

## **Understanding Reform: the Case of Croatia**

by

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*Preliminary version*

November 2003

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Global Development Network Southeast Europe  
(GDN-SEE)

Research Area:  
'Understanding reform'

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The GDN – SEE programme is financed by The World Bank, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank (Proj.Nr. 107)

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# Understanding Reform: the Case of Croatia

## 1. INTRODUCTION

Yugoslavia often used to be considered an ‘experiment’ on a scale unimagined by the currently popular experimental economics. It experimented with socialism (‘selfmanagement’) and frequent thorough institutional reforms (‘normative optimism’) believing that institutional change can act as an ‘engine for change’. The experiment ended with a coherent socialist transformation package (of controlled privatization, staggered liberalization and wide but still limited political pluralism), successful stabilization (a ‘standard’ heterogeneous stabilization program for dealing with hyperinflation) and in spite of this in a violent and brutal decomposition through the still ongoing Wars of the Yugoslav Succession (which even after a decade spawned a still indeterminate number of states).

The successor states of Yugoslavia can still be considered an ‘experiment’. The ease of establishing new states, para-states, semi states and protectorates and the extensive economic and social divergence after 73 years of a common institutional framework and economic space was surprisingly quick and large. The common heritage and divergent transformation policies and the wide range of outcomes with some striking underlying similarities certainly stress the ‘experimental’ view.

This paper hopes to contribute to a better understanding of the ‘experiment’ approach by tracing the economic development in one of the successor states, Croatia. Thus the paper will not attempt to provide a Croato-centric view but will instead concentrate on those developments and interpretations which can be best used in a comparative analysis.

The paper hopes to achieve its goal in next four sections. Section two concentrates on the effect which the Yugoslav transformation package and its underpinning economic policies had on Croatia. By necessity this section will also briefly discuss some economic aspects of Yugoslavia’s decomposition. The next section treats the Croatian transformation experience of the nineties, more precisely Croatia’s crony capitalist phase, its emergence, development and failed consolidation. Section four continues with the crony capitalist view but the central issue is its dismantlement, the promises, efforts, achievements and challenges. The final section of the paper offers some conclusions which seem particularly relevant from a comparative view.

## **2. THE EMERGENCE OF TRANSFORMATION AND ITS LEGACY**

Most analyses of the transformation in Yugoslavia's successor states start in 1990 when they gained their independence and thus start with post independence choices and policies. For understanding transformation this is wrong for the simple reason that all the successor states started independence with a transformation policy package dating back to 1988 already in place and a two year history of their implementation. This had two important implications for each successor state, Croatia included. First because the ideological, political and social breakthrough was achieved in 1988 and that is when the irreversible dismantling of the socialist economy started. Second, for all of them this package represents the first effort of transformation which included economic changes (liberalization and privatization) and political changes (democratization, party pluralism) and their own subsequent independent transformation did not start from scratch.

This section covers how Croatia fared during its first transformation effort. The period covered lasted from 1998 to the beginning of Croatia's second transformation effort in late spring 1991. Arguably, Croatian transformation from a socialist economy to a mixed ownership market economy started in 1988. At that time Croatia was undisputedly part of Yugoslavia and the institutional framework and main features of economic policy were defined by the federal government.

### **2.1 Maturing to transformation**

To understand the nature of the first transformation, events leading up to it must be briefly discussed. The 1980s were the years of economic stagnation (a detailed analysis: Dyker, 1990; Lydall, 1989; Mencinger, 2000). Over the decade there was negligible growth, rising inflation, and increasing instability coupled with low macro and micro efficiency. It was also a period of high distributional conflicts and of institutional experimenting. During the 1980s there was a series of attempts at stabilization and reform (most notably in 1982, 1985, and 1988). For the transformation 1988 is crucial. The events of 1988 include the political breakthrough when the main pillars of economic transformation (of markets and level playing fields for private, state and socially owned enterprises) became acceptable. This major breakthrough was subsequently institutionalized in the 1989 *The Enterprise Law* and

other legislation so that with full justification it can be claimed that the transformation started in all Yugoslav successor states in 1989.

Events leading to 1988 and the analysis of the society wide crisis have been studied in numerous scholarly works. Four 'interpretations' may be offered: cultural/ethnic, strategic behaviour, contextual development and deductive theoretical. Whatever the relative merits of these four approaches each of them leads to a plausible narrative on Yugoslav crisis. Even if none of them offers a full account, and/or lead to over-deterministic or over-strategic explanations, it is useful to be reminded of them, because they certainly point to complexities of the crisis and involved difficulties in building a theory of that crisis. By concentrating on grand schemes these explanations maybe do not give sufficient weight to a learning effect (both by doing, undoing and not doing), muddling through and obstruction. For a redistributive state and redistributive bureaucracies on all levels (federal, republic, local) instituting radical stabilization programs followed by marketization of economy and depoliticization of its functions (distribution and capital-accumulation especially) was more than a nightmare: it amounted to self-denial.

The period prior to 1988 led to five critical aspects of the 1980s which formed the initial conditions for the first, 1989, transformation. The first concerns the economy (high price instability, low growth, low micro and macro efficiency, high regional disparities, growing unemployment and social-economic pathologies which after a decade of failed reforms led to a consensus for liberalization and marketization,), the second the polity (the political terrain was already filled with strong conflicts and low ability to deal with them creating thus a 'window of opportunity' for alternative political projects and towards the end new actors – some with strong nationalistic agendas), the third the systemic-institutional aspect (the extended unresolved crisis created a wide space for institutional entrepreneurship, further development of many regulated and spontaneous market-economy institutions and decentralization which created managerial know-how as well as territorial segmentation), the fourth the state-form (an increasingly weak federal state with rising awareness for a need to renegotiate its content), and, finally, the fifth concerns the international milieu (towards the end perestroika started and the end of the Cold War eroded the international commitment to federal Yugoslavia).

The above combination may have looked like an opportunity for deep reforms of the federal state and its economic and political reconstitution. Closer examination can show that

it was not so. Some initial conditions did not favour such a solution or were neutral (political and international, in particular), some increased the risks of reform (as well as no-reform, high uncertainty resulting from regional differences made the calculus of reform too difficult), and some were clearly missing or were very unequally distributed among the republics (with hindsight: European commitment, credible support for democratic consolidation and a civil society). The development led to a paradox. On the one hand the unfolding economic crisis and stagnation, after each failure, led towards greater consensus regarding the necessity of radical economic reforms (transformation) while in turn opening a even wider space for reform and preparing the population for its necessity (even unavailability). On the other hand the unfolding political crisis reduced the space for a common agenda and solution, increased cleavages (including the discursive ones: the Yugoslav case sharply points to the importance of *reform discourse* – a topic largely neglected in the literature).

Instead of being built on major actors' consensus around goals, costs and credibility of compensation to losers (see Roland, 2002), the first Croatian transition therefore was from the very start frustrated by the paradox: economic transition was dominated by federal government and its policies, political transition was mainly constrained to republics, discourse of economic reforms was homogenizing, discourse of political issues was segmenting. Due to the breakdown of the political and ideological hegemony of the LCY a reform oriented government (with Mr. Markovic as Prime minister) was missing the most critical resource of any reform: political consensus of main actors and generalized matrix of interpretation. This separation of political reforms from economic ones is probably among the most important characteristics of the first transition. The second one is the rising tide of ethnification of politics as the collapse of reform discourse, which dominated the 1980s, turned into ethnic discourse.

## **2.2 Dynamics of success, failure and collapse: design and action**

The consequent delay in producing its own genuinely new legitimizing structure will show to be fatal for the attempted transformation in Yugoslavia. When the federal prime minister started proposing radical economic reform nationalists' agendas had already filled a political

space and became too powerful to be successfully contested by the political message of the program, even when it became clear that it has a potential of being a real alternative, not only to nationalism but to communism, too. Of course, a strong case could be built around the thesis that, even without this basic shortcoming, the federal reform was doomed to failure from the beginning simply because it came too late, even in the eyes of international strategic players (see Woodward, 2000 on the lack of international support). In a situation when a notion of democracy was reserved not for a society as such but for particular nations, from the beginning the federal government was forced to act more like a broker (of other participants interests) than like a genuine reformer being able to claim a massive following. Nor was the government in a position to become radical modernizer with command over resources of violence, which would open an avenue towards a centralist and authoritarian reconstruction of the state and radical marketization of the economy.

Inflation and shortages are the most visible signs of a crisis. By the end of 1989 Yugoslavia and Croatia with it were experiencing both. The January 1990 stabilization programme which overnight brought inflation down to negligible rates led to the country wide popularity of the Federal Prime minister Mr. Ante Markovic. This success, albeit short-lived; and the institutional changes implied by the first transformation moved actors, shaped institutions and formed expectations which together produced new path dependency. The stabilization programme was based on three nominal anchors: fixed exchange rate, tight monetary policy and wage controls supported by internal convertibility and currency denomination. Fiscal tightening, however, was missing since it was largely under the control of constituent republics. The program suffered from internal mistakes from the very start (from the beginning in January 1990 there was initial currency overvaluation, weakness of wage control and fiscal overhang) to which later flaws were added (in June selective central bank credits) making price stability unsustainable (this is persuasively discussed in Mencinger, 2000). In addition, the constituent republics whose commitment to the programme was either low from the start or became such in the process introduced deliberate blockades and trade barriers (see Dinkic, 1996). At the same time political elites (old and new, after first republican multiparty elections) were re-evaluating their strategic preferences and calculations. Lack of international support to federal government reforms and/or the low credibility of the support, and/or its late coming of it (EU commitment) certainly contributed to this. On the other hand, liberalization and privatization, however

partial, produced fast response in the economy. There was an explosion of new firms and start ups, entrepreneurs sprung like mushrooms showing great entrepreneurial alertness and a great willingness to participate in the transformation. This also increased complexities of reform calculus enormously (for some meaning low commitment to privatization, for some low commitment to federal redistribution of costs and compensations).

