

---

## Theory of Economic Growth and Stability: the Case of Croatia

---

LUKA BRKIĆ

Faculty of Political Science, University of Zagreb

### *Summary*

*In this paper contributions to the theory of economic growth are discussed, starting from the standard Harrod-Domar's model, R. Solow's neo-classical model and the model of growth by the new Cambridge school to modern trends in the theory of growth which focus on the development of dynamic models. Dynamic models include macroeconomic aggregates such as the inflation rate, money supply and government expenditure. Special attention has been paid to the approach based on the theory of rational expectations.*

*The author shows that the current relationship constellation of key categories in the Croatian economy is not, either from a static or from a dynamic point of view, particularly favorable for autonomous formation of strong short-term impulses for economic growth with the relative stability of prices being sustained. From the time when hyperinflation was being stopped, and at reasonable economic and social costs, the goal of the economic policy has evolved into a much more subtle and multi-dimensional demand for inducing economic growth at a low inflation rate. Within this framework the author points to the restrictions of the prevailing orthodox approach to the transformation of economies in transition, and due to its orientation only towards those policies which enable market incentives, he suggests that there is a need for broadening such a conceptual framework.*

Despite numerous extensive studies throughout decades, economists still do not fully understand why and how economies grow. So, for example, measures leading to high inflation rates in some countries, do not lead to equal results in others. While in some fast growing countries investments make a large portion of their gross national product, other countries with the same portion of investments do not have or did not have high inflation rates. Economists are still not sure whether it is some combination of institutional changes, changes in investment, labour, savings and risk taking incentives, changes in the accumulation of production factors, changes in economic policies (trade, fiscal, monetary) or just changed luck that creates conditions for a faster growth of an economy compared to other economies.

Economic growth and stability are two highly complex phenomena, so that even today, despite a highly developed economic theory, we cannot say for sure either which are all the factors of growth and in what way they contribute to it, or what is crucial to the realization and maintenance of stability or a low inflation rate. The development of the theory of endogenous growth, which has explicitly introduced human capital into standard theories of growth, and the development of institutional economy

somewhat reduced the size of the “unknown ground”. On the other hand, the theory of rational expectations has been a significant supplement to the rudimentary Keynesian instrument for the analysis of inflation and stabilization policy. However, from a theoretical point of view, little light has been shed on the relationship between growth and macroeconomic stability, which is why there isn’t sufficient empirical evidence. Due to all these restrictions, it is not quite possible to draw relevant economic and political conclusions.

In the absence of a potentially universal theory of growth, all governments striving to increase the growth rate while maintaining stability are trying to find their way on this theoretically and empirically still relatively unknown territory. The same is true of international financial institutions which strive to ensure the growth and stability of world economy. In this context a relatively firm stand has developed, which is, due to the above stated reasons, empirical rather than theoretical, that macroeconomic stability and efficient functioning of the market in all its segments are essential to a stable and sustainable growth. In view of this, at all levels of economic policy implementation, special attention is paid to policies of macroeconomic stabilization and structural adjustment which are used in an effort to affect the key growth factors such as savings, investments in physical and human capital, capital productivity and technological advance.

There is a general consensus on macroeconomic balance and stabilization as prerequisites of growth. A large body of evidence supports the stand that high inflation is incompatible with growth. There isn’t a single state which has achieved stable and long-run growth in circumstances of a very high inflation rate. However, such an assertion is even less clear in circumstances of a low, but still positive inflation rate. In other words, growth does not necessarily require inflation to drop to zero. As far as the relationship of growth and inflation is concerned, the widespread notion that moderate inflation and growth can be positively correlated in a short-term, cyclic context, but are negatively correlated in a medium- and long-term one, has not been clearly confirmed by empirical research either. Namely, while in the fifties and sixties it was still possible to find empirical confirmation of the positive correlation in a short-term context, which was expressed in the well-known Phillips’s curve, in the seventies and eighties, this correlation could no longer be empirically confirmed, and this was expressed in the Friedman-Phelps’s version of the Phillips’ curve, according to which cyclical unemployment can drop under the natural rate only if the actual inflation exceeds the expected inflation.

