

CROATIA'S COMPETITIVENESS CHALLENGE ANNUAL REPORT ON CROATIAN COMPETITIVENESS 2002

EXECUTIVE SUMMARY



Nacionalno
Vijeće za
Konkurentnost

National
Competitiveness
Council

The National Competitiveness Council comprises representatives from business, government, trade unions, research and educational institutions. It was founded at the beginning of 2002 on the initiative of private enterprises and the Croatian Employers Association. Its foundation was affirmed by a decision of the Government of the Republic of Croatia. The Council's mission is to support and promote the development of competitiveness, that is the productivity of the Croatian economy, with the aim of ensuring sustainable growth of the living standards of the population. The Council's activities stimulate dialogue between the private and public sectors, raise consciousness and knowledge about the importance of competitiveness, develop consensus about major economic questions facing Croatia, identify strengths and weaknesses of the Croatian economy, and recommend policies and initiatives that contribute to sustainable improvements in productivity-competitiveness.

The "Annual Report on Croatian Competitiveness 2002" is the first annual report on Croatia's competitiveness. It is an analytical barometer of the state of competitiveness of the Croatian economy. The report provides an assessment of the state of the main components of national competitiveness. It will be published every year, with the aim of facilitating regular identification of key potentials and areas requiring improvement, as well as monitoring changes as they occur.

National Competitiveness Council

10 000 Zagreb, Croatia
Hatzova 12
www.konkurentnost.hr
phone: +385 1 48 97 594
fax: +385 1 48 97 580

CROATIA'S COMPETITIVENESS CHALLENGE
ANNUAL REPORT ON CROATIAN COMPETITIVENESS
2002

EXECUTIVE SUMMARY

National Competitiveness Council
Zagreb, June 2003
Volume 1

Members of the National Competitiveness Council

Željko Čović, MA

PLIVA
Management Board President and CEO

Šime Klarić

The Association of Family Hotels and Pensions of Split-Dalmatia County
President

Franjo Luković

Zagrebačka banka
Chairman of the Management Board

Darko Marinac

Podravka
President of the Board

Božo Prka, Msc

Privredna banka Zagreb
President of the Management Board

Goran Radman

Microsoft Adriatics
General Manager

Mladen Vedriš, PhD

Sonder Ltd
Chairman

Ivan Vidaković

IBM Croatia
General Manager

Miroslav Božić, Msc

Ministry of Agriculture and Forestry
Assistant Minister

Gvozden Flego, PhD

Ministry of Science and Technology
Minister

Ljubo Jurčić, PhD

Ministry of Economy
Minister

Slavko Linić

Government of the Republic of Croatia
Vice Prime Minister

Zdenko Mičić

Ministry of Tourism
Deputy Minister

Boris Kunst

Workers' Trade Union Association of Croatia
President

Zdenko Mučnjak

Croatian Trade Unions Association
President

Krešimir Sever

Independent Trade Unions of Croatia
President

Marinko Vrsaljko

Union of Autonomous Trade Unions of Croatia
Representative

Slavko Krajcar, PhD

Faculty of Electrical Engineering and Computing
Professor

Helena Jasna Mencer, PhD

University of Zagreb
Rector

Stipe Orešković, PhD

Andrija Štampar School of Public Health
Director

Daniel Rukavina, PhD

University of Rijeka
Rector

Dear Readers,

It is a special pleasure to present to you, in the name of the National Competitiveness Council (NCC), the Executive Summary of the first annual report on the competitiveness of Croatia. With this report, Croatia finally joins the majority of developed countries, who monitor the level of national competitiveness as well as recent changes. The findings and arguments of the report are also a basis for determining the key initiatives Croatia should undertake, within the framework of the evaluation of Croatia's application for full membership in the EU and the assessment of its competitiveness.

After more than ten years of transition and post-war reconstruction, Croatia is faced with new challenges. How can it speed up economic growth, increase employment and living standards? How can it integrate itself into the world economy and take advantage of its strengths, while simultaneously avoiding the social risks globalization entails? Does Croatia have the energy for rapid reform and entry into the EU in 2007/2008?

An answer to all three challenges is the rapid development of a strong and stable economy based on the competitive advantages of the country as a whole. Highly competitive enterprises and a highly skilled labor force will play a special role within this.

The competitiveness of a national economy is neither an inherited nor a static category. Instead, it is subject to constant change in the environment. The National Council defines competitiveness as the ability to achieve success in the marketplace, leading to a highly productive economy and improved living standards for the whole population. The question of competitiveness, especially in a small pen economy such as Croatia, must therefore be seen through the ability of the whole economy and society to do business in the new economic environment of the enlarged European Union and in the world economy, where markets and production locations have become global.

The National Competitiveness Council, after a year of intensive work, ratified the "Annual Report of the Competitiveness of Croatia 2002" by consensus. This finished, in fact, the first, beginning phase of its work. This phase included many activities attempting to familiarize the social, economic and general public with the tasks of the National Competitiveness Council: to continually promote and stimulate the development of the competitiveness and productivity of the Croatian economy, with the aim of ensuring sustainable growth and high living standards for citizens of the Republic of Croatia. The Council's main mode of work is to create a meaningful dialogue between four interested parties—the government and public sector, the economy, the unions and the education and knowledge sector. It seeks to reach consensus about an understanding of Croatian reality. Its final goal is to create consciousness of the necessity of change, and the implementation of change in Croatia.

"The Annual Report on Croatian Competitiveness 2002" gives an objective assessment of the state of affairs in the main areas of national competitiveness, highlights the main problems and key weaknesses of Croatia in relation to other transition countries in the region, and seeks to find their causes. The Report is an all-sided evaluation of the internal and managerial competitiveness of Croatia. It aims to be a key source of information for the Council, for economic policymakers and for experts in the field. Its aim is to become a regular and realistic barometer of the state of competitiveness of the national economy, as in many other countries. It is our ambition to become a key platform for creating awareness of the need to constantly improve the level of national competitiveness.

The messages of the Annual Report are extremely serious and are well worth pondering. The extremely high cost of doing business and very weak external competitiveness, limited domestic competition, low product and service quality and inadequately developed entrepreneurship are our most striking weaknesses. In comparison with other countries, these weaknesses are even more noticeable. Some of our advantages, such as macroeconomic stability, an acceptable tax system or a consolidated and stable banking system, are apparently inadequate to compensate for the majority of our competitive weaknesses. In this respect, the Report shows clearly the position of Croatia. We are increasingly falling behind many of the countries of Central Europe.

The message is clear: raising the productivity and overall competitiveness of Croatia must be the guiding purpose of the creators and implementers of economic policy. Emphasis must be placed on the main factors braking development in the main developmental institutions in Croatia - education, the rule of law, innovation and technological development, regional development and development clusters, so as to realize growth potential as much as possible and to achieve the maximum achievable.

Through the process of becoming a candidate for EU accession, Croatia can gain a new chance to become included among the developed transition countries. It must be understood that only an urgent, comprehensive and well-focused policy of improving national competitiveness can achieve the desired path to long-term sustainable growth, prosperity and overall social welfare.

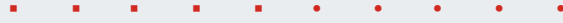
We expect that the broadest expert, political and general public in Croatia will recognize the main messages of this Report. We expect that they will form the needed critical mass of awareness of the need for change, and the corresponding political will to undertake such activities.

Great challenges await all of us.
Let's make Croatia competitive.

Sincerely yours,



Željko Čović, MA
President, National Competitiveness Council



"In a modern global economy prosperity is a choice of the nation."

"Nations choose prosperity if they organize their policies, laws and institutions based on productivity."

M. E. Porter
The Competitive Advantage of Nations

- "New social structure/framework should also be built on:*
- accelerated, but ecologically sustainable economic growth as well as the growth of living standard,*
 - open and competitive economy based on knowledge and new technologies, products and services."*

Development Guidelines for Croatia, Government of the Republic of Croatia

● INTRODUCTION

The Croatian economy is passing through an historic transformation from an economy dominated by the state to an economy based on private ownership. This transformation is important and in fact a requirement for the current and future generations of workers and their families to enjoy the advantages of prosperity and rising living standards.

Competition is intensifying in the world economy. In the last decade alone, world output has increased by 25%, while total exports of the world economy grew by 75%. That is, exports grew three times faster than output. This fact alone speaks volumes about the challenges facing Croatia. On the one hand, it must finish the economic transformation, and on the other hand, it must find an adequate response to increasing competitiveness in the world economy.

Croatia has a choice. We can increase our share in world markets of goods and services by offering cheap products and services, basing our competitiveness on low pay for workers. However, such a strategy would imply a further fall in the price of labor in a struggle for cost competitiveness involving many countries with labor costs far below Croatia's.

A strategy based on high quality products and services, produced by highly educated and well-paid workers employing innovation and technology provides a completely different alternative. In order to implement such a strategy, all of our efforts, from the government to the private sector, must be guided by an overriding goal-increasing productivity growth. Productivity growth is the key to increasing wages and living standards in the long run in Croatia.

We want an increase in productivity that is connected to economic growth, and not productivity growth at the expense of employment. Croatia should focus on investment that introduces new technology and new knowledge to simultaneously raise productivity and achieve economic growth. In this way, human potential will be developed. Our investment strategy should be based on identifying areas of high productivity growth. In the world economy, growing competitiveness can no longer be assured by the size of investment, but rather by the quality of investment.

To become internationally competitive, Croatia must:

- Investment in cutting-edge technology that can be used to produce goods and services sought by consumers world-wide
- Train the labor force to fully utilize the advantages of the new technology
- Build top-flight infrastructure that support productivity improvement in the private sector
- Create the conditions and environment that support investment by the private business sector in leading industries with the aim of creating highly-paid jobs for highly educated workers
- Ensure that our educational system prepares students for the new economic reality facing Croatia and the world.

The transformation of our economy into a competitive economy in the world market is an enormous task. All aspects of the economy play important roles: every citizen of Croatia must contribute to increasing its competitiveness. No industry or individual can isolate himself from the collective effort and process.

Given the extent and nature of this challenge, we have invited individuals from various parts of Croatian society—from the economy, unions, the government, education and research—to work on the development of a common vision. This Report is the result of the work of this group. On the basis of this analysis of Croatian competitiveness, in the next few months several experts working will develop detailed recommendations for further action. These recommendations will be sent to the relevant institutions in the Republic of Croatia.

● 1. IMPROVING THE LEVEL OF COMPETITIVENESS-FOUNDATION FOR FUTURE GROWTH

It has been twelve years since Croatia exited socialism, but its gross domestic product is still 20% less than it was before the war. Wartime destruction and transition contributed substantially to the economic erosion of the country. At the same time, in eight of the last nine years, the Croatian economy has grown. But it has not grown fast in enough in comparison to transition countries in its environment. Our main problems are the sustainable of further growth and the improvement of competitiveness. The enormous gap between low incomes and the economic and social aspirations of the population can only be closed by raising the rate of growth. And this must be based on increased productivity. Accession to the EU is a unique opportunity for Croatia to improve its economy, if it can withstand the competitive pressures of the unified market of the European Union.

Competitiveness is the ability to achieve success in the market, leading to a highly productive economy and improved living standards for the whole population. The question of competitiveness, especially in a small open economy like Croatia, cannot be limited to the question of competitiveness in foreign trade. Competitiveness is the ability of the whole Croatian economy to successfully function in the environment of an expanded European Union and in the world economy, where markets and production locations have become global. Competitiveness is largely a synonym for productivity. Its increase is based on new knowledge, investment and greater efficiency. Increased productivity based exclusively on reduced employment and lower labor costs cannot be the foundation of long-term growth.

Although competition is affected by macroeconomic and other broader socio-economic factors, in the end it can be improved only by more competitive enterprises. This is the fundamental starting-point of the Report, and it determines its structure and content. The conceptual approach of the Report begins from the idea that competitiveness is determined by:

- (i) The quality of the immediate business environment in which the enterprises does business
- (ii) The quality of the broader social and economic environment
- (iii) The innovational and investment abilities of enterprises themselves

Significantly improving competitiveness is key to Croatia's successful accession to the European Union.

Competitiveness-in essence a problem of low productivity.

Enterprises that do business in favorable institutional and economic environments-the key to improving competitiveness.

The source of growth up to now, domestic consumption and tourism, are not strong enough motors to create high growth rates and improve competitiveness.

Competitiveness is expressed:

- (i) In macroeconomic results
- (ii) In international trade competitiveness
- (iii) At the level of regions and sectors.

When it achieved its independence and started the transition to a market economy, Croatia created important preconditions for rapid growth. At the same time, rapid growth requires further structural changes so as to decrease unemployment and resolve fiscal problems. At present, growth is to a great degree the result of growth in domestic consumption and growth in tourism. Of the 3.9% growth achieved in 2000 and 2001, it is estimated that as much as 2.9% came from the expansion of tourism. This means that growth in the rest of the economy amounted to only 1%. Further expansion of tourism at the current tempo is possible only through more rapid privatization and investment to improve the quality of services.

Growth in exports is key to rapid growth in Croatia. However, at the moment one can only see this in the shipbuilding sector, which has been heavily subsidized by the government. Without shipbuilding, export growth was negative since 1996, amounting to -1.4% annually.

Thus, at the present, economic growth based on domestic consumption, tourism and subsidized shipbuilding exports, hides the weak competitiveness of Croatia. Weak competitiveness in foreign trade is an expression not only of the weak competitiveness of the exporters themselves but also of internal competitiveness. The comparatively high level of prices and wages, i.e. labor costs, are visible and direct expressions of the weak competitiveness of Croatia.

2. BUSINESS ENVIRONMENT

2.1 TAXES AND ECONOMIC REGULATIONS

The tax burden greatly contributes to the price competitiveness of enterprises. The quality of economic policy, public administration and laws speak volumes about the quality of the business environment.

