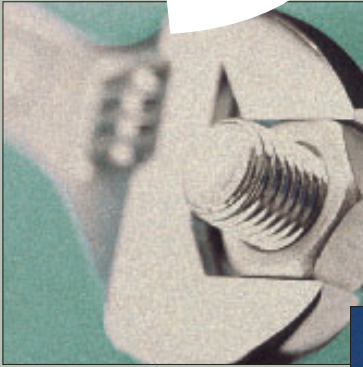


# 55

## POLICY RECOMMENDATIONS FOR RAISING CROATIA'S COMPETITIVENESS



Nacionalno  
Vijeće za  
Konkurentnost

National  
Competitiveness  
Council

The National Competitiveness Council is an advisory body that brings together representatives of business, government, unions, science and education. It was founded in February 2002 by government decision. The initiative to form the council came from private business and the Croatian Employers Association. The Council stimulates dialogue between the private and public sector, raises the level of awareness and knowledge about the importance of competition, develops consensus on major economic issues facing Croatia, analyzes the strengths and weaknesses of the Croatian economy, and recommends and monitors policies that will contribute to long-term sustainable improvement in productivity and the competitiveness of Croatia.

In September 2003, the Council published the "Annual Report on Croatia's Competitiveness in 2002". This first report on Croatia's competitiveness pointed out the seriousness of the problems related to improving the competitiveness of Croatia, and identified a whole set of areas in which changes should be made.

When it released the Report, the Council announced that its next step would be to issue recommendations for increasing Croatia's competitiveness. These recommendations would suggest initiatives and policies that Croatia should adopt to transform itself into an internationally competitive economy. The Council reached consensus on seven priority areas: education, rule of law, cost and price competitiveness, innovation and technology, the development of small and medium enterprises, regional development and the building of clusters, and the development of positive attitudes and leadership. Seven working groups were set up to elaborate these recommendations. The working groups include more than fifty well-known domestic and foreign experts. The results of their several months of work are summarized in this document.

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# 55 POLICY RECOMMENDATIONS FOR RAISING CROATIA'S COMPETITIVENESS

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PLIVA, Management Board President and CEO

Šime Klarić  
The Association of Family Hotels and Pensions of  
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Franjo Luković  
Zagrebačka banka, Chairman of the Management  
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Privredna banka Zagreb, President of the  
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Microsoft Adriatics, General Manager

Mladen Vedriš, PhD  
Sonder Ltd, Chairman

Ivan Vidaković  
IBM Croatia, General Manager

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Workers' Trade Union Association of Croatia  
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Zdenko Mučnjak  
Croatian Trade Unions Association  
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Krešimir Sever  
Independent Trade Unions of Croatia  
President

Marinko Vrsaljko  
Union of Autonomous Trade Unions of Croatia  
Representative

## Science and Education

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Helena Jasna Mencer, PhD  
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Slavko Linić  
Government of the Republic of Croatia  
Vice Prime Minister

Ljubo Jurčić, PhD  
Ministry of Economy

Gvozden Flego, PhD  
Ministry of Science and Technology, Minister

Zdenko Mičić  
Ministry of Tourism  
Deputy Minister

Miroslav Božić, Msc  
Ministry of Agriculture and Forestry, Assistant  
Minister

By Government decision, on January 22, 2004 the following were named as new representatives of the Government of the Republic of Croatia on the Council

Andrija Hebrang, Vice Prime Minister,  
Government of the Republic of Croatia and  
Minister, Ministry of Health and Social Welfare

Ivan Šuker, Minister, Ministry of Finance

Dragan Primorac, Minister, Ministry of Science,  
Education and Sports

Branko Vukelić, Minister, Ministry of the  
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Zdenko Mičić, State Secretary for Tourism,  
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Development

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2. Mira Lenardić, PhD, National Competitiveness Council, Zagreb

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Slavica Singer, PhD, Faculty of Economics Osijek; CEPOR, Zagreb

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### EDUCATION FOR GROWTH AND DEVELOPMENT

#### Chairmen:

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#### Members:

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### RULE OF LAW IN COMPLIANCE WITH EU STANDARDS

#### Chairmen:

1. Božo Prka, MSc, Privredna banka Zagreb,
2. Ivan Koprić, PhD, Faculty of Law, Zagreb

#### Members:

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Alan Uzelac, PhD, Faculty of Law, Zagreb

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#### Members:

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Mira Lenardić, PhD, National Competitiveness Council, Zagreb

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#### Chairmen:

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2. Slavko Krajcar, PhD, Faculty of Electrical Engineering and Computing, Zagreb

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### *Members:*

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### *Chairmen:*

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2. Stipe Orešković, PhD, «Andrija Štampar» School of Public Health, Zagreb

### *Members:*

Darko Marinac, Podravka, Koprivnica

Helena Jasna Mencer, PhD, University of Zagreb, Zagreb

Zdenko Mučnjak, Croatian Trade Unions Association, Zagreb

Damir Sertić, PLIVA, Zagreb  
Predrag Zarevski, PhD, Faculty of Philosophy, Zagreb

### *External expert:*

Goran Milas, PhD, Target, Zagreb

The following experts and institutions participated in the elaboration of the

### Recommendations:

Peter Kraljić, PhD, member of McKinsey Advisory Council, McKinsey & Company, Inc.

Howard Rosen, MA, ex Executive Director US National Competitiveness Council, consultant sponsored by USAID

Dear Sir or Madam,

In its “Annual Report on Croatian Competitiveness 2002,” released in September 2003, the National Competitiveness Council meticulously and objectively delineated the extent of the problems inhibiting improvement in Croatia’s competitiveness, the country’s relative underdevelopment relative to comparable countries, and the need for nation-wide modernization to secure economic progress and accession to the European Union. The Report received a very positive reception from both experts and the general public. It also led to the conviction that Croatia needs a set of measures that would serve as the basis for mobilizing all social groups and institutions whose interests are served by the country’s modernization and its economic advancement.

The National Competitiveness Council is a body dedicated to dialog between four interested parties: the Government and public sector, the economy, trade unions, and academia. The Council’s structure reflects this purpose. The conviction that these interested parties must be activated to enhance competitiveness, has led to the creation of this document, entitled 55 Policy Recommendations for Raising Croatia’s Competitiveness.

55 Policy Recommendations for Raising Croatia’s Competitiveness is the result of the efforts of seven working groups staffed by experts from various fields, as well as people from the business world and the socio-political scene. In this sense, this document merits the full attention of all readers: the Government, business, trade unions, academia, and the general public.

The proposed Policy Recommendations are not a list of measures that the Government of the Republic of Croatia should implement by itself. They are a set of proposals and guidelines for activities that the Council is submitting to the broadest possible public and to the Government for consideration.

The Recommendations are a set of measures that can be implemented using available resources. The actual timing of these actions can be adjusted based on the simplicity or complexity of their implementation. The proposed measures have not been fully elaborated and operationalized, because this was not the objective of the Council’s work at this point. The Council’s view is that postponing their introduction or neglecting them outright will only intensify Croatia’s relative backwardness even more, and move the country even farther away from the EU and the rest of the world.

We are aware that the main constraints to implementing these Policy Recommendations are not so much lack of political will as the limited “administrative capacity” of the public administration. Thus the only way to overcome these major constraints is through close cooperation between the Government and all interested parties - employers, unions, academia, professional associations, etc. In this sense, we hope that all institutions and individuals, who see their interests reflected in the overall objectives and individual measures found in the Policy Recommendations, will find ways to cooperate with the Government to ensure their further elaboration and implementation.

We would like to thank all the members of the National Competitiveness Council and all the members of the working groups, other associates and institutions who participated in the preparation of this document with such great enthusiasm.

Sincerely,

Željko Čović, MA  
National Competitiveness Council  
Chairman



Dear Sirs,

The transformation of the Croatian economy is a challenging goal. The unambiguous facts about the current situation contained in this report by the National Competitiveness Council clearly indicate the need to substantially transform the Croatian economy into a knowledge-based, efficient and export-oriented economy. The overall objective of these vital endeavours in the coming period is to raise the quality of life.

Several major changes will have to occur in the near future. Among them will be the rapid and decisive liberalization of markets, optimization and modernization of public administration, restructuring and privatization of large public companies and improvement of quality in every sector of the economy. These changes should be accompanied by the development of a global mindset.

All of these objectives can be achieved through a clear commitment by all parties concerned: the Government, private industry, academia and entrepreneurs and employees. It is extremely important that all participants work together in a focused and cooperative manner.

An often neglected aspect at the very beginning of this process is the need to openly communicate to the public the initial status of the Croatian economy and its competitiveness. Furthermore, the goals of development must be made transparent, and steps forward publicized. Achieving transparency through targeted communication and publicizing gains made, in Croatia as in other countries, can lead to motivating effects and can increase foreign interest in Croatia

With all this in mind, we place great value on the initiative and efforts of the National Competitiveness Council. From our own professional standpoint, we fully concur with and loyally support all of the Council's policy recommendations contained in this document.



Dr. Roland Falb  
Roland Berger Strategy Consultants  
Managing Partner



Dr. Vladimir Preveden  
Roland Berger Strategy Consultants  
Managing Director



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## INTRODUCTION

The world economy has become flexible, open and integrated under the influence of globalization processes. Technological advancement, knowledge, education, professional training, free movement of labor and capital and other quality-bearing factors have become the generators of growth, and they induce constant changes on the path to development and raising national competitiveness.

Never in history has the opportunity for joining the most developed been so near. But never in history has the danger of missing such opportunities been so high. Failure to respond to this historic challenge means long-term stagnation or even regression.

Even the most developed have realized this. Policy-makers in the EU are aware of the advantages currently enjoyed by the world's most dynamic economy: the United States. Despite high political costs, EU policy-makers are launching reforms of their labor and financial markets, and of their retirement and tax systems, as well as a series of other economic sub-systems, creating a new global center for economic growth and development that will be able to meet the competitive challenges from America and Asia.

At the same time, the National Competitiveness Council believes that Croatia is facing serious problems. Growth up to this point has been generated by high personal and public consumption, and by economic investments of questionable quality. These weaknesses are now reflected in high foreign trade and public sector deficits, and growth in the external and public debt. Croatia has not succeeded in creating a competitive environment for the economy that would secure the level of income and consumption to which the nation has become accustomed.

Therefore the challenge confronting Croatia can no longer be reduced to simply joining the EU and making the transition to a market economy. EU membership and a market economy are only the prerequisites for achieving a competitive national economy that will be capable of competing on global markets while securing sustainable, stable growth in living standards for all citizens. So joining the EU and creating a market economy should not be viewed as objectives, but rather as means to achieve the ultimate goal: creating a competitive economic system operated by wealthy and satisfied people.

These great, historic challenges and difficult tasks cannot be met with quick and easy solutions. Croatia has paid too dearly for past blunders. Over the past years and decades, mistaken notions have fed a destructive sense that easy solutions are within reach. Seven commonly held but major myths in Croatia are:

1. Accession to the EU will solve everything overnight.
2. We have a highly-educated and quality labor force.
3. We can easily lower taxes and increase entitlements.

4. Croatia will attract foreign investment - investors are just waiting due to the political regime in power.
5. The economic policy can be managed without having to openly discuss the currency issues.
6. The State will create jobs.
7. A government can solve most problems during a single term in office.

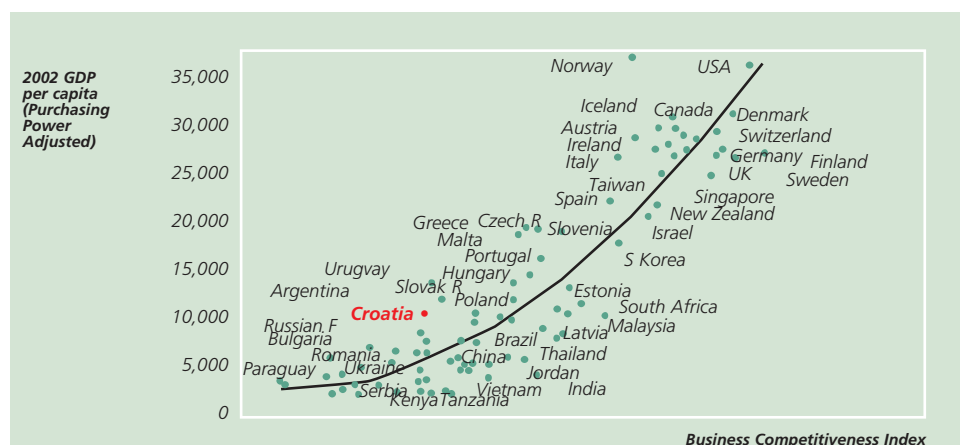
## The National Competitiveness Council and the Diagnosis of Croatia's Competitiveness

Understanding the perils of making a faulty diagnosis, and the even greater danger of providing questionable recommendations and solutions, and appreciating the need for formulating a comprehensive development program, representatives of businesses, trade unions, the Government and academia established the National Competitiveness Council in 2002. The Council's objective is to promote dialog between the principal societal players, analyze social development and propose solutions for social advancement through the prism of competitiveness. The Council does not, and does not intend to substitute for any existing institution.