Only the most recent study by Bruno and Easterly (1994) provided conclusive empirical confirmation of the negative correlation between growth and inflation. But, while in circumstances of high inflation negative correlation is unequivocal, in circumstances of low and moderate inflation this relationship has still remained empirically inconclusive. The finding that as a rule investments take longer to recover than growth is a very

interesting one since it points to some more recent findings about the investments ensuing growth, rather than the other way round.

### *On theory*

The approach of the modern theory of economic growth to the study of economy springs from the work of J.M. Keynes. But, while Keynes focussed on the short-term problem of full utilization of a given production capacity with the volume of capital and labour being fixed, theories of growth are more concerned with circumstances in which the demand and production capacity can both grow in the long run.

First contributions to the theory of growth were made by R. Harrod and E. Domar, who independently, starting from different positions, reached the same conclusions. The essence of Harrod's view of the economic process can be reduced to two hypotheses. The first one is that capital and labour have to be combined in a fixed ratio imposed by the current technology, which means that a fixed amount of capital and labour is needed for the production of one gross national product unit. The second hypothesis is that the community wants to spend a constant portion of income, with the rest representing savings. Capital growth rate is the ratio between two constant flows, savings and investments per production unit, which is dictated by technology. If we want the total amount of capital to be fully utilized at any time, then the above ratio is at the same time the rate at which the production must grow, and it represents, to use Harrod's terms, the "guaranteed economic growth rate". To maintain full employment, with a fixed amount of labour and capital per one production unit, the production growth rate must equal the labour growth rate, which Harrod calls "natural growth rate". Domar's approach differs from Harrod's in the way that the total amount of capital and technological laws determining the production are not explicitly stated, and therefore the emphasis is on the dual role of investments.

The Harrod-Domar's frame of mind has resulted in at least two important conclusions: 1) long-run economic growth cannot be the goal of any economic policy, or at least cannot represent the goal of common monetary and fiscal policies of the Keynesian type, since the only growth rate that can be justified is the "natural" growth rate, which the government can only attempt to influence provided it has ways and means to stimulate technical advances. 2) the state of balanced growth in circumstances of full engagement of labour and capital is a mythical state of economy which can be achieved only if there is full employment and provided that the population growth rate plus technical advance rate do not equal the desired savings/income ratio divided by the capital/production ratio.

According to J. Schumpeter's theory of economic growth the profit made due to inventions is taken away by the competition which imitates new production processes, but, on the other hand, workers and consumers

benefit from reduced prices. The increase in interest rates which is stimulated by inventions soon leads to new savings and capital accumulation until the accumulation of the increased capital stock results in diminishing returns, decrease of profit and minimal interest rate. However, this is when a new explosion of inventions occurs, which again puts the economic system into a process of dynamic motion until the process of economic growth is renewed.

In the original Smith-Malthus's model of economic growth, the relationship between land and production and that between labour and production was not constant. Similarly, the relationships between capital and production in Ricardo-Marx-Solow's model are not expected to be constant in technical terms. In the absence of technical changes, efficient capital formation on the part of society would enable production growth, and the resulting phenomenon of diminishing returns would allow the ratio between capital and production to grow as a constant. Many contemporary economists (R. Eisner, A. Hansen, G. Colm) advocate the view that the ratio between capital and production is practically a technical constant and any attempt to accumulate capital through the rate required by annual growth is soon to fail.

Applying his own analysis method R. Solow has reached the following conclusion: less than half of the increase in productivity in the USA, both per capita and in terms of real wages, can be ascribed to the increase in capital itself. In other words, according to statistics throughout history, more than half of the increased production results from scientific breakthroughs rather than from savings and accumulation.

This model represents an illustration of a well-organized and stable society the prosperity of which depends on the thriftiness, inventiveness and technical ability of its members, in which each member is rewarded according to their contribution to common welfare: here we have clearly entered the neo-classical sphere.<sup>1</sup> In circumstances of balanced growth, the percentage of output growth per capita between two periods can be entirely ascribed to technical advances since the percentage of capital growth equals the percentage of effective labour force growth, and the total amount of capital per efficiency unit is, accordingly, constant.

