

## The starting points of new economic policy in the conditions of recession<sup>\*1,2</sup>

*Ivo Sever and associates*<sup>3</sup>

### **Abstract**

*The purpose of this research is to recommend theoretical and program basis for the new economic policy for the purposes of overcoming the recession and enabling the recovery of production in the Croatian economy. Furthermore, the goal is to show that the results of this study provide the economic policy with a guidance to the consistent and direct answer on relevant issues in resolving the undesired state of economy. This includes other issues relevant for the society as well. The achievement of these goals is feasible by scientific method of analysis incorporated by activities of economic policy based on fundamentals of modern theory. This refers to its fiscal and monetary content in particular and their modern pragmatism. The results of the research show that the causes of recession and economic crisis in Croatia only partly refer to the external origin, and are dominated by internal factors. Among those factors the crucial one is the application of the so called*

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<sup>2</sup> The results presented in the section 3.3. of this paper, entitled “The issue of debt is the central problem of economic policy action to encourage production - Is a balanced budget necessary?”, as well as in the section 5, entitled “Strategy of rehabilitation and stabilization of government finances“ as well as the part of the text “Instruments of economic-financial and development policy“ dealing with the functioning of capital market are a part of the scientific project (Strategy of Socioeconomic Relations of the Croatian Society, No. 081-0000000-1264), supported by the Ministry of Science, Education and Sports of the Republic of Croatia.

<sup>3</sup> This text was prepared by Ivo Sever on the basis of a groundwork study “Starting points of new economic policy in the conditions of recession”. *Ivo Sever is retired Full Professor of University of Rijeka, Faculty of Economics, Ivana Filipovića 4, 51000 Rijeka, Croatia and the Chairman of the Scientific Society of Economists, Zagreb, Croatia. Scientific affiliation: public finance, fiscal policy, economic policy and policy of development. Phone: + 385 1 4667 658. E-mail: sever@efri.hr.* The names of the associates have been stated in the footnote 1.

*“stabilization program” in 1993 and related policy of overvalued and stable exchange rate. The main conclusion of the research is that it is necessary to abandon the neoliberal concept of economic policy and its monetarist content (anchor policy). Without such an action it is not possible to stop recession and direct production towards recovery.*

**Key words:** *recession, goal, economic policy, government finance, means of economic policy*

**JEL classification:** *E02, E21, E22, E23, E24, E31, E50, E62, G01, H0*

## 1. Introduction

The goal of this research is to show the abilities of modern economic policy in providing the answer on important issues brought by present recession and crisis of the Croatian economy (short-term solutions, but they extend to a longer horizon as well). Part of the Croatian economic science from the early nineties, and especially in past decade warns on wrong orientation of national economic policy with a foothold in the liberal economic model. In that way the Croatian economic science joins to those champions of scientific responsibility worldwide that warned on the untenability of market fundamentalist doctrine applied in governing the economies and societies of the modern world. Warnings accentuated its ideological background and failure of orientation on (monetarist) policy of anchor: too low stable prices and fixed exchange rates, as expressions of such (ideological) determination (Krugman, 1998). Its immorality and «vague future» was part of those warnings as well (Henderson, 1999)<sup>4</sup>. Off course, it is well known that such orientation was in the interest of financial oligarchy; however, the recognition of that fact fiercely erupted nowadays. It is about billions of the lost property and its transfer (redistribution) in the hands of minor social groups. Such theoretic “postulates” were linked with the creation of “new financial products” and continuous making of “virtual wealth”. Actual domestic considerations on ways of dealing with the recession and crisis followed such logic which can be observed from the priority of preserving the stability of the economy. Suddenly stability comes in the foreground!? As if the stability is the goal!? That is only the indicator that there are still numerous “believers” with “monetarist mindset”. What stability when the level of GDP growth rate equals zero!? Macroeconomic system of the Croatian economy is brought in an imbalance. By the economic policy at the equilibrium (and by definition that means, *ceteris paribus*, at low level of utilization of available resources) it is not possible to direct economic growth to the higher level. By fixed price of money and capital, fixed exchange rate and low (stable) prices it is not possible to find a way out from sliding to recession and economic crisis in general. However, from such condition

<sup>4</sup> This, of course, is not the first hint of such a fate of liberal economics. It was already in 1926 that J.M. Keynes published a book entitled *The End of laissez-faire* and predicted the strengthening role of the state.

no one will come out without damaged material integrity. The costs of overspending and misused resources and especially foreign money in the previous period (in such a process all social groups are not equally included) will become a burden to all members of a society. Distributional (unsocial) effects of this burden will depend on the balance of social forces. Simply put – on the relationship of the rich and poor groups of a society within the decision-making process during the period of fighting against the crisis. That has been already demonstrated by introducing the “crisis tax” on wages and pensions (later application of this tax on income of middle classes does not change the consequences)! Highlighted assessment of the current state of the economy requires thorough decomposition of causes of such conditions and problems. Only by scientific method of analysis it is possible to reach objective detection i.e. diagnosis, and afterwards to propose radical therapy. This research goes just in that direction. If the current socio-economic circumstances brought the Croatian economy into crisis, than for the recovery, possibly, it is necessary to alter them. Few words were already devoted to these circumstances but wider discussion is on its way to follow.

