

CHAPTER 8: The crisis in South East Europe – the case of Croatia

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This article tells an unhappy tale about one of nine very unlucky countries. Even though the people are charming and clever, their lives are filled with misery and woe. From the very first paragraph of this article, in which the country receives terrible news, continuing on through the entire story, disaster lurks at her heels. One might say she is a magnet for misfortune. (Lemony Snicket, adapted to circumstances)

Impact of the crisis

The South Eastern European countries (SEECs) were hit hard by the crisis. The growth of real GDP turned negative in 2009 after five years of strong growth that averaged 6.5% per annum from 2004-08. General government balances deteriorated and government expenditure was higher than in other transition countries. However, thanks to contractions of imports caused by falling economic activities, the usually high current account (CA) deficits shrank in all SEECs in 2009. Croatia was no exception, as real GDP fell by 5.4%, the government deficit reached 3.3% of GDP and the current account deficit reached 8.5% of GDP.

Table 1: Impact of the global crisis (% of GDP)

	Year	SEECs average*	Transition countries average**	Worst among SEECs	Best among SEECs	Croatia
GDP growth	2009	-6.2	-6.2	-8.0 (Romania)	+3.0 (Albania)	-5.4
GG balance	2009	-4.0	-4.2	-7.3 (Romania)	-0.1 (Bulgaria)	-3.3
GG expenditure	2008	38.1	36.8	47.9 (B&H)	27.4 (Albania)	39.4
CA balance	2009	-12.9	-4.9	-22.8 (Montenegro)	-6.0 (Romania)	-8.5

Source: EBRD (2008, 2009).

*SEECs include Albania, Bosnia and Herzegovina, Croatia, Bulgaria, Macedonia, Montenegro, Romania and Serbia.

**28 transition countries covered by EBRD (2009) and 29 covered by EBRD (2008).

The overall situation in Croatia is not much different from the situation in other SEECS – decreasing GDP, increasing general government deficit, decreasing current account deficit and high general government expenditure. The regional average FDI of US\$ 27.8 billion in 2007 and 2008 almost halved to US\$ 14.3 billion in 2009. Comparable data on public and external debt are unfortunately not yet available; however, the estimates for Croatia show an increase in the national budget deficit from 2.3 billion Kuna in 2008 to 9.3 billion Kuna in 2009, financed through borrowing (Ott et al., 2009) resulting in public debt of the broadly defined public sector above 50% GDP at the beginning of 2010 (Šonje, 2010).

It was not rosy even before the crisis

While some indicators such as economic growth and FDI were strongly affected by the crisis, Croatia had long been confronted with problems that should have been tackled sooner. The country had been living recklessly above its means for too long, and now in the crisis it will have to pay expensive international and domestic bills.

Table 2: Situation before the global crisis (% of GDP)

	Year	SEECs average*	Transition countries average**	Worst among SEECs	Best among SEECs	Croatia
Current account balance	2008	-18.7	-7.6	-33.6 (Montenegro)	-12.3 (Romania)	-9.4
General government expenditure	2007	38.1	35.5	47.4 (B&H)	25.7 (Albania)	40.3
General government balance	2008	-1.8	-0.2	-5.7 (Albania)	3.0 (Bulgaria)	-1.4
Public debt	2008	31.0	-	54.0 (Albania)	14.0 (Bulgaria)	-
External debt	2007	42.0	-	105.0 (Bulgaria)	18.0 (Montenegro)	89.0

Source: EBRD (2008, 2009).

*SEECs include Albania, Bosnia and Herzegovina, Croatia, Bulgaria, Macedonia, Montenegro, Romania and Serbia.

**28 transition countries covered by EBRD (2009) and 29 covered by EBRD (2008).

It was not only in 2008 that Croatia had a current account deficit; indeed, this had been the case over the previous ten years and probably even longer. With high general government expenditures and budgetary deficits, it is not strange that it also had high public and external debts.

