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## Article

# Introduction: an economic reform agenda for Croatia

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# AN ECONOMIC REFORM AGENDA FOR CROATIA

## INTRODUCTION

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### Background of the study

When the Ifo Institute received a request from the Croatian Statehood Foundation to develop an economic and social reform programme for Croatia, it made it clear from the outset that it would keep the study strictly neutral, anchored on sound economic principles and in no way aligned to any existing political party programmes. The only principle Ifo clearly adheres to, as a result of proven theoretical underpinnings and the empirical evidence available, is the conviction that the social market economy (with a strong emphasis on ‘social’) is the most successful system for achieving and combining economic growth and social welfare. The execution of the study was purposefully conducted in close cooperation with Croatian scholars and specialists, in order to ensure that know-how on relevant local conditions would be properly taken into account.

After several months of research, the study put forth a scientifically sound programme on how Croatia’s very serious structural problems can be overcome, condensed into 13 papers dealing in detail with the key issues addressed by the programme. They were published as a book in January 2016.<sup>1</sup> This *Focus* is based on the above book, but further condensing the analyses and recommendations and including further scientific, especially methodological, developments. This publication is not the result of any contractual obligation but of the authors’ own scientific interest in disseminating their findings.

\* Ifo Institute. We are grateful to Julio Saavedra who carefully edited the papers in this ‘Focus’.

<sup>1</sup> Falck, O. and S. Schoenherr (eds., 2016), *An Economic Reform Agenda for Croatia*, ifo Forschungsberichte 70, Munich: Ifo Institute.

### Overwhelming challenges for Croatia

Croatia is well into its eighth year of recession and stagnation. Not even accession to the European Union has brought any visible relief. With a very high rate of unemployment, especially among the young, a bloated and inefficient public sector, unaffordable welfare systems and many of its best brains leaving the country, it comes as no surprise that it ranks poorly in a wide array of indicators. Needless to say, business as usual is no longer an option. Any economic reform agenda to bring Croatia out of the slump has to act on a very wide front and tackle a number of overwhelming challenges.

International price comparisons of key export goods reveal that manufacturing in Croatia is more expensive than in its peer countries. Many Croatians try their entrepreneurial zeal in other countries, removing their business skills and even funds from Croatia, a development that can severely dampen the economy’s future investment and innovative capacity.

Croatia’s labor market participation rate is one of the lowest in Europe, and its unemployment level is nonetheless inordinately high. Worse, more than half of the jobless are long-term unemployed, a rate far higher than in most peer countries. But that is not all: among the young people, the unemployment rate amounts to nearly 50 percent, an outright social disaster.

Croatia’s shadow economy lies far above the average of European countries; only Bulgaria and Romania do worse. This, naturally, erodes the tax base, a disadvantage compounded by the government’s inability to distribute the tax burden fairly.

In general, public administration in Croatia is inefficient by international standards and characterized by poor coordination and a duplication of structures among different units. This is not only detrimental for public services to Croatia’s citizens, but also a cost and competitiveness factor.

Moreover, since the interest differentials between borrowing in the local and foreign currencies have



been high over the past decades, borrowers have decided to take loans denominated in a foreign currency, which has led to the highest 'euroization' ratio in Europe. The misdirected incentives to borrow in foreign currencies have led to Croatia's high vulnerability to external shocks and a de facto loss of its autonomy to manage exchange rates in accordance with economic needs.

Croatia's general government debt-to-GDP ratio is the second-highest among its central and eastern European peer countries, and it is expected to rise further in 2016. Furthermore, the public guarantees given to state-owned companies pose an additional risk to the sustainability of public finances.

The protracted economic crisis has put the dominant pay-as-you-go pillar of the Croatian pension system under enormous financial strain. The subsidy to the pension system from the central government budget measured as a percentage of GDP is nearly as high as the public debt. Therefore, the subsidies could also be considered as largely debt-financed. Demographic factors will increase the debt-finance portion even more. Nearly 20 percent of the working-age population is receiving some kind of pension benefit, while the number of active contributors per beneficiary (the support ratio) has declined dramatically since 1990. On the other hand, the benefit level (as a percentage of average taxable wages) of old-aged pensions is relatively low.

### The political dilemma of structural reforms

The overwhelming challenges Croatia is facing are not new. Their origin may well go back to the socialist system, but they have worsened dramatically since the outbreak of the financial crisis in 2008. The need for reforms has become truly overwhelming. However, as usual in such cases, some political forces are not keen on reforms. In Croatia some of these forces are counting on additional EU funds to solve the economic and social problems. Unfortunately, experience shows that economic stimulation with EU funds has only a short-run effect. It may light up a 'straw fire', but fail to solve any problems in a sustainable way.

External support, such as EU funding, should be utilized to make the process of restructuring and reforming the country easier, but not as a substitute for reforms.