Therefore, the first task, in accordance with such purpose, is to determine a basic working assumption (hypothesis). It can be stated as follows: *it is possible to stop the recession of the Croatian economy and to direct economic activities towards growth, as a strategic goal (in relatively short time period), but under certain conditions*<sup>5</sup>. Achievement of particular measures is automatically followed by corresponding appropriate solutions in the scope of macro and micro economic system (and by all means with regulation activated within the financial subsystem). Since the condition of crisis in the Croatian economy is not something new – it was foreseen long before and predicted – therefore problems that trouble the Croatian economy are of fundamental nature. Therefore, it is not possible to overcome all of those in the short term. Moreover, any sort of “cosmetic” mechanisms within the economic system and its institutions cannot help in resolving these issues. Even less helpful is to insist on fallen paradigm of “monetarism” (and its “anchors”). This society has to start building the appropriate system of values. These values are before all, in tradition and heritage of our people, with deeply embedded sense of social justice. The means to attain this (to use the terminology of economic policy) is in devising the strategic interventions in macroeconomic system and basis of the model of society. It is necessary to clarify this a bit more. Croatian society has experienced the shock which came from vulgarization of the private property that led to formation of

<sup>5</sup> These conditions are as follows: abandoning the neoliberal model of economic and development policy; active role of government; to urgently adopt conception of the whole social and economic development; it is not necessary to balance the budget, but to use income and borrowed money to provide stimulus to economic activities; suspension of all infrastructure programs that are not directly in the function of rising the “short-term” supply and are without significant multiplicative effect; to ensure active role of state in adjusting the institutions of financial system to the conception and strategy of development (CNB and banks); to establish a strong governmental financial institution/bank – in this function to execute emission of public loan for ensuring the additional capital; to curb “monopolization” of Croatian economic space.

current socio-economic relations and was a latent cause of social and political crisis within the society. Such understanding (and consistency of its application) of private property is considered to be an ultimate cause of the crisis of society based on capitalist relations (de Sismondi, 1826; Marks, 1947; Stiglitz, 2004)<sup>6</sup>. Private property makes its basis, but also the source of conflict within the system itself, fortified by a vulgar neoliberal policy of profit maximization with no limits. Before mentioned remarks are a reminder that crisis is deep, it is the crisis of the system based on capital relations and demands radical solutions for its retardation. Indicator of such solutions is relatively fast application of methods of nationalization in production and financial systems of developed economies and relatively fast development of parallel models such as “social economy” and models of market-social countries (compare, de Kerorguen, 2009). Forcing of predomination of the private property has become a menace for the entire stability of the society. Interest of narrow (financial) renter oligarchy nested in this activity has to be replaced by general public interests. This research, off course, is not able to offer receipts to overcome that fundamental disorder. It is directed, as can be seen in configuration of presentation of results in the text that follows (and according to the methodology of activities in society that we classify within the economic policy) towards curbing the recession and swerve of the trajectory of activities to induce economic recovery and, above all, production. However, for such attempt we need fast and well conceptualized strategic solutions which are even more demanding when we consider these issues in a long-term period.

The text is written by method which corresponds to the content of activities of government which is defined as *economic policy*. Material, is therefore, organized by components of this activity starting from the goals, decision-makers, means, instruments and measures. This approach is recommended because, in addition to the scientific approach based on fundamentals, the study should provide an appendix to the formation of proposition of *concrete economic-financial and development policy*. To what extent that was achieved can be observed by the acceptability of arguments provided for specific solutions. But, this will not depend solely on the authors of this text. The material is structured in such a way that the *first* chapter briefly defines those causes of crisis that are objective (of foreign origin) in order to establish their causal relationship (domino effect!) with internal economic tendencies. These domestic causes or subjective ones are in the nucleus of this research. *Second* chapter is devoted to basic evaluations of causes of recession i.e. crisis; the goal is (priority) i.e. to determine hierarchy of priorities (that, by theoretical definition, is in the contents of strategy of certain activity); *third* chapter deals with theoretical foundations of new economic policy; *forth* chapter focuses on guidelines and elements of (new) economic and development policy; *fifth* chapter enumerates means and instruments of activity within economic policy and, finally, in the last, *sixth* part final evaluation is performed.

<sup>6</sup> The Fundamental opposition of the capitalist relationship to production is obvious in Marx's statement in his Capital: social nature of production and private usurpation of the surplus.