Table 1: Indicators of public finance in selected countries (2002)

	Total debt of central government (% GDP)	General government balance (% GDP)	Health care expenditures (% GDP 99)	Tax revenues (% GDP)	Taxes on goods and services (% value added of goods and services)	Income taxes on profit and capital income (% income)	Highest income tax rates	Marginal income tax rate for average taxpayer	Highest profit tax rate
1	2	3	4	5	6	7	8	9	10
Lithuania	23	-1,3	6,3 (98)	22,8	14,1	12	33	33	15
Ireland	38,8	4,5	6,8 (98)	30,6 (98)	14,1 (97)	41,8 (97)	42	42	16
Hungary	56	-3,6	6,8 (98)	32,8	15,2 (98)	20,7	40	40	18
Croatia	50,7	-4,9	9,6 (97)	36,5 (01)	23,1 (01)	7,5 (01)	45	20	20
Bulgaria	53 (99)	0,6	4,1	28,9	18,2	12,5	38	26	20
Slovenia	24 (99)	-1,2 (01)	7,5 (98)	36,5 (01)	17,6	14,2 (01)	50	35	25
Slovakia	33,5	-3,2	6	31,1	11,8	19,6	38	25	20
Romania	..	-1,7 (99)	4,6 (98)	26,7 (99)	13,2 (99)	15,9 (99)	40	23	25
Germany	60,8	-1,6	10,5	26,2 (98)	7,1 (98)	14,6 (98)	48,5	35	26
Czech Republic	15	-3	7,2	32,2	13,7	13,4	32	20	31
Turkey	..	-11,4	4,8 (98)	22,1	15,7	29,5	40	40	33
Austria	63,6	-1,7	8,2	35,0 (99)	10,5 (99)	25,4 (99)	50	41	34
Italy	111,4	-0,6	8,2	38,5 (99)	11,6 (99)	36,2 (99)	45	33	36

Source: World Bank Development Indicators, Heritage Foundation (2003) (columns 8-10).

Major problem:
expenditures of extra
budgetary funds are
almost equal to the
expenditures of the
budget.

The tax burden imposed by direct taxes on the Croatian enterprise sector is low. The progressive income tax is also low, taking only 7.5% on average (2001). This is substantially lower than the 11.9% in 1995. Croatia, along with the Czech Republic, also has the lowest marginal income tax rate for the average taxpayer (20%). It also has a low profit tax rate (20%), with only Lithuania, Ireland and Hungary having lower rates.

These relatively low rates are favorable for entrepreneurs, and partially compensate them for other costs of business that are high, especially labor costs. However, the tax burden on goods and services, which is the highest among the comparable countries, indirectly affects entrepreneurs because it decreases effective domestic demand.

Through decreasing expenditures above all on defense, displaced persons and refugees, the share of government consumption in GDP in Croatia was decreased from about 30% in the mid-1990's to near the EU average of 20% in 2002. However, the fact that expenditures of extra budgetary funds are almost equal to budgetary expenditures represents a major problem. In part, this is the result of Croatia's demographic structure and the large number of pensioners, and in part it is the result of the high costs of the health care system. Along with this, according to a World Bank analysis, wage payments from the government budget amount to 12% of GDP, twice as large as the average among comparable countries.

Public sector expenditures grew from 44% of GDP to a very high 57% between 1994 and 1999, the highest among comparable countries. The main cause of this growth was pensions, which account for 14% of GDP, and health care, which accounts for about 9% of GDP (2001). The growth of these expenditures, like the growth of other government expenditures, could not be financed by current revenues in the short run. Thus the public debt grew from just below 30% in 1996 to more than 40% in 2002. If government guarantees are added to this, total government debt reaches 55.4% of GDP. This is not a very high level compared to comparable countries. But it is unfortunate that Croatia was unable to maintain its inherited low level of public debt. Furthermore, it did not use the substantial funds raised via privatization for development purposes but instead for covering the deficits of the pension and health funds, and for wartime reconstruction and government investment.

Despite relatively large contributions, pension fund revenues cover only 60% of pension expenditures. It is praiseworthy that the minimum age for qualifying for pensions has been raised, and the early retirement has been made less attractive by substantially decreasing pensions for each year a work retires early.

**A simple tax system: a
competitive advantage,
but still a substantial
burden of administrative
regulations.**

A simple and transparent tax system is an important element of Croatia's competitive advantage. Domestic entrepreneurs confirm this view. Their assessment of the tax system is more favorable than the EU average and than the majority of countries in Central and Eastern Europe, excepting Slovenia and Hungary.

At the same time, Croatian managers spend a relatively small amount of time communicating with government officials regarding the implementation of laws and regulations. On this criterion, Croatia is among the more successful transition countries. The costs of imports and import barriers do not make the conduct of business difficult in Croatia. Assessments of stock market functioning are favorable, and the practice of "money laundering" is limited.

However, despite these positive aspects, entrepreneurs consider administrative regulations in Croatia to be substantially burdensome. Regulatory barriers to investment and business are especially problematic at the local level.

**...slow repayment of
claims...**

According to indicators of the time required to repay matured obligations (18 weeks), Croatia ranks very poorly. It is only better than Slovenia and Poland among EU accession countries.

**...subsidies that
bolster noncompetitive
enterprises...**

Entrepreneurs also give government subsidies very poor evaluations. They see subsidies as maintaining non-competitive producers, and not stimulating productivity.

...rigid labor laws...

In the area of legal protection of workers, Croatia, along with Italy and Turkey, is in the group of countries with relatively rigid labor legislation. The complexity of employing a worker permanently is not too different from comparable countries, but the regulations on temporary work and on collective layoffs are rigid. This significantly decreases flexibility, and increases the costs of abandoning non-competitive production and increases risks for entrepreneurs.

...along with decreasing corruption and bribes, except in the legal system and in the process of granting loans.

Evolution of labor costs during the 1990's: fall, rise and stabilization at a very high level.

Croatia-the weakest price competitiveness of labor in Central and Eastern Europe.

Bribes and corruption are substantial, but not crucial problems for business. One should research the basis of entrepreneurs' feelings that there is corruption in the granting of bank credit. However, entrepreneurs rate the courts very poorly, especially regarding independence, effectiveness and transparency.

2.2 COSTS AND PRICES

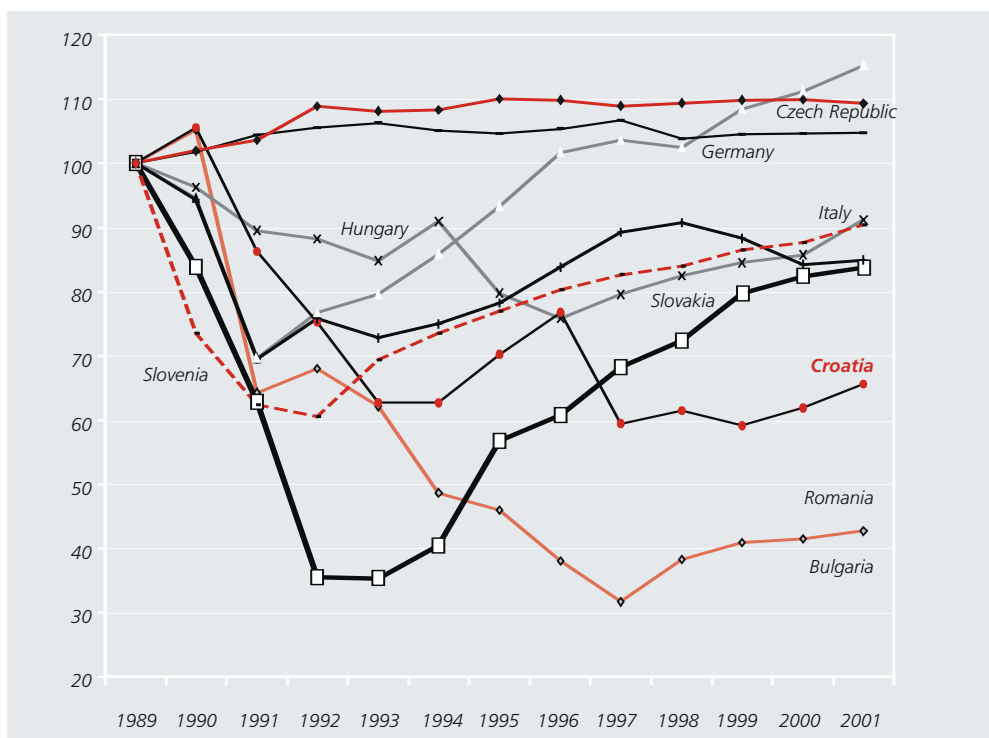
Lower labor costs relative to productivity, that is, lower unit labor costs than in EU member countries, were a major source of competitive advantage for transition countries in recent years. The countries of Central and Eastern Europe improved their foreign trade competitiveness thanks to favorable relations between labor cost and productivity. This competitive advantage was especially visible at the beginning of transition, but it gradually decreased. This raises the question of new sources of competitiveness. In this respect, Croatia is similar to other transition countries.

At the same time, changes in wage levels have been substantial. The decrease in average wages in Croatia during the first years of transition was the largest among all the countries of Central and Eastern Europe: as of 1993, average wages were only one-third of what they had been in 1989. However, after 1994, wages rose some 40%, and wages eventually stabilized at a relative high nominal level.

Nominal wages in Croatia, as in all the countries of Central and Eastern Europe, are substantially lower than in the EU. Wages are four times lower in Croatia than in the EU. However, average labor costs in Croatia are 54% than in other accession countries. Among transition accession countries, only Slovenia has higher average labor costs. Total labor costs in industry in Croatia are 26% of industrial labor costs in the EU, but they are 75% higher than the average in accession countries. Nominal labor costs in Croatia industry are 3.9 times higher than in Bulgaria, about 50% higher than in Hungary and the Czech Republic and 29% higher than in Poland. This shows that Croatia is an extremely "expensive" location for exporters.

Nominal wages, however, are not an adequate indicator of competitiveness. Entrepreneurs assess competitiveness taking into account the level of productivity necessary to achieve a given profit.

Figure 1: Index of average real gross wages in domestic currency (1989=100)



Source: Countries in Transition 2002, WIIW; OECD Economic Outlook, 2002/2.

Note: Dynamic of net wages was used in calculations for certain years and countries because the real gross wages were not available.

Wages corrected for productivity are at the EU average-accession countries have lower wages than the EU average.

Unit labor cost, which corrects wages for productivity, were between 4% and 70% greater in Croatia than in other accession countries. They were approximately equivalent to the EU average. This means that, given its current productivity level, Croatia does not have any competitive advantage in labor cost compared to the EU. By contrast, all the accession countries have between 7% and 33% lower unit labor costs than the EU average. This means that they do have a competitive advantage in labor costs. This further aggravates the problem of how to increase Croatia's competitiveness and thereby to preserve the current level of real wages.

Similarly, industrial unit labor costs in Croatia are between 16% and 109% higher than in accession countries. This even larger different to a great extent explains the very low share of export-oriented foreign investment in Croatia, as well as the weak export competitiveness of domestic enterprises. At the same time, this means that increasing export competitiveness must be accomplished by increasing value-added, which implies building in better technology and knowledge in our services and products.

Changes in unit labor costs depend not only on changes in labor costs but also on changes in productivity. Between 1997 and 2001, productivity in the Croatian economy as a whole grew 7.9%, and in industry it grew 28.1%. The high rate of growth of industrial productivity improved competitiveness, since unit labor costs fell about 14.3% between 1997 and 2001. However, in the economy as a whole, slower productivity growth did not compensate for increased labor costs, and competitiveness expressed in unit labor costs worsened by 6%.

Productivity growth equal to wage growth.

What are the reasons for productivity growth? This question requires deeper research, and therefore this Report does not provide final answers. Productivity has to a great extent been increased by decreasing employment, especially in industry. This substantially resolved the problem of competitiveness for enterprises, but did not resolve the fiscal burden of unemployment on the whole economy.

According to the survey undertaken for the World Competitiveness Report, the position of Croatia regarding unit labor costs is unsatisfactory. Croatia is at the bottom of the list, as it is among transition countries.

Looking at labor costs relative to competitiveness, entrepreneurs place Croatia in next to last place on the list of 80 countries. In contrast, entrepreneurs from Hungary, Romania, Slovakia and the Czech Republic, which took the top four places in the answer to this question, believe that their countries have substantially lower labor costs than competitors.

Table 2: Costs of business in sample countries (2001)

	Cost of domestic telephone conversations (2000) \$/3 min	Costs of telephone conversations -calls to the USA (2000) \$/3 min	Use of the Internet (2001) \$/30 hours, lower tariff/rate	Costs of diesel fuel \$/l	Costs of electric energy €/100 Kwh	Costs of natural gas €/GJ	Differences in interest rates %
Average 12	0,1	1,676	17,89	0,59	7,69	6,53	5,15
Austria	0,15	-	17,21	0,49	10,34	10,91	3,56
Bulgaria	-	-	7,77	0,58 ²	5,21	5,1	8,23
Czech Republic	0,13	0,972	11,6	0,55	6,19	5,56	4,09
Slovakia	0,1	1,131	9,05	0,68	6,71	3,66	-
Ireland	-	-	16,45	0,72	6,95	8,59	4,74
Italy	0,12 ¹	-	17,62	0,68	14,2	12,11	4,57
Lithuania	0,06	3,098	45,38	0,55 ²	6,14	5,42	6,63
Hungary	0,09	1,276	26,33	0,62	6,27	3,63	2,85
Germany	0,09	0,338	13	0,64	9,91	7,06	6,45
Romania	0,11	2,487	15,37	0,33	5,03	3,22	-
Slovenia	0,04	0,809	29,5	0,66 ²	-	-	5,24
Turkey	0,11	3,299	5,45	0,62	-	-	-
Croatia	0,1	1,543³	20,83	0,62	5,62	6,24	6,32

Source: World Bank Development Indicators, Euro stat, National Energy Regulators (costs of energy, natural gas in transition countries) Croatian Telecom.