There is another important feature of the first transformation. It concerns the international environment. As has been mentioned it lacked substantial foreign support, especially at the critical time when failure was not certain (see Woodward, 2000). But another building block of all later transformation was missing as well. What clearly was missing in the first transformation both on the federal level and republican level (Slovenia might be an exception) was the explicit European dimension (in all its meanings – e.g. of EU integration and Europeization). This omission made the break with legacies of the self-managed economic and political system only partial, and commitment to the European liberal democracy of very low credibility.

### **2.3 Legacies of failed reform**

The first transformation project, however radical by its intentions, was in fact a gradualist transformation. It preserved the institution of social ownership, trying to put it on the levelled playing field both with privatized firms and de novo private sector; it organized the reform discourse around ‘new socialism’ syntagma – both may be taken as a desperate (due to lack of republican/ethnic elites’ credible commitments to reforms) reformers’ attempt to relax “ex ante political constraints” (Roland, 2002: 33) Its failure may offer important caveats on gradualist approaches to reform. Particularly if reform lacks a consensus and if the reformers are not commanding resources of violence and if they are facing an extreme time constraint. Furthermore not using windows of opportunity (when and if they appear) forcefully and irreversibly will most likely lead to failure and discredit of reform and reformers.

First transformation efforts and policies certainly faced strong political constraints. Roland comments on four possible strategies aimed at “easing political constraints so that reforms can be enacted: a) building reform packages that give compensating transfers to

losers from reforms; b) making reforms only partial to reduce opposition; c) creating institutions that make credible a commitment to compensating transfers; or d) waiting for a deterioration of the status quo to make the reform more attractive.” (Roland, 2002: 32). It is interesting to note which of them was chosen by the Federal government.

Concerning the fourth one on the list, there is no doubt that *deterioration of status quo* was indeed making Yugoslavia more ‘ripe’ for reforms in the sense that both political elites and the population had become less resistant to them – in principle. Yet, there is a critical difference: the Federal government was not in control of the politics of deterioration. Instead there was a true “war of attrition” between opposing factions in League of Communists of Yugoslavia, between republican political leaderships interests. But with regard to reforms, the result of this conflict was not a complete stalemate but a low-committed acceptance of reforms. This may be explained by two factors: first, all republican communist elites shared the same urgent need to reform non-performing federal/republican economies in order to preserve their legitimacy and second, they could afford an acceptance of federal reforms and even share in some perceived benefits as long as obstruction or even exit remained a viable option for them.

The first of the options mentioned by Roland in Yugoslavia was dominated by large long term regional differences and redistributive policies which had not succeeded in reducing them. Perhaps more importantly during the crises-ridden 1980s these differences widened. Due to great aggregate uncertainty, asymmetric and incomplete information about gains and losses from reform policies, due to a relatively high level of fiscal decentralization and low fiscal discipline of all constituent republics as well as a weak constitutional and political standing of the federal government the *credibility of compensating* potential and/or self-perceived losers was from the very beginning very low. The low level of this credibility was further increased by the low level of international financial support for reforms. The importance of this support was that it could have helped to reduce redistributive conflicts and simplify calculus of reform along republican borders.

The third option concerns *partiality of reforms* which, Roland argues, brings disadvantages such as: lower efficiency gains, losses of complementarities between reforms and in that it does not resolve all uncertainty. However, there may be potential advantages in partiality: it is less costly in terms of compensation payments, and its reversal costs are lower – it makes acceptance easier, due to having an option of early reversal, and, finally, it

can help build constituencies for further reform (Roland, 2002: 33). With regard to Croatia's/Yugoslavia's first transformation some of the arguments in favour of partiality are decreased. For example, early reversal was not simple due to constitutional arrangements of decision-making on the federal level, particularly taking into account asymmetric effects of any reform on republican economies. Secondly, under the circumstances exit from federation, and reform, existed as an option, or, at least was perceived as such. The early reform success of the stabilization program produced a lot of popular support for the federal government and gave it a legitimacy to proceed with further reforms but later events clearly showed it failed in transforming that support into political support. Quite the opposite due to ethnification of politics, loyalties moved to alternative reform or no-reform projects and their attention tuned to individual nations and republics, and not to federation of nations.

The failure of the first transformation clearly points to the importance of both the political and international aspects of the process. The federal government's belief that the economic success may be enough to consolidate support for the transformation and reform and drive it away from the already established republican separate political agendas proved to be false and naïve and the federal government program never got any political momentum. Yet, in spite of this failure, there is no doubt that the first transformation brought some decisive changes which proved important for the consequent separate transitions in newly emerging independent states. These changes concern both the economic and political sphere. This undoubtedly applies to Croatia as well: it inherited from the first transformation some institutions, actors, and transition-related expectations and experiences. The two major legacies of the first transition in Croatia concern the economy and politics. Regarding the economy the legacy concerns the short lived stabilization (which demonstrated that price stabilization can be done), privatization (which had started), entrepreneurship (and entrepreneurial alertness to use the first mover advantages opened by transformation), structure of expectations (about transformation its speed and implications) and a host of new players already on the scene (recruited either from the former socialized sector or private sector). Another important economic legacy was the notion that liberalization and marketization can homogenize an economic space in the new economies. The political legacies primarily concern political pluralization. The political terrain and ideological models developed during the period of high republican and ethnic conflicts led not only to political segmentation of the country but also towards segmentation of ideologies

and their inherent discourses. This in the end led towards the ethnification of politics which no longer took republican borders as reference points thus opening stage for ethnic revolts and military confrontations and wars.

#### **2.4 Breakdown of federation and new states**

There is another important aspect of the failure of the first transformation. This concerns its link to the emergence of independent states, i.e. the break up of the federation and the establishment of successor states. The issue is the following: is the breakdown the consequence of failures of first transition or was it a necessary part of the transition process. The Wars of secession, with all their atrocities and human sufferings, should not divert us of the simple question: was the federal a state necessary victim of transition, or not?

The relationship of changes going as deep as the transformation does and federalism becomes even more interesting when one considers that all three federations which attempted transformation fell apart. European federalism as such was not part of socialist engineering, of the three two (Yugoslavia and Czechoslovakia) were created after the First World War and only one (Soviet Union) together with socialism. Since the decomposition of Yugoslavia falls outside the paper with regard to the very interesting issue of new state formation it can only be said that the immediate costs of statehood in the Croatian case were surprisingly small. The confederate nature of Yugoslavia enabled this. Republican constitution and legislation existed, fiscal federalism meant there was no public finance problem, there was a monetary authority and firm independence maintained business links in most export markets. There was a territorial army and republican police who could provide the backbone for a new army so the only major missing building block was foreign diplomacy (see Bicanic, 1995 and 1996; Bicanic and Škreb, 1996)

It is important to note that other aspects of state formation did not run as smoothly. Independence was contested and the Croatian episode of the Wars of the Yugoslav Succession started in summer 1991 (there was also externally supported civil disobedience and revolt of Croatian Serbs in late summer 1990, an ominous warning of later events). The conflict's imminence became clear in early 1991, the military conflict on Croatian soil lasted till January 1992 but the final end of the conflict when the government regained control over its whole territory came in autumn 1995. International support was mixed and half-hearted

from the beginning yet firmly insisted on keeping Croatia's transformation in the boundaries of internationally imposed conditionalities.

Yet, before proceeding to Croatia's second transformation and first independent one, it is important to note that not only legacies of the first transition were important, but important were actors' actions and choices made in a specific context and under specific contingencies. This is why, in our approach, we agree with Crawford and Lijphart when they point that proper understanding of the role of legacies, requires that the immediate context be taken into account (Crawford and Lijphart, 1995:196): In Croatian case, for example, it is important to note that: (1.) Privatization and other transformation-related reforms proceeded in war-time and alongside the war; (2.) The particular political 'design' of Croatian capitalism was made possible by the rule of one dominant political party: the Croatian Democratic Union (CDU) which was also a movement; (3.) The specific rules of privatization influenced the actors' behaviour and transformation path taken (e.g. privatization through "transformation" of social ownership, denationalization following transformation, banks being privatized through the privatization of their "founders", the model of asset-valuation etc.) (4.) choices (and non-choices) on regulations and institutional design, their timing (e.g., takeover activities not being regulated, late institution of the anti-monopoly legislation) and credibility (low respect and non-credible commitment to the rule of law and hard-budget constraints) and finally (5) International conditioning – in economic, political and social realms – played major constraining, but sometimes also facilitating role too.