## **2. The evaluation of the causes of recession and economic crisis**

### **2.1. General causes**

The risk of occurrence of the economic crisis is inherent to the features of the capitalist system, its values and driving forces, as well as its ways of functioning (Stojanov, 2009). That fact is confirmed in this present state of battle against recession and socio-economic crisis. Focal points of actual crisis are just those most developed capitalist economies and societies. That is especially the case for the USA economy, which economic and financial set up was not able to sustain the pressure of internal and external tensions: deficit of domestic savings and real investments, long-term problem of unsustainably high growth of inequality of income distribution, uncontrolled credit expansion, accumulation of foreign debt, infrastructure and environmental degradation, misconception of regulation (market fundamentalism with simultaneous interventionist support to the corporative sector). Privileged status of dollar and its dual utilization (domestic and international) enabled rapid economic growth and maintenance of high level of employment. But this was paid by high deficit of trade balance. Long-term unsustainability of such policy had to show up one day. That is the reason why this crisis is deeper, and by its consequences in formation of future world and international orders it reaches the longer time horizon than any of the crisis after the Great Depression of the 1930s.

Crisis should be resolved only by the long term restructuring of the global system as a whole (Keynes, 1936; Stojanov, 2009; Cordonnier, 2000.2009). This implicitly means to answer in the direction of doctrinal solutions that ensure the unimpeded development of the global market, but also national, social and ecological balance in the world. Partial solutions by restoration of financial system may be only short-term method. Moreover, by the extension of that operation limited time to complete the reform is spent (Mencinger, 2008). Because, if rehabilitation of financial system of USA realizes and global crisis ends by such method, an open question remains (taking into account the generic deficit of its balance of payments): for how long? It is indisputable that USA dollar is not capable to keep the licence of the leading world currency any more. Therefore, it is probably possible to assert that when crisis ends, the world will be quite different. That order, based mainly on the private property, will not be changed by present “temporary” nationalization of banks, insurance companies and other sectors of the economy. Forty-year long domination of present version of capitalism, i.e. “casino capitalism” moved the social market capitalism aside, replaced owners of the company with owners of the property and transformed workers to the “labour force”. In the background of such transformations are important changes on the account of labour share in generation of GDP and the share of investments reduced as well (Mencinger, 2008: 2)<sup>7</sup>. This difference

<sup>7</sup> In the last 30 years relative share of labour costs in GDP has been reduced from 75% to 68%. At the same time, capital increased its share from 25% to 32%. The share of investments, on the other hand, was reduced from 25% to 18% of GDP (Mencinger, 2008, op.cit., p.2).

went away through privatizations, mergers of the companies and speculations. Exactly that was the difference that enabled increase of all kinds of financial funds that invented new “financial products” and increased distance between savers and investors. That was defined as “financial deepening” which, at the end, had a consequence of separation of financial world from the real one.

Present crisis, on the other hand, creates possibilities to abandon the former system and search for the “new capitalism”. The other solution is recurrence to the European social market economy. This is the system where the “new financial products” are ranked between fraud and games of chance. In this case the owners will primarily be the owners of the companies, not of the property, and workers will be colleagues and not the reproduction material. In a manner of former system, for example, growth of the economy of the EU cannot abruptly and strongly be stimulated by increase of competitiveness of its companies on the global market. However, a way to accomplish such a goal can be an increase of aggregate demand that can be generated by eliminating the social problems and efforts toward environmental protection. That was comprehended by the ECB as well by accepting the policy of printing money (Lordon, 2009). Fiscal solution, on the other hand, demands increase of the EU budget and redistribution both between social groups and different members of the EU. That, however, is much less realistic. It is more real to expect that EU members will not deal with the problems together but each for itself and in contradiction with the others. Recession in the EU will probably remain longer than in the USA, and length of it is more dangerous than its depth.

## **2.2. Evaluation of the causes of recession and crisis of Croatian economy**

In the Croatian society and economy, the main issue is not the global recession but over indebtedness of the government and economic subjects that causes disorders and economic disequilibrium leading to deterioration of economical and social conditions of working and living (Lasić, 2009). The production is decreased, unemployment mounts and large number of citizens and economic subjects become illiquid and insolvent. Due to the openness of the economy on the problem of indebtedness intensifies the reflections of global crisis. There is a reduction of exports due to decrease in foreign demand, banking costs are higher and significantly decrease sources of external crediting of entrepreneurs. Imbalance of investments in large infrastructure is undesirably reflected to the economic and social conditions in reference to the ability of this infrastructure to secure payments of annuities by own cash intake. One of the very significant and dangerous consequences of this misbalance is great sub-investment in technological basis of Croatian production oriented economic subjects. Most of the Croatian production companies cannot be competitive on the international market because of large lapse in pursuing of technological development and relative prices caused by the exchange rate policy. All that happened in global liberal economic model that puts competitiveness of the company in the first plan

and in such set up the competitors from the small economies did not stand a chance. Wrong monetary economic policy of “three anchors” (especially the policy of stable and undervalued exchange rate of Kuna) that has been applied for 15 years (as an essential component of 1993 year stabilisation program) is the main source of propounded issues i.e. misbalance in the functioning of economic system. Exchange rate policy leads to unsustainable misbalance of imports and exports and significant loss of domestic sales market. The consequences of all of this is visible in closure of many production companies, increase of unemployment, mounting of pension system costs and decrease of revenues for national and local budgets.

