



Smarter Thinking for Croatia: An Interview with the Adriatic Institute



There can be little doubt that despite Croatia's relative prosperity, bureaucratic encumbrances are causing problems for investors and Croatian business people alike. In a major interview, CBR speaks to Nataša Srdoč (pictured) and Joel Anand Samy, of Croatia's leading think-tank [The Adriatic Institute for Public Policy](#). They discuss their proposed radical free market solutions, including the much discussed flat tax.

Can you tell us why the Institute was set up?

Nataša: We realised there was a void of free market ideas in Croatia and a great need for economic reforms to bring a better economic environment for Croatian citizens. What Croatian citizens look forward to is a better standard of living - which is accomplished through economic growth. Economic growth is only possible if the business environment is conducive to doing business. We are aware of many areas that need improvement in Croatia.

There hasn't been an independent institute - I have to emphasize that we are independent and non-government funded - and that gives us the power to influence and to talk about issues that governments cannot touch. That is, how to reduce bureaucracy, how to reduce taxation, how to implement reforms that will make government irrelevant in commercial areas, where it is so present unfortunately in Croatia. So we know with that with 40% government ownership in the economy, everything is connected to the government. Either companies are owned by the government, delivering to the government or purchasing for them. So many decisions are politicised in Croatia which means that decisions are more led by political reasons than economic reasons. If politics is always interfering with economics then you cannot have real prosperity.

The principles of the institute are based on free market principles, individual freedom and personal responsibility. We really like to recommend Friedrich Hayek and Dr. Milton Friedman for citizens to read what it is to have personal freedom and responsibility - to be able to undertake certain activities in the community and to be an entrepreneur. To get away from the mindset of communism and the thinking that the government will provide everything for you.

Something government has misunderstood (as its role) is institution building. For entrepreneurs, it's not building institutions but putting a framework - which is the government role - of protection and property rights, rule of law for entrepreneurs to function and be prosperous; not to have an uncertain environment where they don't know whether the contract is going to be abided by, where court cases take 5-10 years to resolve. Property and intellectual rights are not well protected. Going into business becomes a great challenge. Why would you get involved in something if you can't prosper and get ahead?

Have you been able to make an impact on public debate in Croatia?

Nataša: Yes. It's very interesting that we brought the debate of the flat tax to Croatia. We also brought the father of the flat tax, Dr Alvin Rabushka to the Leaders summit (held in Zagreb) in 2004 and 2005. We realised that working with the media, bringing out this issue out with argument, talking about the experiences of other countries who have the flat tax have really brought the debate out and now the parties are talking about it.

The Croatian government are aware they need to do something (tax reform) - the flat tax is the best model. Every country that has implemented the flat tax, tax income has remained the same or has increased after one year of implementation.

Joel: What I would like to stress as well with your question is that prior to the Adriatic Institute's involvement in Croatia, the economic issues were not brought into focus in Croatia - it was only generalities - 'Yes, we want to become like an Ireland or Slovakia'. But any specific areas of reforms were not being debated, discussed or even suggested. That's where the Adriatic Institute has advanced pro-growth principles and also solutions rather than just criticising, and holding government leaders accountable. The role of a think tank is to empower and regulate pro-growth solutions that will lead to market reforms.

The Adriatic Institute constantly asks the Croatian government what has been done since they took office in 2003? There has not been one internal economic reform.

One of the great benefits of the Adriatic Institute is that we can tap into the tremendous network of fellow free market think tank leaders in Eastern Europe that have implemented the flat tax such as Estonia. So we are not talking about economic theory but evidence, experiences, and real positive results which makes the case for reform even stronger.

On the flat tax, there are some criticisms. In the German general elections it was said "it benefits the rich", "socially unjust" and so on. How do you respond to that?

Nataša: It's not about rich vs. poor, it's about high government expenditure vs. economic growth. If you want to keep people in poverty, keep redistributing what you have - you are distributing one slice of the pie which is not really increasing, you are

taking it from one side to give to the other. You are keeping poverty, unemployment and keeping people unhappy. In order to reach full employment and higher paid jobs you need economic growth. In order to have economic growth you to have put in place incentives that allow people to save more, invest more, to work more. You do it through tax reform.

It is important to say that you have to do tax reform through economic policy. Tax policy is not a function of social policy. Tax policy is about collecting money. Tax policy is saying how do you collect money for legitimate functions of government. Social policy is where you decide how the money you have collected is going to be spent.

There is no question of rich vs. poor - that's just a populist statement. It is about reducing government expenditures to have high economic growth. Government cannot be an entrepreneur. They have to get out of the economy completely. They have some important functions to play, but they are connected to a framework - to uphold the rule of law, protect property rights, defence, public order, police, education. But all other areas must be left to the private sector which is much more efficient.