At the initiative of the National Competitiveness Council, Croatia was included in the Global Competitiveness Report for the first time in 2002. This report has been continuously released by the World Economic Forum since 1979. It is generally accepted as an authoritative comparison of data on competitiveness and economic growth among countries that represent 97% of the world's GDP.

The assessment of Croatia's competitiveness shows that in 2002 among 80 countries in the world, it merits a rank of 58 in the growth competitiveness index, and a rank of 52 in the business competitiveness index. In 2003, it remains among the region's transition countries, along with Romania and Bulgaria. Countries like Poland, Hungary, Estonia or Slovenia are located above and to the right of Croatia (see Figure 1):

**Figure 1: Ratio between business competitiveness and per capita GDP**



Source: Global Competitiveness Report 2003 - 2004, World Economic Forum

In September 2003, the Council released its first annual report, which contained an exhaustive analysis of the Croatian economy's strengths and weaknesses. Although Croatia is perceived as successful in some areas, such as the fundamentals of its tax system, banking sector, transport infrastructure capacity, IT distribution and environmental protection, a series of weaknesses were also identified:

- Despite the fact that Croatia has recorded GDP growth, this growth is not wholly sustainable. Growth was generated by excessive public and personal consumption, which were based on levels of public and external debt that must not be allowed to grow any further (see box).
- Foreign and domestic private investment is neither sufficient nor sufficiently concentrated on the export sector.
- Exports are concentrated on highly-subsidized shipbuilding and tourism, which are characterized by low value added. Croatian export goods are losing their market shares in the EU, foreign direct investment in the export sector is lacking, and the export structure is static.
- High prices, wages and other costs make Croatian products and services uncompetitive.
- Low investment rates in research and development (R&D) by business and the public sector, accompanied by meager investment in unreformed education, result in low capacity for absorbing and developing innovations by companies.
- The education system does not prepare Croatian citizens for the challenges of a knowledge-based society.
- An ineffective public administration and cumbersome administrative regulations, as well as inefficient and insufficiently autonomous courts, represent the greatest obstacle to business sector development.
- The competitiveness of domestic companies is limited, so most competition comes from imports.
- The number of start-ups with growth potential is small, as is the number of new jobs.

#### WHERE ARE THE LIMITS TO OVER-INDEBTEDNESS?

*There is a widespread perception of excessive debt levels among the Croatian public and experts, but there is no uniform view of where the limits to indebtedness for Croatia lie at this point. Nonetheless, when speaking of public (i.e. the Government's internal and external) debt, we can conclude that the debt is approaching the 60% maximum permitted by the Maastricht criteria at such a speed that the rate of borrowing must be slowed by reducing the fiscal deficit. When speaking of the overall external debt of all sectors in the national economy, there are no such clear, formal international criteria. Theoretically, borrowing is possible as long as international creditors are prepared to finance external imbalances. Even so, economic analysis shows that a ratio of foreign debt to exports (goods and services) in the zone between 150% and 200% may begin to have a negative impact on economic growth. Croatia is approaching 150% and is not in the excessive debt zone, but it is in danger of moving into the zone in which further growth in debt at the current rate could bring more social costs than benefits. It is true that there are EU member states with higher debt levels, but their debt ratios cannot be compared to Croatia's due to membership in the EMU, access to stabilization and developmental funds, and deeper integration with international financial markets. So we can conclude that further growth in external debt cannot be permitted to continue at the current rate.*

	1998	1999	2000	2001	2002	2003*
Public debt/ GDP in %	31.8	39.3	45.8	45.8	46.3	50.5
Foreign debt/ exports in %	111.2	131.8	125.6	117.8	134.3	153.0

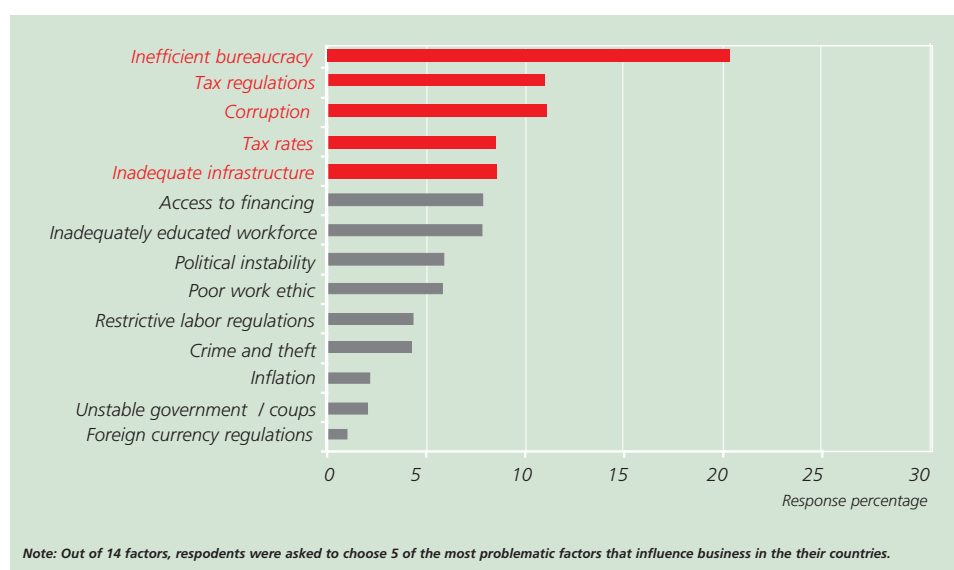
Source: CNB Bulletin, computations; exports encompass goods and services; ratios computed in domestic currency;

\* expected value

Similar conclusions can be found in documents issued by other institutions, such as the Country Economic Memorandum (2003) by the World Bank.

The World Economic Forum's most recent Global Competitiveness Report for 2003-2004 shows that over the past year Croatia's competitiveness has not improved. On the contrary, there was a decline in growth competitiveness and microeconomic competitiveness. The most problematic aspects of doing business in Croatia have not changed. These are: inefficient bureaucracy, tax regulations, corruption and high tax rates (see Figure2).

**Figure 2. The most problematic factors for doing business in Croatia**



Source: Global Competitiveness Report 2003-2004, World Economic Forum

After publishing its first annual report, the Council identified seven priority areas vital to the advancement of Croatia's competitiveness, and established seven working groups charged with drafting thoroughgoing recommendations for future policy. Each working group was staffed with experts in the individual fields, as well as members of the Council. The working groups were established in the following areas:

- **Education for research and development**
- **Rule of law in compliance with EU standards**
- **Cost and price competitiveness**
- **Development of innovativeness and technology**
- **Strengthening small and medium-size enterprises**
- **Regional development and cluster development**
- **Creation of positive mindset and leadership**

The Council's working groups drafted exhaustive recommendations for future policy, which are presented here.

## Setting National Strategic Objectives

The so-far unsatisfactory response to global competitiveness has left a void in Croatia's economic, political and intellectual life. This void is above all reflected in the lack of common perceptions of strategic national objectives and the lack of common understanding of ways to achieve them. Without defining strategic national objectives, there is no way to we can attempt to form a national consensus around them.

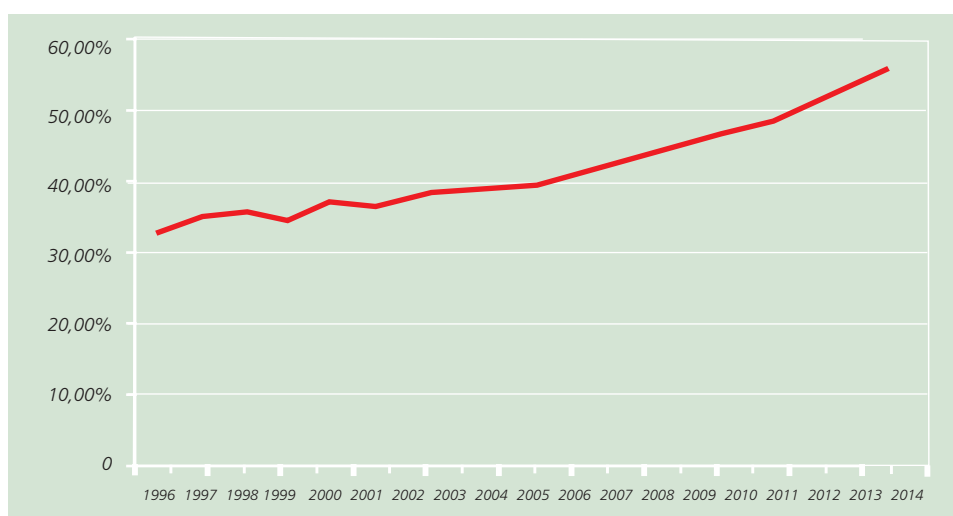
Therefore, the National Competitiveness Council has set four key national strategic objectives:

1. Enabling sustainable GDP growth
2. Reducing unemployment
3. Improving the quality of life
4. Enhancing social inclusion

None of these objectives is defined as a value into itself. All are defined with a view to the reference groups we compare ourselves to and to which we aspire.

**1. Enabling sustainable GDP growth: doubling per capita GDP in the next 10 years.** Per capita GDP was 10 000 euros in 2002 at purchasing power parity. Achieving this growth goal should enable Croatia's GDP to reach over 50% of average per capita GDP in the EU in 2010, and to achieve 55-60% of average EU per capita GDP by 2014 (see Figure 3). To achieve this goal, the economy must achieve long-term sustainable growth of 5% or more annually.

**Figure 3. Croatia approaching the EU - moving towards average per capita GDP in the EU (estimated to 2013)**



Source: World Development Indicators 2003, The World Bank



**2. Reducing unemployment:** the unemployment rate should drop from the current 14% (as measured by the methodology of the ILO) to a sustainable rate under 8% over the next 10 years. This should entail a permanent decline in unemployment resulting from new job creation.

The achievement of this objective will require changes in the educational structure, the functioning of the labor market, and fundamental changes in social and governmental relations to private enterprise. But above all, productivity must grow more rapidly than real wages, which could grow at an average rate of 3% annually.

Intense economic growth and reduction of unemployment can only be achieved through great changes in the quality of the labor force. This means rapid growth in the share of highly-educated people in the labor force: from the current 17% to 29% over the next ten years. This is essential to the transformation to a very open economy with a much larger share of high-technology production in overall production and growing exports. Therefore, the end goal of increasing the competitiveness of Croatian products on EU markets should result in a higher share of exports of goods and services in GDP, i.e. increasing this ratio from the current roughly 50% to over 65% over the course of the next decade.

Macroeconomic stability is also an important condition for achieving these objectives. This means maintaining price stability as well as the stability of the financial system, with a reduction of the fiscal deficit, halting any increases in public sector debt, and putting a cap on governmental spending. These are key prerequisites for all forms of investment, especially private investment, on which sustainable growth depends.

**3. Improving the quality of life:** three key components of quality of life—educational level, employment and per capita income—are encapsulated in the first two national strategic objectives. However, raising the quality of life for the most imperiled social groups should be achieved by seeing that the poorest 20% of the population receives 10% of total income. Additionally, the quality of life should be maintained by preserving the quality of natural resources, reducing mortality rates from 7 to 5 per thousand live births by 2010 and extending life expectancy from 74 to over 76 years during the same period.

**4. Enhancing social inclusion:** traditional indicators such as literacy rates, accessibility of the education system, gender segregation and life expectancy show a relatively high degree of social inclusion. The most important segments for the further enhancement of social inclusion are education, state efficiency (for greater access to public services), control of corruption and the rule of law. These Policy Recommendations pay great attention to these segments.

Furthermore, the current levels of income and regional inequality and pollution must not increase substantially. The Croatian developmental model must be based on the principle of inclusion, social integration of all groups and increasing the quality of life based on the European developmental model.

#### ELABORATION OF NATIONAL STRATEGIC OBJECTIVES OVER THE NEXT 10 YEARS

- *Double per capita GDP, expressed in euros in ten years*
- *Long-term sustainable GDP growth over 5% annually, with GDP per capita approximately 55% of the EU's average per capita GDP*
- *Unemployment rate under 8% after 2010*
- *Productivity growth higher than real wage growth*
- *Exports of goods and services over 65% of GDP*
- *The poorest 20% of the population receive 10% of total income*
- *Reduction of mortality rates to 5 per thousand live births after 2010*
- *Life expectancy increased to over 76 years after 2010*

### Investments and Productivity

The problem of competitiveness is at its root a problem of the quantity and quality of investments in physical and human capital. Only sufficient high-quality investment in physical and human capital can lead to increased competitiveness through productivity growth. Healthy productivity growth cannot be based on passive economic restructuring based on employment reduction. It has to rest on simultaneous growth in employment and production, with production growing faster, so that productivity and competitiveness can also grow. This is the only way that the broadest social strata will obtain a share in the benefits of economic growth.

