey economy, such as the labour market, are impossible to tackle without the close co-operation of private enterprises.

Mechanisms for consultation on draft legislation and reforms to the regulatory environment need to be developed. SMEs would welcome more consultation on new laws and regulations that impact directly on their activities.

### **4.3. Implementation of Tax Policy for Small Businesses**

#### ***The Situation on Taxation Policy for Smaller Businesses***

The tax policy and system in Croatia is designed to be neutral, namely to treat all enterprises equally, regardless of size. However, more recently, some incentives to stimulate private sector initiative have been adopted, such as tax-free zones, war-affected regions, etc. as discussed below.

Croatia has one of the lowest corporate *profit tax* rates among the transition economies. All joint stock companies and other legal persons reporting profits pay at the rate of 20%. There are some exemptions, deductions and incentives, for example:

- Regions affected by the war, where enterprises pay 25%-75% of the standard rate.
- Firms operating in tax-free zones pay only 50% of the standard rate, while those investing more than HRK 1 million (about €133,000) are exempt from profit tax for 5 years; and the profit tax rate is reduced to 7% or even 0% if the investments amount to HRK 10-60 million (about €1.3-8 million).
- The taxable base is reduced by the salaries and social security contributions for the newly employed in the first year of their employment and up to three years for the disabled.

The *income tax* rates are divided into four categories: 15% for those earning less than two monthly personal income tax deductions (2 x HRK 1,500 or about €400); 25% for those earning less than HRK 6,750 (about €900); 35% for those earning less than HRK 21,000 (about €2,800); and 45% for those earning more than HRK 21,000. The annual personal tax deduction amounts to HRK 18,000 (about €2,400).

In addition, there is a *local income tax* in urban areas exceeding 40,000 inhabitants, ranging from 6.25%-18%, calculated on the basis of the income tax. Small businesses fall into the income tax system if their earnings do not exceed HRK 85,000 yearly (about €11,300).

Employers and employees must make social insurance contributions such as pension, health and unemployment insurance. Employees pay 5.8% of gross wages and salaries for pension purposes and an additional 5% for the mandatory private pension fund. They pay a 9% contribution for health insurance and 0.9% for the unemployment fund. The total paid by the employee is 20.6%; the employer pays

8.8% contribution on gross wages for pension insurance, 7.5% for health insurance and 0.9% for unemployment insurance.

The *Value Added Tax (VAT)* was introduced in 1998 and stands at 22%. Products such as bread, milk, books and pharmaceuticals are zero-rated. Entrepreneurs earning more than HRK 85,000 or about €11,300 must register for VAT, while entrepreneurs earning less than HRK 300,000 yearly (about €40,000) are subject to an accounting period of three months. Most micro and small enterprises remain outside of the VAT regime (i.e. if they earn less than HRK 85,000), however, they may choose to register for VAT and are entitled for VAT refunds from the Tax Administration. The foreign companies not registered in Croatia are not entitled for VAT refunds.

*Excise tax* is applied to domestically produced or imported oil and derivatives, tobacco products, alcohol, non-alcoholic drinks, beer, coffee, passenger cars, motorbikes, boats and air planes, jewellery, watches, furs, clothes and weapons. In addition, the *Law on Real Estate Transfer Tax* regulates the transfer of real estate, which is taxed at 5%.

In 2002 the government adopted the *Law to Stimulate Investment*, both domestic and foreign, affecting tax and customs treatment of potential investors. The new incentives apply to new domestic or foreign “green-field” investment above HRK 4 million (€530,000), as well as established company operating in the tourism sector. The incentives cover such aspects as: leases, construction permits, sale or concessions of real estate or infrastructure objects on commercial or special basis as well as subsidies for new employees and their training. The Fund for Real Estate and the Fund for Stimulating New Employment were created for this purpose and the profit tax incentives are applied to the types of investment highlighted in table 4-1.

Table 4-1. New Investment Incentives

Investment (HRK/€ mio.)	Profit Tax Rate	Duration of Incentive	Min. No. of employees
HRK 10-20 / €1.3-2.6	7%	10 years	30
HRK 20-60 / €2.6-8	3%	10 years	50
HRK 60 / €8 and more	0%	10 years	75

Source: MCSME, <http://www.momsp.hr/>.