A similar picture holds for the other SEECS. During the 2001-07 period the regional average GDP growth was 5.7%, while the general government share of GDP across the region decreased by less than one percentage point. The share of general government in GDP even increased – by 5 percentage points in Montenegro and by 4.4 percentage points in Serbia. Although there are exceptions – the general government share in Macedonia decreased by 6 percentage points – most SEECS avoided fiscal consolidation and failed to decrease public expenditures or carry out necessary institutional reforms (Mihaljek, 2009; Ott, 2009).

Poor competitiveness

As a consequence of these failures, instead of being able to use a fiscal stimulus to counteract the effects of the crisis, Croatia should have cut its budget and current account deficits and accumulated funds to repay its debts. The constant current account deficits and poor scores in the EBRD ‘competition policy’ transition indicator point to a serious lack of competitiveness. The situation in Croatia can be compared to other SEECS. Using the EBRD (2009) indicators – scale of 1 to 4-plus – Bulgaria, Croatia and Romania score around 3, while Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia score around 2.²⁷ Moreover, all score poorly in the ‘governance and enterprise restructuring’ indicator (Croatia alone scores 3, while the others score from 2 to 3-minus).

Economic problems in Croatia are related to various institutional and administrative weaknesses. Quite often adjustments to the market are just normative; superficial reforms are made without real contents; new laws are passed without care for implementation and enforcement; laws are poorly harmonized and deficient, causing problems in the courts, while bureaucracy, corruption and organized crime flourish; and for years there was neither long-term strategy nor effective coordination (more in Ott, 2003; 2004; 2005; 2006). However, in April 2010, after being constantly blamed for not reacting to the crisis, government suddenly announced its Economic Recovery Programme. It incorporates some excellent goals: the state’s withdrawal from the economy, the implementation of necessary structural reforms, public administration rationalisation and efficiency improvement, budget expenditure reduction, tax system simplification, state aid system reform and even a fiscal responsibility law. The Programme was soon followed by the Plan for the Enforcement of the Programme.²⁸ Fulfilment of the set goals might lead to higher economic growth, a better fiscal

²⁷ The EBRD transition indicators range from little or no progress in the transition (indicator 1) to standards equivalent to those of a hypothetical advanced market economy (indicator 4-plus).

²⁸ Both the Programme and the Plan are – only in Croatian - available at <http://www.vlada.hr/>.

position and higher competitiveness. The problems with the implementation of the Programme will be elaborated later in this text.

Democratic deficit

To make substantial changes strong pressures are necessary both within the country and from the international community. However, Croatia is faced with a democratic deficit, i.e. it lacks democratic accountability and effective control over the decision-making process.

International indicators like freedom of the press, economic freedom and perceptions of corruption might be used to demonstrate the existence of the democratic deficit, but here the EU Barometer will be taken, which covers EU members and candidates, including Croatia.

Table 3: Comparison of views in Croatia and EU-27 (% of respondents)

	Croatia	EU-27
Distrusting political parties	92	79
Distrusting the government	84	65
Distrusting the parliament	84	63
Unsatisfied with the way democracy works in the country	84	45
Mistrusting the justice system	80	52
State meddling too much in their lives	77	61
Distrusting regional and local authorities	71	43
Government is best suited to deal with the consequences of the financial and global crisis	32	19

Source: European Commission (2009a, 2009b).

Although distrust and dissatisfaction with the political system are much higher in Croatia than in the EU-27, so are expectations that the government is capable of dealing with the consequences of the financial and global crisis.

Is Croatia really ready for real reforms?

The existence of a democratic deficit implies a need for strategies and reforms capable of contributing to building efficient institutions, and improving the respect for laws and individual rights. The future might bring two possible scenarios – the first is derived from the views expressed

by Croatian respondents to the EU Barometer and the second is developed in accordance with the irrational voter theory.

Table 4: Comparison of views in Croatia and EU-27 (% of respondents)

	Croatia	EU-27
Expecting worse situation in the next 12 months	57	31
Expecting better times to come	11	28
Things in the country are going in the wrong direction	71	30
The impact of the crisis on jobs has reached its peak	27	38
Main concerns facing the country		
Crime	59	19
Unemployment	50	51
Economic situation	45	40
Main personal issues faced		
Crime	6	8
Inflation	52	38
Economic situation	35	26
Unemployment	23	20
Pensions	21	15

Source: European Commission (2009c).