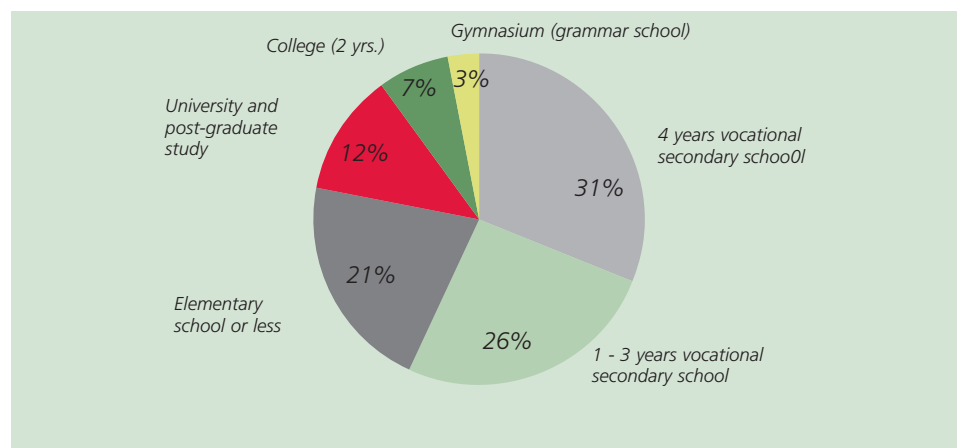
In order to achieve this, investments must introduce new technologies, secure new knowledge, and promote innovation and quality. Investment in human capital is a necessary condition for the success of such a developmental model. Surviving in an exceptionally competitive environment and creating well-paid jobs means that workers in Croatia must add more value to their products than they have in the past. This requires new technologies, new knowledge, new ideas, and new processes; in short new quality.

The conclusion is simple: if we want higher living standards, we will have to earn them by improving the education system and the vocational training of the labor force. We have to raise the competency of workers so that we can maintain current wage levels and increase them realistically down the line. Barring this, we will end up competing exclusively on the basis of prices, lowering our wages and constantly reducing the value of our currency. And this is a race in which we will not be able to emerge as victors, given that numerous producers are appearing on the global market whose competitive strategy is based on a cheap labor force.

“Conquering” international markets through efficient production of high-quality products is the only approach that will in the long run bring prosperity and social justice to Croatia. Throughout its history, Croatia has stressed education as one of its core priorities. But we have only managed to develop an unreformed and insufficiently financed higher education system, which is not a driver of growth today. The educational level of Croatian workers is unsatisfactory in most cases. Over one in five Croatian workers has lower educational qualifications or less. The vast majority of Croatian workers - 56.8%

in 2002 - completed vocational secondary school with duration of one to three to four years. The remaining 20 percent attended some form of college or university (see Figure 4).

**Figure 4. Structure of employees based on qualifications in 2002**



Source: Republic of Croatia, National Statistics Bureau, Statistical Yearbook for 2003.

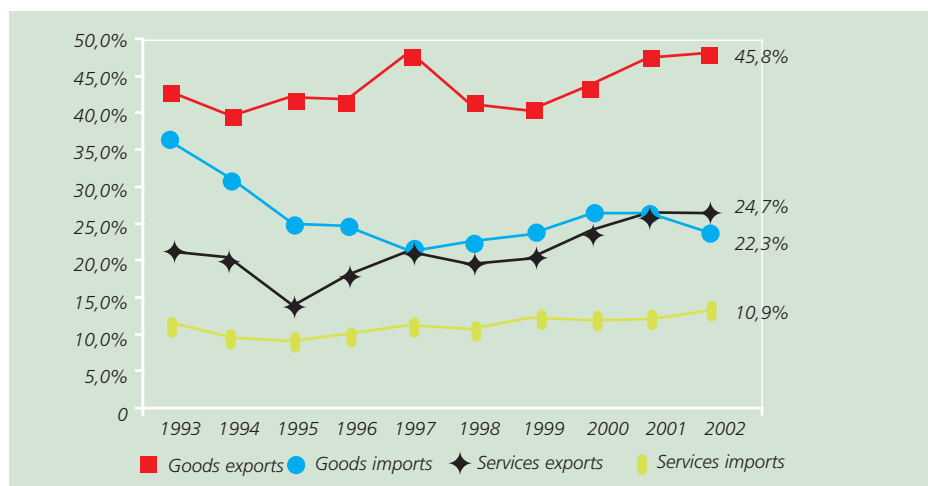
In the field of education, Croatia is facing two challenges: we must raise the quality of our educational programs and we must increase the number of participants in these programs. Deep and comprehensive educational reforms are a condition for attracting and creating firms adapted to the competitive, twenty-first century economy. Successful firms throughout the world achieve impressive levels of productivity and quality by tearing down the barriers imposed by outmoded ways of thinking: they invest in people just as they do in equipment, their business activities are transparent and they award and encourage continuous improvements. Such firms will not decide to enter the Croatian market and we cannot expect the development of such firms if we do not improve the competencies and skills of our labor force in general.

Furthermore, as a small country with limited resources, Croatia is not the source of many new technological breakthroughs. Thus, our firms face the challenge of development and commercialization of technological advances devised elsewhere. To facilitate better and faster commercialization of technology, both the business sector and the Government must increase the funds allocated for research and development, especially in the field of processing technology in production. By the same token, we must greatly bolster the efforts we invest in disseminating “best technological practices” throughout the whole economy.

Small and medium enterprises are a possible source of the creative energy that can contribute to the dynamics of the Croatian economy. It is precisely small and medium enterprises that normally create new jobs in any economy. Their adaptability and ability to respond rapidly to changes in economic circumstances make them a valuable resource. We should encourage them by eliminating administrative barriers to entry and operation and through the further development of capital markets. We cannot lose sight of the fact that the ultimate objective is to create the most dynamic and most globally oriented sector of the economy.

The ultimate test of a country's competitiveness is its ability to produce the goods and services demanded on world markets. In 2002, exports of goods and services were 47% of GDP. But imports of goods and services that same year were 56.7% of GDP (see Figure 5). Although the post-war revival of tourism led to an increase in service exports, Croatia lost its share in world goods exports, particularly on EU markets. These are troubling trends that must be halted if we want to succeed in raising living standards in Croatia. Although tourism plays an important role in Croatia's balance of payments, growth is impossible unless Croatia becomes a competitive Central European export base. In any case, it does not seem that increasing imports will generate goods exports. Although increased service exports have partially balanced the current account, we have to take advantage of the opening of EU markets to improve the technological structure of our products and services.

Figure 5. Share of Croatian goods and service exports and imports in GDP



Source: Croatian National Bank, [www.hnb.hr](http://www.hnb.hr)

### From Questions to Answers: From 'What to Do?' to 'How to Do It'

The State must protect the economy from longer-term imbalances in the government budget and in the balance of payments to prevent over-indebtedness. Sudden changes in prices, interest rates and exchange rates can confound all of the positive efforts made at the microeconomic level by companies and workers efforts to raise Croatia's competitiveness.

At the same time, we must aggressively implement the changes necessary to secure Croatia's membership in the European Union. Croatia's accession to the EU will provide us with one of the greatest economic opportunities in our history. Croatian businesses and workers will have to compete on and have free access to one of the largest markets in the world.

The challenges confronting the Croatian economy demand a comprehensive and coherent development program. The National Competitiveness Council is calling for the thorough formulation of measures to sustain the achievement of our common objectives - increased production, employment and produc-



tivity - accompanied by broader inclusion in social life and the achievement of sustainable improvements in the living standards of all Croatian citizens. With a view to future economic policy, the fifty-five policy recommendations that follow are meant to serve as initial steps in that process. The challenges before us are immense. The response to these challenges requires sacrifice and painstaking efforts. But the price of ignoring these challenges will be paid by future generations of Croatian citizens. The development of a comprehensive and coherent development program, based on increased investment in the economy and labor force, will enable everyone to reap the benefits of rising and sustainable living standards in Croatia.

# 55 POLICY RECOMMENDATIONS FOR RAISING CROATIA'S COMPETITIVENESS

## I. Education for Growth and Development

*“Modernizing Croatia’s education system requires changing what is taught (curriculum), how it is taught (pedagogy) and the accountability of those at the point of service delivery for results.”*

(World Bank, Croatia: Country Economic Memorandum Volume II, July 2003, p.155)

Every national economy and its competitiveness depend primarily on the quality of the human resources available. Effective utilization of these resources and investment in quality improvements are primary factors of development. Education boosts competitiveness by providing human resources of suitable quality. It is education that enables an individual to acquire knowledge, skills, attitudes and values needed to fulfill his or her professional and social role.

Increasing the number of individuals with higher education in the workforce and undertaking appropriate changes in the educational system are prerequisites for accomplishing Croatia’s strategic goals.

A well-educated population is a necessary, but not a sufficient condition of competitiveness. The mobilization and utilization of knowledge provides an important contribution to increased competitiveness. Many characteristics of the educational system influence competitiveness, including the simple balancing of educational profiles and employment needs, adult education, and issues of the quality of education. Quality is not only a question of formal knowledge, but also of the development of the ability to learn and the individuals’ active, creative and productive contribution to the working environment. These skills are learned from an early age.

Education will make the greatest contribution to the development of a knowledge-based economy in Croatia if it is commonly recognized as a potent force of production. Individuals must recognize education as a valuable asset that allows them to improve their material position and quality of life. Therefore educational strategy and every concrete policy must be developed on the basis of the concepts of lifelong learning and the learning society.



### NO ACTION IS THE MOST EXPENSIVE ACTION!

*Competitiveness is built on the application of capabilities, skills and creativity of individuals under ever changing conditions. The three main barriers currently blocking improvement of Croatian competitiveness are:*

- (a) insufficient public expenditure for education (only 4% of the GDP)*
- (b) low educational attainment of the workforce compared to European countries (only 7.1% of the workforce holds a two year college degree, and 12.3% hold an undergraduate degree or higher) and*
- (c) absence of an estimate of future skills needs.*

*Short-term, as well as mid-term and long-term changes are needed if education is to improve Croatian competitiveness. Some changes will require additional expenditure while some are already in the process of implementation, and should merely be connected and expedited. All the measures undertaken must ensure continuous economic growth. They influence education on several levels simultaneously, and result in a modified approach to education. All the measures recommended should be implemented immediately, since, from the perspective of Croatian competitiveness and its global ranking, no action is the most expensive action.*

Therefore, the goals for increasing education's contribution to national competitiveness are:

1. Improvement of educational attainment of the population able to work, primarily through increase in the share of individuals with tertiary education in the work force.
2. Continuous improvement of educational content and methods of instruction across all levels of the educational system, and focus on the development of key competencies.
3. Establishment of a system of quality control of educational processes and outcomes
4. Increase in total expenditure (public as well as private and other non-state) for education.
5. Maximization of the number of children in pre-school care and education.

### **Recommendation 1.** **Increase participation in adult education**

1

Since an adequately trained workforce is a prerequisite for success in the modern economy, education and in-service training are the most efficient methods of maintaining and updating the competence level of the current workforce. Adult education improves individuals' employability and mobility on the labor market.

New forms of lifelong learning and retraining for deficit skills should be organized, especially for the industries identified as the bearers of future development. Educational institutions are expected to offer accelerated programs and a mixture of full and part-time courses, flexible methods of education (distance learning), more adult education sites, and to show greater flexibility to labor market needs.

Individuals should be financially encouraged (via tax breaks or loans) to enroll in adult education programs. The adult education programs that are of general national concern (primary education, acquiring first qualification and retraining for deficit professions) should be fully financed by the state while other programs should be financed in equal parts by the state, local government and the students themselves.

## 2 **Recommendation 2.** **Estimate the labor market's future skills needs**

The availability of a workforce with adequate skills strongly attracts both domestic and foreign investment in highly productive industries. A system of estimating current and future skills needs should be established. EU experience shows that the best practice is to establish permanent expert groups. This system would identify the short-term, mid-term and long-term needs of the leading industries.

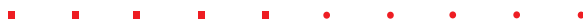
The first step should be to define a system for collecting data on current and future labor market needs (already initiated through the CARDS program). Furthermore, educational programs should be developed in accordance with the analyses of the data collected. In the long-term, the success of these measures will depend on the development of a more flexible model of education.