By early 1991 Croatia was an independent state responsible for its own political, social and economic life. In the economy this meant two dominant pressures. The first was the nationalist pressure for defining a Croato-specific transformation plan whose very important aspect was to be different from the inherited one. The second was the pressure of the nascent new transformation generated entrepreneurs and modernizing socialist managerial elites (Pusic, 1992) to continue with the transformation no matter what (i.e. in spite of war). These two domestic were further influenced by external conditionality which pressed for continued transformation and the independence was externally contested, politically and militarily.

### 3. CROATIA'S VERSION OF CRONY CAPITALISM: THE NINETIES

#### 3.1 *Politics of the period*

The three most important characteristics of development of Croatian democracy and democratic political system during the 1990s were: dominant party system (dominated by Croatian Democratic Union – CDU), ethnification of politics and authoritarian regression. (Kasapovic, 1996a; Kasapovic, 2000; Zakošek, 2002; Cular, 2000) All three are results of constitutional/institutional choices, and actors' strategies, as well as of the wider context. They are critical for understanding the emergence and evolution of political economy of the 1990s.

*Dominant party system* was characteristic for the 1990s. The first multi-party elections (spring 1990), were part of a liberalization strategy of the old Croatian political elite in order to counter conservative tendencies and Serbian nationalism. (Kasapovic, 1996) While belonging to the first transformation, their outcome is a major generator of a new path to be taken in the 1990s. In the setting of increasingly ethnified politics of former Yugoslavia, the election winners were not reformed communists but the Croatian Democratic Union (CDU). CDU achieved dominant political position (the extent of dominance should also be attributed to electoral system enacted by election losers – reformed communists – which gave to CDU much higher share in parliament seats than was its share in total votes, Vrcan, 2002). Frequent and radical changes in electoral systems and institutional reformism during the period (Kasapovic, 2000: 5-6) and electoral engineering (Vrcan, 2002; Zakošek, 2002: 63) were made primarily in order to preserve the dominant position of CDU, as happened in elections of 1992 and 1995, but not in 2000.

There were three fundamental consequences of the first multiparty elections in 1990. The first was the peaceful transfer of power; this was a major contribution to democratic transition. The second was that the election winner received broad legitimacy to pursue the program of nation-state building and systemic reforms. The third must be viewed in terms of the ethnic uprising (Serbs in Croatia), mounting ethnic conflicts, secession and war which together with the dominant position of CDU (which

was both party and broad nationalistic movement) certainly contributed to ethnification of politics in Croatia and authoritarian regressions.

*Ethnification of politics* leads towards “reductionist interpretation of politics and society” in which consensus over state-survival (achieved across the broad Croatian political spectrum) easily became identified with the CDU survival and policies (Kasapovic, 1996a: 164-65). This had an effect of reducing the power of democratic contestation of the reform policies (it was quite common to hear both in parliament and in public, even from unions’ leaders, that in times when we should be unified, it is not appropriate to ask questions on doubtful and/or criminal privatizations which were going on in spite of the war). In addition, *nationalism as primary political identification of the late 1980s and early 1990s*, significantly reduced the scope for political and ideological segmentation of voters and differentiation of debates, the war further consolidated this trend. It will take long before the nature of cleavages, and segmentation of voters will increasingly centre on socio-economic issues, very much related to political and moral economy of CDU-led transformation – this will have an important role in elections of 2000, bringing coalition led by (revigorated) social democrats and social-liberals to power.

*Authoritarian regressions* of the period cannot solely be attributed to the choice of a semi-presidential system, they are deeply connected to “fundamental political objectives” of Croatian nationalism. (Vrcan, 2002: 12) In the presence of political monopoly of one party they were facilitated by “(a.) a decade of harmony between the president and the parliamentary majority; (b). the charismatic/clientelistic nature of the ruling party; (c). a rather weak and suppressed opposition to the ruling party by the unconsolidated opposition parties; and (d). the expressive model of orientation of the actors in political activity”. (Kasapovic, 2000: 3) Institutionalization of the CDU movement into political regime, in which no firm borders existed between movement, party and state (Kasapovic, 1996b: 91) certainly had strong impact on the reforms choices and outcomes.

It may look as if both CDU and Tudman were in favourable (i.e. non-contestable) positions to reform the economy radically by providing protection and insulation of their appointed CDU technocrats to design and execute reforms decisively and completely and without the pressures of short term developments . With hindsight, one

may ask: why they didn't make better use of such a unique position? It may be argued that democracy is at odds with economic reforms (backlash from below thesis), i.e. that authoritarian regimes may be more conducive to them (stronger claim), or that representative democracy may undermine reforms (neoliberal argument for "political insulation of reformers" and using "window of opportunity", see in Orenstein, 2001: 14-15). Probably, the answer should be viewed from a couple of angles. The first is ideological, the second is structural and the third is dynamic (related to actors' strategies). Ideologically, CDU was not profiled as liberal party, but rather it was a conservative and ethno-centric, populist indeed, often openly anti-liberal. Structurally, being also a broad movement it suffered from clientelistic expectations and obligations – redistribution was essential for its legitimation. Dynamically, as non-checked dominant and hegemonic party/movement it not only captured the state as party, but served as an ideal transmission for individual and group strategies for capturing rents. For these reasons, its commitment to liberal economic reforms was not credible at least in the following respects: efficient and fair privatization, enforcement of hard-budget constraint and levelled playing-field for all actors (both to ailing and emerging sectors/firms, but on clienteles as well), and the rule of law. For CDU reform-minded technocrats, the above characteristics acted as constraints, even if some of them were quite pragmatic and not necessarily captured by ethnocentric and illiberal worldview.

Even if not always credibly committed to democratic rules of the game, in spite of often illiberal discourse and politics, CDU throughout the period heavily depended on democratic legitimation from the inside but from abroad too, i.e. on international recognition and Western support for the new state. This was not only because of weak and fragmented opposition which was in a process consolidating, but also because of strong international conditionalities that the 1990s brought *democratic transition* to Croatia, yet without full *democratic consolidation*. These two concepts (discussed in greater detail in Rizman, 2003; and Kasapovic, 1996)<sup>1</sup> allow us to differentiate between formal (are constitutional, legal, institutional and organizational prerequisites of

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<sup>1</sup> "While *democratic transition* is primarily concerned with carrying out its role of undermining authoritarian institutions and replacing them with democratic ones, *democratic consolidation* entails a broader and more complex process associated with the institutionalization of a new democratic set of rules for political life" (Rizman, 2003: 139).

democratic politics in place) and substantive - when stability and quality of institutions and procedures is of primary concern (Cular, 2000: 31).

If the task of democratic transition was accomplished by the mid 1990s (Cular, 2000), during the whole period both substantive aspects (that is democratic consolidation) and political-economic aspects remained problematic. Concerning the first ones, Croatia's democracy during the 1990s remained unconsolidated, and the political regime that developed may be described as "illiberal" or "defect" democracy (Zakošek, 2002: 13 and 64, using Wolfgang Merkel's syntagma), or as an "authoritarian democracy" (Cular, 2002: 30). For that reason, at the beginning of 2000 democratic consolidation was still "in its incipient stage" (Kasapovic, 2000: 3). In spite of serious democratic deficits, during the 1990s a certain level of consolidation was achieved. To conclusion follows from: "four cycles of non-violent parliamentary elections, the peaceful alternation of the parties in power, the contextually low volatility of voters, the moderate parliamentary fragmentation, and the acceptance of the parliamentary rules of the game by the majority of population" (Kasapovic, 2000:12).

In this political setting where there were democratic deficits and defects the economic transformation process unfolded.

### **3.2 Economics of the period**

Croatia's economic development during the nineties could be seen as an example of successful transformation starting from quite favourable initial conditions but proceeding later in an extremely adverse environment. It could be considered successful for a number of reasons. First, there was extensive privatization, at the beginning of the decade the share of the private sector was 30% and at the end 80%. Privatization in independent Croatia started in 1991 and by 1998 there were almost 2500 privatized firms of which most had a minority state share. Second, after hyperinflation where monthly inflation rates were almost 30% (September 1993) the introduction of a stability program in autumn 1993 not only eliminated inflation but led to enduring price and exchange rate stability. Third, some of the major inherited price distortions were eliminated, in housing rent subsidies disappeared, energy (electricity, gas and petrol) prices approached international levels and were loosely

regulated, food prices were deregulated and interest rates became competitive. Fourth, the financial sector was first successfully rehabilitated and privatized by sales to foreign 'strategic partners'. Fifth, some long term transformation trends were firmly established: there was internal liberalization, complete liberalization of international trade, VAT was successfully introduced, pension reform legislation was passed and implemented according to plan, and legislation for a functioning market economy was in place. Sixth, the state budget was becoming transparent and the share of the state was high but under control and international debt relatively small.

During the period monetary sector statistics certainly reflected this success as did most of the real sector ones (with the glaring exception of employment and unemployment). The mentioned price and exchange rate stability has lasted for over a decade. Interest rates fell and the financial sector became competitive so, according to many, the main transformation engine was sound. In the real sector after the Croatian Episode of the War of the Yugoslav succession were completed there were high growth rates. The two macroeconomic crises, banking and balance of payments one respectively, were successfully dealt with.

