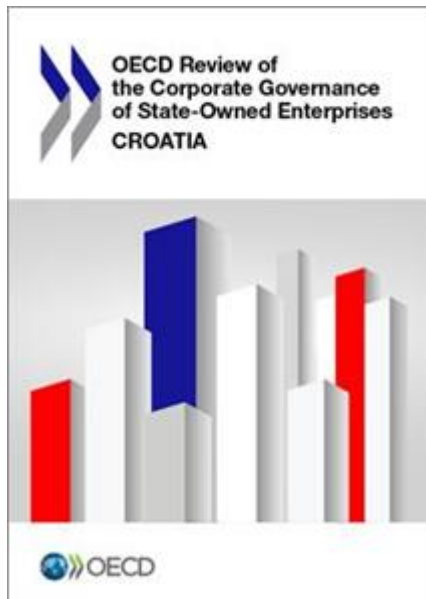


OECD Review of the Corporate Governance of State-Owned Enterprises in Croatia

What is the OECD Review of Croatia?



The OECD Review of Croatia, launched on 8 June 2021, describes and evaluates the corporate governance framework of the Croatian state-owned enterprise sector relative to the OECD Guidelines on Corporate Governance of State-Owned Enterprises (the “SOE Guidelines”). It was developed at the request of the Croatian authorities under a project supported financially by the Directorate General for Structural Reform Support (DG REFORM) of the European Commission, and implemented with the active support of the Ministry of Physical Planning, Construction and State Assets.

The review takes place in the context of Croatia’s ambition to join the Eurozone and redress a set of widely recognised policy challenges. The country entered the European ERM-II Exchange Rate Mechanism on 10 July 2020 and has engaged to implement a number of post-entry commitments in relevant policy areas, including improving the governance of SOEs by revising and aligning national legislation with the SOE Guidelines.

The report is structured as follows: Part I provides background information on the Croatian SOE sector, including the applicable legal and regulatory framework, while Part II provides an assessment of Croatia’s existent legislation relative to the standards of the SOE Guidelines. The final section sets out the conclusions and recommendations for improving the corporate governance framework applicable to Croatian SOEs. The recommendations, which were endorsed by the Working Party in March 2021, aim at supporting Croatia’s ongoing reform efforts by suggesting potential avenues for legislative reforms in view of further aligning Croatia’s SOE framework with the SOE Guidelines and best international standards and practices.

In parallel with developing this Review, the OECD has also committed to actively support Croatia’s legislative and institutional reform efforts by providing administrative and technical support towards developing legislative changes needed to implement the SOE reform proposals stemming from the Review.

The Conclusions and Recommendations resulting from the Review are reproduced on the following pages.

CONCLUSIONS AND RECOMMENDATIONS

(Excerpt from Part III of the OECD Review of Croatia)

The Government of Croatia has taken steps in recent years to improve the management and corporate governance of SOEs. In particular, the five-year country strategy developed in 2017 with the support of the European Commission and the EBRD should continue to help establish, inter alia, a clearer reporting and monitoring system for SOEs as well as a comprehensive framework for the preparation and implementation of restructuring plans and Financial and Operational Performance Improvement Programmes (FOPIPs). Other measures include the adoption of an SOE Corporate Governance Code, the issuance of an aggregate report on SOEs of special interest and the introduction of an obligation for SOEs to set up a compliance monitoring function.

Despite this, important concerns remain. First, the current legal and regulatory framework applicable to SOEs in Croatia makes SOEs subject to multiple – and sometimes unclear – provisions and requirements. In particular, the distinction made between SOEs of special interest and the rest of SOEs, but also the existence of different requirements depending on the legal form of the SOE and its size and/or dependence on the state budget, renders it very difficult to navigate the intricacies of the law and get a clear and comprehensive view of SOE practices in Croatia.