The problem with the neo-classical explanation of stable states lies in the fact that this approach basically relies on special technological preconditions, which are expressed in the form of a mathematical equation entitled "aggregative production function", which establishes the relationship between aggregative production and aggregative capital and employed workers. J. Robinson (1953) was first to suggest that capital represents a

<sup>1</sup>On the basic neo-classical model see R.M. Solow: "A contribution to the theory of economic growth", *Quarterly Journal of Economics*, 1956, and T. Swan: "Economic growth and capital accumulation", *Economic Record*, 1956.

set of heterogeneous commodities which can be added to each other only in terms of values. In more recent times the issues of total capital function and aggregative production function were studied by F. Fisher.

Let us conclude: it seems that efficiency is the only source of capital diversity for which a solution can be found in the aggregative model, which is why one part of the neo-classical theory of growth if focussed on the construction of partially deaggregated models with heterogeneous capital goods.

J. Robinson and N. Kaldor do not believe that capital can be usefully measured as an aggregate which together with labour yields an aggregative product. Although to different extents, they both lean to the macro-economic theory of income distribution whose basic hypothesis is that fast economic growth leads to high profits, and not vice versa. Savings resulting from favorable circumstances lead to further acceleration of capital formation (following neo-classical patterns) and contribute to even faster economic growth.

Major decisions in the neo-classical vision of economy are made by consumers, and they are forwarded to the producer by a mechanism of perfect competition. A simple model, which was first presented by N. Kaldor<sup>2</sup> in 1957 is an illustration of a different growth model, as conceived by the new Cambridge school, in which the causality order of the neo-classical model is completely reversed.

The key assumption is that competition is not perfect and that agents do not charge according the value of their marginal productivity. Another important assumption is that technical advances do not occur automatically: each community has a certain innovating potential which is determined by inherent inventiveness and the level of technical sophistication, but the real rate of technical advances depends on how fast the community's economic sector accepts innovation possibilities. Innovations involve changes in technical production - in the aggregate context, they involve the change in the proportion in which labour and capital are combined.

As in the neo-classical model, the rate of production growth per capita is determined by technical advances only, while its absolute level is directly related to saving tendencies, but the way in which these results are obtained differs a lot. Namely, Kaldor believes that in circumstances of balanced growth the rate of capital returns and the ratio between capital and production are determined by income distribution, and the chief initiator of the process of growth is not the consumer but the producer, whose "readiness to adopt technical change is combined with a wish to invest capital in business undertakings" determines both the growth rate and the product distribution, which adds a Keynesian touch to the model as a

<sup>2</sup>For Kaldor's theory see: "A model of economic growth", *Economic Journal*, 1957.

whole. A more elaborate version of this model was presented by Kaldor in 1961 in cooperation with Mirrlees<sup>3</sup>, where the basic difference lies in the fact that capital goods of different age are not homogeneous and the total amount of capital thus becomes a dubious concept.

Government which would like its economy to follow a growth pattern involving maximum consumption would have to create a fiscal system which would encourage wage spending and profit reinvestment as much as possible. An alternative would be to direct the fiscal and monetary policies on maintaining the market interest rate as close as possible to the long-run rate of economic growth. In order to be able to assess the results of government investment, public expenditure, taxation and money supply must be explicitly introduced into the analysis.

A dynamic model including the government and money was published as early as 1955 by J. Tobin<sup>4</sup>, and in 1956 in one of his texts<sup>5</sup> Solow admitted that it was necessary to introduce money into the model. In recent times this model has also been studied by Johnson and Sidrausky<sup>6</sup>. The basic conclusion is the following: guaranteed rate of capital growth does not depend only on saving tendencies and the ratio between capital and production, and the ratio between capital and production in circumstances of balance cannot be deduced from the equation of guaranteed and natural growth rates if the inflation rate, the rate of money supply growth and the rate of public expenditure are not known.

The analysis of optimal and efficient allocation in time actually derives from the theory of capital and growth, and it owes its ascent to Malinvaud, Dorfman, Samuelson and Solow, who introduced the concept of efficient growth. The size of capital given in the initial period is supposed to reach its maximum, with the consumption following any pattern specified in advance. This is how the problem previously dealt by von Neumann, when he had sought a maximal growth rate, was formulated in a more general form. T.C. Koopmans<sup>7</sup> also joined this discussion emphasizing

<sup>3</sup>Kaldor N., Mirrlees, J.A.: "A new model of economic growth", *Review of Economics Studies*, 1961. A similar model where technological advance is explicitly seen as the result of cumulative experience is the model by K.J. Arrow: "The economic implications of learning by doing", *Review of Economics Studies*, 1967.