The adverse environment also had a number of features. The first was the process of independence and the economic shock of establishing a new economic space. Contrary to the then ruling opinion the establishment of an independent economy was relatively simple. Certainly this was partly because of the confederative features of the Yugoslav federation, partly the contested independence made some possible difficulties disappear. The second was contested independence and military costs of independence. The exact financial costs are unknown (due to lack of budget transparency, arms procurement, cash donations etc.) but the destruction has been estimated, the human loss is known. The indirect effects of lost markets and demographic losses are also unknown. The third was the response of the international community, arms embargo placed on a country facing a technically superior army and lack of financial support for transformation or independence.

Compared to most other transformation economies Croatia fares quite well. Indeed, given its implicit adherence to Washington consensus type 1 policies (liberalized markets, privatized assets, multiparty democracy and macroeconomic stability) it should have got a positive rating. Why, under such circumstances is Croatia considered a slow reformer, a 'south tier' economy and certainly not one of the success stories given as a role model but instead a pariah and outcast requiring strict international conditionality?

There is an easy ‘standard’ explanation. This explanation centres on chauvinism (which excluded minorities) and nationalist expansionism (seeking to annex neighbouring territories), authoritarianism (with a rigid undemocratically minded strong president) and a democratic deficit (permitting formal but not substantive democracy). For a political scientist, indeed for many politicians this was enough, but for an economist this will not do.

To understand Croatia’s economic transformation two things must be considered. The first is the political economy of the transformation which generated Crony capitalism. The second is the long view which shows that there was no sectoral restructuring and long term instability remains.

### **3.3 The political economy of Croatia’s transformation during the nineties: the rise and demise of Crony capitalism**

The political economy of Croatia’s transformation during the nineties should primarily be concerned with the kind of capitalism which emerged in Croatia after the establishment of independence in 1991. Of course this system was not only a result of intention and design but also of contingencies and players’ strategies during the late eighties and whole nineties. It seems best to name the capitalist system which emerged as Crony Capitalism (CC). This is perhaps not the best possible term but the authors feel it necessary to give it a specific name for reasons of clarity. A detailed analysis is provided in Bicanic and Franicevic (2000) and this section draws heavily from parts of that paper. When dubbing the Croatian experience as CC the intention is to stress *its systemic and endemic nature*. The term CC is used to describe a capitalist economy based on cronyism, clientelism and populism, a system in which financial markets do not dominate the allocation of capital, where markets (nascent or established) provide ample opportunity for quasi-rent generation so that the rent seeking behaviour, redistributive coalitions and the protection of rents dominate agents behaviour and optimization, where weak state is hijacked and there is policy capture and in which there is, of course, a large institutional and democratic deficit. CC is at the centre of the political-economic model that emerged during the 1990s and it was in the core of its crisis. In this paper CC in Croatia is viewed primarily as a result of political/institutional choices which were made in a specific context of opportunity, circumstances and tradition. This means that legacies of the past and inherited social capital, or lack of it (low levels of civicness, but

high paternalistic inclinations) have played important roles in the Croatian transition (Štulhofer, 2000: 128) as has the depletion of social capital (with social and institutional uncertainty and extensive restructuring and reduced the scope of the contractual economy). However, such determinacy cannot explain the first decade of Croatia's transformation as CC developed also as a result of policy choices.

In Bicanic and Franicevic (2002) we describe this decade of evolution and demise of CC through three periods. *The first period: 'window of opportunity'* in the development of CC in Croatia started after the first multiparty elections in 1990 and lasted until the replacement of the Government of National Unity in autumn 1992. During that time three important and not necessarily related sequences of changes provided the window of opportunity to CC. The first was the nationalist agenda of the party which won the elections (the CDU), the second the war in Croatia and its repercussions, and the third the chosen transition policies themselves. It must also be stressed that this phase did not appear in a vacuum. There was a transformation path when it started which implies that the process had already started, there were nascent entrepreneurs and rent seekers and some had a head start. But during this phase CC was not being overtly or covertly developed and nurtured. *The second period: 'protected development'* started in autumn 1992, after the second multiparty elections in which the CDU got a two thirds majority in parliament and formed an independent government and after the military conflict in Croatia was over (with a durable ceasefire monitored by the UN). The period lasts until the crisis of 1998. With the war over in Croatia the electoral victors replaced the multiparty government of national unity and started ruling alone. This was the phase in which CC was institutionalized and policy makers through concerted action fostered and protected its growth and development. The period of attempted consolidation is also marked by contradictory developments in the rest of the economy. There was continuous price and exchange rate stability that followed the October 1993 stabilization policy. But the successful tight monetary policy coexisted and permitted many accommodating policies that maintained a soft budget constraint. High growth rates of the mid nineties (the high growth rates of around 6% are best explained by post war reconstruction and state managed infrastructure investments) coexisted with high interest rates, falling employment and rising unemployment and wages. *The third and last period: 'failed consolidation'* of CC in Croatia starts in the 1997 crisis with the exploding trade deficit and lasts till its end, i.e. the January 3<sup>rd</sup> 2000 parliamentary elections. It is dominated

by a sequence of crises management and progressively deteriorating real sector developments ending with a recession. In this sense it is a time during which CC fails to consolidate, institutionally or sectorally. The first crisis was related to the trade deficit, the second and more 'visible' crisis was Croatia's second banking crisis and an extremely expensive banking rehabilitation, the third crisis that loomed during the whole period was fiscal. State expenditures were rising with the rising demands of firms for debt relief and subsidies, rising demands of extra-budgetary funds (the pension fund is approaching a pension crisis) and the unwillingness to downsize the post-war army and police. These crises were accompanied by unfavourable trends in major economic variables: real sector indicators deteriorated (employment, production, trade, growth rates) or remained low (investment rate). The rising wages, nominal and real, were the exception and the political cycle was their main engine. In addition, the economy failed to restructure. The unconsolidated economy was matched by a continuing institutional and democratic deficit. As a result of such developments the system became socially too expensive and exploding economic inequality raised social tensions; it lost its credibility to deliver economic growth as growth rates kept falling finally leading to a recession in spite of price and exchange rate stability; large infrastructure investments and normal entrepreneurial ventures were being crowded out by the state investment, high interest rates and economic contraction and very often by CC itself. It was the state, and its particular forms of governance, that produced an erosion of the "moral economy" of the period (more in Franicevic, 2002). The inability to produce economic and political good (both in terms of political system and citizens rights), but also decreasing credibility of European integration under the prevailing circumstances, proved to be important and threatened with delegitimization of the transition in general. Thus CC in Croatia has a somewhat unclear start but clear ending.

In a crisis it generated CC proved to be unable to produce a flexible response, as if everybody was stuck in a sinking ship! Networking between members of the new political and economic elite was based too much on strong traditional social capital and identification which was only cemented by the common acceptance of nationalist fundamentalism. In some networks the Mafia-type morality of 'binding through crime and corruption' was present as well. While the negative impact on the credibility of institutions and their enforcement capacity was strong, the semi-authoritarian political system dominated by

redistributive coalitions and struggles was unable to produce adequate responses to crisis tendencies, blocked by powerful interest groups and their political sponsors.

The institutional structure that evolved during the first years of transition in Croatia failed to provide security both for the population and for the participants and beneficiaries of CC. For both groups it was not able to generate sustained economic growth. In the end it also failed to provide security for its members and supporters. It achieved this because privatization failed both to bring about a restructuring to firms, and thus economic security, and provide legitimacy to new owners who continually faced challenges to their ownership and could not consolidate their financial gains. For the population in addition to not providing economic security through growth and employment it also failed to ensure a working democracy and full respect for the rule of law and civil rights. This lack of security eventually led to an untenable and rigid system unable to adapt but which used increasing amounts of resources for its reproduction. Thus there was weak economic and public governance, widespread clientelism and corruption, syndrome of early winners (often: of dubious reputation) blocking further reforms, absence of the rule of law and low credibility of institutions, booming unofficial economic and political activities, speculative (often criminal) entrepreneurship crowding-out the productive one, authoritarian tendencies in politics based on premises of national fundamentalism, growing inequality and poverty, denial of individual and group rights, combination of xenophobic and imperial ambitions, both working against co-operation with neighbours, but with wider international community as well, increasing the pressure of conditionalities being subsequently imposed on Croatia by international organizations and institutions. All this led towards a broad de-legitimization of the political economy of the 1990s, as emerged under the CDU and Tudman rule. The first decade of Croatia's transformation thus ended with a widely de-legitimized CC and was in many senses a failure. The second decade of transformation was seen, by many, as a task to (re) build, through eminently political processes, conflicts and choices, a new institutional structure, providing a stable framework for sustained economic growth and democratic evolution.

### **3.4 Long term sectoral instability**

The political economy of Croatia's transformation provides one reason for including Croatia among the slow reformers and laggard transformers. The second concerns economic structures and the speed of institutional and sectoral restructuring. This is obviously linked to the political economy aspect (in the sense that the restructuring was to a large extent policy dependent) but is worth separate consideration for two reasons. The first is because of the time required for its change, sectoral restructuring cannot be done overnight even when one has a definite goal and commitment as well as a well defined policy. The second is because of the path dependency it creates. Existing structures provide constraints for any policy goals society may choose. An important aspect of this path dependency is that they could be considered as the legacy of crony capitalism for the type of capitalism following it. As can be seen both of them have a strong secular character and thus deserve being discussed as long term features.