The findings of the Eurobarometer survey demonstrate that Croats are not only more pessimistic than citizens of other countries in the EU-27, but also that in the autumn of 2009 the number of those expecting the situation to worsen in the subsequent twelve months had increased by 6 percentage points since the equivalent springtime survey, while in the EU-27 it had decreased by 3 percentage points. Similarly, the number of those expecting better times to come decreased by 3 percentage points in Croatia, while in the EU-27 it increased by 3 percentage points.

The fear of crime in Croatia increased by 21 percentage points in just six months, while fears of unemployment and the economic situation actually decreased in the same period (by 2 and 4 percentage points respectively). That is rather strange as the majority of the same respondents said that the impact of the crisis on jobs has not yet reached its peak. Increased concerns about crime might be the consequence of strong EU pressures regarding crime in Croatia and investigations revealing widespread criminal activities among senior public officials.

While Croats are extremely worried about crime generally, it does not bother them personally. The personal fear of crime is at the same level as in the spring survey. This discrepancy in views of the effects of crime upon them personally and upon the country might mean that crime is perceived as something happening somewhere above ordinary citizens, in some high places. The highest personal concerns about inflation, the economic situation, unemployment and pensions are in line with the view that the crisis has not yet been overcome.

However, Croats seem to support reforms: 76% think that Croatia needs transformation to be able to confront the future, 67% are willing to make sacrifices for the benefit of future generations and 56% believe that the crisis makes transformations easier.

On the other hand, in a time of decreasing GDP, public sector trade unions demand increased salaries, pensioners call for higher pensions, patients resent even the smallest participation in covering the costs of health services, university students expect free education irrespective of performance, and parents insist on free textbooks for their children irrespective of their income. The list of irrational demands is endless, and bears out the claim by Caplan (2008) that voters are biased towards irrational policies, and that politicians are rational in trying to satisfy the voters and accordingly in the long run harm voters' wellbeing. Voters usually wish for markets that are less free and for more government intervention, not understanding that a successful private sector brings benefits to the public sector; voters are against liberalization of domestic markets, not understanding the benefits from participation in a more open market environment; voters wish to maintain employment at any cost, not realising that only the performance of the workers counts, and not the sheer maintenance of employment. Judging by the extent of the general government expenditures and deficits and the resulting public debt, the irrational voter theory seems to be functioning in the Croatian practice.

Ready or not Croatia needs immediate fiscal retrenchment and long run institutional reforms

In order to achieve higher competitiveness, an improved global position and higher wellbeing for its citizens, the Croatian government should insist on the set Programme and carry out long-term institutional reforms. The crisis is an ideal moment for new strategies and reforms, as the government could use the adverse circumstances to motivate society to accept unpalatable changes. Both the society and the economy have to be ready to accept and to realize the goals of the

Programme. Readiness for serious and deep reforms – liberalization and the demise of state economic interference – will be crucial. Reforms are always painful and it is now obvious, for example, that public sector employees – protected and privileged in relation to those employed in the private sector – are bent on resisting changes. They are not ready to accept changes that might benefit the young and the unemployed.

What we need is the readiness of all citizens to take the medicine – trade unions, employers, pensioners, patients. Citizens, relatively lucky to be living in a democracy, hard-won and frail though it may be, should support the changes. Politicians should be brave enough to face the risk of losing at the next elections. Without a new role for government, shifting from vertical to horizontal state aid, without education, modern technologies and entrepreneurship in the times of globalisation and the liberalisation of markets, Croatia will not be able to cope with more competitive countries.

And what is happening? First, the goal of the gradual reduction of the share of general government expenditure in GDP by 3 percentage points by 2020 is not ambitious enough, since Croatia's general government budget (at 50% of GDP) is closer to the levels of more developed countries than to the average of transition countries (at 33% of GDP) with which Croatia should compare itself. Second, some of the crucial activities set out in the Programme are already seriously behind schedule, such as the urgent improvement of liquidity within the country by the payment of all due government obligations by June 2010. Third, the government gives up its own plans whenever some interest group protests loudly enough. For example, upon announcement of the government's intention to abolish collective agreements with trade unions, these bodies started collecting signatures for a national referendum on the issue. It seems at the moment that the trade unions will collect a substantial number of signatures, since the population perceives this referendum as a vote for or against the government. The latest news is that the government has signed an annex to the collective agreement with the trade union of government employees promising them various benefits and guaranteeing not to cancel the collective agreement unilaterally. This means that agreement will oblige the government to make payments of various benefits for another two years.