## 3 **Recommendation 3.** **Adjust educational programs to the development of knowledge and skills needed in the future**

The ever-faster rhythm of technological change, which can be seen, for example, in the fact that the minimum educational requirements have shifted from basic literacy to computer literacy, aggravates the problem of harmonizing technological needs and education. This problem cannot be resolved adequately by simply increasing the time spent in elementary, secondary and higher education. Today, much knowledge becomes obsolete even before it can be applied.

Education in Croatia is still focused on elementary and secondary education, putting emphasis on outmoded methods and teaching techniques of a narrow range of basic skills. The education system must set for itself the task of insuring the best possible foundation for lasting advancement of knowledge through the concept of life-long learning. This implies the need to adapt the curriculum and structure of elementary and secondary education to the development of basic competencies and multifunctional knowledge with high transfer value as well as the competencies demanded on the labor market.

The European Commission recommends in its documents basic competencies in the following areas as common goals of the system of compulsory educa-



tion and professional training in the knowledge economy: functional literacy, numeracy, ICT (informatics-communications) competencies, foreign languages, entrepreneurship, mathematics and natural science, interpersonal and social competencies, learning how to learn, general culture (recognizing and using its accomplishments).

The most rapid changes in compulsory education can be achieved by decreasing the burdens placed on students (and teachers) and by changing the focus from rote-learning to knowledge of transferable values (basic competencies and competitive knowledge and skills). The current content and organizational structure of compulsory education are inappropriate to the lasting development of the developmental-educational goals that are defined as the foundation of the development of the knowledge economy. The aim of these changes is not to create a unique “hard” school system, but to allow the creation of a system that can be constantly improved. Our system is structurally incompatible with the systems of compulsory education in developed countries, and this makes it difficult to harmonize the qualifications received in secondary education in Croatia (especially vocational education, which is attended by about 73% of Croatian secondary students).

To facilitate the mobility of the labor force, it is necessary to prevent premature specialization in secondary education as well as leaving the educational system before mastering the competencies. The ultimate goal is to restructure the content of secondary education so as to harmonize it with changes in compulsory and higher education, above all with the goal of making it easier to continue schooling from various secondary schooling programs. Support must be given to programs that bring the educational system up-to-date and to harmonize qualifications with EU countries.

It is important to work intensively on the system of education for gifted students. The development of enriched programs for gifted students in regular classes helps to create a climate of excellence that has a stimulative effect on all students, not only on gifted students.

#### **Recommendation 4.** **Increase both horizontal and vertical mobility in post-compulsory education**

# 4

In the EU, about 50% of those finishing secondary education enroll in some form of tertiary (university and non university) education. In Croatia, this rate is significantly lower: according to World Bank indicators, in 2001 27.3% of the population aged 19-24 was enrolled in tertiary education. Given that the quality of post- $\text{D}$  compulsory education depends on the quality of compulsory education, the key issues in structuring compulsory education are the duration and methods of diversification of the system, how to direct students onto appropriate educational paths and how to ensure mobility between courses of study. In the short-term, reducing the amount of material covered in secondary education and updating vocational programs will result in improved mobility in secondary education. Finally, structural changes must be made in

compulsory education to permit sustainable mobility to the students, and flexibility of secondary education in relation to labor market needs. Also, access to higher education courses must be enabled from a greater number of secondary school programs.

In order to increase the share of individuals with tertiary education in the workforce, opportunities for transfer and mobility within higher education programs should be increased as well. According to the latest data, the ratio of graduates to first year students is 40%, indicating a low success rate of HE courses. It is recommended that the Bologna process be implemented by 2005 at the latest, providing a new HE structure (3+2+3). This will reduce graduation time, since the first three year cycle ends with an employable qualification.

## Recommendation 5:

### 5 Improve the system of higher education

Successful completion of higher education programs in Croatia remains low. This is expensive both for the state and the economy. Higher education in Croatia is inefficient (students take twice the expected time to complete their studies and an alarmingly small number of students reach graduation), and is therefore too expensive (relative to the outcomes), out of date (conceptually, in terms of equipment and age of the teaching staff) and of insufficient capacity to be able to seriously alter the educational attainment of the population. If Croatia wishes to reach its goal of becoming a knowledge society, it must undertake significant changes in the fields of higher education and research.

Introduction of the Bologna Process should be used to implement significant changes within the system of higher education and research. Those changes should focus on: raising the educational attainment of the general population (here the contribution of universities and polytechnics to the production of value-added is crucial, primarily within their immediate environment); formal and curricular incorporation into European trends, the ERA (European Research Area) and the EHEA (European Higher Education Area). The universities should be pushed to develop curricula following global scientific trends; and their teaching staff should take responsibility for the quality and efficiency of the courses taught and their delivery.

The flexibility of higher education programs should be increased through a wider spectrum of courses and elective modules, part time courses, distance and computer-based learning. Furthermore, such courses should satisfy the genuine requirements of the labor market. In accordance with global trends and requirements for an ever-wider spectrum of knowledge and skills, it is desirable to introduce interdisciplinary courses. Work experience should become a standard part of higher education, thus facilitating an easier transition from full time education to the labor market.

To enable higher education institutions to catch up with their competitors in the global arena, their teaching and research equipment should be updated.



The institutions of higher education also require fresh teaching staff with new ideas and energy, completing the cycle of the already developed system of research assistants. The teaching and research staff should be encouraged to take part in specialist training and supplementary education programs abroad, and foreign lecturers should be invited to Croatian universities.

### **Recommendation 6:** **Increase the number of students in natural and technical sciences**

6

The reported annual need for individuals with tertiary education is almost 50% greater than the number of the unemployed with that educational level. This indicates a permanent deficit of certain expert profiles. The share of graduates in natural and technical sciences in the total number of graduates in Croatia is decreasing, contrary to global market needs. Therefore, the short-term priority is to increase the enrolment quotas for courses in natural and technical sciences. Due to the ever-greater need for IT and e-business skills, such content should be included in all educational courses.

In the long-term, this should be connected to changes in the structure of higher education programs. Students should be permitted to change their course of study, thus allowing permanent harmonization with labor market needs. The financing of these short-term needs should be tied to the system of scholarships from the business sector.

### **Recommendation 7:** **Modernize teacher education (“teach the teachers”)**

7

To successfully implement the changes needed within the educational system and to enable instructors to teach the desired knowledge and skills, the highest quality professionals must be educated and retained within the educational system. Currently, capacities for practical teacher education are insufficient, and the teacher education curricula are outdated. Undergraduate teacher courses do not reflect the educational needs of the economy, and lack the mechanisms required for a timely response to changes of those needs. On top of that, teacher incomes and social status are extremely low and they lack clearly defined career development goals. Time and financial support should be allocated for in-service training and supplementary education of the current primary and secondary education teaching staff. However, the final aim should be to restructure the profession so as to enable career progression on the basis of in-service training, accompanied by increase in earnings.

A change in the curricula for teacher education is needed to enable students to learn contemporary teaching methods, increase the availability of practical training, as well as to facilitate mobility from other undergraduate courses of study to the teaching course. It is important that the teaching staff at universities should also be trained to teach the key competencies, as well as the knowledge required by the modern economy.

The developmental objectives of pre-school education are exceptionally demanding and can only be accomplished by experts with the right qualifications. In Europe, the prevalent form of pre-school career education is a three-year undergraduate course. Croatia should strive to adopt this model. Furthermore, the system of lifelong education of pre-school care-givers, as well as other professional pre-school staff, should be improved. In addition, the system of monitoring and evaluation, as a standard of career development and extension of the pre-school care-givers' license, should be introduced.

## 8 Recommendation 8: Implement external and international evaluation, and increase the involvement of society

A national system of external evaluation and certification would provide a comparison of the quality of individual secondary schools throughout the country. The PISA project will provide an evaluation of compulsory education at an international level. It is desirable to develop systems of quality control of the educational process, so as to correct shortcomings and to minimize the adverse effects on the students.

Introduction of a national system of certification based on external evaluation of secondary education, and of a national system of certification for vocational education, is recommended. The final aim, following the reform of the structure and curriculum of secondary education, should be to enable adults to attend parts of secondary education courses (particularly vocational courses) to obtain national certificates (and thus a higher qualification) or update their knowledge.

The state, acting as the founder of public universities and polytechnics, should financially reward the most efficient institutions of higher education, and apply punitive measures to poorly performing institutions. Universities should be encouraged to establish offices of quality control of educational processes and content. It is equally important to compare the achievements of Croatian and European universities, in the key performance areas, through the Croatian office of ENQA (European Network of Quality Assurance).

Since education is a matter of national interest, the educational system has a responsibility to the general public for the quality of its services. Local and regional associations of employers, educational experts and parents must be developed, with authority to recommend development strategies for educational programs on a regional level, as well as to provide the necessary financial support. As a part of the structural changes of secondary vocational education, development of cooperation with businesses on programs of certification in vocational education is recommended. Development of programs to encourage employment is also recommended. Businesses should be invited to take part in career days organized in their local primary and secondary schools.

### Recommendation 9:

#### **Increase the role of the private sector in the provision of educational services**

9

The role of the private sector in the provision of educational services should be promoted, in accordance with international indicators of quality control. Businesses should pool their resources and develop common programs of staff education in management and business skills. The economy also needs the development of private schools offering vocational training for low-medium level management and production.

Businesses should increase their direct investment in education to the level prevalent in developed market economies. Methods should be created to measure direct investment by business in education. By encouraging material donations from businesses, a target of one personal computer for every five students in secondary education by the year 2006 can be reached. Within the program to identify and support gifted students, a system of scholarships financed by businesses should be developed, providing those businesses with the highest quality professionals and reducing 'brain drain'.

### Recommendation 10:

#### **Increase public expenditure for education**

10

Public spending on education in Croatia remains at approximately 4 % of GDP, while the OECD average is 5%. Spending on higher education and research in Croatia is among the lowest in Europe. With levels of investment this low it is impossible to expect an increase in the efficiency of higher education. It is therefore necessary, along with the gradual modernization of the content and structure of the educational system, to secure adequate budgetary expenditure. Considering the importance of education for Croatia's competitiveness, it is recommended that government subsidies to businesses be gradually reallocated to education. The reallocation of funds enables the state to increase spending on education, and thus bring it in line with the education expenditure in the developed countries, without increasing the tax burden.

### Recommendation 11:

#### **Increase the number of children in pre-school care and education**

11

High quality pre-school educational programs provide children with solid foundations for lifelong learning and reduce the overall cost of educating an individual. Under current conditions, those children who enroll in the educational process at a later stage cannot catch up with those who enrolled at an earlier stage. Pre-school education that is accessible to all also helps improve social equality. It is recommended that the necessary conditions (financial, material and professional) be created to include all children in one-year school-preparation programs, or to enroll an increasing number of children (especially those over three years of age) in pre-school care programs. Also, the quality of pre-school programs should be monitored.

## II. Rule of Law in Compliance with EU Standards

An efficient, lawful, democratic welfare state provides a favorable environment for free enterprise and market validation of entrepreneurial achievements. It facilitates the protection of property rights, competition and the free movement of knowledge, labor, capital, goods and services. It is therefore necessary for the State to have sufficient institutional capacity to solve public problems, to be oriented toward the principles of the rule of law, to be large enough to take on the tasks facing the country, and to conform to the standards of the framework of the EU. To achieve this, deep reforms of the State must be conducted based on the doctrine of new public management, which particularly stresses the need for inexpensive, efficient and high-quality public services for citizens and businesses. This requires fulfilling prerequisites such as providing adequate technology to and modernizing public administration, which in turn improves the quality of public services and reduces corruption.

In Croatia, three problem areas in the rule of law require change:

- (a) legislation: the Croatian legal system needs to be brought into compliance with European legal standards while eliminating the major legislative barriers to private sector competitiveness,
- (b) the judiciary: rational organization needs to be secured to allow the efficient, impartial and ethical functioning of the courts,
- (c) public administration: national administration requires reform, local self-government needs to be rationalized, public services need to be modernized, and professionalism and sound standards for legislative technology need to be developed to plan, prepare and execute legal norms.

Croatia has come relatively far in the alignment of legislation. However, much more still has to be done. Besides this, it is now already necessary to begin creating the conditions for the effective implementation of these regulations to ensure the co-ordinated execution of public policies, and the speedy and efficient judicial protection of citizens and businesses. So over and above legislative adjustments, adjustments in public administration and judicial reforms are particularly important.

Establishment of the rule of law in compliance with EU standards must rest on a systematic approach and the following principles:

1. Ethical behavior, impartiality and incorruptibility
2. Education and expertise
3. Efficiency and quality
4. Computerization and co-ordination
5. Privatization, cost effectiveness and new public management
6. Subsidiarity and decentralization
7. Accountability

By accepting these principles, we can create the prerequisites for systematic activity to reduce corruption.



## Recommendation 12: Enhance free market competition

12

It will be necessary to clearly formulate, normatively regulate and consistently implement free market competition policies and implement the doctrine of strict adherence to equal market competition for all, regardless of market shares and market positions.