Second, Croatia's current ownership arrangements make it difficult to exercise state ownership rights on a whole-of-government basis. Line ministries, in concert with the Ministry of Physical Planning, Construction and State Assets, oversee a portfolio of 39 SOEs of special interest, while CERP exercises more direct ownership rights over the rest of the state's portfolio (including 19 fully or majority-owned companies). The situation is further complicated by a lack of clarity on roles and responsibilities between ownership entities vis-à-vis SOEs and an apparent lack of communication and coordination between competent ministries.

Third, the absence of a formal state ownership policy and ambiguities regarding the extent of SOEs' commercial and non-commercial objectives, contribute to a situation in which the performance of SOEs is likely to be sub-optimal and difficult to meaningfully monitor.

At the level of individual SOEs, a fundamental shortcoming is the limited role of the boards of directors, who generally have neither the independence nor the responsibilities to fulfil essential strategy-setting and corporate oversight roles. Nomination procedures are not uniform across SOEs and do not sufficiently protect boards from political interference. Moreover, the remuneration framework for SOE boards does not incentivise professional business people to apply for such vacancies. In practice therefore, many SOEs operate either as extensions of their ownership ministries or at the discretion of their executive management (whose representatives are appointed by the state rather than the boards of directors).

Integrity in the state-owned sector is also an issue. Most SOEs generally have various internal controls, ethics and compliance measures in place, but the risk

of exploiting SOEs for illicit gain has not been eliminated, as demonstrated by recent scandals and indictments involving SOE managers and high-ranking politicians. The problem in many cases appears directly linked with the excessive politicisation of SOEs and their governing bodies.

Finally, as SOEs are often sizeable operators in commercial sectors of the economy, due attention should be paid to maintaining fair competition. Several elements may distort the level playing field between SOEs and (actual or potential) private competitors, including the partial corporatisation of several commercially-oriented enterprises as well as uneven application of public procurement rules by SOEs as raised by multiple control bodies of the Croatian administration

RECOMMENDATIONS

Strengthening the state ownership function

- *Establishment of an ownership coordination unit.* In the context of Croatia's mostly decentralised ownership arrangements, considerable progress could be made by establishing a central state ownership coordination body. This ownership coordination entity would report to the Government of Croatia and ideally be housed within an independent public agency reporting directly to the Government of Croatia or within a ministry provided it is not simultaneously tasked with sectoral regulation. The entity should be afforded in law the adequate mandate and resources required to effectively fulfil its coordination role, including but not limited to the following tasks: developing and monitoring compliance with the state's governance and disclosure standards for SOEs; monitoring the performance of SOEs, and; engaging in regular public reporting. It should also play a role in SOE board nominations by proposing candidates to the ownership ministries, thus helping establish professional boards. The ownership coordination unit could additionally be granted direct ownership rights, in a first stage, for a defined portfolio of SOEs, with a view to eventually broadening the portfolio to include all SOEs.
- *Elaboration of an ownership policy and strong corporate governance and disclosure standards for SOEs.* Priority should be given to develop an ownership policy clearly outlining the rationales and objectives for state ownership in Croatia. The scope of the ownership policy should cover all SOEs fully or majority-owned at the national level. It should define the respective responsibilities of the state bodies involved in its implementation, including the foreseen mandate of the proposed ownership coordination unit. The state ownership policy, or other complementary policy document(s), should clearly outline all corporate governance and disclosure requirements applicable to SOEs, including any differences in requirements according to size, market-orientation or legal form. The ownership coordination unit should be tasked with leading the development of the ownership policy, in consultation with, and, the full support of, all relevant government departments and the associated ministers. A requirement to update regularly the ownership policy should also be established.

- *Clarify SOEs' financial and non-financial performance objectives.* Guided by the state's overarching expectations as an owner set forth in the ownership policy, the Croatian authorities, with the participation of the ownership coordination unit, should define clear financial and non-financial performance objectives for all SOEs. The definition of objectives could usefully start with a classification of SOEs according to whether they undertake (i) a primarily public-policy function; (ii) a predominantly commercial function; or (iii) a mixture of both. A structured mechanism should be established which can then be utilised to set and monitor these enterprise-specific performance objectives. The development of such objectives could initially be the responsibility of ownership ministries, but it should be subject to review by the ownership coordination unit in a mandatory advisory capacity.