### Assessment

The recent changes in the tax system, such as reduction of the profit tax rate, introduction of some income and profit tax exemptions and incentives, such as those in war affected regions, new employment incentives, free zones, etc., as well as reduction of VAT refunds period from 30 to 15 days, are considered as a positive developments for SMEs by most representatives of the small business community in Croatia. Simplified procedures exist for tax reporting and refund for small and micro enterprises, though there is room for improving the information and training for entrepreneurs, implement on-line submission of tax returns, etc.

There is still a perception among the business community that the present tax system is more attuned to the interests of the large enterprise sector, which dominates the economy, although in principle the system is neutral and treats all enterprises equally, regardless of size. In particular, large enterprises not surprisingly are more able to influence changes and reforms to the tax system in a way that small enterprises cannot. The tax burden is considered far too high for small firms, something that enterprises typically complain of, and this may be part of the reason why a proportion of the small enterprise sector (especially in the tourism, retail and construction sectors) continues to operate in the informal economy.

In brief, some positive feedback on the tax system however a general view that it could be more encouraging to SME development and specific suggestions, as outlined in the section 3.4, were made in this regard.

#### 4.4. Implementation of Financial Instruments for Fostering Small Businesses

##### *Current Situation on Financial Instruments*

The level of banking sector intermediation is high compared to that of other transition countries that are candidates for EU accession. However, the public sector is increasingly crowding out the rest of the economy. Total domestic credit accounted for 64.1% of GDP at the end of 2002, up from 54% in 2001 but domestic credit to the private sector only accounted for 52% of GDP in 2002, up from 43% in 2001. The rapid increase in loans raises concerns given the level of capitalisation of domestic banks. To limit credit expansion, the Croatian National Bank (CNB) adopted a number of measures in early 2003. These included the compulsory purchase of CNB bills if bank loans expand at a rate higher than 16% and a reduction to 35% of the minimum required ratio of foreign exchange assets to foreign exchange liabilities.

Table 4-2. Domestic Credit (in % of GDP)

	1996	1997	1998	1999	2000	2001	2002
Domestic Credit	44.9	45.4	48.6	46.6	47.2	53.8	64.1
Domestic Credit to Private Sector	29.3	37.3	41.2	37.4	37.4	43.0	51.9

Source: IMF

As of April 2003, the banking system includes the Croatian Bank for Reconstruction and Development (HBOR), 46 commercial banks (of which 6 are local subsidiaries of foreign banks), and 4 housing savings banks. Total banking assets amounted to HRK 45,472 million. Following a series of sales to foreign strategic investors and subsequent mergers and acquisitions during the period between 1998 and 2002, the market is led by Unicredito/Allianz group holding 29% of the market through Zagrebacka Banka, followed by Intesa-BCI controlling around 21% through Privredna Banka Zagreb.

The government, mainly through the Ministry of Crafts and Small and Medium Enterprises (MCSME), has played an active role in stimulating SME credit by providing loan guarantees and, in some cases, loan subsidies for special programmes (e.g. export-oriented SMEs as well as SMEs in the tourism sector) or regions. Subsidised loans under HRK 400,000 (about €57,000) are offered at an interest rate of 8%. The loans are provided with a guarantee from the Croatian Agency for Small Business (HAMAG) up to a maximum of HRK 16,000 (about €2,000). A programme designed for start-up businesses offers additional support for 50% of loan-related costs such as consulting fees (however, these have to be arranged through a special Consulting Network and agreed in advance). Thus, significant funds have been made available to support the provision of long-term loans to SMEs. This has resulted altogether in the approval of 3,600 SME loans amounting to nearly HRK 1.9 billion (about €270 million). The "Export" and "Tourism" programmes administered 109 and 36 loans amounting respectively to HRK 276.4 and HRK 321.2 million.

A number of problems in policy design and implementation have affected the performance of these programmes and policy measures. In particular, there has been insufficient co-ordination of the various institutions in charge of implementation of the programmes and measures. Also, a lack of transparency has affected results. Moreover, the effectiveness of the government's SME programmes has been affected by exacting collateral requirements and slow banking and guarantee procedures. Prudent lending practices adopted by the domestic banks since their restructuring and privatisation and a higher degree of risk aversion, as compared to the pre-crisis phase, contribute to the relatively slow implementation of the government's programmes.