The obstacles to competition created by laws, general ordinances and other regulations issued by public administrative bodies must be removed, while protectionism, which most often emerges as a result of lobbying for special market privileges, must be resisted.

Regarding the regulatory institutions - The Croatian Competition Agency, the Telecommunications Council and the Croatian Energy Regulatory Council<sup>1</sup> - the quality and education of their staffs must be improved, their budgets increased, and their financial and all other forms of independence strengthened. Cooperation and co-ordination among the regulatory bodies must be encouraged in the interests of setting up equal legal standards in various fields of authority. Independent experts should also be involved in their work as advisors.

<sup>1</sup> The Croatian National Bank also regulates market competition in the banking sector. This institution is financially and institutionally independent of the Government and is not funded by the budget, so that only the recommendation on staffing improvement and professional training apply to it.

The Market Competition Protection Agency must be decentralized by opening at least three regional offices outside of Zagreb (Split, Rijeka, Osijek. These offices will carry out professional, analytical and promotional operations in the protection of market competition.

Much more information on the principles, purposes, and rules of market competition must be disseminated. A systematic and permanent promotional program should be established for this purpose.

A special research project should also be launched to begin the analysis of the application of market competition law in practice.

## Recommendation 13: Increase the transparency of public company operations and privatize certain public services

13

Elements of market competition should be introduced in the public enterprise sector, including the larger utility companies. All the parts of the public sector and public administration that can be privatized should be identified, and a realistic plan for their privatization should be drafted.

A body to regulate public utilities should be created, since there is a regulatory void caused by the Market Competition Protection Agency's lack of jurisdiction over these matters. The body charged with regulating public utility services must prevent arbitrary behavior by local authorities and reduce the great regional differences in standards for providing public services. It must conduct nation-wide policies to ensure competitiveness in the field of public utility services.

## 14 **Recommendation 14: Modernize laws and regulations governing public procurement**

Existing laws governing public procurement must be urgently amended, and an entirely new approach to regulating public procurement must be prepared. The reasons for the unsuitability of a bidder must be precisely defined, legal deadlines for all forms of public procurement must be established (principle of efficiency and expeditiousness) as well as sanctions for their violation, the principle of confidentiality in evaluation of bids must be consistently observed, contradictions within legal texts must be removed and the means for legal recourse (complaints, appeals, lawsuits) must be precisely regulated. New regulations should ensure broader legal encompassment of public procurement and secure an equal legal position for all businesses, guarantee transparency (announcement of decisions, violators, etc.) and improve legal security.

Alternative methods for resolving disputes emerging from public procurement should be developed.

Speedy and predictable court protection should be secured by means of a separate judicial department within the Administrative Court of Croatia charged with administrative cases relating to public procurement.

The level of public knowledge of legal regulation and its application in public procurement should be enhanced. Professionals and impartial experts should be given adequate representation in bodies conducting public procurement procedures.

## 15 **Recommendation 15: Reduce the instance of special property management rights**

The number of cases in which regulations set up special property management rights for individual facilities, structures or entities should be reduced.

This would remove barriers to using or exploiting land, woods and other natural resources, increase opportunities to acquire or purchase natural resources or grant concessions to research and exploit mineral ores, etc.

## 16 **Recommendation 16 Create reliable land records and enhance operations of land registries, copyrights and similar rights and industrial property**

Land registers must urgently be revised and updated to provide an accurate picture of ownership. The existing regulations on land registers must immediately be fully implemented to ensure that they are comprehensive and reliable. Computerization must be fully implemented, so that all elements of land registers, including encumbrements to ownership, are made available to all citizens and legal persons. Public officials in charge of land registers must be fully trained in their duties.



Officials and judges working in the field of copyrights and industrial property must be given appropriate education and the opportunity to receive specialized training. This will enable more rapid and higher quality implementation of procedures to recognize industrial property and more effectively protect intellectual property rights through customs agencies, inspectorates and the police.

It will be necessary to promote the significance of intellectual property by introducing mandatory courses covering industrial property in technical, arts, legal and economics education programs.

### **Recommendation 17: Reorganize judicial bodies and agencies**

17

The number of judicial bodies and their actual jurisdiction will have to be adjusted to the needs of efficient operations: reduce the number of appellate courts, transform some appellate courts into courts of first instance, rationalize the number of municipal courts and distribute the case-load equally among all judges.

The areas of operation of courts and judges in relation to other judicial agencies and professions (e.g. participation of judges in electoral commissions, etc.) should be more clearly delineated, and judicial support officials and court assistants must be educated.

When recruiting new personnel, maximum objectivity must be exercised, while the judicial examination must be reformed and accompanied by a mandatory professional judicial study course (possibly by establishing a judicial academy).

It will also be necessary to re-examine and reform the role and function of individual ancillary agencies and professions, such as notaries public, court advisors, bankruptcy trustees, and court executors, and additionally privatize some of these areas, or introduce greater competition.

Support should be given to research on the functioning of the judiciary. The statistical monitoring of judicial operations must be reformed (particularly where this concerns statistics maintained by the relevant ministry).

### **Recommendation 18: Increase the speed and efficiency of the judiciary**

18

A professional structure must be created and modern judiciary management must be implemented. This should be accompanied by the establishment of a national judiciary management agency that would facilitate the hiring of managers to handle court administration in the larger courts. Within this agency, and in the interests of statistical/analytical reforms, a national system should be established to monitor procedures and management of case circulation using computer technology. Intervention measures should be

instituted to handle crises, including the reassignment of staff, cases and capacity from overburdened to less-burdened courts.

Appellate courts should, to a greater degree, make final judgments in civil and commercial cases. Computerization should automate the settlement of formulaic and routine cases.

A strategic planning system and efficient operational functions within the judiciary must be established such that new efficiency criteria are formulated. Judicial service operations should be evaluated by introducing more complex measuring instruments rather than simply using the number of settled cases.

To raise motivation and accountability in the judiciary, the bureaucratic style of work of judges, attorneys and court experts should be cast aside by creating a stronger link between advancement and efficiency and quality of work, raising accountability for inefficiency and low-quality work and eliminating external reasons for delays among other participants in proceedings (e.g. introducing new forms of control over attorney fees, reducing the importance of criteria such as motions undertaken as a criteria for payment of attorneys, etc.).

Judges and other judicial officials must undergo ongoing education, which would be both their right and obligation. Their continued engagement in the service should be tied to the results of professional training and work.

## 19 **Recommendation 19:** **Encourage amicable and alternative methods for dispute settlements**

Settlements should be encouraged in all types of cases. Mediation systems should be supported both within judicial proceedings and outside of them. Amicable and out-of-court settlements should be fostered by encouraging arbitration.

## 20 **Recommendation 20:** **Bolster the principle of rational organization in public administration**

The central government must be rationalized by reducing the number of ministries and so-called public administrative organizations. Some of these could be reorganized as independent public institutions outside of the public administrative system.

The structure of public administration needs to be simplified by reducing the number of public administrative offices and their territorial networks. This also means reducing the number of employees working in them.

The existing functional overlap between national administration and local self-government, and within the national administration itself, must be eliminated. A modern regional self-government system must be established with the fundamental objective of fostering regional development. In this sense, it



may be necessary to re-examine the role of the existing counties, and possibly to abolish some of them.

The structure of municipalities and towns/cities must be rationalized by re-examining the justification for maintaining multiple types of organizations and a large number of very small and in every sense feeble self-governing units.

### **Recommendation 21:**

#### **Reinforce the institutional capacity of public administration**

21

The functions of the Government and Prime Minister must be consolidated and strengthened in relation to the ministries and other organizations of central government. In this sense, besides command authority, the Government's professional support staff should also be reinforced.

Tasks requiring creativity and expertise should be separated from repetitive tasks in central government bodies, so that the ministries can primarily perform core tasks such as monitoring, conducting expert analyses, drafting public policy and implementing new regulations. Executive and repetitive tasks should be entrusted to executive agencies.

The staffing, material, IT, and financial conditions for operations in independent regulatory and supervisory bodies must be enhanced.

Public management and entrepreneurial methods must be introduced to public administration. This means, in other words, strengthening and coordinating the Government's capacity by establishing matrices in the public administrative system (expert task forces to align policies) and by enhancing ties with expert institutions, civil society organizations, etc. All of this must be sustained by means of modern standards of automated operations and management of public records, and by administering a quality assurance system.

### **Recommendation 22:**

#### **Raise the level of professionalism and ethical standards, and depoliticize administrative agencies**

22

Establish a higher educational institution to train civil servants, and develop a curriculum for university-level qualifications for so-called administrative specialists and public managers.

A comprehensive system of human resource management in public administration and local government must be set up. This system, besides keeping records, should also involve a permanent system of education. This also implies a different concept for civil service examinations, i.e. introducing an admissions examination adjusted to the individual's qualifications, vocation and type of work to be performed. Existing civil servants must undergo additional training, while bonuses and promotions should be linked to education and peer reviews.

The number of political appointees should be reduced to a minimum, while the hitherto unregulated status of local officials should be unambiguously and rigorously regulated.

## 23 **Recommendation 23:** **De-bureaucratize public administration to make it results-oriented, transparent and open**

Processes need to be simplified and expedited by opening as many 'one-stop shops' as possible using the Internet, especially when business activities are involved.

The civil service must become more flexible, and civil servants need to be imbued with the spirit of responsible service rendered to citizens and businesses. An effective system must be set up to oversee the legality, operational quality and ethics of civil servants, both in public administration and in public and utility companies.

The newly formed executive agencies must be given a greater degree of independence, and their managers should receive performance-based remuneration. Strategic plans (administrative programs) must be defined to set the course for executive agencies, while budgets should be executed on the basis of projects, so that costs are tied to results rather than the number of employed officials.

Budgets and annual accounts must be transparent at all levels, and taxpayers should be granted access to review public spending. All necessary steps must be taken to ensure that citizens can actually enjoy the rights already granted to them by law regarding access to information about the public sector. Citizens and business should be informed in an appropriate manner about the activities and services of the public administration.

## 24 **Recommendation 24:** **Decentralize government**

In the interests of reducing administrative barriers, local and regional self-governments must become capable of reliably, efficiently and responsibly performing all public tasks. This requires rationalizing the structure of local units by forming modern regions and more realistically regulating local committees and other forms of local self-government.

The status of local self-government must be regulated by constitutional law. Local government jurisdiction should be expanded in line with EU standards. Plentiful financing should be secured for local and regional governments, accompanied by a reasonable degree of financial autonomy and effective central oversight. Decentralization should be a firm commitment, but it should be implemented gradually, in accordance with assessments of the capability of local administrations to effectively provide public services.



### III. Cost and Price Competitiveness

The overall price level on the domestic market is higher than in other transition countries, except in Slovenia. The price of basic inputs for production—electricity, telecommunications services, motor vehicle fuel, and natural gas—is in some cases higher than in competing countries. Due to growth that has largely been based on growth in domestic demand, the prices of goods and services not subject to international trade grew much faster in Croatia than other prices, while labor productivity did not grow fast enough to neutralize this effect. Therefore, the relationship between wages and labor productivity, expressed as unit labor cost, is much less favorable than in other transition countries. This situation creates great obstacles to improving Croatia's price and cost competitiveness. The call to change this situation is tied to the fact that lower prices and costs would leave additional funds for investment at the disposal of citizens and businesses. Over the long term this would have a powerful impact on the growth of competitiveness.

If we compare Croatia with other transition countries, we note a disproportionately high position on the ranking of prices and wages in comparison with a lower position on the ranking of real per capita GDP (measured at purchasing power parity) (Table 1). Although one can, to a certain degree, express doubt about per capita GDP rankings owing to the great differences in the quality of measurement, the extent of the grey economy and neglect of the quality of goods and services being consumed, it is very likely that this disproportion would remain visible even after the necessary statistical corrections. The disproportion is fundamental and cannot be corrected using short-term measures (e.g. devaluation of the domestic currency). The causes have to do with the structure of preferences of Croatian citizens. Croatian citizens have preferences similar to consumer preferences in developed countries. The currency structure of savings also resembles that in developed countries. This means that the disproportion should be eliminated only gradually and cautiously, so that whatever growth in competitiveness has been initiated can have lasting effects.

Table 1: Real per capita GDP, national level of prices and wages in select transition countries

	Real per capita GDP in 2000* (EU15 = 100)	National price level (EU 15 = 100)	Average gross wages in € in first half of 2003 (Index, Croatia = 100)
<b>Croatia</b>	<b>36</b>	<b>56</b>	<b>100</b>
Slovenia	67	65	145
Bulgaria	25	29	19
Hungary	49	44	72
Poland	40	50	72
Romania	23	24	34
Russia	29	29	20

\* Current exchange rate, based on buying power parity

Source: UNECE, 2003., "Summary Results of ECP 2000: A note by the OECD Secretariat" Conference of European Statisticians Working Paper, no. 6. and WIIW - Monthly database on Central and Eastern Europe.