Harmonising the SOE legal and regulatory framework

- *Harmonisation of the legal and regulatory framework.* The challenges highlighted in the previous section may be best addressed by promulgating a new law and/or amend existing legislation. However, given the current fragmented state of the legal and regulatory framework governing SOEs, the Government of Croatia would gain from consolidating existent and relevant rules into one comprehensive law on SOEs. In addition to harmonising the legal and regulatory framework, this would help align applicable corporate governance standards and requirements with the SOE Guidelines and the present recommendations. The law could, *inter alia*, address issues such as the rationale for state ownership, the roles and responsibilities of all stakeholders exercising SOE ownership rights in Croatia, the selection and appointment of board members and other relevant corporate governance issues such as transparency and reporting requirements.

Maintaining a level playing field with private companies

- *Streamline SOEs' legal and corporate forms.* Statutory SOEs (known as "legal entities" in Croatia) that operate commercially (i.e. those that are not primarily undertaking public-policy or administrative functions) should be incorporated as joint-stock companies. The Croatian authorities could also consider converting large and economically important SOEs operating as limited liability companies to joint-stock companies. Any transformation of SOEs' legal forms should be preceded by an in-depth review of individual SOEs' objectives, in order to make an informed assessment of their commercial orientation.

Improving transparency and disclosure practices

- *Extend the scope of the aggregate report.* In order to enhance transparency, the Croatian authorities should develop annual aggregate reports on SOEs that cover not only enterprises of special interest but all SOEs fully or majority-owned at the central level of government. In addition to the current information on SOEs' financial and non-financial objectives and related performance, the aggregate report could also include an assessment of SOEs' compliance with the state's applicable governance and disclosure rules, including the

Corporate Governance Code for SOEs. The reports could also serve to inform the public of the state's ownership policy and any associated standards, as well as any recent or prospective changes to the state's ownership portfolio or practices.

- *Improve financial and non-financial disclosure by SOEs.* Disclosure standards could be further strengthened and harmonised across the SOE sector to ensure high quality and credibility of all SOEs' corporate reporting and not just of listed SOEs. In this regard, it would be useful to establish in a single policy document (or include as part of an existing policy document) what accounting, audit (internal, external and state) and disclosure standards are applicable to SOEs, including any differences according to enterprise characteristics.

Strengthening internal control systems

- *Strengthen the effectiveness of SOEs' internal control systems.* The Croatian authorities should strive to improve the effectiveness of SOEs' internal control systems, notably by: continuing the rollout and ensuring the effectiveness of mandatory compliance functions in majority-owned SOEs; ensuring proper implementation of safeguards to protect the autonomy of internal auditors and the independence of external auditors, including transparency around provision of non-audit services to the SOE subject to external audit, and; ensuring the existence and effectiveness of specific control measures – notably, whistle-blower channels and for the management of procurement and other material risks.

Strengthening board autonomy and independence

- *Establish professional and independent boards of directors.* The boards of at least Croatia's largest SOEs¹ (as defined in the Accountancy Act) should be required to comprise a majority of independent directors, with clear criteria for their independence including from the shareholder and from the company and its management. No state representatives – civil servants or otherwise – should be considered as independent. Nomination procedures should ensure that supervisory board members of all majority- and fully-owned SOEs are selected based on their professional qualifications and subject to a transparent and competitive procedure. The state's board member remuneration policy and practices should ensure that it is able to attract and retain qualified industry professionals.
- *Establish independent audit committees in SOEs.* The audit committees of at least large SOEs should have financially qualified members and an independent chair – that is, independent from the company and the state shareholder. No state representatives – civil servants or otherwise – should serve as audit committee chair.
- *Empower boards of directors to carry out the functions of setting strategy and supervising management.* The current role and responsibility of SOE boards of directors in Croatia should be strengthened to empower them, whether by law, corporate bylaws or board charters, to consistently oversee strategy, appoint the CEO (or

¹ Entities with more than 500 employees.



the management board, in two-tier boards) and supervise management, free from political pressure and interference.

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