Notes: 1-1999; 2-2000; 3-costs of telephone calls are prices in 2003, deflated by 2000 prices.

Labor costs are important, but not the only cost of doing business.

Labor costs are important, but they are not the only costs of doing business. Costs of energy, communication, finance etc often actually have far more important implications for companies' competitiveness. Analysis of these costs in Croatia shows that the general level of prices, and the price of inputs, is stable and in fact lower than the European Union average. However, these costs are higher than in most other transition countries.

With the exception of the cost of borrowed funds, other costs of doing business continue to grow.

Growth of productive inputs in the last 5 years has had a negative impact on the competitiveness of Croatian enterprises. This is especially true for the high cost of telephone services, which slows the expansion of the Internet and the use of other IT services. The price of communication services in Croatia is near the average of the sample countries, but is significantly above the level in Germany.

Energy costs are somewhat lower than in EU countries. They are comparable to those in Central European transition countries. However, in the last two years the price of fuel in Croatia has converged toward prices in Western countries.

An exception to the pattern of increased costs has been the costs of borrowed funds, expressed as the margin between interest rates on loans and deposits. This cost has fallen 43%. Falling interest rate differences indicate greater economic stability and increased competition and efficiency of the financial sector after 1998. For individual companies, this means that it is now possible to find cheap funding sources. This provides a favorable foundation for the expansion of domestic entrepreneurship. However, despite substantial decreases in real interest rates, Croatia remain among the group of countries with large margins between interest rates on loans and deposits.

2.3 COMPETITION AND RELATIONS WITHIN THE BUSINESS CHAIN

A national economy can be competitive on the world level if stiff competitive struggles on the domestic requirement require local companies to constantly develop innovation and new abilities. These innovations and abilities require a stimulative domestic business environment, including above all local competition.

Domestic competition is limited...

Since Croatia is an open economy, the intensity of domestic competition is still not great. Croatian entrepreneurs assess that competition in Croatia is less intense than the world average. The small domestic market cannot explain the low level of competition, since Slovene entrepreneurs rate the level of competition in their economy higher. The reason for weak competition probably lies in the fact that corporate activities in Croatia are dominated by a few corporate groups. Entrepreneurs believe that their influence is substantially higher than in other countries in Central and Eastern Europe.

Attempts by the government to stimulate competition are still very weak. Among the transition indicators, Croatia received a grade of 2+ for market competition. Bulgaria, Romania and Latvia received the same grade, while the other accession countries received higher grades. Even though the Agency for the Protection of Market Competition has been founded, it does not influence the development of competition enough. Entrepreneurs also feel that anti-monopoly policy in Croatia is weak and ineffective in promoting competition.

...and superior import products lead to a lack of local suppliers, both in number and quality, who work with customers and partners.

Since the domestic market is dominated by a few business groups with a low level of competition, imports are the main source of increased competition. According to this criterion, Croatia is in last place, 74th among comparable countries. This is an indicator of the openness of the domestic market, and also the weak ability of domestic producers to compete with import producers. The result of weak domestic competition and strong foreign competition is that enterprises mainly import components and machines rather than purchasing them from domestic producers. According to these criteria, Croatia lags behind the majority of accession countries.

Whether they purchase components and machines from foreign or domestic suppliers, Croatian firms work closely with suppliers and partners. According to this criterion, Croatia is substantially ahead all the accession countries. However, without further research it is very difficult to establish whether this cooperation is a way to compensate for weaknesses in the number and quality of domestic suppliers or whether it is an expression of business opportunities. Since cooperation with organizations offering specialized services and research is weak, this cooperation is very likely limited to direct suppliers. This contention is confirmed by the lack of clusters or groups of producers in similar activities that cooper-

Sophistication and innovation of buyers roughly corresponds to their purchasing power, resulting in a business environment that does not stimulate enterprises to be competitive.

ate in their businesses. It seems that production links between domestic producers are rare and limited to suppliers with whom companies work very closely.

The limited purchase power of consumers does not force producers to produce innovations. Nor are consumers especially sophisticated in relation to their purchasing power. Unfortunately, neither the standards of quality of products and services, energy and other regulations are not such as to force producers to produce at high levels of quality or to improve their products and services.

Despite Croatia's openness to investment and trade, the Report points out the low level of competition on the domestic market. Superior imported products, the small number and weak competitiveness of domestic suppliers make cost improvements expensive on the market. If we add to this high costs of doing business, then it is clear that multiple factors in the direct business environment do not favor the formation of competitive advantage.

Table 3: Ranking of the competitiveness of Croatia and selected countries

	Croatia	Slovenia	Hungary	Bulgaria	Romania	Austria	Ireland
<i>Level of competition on the domestic market</i>	60	40	21	64	72	13	39
<i>Cooperation with local partners and institutions</i>	21	47	33	55	32	9	28
<i>Orientation of local enterprises to customers</i>	64	22	43	48	74	14	26
<i>Existence of local suppliers</i>	63	37	57	59	65	10	31

Source: Database of the World Competitiveness Report 2002-2003.

● 3. THE BROADER BUSINESS ENVIRONMENT: THE BASIS FOR FUTURE GROWTH AND COMPETITIVENESS

The socio-economic environment, comprising the education level of the population, the quality and prevalence of information, transport and energy infrastructure, and social partnership, represents a broader environment for businesses. This broader environment is a key factor in the future improvement of competitiveness, productivity of productive factors and in the adaptability and innovativeness of enterprises. Although these factors do not directly affect current cost competitiveness of enterprises, they are crucial in the improvement of competitiveness and in future non-price advantages.

3.1 EDUCATION AND TRAINING: BASIS FOR A KNOWLEDGE-BASED ECONOMY

Training of the labor force and the ability of workers to continually improve quality and assimilate new technology are crucial determinants of improvement of Croatian competitiveness. Since Croatia cannot maintain its competitiveness by decreasing the cost of labor or through exchange-rate depreciation for structural reasons, the only long-term solution is to increase value-added per employee through improved education of workers and improvements in the educational system.

Croatia has an educational structure of the population typical of the majority of Central and Eastern Europe. The predominant category is individuals with intermediate education levels. The share of the population with higher education is similar to the Central and East European average. Croatia has a high ratio of people who have only finished elementary school (30.8%). This is largely the result of the high share of elderly, agricultural population, as in other European countries.

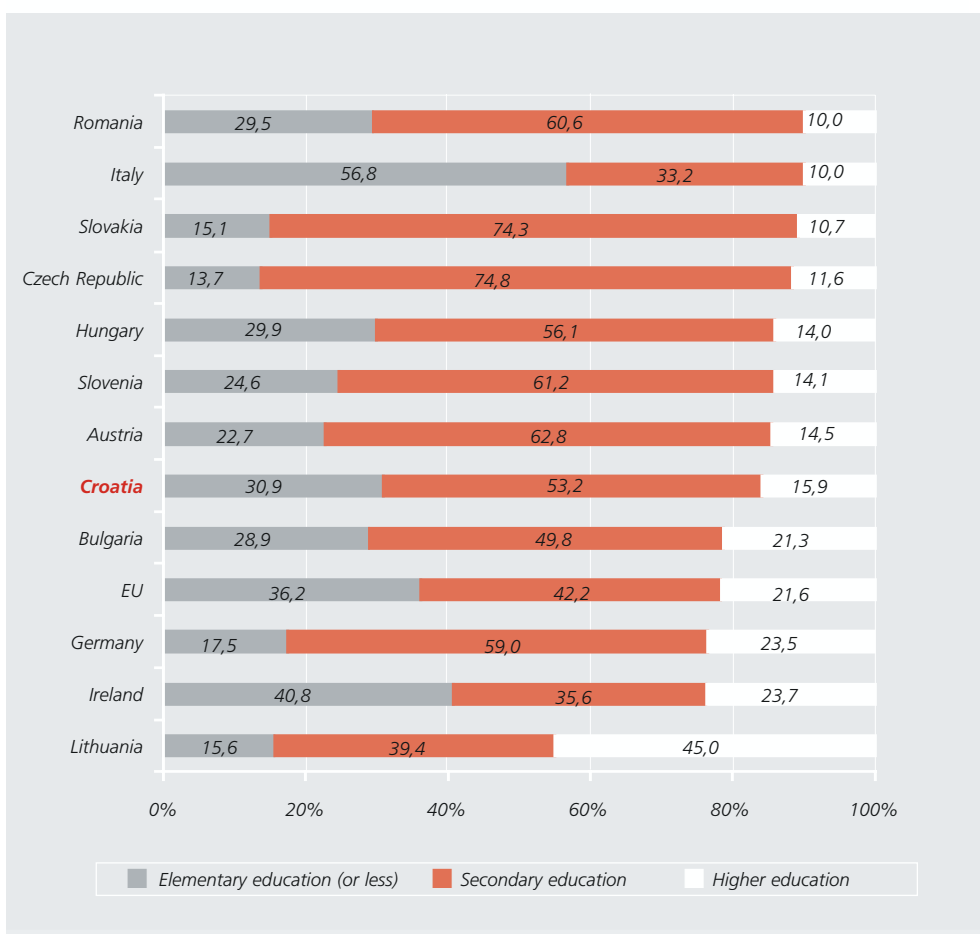
The high share of the population with secondary education is a favorable factor in countries basing their competitive advantage on a relatively skilled workforce with low labor costs. Since Croatia has relative-

A large share of the population has high school education; a small advantage in the presence of high labor costs.

ly high labor costs, this advantage is not felt significantly in exports nor in foreign direct investment. In the long term, this structure is unfavorable for adopting and adapting information technology, and is unfavorable for the diffusion of knowledge-intensive economic activities. In 2001, Croatia's share of population with higher education (2-year technical college and university degrees) was 15.9%, substantially lower than the EU average of 21.6%.

The fact that greater numbers of young people are finishing secondary school. Due to this, the share of secondary school finishers in the corresponding age cohort has increased to 80%. This is a good basis for increasing the share of the population with higher education. Public expenditures on education account for about 4% of GDP, which is below the EU average of 5%. It is encouraging that the share of expenditures on education has not fallen below the critical level.

Figure 2: Educational structure of population aged 25-64



Sources: Labor Force Survey-Principal results 2001, Statistics in focus, Eurostat July 2002, Census 2001, Central Bureau of Statistics.

The social function of higher education: rapid growth in the number of students, while the number of graduates de facto has stagnated.

Despite decreases in the years from 1990 to 1995, in the last ten years the number of college graduates has risen from 7800 to 13,800. The total number of college students has also grown significantly, from 69,000 to 108,000. However, it seems that educational reproduction in Croatia has stalled. This stalling can be seen in the exaggerated social function of higher education, which mildly decreases high unemployment and only partially fulfills its main function. In fact, the number of graduates has stagnated in the last 4 years at the relatively low level of 23% of the relevant age cohort. The ratio of college graduates relative to the number of newly enrolled first year students (with a 5-year lag) of 39% suggests that success at school is still low. This becomes even clear in view of the social function of higher education.

The expansion of higher education has been accompanied by important changes in the structure of college graduates. The highest growth in the number of college graduates has come in the social and humanistic fields. Their share in the total number of college graduates has risen to almost 57%. The

share of natural sciences has also risen, but to a very low level, less than 3% of total graduates. The greatest decrease has come in biotechnical fields, and some smaller decreases have occurred in medical and technical fields, whose share in college graduates has fallen below 30%.

The expansion in the number of students has not been accompanied by corresponding investment. This decreases the quality of education. Thus, the ratio of faculty and expert staff to students has decreased in the last ten years from 1:10 to 1:14.

Problems with the quality of education.

Entrepreneurs rate education and training even lower than they rate overall Croatian national competitiveness. In comparison with other countries, they assess the quality of public schools as substantially worse. This means that the quality of public schools is not a factor in the competitive advantage of enterprises. This difference is especially dramatic in relation to the Czech Republic, Slovenia, Slovakia and Hungary, whose companies enjoy high-quality education that is even better than the general level of competitiveness in these countries. The number of scientists and engineers and the availability of specialist services in research and training in Croatia get relatively better evaluations, but still are significantly worse than in comparable countries in Central Europe.

The worst aspect of the education and training system, according to entrepreneurs, is the system of business schools. On this criterion, Croatia ranks very poorly, in 70th place among 80 ranked countries.

Weak demand for higher education.

The decrease in the number of college graduates suggests that the demand for highly educated workers is very weak despite possible structural imbalances. Weak demand does not encourage increases in the number of graduates. For example, the decreasing percentage of graduates in the natural sciences and technical fields probably is the consequence of long-lasting stagnation in employment in various technical professions. This may have a decisive influence on perceptions relating to the choice of education field.

Weak demand for highly educated cadre is not only the result of inadequate quality of education, but is also the result of very weak interest of enterprises in investment in education and development of their employees. In this respect, Croatia ranks worse than its rank in overall competitiveness. Croatia is only ahead of Bulgaria and Romania, and lags substantially behind other countries in Central Europe.

Weak demand for highly educated workers is confirmed by the perception of an outflow of talented people. In this respect, Croatia is behind the countries of Central Europe and Turkey.

Table 4: Results of the survey on Global Competitiveness Report 2002-2003

	Croatia	Slovenia	Hungary	Bulgaria	Romania	Austria	Ireland
<i>Quality of public schools</i>	67	18	25	41	35	1	6
<i>Investment in human resources</i>	67	30	23	74	70	12	14

Source: Database of the World Competitiveness Report 2002-2003.