<sup>4</sup>Tobin, J.: "A dynamic aggregative model", *Journal of Political Economy*, 1955.

<sup>5</sup>Solow, R.M.: "A contribution to the theory of economic growth", *Quarterly Journal of Economics*, 1956.

<sup>6</sup>Johnson, H.G.: "The neo-classical one-sector growth mode", *Economica*, 1966; Sidrausky, M.: "Inflation and economic growth", *Journal of Political Economy*, 1967, and "Rational choice and patterns of growth", *Journal of Political Economy*, 1969.

<sup>7</sup>Koopmans, T.C.: "Economic growth at a maximal rate", *Quarterly Journal of Economics*, 3/1964, p. 355-394.

the close relationship between efficient and optimal growth since both have steady state solutions.

F. Modigliani has come up with an alternative theory, according to which the constancy of the ratio between capital and production is not accidental. On the contrary, he attempts to explain it in terms of people's mental decisions about wealth, consumption and saving. He attaches enormous importance to savings which spread throughout life and the purpose of which is to provide for old age.

The "new theory of growth" is associated with P. Romer, R.E. Lucas, E. Helpman and G. Grossmann<sup>8</sup> who base this theory on the following assumptions:

- Endogenous innovation stimulates economic growth. So far innovation has always been considered exogenous.
- In contrast to previous "recognition" of diminishing returns only, production structure shows increasing returns.
- As opposed to perfect competition as the only normal state, some monopolistic market structure is necessary.
- There is a difference between optimal and balanced growth. So far only balanced growth has been considered optimal.

Furthermore, the theory is based on the assumption that individual decision makers learn rationally, and not by adaptation. This means that they do not change their behavior gradually, responding to new information or different circumstances, but adopt new decision making rules fast and discontinuously. In making decisions people are supposed to be turned to the future and their expectations, and not to their past and experience. This is why any theory that assumes only gradual changes in behavior and flexible expectations is clearly wrong.

If markets provide full realization at all times, sources of fluctuation must be sought in the shift of the supply and demand curve, and not in movements from or towards their intersection. Labour demand curves and marginal productivity curves shift with technological changes; supply demands shift with changes in taste, especially in preferences between work and leisure. Since intertemporal optimization exists on both sides of the market, rational expectations regarding future technologies and tastes are significant. These shifts lead to smooth waves of established cycles due to autoregression of exogenous breakthroughs of technology and taste. It is

<sup>8</sup>Romer, P.: "Increasing Returns and Long Run Growth", *Journal of Political Economy*, Vol. 94, 1986, p. 1002-1087; Lucas, R.E.: "On the Mechanics of Economic Development", *Journal of Monetary Economics*, Vol. 22, 1988, p. 3-42; Grossman, G.; Helpman, E.: "Product Development and International Trade", *Journal of Political Economy*, Vol. 97, 1989, p. 1261-1283.

assumed that waves of economic activity simply reflect technology and taste waves in the background.

Joint assumptions on full market realization and rational expectations are essential as well as ad hoc specification on information available to buyers and sellers.

This model explains roughly the same observations as the Keynesian theory and Phelps-Friedman's hypothesis, but with different implications regarding the policies of the two models. A policy can never make more than a temporary difference in actual results, and even that temporary difference is always distorted. Policy makers can bring about permanent growth of production and employment only through a series of unexpected severe inflationary pressures. Private decision makers know as much as public decision makers, and by definition there is hardly any opportunity for the newcomers to the market to realize above-average returns rates, and if there is no such opportunity, there is no one who could improve the current economic performance.

According to neo-classical economics, the political process usually plays the role of the rational being which is trying to meet the "public interest". For the purposes of economic models, this role is most of the time interpreted as a problem of the welfare function maximization - usually the sum of the producer surplus and the consumer surplus. However, the very hypothesis on the optimizing conduct of the political process is questionable, because the "basic problem lies in the inherent impotence of the policy as a process of making economic decisions. Experience suggests that the political process is limited in its ability to accept consistent goals, set priorities and choose between competing economic programs, particularly when such decisions require understanding of complex technical problems and continuous update of complex information. For example, while economists research the dynamics between inflation and unemployment and discuss in detail whether the trade off between unemployment and inflation is possible, the political process has enormous difficulty accepting the idea that such a trade off is necessary in the first place. In reality government behavior alternates between giving priority to reducing unemployment and giving priority to reducing inflation". (Grossmann, 1980).

