Croatia and the European Union: an Opportunity, not a Guarantee

Europe has invented a “Convergence Machine”. Much as the United States takes in poor people and transforms them into high income households, the EU has welcomed poor countries and helped them become high-income economies. This is perhaps the most remarkable achievement of Europe’s growth model. While it is not easy to identify a single ‘European growth model’ given Europe’s diversity, there seems to exist a common approach to economic growth and social progress involving policies and institutions that govern trade and finance, enterprise and innovation, and labor and government. Guided by the findings of the World Bank report, “Golden Growth: Restoring the Lustre of the European Economic Model”, this note assesses Croatia’s readiness to make the most out of the opportunity of EU membership. To do this, we compare Croatia with other small, emerging European economies: the Czech Republic and Slovakia, both had the same average income level in 2004 when they entered the EU as Croatia today—US$16,000 in PPP terms; Estonia, a country that now has the same income as Croatia; and Slovenia, the only other former Yugoslav republic to enter the EU. The question is: how does Croatia compare to these countries now and relative to when they entered the EU?

Croatia had been steadily converging with the EU in income and living standards. Between 1998 and 2008, Croatia doubled its GDP per capita, reaching more than 64% of the EU’s average on a purchasing power parity basis. However, since the 2008 financial crisis, Croatia has seen its convergence gap widen by some 3% as its economy has been in recession for much of the last three years. As Croatia prepares to enter the European Union in 2013, the challenge is to reverse the recent trend and to resume convergence. In this respect, our overriding concern about Croatia is its timid approach to structural reforms. In almost all areas of the European growth model, Croatia needs to improve if it is to benefit fully from EU membership. Like many countries in Europe, Croatia is best placed in its trade and finance integration, but needs to do much more on business and innovation, and most of all in labor and government.

What are Croatia’s strengths?

One is trade. Trade, the first leg of the convergence machine, has been instrumental to Croatia’s growth. Europe’s rich and poorer economies are more integrated through trade in goods and services than in any other part of the world, resulting in quicker convergence in incomes and living standards. During the last two decades, the new member states of the EU have done especially well at taking advantage of the trade opportunities, integrating westward by trading goods and modern services. Croatia is no exception, and Croatia has clearly benefited from this integration. It has even expanded its trade beyond the EU15, developing new markets.
Another is finance. Financial integration is the second leg of the convergence machine. In Europe, capital behaves the way it should: it flows from richer to poorer economies, and countries receiving more capital tend to grow faster. Finance has served Europe well. The empirical evidence suggests that these capital flows supported growth among the EU12 countries. A key driver of these capital flows was financial FDI—big investments by Austrian, French, Italian, and Swedish banks in Central and Eastern Europe. Countries in emerging Europe have taken European financial integration to a new level. Croatia has benefitted from these flows, with as much capital flowing into equity to support investment as to debt to fuel consumption.

What are Croatia’s weaknesses?

A poor climate for private enterprise. Croatia could get more out of its enterprises by making it much easier to do business. The experience of other countries in emerging Europe with regulatory reform, such as Latvia and Lithuania, is that these necessary improvements can be made over years, not decades. And they need to be done quickly. Otherwise, enterprises remain small and unproductive—increasingly unable to attract foreign investors, incapable of taking advantage of a pan-European market, and progressively uncompetitive in global markets. A better business climate will help to stem the growth of imbalances, shift gears of the convergence machine, and make Croatian enterprises globally competitive. The need for change in this front is pressing as Croatia lags its comparators when these entered the EU. What does it take? Croatia must make it easier to create, operate and protect business activities. It currently ranks 133, 143 and 102 in three of the key areas (protecting investors, dealing with construction permits, and registering property) in the World Bank’s Doing Business flagship. And Croatia does much worse than the comparator group of countries in many of these areas. A concerted effort to improve these three areas in particular would yield big benefits.

Doing Business, Croatia and its Peers, Principal Component Analysis (ranging from 0 to 100) (2004 and 2011)

Limited support for R&D and Innovation. Despite high rates of technology adoption, and the high level of research in universities and scientific think-tanks, the ability to forge research into commercially viable manufacture has eluded Croatia. Croatia spends about 0.8% of GDP on R&D, of which the state spends the majority. Business R&D is about 40% of total R&D or €30.24 per capita; in contrast Slovenian business expenditures is about 62% of total R&D or €130 per capita. R&D leaders in Europe (Germany,
Norway, Sweden, Finland, etc.) and globally (Israel, Korea, Japan, China, U.S. etc.) spend well over 3% of GDP, with more than two-thirds spent by private sector. Three-quarters of OECD countries took measures to foster innovation after the crisis, increasing R&D tax credits and providing additional direct grants for business R&D, and in its Europe 2020 strategy, the EU has set 3% of GDP as a target for all members to achieve. In Croatia, very little public sector research has been commercialized with the private sector and public support to R&D activities is comparatively low. The Global Competitiveness Index suggests that Croatia’s knowledge-based growth is still in its infancy, and huge gaps remain in innovation, technological readiness, institutions, and business sophistication. With Croatia’s knowledge endowment, this is an area where sharp gains could be made with an aggressive policy stance.