3.2 INFORMATION SOCIETY FOR ALL: THE KEY TO INTEGRATION IN THE WORLD ECONOMY

The creation of a knowledge-based economy is impossible without widespread use of information technology. Slow diffusion of information technology does not insure the maintenance of the competitiveness of Croatian enterprises. The spread, adaptation and implementation of information technology must become a part of the strategy to improve competitiveness.

Table 5: Indicators of the use of information and communication technology by country (per 1000 population) 2001

	Number of Internet users servers	Number of personal computers lines	Number of secure Internet lines	Number of main telephone in total subscribers	Number of mobile subscribers of total phone subscribers	Share of phone subscribers	Number of telephone lines and mobile subscribers
	2001	2001	2001	2000	2001	1999	2001
<i>Austria</i>	31,9	310	82,3	466,8	807	..	127,5
<i>Bulgaria</i>	7,5	49	2,2	350,3	191	11,6	55,1
<i>Czech Republic</i>	13,6	136	26,6	377,9	659	50,2	103,3
Croatia	11	142	13,9	375,8	395,1	19,9	74,2
<i>Ireland</i>	23,3	390	91,3	419,8	729	..	121,4
<i>Italy</i>	27,6	190	18	473,8	839	..	131
<i>Lithuania</i>	9,8	71	12,3	321,1	253	30	56,6
<i>Hungary</i>	14,8	100	12,5	372,4	498	44,9	87,2
<i>Germany</i>	36,4	350	62,7	610,5	683	..	131,8
<i>Romania</i>	4,5	36	2,4	174,6	172	39,8	35,5
<i>Slovenia</i>	30,1	275	51,3	386,3	758	82,4	116,1
<i>Turkey</i>	3,8	41	3,3	279,9	302	..	58,7
<i>EU 15</i>	32	310	40	544	724
<i>World</i>	8,1	163,1	32,3

Source: World Bank Development Indicators, Eurostat, Central Bureau of Statistics.

Croatia has greatly increased its use of information and communication technology. In the period 1997-2001, use of mobile phones per 100 populations grew 14.6 times, and Internet use grew 6.1 times. However, the number of personal computers per 100 populations has only reached 30%, still below the EU average of 40%. The number of secure web servers used in electronic commerce grew 40% (2001/2000). Unfortunately, we do not know what is the state of diffusion of information and communication technology in industry and services, since official statistics do not yet collect data on this.

Croatian entrepreneurs consider information and telecommunication technology relatively available for business and education. However, they are unsatisfied with the quality and price of Internet services, and they believe that competition among Internet providers is low. Croatia ranked 70th on this criterion. That is, an undeveloped market for providers, along with relatively high prices, is not favorable for spreading Internet technology. Entrepreneurs consider current government policy to be passive and ineffective in stimulating the use of information technology.

Although high, the growth of information technology in Croatia in fact is only keeping pace with the tempo of diffusion in Europe. As a result, on most indicators, with the exception of the number of personal computers, Croatia is regularly ranked behind the countries of Central Europe, and ahead of Bulgaria, Latvia, Romania and Turkey. Croatian companies do not enjoy the advantage of an exceptionally favorable information and communication technology environment. Instead, that environment corresponds to the general level of development and competitiveness of Croatia. If Croatia wants to increase its competitiveness in services, it will have to stimulate the diffusion of information and telecommunications technology.

Rapid diffusion of information technology despite poor quality, high price of internet, and passive and ineffective Government policy-sufficient only to preserve the lag with the EU.

3.3 TRANSPORT INFRASTRUCTURE

Transport infrastructure has a substantial influence on enterprise competitiveness through its effect on the cost of transportation and the cost of logistics and distribution. The priorities of the Croatian transportation system have changed radically since Croatia received its independence. Along with the east-west Pannonian corridor, connections between Zagreb and the south have become exceptionally important, as has inclusion in West European transport networks.

The capacity of transport infrastructure in Croatia generally satisfies needs at the moment...

The capacities of transport infrastructure in Croatia generally satisfy current needs. This assessment is true of all forms of transport. Railroads carry less than one-third of prewar traffic, and it is not expected that they will reach the prewar level until 2020. Similarly, marine transport through Croatian ports is only half of the prewar level. This is less than one-third of capacity. Croatia also has seven airports that can accommodate large airplanes. Most of them have very little traffic. The majority of Croatia's 626 km of highways and semi-highways are inadequately used.

Costs related to fatalities and highway accidents amount to about 1% of GDP. With 7 fatalities per 10,000 automobiles, Croatia is among the countries with the most risk-prone traffic in the world. Only about 47% of national roads are in good condition, in comparison with 95% or more in the major of Western European countries.

...but its quality is unsatisfactory.

The most important roads have very low traffic capacity and do not allow rapid passage. Likewise, speed limits are in force on 30% of rail lines, signaling and telecommunications are outdated, and the available of locomotives is very low, that is, 55 to 65% because of postponement of repairs. Data on the time required to travel between the north and south of Croatia are worrisome. At the same time, the Port of Rijeka is inefficient, and the port has lost more than half of its business, with high costs of repacking and inadequate capacity for containerized transport.

The specificity of Croatia lies in its exceptionally great peak load on roads during the main tourist season. The corridors leading to the Adriatic Sea have been recognized as of strategic interest because of substantial indirect effects that justify sub optimal average yearly use of the roads.

In the last decade, the number of registered road vehicles has doubled. This has exacerbated the problem of the quality of roads. At the same time, commercial freight and passenger traffic per unit of GDP (corrected for purchasing power parity) is relatively low, since transit traffic has not fully recovered.

Entrepreneurs consider the development of transport infrastructure to be poor. They assess it roughly in line with overall competitiveness. The development of general infrastructure is assessed as especially bad, along with the development of railroad tracks. Least developed are ports and waterways. The quality of electric energy supply gets relatively favorable assessment, along with faith in the postal system and the availability of new phone lines. In these three elements, infrastructure is not a limiting factor for competitiveness of domestic enterprises and is not a factor hindering foreign investment.

Improved road quality-a government priority.

The great gap between capacities and the quality of transport led the Government to adopt a program of major public transportation projects. These projects have substantially improved the quality of infrastructure, especially roads. It is expected that this program will have its greatest impact on the growth of tourism, and on the overall improvement of the infrastructural prerequisites of general economic development. Increased traffic safety should decrease the currently high health and social cost of accidents.

3.4 ENVIRONMENT AND ENERGY

The costs of pollution create large and long-term costs for enterprises and the economy. The quality of the environment and the degree of energy intensiveness should be a factor improving the competitiveness of Croatia. The importance of tourism is an important stimulus to restructure towards low energy intensive and ecologically safe economic activities.

Satisfactory energy efficiency and low levels of pollution-the result of decreased economic activity, industrial structure, large share of hydropower and large electricity imports.

Croatia and Slovenia have the best energy efficiency among comparable transition countries. This is true even though low levels of GDP make that level twice as low as the EU average. However, calculated on the basis of purchasing power parity, Croatia's energy efficiency is relatively satisfactory. Energy intensity has been gradually falling, primarily as a result of the decrease in activity of energy intensive industry. However, satisfactory macro energetic efficiency is not the result of good energy management at the level of individual enterprises.

The relatively satisfactory situation is confirmed by entrepreneurs, who rated energy and environmental protection better (35th place) than overall competitiveness (52nd place) in the survey of the Global Competitiveness Index.

High levels of energy efficiency are the consequence of high shares of hydropower and substantial import of electrical energy. Also, as a result of the recession, ambient emissions decreased in the last ten years, improving air quality. In the last ten years, there has been a visible trend to decrease water consumption, mainly as a result of decreased industrial production. Also the amount of water used for irrigation in agriculture has decreased, largely as a result of damage to and abandonment of hydro technical installations.

Waste management lags the most (organizationally and financially) behind the EU. Waste is dumped in 126 official sites, of which only seven satisfy the basic standards of environmental protection and are licensed. In 80 sites, in addition to household waste, toxic waste is dumped, and evident pollution of the environment has been established at 40 dumps. Up to now, new sites have been built for toxic waste, and only 10 percent of the total quantity of toxic waste is managed in a regular and appropriate manner. Overall waste management has only partially been undertaken in Zagreb; elsewhere it has not begun.

Only 40 percent of the population of Croatia is connected to sewage systems. This is far below the European Union average, and half of the level of Germany, where 92% of the population has sewage connections. From the point of view of competitiveness, this indicator represents an important weakness, especially in relation to tourism, catering and the like. The problem is especially acute at the seaside and on the islands, where only 35% of the total area is covered by adequate sewage systems and where the problem of dumping waste has not been resolved adequately. There are no real indications that this situation will substantially change in the next decade, although this is one of the basic preconditions for improving the quality of tourism services offered.

Entrepreneurs consider existing legal regulations on environmental protection in Croatia to be somewhat reasonable, transparent and stable. This assessment is somewhat lower than the European average, but does not differ greatly from assessments in comparable countries.

Croatian entrepreneurs show a great degree of willingness to accept and abide by standards of environmental protection, substantially above the average for the European Union, Germany and Austria. However, they also believe that laws and regulations are not enforced fairly, and do not substantially contribute to the development of entrepreneurial activity.

3.5 SOCIAL CONSENSUS

Social consensus is the result of harmonization of differing interest and exchange of information about the achievement of common long-term economic and social goals. Improved competitiveness requires broad consensus, flexibility and realism from all social groups in determining their short-term and long-term economic goals.

When compared to the whole region, Croatia has an average level of inequality in the distribution of income. This should make it easier to reach social consensus between the government, workers and employers. However, comparison with other countries shows that income inequality is not a precondition for reaching social consensus. It is much more important to reach a common vision and a social "program for growth and welfare" in which all social groups clearly see their own interests promoted along with the overall social welfare. The existence of formal mechanisms for social consensus cannot, in the absence of such a program, whether explicit or implicit, achieve much.

The mechanisms and approaches to achieving social consensus in Croatia in an institutional and organizational sense are regulated by the Labor Law. The basic mechanisms are the national Economic-Social Council, the County-level Economic-Social Councils (founded in 2001 and 2002 in almost all Countries) and, at the enterprise level, the presence of unions and workers councils.

Social consensus is limited to information sharing and consultation, that is, to tripartite representation. There is a visible lack of trust and true partnership that limits the potential for compromise.

Waste management-the greatest problem in environmental protection in Croatia, including the inadequate number of sewage connections.

Entrepreneurs-great willingness to accept environmental protection standards, but rigid enforcement hampers entrepreneurship.

A common "program for growth and welfare"-a basis for improving competitiveness.

In the absence of a common program, the existing mechanisms for social consensus seem formal and without substance.

Although the system of collective bargaining is quite decentralized, wages are nonetheless linked to productivity.

The system of collective bargaining as a means of negotiating about economic-social interests is to a great extent decentralized and oriented to negotiations with individual employers. Wages are to a great extent determined at the enterprise level. This is similar to the collective bargaining system in comparable countries.

Croatian entrepreneurs believe that wage determination is in fact centralized, but they believe that there are mechanisms tying wages with productivity.

Table 6: Assessments of the effectiveness and importance of undertaking reforms

Packet of reforms	Assessment of the effectiveness of reform packages (from 1 to 5)	Assessment of the importance of reform packages (from 1 to 3)
<i>International relations/preparations for the EU</i>	2,98	2,34
<i>Pension reform</i>	2,64	2,14
<i>Tax system</i>	2,24	2,20
<i>Education system</i>	2,22	2,09
<i>Collective bargaining</i>	2,22	2,54
<i>Government budget</i>	2,14	2,60
<i>Social policy</i>	2,08	2,29
<i>Reform of the health system</i>	2,05	2,25
<i>Privatization</i>	1,97	2,26
<i>Wage policy</i>	1,92	1,98
<i>Rule of law/justice</i>	1,87	2,28
<i>Unemployment</i>	1,41	1,47

Source: Omnibus public opinion survey Henda Global Market Research 22-28. March 2003; Sample of 1015.

● 4. ENTERPRISES, MANAGEMENT, ENTREPRENEURSHIP: AGENTS OF TRANSFORMATION OF COMPETITIVENESS POTENTIAL INTO REAL COMPETITIVENESS

The business environment, both immediate and broad, substantially shapes the prospects for improving competitiveness. However, the key actors in improving competitiveness are companies, that is entrepreneurs and management. Their abilities will to a great extent determine whether potential competitive advantages are turned into actual ones. The business environment shapes the possibilities and limits, and at the same time business activities actively change the immediate and broader business environment.

4.1 FOUNDING NEW ENTERPRISES

Founding new private enterprises, especially small and medium sized ones, is one of the most important levers of technological advance, innovation, new employment and economic growth. The growth of new, and in particular the growth of small and medium enterprises in Croatia in the last 5 years has been similar to EU countries and EU accession countries. Growth in the formation of new enterprises was especially rapid in 2001, more than 5%. Some of that growth was certainly the result of government programs and stimulative measures by the Government and its ministries.

According to the responses of entrepreneurs to the survey of the Global Competitiveness Report, the position of Croatia is favorable regarding the ease of founding new enterprises. Croatia ranks 33rd on this criterion, ahead of the majority of accession countries, but behind Slovenia and Hungary.

The establishment of new enterprises does not depend only on business possibilities but also on the exit of noncompetitive companies from the market. Croatia stimulates the establishment of new companies, but at the same time forcefully protects old enterprises without regard to their profitability. Rigid labor laws, bankruptcy laws and procedures slow the exit of enterprises from the market, at the same time narrowing the space for the rapid formation of new companies.

The number of enterprises is growing-establishment is relatively simple...

...a growth could be even faster if there were lower barriers to exit...

...while the number of active enterprises is decreasing...

Slow privatization, especially of the largest enterprises, also slows the process. The result is that the share of the private sector, 60% of GDP, is lower than in comparable countries.