Commercial banks also take an active part in the provision of loans for SMEs through the administration of dedicated credit lines provided by various national and international organisations and agencies, such as MCMSE, HBOR, and EBRD. These credit lines played a significant role in the past, when banks suffered from liquidity constraint. Currently, as liquidity is no longer a problem for commercial banks, credit lines are no longer as widely solicited as in the past. Commercial banks now mostly use own funds to lend to SMEs, mostly for short maturities, in domestic currency with a form of indexation to hard currency (devizna klavzula). Interest rates have been steadily decreasing over time. Loan application processing times are long, ranging between three weeks and two months.

Currently, HBOR operates two targeted SME credit lines. The Loan Programme for the Development of Private Small and Medium Entrepreneurship aims to support private SMEs (less than 250 employees and 51% privately owned) by providing long-term loans for modernisation and expansion of existing enterprises. Loans can be used for investment in the fixed assets, for working capital requirements (up to 30% of the loan amount) and refinancing of existing financial obligations. The Loan Programme for Incentives to Start-ups targets export and production projects, investments in new technology and joint investments with foreign partners. The categories of investments covered by the programme include machinery and equipment, and business premises.

There are also a number of programmes launched with the support of international organisations. There is a USAID 5-year programme with special emphasis on SME development focusing on training, education and SME investment projects. The total USAID budget for Croatia in 2001 was approximately US\$ 44.5 million. The UNDP and the UNOPS started in 1996 a 4-year programme to create Local Economic Development Agencies (LEDAs). Four LEDAs are operational. Phase I involved the extension of small loans (up to a maximum of US\$ 7,000) via local banks to households. The loans were based on the membership system and the UNDP guaranteed up to 50% of the loans. New EU funds (€2.3 million) are expected to expand and consolidate this programme. Under Phase II, small credits will be provided to SMEs, with an initial ceiling of €25,000.

There are also a number of micro credit programmes active in Croatia. The CRS/MIKRO-PLUS micro credit programme was founded in 1999 to support the war-affected regions of Banija and Kordun. Osijek, Sisak and Karlovac were included some time later, while other areas considered for expansion include the cities of Zagreb, Šibenik, Zadar and Rijeka. Six-months loans in the range of €500 to €3,200 are extended at 2% interest rate per month. The loans are to finance both working capital and small investments. The average size of micro-loans extended under this programme is €550.

The Micro Credit Savings and Loans Co-operative "NOA" was established by the SOROS Foundation together with "Opportunity International" in Osijek in 1996. NOA has established offices in Central, Western and Eastern Slavonia and in Southern Croatia. It provides group loans, specific loans for agriculture and security for individual loans. The loans are provided for equipment, raw material, and working capital. They carry an interest rate of 1% per month, with a maturity of 6 months, a grace period of up to 90 days and an administrative fee of 2%. Security derives from groups of three to five members who guarantee for each other, based on the "graduation principle": the first loan provided to the group is for an amount up to €1,225 per member, the second loan can be up to €1,750 and the third up to €2,500. Annual interest rates range from 10-15%, with a maturity of 12-36 months and a variable grace period. Security (up to €2,500) is required from three guarantors; for loans between €2,500 and €15,000 the registration of a mortgage on property valued 1.5 times the approved loan plus interest is also required. The Soros Foundation - Croatia is acting through the (non-governmental) Open Society Institute. As for SME development, the Open Society Institute supports activities of the Centre for Entrepreneurs (CEPOR), based in Osijek. The Centre is co-operating in the management of credit line of US \$200,000 launched through NOA.

The Government has recognised the importance of leasing as a key source of SME finance and has requested technical assistance from IFC in preparation of further development of the leasing industry in Croatia. Following an initiative by the Croatian Chamber of Commerce in February 2002, an Association of 14 leasing institutions was formed.