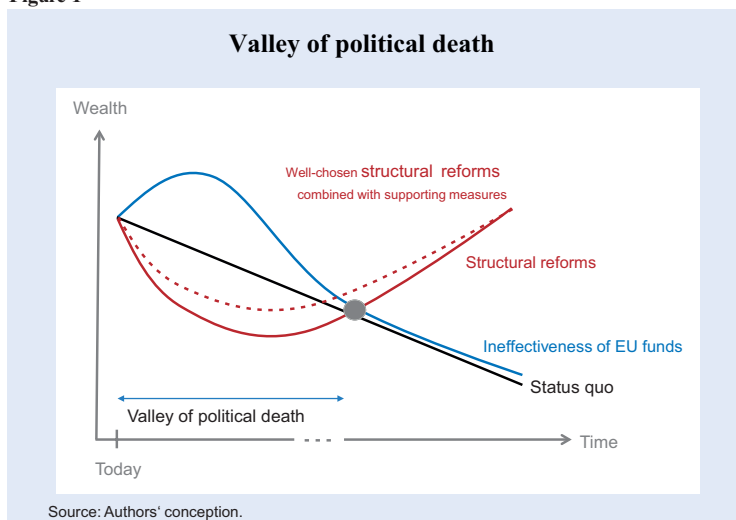
Structural reforms may of course be less than popular among parts of the electorate in the short run, because change may be considered uncomfortable, even if unemployment in general stays in check. In certain cases, this may lead to a potential 'valley of political death' for a government, at least in the short term and especially if structural reforms are announced before an election. A committed and socially responsible government will implement structural changes in combination with social support measures, carefully monitoring the economic and social effects during the critical early stage of implementation. Figure 1 below illustrates this concept and explains how EU funding can be part of the reform strategy.

To alleviate the political dilemma problem, reforms should be chosen that keep the death valley as short and shallow as possible. Some reforms will have an immediate positive effect, while others will take time to be implemented and make an impact. Flattening the valley could be achieved by combining structural reforms with EU funds for employment generation and other social support, an approach that has been successfully followed by other countries.

### Elements of a reform agenda for Croatia

A thorough study of the available data, the results of interviews with stakeholders in Croatia, reviews of the relevant literature, the study of benchmark

Figure 1



countries, fruitful workshops with our Croatian partners and a careful adherence to economic principles have led to a set of policy proposals that can be characterized as comprehensive, feasible and tailored to tackle the above challenges. The study devotes its analysis to providing answers to the following questions and issues:

#### *External versus internal devaluation*

Could a managed devaluation of the kuna reduce Croatia's competitiveness problem and eliminate incentives to borrow in foreign currencies? Or would it be more desirable instead to reduce production and services costs? Or maybe a combination of both? While either approach carries a social cost, is there any other realistic option for increasing competitiveness?

#### *Consumer protection and bank regulation to reduce borrowing in foreign currencies*

High rates of borrowing in foreign currencies reduce the scope and autonomy of a country to adjust its exchange rate according to economic demands, causing serious competitiveness problems. Can international experience be drawn upon to devise the right incentives and information systems to reduce foreign borrowing? Would it be advantageous to adopt the European Systemic Risk Board (ESRB) recommendations? Could the national supervisory authorities impose borrowing limits and risk management policies on financial institutions?

#### *The importance of a consumer bankruptcy law*

The introduction of a consumer bankruptcy law giving individuals and micro-enterprises the possibility to restructure their debts, along the lines of the continental European approach for a consumer bankruptcy law, would give indebted households a fresh start. What are the social and economic benefits of such an approach, and what are the conditions for applying such a relief program?

#### *Labor market reforms*

Labor markets in Croatia are too inflexible, imposing high costs and, therefore, driving down competitiveness. Improvements in flexibility contribute significantly to more employment, but are often seen as unjust and solely in the interest of employers. What does international experience show?

#### *Activating the inactive*

Activating policies have shown positive results in many countries, reducing long-term unemployment,

and improving public finances and economic output. What instruments can be applied to turn a social welfare system that too often rewards not seeking work into a system that spurs the unemployed to actively search for jobs?

#### *Coping with an aging society*

Croatia's current pension system not only poses a heavy financial burden on the public budget: it is simply unsustainable. Should the statutory retirement age be linked *automatically* to life-expectancy? Should the eligibility rules for disability pensions, early retirement, and privileged pensions be revised? Can adequate changes be designed and implemented without undue social hardship? Does international experience help to identify the most suitable systems?

#### *Stabilization and eventual increase of old-age pension benefit levels*

Both the current and the expected levels of pension benefits are low compared to Croatia's peer countries. How can the present level be stabilized and later increased?

#### *Facilitating the transition from school to work*

The dual education system in Croatia should be expanded dramatically to tackle the high levels of youth unemployment and the perceived mismatch of skills in the labor market. What does international experience tell about the capacities of the dual training system to reduce youth unemployment? How can the system be expanded?

