

## Review on plenary session\*

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*Plenary session* organized by Scientific Society of Economists, December 7<sup>th</sup> 2007, subject: book *Dynamic economic development* by Branko Horvat, Biblioteka Hrvatska ekonomska misao, Publisher DOM I SVIJET – Faculty of Economics Zagreb, 2007.

In the scientific part of the annual assembly of the Scientific Society of Economists a *plenary session* was organized about the possibilities of using the theory of economic growth, developed by Branko Horvat, in solving the current problems of fast growth and development of Croatian economy (primarily production). The basis for such a discussion was the book composed of scientific papers by Branko Horvat on dynamic economic development, prepared by academic Vladimir Stipetić. The *plenary session* was not able to analyze, judge and select those parts of Horvat's theory that could objectively help in better scientific understanding and shaping the long-term strategy of socio-economic development of Croatian society. The *plenary session* focused on a number of theoretical questions, such as; optimal rate of investments and economic growth, foreign direct investment (FDI and its fallacies), functioning and development of local public sector, the position of modern enterprise in the society. Naturally many theoretical subjects have not been discussed but the opportunity will arise on some other occasion. To better understand Branko Horvat's analytical method and concept, we draw the reader's attention to some fundamental determinants of his scientific approach to socio-economic development. These determinants are explained in an inspired foreword written by academic Vladimir Stipetić. A passage from the book reads: *they strived and worked so that our mother-land can achieve prosperity, and recover from centuries-*

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*long economic backwardness that she was condemned to by living on this historical windward.* For Branko Horvat as a person and as a scientist it is crucial to point out that in his scientific work he managed to successfully combine the two great schools of economic thought: the Marxist and the modern macroeconomic theory. The author of foreword has appraised and systematically sorted the most important and internationally recognized contributions to economic science in theory of economic growth and economic cycles, political economy of modern society and the theory of self-governed company. When discussing these subjects we should always bear in mind the fundamental determinants of Horvat's theory and that is the historical meaning of Yugoslavian self-governance system, a system that can be fairly judged by the future historians of economic thought. Horvat believed that the transition of socialist economies represents a decomposition of achieved accomplishments in social sphere and the restoration of primal accumulation of capital by the new political elite. Furthermore, he believed achieving prosperity and social justice are cornerstones of modern civilization, which cannot be left to free market but has to stay in the states care. Now we turn our attention to the subjects mentioned in the beginning of this review.

*Foundations of Branko Horvat's theory on optimal rate of investments and economic growth*<sup>2</sup>. Horvat developed his theory of growth optimization and appropriate rate of accumulation during his study in England. He was inspired by the theory of marginal returns and expenses together with Harrod-Domar model and theory of growth that he learnt about at that point. Distancing from the Soviet Union demanded a new paradigm of development, institutional and scientific. New institutional paradigm was self-governance; that was resolved by politicians. The remaining issue was economic "scientific paradigm", and especially paradigm of development. Horvat offered an eclectic solution: to apply western theory, in this case of development, within the institutionally new self-governance system. That means that he places planning instead of market on the first place, as an instrument of society, i.e. government, and rejects the market system as development factor allocator. Horvat argues for criteria of market efficiency, such as marginal efficiency of investments. Process of investment increases production up to the level where marginal efficiency of investments is above zero, as market mechanism, at least in theory demands. According to Horvat, potential production of society relies on his absorption capacity. Thus he claims that decreasing returns are caused by limited absorption capacity of any economy. These limits finally overcome previously increasing returns and for the sufficient high rate of growth economy reaches the point where marginal efficiency of investments equals zero. Therefore, Horvat argues, economist can give clear-cut advice regarding the rate of investments: invest until the optimal path of maximum growth is reached! Testing of the optimality of the investment levels

<sup>2</sup> The basis for discussion on this part was contributed by Stjepan Zdunić, PhD, The Member of Scientific Society of Economists

follows afterwards. The conclusion is that it is beneficial to invest (additionally) to the point where additional investments become higher than the growth of GDP. Horvat distinguishes three possible alternatives. These are possibility of under-investments, over-investments and optimal investments. First alternative relates to the case of western economies (“sub-planned solution”), second on the Soviet practice (“over-planned solution”) and third alternative needs to be practice of socialism of self-governance (and that's the case of optimal investments). Horvat based his conclusions on the basis of the “investment-production” function. That function shows average returns on investments based on all of the three alternatives. All these options increase total production but with different dynamics. Basis on the optimal rate of investment thesis was derived by the conclusion that investments need to be increased as long as the elasticity of capital coefficient, regarding to investments, does not equals unity (or marginal efficiency of investments equals zero). National product increases until that point, and all investments above that point present government consumption (and personal consumption decrease).