At present there is only one SME targeted equity fund operating in Croatia, the Small Enterprise Assistance Fund (SEAF), a private fund established with assistance from USAID. It seeks to gain equity participation in medium-sized enterprises with a good track record. Investments can range between €100,000 and €1,000,000, for a maximum duration of 5 years, after which the shares can be re-purchased by the firm's owner or sold in the local capital market. SEAF can also provide technical assistance on a cost-sharing basis. The SEAF equity fund has been active in SME equity participation over the last three years. Up to the present time, 15 investments ranging between €40,000 and €325,000 have been made and the average investment size is US\$ 143,000. Another equity fund, Croatia Capital Partnership set up in 1997 with funds from EBRD, IFC, Erste and UCI, targets investments in SMEs.

### **Assessment**

Croatia has a relatively developed financial sector, as shown by the scores of table 4-3. Using EBRD's standard scoring system (ranging from 1= little or no progress from the command economy starting point to 4+= equivalent to those of a well functioning market economy), the Croatian banking system was rated as 3.7 in 2002. Bank privatisation is almost complete and the recent adoption of a new banking law consistent with EU legislation has further strengthened the regulatory environment. On the other hand the non-banking financial sector is still relatively lagging behind at 2.7 in 2002.

**Table 4-3. EBRD Score for Financial Sector Reform**

<b>Financial Sector</b>		<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Banking and Financial Institutions	Banking reform & interest rate liberalisation	2.7	2.7	3.3	3.3	3.3	3.7
Non-banking Institution	Securities markets & non-bank financial institutions	2.3	2.3	2.3	2.3	2.3	2.7

Source: EBRD

A healthy, profitable financial sector is needed for providing access to finance for SMEs on a sustainable basis. Profitable private financial intermediaries are the necessary link between domestic savings and investment by private sector enterprises. Despite the positive trend of deepening bank intermediation, increased liquidity and decreasing real interest rates, the private sector regards the risk-averse approach of banks and the cost of obtaining bank finance as obstacles to doing business. Suggestions are made by private entrepreneurs to adopt mutual guarantee schemes, successful in developed OECD countries, in order to deal with the current phase of high risk aversion of the restructured and privatised local banking system. Supply of short-term bank finance for SMEs is increasing. Yet, provision of long-term bank finance for the sector remains insufficient to meet the SME sector's development potential. Demand for finance from the SME sector still widely exceeds supply.

The main sources of finance for the Croatian SMEs are internal funds and loans from family/friends, however, other sources of finance such as local and foreign banks, equity and leasing play a far more important role than they do in other countries of the region. Access to venture and equity capital remains poor.

Moreover, commercial dedicated institutions such as micro-finance banks, seen potentially as of great use for start-ups and the smallest firms, are not yet developed in Croatia, apart from a few non-commercially based schemes. Thus, the financial sector is not yet sufficiently responsive to the needs of micro enterprises and SMEs.

#### 4.5. Implementation of Advisory Services to New and Small Businesses

##### *The Situation on Advisory Services*

Among the 21 *business support centres* in Croatia at least two types of institution can be distinguished: classic business centres dealing with a very broad range of activities; and those that were founded as centres for entrepreneurship and are oriented toward technology development and technology transfer. Most of the former are trying to develop along the lines of the “one-stop-shop” advisory model and offer services such as: information (e.g. new credit lines); consultancy services; access to finance (financial and credit consulting); development, investment, marketing and business planning; services for co-operation (in Croatia and abroad) and education and training services. The latter focus on issues such as technology transfer, R&D, publishing activities, business plans and investment studies, as well as business, technical, financial, legal and educational services.

These institutions are fairly new and face a range of challenges relating to such issues as financial sustainability, appropriateness of geographical location and retention of experienced human capital. There is a tendency for these organisations to struggle to survive once donor or other support comes to an end. For this reason some are attempting to become local development agencies, partly because of the potential offered by the regional development agenda with EU accession in mind, and partly due to central government’s intention to support the establishment of such agencies.

There are six new *Local Economic Development Agencies (LEDA)*, all established between 1999 and 2001. Four of the LEDAs were established as a part of UNDP/UNOPS programme, oriented towards economic recovery in the former war-affected areas, namely Southern Dalmatia, Banovina, Western Slavonija and Eastern Slavonija. All were established as non-profit institutions seeking to exploit the full range of opportunities, including co-operation with other institutions.