The nineties created numerous long term sectoral constraints for the Croatian economy. Of the many two seem especially important and binding. The first of these is concerned with an unusually large increase in economic inequality (see World Bank, 2000) and the second with inward looking development and low exports levels. Thus some important ones such as agriculture will not be discussed. Neither will the institutional ones.

Exports are arguably the most important structural constraint of the Croatian economy. Croatian commodity exports contracted after 1990 and never recovered. Croatia's pre-transformation trade was mostly in industrial products, in 1989 Croatia was Yugoslavia second major exporting area. The industrial sector in the early nineties simply imploded, industrial production and employment fell to minimum 49.6% and 73.9% respectively of 1989 levels, and never reached its pre transformation levels, industrial production and employment by 2000 was still only 63% and 82.4% respectively of 1989 levels.

The contraction and subsequent low levels can be partly explained by external reasons, partly by the usual transformational restructuring, partly by crony capitalism and partly by policy options.

The external causes concern loss of established markets and tourist contraction. Croatia's independence started with a loss of markets. The first and, arguably, most important was the loss of markets in former Yugoslavia. Serbia and Bosnia and Herzegovina were Croatia's largest trading partners. Both were lost, the first due to policy reasons and the second due to war induced economic collapse. The second loss of markets was the former

COMECON area, more precisely the Soviet Union. This market was lost due to economic recession in the trading partner and due to post-liberalization trade re-direction in the partner. The collapse of Croatian tourism was war and security related.

The second major reason for export collapse was internally generated by the transformation. Loss of subsidies for major exporters and the general transformation induced de-industrialization obviously led to an initial contraction of exports. But while the initial contraction is a shared experience with other transformation economies the subsequent low levels and lack of recovery are a Croatian specific (not even shared by most other 'South tier' economies). The explanation focuses on two levels: on the 'grand' transformation strategy one and 'less grand' macro-stabilization policy choices.

On the 'grand' level exports and outward looking transformation is incompatible with crony capitalism and nationalistic development visions. Crony capitalism requires closed markets, favours first mover advantages and access to first choices. The nationalistic agenda of creating a strong national capitalist class capable of competing with foreign capitalists requires protection. Both policies favour induced bankrupting potentially viable firms (including exporters), erecting barriers to uncontrolled FDI inflow, creating institutional entry barriers, and a generally unfriendly attitude to foreigners. All these can have disastrous effects on exports and competitiveness of Croatia firms.

On the 'less grand' scale the influence of macro-stabilization policy options was important. The stubborn belief in minimizing inflation rates and fixed exchange rates consistently ruled after autumn 1993. Both policy goals were from the beginning questioned by a few non government economists but the authoritarian regime firmly backed price and exchange rate stability and received support from the IMF (Croatia signed a stand by arrangement in 1996). The opponents of fixed exchange rates, the most notable ones are Zdunic and Grgic (1996, 1999), pointed to the exchange rate as the dominant determinant of trade and the effect a fixed nominal exchange rate has on real exchange rate appreciation. Other economists calculated the relatively high Croatian price level, the departure from usual stabilization packages which use only a temporary fixed rate and business men timidly talked about overvalued currencies. The official response, supported by the IMF and its wealth of research and conditionality, pointed to inflationary expectations especially if there was a regime change; the practice of contracting with DEM/EU indexation and the very high level of DEM/EU use in domestic transactions; liberalized and hence market determined

exchange rate; the policy time horizon where general equilibrium would lead to external balance; calculated there was no real appreciation, etc.

Despite the dispute, fixed exchange rates reigned, FDI did not come freely, exports remained low and imports kept rising and the balance of payments worsened. While large state managed privatization (banks, pharmaceuticals, and telecom) could keep the foreign debt low, the trade balance crisis exploded in 1998 and administrative measures to curb imports reduced the immediate danger of the trade imbalance.

At the end of the period, by 2000 the Croatian economy had developed an inward looking approach and low and unrestructured foreign trade. The constraints are lasting and cannot be changed overnight (as clearly follows from 2002 report from National Competitiveness Council, 2003).

### **3.5 Croatia: a 'South tier' transformation economy and a 'land in between'**

It is now common for economists to distinguish two transformation paths for economies outside the FSU: the 'South' and 'North' tier. The former are the Southeast European economies and the latter the Central European and Baltic economies which later participated in the eastward EU expansion. The main distinguishing feature lies in the sequencing of political and economic reform. The 'South tier' economies first introduced economic reforms (complete liberalization with some limited form of privatization and the motions of stabilization policies) while the 'North tier' ones started with political reforms or the two went almost simultaneously. Comparing the generated transformation paths, there are systemic differences. Thus the main features of the 'South tier' path is greater instability (e.g. inflation, budget and trade deficits), longer and larger economic downturn (production contracted more, unemployment increased more, the upswing started later), weaker recovery (with pre-transformation values still not achieved), at least one economic 'melt-down' (extreme crisis requiring special recovery efforts), non-linear transformation (as changes were non continuous, out of synch. and there was backtracking) and relatively higher transformation costs (relatively higher unemployment, inequality increase, poverty levels

and social exclusion). But most importantly for the topic of this paper, there is crony capitalism. With the exception of Slovenia all of Yugoslavia's successor states and, arguably, the remaining three Southeast European economies as well, developed an economic system best called crony capitalism. As has been shown in this section Croatia's transformation during the nineties firmly places it into the 'Southern' tier.

In many respects Croatia's second transformation was very similar to the 'stylized transition' (and Washington consensus type I) blueprint of "liberalization+marketization+privatization+democratization+europeization". This is a transformation scenario which was supposed to move society towards capitalist market system, based on liberalization, private ownership and entrepreneurship; towards state concerned with economic stability and reduced welfare guarantees; towards political democracy, comparable formally and substantially to the West one; and, finally, towards full systemic and institutional compatibility with the countries of European Union. The belief in the blueprint as the 'right path' led to a linear view of the progress of individual countries and efforts to rank them and monitor their progress along the common path. As a result the rankings distinguished stages and the like. In these ranking Croatia's standing is far from being the worst one, particularly concerning the first stage, but, in all rankings, it is relatively worse concerning the second stage and democracy indicators (see EBRD Transition Reports). These peculiarities of Croatia's path and reform choices made while moving on this path led us (in Franicevic and Bicanic, 2003) to characterize Croatia as a land 'in-between'. Viewing Croatia in this way permits it to be interpreted as both a lagging 'north-tier' country and/or leading 'south-tier' one. This ambivalence seems to be the major characteristic of Croatia, and major issue in her international (regional and European) re-positioning, something we shall deal with in concluding sections.

#### **4. CROATIA 2000-2003: END OF CRONY CAPITALISM**

If 1900-91 can be considered as the first point of discontinuity on Croatia's transformation path then the elections held in January 2000 can be considered as a second point of discontinuity. This second point was different from the first one in many respects. For example, Croatia entered the millennium as an internationally recognized state and member

of many international organizations (yet facing serious international conditionality), it was an unconsolidated democracy, the economy was highly privatized and marketized, and the change received wide international support and backing.

The elections of January 2000 were held in a period of a heightened and sharpened legitimacy crisis of the ruling party (the CDU). This party entered the elections while in the midst of leadership crisis and internal fragmentation caused by the death of president Tudman in December 1999. Not surprisingly the elections were won by a coalition of six parties led by Social Democrats (SDP) and Croatian Social Liberals (CSLP). In terms of democratic consolidation these elections certainly were important for a number of reasons. First, this was the second major change of power with no violence; second they brought an end to authoritarian regression and political monopoly; third, they brought to power parties which were both ideologically and programmatically, in spite of some major differences between them, dedicated to continuance of economic and political reforms, as well as to regional stabilization and European integration; finally, the signals being given by international organizations and markets in great measure encouraged and enhanced the credibility of such policy orientation.

Over time the reform capacity of the coalition diminished. The ruling coalition was formed around an 'anti platform' (replacing the authoritarian CC system) and not on a well-defined common agenda for change. Once in power the latter became dominant and very soon there were major internal differences among the coalition partners leading to internal struggles, blackmailing, and deliberate politicization of particular reform policies and moves. Under such circumstances decision-making will prove to be difficult, slow, and often without an easily recognizable pattern but with a serious negative public relations effect. The reformist discourse itself was often contradicted by an imposing national(istic) discourse where lines of division was not reserved to incumbents vs. opposition (moderate and radical right) but were increasingly reaching across the coalition itself, further reducing its reform capacities. A further reduction in the reform capacities came from the consolidated main opposition party which could capitalize on the 'no-win' position in the coalition, particularly concerning the cooperation with the Hague court. The net effect of these developments was threefold: further weakening of coalition and further consolidation on the centre-right pole of the political spectrum and meandering reform policies. Understandably the public dissatisfaction increased as did the feeling of a missed opportunity of change.