Under these circumstances, price and cost competitiveness can be achieved through three courses of action:

1. Ensuring that labor productivity grows faster than wages
2. Intensifying competition on the domestic market and reinforcing the regulation of monopolies and quasi-monopolies
3. Reducing the tax burden

## Recommendation 25:

### 25 Ensure that labor productivity grows faster than labor costs

Demand for labor, i.e. employment, depends on the unit cost of labor. This is the ratio between the price of labor and its productivity. When the unit cost of labor grows, employment falls; when the unit cost of labor falls, employment rises. Reducing or freezing real wages, meaning living standards, cannot secure decreasing unit labor costs. Consensus between social partners cannot be based on reduction of real wages through reduction of nominal wages, inflation and/or devaluation of the domestic currency. Education, innovation and other policy measures should create an environment conducive to GDP growth. The social partners should jointly seek a way to leave free space for investment through moderate wage growth (wage growth less than GDP growth). Investment stimulated in this manner will be compatible with a positive relationship between growth in GDP and real wages and will support the social consensus.

Labor costs per employee in the public sector must grow slower than GDP growth, provided that labor costs per employee in public companies can be tied to the performance of individual companies rather than to GDP.

The National Statistics Bureau or FINA, employing best-practice methods, should develop reliable sector measures of labor productivity by the end of 2004 that the partners would accept as authoritative indicators for wage negotiations. Here the statistical computation of wages and fees for managers should be separated from the wages and compensation of other work-



ers. Based on these improved statistics, the Government's Social Partnership Office, with possible cooperation from the National Competitiveness Council, could initiate the preparation of a national wage policy with the goal of regulating transactions on a more flexible labor market by a variety of means.

### **Recommendation 26:** **Intensify domestic market competition and reinforce regulation of monopolies and quasi-monopolies**

26

Steps should be taken to allow true competition in the market for electrical energy, oil derivatives and the market for communal services. Regulation of the price of electric energy, fuels, fixed and mobile telephony and communal services should be harmonized with EU practice. Additional concessions and licenses for fixed and mobile telephony should be granted.

The operations of public companies should be thoroughly reorganized by means of international public tenders for top management officers, with the introduction of bonuses tied to an appropriate return on capital. The targeted return on capital must be sufficient to secure economic efficiency but also low enough to protect public interests if it is a matter of an unavoidable state monopoly.

A schedule and methodology for privatization of part of the public sector (some energy industries, a part of the railroads, maritime transport) should be drafted by 2010, as well as a plan to privatize, or reasons for retaining state ownership of, the remaining public companies (Croatia Airlines, Croatian Post Office, Croatian Postal Bank, etc.). Privatization revenues must be used exclusively to finance public investment or held as reserves, and should not under any circumstances be used to finance the current fiscal deficit. Privatization should be conducted only if there are genuine perspectives for increasing efficiency. With careful monitoring and by conducting pilot projects, portions of public companies should be privatized first (including parts of public utility companies). Within this framework, incentives should be created for the development of small, local, private or privatized public service providers (maintenance of green areas, transit - public and taxi services, utilities infrastructure, etc.). All of these efforts should be taken within the context of uniform policies to encourage competitiveness on the domestic market.

Last but not least, Croatia must continue to liberalize its foreign trade regime to prepare its economy for competition on the open markets of the European Union.

### **Recommendation 27:** **Reduce the tax burden**

27

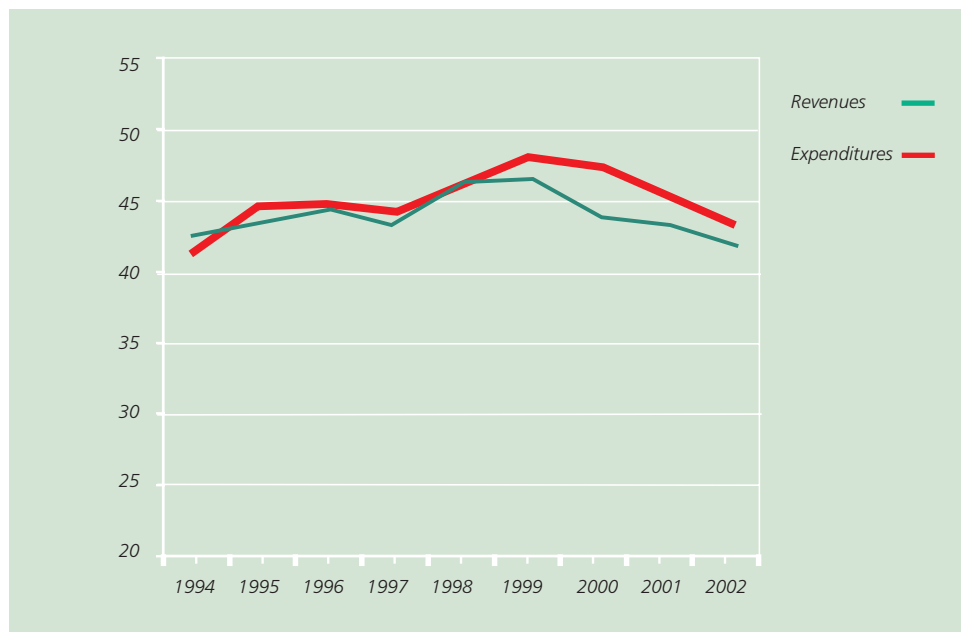
Figure 6 shows that that the consolidated central government's total revenues have been constantly above 40% of GDP. Despite the obvious reduction of the effective State burden measured in this manner since 2000, this percentage is still greater than in most small, competitive, open European countries that are

<sup>2</sup> In Ireland, Portugal, Greece and most other advanced transition countries, this percentage varies greatly, but it is generally between 30% and 40% of GDP. Corrections for capital revenues do not significantly alter this picture or these conclusions.

<sup>3</sup> Tax revenues of general government (which includes central government, extra-budgetary funds and local governments) were about 44% of Croatian GDP between 1995 and 2002. This represents a substantially higher tax burden than in other transition countries. Slovenia had the next highest tax burden during the period, with tax revenues of about 40% of GDP, while the average for transition countries was 34%.

at a somewhat higher developmental level than Croatia<sup>2</sup>. Croatia obviously has to seek ways to join this group of countries and reduce the share of revenues of consolidated central general government in GDP to considerably less than 40%.<sup>3</sup>

**Figure 6: Consolidated central government revenues and expenditures as a percentage of GDP**



Source: Croatian National Bank, No. 89/2004

The framework for reducing the tax burden should be sought in the reduction of total public spending. This will open up opportunities to reduce income taxes by the following means, which are complementary rather than mutually exclusive: (a) increasing personal exemptions, (b) reducing all income tax rates by five percentage points, (c) expanding the range of income to which the tax rates apply, (d) reducing or altering increases in the degree of progressivity of income taxes by eliminating or lowering the maximum income tax rate.

Furthermore, a register of all taxes, levies and fees collected at the local level and at all governmental levels (from municipalities and cities/towns to counties) must be compiled, and they must be compared. Local taxes and quasi-taxes need to be made transparent, and attractiveness rankings of municipalities/counties/regions in terms of tax burdens should be published. This would encourage tax competition among local governments.

Local and national authorities should come to an agreement on reducing the prices of building permits and other licenses, while utility companies should be encouraged to lower the price of utility connections to facilitate and spur investment. Tax discipline and prevention of tax evasion should be strengthened simultaneously.

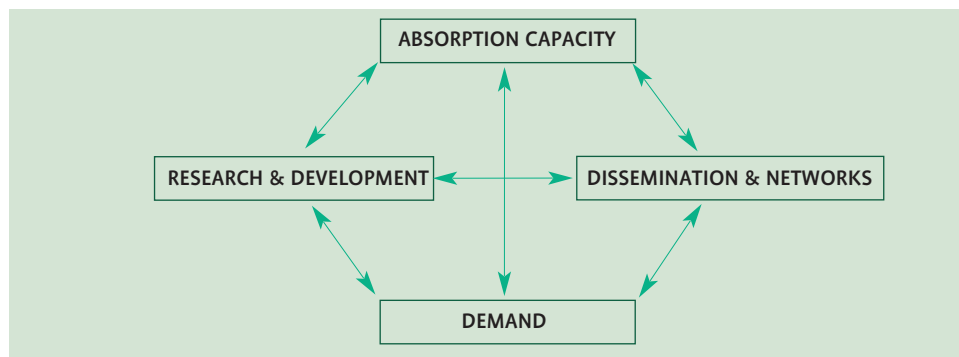
## IV. Development of Innovativeness and Technology

Productivity should be enhanced on the basis of innovation, investment in employee expertise and new technologies. Innovation should be the basis of competitiveness.

Even so, innovation is not simply the result of research and development (R&D). It emerges through the ability of companies to adopt new technology. To achieve the economic effects of innovation it is necessary to spread/diffuse/expand/broaden it in all sectors regardless of their technological level. Technological innovation as defined by Eurostat includes the development of products and processes and organizational innovations such as marketing and education that are directly tied to the creation of new products, services and processes. Productivity does not automatically improve if a country invests in R&D and innovation. There is no inevitable, spontaneous diffusion of innovation. Innovation flows into increased productivity only if it occurs in those operating processes that create new value for customers. Therefore, instead of linear models, which automatically assume the impact of R&D investment on productivity, today we view innovation policy through the prism of a systemic or interactive approach. This approach assumes that innovation encompasses a series of activities in companies based on engineering product designs and processes. Further improvements and application of innovations can become more economically important than the original invention. The key question is: what determines a company's innovativeness (see Figure 7).

Besides internal characteristics, company innovativeness depends on context: the organizations, institutions and regulations surrounding it. These factors are crucial to absorption capacity—the labor force's ability to adopt and adapt new technology to increase productivity. This ability depends on educational levels. So innovation incentive measures must not only depend solely on R&D activities, but rather on all four components of innovation capacity.

Figure 7. National innovative capacity



## HOW INNOVATIVE ARE WE?

*According to the share of government expenditures on research and development in GDP, which is 1.25%, Croatia has a high rating, just behind Slovenia and the Czech Republic, and far ahead of other transition countries. However, when we look at investment by the enterprise sector in research and development to GDP, which is 0.43%, Croatia is only slightly ahead of Romania and Latvia, a far behind other transition countries. If we add to that the fact that, with 65 ISO 9000 certificates per million inhabitants, Croatia in 2000 was only better than Poland, while other transition countries were several times ahead on this indicator, it becomes clear that the basic Croatian problem is a low level of investment in research and development in the business sector.*

*It is interesting that, in 1995, Europe found that it had a similar problem, but at a much higher level of development. This led to the creation of a new innovation policy in Europe in 1999 ("Trend Chart on Innovation in Europe").*

Innovation policy is horizontal, and encompasses all sectors, as opposed to vertical policies, such as direct government assistance to agriculture or ship-building. This is why the introduction of innovation policy demands a broader perspective on the economy and an understanding of the complex links between technology, innovation and economic growth. Croatian innovation policy must be based on the following objectives:

1. Innovation policy must be mainly market-oriented and focused on improving company innovation - which is the source of the supply of and demand for innovation and technology - and at improving the R&D and innovation infrastructure.
2. Innovation policy must be directed towards the four components of innovation abilities: absorption capacity, demand, dissemination of innovation and R&D.
3. Innovation policy must lead to productivity growth.
4. Innovation policy must increase the knowledge component in all new investments.

## 28 Recommendation 28: Initiate a standard quality system and raise productivity in companies

Programs to prepare for and introduce ISO standards should be expanded to all companies and continued during the next five years, so that Croatia can catch up to the number of ISO 9000 certificates per million inhabitants in Slovenia. Upon certification with international standards organizations, companies should be given vouchers that they can use to obtain a refund of 50% of the normal costs of introducing quality standards<sup>4</sup>. The programs must be accompanied by promotional campaigns through the regional offices of the Croatian Chamber of Commerce and the Croatian Employers Associations.

<sup>4</sup> A variable subsidy can be introduced that would be larger for smaller firms - see Policy Recommendation VI.6.

Assistance must be secured for activities aimed at increasing productivity in companies. A practical program for raising productivity in factories and other organizations is a program that helps companies to permanently raise their



productivity and quality, and to develop competitive advantage. Consultants should be involved/hold training session within such programs, and companies that have instituted programs and successfully completed them should be co-financed for two years.

### **Recommendation 29: Organize “Enterprise Croatia”**

29

Support to the business sector requires a ‘one-stop shop’: “Enterprise Croatia.” “Enterprise Croatia” should be a government agency that co-ordinates various types of support for strengthening the innovative capacity of companies. The tasks of this agency are: (a) establishment of a Skill Development Fund, (b) implementation of assistance programs, (c) implementation of the Techno-Integrator Program, (d) implementation of support to foreign direct investment, (e) co-ordination with ministries and other governmental bodies based on their programs.