Croatia lacks a well-articulated institutional structure for regional development, resulting in intense competition between various bodies (business centres, LEDAs, chamber of commerce, private consultancies etc.) for a market niche within the field of local economic development. The long-term LEDA strategy is to become the key actors, linking up with local authorities and other government and non-government institutions. In the short-term they are developing a very broad range of activities.

There are several different types of business networks functioning. Most of them were established around some formal business-related *NGO organisations and associations*. For example, the Croatian Employers’ Association (HUP, Zagreb) in co-operation with USAID started a programme of networking enterprises within the Global Technology Network (GTN, [www.hup.hr/hrvatski/gtn/gtn.asp](http://www.hup.hr/hrvatski/gtn/gtn.asp)). In 1997, the *Croatian Network of SME Consultants (KMK)* created a network of approved consultants and trainers focusing on enterprise development. The Ministries of Economy and Finance, as well as the Croatian Guarantee Agency appointed the members of the HMK Board, however, the network has been affected by lack of funds, as well as state influence on the consultants in the network. HMK is no longer operating but retains a small, certified pool of consultants. The Croatian Association of Business Women (KRUG, [www.businesswomen.hr](http://www.businesswomen.hr)) was established in 2002 and consists of women managers, entrepreneurs and others involved in economic development. Finally, a Network of Business Innovation Centres (BICRO) was founded in 1997 and is closely linked with R&D at universities and financial institutions, offering seed capital and various innovation schemes.

##### **Assessment**

The development of business advisory services started some time ago, with the majority of business centres having been established between 1995 and 2001. Most of these were founded by local / county authorities, some interested private enterprises and donor support. They typically started operating without significant financial support from central government and they continue to be dependent on local assistance and offer a highly diverse range of products and services. The Ministry for Craft, Small and

Medium Enterprises is trying to enhance their work with additional funds, for example, via the Programme of Support for SME Development, which includes creation of entrepreneurial zones, business incubators and financial support for the development of new SME business support centres. Nevertheless, the issue of the financial sustainability of these organisations remains an on-going concern, leading to problems of continuity of provision.

The expansion of state-, donor- and private-funded advisory services means that there may be an oversupply of such services in certain areas. Possibly as a result of the competition in the market in those areas, the range and quality of the business support services available is considered to be satisfactory by SMEs. There appears to be a geographical concentration of services in the capital city and the more economically dynamic regions. The lack of support to start-ups and established businesses is particularly notable in the small towns and less developed counties, such as Slavonija, Dubrovnik and Banovina. The government needs to reassess its policies in this respect, for example, to make them more consistent with the EC pre-accession instruments, for which it will be eligible in due course, which lay a strong emphasis on regional development, including SME development.

There is an ambivalent attitude on the part of entrepreneurs about using local consultants and indeed about paying for advisory services. The services on offer only partially correspond with what is demanded by SMEs. In particular the services on offer remain fairly basic, whereas Croatian SMEs are increasingly looking to obtain more sophisticated services with the potential to add real value to their operations. There is a need for more diversified and specialised advisory services focusing on issues such as financial management, organisation, governance and technological development.

The most capable consultants tend to have higher education, as well as domestic and/or some other form of international professional certification, in combination with extensive professional experience. There is a need to improve the overall standards of this relatively new market. The introduction of minimum standards and certification for providers of advisory services (such as qualifications, membership of relevant bodies, confidentiality principles, charging policies and other general quality standards) would go some way towards generating greater confidence and willingness to use and pay for advisory services.

#### **4.6. Implementation of Business Incubators**

Business incubators are a particular form of business service that offers potential in transition economies, even though there appears to be a general lack of information about them among entrepreneurs. Business incubators are generally defined as special areas for new and young developing businesses that provide such businesses with premises, infrastructure, a comprehensive range of services and support that can improve their ability to initiate and run their operations during the early developmental period. The combined features of physical facilities focus on start-ups and SMEs and “soft” advisory and support services provided are what distinguish business incubators from other industrial centres or industrial estates (OECD-UNIDO, 1999, pp.51-53).

##### ***The Current Situation on Business Incubators***

Eleven business incubators can be identified in Slavonija (4), Banovina, Lika and others on the Adriatic coast, the best known of which are Labin, Porin (Rijeka) and the Technological Centre Split (TCS). The maximum tenancy duration tends to be 60 months (five years). In the majority of business incubators, the premises and services are partially subsidised by the municipalities.