### *Macroeconomic stability and growth*

Macroeconomic balance is defined as such a constellation of inner and outer balance that is consistent with dynamic and steady growth. In other words, dynamic balance is defined as a situation in which growth is consistent with low and steady inflation and with a sustainable balance-of-payments position. This is based on the assumption that in the short-run high inflation is compatible with growth and that the balance of payments defi-



cit can accelerate growth, but in the medium- and long-run high inflation and increasingly high indebtedness have a negative impact on growth.

In the absence of a general growth model which would integrate macroeconomic balance and growth, our attention is focussed on the analysis of macroeconomic balance within the framework of the analytical model of a small and open economy. We will try to suggest that stabilization assumes elements of growth in order to be sustainable. If they are missing, stabilization tends to fail due to recession resulting from problems in income distribution. Some social groups are not willing to participate, and those who are forced to participate are brought to the brink of physical existence during the long periods of stabilization.

Croatian economic reform resembles that in Eastern European states. Price reform, trade liberalization, privatization and the restructuring of companies represent the major reform areas. Here, too, the "laissez faire" approach prevails instead of an active industrial policy. The emphasis is put on the macroeconomic context, and the market and its agents are supposed to adjust accordingly on their own.

Since 1992 or rather since the second half of 1991 the loss of the former Yugoslavia market and the impact of war resulted in the decline in production, savings and investments. War risks have had a negative impact on the exports, but the concurrent redirection of production from the market of former Yugoslavia to export markets has neutralized that effect and reduced the decline in exports. Nevertheless, the imports have been declining due to the fall in production and investments. Apart from that, by gaining independence Croatia found itself in a structurally different situation. Namely, in former Yugoslavia due to surpluses in its current account balance Croatia was the supplier of foreign currency which was spent on the state level. Because of that, when Croatia became independent, its currency's real exchange rate, which balances Croatia's foreign accounts, increased.

What constellation of fundamentals - savings, investments, public expenditure, trade protection and exports - which are essential both to macroeconomic balance and to growth, suits a small, open economy which wishes to maximize the standard of living in the long run? According to the theory of growth, savings and investments in physical and human capital ought to be as large as possible, public expenditure should be as small as possible in order not to replace investments and exports, and exports should grow at a dynamic rate. Furthermore, it is necessary to make sure that the stage of growth accompanied by debt accumulation and direct investment inflow is followed by a stage of growth accompanied by a positive current account balance, so that the accumulated debt can be continuously serviced. The growth rate should therefore reach at least the level of real interest rate on the world market (in the medium-run it should be at least 5-6% with a tendency to reach a long-run growth rate of 2-3%, which corresponds the long-run real interest rate on the world market).

What do these variables look like in Croatia? Domestic savings rate is halved compared to those in the pre-war period and represents 13-14% of the GNP. Gross investments in fixed funds have reached a slightly higher level - they are about 15% of the GNP. Public expenditure directly reduces savings, which is also reduced by the deficit in the public sector. Also, the poor financial structure of Croatian economy, high fiscal pressure and fierce competition with imports heavily aggravate the effectuation of the money supply increment in an increase of home supply of goods and services. Transfers of accumulated foreign currency reserves enable the maintenance of a steady rate of exchange on the foreign currency market at a level that does not cover the difference between the current domestic and world labour productivity for the majority of both exported and imported products. Due to the low level of income, the level of marginal propensity to save is low, and due to high interest rates, the marginal propensity to invest is also low. Quality, assortment, sales terms and technological production level represent an additional obstacle to a powerful expansion of commodity exports to more demanding markets, and at the same time the possibilities of placing some product on the home market are increasingly limited.

All this suggests that the current constellation of key categories in Croatian economy is not particularly favorable for autonomous development of strong short-term impulses that would stimulate economic growth at the same time maintaining relative stability of prices at their current level. It also suggests that the possibilities of short-term effects of the economic policy in terms of stimulating economic growth at a low inflation rate are rather limited.