Skill Development Fund for companies with over 100 employees: All firms with over 100 employees would pay a certain percentage of gross salaries (e.g. 2%) to the “Skill Development Fund.” This money would be returned to the firms in the form of vouchers usable to pay for educational services provided by approved firms and institutions. This means that payments to the Fund would be a tax on those companies that did not make sufficient investments in additional employee training. Payments will not be made for educational programs that companies would have undertaken in any case. Parallel to these measures, certification for professional qualifications should be accelerated.

“Techno-integrator”: vendor network for multinationals: Dissemination of technological innovations is to a large measure carried out through multinational companies. Innovation policy must adapt to this fact by encouraging multinationals to purchase goods and services for high technology from domestic vendors. The direct goal of the Techno-Integrator Program is to create and expand a network of technology-intensive local vendors, based on the Hungarian Integrator Program. The program’s success would be measured by the share of domestic vendors in the purchases of large companies. A large company and at least two small and medium-size domestic companies with head offices in Croatia could apply for the program. The application would have to contain a plan for technical and educational activities with the objective of increasing purchases from local companies by the subsidiaries of multinationals. The State would encourage integrators with subsidies for technical and educational activities. A large share of the subsidies (e.g. 90%) would be set aside for local vendors.

### **Recommendation 30: Improve subsidies for company technological activities**

30

Research must be conducted on the best ways to encourage companies to undertake technology development activities and design/engineering projects with high knowledge content. This would form the basis for expanding

tax incentives. These changes should be made while keeping in mind that the objective of incentives is not for companies to achieve private interests more easily, but to create system-wide as well as general public benefits through improvements in the national technology base.

A “one stop shop” must be established in which entrepreneurs can learn about all available financial incentives, technological developments, education and training opportunities, and R&D activities aimed at helping companies.

### 31 **Recommendation 31: Enhance support for technology transfers and expand it with an assistance plan entitled “Learning Companies”**

This Recommendation is an expansion of the program entitled “From College to Work,” and so it partially falls under education. However, the objective of this program is not employment, but technology transfers and the development of a national technology base. Graduate students should be given the opportunity to work in companies on challenging projects of major development importance to the companies themselves. These do not have to be strictly R&D projects. They can be any type of technology project in which there is an interest in cooperation. In this manner, institutions and universities will have the chance to provide services to the business sector, expand the field of research important to industry and develop their own personnel. Such projects could be contracted between firms and universities for periods of 1 to 3 years, and the progress of such projects would be encouraged by additional funds from the Government.

### 32 **Recommendation 32: Introduce and modernize the knowledge-based economy’s statistical system**

In terms of modernizing the statistical monitoring of knowledge-based statistics (IT diffusion, Internet, software, innovations, etc.), Croatia is behind not only the EU but also the candidate countries. The monitoring of these activities must be introduced more rapidly on the basis of indicators that keep track of innovation capacity and other knowledge-based economy indicators. The key tasks are: (a) to collect innovation statistics for industry and services based on the Eurostat model, (b) to introduce statistics on permanent professional training according to Eurostat methods, (c) to collect data on the information society based on the European Survey on Information Society II - ESIS II (<http://www.ii-a.fr/esis-extension2>) (d) to align domestic R&D statistics with the updated Frascati Manual, (e) to align domestic statistics to monitor human resources for science and technology with international standards (Canberra Manual); (f) to introduce statistics based on the balance of technological payments according to OECD methods.

### Recommendation 33: Establish a national individual award for innovation by individuals and companies

33

Promoting technological entrepreneurship within Croatian professional circles and the public is absolutely essential. This would help improve public perceptions of innovations, and stimulate their recognition as economically and socially beneficial activities. The annual award for innovation should be given to individuals and companies for innovative activities that lead to significant commercial results.

## V. Strengthening Small and Medium-size enterprises

Small and medium-size enterprises in Croatia account for 98.9% of the total number of companies, 53.5% of employment and 44.2% of total revenues, and they are responsible for approximately 60% of export revenues (2002). International experience has shown that these firms are the prime generators of new jobs. Small and medium-size companies provide the framework for private enterprise initiatives, which form the basis for economic and social inclusion in the broader sense.

We cannot be satisfied with the pace of entrepreneurial initiative and the financial strength of small and medium-size enterprises. Besides these basic, general shortcomings, the sector is burdened with a chronic deficit of enterprise programs, lack of co-ordination of government policies to create a stimulative environment for entrepreneurship, administrative barriers in the different phases of a company's life cycle, underdevelopment of financial markets needed to meet the needs of small and medium-size enterprises, and great regional discrepancies in entrepreneurial activity.

### HOW (UN)ENTREPRENEURIAL ARE WE?

*The TEA (total entrepreneurial activity) index measures the number of newly established companies over the past 42 months in relation to the adult (18-64) population of a country. In Croatia in 2002 there were 3.6 new companies for every 100 adults, while the TEA index for Poland was 4.4 and 4.6 for Slovenia, 6.6 for Hungary and 9.1 for Ireland.*

*According to data from FINA, profits of medium-size companies in 2002 were 0.55% of total income, while small companies incurred losses. Although such data should be viewed with some reserve due to the role of a rapidly restructuring market and tax evasion, the importance of this data cannot be completely ignored. These data are an important call for an active approach in the small- and medium sized sector.*

It is therefore important to begin implementation of these recommendations. This should lead to the achievement of the following three objectives:

1. TEA index - the number of newly established companies per 100 adults should increase from the current 3.6 to 10.

- 2. Increase the productivity of small and medium-size enterprises.
- 3. Make small and medium-size enterprises more export-oriented.

The context for the selection and formation of this recommendation is the European Charter for Small Enterprises, which Croatia will sign in 2004, and the assessment of the contribution of the small and medium-size enterprise sector to the achievement of the strategic objectives of raising Croatia's competitiveness.

## 34 **Recommendation 34: Develop an open entrepreneurial culture**

Croatia's culture and societal norms do not support entrepreneurial culture sufficiently. Entrepreneurs are most often erroneously perceived as people who want to get rich quick and who operate on the edge of the law. This is why it is necessary to incorporate general entrepreneurial knowledge and skills into curricula from elementary to tertiary education by establishing a special task force for this purpose.

A program of student enterprise should be incorporated into secondary school curricula, and student enterprise trade fairs should be organized as part of the Zagreb Trade Fair.

There should also be competitions for the best business plans by students enrolled in tertiary education.

## 35 **Recommendation 35: Formulate consistent government policies and instruments to encourage entrepreneurial activity**

Government policies so far have been neither comprehensive nor fully conceived, and the regulatory framework for entrepreneurship frame is fragmented and inadequately transparent. A task force should be established to coordinate policies, instruments and programs that encourage entrepreneurial activities, particularly those pertaining to education, tax, export and financial policy. This would create a structure for permanent horizontal cooperation between all governmental policies and programs focused on the small and medium-size enterprise sector. This task force should be an advisory body to the Prime Minister.

## 36 **Recommendation 36: Eliminate administrative barriers in all phases of the entrepreneurial life cycle, from establishment, through development, to transfer of ownership**

The biggest regulatory "blockage" is found at the beginning of the process of establishing entrepreneurial activity. There are still approximately 70 different regulations governing the process of registering and launching entrepreneur-



ial activity. Nothing has been done to eliminate administrative barriers in the later phases of entrepreneurial undertakings, and various institutions often interpret these regulations differently. It is therefore necessary to conduct a thorough analysis of the legislative and regulatory framework in which small and medium-size enterprises operate in order to respond to the following questions: (a) how transparent and predictable is the regulatory framework, (b) is there equality in its application to all users, (c) what are the costs to end users?

The results should be used to effect regulatory changes that will in turn achieve the following standards: (a) time to register a limited liability company: 3 days, (b) number of necessary forms and documents: 5, (c) number licenses and certificates: 1.

Until the regulatory and legislative framework is changed to achieve the 3-day limit, the time it needed to register a business should be decreased as follows: 20 days in 2004, 16 days in 2005, 12 days in 2006, 8 days in 2007 and 3 days in 2008.

A project for the on-line registration of companies needs to be launched with the goal of implementing pilot projects in several local self-government units in 2005.

### **Recommendation 37:**

#### **Stimulate the development of the capital market to finance new business undertakings and small and medium-size companies with growth potential**

37

Attempts to mobilize bank funds and the banking sector to provide all the services needed by the small and medium-size enterprise sector simply will not work. One reason is the inappropriate risk profile. Another reason is the fact that banks do not yet possess the processes or procedures needed to offer products on the mass corporate market. Therefore, it is necessary to encourage savings through forms of non-banking private and institutional investment. Here two objectives can be achieved: higher yields on invested capital and financial support for all phases of business undertakings.

It will be necessary to conceive a program that will introduce new forms of financing alongside the standard forms. New forms could include business angels and social investors. In addition, it will be necessary to further stimulate the use of previously under-utilized financial forms (seed capital funds, ESOP, IPO) in the small and medium-size enterprise sector.

### **Recommendation 38:**

#### **Set up an institutional infrastructure to provide professional services to small and medium-size companies**

38

An impact analysis must be conducted of all government and international programs to support the development of institutional infrastructure for the

provision of professional services to small and medium-size companies. Based on this analysis, a strategy for developing professional services markets for small and medium-size companies must be elaborated, as well as a map of infrastructure institutions. It is important to identify market segments for professional services and encourage the improvement of these institutions. Certification should be introduced for consulting services in this sector.

### 39 **Recommendation 39:** **Establish productivity benchmarks for the small and medium-size enterprise sector based on the corresponding industries in the EU**

A comparative analysis must be conducted of the material costs, labor costs and profit margins of selected industries in Croatia and the EU. The reasons for differences must be analyzed. Annual financial indicators at the sector level, categorized on the basis of company size, should be made publicly available so that entrepreneurs can assess their positions within a given industry.

As a part of stimulating quality certification in Croatian firms, measures should be proposed to subsidize the fixed costs involved in introducing quality standards. This would mean relatively higher subsidies for relatively smaller companies.

### 40 **Recommendation 40:** **Encourage the “export mentality” among small and medium-size companies**

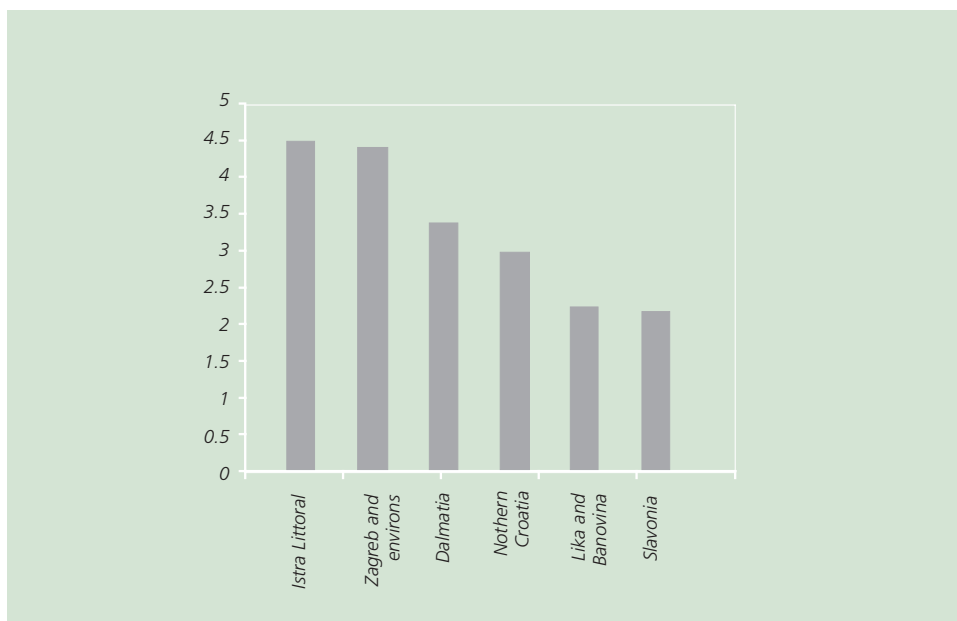
Programs financing export activities and efforts of small and medium-size companies can more successfully develop the “export mentality” (e.g. research in foreign market niches, loans for export programs, participation in international trade fairs). The Croatian Bank for Reconstruction and Development should play a special role here in cooperation with governmental institutions, the Croatian Chamber of Commerce and the Croatian Chamber of Trades and Crafts.

### 41 **Recommendation 41:** **Diminish regional development inequalities by employing clusters**

In Croatia, there are drastic regional inequalities in entrepreneurial activity (see Figure 8). In the interests of creating more balance, a cluster program should be launched. The program should be based on an analysis of the regional distribution of industries, identification and thorough preparation of potential participants in the cluster and the development of support infrastructure (information, marketing, quality assurance).