For example, TCS promotes new technologies, innovations, and entrepreneurship. Its objective is to provide support to SMEs in order to develop innovation, know-how, technology, prototypes and to market preliminary products in as short a time span as possible. The business incubator assists tenant firms by offering:

- Office and workshop space at preferential rates.

- Use of office, computer and communication equipment.
- Use of meeting facilities.
- Other support services.

Its tenants are small, hi-tech companies operating in the area of business software, process software, information and communication technologies, process automation, advanced internet services, system and design optimisation, etc. It was established as a project of the Ministry of Science and Technology of the Republic of Croatia, jointly with the German Ministry of Science and Technology. It acts both as a business incubator and a technology transfer centre.

Free zones and technological parks also provide a potential structure for the location of business incubators.

*Fifteen free business zones* have been established based on the Croatian Free Zones Act, which stipulates that:

- Domestic and foreign persons benefit from equal treatment in the free zones.
- All forms of international trade and exchange may be carried out within a zone.
- Goods may be freely imported and exported.
- Goods may remain within a Zone for an unlimited period of time.
- For the goods stored in a Zone, no customs duties or taxes are levied.
- Users of a zone pay profit tax amounting to 50% of the prescribed rate (i.e. 10%).
- Users who build infrastructure facilities within a zone exceeding HRK 1 million (about €133,000) are exempt from profit tax in the first five years of doing business.

A Free Zone may be established on the basis of a concession granted by the Croatian Government through a competitive process. Domestic and foreign firms may carry out any economic activity in a Zone (except for retail trade) on the basis of an agreement made with the founder of the Zone.

There are *two technological parks*, the Innovation Centre of Rijeka (TIC) and the Techno Park Zagreb (TPZ). TZP was founded in 1994 and is a combination of technological park and business incubator. Its remit is to support business start-ups, advise entrepreneurs, provide business education and training, deliver project management to introduce quality certifications such as ISO 9000. The City of Zagreb finances the TPZ project with the support of the funds from SME Development Programme of the Ministry of Crafts, Small and Medium Entrepreneurship. It has 1,000 m<sup>2</sup> of business premises and about 300 - 500 clients. 50% its operating budget comes from the municipality and the remainder from commercial services such as renting space and facilities to other entrepreneurs. TIC deals with similar issues as TZP.

### **Assessment**

The eleven business incubators in Croatia are considered to have had a positive impact on new entrepreneurs, especially with regard to access to office / production space needed in the first few years following the establishment of firms. The entrepreneurs participating in the research generally rate the experience of business incubators as being “satisfactory”, and they are regarded as being useful instruments to assist start-ups.

There is a Government policy with respect to supporting business incubators, however, the necessary funds are not yet available. Government policy appears to have paid insufficient attention to encouraging business incubators in economically depressed regions as a means of stimulating entrepreneurial activity. For example, the participants in the focus groups suggest that unused State property could be assessed to determine whether it can be converted into effective business incubators.

The development of business incubators may also be constrained by the lack of adequately trained and experience human resource capacity. In particular, management needs to be better trained on the

meaning of entrepreneurship and may benefit from more sharing of experience with business incubators in OECD member countries. Appropriately qualified incubator more sharing of managers, combined with adequate financial support, are important factors for the future policy and programme encouraging business incubators.

Efforts should be made to raise the awareness among entrepreneurs of the potential offered by business incubators. The SMEs participating in the research are broadly aware of their meaning and potential usefulness, however, better information is required for the concept to take-off more effectively. Research is required on the performance and effectiveness of the eleven existing incubators, including the entry and exit policies, follow-up and governance structures in order to ensure compliance with best practice in transition and OECD member countries.

Chapter 5.