Since private capitalist economy autonomously, i.e. exogenously regarding the government, determines the rate of savings i.e. accumulation, within the self-governance economy that should be done by government planning. Only the government plan can set up the exogenous development goal of GDP growth rate maximization by maximization of investments i.e. rate of savings. Market mechanism cannot do that. This is the origin of Horvat's rejection of neoclassical model of growth (Phelps, Swan!) and argument for the economic theory of planned economy. Such ingenious conclusion deserves consideration, rejection of market fundamentalist-ideological delusions and opens up a more successful, faster and more stable path of economic development and growth. Thus, devising of Croatian strategy of development has to overcome utilization of «imported» prescriptions.

Horvat's critical position towards the neoclassical equilibrium model of growth was conditioned by the foundations of neoclassical model based on exogenously given savings rate, even though he uses variable production (capital) coefficients. In addition, neoclassical model bases on market mechanism that on its own sets up the equilibrium rate of production growth, investments and “production coefficient” (ratio of additional product in current year and investments in the previous periods), and coefficient of capital per unit of labour with technical progress included as well. Equilibrium is reached at the point, where growth rates of these variables equal so called natural rate of growth, i.e.  $g = n + \mu$ , where  $\mu$  is rate of growth of technical progress,  $n$  natural growth rate of population, and  $g$  equilibrium long-term growth rate of GDP. Instead of the market Horvat introduces planning mechanism which is basically his ideological criterion, supported by some other economists (i.e. Laski). Horvat needed a model of growth with variable rate of accumulation i.e. savings in order to speed up growth above the natural rates that were sufficient for developed

economies that already reached state of full employment. That is the essence of difference between Horvat's theory and the neoclassical approach!

Contemporary research on interdependency between investments and economic growth not only confirm standings of Branko Horvat but they go much further and with more detail. Within the empirical research there are efforts to determine not just the optimal rate of investment in broader sense but to optimize the ratio of investments of private and public sector, regional and sector allocation of public investments. It is necessary to point out that within the analysis of relation of investments on economic growth significant attention is devoted to role of institutional sector on efficiency of the investment process. In fact, there are many factors on the final outcome of the investment process in form of higher growth rates such as cost of capital, level of corruption, level of education and many others. In another words, there are efforts to determine in what way investments can indirectly affect on growth rates by increasing the absorption potential of the economy. Branko Horvat's theory provides a basis for such developments.

*Foreign direct investment and the common fallacies*<sup>3</sup>. It is a common claim that foreign direct investments (FDI) substantially contribute to the economic development and that they even stimulate the process of economic growth. This claim is so widespread and common that it is often treated as an axiom and therefore the general consensus is that is superfluous to investigate its truthfulness. The need for the one way flow of resources from the developed to the developing countries is usually backed by three hypotheses: the lack of know-how in the developing countries; the lack of savings and the import-export gap.

The use of these hypotheses to advocate FDI is at best problematic. Although all of these hypotheses are in general valid, these problems will not be necessarily minimized by the FDI. The lack of know-how presents a very serious obstacle to economic growth. This problem cannot be addressed by simply moving capital from a developed to a developing country. The lack of domestic savings is often cited by the advocates of FDI but usually it is not a real problem since huge amounts of savings can be accumulated by minimally lowering the living standard of the citizens. Finally, unlike the lack of savings the import-export gap represent a real problem for any economy. Economic growth is a phenomenon of structural transformations and as such cannot be perfectly coordinated and balanced. Fast economic growth always leads to unbalance between the composition of domestic demand and domestic supply, which cannot be corrected by export induced imports, and as such creates a surplus of imports. Since structural transformation means a constant creation and elimination of bottle necks the surplus of imports is not a financial phenomenon

