**Croatia's Path into the EMU and the Role of SOEs in Achieving Real Economic Convergence**

Kristijan Kotarski

Assistant Professor

Faculty of Political Science, University of Zagreb

Zagreb, Croatia

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**Introduction**

Croatia constitutes the case of a country with vast and expansive sector of state-owned enterprises (SOEs). A detailed comparison leads us to this conclusion since Croatia has the lowest number of residents per one state-owned enterprise among the sample of post-socialist countries. There are more than 1000 SOEs in Croatia and they employ comparatively very high percentage of employees as of total number of employed persons (*Figure 1* and *Figure 2*). According to the ILO dataset, only Greece has higher percentage of employees working for SOEs among the EU-27 sample (Vidačak and Kotarski, 2019).

***Figure 1***

Source: IMF (2019) and World Development Indicators (author's calculation)

***Figure 2***

Source: Vidačak and Kotarski (2019)

Numerous international and domestic studies point out that SOEs act a major drag on Croatia's economic performance (Šonje, 2019). Croatian SOEs are generally inefficient and their resource allocation is mostly politically-driven. The main reason for this specific outcome is to be found in the very political equilibrium which has been reinforced over past three decades. In the early days of transition from socialist into a market economy SOEs offered an umbrella of protection from the vicissitudes of the free market. This kind of disposition closely dovetailed with the widespread perception of ubiquitous insider privatizations and crony capitalism structures emerging in the first decade of Croatia's independence. The mounting challenge of extinguishing violence and establishing stable social order in the midst of a violent state-formation was primarily addressed by forging dominant coalition of organized interest groups.

Therefore, at the end of 1990s Croatia belonged to a group of highly captured post-socialist states which relied on the collaboration of powerful enterprises with the political elite, the main goal of which was to appropriate rents in an uncertain political environment (Kotarski and Petak 2020). As the time progressed political parties, especially the electorally dominant HDZ (Croatian Democratic Union), have increasingly started to use SOEs as a tool of accumulating and retaining political power, providing jobs and securing contracts and investments to their preferred constituencies. Sometimes, part of that money even found its way back to the political parties via opaque and unregulated financing schemes.

Interestingly, all of this occured against the backdrop of EU accession negotiations and since 2013, full EU membership. This kind of political equilibrium has been problematic in three important aspects. First, political parties have largely lost their role of articulating public interest, creating sound economic policies and creating a class of competent managers, while their prime focus has become claiming and distributing economic spoils. Second, managerial selection according to the criteria of political loyalty as compared to the criteria of business acumen has diverted the bulk of talented personnel and managers to private sector, leading to further rounds of deterioration in SOEs economic performance. Third, large swaths of population have started to prefer SOE employment over other sources of employment and this has seriously raised hurdles to any future reform efforts. In a nutshell, large sector of state-owned enterprises should be viewed as a specific, albeit negative, democratic equilibrium.

**State-owned Enterprises in Croatia: A Useful Policy-Lever for Growth Promotion or An Almost Endless Source of Cronyism and Inefficiency?**

There are at least five important arguments which validate the view that Croatian SOEs performance constitutes a major drag on country's growth prospects (Šonje and Kotarski, 2020). First, the portfolio of SOEs is extremely fragmented and those enterprises can be found across various sectors, regardless of the economic rationale behind it. That means that SOEs are equally present in sectors where natural monopolies normally arise, as well as in sectors where this is definitely not the case (retail, hotels, construction). This state of affairs reflects both the legacy of privatization 'Croatian-style', as well as the lack of coherent governance strategy that lists a set of justfiable criteria for when and why state-ownership represents a necessary instrument of public policy.

Second, over the last decade the total number of SOEs has been on the rise. The multitude of SOEs has complicated a well-known principal-agent problem of how to ensure democratic oversight on behalf tax payers and citizens vs. political elite and state-appointed directors. In the current equilibrium the interests of true owners of state assets are impaired due to missing or insufficient accountability and transparency. As a consequence of this environment, corruption scandals and malinvestments abound.

Third, the production function analysis spanning all kinds of Croatian enterprises showed that SOEs total factor productivity (TFP) shrank by 40% in the period between 2006 and 2015. At the same time private sector TFP was reduced by 20% while the total TFP was down by 15% (IMF, 2019).

Fourth, a recent report conducted by the EBRD showed that according to the RoA (return on assets) metric Croatian SOEs record a subpar performance in comparison to SOEs in the Visegrad and Baltic group of countries (0.7% vs. 2.8%). At the same time, in the period between 2006 and 2016 average subsidies paid out to Croatian SOEs as a percentage of GDP was twice the share of profits paid back into state budget. Furthermore, the aforementioned average share of subsidies as a percentage of GDP was almost double the share observed among the EU-28 sample (Tabak and Zildović 2018).

Finally, Šonje (2019) shows that SOEs in cases where state acts as a 100% owner are generally less efficient (producing less than the expected level of output given the disposable resources and as compared to private enterprises), even after capital-intensive sectors such as railways, energy production and highways are excluded from the sample. SOEs generate far less in terms of revenue per employee and the total sum of salaries makes up far larger share of their operating revenues.