However, it seems that the largest problem facing Croatian entrepreneurship is the decrease in the number of active companies. In the 1996-2001 period, the number of active enterprises fell from 64,000 to below 57,000. The share of active enterprises in total registered enterprises fell from 43.2% to 36.8%, which suggests that there are important problems blocking the growth of new enterprises.

Table 7: Average rate of establishment of enterprises in referent transition countries, 1995-2000. %

	Rate of establishment of enterprises, %	Share of active enterprises, %
<i>Czech Republic</i>	13,9	57
<i>Slovakia</i>	14,1	44
<i>Hungary</i>	11,5	32
<i>Slovenia</i>	10,7	67
<i>Lithuania</i>	15,7	26,7
<i>Bulgaria</i>	17,4	41
<i>Romania</i>	15,4	40
Croatia (1997-2000)	2,17	40,14

Source: Radošević, S., Mickiewicz, T., (2003), "Innovation capabilities in seven candidate countries: an assessment, Volume 2.8, Enterprise Directorate General, European Commission, Brussels, p. 36.

...which suggests a problem in the mechanism of "creative destruction".

The establishment of new enterprises and the opening of new jobs are connected with the number of enterprises and jobs being eliminated. The key to successful economic transition is a good connection between processes of "destruction" or elimination of noncompetitive enterprises and jobs and "creation" or opening of new jobs. According to research by the World Bank, the cause of employment problems in Croatia is not only the eliminating of jobs, but also the low rate of new job creation. The rate of elimination of jobs is much lower than in other transition countries, and lower than in developed countries such as France and Germany. However, the rate of new job creation is even lower, which suggests the problems of slow reallocation of capital and labor from low productivity to high productivity activities, or, to put it differently, problems with the mechanisms of "creative destruction." For example, the rate of change of employment in the private sector in Croatia is only half of the rate in Bulgaria.

Medium sized enterprises: future bearers of growth?

Large enterprises continue to hold dominant positions in the Croatian economy, since they have the largest capital and financial resources. However, medium size enterprises show an increasing share, while small enterprises are decreasing their share in total income and profit. It would be worthwhile to analyze change in the industrial sector in more detail in order to find out what factors are limiting company growth, in addition to the factors limiting establishment of new companies.

4.2 ORGANIZATION, STRATEGY AND MANAGEMENT

The organization and strategic features of Croatian enterprises express the foreign and internal competitiveness of Croatia.

According to the survey of the Global Competitiveness Report, Croatian enterprises share certain characteristics with enterprises in the other Central and Eastern European countries. Export enterprises are mainly involved in production, and only to a small degree in the design of products, marketing, logistics and post-sale services. They export under their own name, but they also sell to other enterprises that actually carry out the marketing or sell the goods on commodity exchanges. They mainly obtain technology through purchase of licenses and usually do not have their own formal research and development. In the production process, they use labor-intensive methods or previous generations of technological processes. They very rarely use best-practice methods. This technological and organizational structure of enterprises requires only very limited marketing, with very infrequent use of the most sophisticated materials and techniques. This is, of course, a picture of the average, and not the leading companies.

One area where Croatian enterprises are better than most Central and East European countries is the degree to which they independently organize international distribution and marketing. Croatia is behind Slovenia in this regard, but ahead of the other former socialist countries, whose enterprises inherited

The professionalism of domestic management-weak corporate ethics.

Quality: the first test of the organizational ability of domestic enterprises for export. Results: discouraging.

very weakly developed distributive functions. Despite this, Croatian enterprises are less oriented to their customers than enterprises in most Central and East European countries. In this regard, Croatian enterprises are only ahead of Romanian ones. The reason for this probably should be sought in the low level of competition on the Croatian market. Also, the structure of exports, which mainly include labor and material intensive products may be a reason. Romania is most similar to Croatia in this regard.

The quality and orientation of domestic management to a great extent is an expression of the organization and strategy of domestic enterprises. On the positive side, our managers are to a great extent professionally recruited, and only to a lesser extent chosen based on family connections. The strongest point of Croatian management is its willingness to delegate authority to subordinates. In this respect, Croatian management lags behind Slovenia and Hungary, but is ahead of the other comparable countries. Croatian enterprises do not stand out for strong corporate ethics in contacts with public officials, politicians and other enterprises. In this respect, they are only ahead of Bulgaria and Romania.

Although the survey of the Global Competitiveness Report gives very limited information about the orientation and professionalism of domestic management, it nonetheless seems that the quality of management is not at present a factor that could substantially improve domestic competitiveness. In part, this is due to the low quality of business schools in Croatia, among the worst in all accession countries, just ahead of Bulgaria.

Awareness of the importance of quality and the effectiveness of quality management improves competitive advantages of enterprises on the market. Systems of total quality (TQM) see quality as a strategic imperative for enterprises. TQM is not only based on the quality of goods and services, but actually looks at the quality of the whole enterprise, above all management, which plays a key role. Introduction of TQM in Croatian enterprises would be the best test of their readiness to develop into competitive exporters.

Table 8: Number of ISO 9000 certificates issued per million inhabitants

	12/98	12/99	12/00	12/01
<i>Slovenia</i>	521	521	843	1.026
<i>Ireland</i>	751	816	876	974
<i>Italy</i>	314	366	527	835
<i>Hungary</i>	166	328	467	636
<i>Czech Republic</i>	141	147	378	552
<i>Romania</i>	251	261	422	513
<i>Germany</i>	293	368	396	508
<i>Austria</i>	406	428	478	500
Croatia	27	45	67	92
<i>Bulgaria</i>	12	24	32	57
<i>Lithuania</i>	11	25	48	56
<i>Turkey</i>	25	26	36	46

Source: Author's calculation based on data from: The ISO Survey of ISO 9000 and ISO 14000 certificates-www.iso.ch and www.coe.int/t/e/social-cohesion/population.

The best-known quality standards are ISO 9000 and ISO 14000. Obtaining an ISO 9000 certificate is becoming more and more obligatory for enterprises hoping to enter European markets. Unfortunately, the situation in Croatia regarding quality is very discouraging. Croatia ranks in a group with Turkey, Latvia and Bulgaria on the number of ISO 9000 certificates per million inhabitants. Even Romania, which has a very similar foreign trade position to Croatia, has five times more ISO 9000 certificates per inhabitant than Croatia. Only 415 Croatian companies have ISO 9000 certificates. This is very few compared to the 1026 Slovene enterprises with such certificates.

What to do? Open and stimulate the domestic market for quality.

There are nine certification companies in Croatia, of which only two, both Croatian, are authorized by the State Institute for Norms and Measures (SINM). It is interesting that no foreign certification company has been authorized by SINM. At the same time, two certification companies have only Croatian accreditation, while the foreign companies have tens of accreditations throughout Europe and the world. A certificate from a Croatian certification company has no value elsewhere in the world. For that

reason, the closed domestic market for quality services is very unfavorable for spreading quality in Croatia, since it makes services more expensive. Medium and small enterprises are prevented from achieving the advantages of quality certificates for their exports.

One of the problems related to the introduction of quality standards in Croatia is the procedure and price of introduction ISO standards in small and medium companies. The procedures are too complicated, too time consuming and too expensive for these companies. The relevant ministry has made a positive step in this respect by offering partial subsidies.

4.3 PRODUCTIVITY, INVESTMENT AND INNOVATION

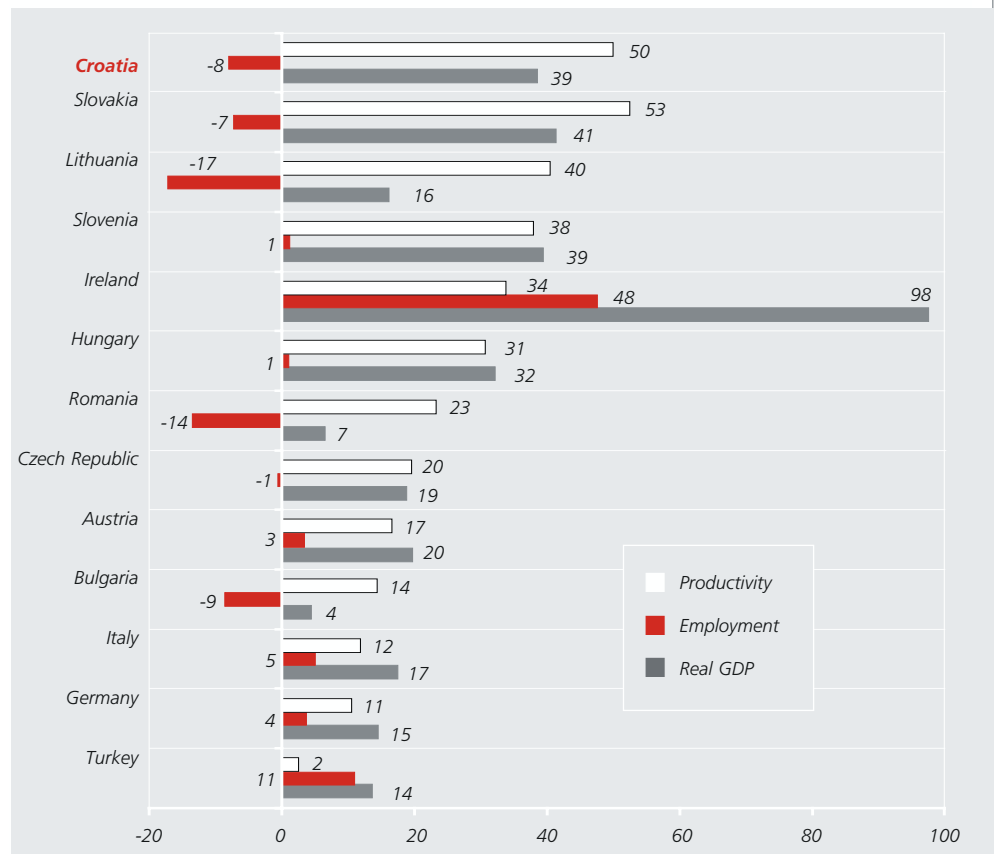
Enterprise-level restructuring is the main lever of economic growth. Active or offensive restructuring implies finding new markets, introducing new products and processes, investing in increased capacity and employment. In contrast to active restructuring, enterprises often adjust passively or defensively, by decreasing productive capacity and employment, not paying taxes and contractual obligations, abandoning non-core activities and the like. In both cases, productivity growth is observed, although its sustainability and potential are completely different in each case.

PRODUCTIVITY

Between 1993 and 2001, the productivity of labor in Croatia rose 55%, the largest growth among comparable countries. This is a very positive result, and it suggests that there were organizational and technological improvements at the enterprise level. However, this increase was mainly achieved via decreases of unemployment or defensive restructuring. In this respect, Croatia is similar to Slovakia, Poland, Latvia, Romania and Bulgaria, while other countries achieved productivity growth with minimal decreases in employment (Czech Republic) increased employment (Slovenia) or increased employment along with lower rates of labor force participation and retirement (Hungary).

Rapid productivity growth based on passive or defensive restructuring...

Figure 3: Real GDP, employment and productivity, % change 2001/1993



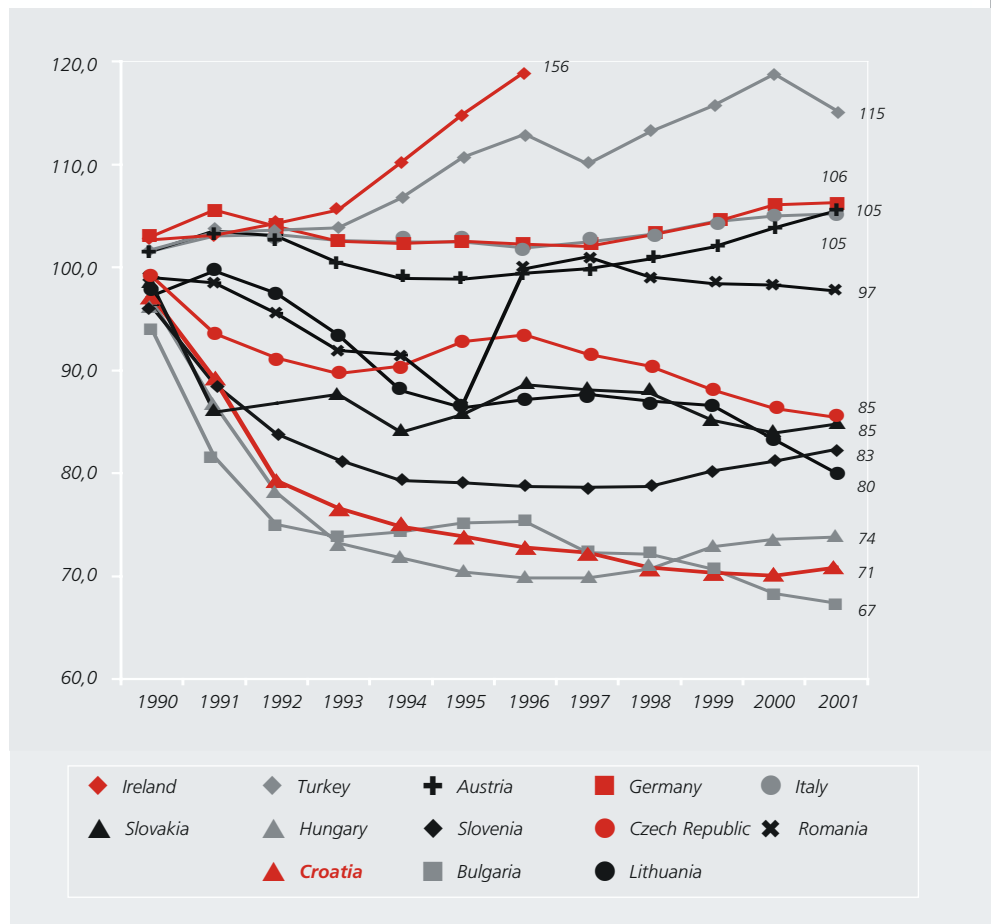
Source: Economic Survey of Europe 2002 No.2., UNECE.