Figure 7: TEA index of entrepreneurial activity by region



Source: What makes Croatia an (un)entrepreneurial country?, GEM 2002, Results/Findings for Croatia, CEPOR, Zagreb, February 2003, p. 29.

## VI. Regional Development and Cluster Development

Regional differences in entrepreneurial activity represent only one aspect of regional differences in Croatia. The range of unemployment rates, from 13% in Krapina-Zagorje County to 31% in Šibenik-Knin County, testifies to the severity and probable deepening of these differences. The range of education measured as the share of highly-educated in the population aged 15 and older runs from 3.2% in Krapina-Zagorje County to 16.6% in the City of Zagreb. And the ratio of earnings to total revenues goes from -16.2% (losses) in Lika-Senja County to +8.2% in Istria County.

It is therefore apparent that Croatia needs a regional policy as a component of its overall developmental policy. Modern regional policy places great strategic emphasis on industrial restructuring and other structural adjustments in underdeveloped regions. However, it is not limited to relatively undeveloped regions, for wealthy regions can create demand that will “draw” growth into relatively less developed regions.

The first constraint to implementing modern regional policy in Croatia is the inherited doctrine of reconstructing war-affected regions. This doctrine is no longer appropriate to the demands created by process of Croatia’s accession to the EU. This is particularly important given that one of the EU’s key criteria for membership is that a country must be able to withstand competitive pressures within the framework of a single market. Regional policy plays a unique role in this respect.

The next constraint lies in the marked sectoral rather than integral approach, which is best reflected in the numerous uncoordinated actions taken by various ministries and other governmental bodies. The sectoral approach has led to concentration on specific developmental segments, thereby preventing the achievement of synergy. Valuable funds for direct State assistance that have an implicitly regional character (e.g. shipbuilding, agriculture) have been spent as a part of the sectoral approach, but there has been no assessment of the impact of such State assistance.

Furthermore, the legal framework is disjointed, so that Croatia has no uniform legislation that systematically governs regional development throughout the country's territory. At the same time, the process of fiscal decentralization is not appropriate to the developmental moment. Currently, between 6 and 9 percent of non-earmarked budgetary funds have been decentralized, while in this phase, about 20-25% of funds should be decentralized to the county level. The ultimate goal should be decentralization of 50-70% of budgetary funds.

The final, and also greatest constraint, lies in the low capability of public administration, which falls particularly short in regional planning, programming and evaluation of regional program implementation. The need to plan, program and evaluate is one of the most important principles of contemporary regional policy.

This situation can be overcome by achieving the following four regional policy goals:

1. Achieve national cohesion and sustainable development in local and regional communities.
2. Develop human resources with the objective of retaining the population by creating perspectives for jobs and employment.
3. Preserve and validate urban, rural and littoral zones, and make optimum use of them.
4. Develop competitive and restructured sectors with special emphasis on the growth of small and medium-size companies and the corresponding climate.

## 42

### **Recommendation 42:** **Apply the basic principles of modern regional policy**

The principle of subsidiarity must be incorporated into the ongoing process of decentralization and public administrative reform. The partnership principle must be included so that all interested parties (local and regional authorities, non-governmental institutions, social partners, business community representatives, etc.) are involved in all phases of planning and implementing developmental programs. The principle of complementarity entails gathering data whose analysis should ensure that the funds being allocated for individual regional developmental programs do not displace other sources of financing for those receiving the funds. The programming principle means that first developmental plans spanning several years must be adopted through appli-



cation of the partnership principle, under the auspices of the National Plan, the drafting of which is foreseen as part of the existing CARDS program of EU technical assistance. Every developmental program must be continually monitored and evaluated (monitoring and evaluation principle).

A statistical/analytical base must be created to assess regional competitiveness and to monitor and evaluate the impact of regional policy in line with EU statistical standards. GDP measurements at the regional level must commence with this purpose in mind. A database should be established that would facilitate measurement of regional competitiveness and monitoring and evaluation of the impact of regional policy based on annual frequency.

### **Recommendation 43:** **Establish a legal and institutional framework for efficient regional policy management**

43

The existing framework should be replaced with a single law governing regional development, which would be prepared and publicly debated as part of implementation of the National Regional Development Strategy<sup>5</sup>. In this vein, the legal conditions must be created for the functioning of institutions charged with regional policy and development management, and care must be taken to transfer rights and obligations from national, regional and local administrations to specialized institutions.

<sup>5</sup> Implementation of the regional development strategy project commenced in October 2003. The project is being drafted with the technical support of the EU through the CARDS program, while the Strategy's preparation is being co-ordinated by the Ministry of Public Works, Renewal and Construction.

The establishment of the National Regional Development Agency (NRDA) and a network of regional agencies is a priority. The regional agencies must be organized and structured so as to be operative bodies of their own counties and local self-government units, but also "terminals" and "extensions" in the implementation of a uniform regional policy. The Regional Development Advisory Council must be formed within the NRDA.

National and regional administration must become qualified to implement regional policy.

### **Recommendation 44:** **Encourage local developmental initiatives and development instruments**

44

A network of regional development agencies (RDAs) must be established and its functioning encouraged. Some of them can be specific-purpose centers intended for locally important traditional sectors (tourism, agriculture, textiles, lumber industry and so forth). One or more pilot agencies/R&D technology centers should be set up based on the model used in north-eastern Italy (Friuli-Venezia Giulia) and parts of Slovenia.

There will be a need to formulate and conduct specialist programs for education and training in public administration, which needs to become capable of managing local and regional development.

The existing “spontaneous” local development and entrepreneurial initiatives should be further encouraged.

45

**Recommendation 45:**  
**Devise financial incentives for regional development at all levels**

The Regional Development Fund needs to be further reinforced, and guarantee instruments need to be created. A task force consisting of representatives of the Fund, members of the Regional Development Advisory Council and other financial experts would work on finding an optimum financing model for regional development.

46

**Recommendation 46:**  
**Develop clusters**

A task force needs to be established to focus on cluster development within the National Regional Development Agency (NRDA). The task force would analyze potential regions for cluster development, visualize their development, and commence cluster pilot projects by launching public tenders with limited-time State support. A project to train cluster managers/network brokers would be conducted, accompanied by a process of organizational learning that would change ways of thinking and behaving by cluster management members.

47

**Recommendation 47:**  
**Enhance the economic component of spatial planning and management**

Legislation governing spatial planning and the corresponding subordinate legislation should be amended where this concerns the methods required for drafting spatial management plans at all levels, and a separate law governing environmental impact assessments should be enacted. The knowledge and abilities of spatial planning officials should be improved. Higher education and research capacity needs to be strengthened with a view to applied knowledge, spatial planning and the spatial economy.

48

**Recommendation 48:**  
**Enlarge the territorial units involved in regional development**

The atomization of territorial units, municipalities, cities/towns and counties must be halted, and special measures should be taken to encourage ties between them in the economic, spatial and social spheres. The number of municipalities and towns needs to be optimized at the local level.



## VII. Creation of Positive Mindset and Leadership

Major changes will be required to move the attention of all social actors to the problems of competitiveness and implementation of the recommendations set out in this document. And every change gives birth to resistance and barriers. Resistance and barriers can be overcome through the creation of a positive social climate and a positive attitude towards change, among other things. The initiator and sponsor of change must be up to this task.

The National Competitiveness Council has surveyed the attitudes of people towards change. The goal was to see whether political and economic leaders have reached consensus about the basic goals of change, to establish the possibility of change, and to identify the main barriers to change. The research was done on a sample of 500 households with telephone connections, stratified by counties. Four target groups were surveyed: university teachers, managers, political leaders, expert advisors for economic policy in political parties, and union leaders.

The results showed the following:

1. General awareness of the crisis is very high and represents a sound basis for initiating reforms.
2. Willingness to make sacrifices is modest relative to the degree of further abstinence required. For this reason, it would probably be good to think about a strategy of supplementary mobilization of the population that could increase this readiness.
3. The work culture is not a main source of problems in the Croatian economy, but it also is not a comparative advantage.
4. Future change agents should be perceived as expert and morally unquestionable. This would ease and speed up the process of reform.
5. Disagreement among the principle creators of economic strategy about the vision of Croatia could become a serious problem during the definition of an economic strategy and the mobilization of the broad public.

### Recommendation 49:

**Present an objective assessment of Croatia's economic status to the public, and based on that assessment create a sense of urgency for radical change**

49

### Recommendation 50:

**Croatia's political leadership must set up a team of people capable of initiating and managing changes**

50

### Recommendation 51:

**Create a development vision, gather the leading experts around it and secure their support**

51

- 52 **Recommendation 52:**  
Top Government officials must continually, accurately and unambiguously keep the public abreast of changes and the purposes underlying the comprehensive reform package
- 53 **Recommendation 53:**  
Make use of foreign experiences and verified methods to find specific solutions
- 54 **Recommendation 54:**  
Define, communicate and achieve short-term and medium-term objectives based on dialogue between the principal actors in society. This Council and other non-governmental organizations can make significant contributions to this process.
- 55 **Recommendation 55:**  
Invest in education of the political elite so that they gain best modern leadership skills and knowledge.



## CONCLUSION

Croatia and its economy are confronted by a series of severe problems. The National Competitiveness Council still believes that there is a chance to overcome these problems and to manage the challenges facing Croatia. But this will require an objective assessment of Croatia's economic status and its presentation to the public. It will also require the mobilization of all resources around a new developmental program for Croatia.

The formation of a new Government represents a unique opportunity to develop an extensive and comprehensible strategy to meet these challenges. Action must be taken immediately; any further delay will only intensify the challenges confronting Croatia. At the same time, the public must be made aware that the new strategy surpasses the time limits of a single term of office of the Government.

**Therefore a national consensus must be reached. There is an urgent need to act on the basis of a common understanding of our current economic situation and the challenges we face.**

Accurate and impartial assessments of the current condition of the Croatian economy must be presented, along with the future challenges. The tendency to concentrate only on "good news" must be avoided, and the commitment must be undertaken to present an accurate picture of the strengths and weaknesses of the Croatian economy. It should be made clear that our future living standards are severely threatened. The National Competitiveness Council is prepared to serve as the driving force to building a national consensus on the challenges ahead of us.

**All social groups and institutions must be involved in these efforts.**

Everyone must be involved in this process. All social groups, from political decision-makers and scholars to businesses and trade unions, must do their part to respond to the challenges confronting the Croatian economy.

**Action must be taken urgently.**

The challenges before us are time-sensitive. Delaying changes and transformations will only harm our chances of achieving the long-term objective of raising living standards in Croatia. Therefore, we must all share in this sense of urgency.

### **Develop and implement a sweeping program to enhance competitiveness**

A strategy and program must be drafted, and their implementation must commence with the mandatory monitoring of progress. The development of a sweeping program to enhance competitiveness must pass through several

phases. Some steps must be taken immediately; the implementation of others will take much longer.

First and foremost, the State must adopt a multiple-year budget that will be aimed at achieving three objectives: sustainable improvement in GDP growth, reduction of unemployment, and increased productivity. This budget must contain long-term financial goals for education, research and development, and improvements in infrastructure. Only long-term planning will create the discipline necessary to ensure fiscal accountability.

A far-reaching program to enhance Croatia's competitiveness must be based on the principle that governments do not create jobs - the business sector creates jobs. The Government should create an environment conducive to investment in activities that raise productivity. The National Competitiveness Council calls for the establishment of a partnership between the Government and private sector in the fields of research and development, education and quality assurance.

Second, implementation of the necessary reforms to secure the successful integration of Croatia into the European Union must become a national priority. Particular attention must be dedicated to the removal of administrative barriers that hinder entrepreneurial activity, increasing transparency in public companies, and commencing the process of privatizing public services.

Education of the labor force is crucial to the future improvement of productivity and living standards. Given that educational reforms take a long time, this process must commence immediately. The proposals submitted by the National Competitiveness Council's working group on education could serve as the foundation for further work.

Increasing productivity, reducing unemployment, and ultimately raising Croatian living standards will not happen overnight. An all-encompassing strategy and developmental program are needed, as is the firm commitment of all participants—businesses, trade unions, academia and the Government—to see it through. The Policy Recommendations contained herein, which were drafted by the National Competitiveness Council's working groups, are intended to be the beginning of that process.

The National Competitiveness Council will publish annual progress reports on the implementation of these Policy Recommendations, and on the achievement of the objectives contained in them.

It is our conviction that this document will help engender public understanding of the challenges Croatia is facing, and prompt the necessary action to meet them. We believe that through cooperation we can achieve sustainable improvements in production, investments, employment and productivity, which will in the end result in higher living standards for all Croatian citizens.