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<sup>3</sup> The basis for discussion on this part was contributed by Saša Žiković, PhD, The Member of Scientific Society of Economists

(like lack of savings), but a consequence of production function. By eliminating bottle necks, imports surplus increases the efficiency of investing, moving the entire production function and increasing the growth rate. Trade expansion and imports surplus increases the absorption capacity of national economy. In connection to this Branko Horvat identified five critical problems and fallacies about FDI:

Fallacy No. 1: Equity capital has a stabilizing effect on economic cycles, which makes it more desirable than debt financing. First part of this claim is true but since government bonds usually pay between 5-6% and ROE is around 10-15%, it turns out that the costs of debt financing are 2-3 times lower, and the obtained savings can be used more efficiently in damping the economic cycles. Repayment of debts can be arranged very flexibly, over long time periods and can be linked to the balance of payment position of the country. In this regard equity capital while being far more expensive has no comparative advantage over debt financing.

Fallacy No. 2: In the short run costs of equity capital can be lower than debt financing since dividends can be lower than the cost of debt (dividends can be less than interest + principal). In the short run, equity capital can have a beneficial effect on balance of payments of a country. These claims are correct only if we are taking into consideration commercial interest rates and short-term credit arrangements. If interest rates are lower than commercial and/or credit arrangements are long-term, the costs of debt financing can easily be lower even in the short term. Furthermore, a foreign owner can easily compensate for a payment of a lower dividend in one year by: increasing dividends in the following years, lowering of capital, transfer pricing etc. It is far easier, faster and cheaper to get a credit arrangement than attract foreign capital when the need arises. A credit can be paid by arranging a new credit line, reprogrammed or put into moratorium

Fallacy No. 3: The profits from equity capital can be reinvested in such a high percentage that the flow of money out of the country will fall under the level of interest that would be paid on debt. Although this is possible in a developed country, it rarely happens in developing countries, and the practice shows that often the exact opposite occurs.

Fallacy No. 4: Equity capital brings know-how. By moving to less developed countries, a foreign company brings with it new technology and new management techniques, secures education and training for local employees and management, stimulates local entrepreneurship. The same effects can be achieved by joint ventures in companies that are under local control. On the other hand, the positive effects of entrance of a foreign company are often very limited because there is a tendency for a foreign company to always remain a foreign sector in local economy. The greater the need for the know-how, the greater the separation between foreign and domestic part of the economy. This simultaneously indicates a greater cultural and economic gap between the two countries. Japan can be used as an excellent primer for these claims.

Japan allowed, almost exclusively, only joint ventures with domestic companies and with domestic companies as senior partners. This allowed Japanese companies to acquire the necessary know-how, while at the same time defending themselves from foreign takeovers.

Fallacy No. 5: Foreign capital stimulates entrepreneurship and maximizes profits. Although foreign capital is motivated by profit, this maximization of profits is in the exclusive interest of the foreign company not in the interest of host country. Another negative element is the fact that foreign businessmen bring with them their cultural and political prejudice and will therefore be more willing to endorse, politically and economically, their countries of origin and disregard the legitimate interests of the host country (the case of foreign owned Croatian banks and their credit policy!?).

The stated problems, identified by Branko Horvat, clearly point to the conclusion that foreign equity capital is not necessary and often not even desirable. All the positive effects that are usually attributed to FDI can also be achieved in other ways and simultaneously avoid the negative consequences of FDI and foreign control. It is naïve to expect a significant contribution to economic growth from import of equity capital. A large quantity of foreign equity capital can even have serious negative consequences, as is clearly visible on the example of Croatia. In spite of selling most of the major economic subject to foreign owners and handing over of the entire domestic banking sector to foreign banks from developed European countries a strong impetus to economic growth did not occur. It is possible to deduce that even after more than a decade from introduction of first stabilization programs and the initial transitional shock and economic downturn, the conclusions about the utility of FDI in Croatia are to say the least doubtful.