#### **4.1 The pressures and record**

The new coalition government of January 2000 inherited an extremely complex policymaking environment composed of generally unfavourable initial conditions and numerous external and internal pressures. Being brought to power by a large constituency of self-perceived crony capitalism losers it faced contradictory task of continuing pro-market economic reforms, revigorating privatization, stabilizing private sector and stimulating private capital accumulation, on one hand, and fulfilling great expectations that included not only growth but social justice and opportunities. In addition the initial conditions included an administration completely appointed by the electoral losers and six parties' cadres impatient to cash on their loyalty and risk-taking; second, the set of pre-election overt and covert commitments and non-too-cautiously given promises; and third, the new policy makers own lack of policy making knowledge, experience as well as ambiguity over coalition priorities. Not really well prepared for the task, coalition government and parties will start discovering government's and parties' priorities by doing (and some learning). In that process conflicts between the different sets of priorities will be discovered, adding to inherent complexity of broad coalitions' led reforms (such as 'revision of privatization', further privatization and especially of large state monopolies, etc.). Over time the initially undefined differences formed ad hoc over individual policies and the squabbling over policy issues increased as the different agendas of the coalition partners diverged. For the above reasons, from the beginning there was no coherent economic policy, goals, agendas, measures or sequencing. Even when economic policies were defined and decisions taken, often in the implementation phase various foot-draggings by administration or politicians slowed down or sometimes even overturned once already agreed policies. Such a dichotomy often made pre-decision discussion relatively easy and they did not resolve the differences which dominated post-decision developments. This pattern is not uncommon in countries such as Croatia. Such inconsistencies led to credibility problems and further increased complexities and vagaries of decision making.

External pressures and constraints of overlapping political and economic conditionalities were also important. These were generated by two different sets of circumstances. The first were externally generated conditionalities (for example the Hague

ICTY or IMF), the second resulted from Croatia's voluntary external commitments (following from membership in the WTO, to join CEFTA, and much more importantly to integrate into EU). In both cases they limited the freedom of policy makers. It is important to note that with regard to pro-market reforms and maintenance of macro-economic stability arrangements with IMF played a double role. They were certainly constraining but by being binding they also acted as a self-imposed commitment enhancing government's credibility against internal challenges to economic policy. The external economic constraints were not without cost. They provided the government with the label of pursuing neo-liberal economic policies and of following the Washington Consensus. The government will have a hard time proving, primarily to its varied and in some respects mutually incompatible constituencies, that it has remained faithful to its promises and worldviews. This task will become increasingly difficult both for SDP and CPP (Croatian Peasant Party) (both in terms of their constituencies and their professed ideologies). As the election year approached this led to many internal conflicts and deliberate the politicization of issues and was used as a way to send signals to the voting constituencies. One can further attribute this confusion also to the fact that, after the failures of 1990s and the 1999 recession, two quite different types of economic policy measures had to be taken. Short term ones with immediate effects included measures designed at restoring viability of market economy and confidence in it (e.g. internal liquidity, arrears, hardening budget constraint, financial sector transparency and stability). The reforms (particularly those that could be seen as commitment to losers' compensation – labour and social policies, health, education, justice and public administration et al.) took much more time both to form a consensus and design (they are complex, and often controversial, they ask for wider participation and a lot of expertise, both lacking) and received less priority at start. Sequencing of reforms was also under the impact of considerably differing design and implementation capacities of numerous ministries and other relevant bodies. The coalition inherited the state apparatus whose professionalism was questionable and could not always be relied on to implement the government policies.

Political conditionality also had complex effects. While the unambiguous commitment to cooperate with the Hague court had been essential for restoring European credibility and was the 'must' condition for becoming a candidate country (not only for EU, but NATO too) it made the internal position of the coalition very hard. It led to the government being

accused of not only being neo-liberal (that is not protectionist enough) but also of selling out the victims and the victorious heritage from The Wars of the Yugoslav Succession. Under such circumstances the government's rational discourse of reforms, regional cooperation and Europe, was hardly up to the emotionally charged high-powered discourse of nationalistic anti-coalition mobilization. This not only put the coalition on a defensive from the start sapping a lot of its energy (endless discussions in Parliament, for example) but opened additional lines of cleavages in the coalition itself – resulting finally with the exit of CSLP (one of the 'two') – with an effect of questioning the legitimacy of what remained in the coalition.

The government also faced many pressures of a different kind. Among internally generated pressures, three stand out: bias to micromanagement, developmentalism and privatization issues. Arguably the pressure which cuts through all policy decisions is *the strong pressure to government's economic micromanagement*. This can be attributed, firstly, to the nature of the coalition. With lack of experience or government expertise and no clear agenda or policy sequencing there are strong pressures for ad hoc decisions and micromanagement, but for political exploitation of issues too if any particular party finds it profitable. This is made even stronger as coalition partners diverge and economic complexities increase. Secondly, there is the inherited tradition, both from socialist times and crony capitalism which both cultivated centralized decision making, hierarchy and lack of team experience and true devolution and decentralization. Thirdly, there was country size. Size (or more precisely lack of it) provides a great impetus to micromanagement and leaves an illusion of possibilities for micromanagement.

The second major pressure was that of *developmentalism*. This pressure is a result of both relative and absolute backwardness, as well as dismal effects of the first transition's decade which didn't succeed in bringing economy back to 1990 level of output, nor to make up for loss in living standards and social welfare. Moreover, in 1999 there was a recession, adding pressure for quick recovery. As a middle income country it is facing serious developmental challenges, both some 'old-fashioned' ones (agriculture, industry, infrastructure) and some more recent ones (restructuring and technical progress). However horizontal policies levelling the entrepreneurial playing field did not end up dominating, but rather policies attempting to find engines of growth and national champions or revigorate ailing and other troubled sectors. Recent research shows very high level of state aid to

enterprises both in comparison to EU and candidate countries (3.8% in 2000 and 5.25% of GDP in 2001 for example). Moreover, it is highly selective/sectoral (transport, shipbuilding and tourism) and much less horizontal (Kesner-Škreb et al., 2003) In spite of efforts on the part of policy makers to improve the business climate, to reduce barriers to entrepreneurship, to provide efficient support for a vibrant medium and small enterprise sector, and to enhance private sector competitiveness, some real sector indicators deteriorated. Most notably unemployment increased giving everything a stigma of urgency and crises. State-developmentalism was not a surprising response: ad hoc decisions with important developmental (rate of return, gestation period and multiplicative effects), macroeconomic (fiscal viability and external stability) and microeconomic (crowding out, sectoral reallocation) consequences came to the forefront. State developmentalism primarily concerned major infrastructural projects (highways and natural gas pipelines) as well as state housing projects. (On ambiguities of postsocialist developmentalism, more in Franicevic, 2003).

The *privatization pressures* were formidable too. These pressures are mostly due to major failures of 1990s which threatened with a loss of legitimacy for privatization reform. The coalition found itself under the pressures to revise privatization (electoral promise), to reform privatization model (electoral promise) and privatize the still considerable assets in state ownership (also electoral promise) that were even increasing when previous privatization's went bad and the property reverted to the state (in June 2000 the portfolio included shares in 1850 firms with the state share varying: in 1111 it was between 0-25%, in 432 between 25-50% and in 307 between 50-100%). The list of firms included the 'family silver' (e.g. oil, oil pipeline, electricity, insurance, arguably tourism), 'lame ducks' (e.g. shipbuilding, steel, arguably tourism), and 'hot potatoes' (e.g. agriculture, arguably tourism). But during its mandate the coalition failed to revise privatization (it proved to be unachievable) and it failed to reform the remaining privatization (due to internal conflicts, inability to reach wider consensus, and due to pragmatism). Instead, after 2000 there were attempts to improve corporate governance in state controlled firms, which gave some results concerning reduction of losses and insolvency, increased transparency of sales, improved quality of contracting with buyers concerning their obligations and protecting stakeholders interests (CPF 2002, Vlada 2003). But the institutional framework for their monitoring remained unstable while political pressures for maintaining their current position strong (e.g.

in terms of subsidies, bail-outs and state guarantees and as a vehicle for clientelism). Privatization proceeded in piece-meal fashion, without any major change in methods or strategy. On the other hand, some of cases proved ideal for politicization, generating bitter inter coalition political conflicts and putting further brakes on the process. It is probably too early to discuss whether pragmatic and opportunistic approach was actually the wisest and most efficient course to be taken. What seems certain is that the privatization efforts generated major political costs for the coalition but left Croatian capitalism firmly on the path opened in early 1990s (many would probably like to think of it as a cost as well). By choosing not to change anything radically and concentrate on improving overall economic conditions the government has certainly consolidated the Croatian business/managerial elites and national champion-capitalists. However, an attempt to build consensus between business elites, unions and government will prove to be difficult, and is far from a fully accomplished task, that would eventually lead towards consolidation of neo-corporatist arrangements (labour markets reform attest to that)

#### **4.2 Performance and deficits**

The Croatian economy since 2000 has built on the favourable price and exchange rate stability firmly established beforehand (in autumn 1993). Inflation remained low, the 2000-2002 average was only 4.3% and lower than in any other transforming economy (the 2001-2003 average is below 3%), while the exchange rate has remained stable within  $\pm 3\%$  band around 7.60 HRK to the Euro and was supported by increasing reserves reaching 5.4 billion dollars by July 2003 (net reserves of HNB, *Makroekonomske prognoze*, 11, 2003). Growth rates have been impressive, average 2000-2002 growth rate was 4% (it is expected to be 4.2 in 2003) and they were regularly higher than in EU candidate countries. This high growth is largely attributed to domestic demand, private (as banks loans to citizens increased) and state (due to state led growth). After a long period of rising unemployment rates since the autumn of 2002 unemployment rates have been falling, registered rate fell from a 23.5% high to 21.5 (end 2002). These rates are still very high but the trend seems to have been reversed. Net real wages have been growing: 1,5% in 2001, and 4.1% in 2002. Furthermore, the unofficial economy has decreased in size (Ott, 2003) and corruption has fallen

(Transparency International). Major structural changes have started concerning financing pensions, labour market reforms and capital markets. International financial markets have reacted: the economy is attracting more FDI (even though FDI remains largely privatization driven), the interest rate spread on government bonds remains low, the IMF has approved a stand-by loan and positively evaluated the economy in the first quarter of 2003, and again in November 2003, the EU is making first steps in upgrading the country from Stability Pact to candidate membership status.