It seems that Croatia went the furthest in passive productivity growth since its labor force survey showed a rate of employment of 50.9%. This was, except for Bulgaria, substantially lower than the level in all other comparable countries. Enterprise adjustment by decreasing employment at first glance seems to simplify the problem of competitiveness. But, at the same time, it increases the total fiscal burden.

According to indicators of industrial productivity, Croatia is not the most successful transition country, although its 49% growth in industrial productivity between 1993 and 2001 was a solid accomplishment. It was a little better than Slovenia, but much less than Hungary and Poland, which recorded two-fold growth in industrial productivity.

Industry productivity rose slower than productivity in the service sector. Value added per employee rose slower in industry than in services. In this way, a worker in services "creates" about 110,000 kuna of value-added per year, while a workers in industry produces less than 80,000 kuna, and agricultural worker produces a little more than 50,000 kuna. This implies that the competitive problems of industry are substantially greater than the competitive problems of services, which are oriented to the domestic market and have a substantial presence of foreign investment in banking and telecommunications.

Figure 4: Employment (1989=100)



Source: Economic Survey of Europe 2002 No. 2, UNECE, Central Bureau of Statistics.

...has lead to high levels of productivity.

The dynamic growth of productivity greatly raised Croatia's relative productivity. This means that Croatia has a high level of "nominal" productivity per employee or productivity at current exchange rates. Compared to other countries, Croatia, with its nominal 19000 € GDP per employee is comparable to Poland and Hungary, and ahead of most of the other transition countries, except for Slovenia. Its nominal GDP per capita is above the values for Slovakia and Latvia. Employees in Croatia create on aver-

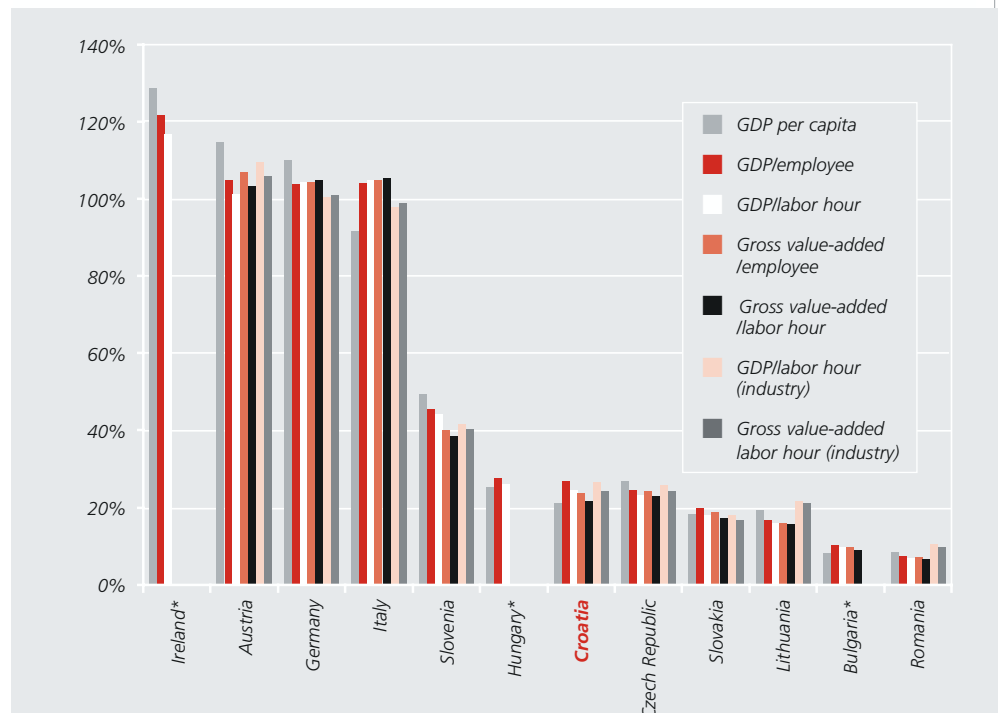
¹Gross value added, as the output value increase equals the difference between gross output and intermediate consumption.

...but income per capita is still very low, exacerbating the question of future sources of productivity growth, since the current level of competitiveness of Croatia rests on fragile foundations...

age 7.5% nominal gross domestic product, and in industry 5.3% value-added per hour worked. This is comparable to successful transition countries, but it has a reflection in the large share of the economically inactive population.

The large share of the economically inactive population leads to a large difference between the level of productivity per worker and the level of income per capita. High nominal productivity or high value added per employee is accompanied by low levels of income and value-added per employee. Croatia GDP per employee at purchasing power parity was 20,500 €, and GDP per capita was 6800 €. This difference is the result of the very low level of employment, or, to put it differently, the high level of unused work-potential.

Figure 5: Croatia and comparable countries - productivity in 2001 (Purchasing Power Parity, EU=100%)



Source: Central Bureau of Statistics, Eurostat Statistics in Focus, Theme 2-4/2002, 53/2002, Theme 3-19/2002, 20/2002.

*Note: only some of the comparable data are available.

Since the growth model based on passive or defensive adjustment has been exhausted, it is necessary to open new sources of growth based on active or offensive restructuring.

Croatia's relatively high productivity is based on fragile competitive advantages. On the one hand, the level of competitiveness achieved is threatened by high costs of doing business, especially high labor cost. On the other hand, weak competitive advantages of enterprises, especially very weak export competitiveness, also threaten the achieved level.

More rapid restructuring, mainly through defensive measures-decreased employment and abandoning unprofitable products-has allowed Croatia to achieve a level of productivity comparable to that of the countries entering the EU in 2004. However, growth in GDP per capita requires offensive restructuring through investment in existing and new activities, along with increased employment. To opens the key question: how to improve competitiveness through investment, innovation and increased employment?

INVESTMENT

Offensive or active restructuring demands a new structure of investment.

High rates of growth require high rates of investment, which in turn provide high levels of value-added. However, more important than the share of investment in GDP is the structure of investment. Croatia is attempting to connect itself to EU countries just when they are investing in technology and knowledge-intensive products and business systems. Their investment now includes substantially greater investment in research and development, engineering, software, logistics and marketing. De factor investment expenditures are often financed from current expenditures, and the concept of investment is a

A relatively satisfactory share of fixed investment...

much wider one today, not limited to physical investment (buildings and equipment), most often shown in investment statistics. To better understand the problem of competitiveness and growth of Croatia it will be necessary for statistics to much better cover investment.

The share of physical investment in Croatian GDP was extremely low until 1996. This is understandable in light of the political-security situation of Croatia in these years. Between 1997 and 1999, investment recovered. Its share in GDP rose from 15.6% (1995) to 23.3% (1999). However, after the recovery, in the last two years investment has somewhat decreased. This is worrisome, since above average investment activity is needed to make up for the large lag that occurred in the earlier period. The share of investment in GDP in 2001 of 22.9% exceeded the EU average, and was similar to the share in the majority of countries of Central Europe.

Table 9: Croatia: sectoral structure of investment - by use of investment (%)

	1997	1998	1999	2000	2001
<i>Agriculture</i>	3,6	2,9	2,5	3,6	3,3
<i>Fisheries</i>	0,2	0,0	0,0	0,1	0,2
<i>Mining</i>	1,3	2,6	2,2	2,9	1,6
<i>Manufacturing industry</i>	17,9	15,5	13,4	14,7	16,7
<i>Supply of energy, natural gas, water</i>	12,5	9,6	11,3	9,5	8,1
<i>Construction</i>	11,8	15,7	17,8	19,4	14,2
<i>Trade</i>	6,6	7,2	8,0	9,4	13,6
<i>Hotels and restaurants</i>	4,1	5,2	3,9	2,4	2,6
<i>Transport, warehousing and communications</i>	13,6	13,8	14,9	14,3	12,3
<i>Financial intermediation</i>	2,9	2,3	4,0	4,0	6,8
<i>Real estate</i>	11,8	12,4	8,7	8,5	8,9
<i>Public administration and defense</i>	5,9	5,6	4,3	3,2	2,4
<i>Education</i>	1,5	1,6	2,1	2,2	2,7
<i>Health and social welfare</i>	2,5	1,9	2,1	2,2	2,4
<i>Other services</i>	4,0	3,5	4,6	3,7	4,3
Total	100,0	100,0	100,0	100,0	100,0

Source: Central Bureau of Statistics.

...that expresses domestic demand and government priorities...

Because of large government investment in roads and reconstruction, the share of infrastructure investment, which is investment in construction and real estate, in total investment is high. Trade had a relatively high share of 13.6% of investment in 2001 because of domestic demand and relatively high rates of return. The shares of manufacturing industry and export services are low. Growth up until now, which has been "pulled" by the recovery of tourism and shipbuilding, has mainly been based on existing capacities.

Although according to data on nominal foreign investment, and on total investment, Croatia has not lagged behind comparable countries in recent years, investment has not been used enough as a lever of growth in exports and technological development. On the one hand, investment has been fairly large because of substantial foreign investment in purchases of shares of existing, successful firms and government infrastructure projects. On the other hand, investment in the private enterprise sector, and especially in export industry and services and in new technology intensive sectors has been below the required level.

Foreign direct investment should be an important factor in changing the structure of investment in Croatia. Foreign investment in industry usually comes in technology intensive branches in which new equipment and technology dominate. With a share of foreign investment of 30% of GDP in 2001 or 1315 USD per capita, Croatia finds itself among the more successful transition countries. However, only 13.2% of total investment between 1993 and 2001 has been in so-called "greenfield" investment or construction of new productive or service installations.

Table 10: Foreign direct investment in Croatia, by sector 1993-2002

Sector	1993-2002
Telecommunications	26,25
Other financial intermediation	21,35
Production of pharmaceutical products	13,99
Production of cement	4,49
Hotels and motels, with restaurants	3,31
Extraction of crude oil and natural gas	2,93
Other wholesale trade	1,7
Beer production	1,35
Production of bricks etc.	1,19
Other retail and unspecialized products	1,06
Other	22,38
Total	100

Source: Croatian National Bank.

...and the exclusive orientation of foreign direct investment to the domestic market...

In addition, the majority of foreign direct investment in Croatia so far has been oriented to the domestic market, in particular to the service sector, including finance and telecommunications, or industrial branches producing for domestic consumption such as production of drinks or construction materials. The preponderant share of foreign investment has been concentrated in several privatization projects such as Croatian Telecom, PLIVA and large banks (Rijecka, Splitska, Privredna and Zagrebacka).

In the last few years, Croatia has also undertaken significant investment abroad. Even though the cumulative amount of outward foreign direct investment in the same period is much smaller than investment in Croatia (0.5 billion USD), the amount is nonetheless substantial, and indicates the internationalization of the Croatian economy. The leading sector in outward investment has been the pharmaceutical industry.

...still does not insure adequate competitive advantage, since the structure of investment changes slowly.

In conclusion, although the total share of investment in GDP has been relatively satisfactory, its structure has not been such as to secure future competitive advantage. The structure of investment up to now expresses areas in which substantial domestic demand exists (for example trade and telecommunications) and areas of public policy priority (for example roads). However, it seems that this structure is starting to slowly change towards a greater share of industrial equipment in total investment. Thus in 2001, of total investment in industry, more than 3/4 went for equipment, and a similar statement can be made about agriculture, banking and public administration. The greatest share of the rest of investment is accounted for by construction projects.

However, a consolidated financial system and several other factors give a basis for optimism.

According to entrepreneurs, the financial sector in Croatia does not limit the competitiveness of enterprises in comparison with other countries in Central and Eastern Europe. Entrepreneurs state that credit has become more accessible in recent years. In fact, Croatia is ranked first in the Global Competitiveness Report in this respect. Assessments of the ease of gaining credit on the basis of a good business plan are also relatively favorable.

However, entrepreneurs continue to be skeptical about the health of banks, and consider the financial system very unsophisticated. They also give low marks to the feasibility of raising capital via issuing shares.

Offensive restructuring requires substantial changes in the structure of investment. Investment in equipment and "soft" investment in knowledge, new technology and investment in export activities are required. There are very few signs of such a shift, although a few trends are encouraging:

- Initial post privatization restructuring is mainly finished, and enterprises are in a position to undertake development projects;
- The banking system is consolidated and real interest rates are low;
- The signing of the Stabilization and Association Agreement and the application for full membership in the EU have created a long-term framework for political and economic stability necessary for serious investment and forging links with foreign entrepreneurs;
- In recent years, labor costs have risen slower than productivity, and Croatia is becoming a cost competitive country;

- The legal and institutional framework for investment is developing, thanks to the introduction of stimulative tax treatment for investment, development projects and small and medium enterprises
- Serious efforts are being made to remove administrative barriers to investment.

INNOVATION, RESEARCH AND DEVELOPMENT

The innovation process in the business sector: a great unknown.

Unfortunately, Croatia does not have well-developed statistics regarding innovation. Because of this, we do not understand the problem of the weak innovativeness of enterprises, limited innovation, and weak quality and technology links in the business change. Weak understanding means that the measures suggested to remedy the situation are based more on intuition than on data. It is time to follow the example of accession countries, and to introduce separate statistics on innovation.

Substantial relative increase in investment in research and development...

Along with achieving quality and accepting international standards, investment in new products and processes is key. Introduction of new equipment and processes demands a large share of "soft" investment in human capital. In this respect, investment and innovative activity are closely linked. Active restructuring requires constant innovation, and it forces investment in research and development that is integrated into business processes.