**Labor markets that need modernization.** In 2011, Croatia’s 52.4% employment rate and 61% labor force participation rate were among the lowest in the EU. These results suggest a need to reduce labor market rigidities to ensure that it contributes to higher and sustained economic growth. Croatia needs improvement in raising labor productivity and generating employment. Croatia’s progress over the past decade has been limited on both counts, but all comparator countries have been equally unsuccessful at creating jobs; the arrows in the chart point decidedly upwards. Croatia in particular lags in its ability to increase labor productivity. What explains Croatia’s poor performance? Business regulation plays an important role in the process of creating jobs and increasing productivity. Policies concerning the operation of firms, such as tax administration and labor regulation, can improve the firms’ cost structure. Reforms in these areas can be especially important in transforming small and medium enterprises into larger firms. With a declining population, and with an exchange rate essentially tied to the Euro, increasing labor market flexibility in order to increase productivity is key. A regulatory environment conducive to private sector growth is also closely related to the success in expanding foreign markets. Thus, reforms that make it easier for firms to export and run their business operations are likely to lift the export performance of an economy and overall employment. Only with radical change can Croatia counteract a rapidly aging population and a shrinking labor force, by encouraging people to participate—especially among women, youth and the elderly. This must be aligned to ensure that work pays for both the employee and the employer, requiring changes in labor taxation and social benefit design. Disincentives to labor force participation, such as the generous availability of early retirement, must be addressed, and incentives for participation, for instance, improved child care facilities that allow women to better juggle multiple roles, and allowing older workers to phase in retirement on a part-time basis.

**And too large a Government.** Croatia will also have to make big changes in how it organizes government. The reasons are becoming ever more obvious: societies are aging, social security is already a large part of government spending, and fiscal deficits (5% of GDP in 2011) and public debt (63.3% of GDP in 2011 including guarantees) are already onerous. European governments are too big, and Croatia is no exception. Government expenditures in Croatia is about 43% of GDP, on par with its peers, and a
sizeable fraction of this is spent on social protection—public pensions, unemployment benefits, and social assistance. Indeed, Croatia currently spends more than some of the best performers among emerging European countries—the Czech and Slovak Republics.

The highest priority must therefore be public expenditure consolidation. To ensure fiscal sustainability, adjustments to expenditures must be accompanied by structural reforms—reforms to the pension and health systems, modernized social assistance systems and a more streamlined public administration. Expenditure adjustments mean better targeting spending for the truly needy and vulnerable. Targeted expenditures will create the fiscal space to allow more public spending on growth-enhancing expenditures (on infrastructure, R&D and innovation, and trade facilitation) that enhance competitiveness in the economy.

What governments do and how they finance their activities are as equally important as the size of government. Countries like Sweden show that big governments can go together with thriving, dynamic economies. The option is either to become more efficient or to become smaller. But Croatia has not done well in either front. As on example, social transfers are, as a percent of GDP, above their 2004 level. This is not because of the burden of demographics. In Croatia the share of social transfers in GDP has risen faster than the size of the dependent population, because of the increase in spending per capita on social transfers.

While Croatia’s recent consolidation efforts have reduced the fiscal deficit from 5.0% in 2011 to 4.3% in 2012Q2, securing debt sustainability and the challenge of absorbing EU funds upon accession will require more forceful fiscal consolidation measures. This in turn will require structural reforms to ensure public spending reductions are on a sustainable footing. With callable government guarantees, public debt exceeded the statutory limit of 60 percent of GDP. In 2010 and 2011, the government had to borrow an average of 12.5 percent of GDP annually to refinance old debt and cover the deficit. Refinancing could become a problem unless investors can be convinced by a credible reform program. Moreover, it is imperative to create the fiscal space for Croatia to co-finance a six-fold increase in EU-funded projects.

**Croatia is at a standstill—it must start moving**

Once it joins the EU, Croatia will be obliged to contribute about €520 million annually to the EU budget. But Croatia will have access to EU structural and cohesion funds amounting to nearly 2.5% of GDP, exceeding €1.5 billion a year. While EU grant funds are expected to provide a source of financing relief, the needs for co-financing will put pressures on the national budget when fiscal consolidation is a priority. To better absorb the EU funds, the government must prioritize spending patterns to ensure that EU-funded projects are closely linked to Croatia’s strategic priorities; create the fiscal space to ensure co-financing capacity; and upgrade its administrative capacity to ensure that projects qualify for financing and meet fiduciary standards.
Membership in the European Union will create unprecedented opportunities for Croatia as it gains unrestricted access to the world’s biggest trading bloc. Many countries, large and small, have made enormous progress after entering the EU. But it will come with equally large challenges. It will be difficult for a country that is 80th in the World Bank’s Doing Business rankings to participate profitably in an economic union with many of the world’s best nations for doing business. It will be difficult for a country that spends more than 40 percent of its GDP on government services to grow if the quality of these services is not among the best in the world. It will be difficult for the Croatian economy to grow if an ever-increasing share of its public budget—close to 20 percent of GDP—goes to social security and assistance programs that are organized in a manner that is inconsistent with a modern market economy. But all these issues can be addressed, successful examples abound in Europe and Croatia has the potential to turn them around in a relatively short period of time.

Croatia’s structural reform credentials are limited, and certainly less impressive than its comparator countries. It lags where earlier EU entrants have done more before joining the European Union. Judging by the present challenges of previous EU entrants, unless structural weaknesses are addressed early—before entry—they will reappear with a vengeance. The lesson from the new member states is to use EU entry as a lever for change: EU membership is an opportunity, not a guarantee. Otherwise, it will enter the European Union weak—exacerbating its weaknesses instead of adding to its strengths. With less than a year to go, before its expected accession on July 1, 2013, Croatia must make this time count, and turn opportunity into reality, not missed opportunity into regret.