Policy makers have supported these favourable trends (by state developmentalism and soft loans to SME's, budget transparency) but in early 2003 started fearing overheating and the effects of the rapidly rising external debt. Restrictive monetary policies were passed (determined by HNB which gained increased autonomy from the government with the Law enacted in 2002) aimed at controlling excessive borrowing by the financial sector, especially to the population and consumer loans (measures undertaken during 2003).

But in spite of these seemingly favourable trends some developments point to either serious structural deficiencies and/or institutional deficits, and reform lags. The high rate of growth is generated by the state led investments (major highway construction and subsidized housing) and consumer-driven demand. The first has a finite time horizon and the second was financed by foreign banks importing capital and largely used to finance consumer durable imports. Exports continue stagnating (since independence). Growth is not based on intra-private sector business in manufacturing or services so the high growth rates are not Modern Economic Growth. The aggregate investment rate remains a comparatively low and since the savings rate is even lower there is an investment deficit of about 6% (in 1995-2001 period, Mihaljek, 2003: 45), which is continuing to be filled by importing capital. The share of the state remains high and the state apparatus inefficient. The general state deficit is extremely high at 6.2 (2002) and expected to be around 5% in 2003. The deficit is financed by bonds which imply intergenerational redistribution and ad-hoc sale of 'family silver' and large privatization (telecom in 2000, oil in 2003). These two deficits combine with a rising trade deficit. Indeed the economies foreign trade sector exhibits continued unfavourable trends. Croatian exports simply remain low, rising 2001-2002 at average 10.3%, while imports increased in the same period by average 15.1% yearly from a much higher base. Such circumstances lead to a rising foreign debt which has reached 16 billion USD and is larger than the rule-of-thumb threshold of 60% of GDP, and is expected by NBH to be more

than 20 billion (or 75% of GDP) by the end of 2003 – putting it at the centre of pre-elections confrontations. Most importantly, sectoral restructuring remains incomplete (especially foreign trade and agriculture, tourism and labour markets) and major challenges for institutional restructuring remain (only pension reform is almost completed, military downsizing seems to be on track with surprisingly little resistance, while health reform, reform of education as well as public administration reform remain in a meandering stop-go mode).

These three deficits are indicative of a fundamental macroeconomic instability which in turn imply reform-lags and skewed incentives actors are facing. The importance of the three deficits requires a more detailed description of their implications. This particularly concerns the investment deficit. Namely, low savings rate point to failure to build incentives and institutional framework for higher savings and smaller preference for current consumption. If trade deficit points to the weaknesses of real sector, its low competitiveness points to failures in restructuring policies and incentives. Economic restructuring failed in some fundamental respects. While Croatia still has a couple of ‘star’ firms, de-industrialization effects are far from being overcome. Mihaljek is right when pointing to the failure of developing a vibrant sector of small and medium-sized firms. In his opinion this sector could co-operate with foreign partners and produce “various intermediate products for industry and services.... Dynamic development of this sector....are necessary to achieve long-term sustainable growth” (Mihaljek, 2003: 47). Finally, fiscal deficits are indicative of failures in reforming the state itself and public sectors. Economy and society are dependent on big state, on paternalistic support, on clientelistic rent-provision. The state, however, in providing services is inefficient and expensive. In solving Croatian growth and welfare equations, and both are matter for concern (see Bicanic, 2003, and Franicevic and Bicanic, 2003) this is certainly the greatest challenge

#### **4.3 Croatia in the new millennium: between continuity and discontinuity**

There is no doubt that Coalition government, like the population, was reform-minded and reform-oriented in 2000 and was intent on correcting the deformations and inequities of CC of the nineties. This implied both institutional restructuring and institution building of the extent that some talked about a “second republic” and “second transition”. Some reforms

which were started in the earlier period were completed and implemented (pension reform, tax reform, financial regulation), and some new ones were introduced (budget transparency, firm rehabilitation, privatization) or are in the process of being introduced (competition law, labour law, changes to bankruptcy proceedings, health and education reforms). Moreover, with opening the process of the EU accession, reform and harmonization activities gained much stronger constraints, but also much firmer direction, clear focus, and somewhat reduced political opposition – there are not many on the political scene that would be ready to bear the blame for Croatia’s not succeeding in complying with the EU requirements and expectations.

However, the reforms did not come as a convincing, coherent package but in a halting and meandering trickle with some backtracking. Even though there were undeniably significant reforms this kind of reform sequencing failed to enhance the credibility of the policy makers and led to a feeling of failed “new start”. In addition, some reforms clearly failed to realize (e.g. reform of justice, reform of public administration) which, coupled with unfulfilled promises but high expectations raised to deal with ‘moral economy’ and criminal issues of the 1990s, certainly diminished credibility and legitimacy of reformers. A part of this loss of reform’s capacity and credibility is failure of public relations, i.e. too often government failed to communicate with reform-affected constituencies on costs (always inflated by opposition, but affected too) and benefits of reforms and policies, as well as on their complementarities.

If we compared the track record of the post-2000 coalition government to its early promises (e.g. in Program Vlade, 2000 and other pre-2000-election documents) and the not very cautiously nurtured expectations, then it comes as no surprise that dominant opinion of the Government record is that of unfulfilled promises (e.g. concerning revision of privatization, reduction of unemployment, introducing hard-budget for all, fighting corruption and organized crime) and unused opportunities. But, what is more worrisome for the coalition, there seems to be a tendency of the public inflating the real extent of the failures (‘everything is the same’, ‘they are the same as the old ones’ - and both is not really true), and deflating the extent of accomplishment and changes. This is certainly a source of concern in parties in the coalition. More importantly, this may be an indication of failure in democratic reforms, when high level of public engagement and citizens’ participation is substituted with partitocratic governance (leading to stop-go, political bickering after

decisions were taken, suspected intra-coalition horse trading), leaving citizens increasingly sceptical and removed from the political terrain.

For all above reasons, the period of 2000-2003 can hardly be termed as a period of 'second transition', it clearly came short of the high expectations generated at its beginning. However, important discontinuities certainly emerged so that the post-2000 period cannot be included into Crony capitalist phase. The changes were primarily in the political sphere (change in party system, break with authoritarian regression and dominant party system) and democracy consolidated (against some serious challenges). Regarding the economy, while the transformation continued (further privatization, labour market reforms, budget transparency with no substantial backtracking) the outcome is more one of stabilization and normalization, of consolidation on the path taken during the 1990s than of a radical break. In some most important respects the 2000-2003 period is a period of continuity. This is true in terms of economic policies (exchange rate, price stability, infrastructural investments, state restructuring), in terms of continuance of and building on some major reforms undertaken and started in the 1990s (pensions and privatization particularly), and in terms of restoring legitimacy to major actors of the 1990s political economy: both political and economic. Consolidating democracy, and stabilizing and revigorating the economy provided the main actors of Crony capitalism with an opportunity and environment in which their adaptation was possible. The main party of the 1990s is professed to have turned into a modernized and moderate Christian-Democratic party committed to Europeization (see Fish and Krickovic, 2003); the main economic actors and national 'tycoons' (those who survived the CC crisis) turned into champions of national capitalism with an outward looking orientation (regional expansion on the terrain made ready by government's successes in regional cooperation). Croatia, after all, is very different to what it was by the end of the 1990s, yet so similar! For some it may be great achievement, for some it is a source of disappointment.

This ambivalence will certainly affect elections taking place in November 2003, but is a source of some profound challenges too.

Reformers may not capitalize on their successes, and not so much because of true extent of their failures of reforming (however important they may be), but rather because of actors' interpretation of this performance. Firstly, the interpretation of the fulfilment of promises made on a political terrain is affecting the political cycle – this is a standard election game. Secondly, and more fundamentally, it is deeply connected with credibility

and legitimacy of the state, and wider ‘moral economy’ issues; it deeply affects the political ambience, the climate (pessimism vs. optimism, readiness to engage in collective action on a political terrain...). This may greatly affect not only the members’ of ruling coalition performance in next election; but also the future course of reforms and commitments to them.

#### **4.4 Challenges of reform and Europeization**

Politics of further reforms are certainly going to remain at the centre both in economic (growth) and political (democracy) terms. There are two major reform challenges to face: (1) consolidating support for market plus democracy types of reforms, and (2) Europeanize the country.