At a low inflation rate it is clearly difficult to expect dynamic economic growth. Low inflation over a long period of time and the participation of public sector income in the gross national product of about 60% (out of which one third represents defense expenditure) replace savings and investments, generate costs that are incompatible with the level of exchange rate on the foreign currency market and support heavy demand for loans for funding regular business operation at a high risk of their repayment and at high interest rates. More dynamic economic growth cannot be expected if the state is directly or indirectly involved in the operation of economic agents and in the absence of measures that would directly stimulate investments in the private sector and new openings and with continuous pressures on the banking system to socialize certain problems.

All this suggests that economic policy has to focus on changing the factors it can influence in a direction consistent with dynamic steady growth, at the same time sustaining low and steady inflation. Through macroeconomic policy, structural policies and the development of an institutionalized framework, the economic policy should create a stable yet flexible environment which will ensure such incentives that would make the

adjustment process result in increased savings, investments and competition ability that would ensure maximal involvement in the international economy.

### *Politico-economic structural adjustment alternatives*

In terms of theory and practice, we are now going through a productive period of examining orthodox hypotheses which do not only concern countries in transition, but also market economies themselves. At the same time, from the point of view of economic policy this is a period of great confusion in which there is very little consensus on most issues.

Problems related to the achievement of growth in circumstances of stabilization primarily lie in the fact that frozen resources or resources set aside for the economy cannot automatically reach export production. Namely, companies' readiness to invest in exports also depends on the stability of expectations and on their trust in the stability of the announced system. Neither prices nor competitive markets are sufficient to ensure growth, since they do not ensure social consensus, nor solve problems of the abilities and knowledge left behind. This is why stabilization cannot be lasting without defining industrial or development policies. The need for long-run growth must be treated in the same way as the need for stabilization, otherwise it is not possible to change people's expectations. This requires strategic coordination in the economy, and this requires the development of certain mechanisms.

"In the long run, economic growth results from the interplay of incentives and abilities. Abilities define the best that can be achieved, and incentives affect the use of abilities and really stimulate their expansion, renewal or disappearance. In advanced economies abilities largely refer to human capital supply, savings and the existing capital stock, as well as technical and organizational skills needed for their use. Incentives largely originate from the product market and are more or less reflected in factor markets thus determining the efficiency of the use of abilities. Both the incentives and abilities function within an institutional framework. Institutions set rules of the game and are directly involved in the game. They act in the way that they change the abilities and incentives and they can change behaviors by changing attitudes and expectations".<sup>9</sup>

Economic incentives are primarily determined by the macroeconomic policy, and the existing abilities are advanced or set back by the industrial policy. As neither of the two policies can exist in an institutional vacuum, each of them is formulated within the existing institutional framework. At

<sup>9</sup>OECD (1987), *Structural Adjustment and Economic Performance*, Paris, p. 18. cited from S. Radošević (1994): *Konkurentni izvoz Hrvatske, Konceptijski ogledi i empirijska istraživanja*, p. 152.

the same time changes in these policies usually require institutional changes in order to be implemented in the first place. All these three elements are contained in the development policy of economies which are being successfully restructured.

Elaboration of policies and mechanisms, even their rough illustration exceeds the scope of this paper. Therefore we shall “draw the conclusion that there is an interdependence between institutionalized circumstances (order policy), and macroeconomic processes and microeconomic reactions (process policy). All the three groups of activities are necessary and have been noted in “virtuous circle” economies (Radošević, 1994, p. 160).

Controversy regarding the role of the state and the market in the development process keeps coming up in economic debates. On the one hand, some, in the best *laissez-faire* tradition, believe that it is the market that can best move scarce resource in the direction which would make their use most efficient, while others, on the other hand, think that the market works with numerous failures which is why it should be directed by additional state intervention. In the theory of economics, and particularly in development economics, the former approach is usually called neo-liberal, and the latter structuralistic (Chenery, 1979).

The neo-liberal approach identifies the desired structural change with the result of the general market competition process. Rooted structural imbalances and problems result from slow market adjustments and obstacles set to free competition.