Croatia's investment in research and development of 1.25% of GDP is substantially lower than the EU average (2.21%), but it is also higher than in Ireland or Italy. Of accession countries, only Slovenia and the Czech Republic have higher research-development intensity than Croatia. The number of researchers in Croatia is also reasonably high. With 37 researchers per 10,000 employees, Croatia is ahead of Italy, Austria, the Czech Republic and Hungary, but nonetheless is well below the EU average (52 researchers).

Table 11: Basic indicators of R&D, 2000

	R&D expenditures (mil €)	R&D expenditures per capita	R&D expenditures % GDP	% R&D in the business sector	Number of researchers per 10,000 employees	Patent filings of residents per mill inhabitants (99)
EU-15	141,2	374	0,90	66	52	-
Germany	50,316	612	2,46	70	60	904
Austria	3,687	455	1,79	56	34	380
Ireland	1,076	283	1,21	74	51	327
Italy	11,524	200	1,04	54	33	167
Slovenia	297	149	1,52	56	21	147
Czech Republic	744	72	1,33	60	26	60
Hungary	405	40	0,8	44	31	77
Lithuania	73	21	0,6	22	-	24
Turkey	851	13	0,6	38	8	5
Bulgaria	71	9	0,52	21	13	37
Romania	149	7	0,37	69	-	48
Croatia (2001)	276	63	1,25	42	37	61

Source: Eurostat, Statistics in focus, Theme 5-1/2003 "Research and development 2000" Central Bureau of Statistics.

Note: Indicators of R&D intensity are calculated as percentage shares in GDP of gross expenditures on research and development.

...has not improved the structural problems of research and development mainly because demand for domestic research and development is weak.

In the period 1997-2001, gross domestic expenditures on research and development increased substantially. The largest share of that increase came in the business sector, whose share in total research and development expenditures increased from 32% in 1997 to 42% in 2001. The majority of this growth consisted of investment and material costs of the business sector. The growth of material costs and wages in higher education grew at an above average rate. Unfortunately, in the period under consideration, the number of researchers employed did not grow significantly.

Only 16% of all researchers are in the business sector.

The dynamic growth of expenditures on research and development in the last five years has greatly decreased the gap with comparable countries. However, these expenditures are still inadequate in the business sector, especially in technical knowledge. However, increased investment has not substantially decreased the problems of the research-development sector. The share of research in the business sec-

tor is only 16% of total employment of researchers in Croatia, while the same figure for EU countries is 49% and for OECD countries is 63%.

In Croatia, the share of natural science in research and development activities is especially large, with natural science taking as much as 41% of expenditures, while the share of technical science is relatively low, only 22%. In this respect, Croatia is substantially behind comparable countries.

Despite relatively favorable levels and growth of research and development expenditures, the very low shares of industrial and technical knowledge point to structural limitations that decrease the contribution of research and development to improving the competitiveness of Croatia. This is largely the result of very weak demand for research and development services in the business sector.

In contrast to this, enterprises have a strong interest in adopting new technology, but mainly through licensing foreign technology. Entrepreneurs have favorable opinions of the quality of scientific research institutions in Croatia, but they themselves do not invest enough in research and development. Nor do they work with local universities. Entrepreneurs also believe that the Government only weakly stimulates enterprises that undertake research and development.

Entrepreneurs assess the contribution of foreign investment to the use of new technology as very poor. In this, Croatia is similar to Slovenia. This assessment is the result of the orientation of foreign investment exclusively to the domestic market and to services more than the potential technological contribution of foreign investment. For example, in countries in which foreign investment is substantially export oriented (Ireland, Hungary and the Czech Republic), entrepreneurs' assessments are completely the opposite.

Table 12: Results of the survey of the Global Competitiveness Report 2002-2003

	Technological development of the country	Foreign direct investment as a source of new technology	The quality of scientific and research institutions	Enterprise investment in R&D	Cooperation with local universities
<i>Bulgaria</i>	70	67	61	66	69
<i>Slovenia</i>	26	61	30	24	33
<i>Hungary</i>	33	2	26	30	27
<i>Romania</i>	72	48	73	74	72
<i>Lithuania</i>	62	47	33	38	53
<i>Turkey</i>	66	73	65	69	71
<i>Germany</i>	7	50	4	3	8
<i>Ireland</i>	18	1	19	19	6
<i>Austria</i>	14	45	11	15	14
Croatia	67	65	37	59	56

Source: Database of the Global Competitiveness Report 2002-2003 survey.

● 5. RESULTS OF COMPETITIVENESS

Competitiveness is often equated with export competitiveness and increased share of the country on foreign markets. However, this is a narrow view of competitiveness that does not take into account the real determinants of the competitiveness of countries. Applied this to Croatia, it can be said that weak foreign trade competitiveness of Croatia is a symptom and not the cause of weak competitiveness. The real competitive challenge for the Croatia economy is how to create conditions for continuous growth in productivity and, through this, to achieve improved living standards and quality of life for the population.

Just as the competitiveness of a country is determined by many factors and at many levels, so also the results of competitiveness are visible at the macro level, at the level of international trade, and at the level of the sector and the region.

5.1 MACROECONOMIC COMPETITIVENESS: STABILITY, GROWTH AND EMPLOYMENT

Macroeconomic stability is a success at the moment, but...

Macroeconomic competitiveness is expressed in high rates of GDP growth along with growing employment and a stable macroeconomic framework. Viewed in this manner, Croatia has achieved its best results in the area of macroeconomic stability, and its worst results in the areas of employment. The achievement of macroeconomic stability undoubtedly was a momentary success, but today it must be evaluated dynamically in the context of the two results of macroeconomic competitiveness, growth and employment.

A stable macroeconomic framework is key to long-term planning and enterprise investment. The fact that inflation has averaged 5.1% in the last five years suggests a relatively stable macroeconomic framework. This is certainly a positive result. Inflation was a low 2.2% in 2002, most of all because of decreases in the prices of imports.

In the international comparisons of the Global Competitiveness Report, entrepreneurs confirm the positive picture of macroeconomic stability, and rank Croatia 41st on this criterion. This is substantially above Croatia's 58th place in overall competitiveness.

Macroeconomic stability: the prerequisites of competitiveness have been established, with a low level of employment and low rates of exports...

However, according to indicators of employment and unemployment, Croatia is among the least successful countries. The Labor Force survey finding that employment is only 50.9% says that large quantities of human resources are unused. Furthermore, in 2002 the fall in employment and the growth of unemployment continued. This situation differs substantially from the one in Slovenia and Hungary, who decreased employment substantially in the first phase, and then in the last three years began active restructuring and significant increases in employment. However, Croatia's situation is similar to that in Latvia, Bulgaria and Poland, where the decrease in employment has not been stopped. Still, the fall in employment is greatest in Croatia.

Table 13: Basic macroeconomic indicators for selected countries (2001)

	Annual GDP growth 1996-2001	Nominal GDP per capita, 000 €	Nominal GDP per capita (EU=100)	GDP per capita, PPP (EU=100)	Inflation (consumer prices) av 97-01	Employment 15-64, %	Labor Force Unemployment, Survey	Index 2001, 1991=100		
								GDP	Industrial Production	Consumption
Ireland	9,5	29,8	128,4	118,5	3,2	54,5	3,6	210	345	179
Austria	2,4	26,6	114,7	113,4	1,5	67,8	4,0	123	143	122
Italy	2,0	21,3	91,8	104,7	2,2	54,5	9,6	117	116	122
Germany	1,8	25,5	109,9	103,9	1,6	59,7	7,8	116	110	113
Slovenia	4,2	11,5	49,6	69,0	8,1	63,6	5,7	136	105	144
Czech Republic	1,0	6,2	26,7	57,3	5,9	65,0	8,0	118	114	127
Hungary	4,5	5,9	25,4	51,3	12,4	56,3	5,7	127	189	111
Slovakia	3,3	4,2	18,1	47,8	8,5	56,7	19,4	125	120	124
Lithuania	3,7	4,5	19,4	37,5	3,4	58,6	16,5	77	46	-
Croatia	3,0	4,9	21,1	33,1	5,1	50,9	14,1	113	95	121
Bulgaria	2,0	1,9	8,2	28,0	219,4	50,7	19,9	95	65	91
Romania	-1,0	2,0	8,6	25,4	68,1	63,3	6,6	102	86	119
Turkey	1,1	2,5	10,8	22,0	68,9	-	-	130	135	117

Source: Eurostat Statistics in Focus Theme 2-41/2002, 53/2002, Theme 3-19/2002, 20/2002 (GDP level, employment, unemployment), UNECE (GDP growth, inflation, GDP indexes, industrial production and consumption), Central Bureau of Statistics.

...with below average growth in comparison to Central and Eastern European countries.

Average real GDP growth in Croatia in the last ten years amounted to 3% per year. This is less than the rates achieved by the most successful comparable countries, but also equal to the average for Central and Eastern Europe. GDP per capita expressed at Purchasing Power Parity is only 29% of the EU average. Croatian GDP is still below the level of 1989. In the period 1991 to 2001 it grew only 13% in real terms, mainly because of the large fall between 1990 and 1993.

This opens the question of short-term and long-term sources of growth.

After the fall in GDP in 1993 to about 60% of the 1989 level, average annual growth was almost 6% in the 1994 to 1997 period, similar to the most successful transition countries. However, this growth was based on domestic demand, growth in the public and foreign debt. Investment and exports were inadequate.

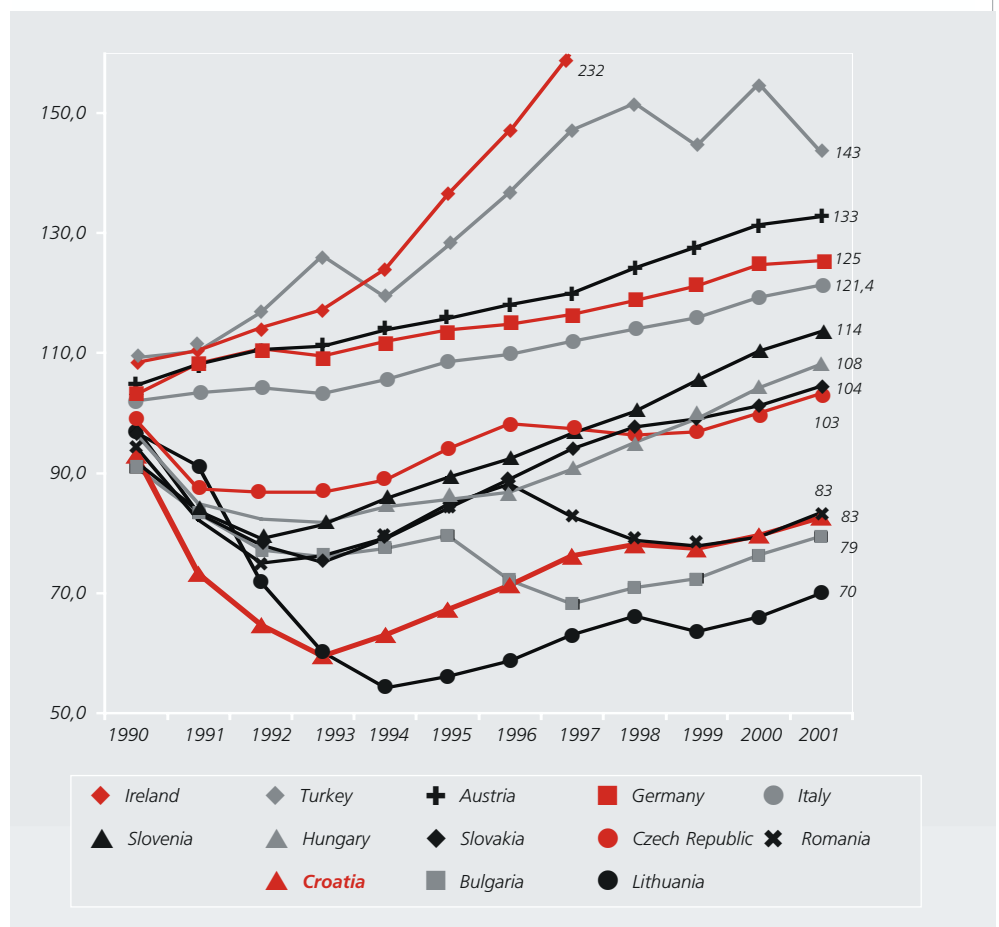
The growth of the current account deficit stopped growth, and restrictive monetary policy had an influence on the fall in GDP in 1999. In the last three years, dynamic growth of about 5% has been achieved again (real growth in 2002 was 5.2%). In this period, tourism has "closed" the foreign trade deficit, and the fiscal deficit and personal consumption have been financed by growing borrowing from commercial banks.

In light of the inadequate growth of exports and private investment, it does not seem likely that the current framework for economic policy will be adequate to continue such rapid growth. Also, in the last three years consumption has risen faster than GDP. This also suggests caution about the sustainability of growth. However, on the other side, the growth of industrial production in Croatia in 2001 and 2002 (6.0% and 5.4%) are encouraging, since growth has been seen in more sectors than before, especially in sectors not directly linked to reconstruction and public investment. However, encouraging long-term growth has not yet been assured.

The analysis of the Global Competitiveness Index shows that the level of income per capita of Croatia corresponds to its achieved level of competitiveness. This is both good and bad news. Optimists might be pleased, since the current level of income per capita of Croatia is sustainable in the long term. But pessimists will note that income per capita, unlike income per employee, is very low. At a level of 33% of the EU average, GDP per capita (by Purchasing Power Parity) is lower than in all the comparable countries, except for Bulgaria, Romania and Turkey.

Since the level of income and the level of competitiveness are well balanced, the only source of improved competitiveness is long-term GDP growth. This opens the question of how to maintain macroeconomic stability and at the same time stimulate new sources of growth.