Most of the transitional economies have started on their way to recovery, but their experiences are different. Some countries succeeded in obtaining high growth rates, but at the cost of accelerated deterioration of foreign indebtedness parameters and ability of servicing their foreign debt. Some of them have managed to significantly improve the productivity of their economy and the efficiency of their investments despite the relatively low volume of FDI in them and vice versa, which can be easily demonstrated by simple statistical analysis. High growth rates in a number of transitional countries are a result of greater efficiency of investments and not a consequence of higher share of FDI in GDP i.e. the existence of “low starting-point” phenomena.

At the beginning of transition toward market economy the countries of Central and Eastern Europe have started the liberalization of their current and capital account on their balance of payments. Transitional countries have soon realized how an inflow of foreign capital is important for them, primarily foreign capital needed for funding investments necessary for development. All of these countries came out from a process of central governance, which is among other things characterized by low capital equipment and generally speaking obsolete capital equipment. The beginning

of transition was characterized by the transformation recession, which was common in all of the countries, so the inflow of foreign capital had an important role to play in the activation of the economy. The inflow of foreign capital has stimulated the development of capital markets in Central and Eastern Europe countries. Because the development of capital markets started from a very low level of development it achieved an impressive growth, a process that is continuing even today. Parallel with the development of capital markets in the transitional countries their integration into the international capital markets also developed, especially EU and US market (which are also the main sources of capital inflows into the transitional countries). Integration into the international capital markets led to further growth of capital markets in the transitional countries but also was one of the main causes of continued inflow of foreign capital and the growth of debt. Interest rate differentials and the differences in return on capital between the developed and transitional countries were also very attractive to foreign capital.

There are numerous factors that influence the company's decision to undertake foreign direct investments. Some of these factors are under the control of companies (internal factors), and some are exogenous and companies cannot influence them (external factors). All of the factors that encourage foreign direct investments are synthesized in the so-called OLI paradigm<sup>4</sup>.

Efficiency of investments is not correlated with the share of FDI inflow in the GDP, but the influence of FDI on different sectors of the economy can have different effects. Efficiency of investments is correlated with the share of FDI inflow into the tertiary sector i.e. higher inflow increases the efficiency in the sector. The reason for this can be found in the fact that efficiency in the services sector is higher than in other sectors of the economy, so it is logical that with the greater output of the tertiary sector, the efficiency increases along with the increase in the growth rate. Countries with the highest efficiency of investing, highest growth rate and above average share of FDI in the tertiary sector are also the countries with the highest growth of foreign debt as a share of GDP (Croatia and Baltic states).

This situation clearly points to the soundness of Horvat's conclusion that equity capital is exclusively motivated by the maximization of personal profit and that it enters sectors that are a priori highly profitable. In the case of Croatia this can be seen in extremely high profitability of foreign capital invested in the banking and telecommunications sectors. Short-term effects on the GDP growth have been, and still are negligible and in the long run they will most probably prove harmful.

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<sup>4</sup> According to OLI paradigm, companies decide to undertake foreign direct investments if they can simultaneously achieve the following advantages: O – ownership, an internal factor that allows the foreign direct investor an advantage over the local competition; L – location, mainly lower costs of production and transport, as well as access to specialized labour force knowledge and skills in the field of interest; I – internalization, an institutional factor that allows the company to retain previously obtained advantages and benefits and use them only internally within the company.

*Local public sector in the light of Professor Branko Horvat's theory*<sup>5</sup>. Branko Horvat was not particularly engaged in issues of local public sector, even public financing in broader sense. However, the importance of his scientific contributions within these topics can be observed by analyzing his general views that are extremely applicable on current understandings of local public financing and importance of local sector for economic development. His prescriptions for local public sector can be separated into several baselines: fast economic growth ("New deal" for Croatia), globalization, efficiency of government apparatus, capital accumulation, planning, decentralization, reform of economic system ("New way").

Horvat propounds unemployment as the most sever social issue. Growth rates at 4% cannot absorb unemployment in the short term. For the increase of production, investments are crucial. For the growth rates of 10%, ratio of investments in national product has to be on the level of 30 to 40%. Horvat believes that fast growth together with high investments means fast increase of living standards (and proposes "New deal" for Croatia). Latest theory of fiscal federalism accents the relationship between higher economic growth and higher role and autonomy of the local sector particularly regarding the investment activity. Finally, the role of local public sector within the stabilization of the economy by process of coordination of activity of all levels of government is recognized.