#### *Training systems for the low-skilled*

Would a voucher system especially targeted at persons with low or no formal qualification improve their employability? Could it also improve transparency of training facilities and offers? Could it increase lifelong learning and reduce skills mismatch, thus increasing employment?

#### *Ensuring the tax system continuity and predictability*

What are the advantages of aiming overall budget consolidation towards long-term sustainability *via* structural reforms compared to short-term fiscal adjustments? Does continuity of the tax system increase confidence in legislation and government and, therefore, improve the attractiveness for foreign and domestic investment? Is broadening of the tax base better than increasing tax rates? If so, what possibilities are there to broaden the tax base?

### *Increasing public administration efficiency and effectiveness*

The introduction of digital procedures and bringing all levels of public agencies to an e-government operational status could significantly reduce red tape and remove opportunities for corruption. The elimination of duplicated structures as well as reducing the number of public employee would also contribute to increased efficiency. How can public employment be reduced without creating serious social problems? Is the current wage-setting mechanism appropriate?

### *Privatization options for non-strategic public companies*

Privatization often is a sensitive issue because it may imply rationalization of employment. Is privatization necessary to solve the public budget and competitiveness problems? State guarantees and subsidies to publicly owned companies should be reduced and made far more transparent. Are there procedures based on international experience to ease the process of transforming state-owned enterprises into efficient businesses? Can privatization be achieved without significant loss of employment?

### *Improving the ease of doing business*

Ease of doing business refers to how easy or difficult it is for an entrepreneur to set up and run a business when complying with relevant regulations. It is also positively correlated with domestic as well as foreign investment inflows. It may also reduce the opportunities for corruption. How can Croatia achieve a sound business environment with transparent and streamlined administrative processes?

### *Innovation strategies*

Foreign direct investment has proved that it can be a substantial source of technological transfer. Another powerful way to foster innovation is to encourage research and development (R&D) in the private sector. While all the measures outlined so far aim at promoting foreign direct investment, public innovation promotion requires specific funds and know-how. Which promotion measures are plausible for Croatia in both the short and long terms, given the scarcity of public financial resources? What can be learned from international experience?

### *Infrastructure policy issues*

Infrastructure is essential for the economic development and competitiveness of a country. A well-developed transportation and communication infrastruc-

ture integrates the local economy and connects the domestic to the international markets. Where are the major deficiencies? How good is international integration, especially with the rest of the EU? How could EU funding contribute to overcoming the problems of building an adequate infrastructure?

### **Concluding remarks**

Eight years of recession and stagnation, high indebtedness and crushing unemployment are unmistakable signs that, as we said above, business as usual is no longer an option for Croatia. Conditions have to change for a better future even if the change may involve some pain. The proposed reform program has been crafted with care to ease possible hardship. It is designed to stop unemployment from increasing, and to restructure employment to a certain extent. International experience shows that such measures lead to a rapid increase in employment and to an improvement in economic performance on a more sustainable basis.

Foreign direct as well as domestic investment will start to increase as soon as the Government adopts a well-defined and credible reform program, coupled with well-calibrated incentives to turn Croatia into an attractive investment destination. European funds could provide a further impetus. Once investment picks up, employment will increase, opening the opportunity to implement the more 'painful' reform steps. Careful monitoring and the timely introduction of employment-generating measures will help this process along substantially.

Depreciation is unavoidable, but its more painful effects can be alleviated considerably if it is carried out in small, predictable steps over a long period. It is crucial to make people aware that Croatia will return to a more autonomous foreign exchange policy only after a certain 'grace period' to allow restructuring of loan portfolios. Disincentives have to be set for new loans in foreign currency. The announcement of a future change in the foreign exchange policy will already have a major impact on reducing the level of euroization.

The proposals contained herein take into account the interactions and interdependencies among the various policies. They should be enacted as a well-sequenced package. A piecemeal approach will not produce the

desired results. The reform proposals put forth, therefore, are neither radical nor do they call for an austerity programme. They outline a roadmap for the medium-term recovery of the chronically underperforming Croatian economy, starting with quickly-acting measures to reduce unemployment.

Croatia is faced today with the option of lurching from crisis to crisis, burdened by a permanently high unemployment rate and the loss of some of its best (young) brains to emigration, in a course that will unavoidably lead to the erosion of its public finances and ultimately to following the Greek path. This would be the price exacted by caving in to the vested interests of government-associated elites and other privileged groups who so vehemently defend the 'business as usual' approach.

The other option, that of sustainable, dynamic and employment-generating economic growth that offers increasingly good prospects, in particular to younger Croatians, will of course not be completely free of pain. Fortunately, there are ways available to ameliorate the pain. But a credible commitment to a serious, predictable reform programme is imperative to see this option through. Clearly, Croatia has what it takes to achieve as much progress as other former socialist countries now in the EU have already attained. It just needs the commitment.