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*Chapter 6.*

**WEB SITES**

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Association of Management Consultants: <http://www.ups-amc.org/>

Centre of Entrepreneurship, Osijek: <http://www.cfe.tel.hr>

Centre for Entrepreneurship Promotion (CEPOR): <http://www.cepor.hr/>

Croatian Bank for Reconstruction and Development (HBOR): <http://www.hbor.hr/>

Croatian Chamber of Economy: <http://www.hgk.hr>

Croatian National Bank: <http://www.hnb.hr>

Croatian Post Bank: <http://www.hpb.hr>

Entrepreneurship Centre Pakrac: <http://www.grad-pakrac.hinet.hr/>

Erste & Steiermaerkische Bank, Zagreb: <http://www.esb.hr>

Financial Agency FINA: <http://www.fina.hr/>

Hypo-Alpe-Adria Bank, Zagreb: [www.hypo-alpe-adria.hr](http://www.hypo-alpe-adria.hr)

International Finance Corporation, Croatia: <http://www.ifc.hr>

Institute of Economics, Zagreb: <http://www.eizg.hr/>

Institute for International Relations (IMO) Zagreb: <http://www.imo.hr/>

LEDA- Krka: <http://www.hinet.hr/lera-krka>

LEDA- Western Slavonija: <http://www.hinet.hr/leda>

Medjmurje County Centre for Entrepreneurship (MPC): <http://www.mpc-cakovec.hr/>

Ministry of Crafts, Small and Medium Entrepreneurship: <http://www.momsp.hr>

Ministry of Economy, <http://www.mingo.hr>

Privredna Banka, Zagreb: <http://www.pbz.hr>

Rijecka banka Rijeka: <http://www.rbri.hr/>

Reiffeisen Bank, Zagreb: <http://www.rba.hr>

Seaf Fund: <http://www.seaf.hr>

Technological Centre Split (TCS): <http://www.tcs.hr/>

Technological Park Zagreb (TPZ): <http://www.tehnopark.hr/>

Technological Innovation Centre (TIC) Rijeka: <http://www.ticri.hr/>

Women Entrepreneurs Association- Krug: <http://www.businesswomen.hr>

World Bank Office, Croatia: <http://www.worldbank.hr/>

Zagrebacka banka: <http://www.zaba.hr>

*Appendix 1.*

**OBSTACLES TO DOING BUSINESS**

The main results of the Croatian Business Environment and Enterprise Performance Survey (BEEPS) 2002 are summarised in the following table. It contains the average score assigned by respondents to each aspect of the business environment, where the scores can be interpreted as follows: 1 = no obstacle; 2 = minor obstacle; 3 = moderate obstacle; 4 = major obstacle.

**Rating Of Severity Of Obstacles To Doing Business (BEEPS, 2002)**

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Economic policy uncertainty	2.9
Functioning of the judiciary	2.6
Tax rates	2.6
Macroeconomic instability	2.5
Anti-competitive practices of other producers	2.4
Corruption	2.3
Cost of financing	2.3
Access to financing	2.2
Contract violations by customers and suppliers	2.1
Business licensing and permits	2.0
Tax administration	1.9
Skills and education of workers	1.8
Customs and trade regulations	1.8
Organised crime	1.7
Street crime	1.6
Labour regulations	1.5
Transportation	1.4
Title or leasing of land	1.4
Access to land	1.3
Telecommunications	1.2
Electricity	1.2

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*Source:* EBRD

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*Annex 1.*

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The Organisation for Economic Co-operation and Development (OECD) groups 30 member countries sharing a commitment to democratic government and the market economy. With active relationships with other countries, Non-Governmental Organisations and civil society, it has a global reach. Best known for its publications and statistics, its work covers economic and social issues from macroeconomics, to trade, education, development and science and innovation. Over time the OECD's focus has broadened to include extensive contacts with non-member economies and it now maintains co-operative relations with some 70 of them. These contacts aim to further economic integration by making the OECD's experience available to other countries and enabling the OECD to profit from the insights and perspectives of non-members. (see [www.oecd.org](http://www.oecd.org))

The European Bank of Reconstruction and Development (EBRD) was set up in 1991 to support the development of market economies in Central and Eastern Europe and the Commonwealth of Independent States following the collapse of communism. The EBRD supports the economies of its 27 countries of operations by promoting competition, privatisation and entrepreneurship. Taking into account the particular needs of countries at different stages of transition, the Bank focuses on strengthening the financial sector, developing infrastructure and supporting industry and commerce. The EBRD is the largest investor in South Eastern Europe and is also an active contributor to the Stability Pact. (see [www.ebrd.com](http://www.ebrd.com))