Figure 6: Real GDP (1989=100)



Source: Economic Survey of Europe 2002 No.2., UNECE.

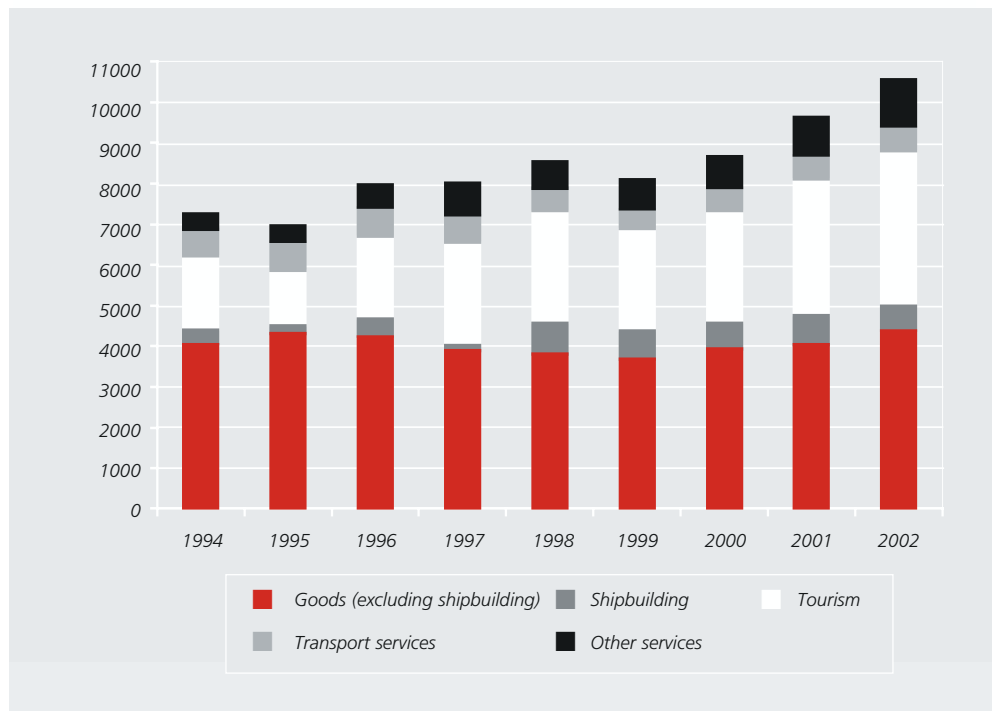
5.2 INTERNATIONAL COMPETITIVENESS

The ability of a small economy to grow is closely linked to its ability to take part in international trade, whether as an exporter or as a location for foreign direct investment. This is especially true if a country is a location for investment in knowledge or technological intensive activities.

Croatia's trade openness (exports plus imports of goods and services as a percentage of GDP) is relatively high. In the last five years, openness has risen from 88.2% of GDP (1998) to 103.6% of GDP (2002). However, this growth has not been the result of growth of merchandise exports, which in fact has stagnated, but rather the result of increased income from export services and increased merchandise imports. In the last several years, exports of services has kept the current account deficit fairly low, most of all because of the growing share of tourism in services exports (from 55% in 1995 to 68.4% in 2001). In view of the fact that tourism is mainly seasonal and is influenced by a large range of factors (war, climatic influences, ecological phenomena etc) this "compensation" effect of tourism is not stable enough to support such a high level of trade openness.

High level of trade openness: thanks to tourism and merchandise imports.

Figure 7: Croatian exports of goods and services by main sectors 1994-2001



Source: Central Bureau of Statistics and Croatian National Bank.

The share of merchandise exports in GDP in Croatia fell from 30% in 1994 to 20% in 1997. After this, the share began to rise, reaching 25% in 2000. While Croatian merchandise exports stagnated during this period, many other Central European countries substantially increased their exports relative to GDP.

The main increase in Croatian merchandise exports came from shipbuilding, whose share has increased 1997. However, that growth was only enough to keep exports at a level of 4.0-4.5 billion USD. Other than that, the some of the import component of shipbuilding, the direct and estimated indirect subsidies and realized losses actually exceed the value of ships exported. This calls into the question the economic rationality of such exports.

Net exports of services between 1997 and 2002 almost doubled. This is certainly positive. But this achievement is almost exclusively due to tourism. On the contrary, net exports of transport services were almost halved, falling from 300 million USD (1996) to 167 million USD (2001). The balance on other services (communication, construction, financial, consulting, legal, research and development etc) was generally negative during this whole period.

Export competitiveness: the weakest dimension of Croatian competitiveness, which increases the one-sided dependence on tourism.

Table 14: International trade of goods and services (% GDP), 2001

	Export of goods and services	Import of goods and services	Goods and services balance
<i>EU</i>	35,90%	34,80%	1,20%
<i>Ireland</i>	98,20%	83,40%	14,70%
<i>Austria</i>	52,50%	52,50%	0,00%
<i>Germany</i>	35,10%	33,20%	1,90%
<i>Italy</i>	28,30%	26,70%	1,60%
<i>Slovakia</i>	74,00%	82,50%	-8,50%
<i>Czech Republic</i>	71,30%	74,00%	-2,70%
<i>Slovenia</i>	60,10%	60,50%	-0,40%
<i>Hungary</i>	60,50%	62,60%	-2,10%
<i>Lithuania</i>	50,40%	55,80%	-5,40%
<i>Romania</i>	33,50%	41,60%	-8,10%
<i>Turkey</i>	33,20%	30,80%	2,40%
<i>Bulgaria</i>	55,70%	63,20%	-7,50%
Croatia	49,30%	55,30%	-6,00%

Source: Eurostat, Statistics in Focus, Theme 2-41/2002, 53/2002, Central Bureau of Statistics and Croatian National Bank.

Foreign direct investment has been oriented to the domestic market...

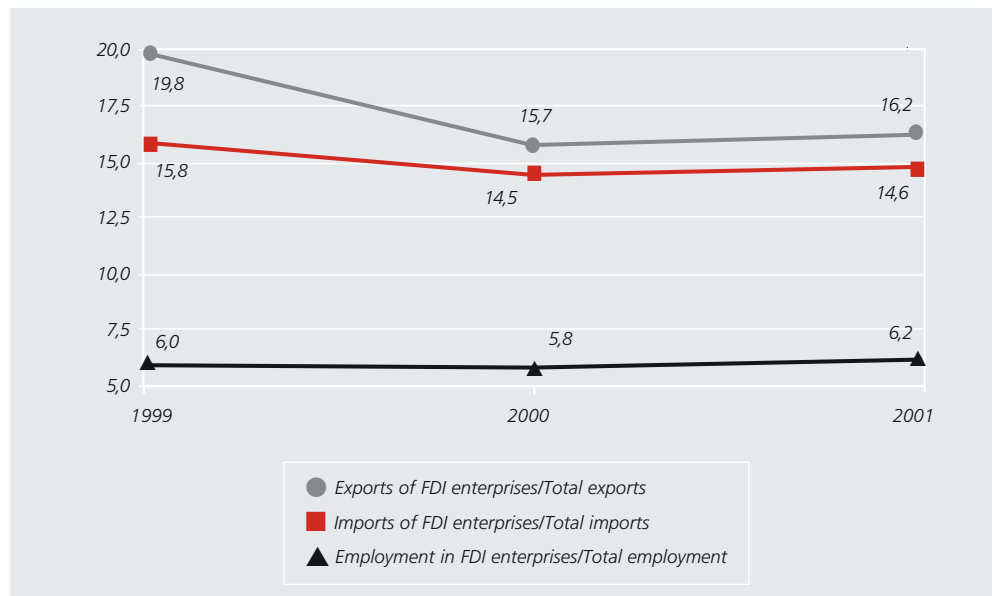
...and thus has not directly contributed to export competitiveness.

Until 1996, the majority of foreign direct investment went into manufacturing industry. However, after 1996, investment in large-scale privatization projects (especially telecommunications) and the banking system predominated. The share of foreign direct investment in manufacturing industry in 2001 was 16.9%.

The relatively high level of foreign direct investment in telecommunications and banking helped improve services in these sectors and reduced prices. Interest rates on bank credits fell, allowing enterprises more favorable terms for borrowing to finance projects. But at the same time, low interest rates on loans to households generated increased imports of consumer goods, increased the current account deficit.

Up to now, foreign direct investment has not increased exports or employment in Croatia. In some sectors exports and employment have increased, but on the overall level these effects are neutralized by decreases in other sectors. The share exports by firms with foreign direct investment in total exports fell by 3.6 percent between 1999 and 2001. In conditions of stagnated total exports, this means that the exports of firms with foreign direct investment also stagnated.

Figure 8: Share of exports, imports and employment in FDI enterprises relative to totals



Source: Central Bureau of Statistics and Croatian National Bank.

5.3 SECTORAL AND REGIONAL ASPECTS OF COMPETITIVENESS

The sectoral and regional structure of competitiveness adds to the macroeconomic and international dimensions of competitiveness.

SECTORAL ASPECTS

Value-added in the service sector (hotels and restaurants, financial intermediation, real estate trading and business services, transport, warehousing and communications) and industry grew at above average rates between 1997 and 2002. Agriculture, construction and public services decreased their share in gross value-added. Despite its falling share, industry still has the largest share in total gross value added, 27.7% in 2002. Next is the public sector (public administration, health, education) with 18.2%. However, the share of industry is lower than in the most advanced transition countries (Slovenia, Czech Republic, Hungary), which have shares of industry in gross value-added of about 30%.

The fastest-growing industrial sectors have also had the highest productivity, with the exception of the office machines and computers sector. The sectors with the lowest productivity were mainly labor-intensive sectors, whose share in GVA has consistently fallen. Such sectors included textiles, clothing, leather products, production and machines and equipment, production of metals etc.

The decrease in output in technologically demanding product sectors is especially worrisome. For example, production of office machines and computers and RTV and communications equipment output has fallen.

The main sectors in which exports have grown in the past five years have been shipbuilding, machine building, communications equipment and tobacco products. At the same time, chemicals, clothing, leather and shoes, electro industry, metallurgy and food production has decreased. With the exception of the growth of exports in shipbuilding, Croatian exports are notably lacking in technologically demanding sectors. While the share of complex product exports in the exports of comparable countries has increased by 25 percentage points, such growth is much lower in Croatia, only 9 percentage points. And it must be remembered that total exports have stagnated over the period.

Services are growing the fastest, although industry remains the most important sector.

Technologically demanding industries are not among the main export industries or export oriented foreign direct investment.

The largest gap or structural defect, relative to comparable countries, has been in vehicles, which make up 18% of the exports of four Central European countries (Slovenia, Hungary, Czech Republic and Slovakia) and only 1.6% of Croatian exports to the EU. Also, there has been a great lag in exports of machines and electrical products. This lag is the expression of large-scale foreign investment in the automobile and electronics industries in the Central European countries. Such investment has been insignificant in Croatia.

Restructuring of the exports of Central European countries towards more demanding product segments is closely tied with foreign direct investment in these sectors. The share of enterprises with recorded foreign direct investment in exports was 60% in the Czech Republic and Poland, 89% in Hungary, 33% in Slovenia, 35% in Estonia, and only 16% in Croatia.

REGIONAL ASPECTS

In a globalized economy local factors of competitiveness do not lose importance. On the contrary, competitiveness in the world economy is more and more based on local competitive advantages. From that point of view, it can be said that Croatia's competitiveness is just the competitiveness of its regions.

Regional differences in Croatia are substantial. The difference in unemployment between the highest (31%) and lowest (13%) regional unemployment rates is 18 percentage points. Greater dispersion of unemployment is only seen in Bulgaria and Italy. If the differences are measured by the average deviation from mean unemployment, Croatia remains in the group of countries with high regional differences, even though quite a few of the counties are concentrated near the average level of unemployment.

Only five counties experienced decreased unemployment between 1999 and 2002. Of this, unemployment fell by more than 10% in only two, Istria and Primorsko-goransko. At the same time, the greatest increase in employment, more than 10%, was seen in seven counties. Several of these are relatively successful on other indicators (for example the city of Zagreb and the county of Zagreb). Relative increases in unemployment were especially large in Virovitičko-podravsko county (27,3%) and Sisačko-moslavačko county (29,1%).

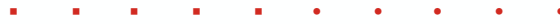
The most competitive regional units were the city of Zagreb and Istria county. The counties in the north-west of Croatia also generally showed good economic results, although they lagged a bit in the area of education. The worst situation among counties are found on the eastern border (with Bosnia and Herzegovina, and with Serbia and Montenegro). These areas suffered the greatest damage from the Independence War. These counties still show greater enterprise losses than profit, low industrial productivity, poor education and very high rates of unemployment.

Looking at overall business results, the Croatian economy has greatly improved. Croatia as a whole was a "loser" in 1999, with net enterprise losses of 5,8 billion kuna. In 2001, the enterprise sector showed profits of roughly equal magnitude. However, this positive change does not apply to all counties. Entrepreneurs reported greater profit than losses in only eight counties in 2001, while in the other thirteen counties losses were greater than profits. The improvement is obvious relative to 1999, when sixteen counties reported that losses outweighed profits.

Large regional differences in unemployment.

Most competitive: the city of Zagreb and Istria County. Worst are counties on the eastern border.

A mild trend to decrease the number of "loss-making" counties.



Publisher:
National Competitiveness Council

For the publisher
Dr. Mira Lenardić

Executive editors
Dr. Mira Lenardić
Dr. Slavo Radošević

Copy editor
Mirjana Paić-Jurinić

Graphic editor
Neda Šegović

Translation
Dr. Evan Kraft

Printing and binding:
Lana - Karlovačka tiskara