Failures of the state include in the first place the following: 1) inherent shortsightedness of the political process since political mandates usually last several years, while the development and implementation of an economic change takes much longer. Politicians are interested in the success of their short-term stabilization policy rather than in a long-run policy the results of which become evident only after their mandates are over. 2) Making and supervision of state decisions imply that the state responds to changes at a much slower rate than private entrepreneurs, and decision making in the state sector must follow a complex administrative procedure. Once a decision is made following parliamentary procedure, its supervision is aggravated by the fact that its implementation is forwarded to a state organization, so the parliament rarely receives timely and detailed feedback on the implementation of the decision.

And lastly 3) relying on state assistance implies the domination of a small interest group, which is led solely by its own interests and is therefore often hostile to other citizen groups. When an interest group captures state intervention (capture hypothesis) it is not willing to give it up. It engages in extensive lobbying, bribery of state administration and invests in legal advisors in order to get to the source of rent which some other companies have already benefited from (rent seeking activities).

The structuralistic approach is based on the hypothesis that continuity of market relations is by no means a spontaneous process. The market is a comprehensive form of regulation, but it can direct economic agents only when the markets themselves are structured in the way that they reduce uncertainty, channel social conflicts, prevent the loss of dislocation for important agents, define expansion orientation and sustain macro-economic stability. Market failures which are usually pointed to in order to justify state intervention include external effects (negative and positive), volume economies and asymmetrical information (Grossman, 1990).

The 1990s have brought a certain convergence of attitudes. In other words, the structuralistic and neo-liberal views have grown much closer and a certain theoretical consensus has been reached. Today many authors claim that the usual distinction between the role of the state and the role of market in development is actually just a choice between “imperfect alternatives” (Wolf, 1993), and that serious implementation of the development policy cannot be based on a strict distinction between the two roles (De Bandt, 1994, Oughton, 1995).

Under the influence of the neo-classical perspective the role of the state is seen only as a role of someone who ensures the functioning of the “free market”. But development literature shows the complexity of the state’s role. Non-market and collectivist institutions are underestimated in their contribution to the functioning of free markets. Their significance lies in the fact that market failures or deficiencies are not exceptions, but rather a rule. The absence of such mechanisms is termed articulation deficiencies, with the term “mechanism of economic articulation” implying a powerful network of formal and informal connections. In successful economies these connections are involved in the dynamics of market forces, they negotiate on market failures and in other ways perform functions required in the operation of the complex economic mechanism.

The author of this paper is fully aware of the fact that some of these hypotheses might be resented in a country with painful historical experience of state and parastate intervention. However, the basic assumption here is that market economy in circumstances of institutional vacuum represents great uncertainty for economic agents which then obstructs any long-run entrepreneurial activity. The exceptions are short-run activities, which are then usurious or mercantilist. Confirmation of this can be found in the structure of newly established Croatian companies.

Croatian institutions of economic articulation are powerless, they operate on an ad hoc basis and are ignored. Its flexibility will not be reflected solely in market mechanisms but also in non-market ones, in other words, in mechanisms of economic articulation.<sup>10</sup> Major elements of the institu-

<sup>10</sup>In the work by P. Katzenstein: *Small States in World Markets*, Cornell University Press, 1985, adaptability of small, well-articulated European countries and

tional framework that is to be developed in economies in transitions include: civil law, protection system for the unemployed, effective bankruptcy system etc. However, each market economy represent a specific institutional context, which is why the discussion on “pure” market economy is only of limited value. There isn’t a single market economy, but an institutionally very specific type of market economy. Since there is no market economy without an attribute, the question is what kind of market economy is Croatia after?

On this occasion we would like to emphasize that we should not give in to new ideological blindness which would again ignore perverted and uncontrolled forms of state intervention. Rules of the game need to be clearly defined, which requires providing minimal political consensus and a developed administrative structure which will be able to build cooperative relations with the private sector. Croatia is undergoing a difficult process of developing an institutional structure which can serve as the basis for any neo-liberal project. It is a political process, because it involves the elimination of the chief source of power for individual social groups.

The major problem highlighted by the failure of orthodox marketization lies in ignoring the institutional foundations of market economy, which marks the limitations of the prevailing orthodox approach to the transformation of economies in transitions. Its orientation towards only those policies that enable market incentives suggests that this conceptual framework needs to be broadened.