Joel: The truth of the matter is that the progressive graduated tax system is very unfair. It was proposed by none other than Karl Marx. In our system what it has created is for the rich to avoid paying taxes and greater tax evasion, whereby the middle class carry the heavier tax burden. It is unfair for them and for those in poverty as it keeps them at a lower level. The flat tax creates a mechanism where everyone pays that one same rate. The statistics we have from East European countries that have adopted the flat tax is that they have doubled their rates of economic growth.



Nataša Srdoč and Joel Anand Samy

Countries like Romania has a flat tax, but also have corruption. Is there a danger that the flat tax could be seen as a panacea when there are other issues to be looked at (corruption) ?

Joel: In a lot of these countries, the flat tax becomes the centrepiece of a package of market reforms, and a flat tax is one of the most simple reforms a government can undertake. In fact, when you look at the forefront of personal income tax in Croatia, it can easily be transferred into the new flat tax system. Importantly, once we have that major reform done, then the other package of reforms can be done simultaneously. But you need that one key reform. And in Estonia, Slovakia these have been the centrepiece of a package reforms. The Adriatic Institute is not just championing the flat tax, but a package of reforms with the flat tax being the centrepiece.

Nataša: Unfortunately, Croatia's tax burden is the highest compared to every other country in South East Europe, even the EU average. Tax competition becomes a real factor (for investors) in deciding which country to go to.

Joel: One of the key areas that the Adriatic Institute has also advocated for is pension reform and flexibility in the labour market which is one of the most stringent in all of Europe.

We have to realise there is greater competition in the region than ever before. Croatia is lagging behind the competition. Romania's new government when it came into office (2005) were able to put together in three days a package of reforms and pass it through parliament. In three days they brought in a flat tax, they were able to implement a number of reforms. There is no excuse for Croatia's leaders to say it's impossible.

On pensions reforms, with regard to Chilean reform, why do you think that would work in Croatia?

Nataša: Dr. Jose Pinera, President of the International Centre for Pension Reform, who designed it, which has been successfully implanted in countries like Slovakia and the Baltic states. He has even advised President Bush, Prime Minister Blair and President Putin. We think it would work, as the existing 'pay as you go' system does not work. Obviously government expenditure is so high and out of control, that you can't expect the fiscal responsibility from a future government in 20 years that is going to be responsible with the money given under pay as you to have the money to give to pensioners.

A private system is the only thing that works. You save for your future, putting money aside to a separate channel, bypassing the government, giving it to an investment fund who actually investing in securities that are going to bring greater return to allow you to retire and get your money back.

Can you tell us about Labour market reform?

Nataša: We need to make the labour market more flexible. There are a lot of requirements and regulations about how to hire and fire people. Evidence has shown that the more stringent the laws on labour there are, the less employment there is. The more difficult it is to hire and fire people, the less inclined businesses are to employ anybody.

Something that is related to labour law reform are trade unions. Trade Unions have too much power in Croatia. The problem is the way they want to negotiate. They want to keep it centralised at the national level. You have two forces - trade unions on one side, businesses on the other. You can't be competitive. The suggestion is how to decentralise negotiations, to bring trade unions on the company level. To negotiate terms within the company. So they will be aware that if they keep salaries high, the company could go down, as other companies negotiate something else. So you don't have companies vs. employees but companies vs. companies, and you get more competitive that way.

Government sometimes likes to sometimes be straight jacketed - they say they can't do things because of trade unions. They need to understand that Croatia does not live in a vacuum, that Croatia has to compete locally for investment.

Joel: Croatia has missed opportunities in the manufacturing sector. A lot of (foreign) companies that have been involved in investing in manufacturing have done it already. Look at Slovakia, Romania, Bulgaria, even Serbia. General Motors, Ford, Toyota... all these companies are not going to uproot the companies they have established to come to Croatia.

The longer Croatia delays economic reforms, it will delay attracting investment.

It is a real completion. Croatia is not a player at the moment.

What about privatisation in Croatia?

Joel: The Adriatic Institute strongly advocates rapid privatisation. I think it's so crucial given high government expenditures as % of GDP. A great number of industries are not competing because they are heavily subsidised. As long as the government is involved in the economy, some 40% plus, it will remain a major problem for Croatia's economic growth.

Nataša: Experience has shown that the best way to privatise, to get companies that are sustainable afterwards, is to have it done through open tender, same conditions for domestic and foreign investors - that there are no conditions. There should be no conditions on how the company should operate once it is privatised i.e. how much money is to be invested, how many employees to be kept. Putting those conditions you practically reduce the pool of potential investors.

Companies have to be privatised as government is not an efficient owner, government cannot be an entrepreneur because it does not risk its own money. Government works with taxpayers money. As it works with taxpayers money it does not really hit the bottom line; it's not important to make profits because they are not going to get rewarded for it. It's not really in your interest to be efficient because it is not affecting your own pocket.

You still have government officials sitting on supervisory and management boards of government owned companies, which is not acceptable because decisions are not made on economic criteria but political criteria.