The Croatian government should secure the preconditions for economic growth and fiscal consolidation. The country needs economic growth to decrease the public debt burden, increase budget revenues and enable the decrease of the deficit. It also needs fiscal retrenchment, which will be more successful and better enhance economic growth if it relies on a decrease in government spending instead of increased taxation, on cutting public sector salaries and social benefits and not

investment, on taxing consumption and not income. The country also needs a more efficient judiciary, a determined fight against corruption, and public sector transparency, in brief, a real de-politicization of the public sector.

Unfortunately, as shown above, public sector users are able to blackmail weak coalition governments. High social benefits and public sector salaries amounting to 70% of budgetary expenditures are the result of the long term pressures exerted by trade unions, pensioners, war veterans and other users. The government should break these vicious circles – carrying out reforms in the public sector, pension and health system – because ever more new borrowings to cover ever growing expenditures show no responsibility towards the new and shrinking generations of taxpayers. Instead of sticking to its Plan and drastically cutting public expenditures, which might help to establish the trust of the market and higher economic growth, the government condemns the country to stagnation supported with constant new borrowing, only transferring the consequences of irresponsible fiscal behaviour to future generations.

The way out of the crisis: the EU option and sticking to the Economic Recovery Programme

As shown in table 5 the EU Barometer's results for Croatia might lead to worrying conclusions.²⁹ However, like EU-27 respondents, Croats highly value security, solidarity, free trade and flexibility (85, 84, 80 and 74%, respectively). Croats also gave strong support to the euro and showed a higher trust in European than domestic institutions. In the midst of the crisis – despite the problems with the Slovenian blockade of Croatia's negotiations with EU because of some unresolved border issues (which now seem resolved) and the EU's accusations that Croatia does not cooperate adequately with the International Court in Hague regarding war crimes – the country strives to satisfy EU requirements. Furthermore, in the presidential elections at the beginning of 2010 voters did not elect a populist presidential candidate connected with corruption scandals (Milan Bandić, current mayor of Zagreb), but Ivo Josipović, a diffident university professor and classical music composer with no previous political exposure.

As a small country bordering with the EU, Croatia has no other option than to join the Union. Despite all its deficiencies the EU offers values Croatia should share and follow; it could help in developing an institutional framework capable of improving the cultural, historical and political patterns; it could

²⁹ Interestingly, in contrast to the Croatian results, 66% of respondents in Macedonia think that EU membership would be a good thing for their country (European Commission, 2009d).

enable an environment conducive to investment, and in the long run it could improve political stability.

Table 5: Comparison of views in Croatia and EU-27

	Croatia	EU-27
The country benefits by being a EU member	36	57
The country does not benefit by being a EU member	52	31
EU membership is a good thing	24	53
Insistence on social equality and solidarity is most important for facing global challenges	56	45

Source: European Commission (2009a, 2009b).

The success of Croatia's response to the economic crisis will depend on the readiness of its citizens and politicians to persevere in the implementation of the Economic Recovery Programme and in fulfilling the requirements of the EU, but for both issues, leadership will be crucial. The leaders will have to be firm, ready to resist compromises and tell citizens that the reform cannot be pleasant but might bring benefits. The leaders should confront the fact that they cannot be popular and that they will be disliked by everybody – family, friends and party comrades (Harberger, 1988).

No one can guarantee success, but the crisis could and should be used to change the old and unsuccessful patterns of society. The Programme is finally a step in the right direction, but only with its proper implementation – particularly to bring about responsible fiscal behaviour – it could result in balanced revenues and expenditures, a lower budget deficit and public debt. That could then lead to higher economic growth, political stability and well being of citizens, although only over the long term. Unfortunately, there are no short-cuts in achieving these goals.