In conclusion, public expenditure which reaches about 28% of GNP is too high in terms of the need for increased domestic savings. In accordance with the theory of endogenous growth, the share of public expenditure reserved for education, science, technology and health should be increased, as well as investments in human capital, and this should be done at the expense of defence expenditure. Further liberalization of the trade system and opening towards the world are also desirable incentives for the increase of exports, and low and stable inflation rate is essential to the implementation of a scenario which would lead to a significant and stable growth.

However, the author of this text would particularly like to insist on the hypothesis that stabilization is not automatically followed by growth, and macroeconomic policy alone is not sufficient for Croatia’s competitiveness. This means that national policies comprising all sectors (monetary, customs, exchange rate policy etc.) are insufficient to make economic growth possible and enhance competitiveness. The original macroeconomic concept of the sources of economic dynamics and competitiveness seems particularly inadequate for a small economy such as Croatian. Accordingly, the devel-

regions with a high level of political autonomy and cohesion of various social partners is emphasized.

opment philosophy will have to be revised and more significance will have to be attached to sector-specific and microeconomic aspects of competitiveness. A policy must develop the environment and mechanisms for market niches, which are a small economy's only prospects.

The process of state transformation and the establishment of a new system of "regulation" in a society requires the political consensus of all social groups, since the process of gaining competitive advantages is an immanently political process, which makes it significant in terms of continuous initiation of the process of institutional and non-institutional coordination of politically different perspectives of economic development. This means that the relations between trade unions and the state, as well as those between new owners must to a certain extent be cooperative.

This leads us to the conclusion that policy makers should be aware of the fact that the political dimension of current and development policies is a political and administrative requirement for Croatian transition from a lower, factor based economic level to a higher, investment level.

### References

- Arrow, J.K. (1967), "The economic implications of learning by doing", *Review of Economics Studies*
- Bruno, M. Easterly, W. (1994), *Inflation Crisis and Long-Run Growth*, The World Bank
- Chenery, H. (ed.) (1979), *Structural Change and Development Policy*, Oxford University Press
- De Bandt, J. (1994), "Policy Mix and Industrial Strategy", in: *Europe's Economic Challenge*
- Grossman, G. (1980), "Rational Expectations, Business Cycles and Government Behaviour", in: Fischer, S. (ed.), *Rational Expectations and Economic Policy*, University of Chicago Press, p. 5-22
- Grossman, G. Helpman, E. (1989), "Product Development and International Trade", *Journal of Political Economy*, Vol. 97, p. 1261-1283
- Grossman, G. (1990), *Promoting New Industrial Activities: A Survey of Recent Arguments and Evidence*, OECD, Economic Studies, No. 14, p. 87-125
- Johnson, H.G. (1966), "The neo-classical one-sector growth model", *Economica*
- Kaldor, N. (1957), "A model of economic growth", *Economic Journal*

- Kaldor, N. Mirrlees, J.A. (1961), "A new model of economic growth", *Review of Economics Studies*
- Katzenstein, P. (1985), *Small states in World Markets*, Cornell University Press
- Koopmans, T.C. (1964), "Economic growth at a maximal rate", *Quarterly Journal of Economics*, 3, p. 355-394
- Lucas, R.E. (1988), "On the Mechanics of Economic Development", *Journal of Monetary Economics*, Vol. 22, p. 3-42
- Oughton, Ch. (1995), "Bottom-Up and Top-Down Approaches to Industrial Strategy: An Overview", Berlin Workshop, September 8-19, 1995
- Radošević, S. (1994), *Konkurentni izvoz Hrvatske - Konceptijski ogledi i empirijska istraživanja*, Zagreb
- Romer, P. (1986), "Increasing Returns and Long Run Growth", *Journal of Political Economy*, Vol. 94, p. 1002-1087
- Sidrausky, M. (1967), "Inflation and economic growth", *Journal of Political Economy*
- Sidrausky, M. (1969), "Rational choice and patterns of growth", *Journal of Political Economy*
- Solow, R.M. (1956), "A contribution to the theory of economic growth", *Quarterly Journal of Economics*
- Swan, T. (1956), "Economic growth and capital accumulation", *Economic Record*
- Tobin, J. (1955), "A dynamic aggregative model", *Journal of Political Economy*
- Wolf, Ch. Jr. (1993), *Markets or Governments: Choosing between Imperfect Alternatives*, 2nd ed., MIT Press