Branko Horvat believed that Croatian society has to engage in the process of globalization as fast as it can. Regional cooperation and cooperation between cities is increasing. However, inappropriate formation of Croatian region, that are not recognized as regions in international statistical publications, present starting obstacle in intensifying such cooperation. Next problem is in passivity and even resistance to such cooperation. He supports economic integration especially towards less developed countries where Croatia could have dominant position and advantageous market position.

Regarding the efficiency of government apparatus, Branko Horvat marks state's government administration to be most unproductive sector of the country. He was convinced that our public services are organized based on the principle of government that gives orders to citizens instead of modern principles of citizens' service. He also indicates that absence of sanctions for errors and inappropriate behavior of government agencies favors corruption.

Horvat dealt with optimal rate of investments. He defines underdeveloped economy as such with suboptimal level of investments. Related to that, it is important to mention that local public sector in Croatia has 12% of total government revenues and generates around 30% of investments. Such data are surprising since local public

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<sup>5</sup> The basis for discussion on this part was contributed by Saša Drezgić, PhD, The Member of Scientific Society of Economists



sector is severely limited in its activities especially with harsh administrative criteria on local borrowing. Local sector has substantial investment needs and irrational financial policy prevents not just local growth but growth of the economy in whole. Latest theoretical advances support thesis on the importance of local sector in stabilization policy and policy of economic development especially in the case of idle capacities and high level of unemployment.

Horvat advocates decentralization: economic and political. In order to mobilize human resources completely, it is necessary to use all the information that exists within society. That is the reason for decentralization of decision-making. Decision making is brought to higher instance only in case of confrontation of economic subjects. One has to recall the principle of subsidiarity – it is economically efficient to delegate public functions to the level most capable for their pursuing. The critical assumption is that local governments possess better information on needs of local inhabitants from the decision makers from the central level. Croatia is one of the most centralized European countries (with only 12% of the expenditures of local public sector in total government expenditures; only Slovakia, Slovenia and Portugal are on the lower level, and Albania has 19%). From such data it is necessary to draw appropriate conclusions and use them in creating more appropriate strategy of political-economical and financial relations between central functions and those on the other levels of governance for the Croatian society. In that way, the trap of asymmetrical development of country can be avoided.

Branko Horvat did not suggest miniature improvements of economic policy but completely new approach that he called the “New way”. Thus, Croatian system of public financing needs radical reform. Administrative-territorial division of Croatia led to the system of public government (system of public financing) with extreme territorial fragmentation but with outcome of extremely high centralization in generation of public sector activities. Therefore the activities of local sector are very limited. Alternatives are offered – scientists, public pressure, but there is still no political option in Croatia ready to carry out radical reforms in that sense due to the fact that parts of social groups favor current state and economical-financial relations.

*Contribution to the theory of modern management of the company*<sup>6</sup>. Branko Horvat gave his contribution to modern management of property and enterprise (company). Many changes in society had influence on social character of the company. Most important change in the latest capitalist companies is separation of ownership rights into capital and rights of management of this capital. Horvat defined this difference as property of company and property of capital. this change in modern company

<sup>6</sup> The basis for discussion on this part was contributed by Vito Gašparović, PhD, The Member of Scientific Society of Economists

– made corporation *ius utendi* significantly limited, and established autonomy of the company in sense of independency from all influences that conflict the interests of a company, as an autonomous economic entity, independent from special interests of its stakeholders. Such understanding of corporation leads to organizational changes: independency of production factors and their institutionalization as co-management of workers and capital owners, and divergence of their interests is synchronized by new institution of manager “that really becomes *dramatis persona*” ( J.Schumpeter) but with different authorities and responsibilities. Because, that most picturesque figure in capitalistic company, is prone, as it was shown, to criminal, corruption, and depredation. Thesis on management of company and appropriate organization would not lead to large plundering of social property in period of privatization. Extent and magnitude of pillage in post capitalist company, Nobel Prize winner Stiglitz called corporation corruption, and incapability of capitalist society to resist to that address on the corporation crises.

In that way, Branko Horvat appears as a founder of one new socially more equitable and iniquitously neglected theory of a company i.e. the theory of an enterprise.

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