##### **4.4.1 The market and democracy coupling**

Croatia’s record of the 1995-2003 period seems to be an encouraging sign that, however imperfectly, this coupling has consolidated. Yet, major challenges remain: serious institutional and democratic deficits, uncompensated losers and undeserving winners, strong bases of fundamentalist nationalism, inequalities and uncertainties concerning personal and intergenerational and interregional developments. They may easily lead to questioning the post-socialist reform agenda of marketization and democratization, particularly if economic growth remains unstable and cannot be sustained. In Franicevic and Bicanic (2003b) we discuss at greater extent the importance of high inequality and high subjective poverty levels as well as of widespread pessimism for reforms’ legitimacy and associated challenges.

One particularly important issue that emerged in discussions is simultaneity of economic and political change, that is of the relation between market (capitalism) and democracy in postsocialist transformations. (For a review see Orenstein, 2001; Kasapovic, 1996; Rizman, 2003). Two questions are central: (1.) Can democracy endanger economic reforms (backlash thesis), and (2.) Could economic reforms lead to the demise of non-

consolidated democracies? Or to put it simply: do market and democracy in postsocialist conditions go together?

That coupling and simultaneity of democracy and marketization (i.e. capitalism) may be risky – for economic reforms and/or democratic consolidation – was a view shared, ironically, by both neo-liberals and some of their critics coming from institutional and/or political sociology camps. ( Orenstein, 1991 ) Concerning Croatia, against the backlash thesis two major objections may be raised. Firstly, there were no major challenges to reforms in which self-perceived losers would use democratic terrain to reverse reforms and challenge democratic constitution, and they don't seem likely in the future either. Secondly and arguably: problem for continuation of reforms may be winners and not the antireform backlash from below (i.e. losers) (as argued in Hellman, 1998). Deep and lasting inequities in Croatian society and their consolidation in 2000-2003 period point to plausibility of such a scenario – leading towards Greskovits's “ ‘low-level equilibrium’ between incomplete democracy and an imperfect market economy” (Greskovits, 1988, 178, in Orenstein, 23)

It is precisely why the European challenge looks as the most formidable one: with growing credibility of EU integration, it is less likely that democratic rules of the game, and the field itself, will be questioned and further reforms (leading not only to legal-institutional harmonization, but substantial too) contested. (See Orenstein, 2001 for elaborated argumentation). Consolidation of democratic and economic reform path therefore greatly depends on Europeization.

#### **4.4.2 Europeization credibility**

Most political parties (exception is radical right) and the majority of the population seem to be committed to Europeization. Yet, the meaning being given to Europeization in political discourse is limited to equating it with EU integration, and developing true institutional and social capacity for the task. The signals coming from the EU look favourable too, but with some reserves and a lot of political conditioning which may easily backfire in internal political confrontations.

If assessing European integration challenges from a comparative point of view – how far is Croatia from fulfilling the EU criteria and demands than we can (following

particularly Mihaljek, 2003 and EU, 2002) conclude that Croatia's position seems favourable.

Concerning *regional co-operation*, in spite of achievements (free trade agreements, growing trade and inter-regional FDI) Croatia is still falling short in many critical aspects of Stabilization and Association Process' expectations and demands. (EU, 2002a; 2002b; Mihaljek, 2003: 58). More importantly, it is still not widely understood in Croatia that co-operation is not only about formal agreements and quantities but also about quality: being able to co-operate on 'European terms'.

Concerning 1993 *Copenhagen criteria*, in many respects Croatia fares quite well. The EBRD rankings on economic, institutional reforms and development, trade foreign exchange and banking systems in the last couple of years have certainly improved Croatia's position relative to the CE-5. However by these same indicators in the non-bank financial system, competition policy, the legal system and in corporate governance Croatia is lagging behind (some four years behind CE-5 average). In Mihaljek's view this is closely related to the 'low share of private sector in GDP'. (Mihaljek, 2003: 58, and table 2, p. 38).

With regard to fulfilling the macroeconomic *Maastricht criteria*, which concern readiness to join EMU, again Croatia is meeting (or is close to) the criteria for inflation, long-term interest rate and exchange rate stability, but not for the budget deficit (Mihaljek, 2003: 59 and table 3, p. 43). The budget deficit certainly remains a reason for concern and an indication of a need for deep structural reforms Croatia is still facing, especially when considered together with the high and growing public debt, including the foreign one whose current level is certainly opening some potentially disturbing consequences if trend continues. A recent dramatic warning given by HNB governor testifies to that.

But taken in their entirety it seems that on most of the above criteria Croatia is the SEE frontrunner. Should this be a reason for deep satisfaction and excessive optimism? If one takes a more complex approach not necessarily. The possible caution is a result of two sets of circumstances. The first concerns the economy: microeconomic fundamentals are still weak, macroeconomic shocks may happen because it is still a fundamentally unstable economy, the current base for economic growth might be unsustainable, the underpinning policies may change. High expectations about Europe

should be moderated at least for three more reasons: (1) the shock of first enlargement wave may slow down the whole process of further EU enlargement, (2) it is much easier, experience shows, to achieve macroeconomic stabilization, than, in such a setting, implement deep and far-reaching reforms, institutional, structural and other simultaneously with such economic growth rates which are closing the development gap, and (3) the accepted models of behaviour very much depend on the credibility of institutions and enforcement. In this respect Croatia is certainly still lagging behind, and this is where change is most difficult to achieve. As long as the traditional (ethnic, organic) interpretation of nation dominates over the citizens' one (Sekulic, 2003) it is hard to expect that a true meaning of becoming European will be fully grasped. In other words: as long as Europeization is reduced (both in public discourse, and as a 'shared mental model' – North and Denzau, 1994) to becoming part of the EU, credibility of democracy and the rule of law is likely to fall short of what is really needed. But on the other hand, all this need not matter that much in a context of wider global games and involved strategies.

## **5. CONCLUSIONS**

This paper attempted to trace the political economy of Croatia's transformation through three points of partial and limited discontinuity and three phases of development. The three points of discontinuity concern first the 1988 breakout from socialism and the start of transformation, second the 1991 breakout from Yugoslavia and establishment of a national transformation path and third the 2000 international acceptance of the path taken. The phases cover the first transformation model while Croatia is in a federal state, the second phase generated a national transformation path best described by the term Crony capitalism and the third phase was Crony capitalism's evolution into an international accepted system. All the three discontinuities are limited in scope and hence partial, the first lacked a democratic component to back economic change, the second opened the window of opportunity for regression with economic continuity and the third was most relevant for the democratic deficit. Because of this limited scope of each discontinuity there is a continuity on the transformation path. This is traced in the paper through the evolution of the Croatia's

'transformation U'. In Croatia's case the downward slide was not only an economic contraction but social and political regression brought about by Crony capitalism. The lowest point is in 1998 and the inability of Crony capitalism to consolidate and manage the crisis it generated. The upward part of the slope can be viewed through the continuity of the slow escape from regression (democratic, social and economic), the changing but dominant entrepreneur state nexus (with weak state being main determinant of entrepreneurial success), the drawn out process of stabilizing initial transformation winnings (from demands for a revision and backtracking to respectability), stubborn maintenance of inward looking development (state developmentalism and unstructured trade) and the trend of increased international acceptance (from isolation and sanctions through conditionality to prospective EU membership). Another aspect of continuity is Croatia's inability for structural change: the weak state cannot change (in size or efficiency) and the three deficits (trade, investment and government) persist.

The paper is structured so as to point to the possible contributions Croatian transformation can make to a general understanding of the process. The most interesting lessons may concern the gradualist argument for partiality of reforms (first transition), the Washington consensus policies (extreme price and exchange rate stability did not lead to growth or accelerated transformation, privatization led to crony capitalism), the critical relationship of democratic and economic transformation (without which pathologies are likely to develop), the limited contribution of extreme price and exchange rate stability (did not engineer sustained growth and, arguably had a important negative impact of through currency appreciation), the flexible behaviour of entrepreneurs (whose rational behaviour both led to the rise of Crony capitalism and later its demise), the inherent instability of federations facing major political and economic reforms in the context of radical uncertainty (all three transformation federations broke up), and above all the continuity (discussed above).

The paper tries to show that Croatia's experience can be interesting in a forward looking way. Concerning market and democracy coupling, Croatian experience shows that democratic backlash (from below) didn't happen in spite of serious transformational deficits and failures. However, it gives some plausibility to the 'reverse backlash' thesis, i.e. when winners block further socially beneficial reforms keeping society on the low equilibrium level. Yet, both thesis demand more research.

EU integration commitment and credibility is critical for reform continuance and democratic consolidation. As a process, EU membership has an important ratchet effect (backtracking is impossible), incentive effect (the carrot and stick of accession) but above all the implication of normative optimism (that nominal convergence leads to real convergence). Yet, the Croatian case also points to ambiguities of Europeization. As long as Europeization remains reduced to becoming part of the EU and fulfilling benchmarked conditions it is hard to expect that the full meaning and demands of becoming true European can be achieved. In a society where organic identification with nation is still dominant Europeization might take much longer than becoming EU member.

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