Government subsidies are also not acceptable; you are perpetuating the system of supporting unsustainable entities that would collapse. We give subsidies to the shipbuilding industry to make ships for foreigners; we are paying (effectively) foreigners to buy our ships.

The EU - How does the Adriatic Institute view the issue.

Joel: I have to say Croatia is in a unique situation, taking into consideration the manner in which it gained its independence. It did not experience its independence like other countries. It suffered a very brutal war which cost many lives and tremendous damage to infrastructure and there's a healing process with neighbouring countries. On the other side, sovereignty is a key issue Croatia needs to understand as well. Our approach is to look at the EU objectively. What are the advantages and disadvantages, to look at it not only from a short term perspective but also a long term perspective.

Yes, there are some clear benefits. It allows the opportunities of a larger market and the fact that it will help strengthen Croatia's legal framework.

But there are certain myths about the EU that once we enter - our lives will change dramatically, our living standards will be similar to Germany, that all of a sudden there will be more jobs, greater prosperity. That's not the case. Look at Greece, their economy went the other way, declining in economic power. When you think about the contribution Croatia will have to make to the European Union, and secondly when you think what Poland had to pay per month into the treasury of the EU - that's an additional amount it had to come up with on a monthly basis to facilitate the growing bureaucracy.

We are replacing one set of regulations and legislation with another heavy bureaucracy without even touching economic reforms. So the key issue for Croatia is the positive views on beginning talks with the EU should not lead to them to believe that everything is going to be fine for the next few years. It should re-commit itself to focus on domestic reforms, economic ones primarily. First and foremost they should start implementing tax reform, pension reform, labour reform, education, healthcare. That has to be done as pre-requisites before entering the EU. Otherwise, it will not be able to compete with the

EU. Portugal and Greece are clear examples, as well as countries that have recently entered. The New Europe is concerned about the fact that they have lost their competitive edge because of the regulations that impede economic growth.

If the EU existed as a place where it was a free trade zone with less bureaucracy and less regulation, of course it would be great. Croatia's agricultural sector will be deeply impacted. It's a myth that Croatia will be able to negotiate through this. How can Croatia negotiate with countries like France and Germany that have a tremendous stake in the agricultural sector. Will France say "all right, Croatia, you can produce as much wine and cheese as you want to and export it to other EU countries" ? No, that is not the case. If Croatia acquiesces to these regulations, its wine industry will certainly suffer.

One of the challenges we have is that it will be politicians who benefit most, not the citizens. Politicians who go to the European Parliament get paid some €7,000 per month tax free. If every citizen could have that opportunity I am sure they would want to get into the EU, but that is not the case.

Are you suggesting that Croatia should not join the EU?

Nataša: I think that the recent French and Dutch 'no' to the EU constitution means there is an opportunity of changing the EU from within. I think that the New Europe and others who are joining have the chance of helping the process.

Croatia does not exist because of the EU, it never has. Croatia has the whole world to trade with. Croatia has to be free to be able to be more prosperous.

To join the EU, yes, but a different EU. An EU that moves towards a free market economy with a free flow of capital growth and jobs.

Joel: Negotiations will be a long term process. The citizens need to be fully informed and aware through the government as to what is being given away and what is being negotiated. That's a very important issue of transparency required of the government.

The key focus for Croatia should be economic reforms. That's the only way it will survive in the marketplace. The EU is not a guarantor for economic growth.

One of the big criticisms of free market thinking in the New Europe is social dislocation. Some say if it was working why do people migrate to work in Western Europe, especially the UK. Do you think that your ideas implemented in Croatia can mean Croatia avoiding this sort of social dislocation?

Joel: I think a good example are countries like Slovakia and Estonia. Those countries are known as economically freer than most countries in the developed world. It is important to look at what happened in Estonia - there was a concern Estonians may flee to Sweden, for example. That is not the case. Estonia today has generated tremendous economic growth.

We believe Croatia has tremendous potential. With Croatia's diaspora in Germany, Australia and the United States - a great number have an interest to invest and have a closer connection with Croatia. But many of them have communicated to us very clearly that they are not willing to invest in Croatia until the economic conditions are right. That's where free market ideas need to prevail in Croatia.

Nataša: Citizens are not there to support companies that are inefficient. They are going to go for the lowest price, the better product. We have to look from the citizen's point of view. Companies have to cut costs and compete among themselves - be innovative, find new concepts. The ones who profit the most are the citizens. We have to improve the standard of life for citizens - to buy more things for less money.

You have a view on Public-private partnerships?

Nataša: The governments is proposing public-private partnerships in the tourism industry and real estate. Government should not be involved in these sectors. Any public - private partnership there is a great danger of corruption. We are very strongly against such public-private partnerships in commercial areas. It doesn't work.

It is always best when it is a pure private initiative.

Nataša Srdoč is the Co-Founder and President of the Adriatic Institute. Joel Anand Samy is Co-Founder of the Adriatic Institute.

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