**Euro Introduction to Croatia and the Role of Transforming SOEs in Achieving Real Economic Convergence**

As already stated above, the current system of corporate governance in the sector of SOEs is an offshoot of political forces. However, this system is fundamentally incompatible with Croatia's ambition to adopt the euro and leverage its EMU membership for significantly lifting country's long-term growth prospects, which are currently meager based on the European Commission's own estimates.

On 10th of July 2020 Croatia was officially adopted into the ERM II, whose main role consists of representing a formal waiting room before the full introduction of the euro. At the earliest, Croatia could enter the eurozone in 2023, if it keeps fulfilling all criteria of nominal convergence (convergence in nominal variables like inflation, interest rates, budget deficit, public debt and exchange-rate stability). The economic impact of COVID-19 will certainly aggravate this goal since Croatia is predicted to be one of the most afflicted EU members states in terms of the projected output fall. Hence, public debt will significantly increase over coming months. However, an elevated public debt to GDP level won't represent a key inhibiting factor to sustainable real convergence in the long-term if Croatia embarks on a gradual trajectory of public debt reduction, similar to its successful track record over the 2015-2019 period. On the other hand, a significantly more demanding task consists of achieving real convergence or β-convergence (convergence in per capita incomes that postulates faster growth for lower income countries as compared to their more developed peers). For this type of convergence to be sustainable it needs to be firmly anchored in structural convergence, a process that engenders structural reforms esstential for enhancing productivity and competitiveness (e.g. educational system reform or SOE privatization).

In the EU, there were several prominent episodes of unsustainable nominal and real convergence such as those observable in Greece and Italy during the last eurozone crisis. More importantly, during the first few years of their EMU membership those countries enjoyed both real and nominal convergence paired with pronounced structural divergence. This mainly referred to their sharp deterioration in productivity growth, diverging macroeconomic indicators such as foreign and domestic debt and lingering institutional sclerosis (lack of judicial reforms and privatizations, onerous business regulations and inefficient public administration). So far, Croatia has missed an opportunity for raising real convergence both in absolute and relative terms. *Figure 3* shows that Croatia has fared significantly worser in terms of real convergence as compared to other post-socialist member states. The main reason is to be found in the fact that institutional quality that is so decisive for economic prosperity has been largely absent during the last two decades, as shown in *Figure 4*.

One of the most important avenues for structural convergence and improvement in institutional quality is to be found in the liberalization and privatization of Croatia's sector of state-owned enterprises. Unfortunately, low efficiency and continual losses have resulted in substantial fiscal costs and contingent liabilities for the state. Conversely, the creation of a sovereign-wealth fund in the mold of Austrian, Swedish or Finnish national wealth funds would enable professionalization and depoliticization of SOEs management structures. This would finally free up board members from undue political influence and the very logic of political-business cycle, which is similar to the separation of monetary policy within independent central banks, in order to avoid unwarranted political influence on monetary policy decisions.

Exactly this kind of institutional environment would enable political elite to set overraching political goals (public goods provision or national security) without exessively meddling into the day-to-day operational processes or relinquishing commercially viable business conduct. This transformation would also improve resource allocation and change relative incentives (risk vs. reward) for holding an employment in state-owned enterprises versus private sector employment. At the same time this would attract more talented managers to the SOE sector while less-skilled prospective or current SOE employees would be more inclined to consider employment in private companies.

***Figure 3***

Source: Eurostat; author's calculation

***Figure 3***

Source: Eurostat and Worldwide Governance Indicators; author's calculation

**Conclusions**

The euro is not a golden goose that will magically solve Croatia’s accumulated structural and fiscal problems, and irrevocably secure prosperity for generations to come. Nor is it a stinging viper that will inadvertently allow the large member states or corporations to ‘devour’the smaller ones, a popular trope often espoused by populist politicians of various stripes. The euro is a generational opportunity to seriously transform Croatia’s unbalanced political economy and to enjoy long-term benefits of exchange-rate risk elimination, lower interest rates and access to the eurozone’s new crisis fighting mechanisms created during the last crisis, to name just a few (Kotarski, 2019).

We have already seen in previous passages that SOEs reform is a long overdue issue, offering significant opportunities to taxpayers, future retirees, future reform-minded governments and investor community. Nevertheless, it is to be seen whether Croatia's political elite is ready to show ownership of the reform process necessary to boost the performance of SOEs and that incorporates several important steps: privatization, liberalization and professionalization of corporate governance. It is certain that those steps are incompatible in the short-term with the current political equilibrium and that they provide large long-term benefits to the Croatian economy. What remains uncertain is whether and how the aforementioned political equilibrium could be overcome. Maybe recent July 2020 election results could provide us with some answers. Croatian Democratic Union won by a landslide and will form a new government under very auspicious circumstances, with only two undemanding and relatively weak coalitional parties. Unlike previous governments over the last two decades, new government headed by Prime Minister Plenković will finally avoid large government fragmentation as a well-known obstacle to achieving structural reforms. This time around there won't be major political excuses for backtracking on the aforementioned reform agenda.

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