### **3. Theoretical starting points of new economic policy**

Determination of appropriate strategy, as the first step, is of the priority importance in the battle against recession. It is necessary to define, above all, what is the goal, i.e. what is the main task in stopping the recession and how to direct trajectory of economic activity to the positive sign as soon as possible. By curbing the recession only half of the mission is accomplished. That is not a goal by itself! The goal is to switch to the increase of production. Therefore, the means and measures for curbing the recession have to consist of components necessary for that purpose. However, the period in which the fronts against recession are opened – not only in Croatian economy - is transitory period where the hierarchy of components of economic policy intrinsic to the former neoliberal mode has to be abandoned (trinity of the “anchor”). That policy executed important and strategic mistake that was bounded, ultima linea, to lead to the breakdown – it superseded the places of function of goals and means. Because of that, these functions have to be clearly defined. With such foundations, the first step is to give appropriate clarifications and definitions of components of economic policy. Afterwards, the essence of this study will be determined: its strategy of stopping the recession that will be the turning point towards recovery of production. That means that it is necessary to determine the first goal of antirecession policy, but hierarchy of goals as well, which by definition makes strategy.

#### **3.1. Clarification of concepts of economic and development policy**

In recent period of domination of market-fundamentalist principles of economic policy it was shown that roles of means and goals of this policy were substituted. The tester was turned upside-down. Low and stabile prices and fixed exchange rate became the main goals of so called stabilization policy. There was nothing about development. There is no variable of development within the neoliberal models. Therefore, it is stabilization on the low level of utilization of resources. Apparent example of such (monetarist) economic policy is the “Stability and Growth Pact” from 1997 by which monetarism “put a nail in the coffin” to the economic growth of Europe since second

half of the 1990s until today. Means of economic policy are changed into goals (prices and exchange rates). Warnings about such devastating policy, with ideological backgrounds, have a long history (Levitt and Lord, 2000). In this place we will focus attention on two standpoints. One is about importance of accepting the lessons given by economic history. The other one derives the conclusions partly dependent on the previous standpoint, and partly on the basis of neoliberal aspirations. However, for such purposes it is relevant to excerpt evaluations as it follows. Thus, Paul Krugman like a fortune-teller asks whether in those days madness of financial markets could turn into a global crisis i.e. Great Depression (Krugman, 1998: 47). At that time such a scenario could not have happened! The assumption was that central banks had all the necessary means for curbing the recession. It was believed that real risk for world economy is not in a weak basis, but in *rigid ideologies (italics by I.S.)*. These are: *firstly*, that strong currency makes strong economy and *secondly*, that stable prices enable progress; Krugman warns about possible scenario in which serious mistakes could occur in case of rise of interests (in purposes of defending the stability of the currency) or keeping them on the same level (recommendation is, therefore, decrease). He draws the argumentation from the research on causes of Great Depression in the late 1920s and early 1930s of the last century (Eichengreen, 1995). That economic depression was mainly caused by stubborn determination of governments i.e. central banks to keep their currencies pegged to gold under any circumstances. This behaviour caused high interest rates in weakening economies (due to falling in recession and crisis). There is no golden standard nowadays. Developed world learned the “monetarist lection”. It started to coerce crisis with application of most efficient means. And these are, as always, in the hands of government. That, however, is not the case in Croatia. The policy of defending the *monetary stability* remained here regardless of the weakening economy. Croatian economy is rapidly sinking to the recession but monetary government is firm in defending of exchange rate, prices and stability of the financial system. Moreover, Croatian currency, if not stable is even strengthening! As if the financial system cannot be stable in circumstances of different conditions. That monetary policy is not in the interest of Croatian economy but of foreign capital in Croatia.

### 3.2. Determining the hierarchy of goals – what is the priority goal?

Every activity, and, therefore, economic as well, in order to be successful has to have clear goal i.e. goals<sup>8</sup>. What are these goals? What is relevant in a given group or agglomerate of problems? In the period of crisis such approach to the problems is important. And this is valid to the case of the Croatian economy as well. From the previous recommendations it follows that economic and development policy should not prolong orientation on “monetarist ideology” as a tool for conceptualizing the strategy of

<sup>8</sup> In normal trend of economic development, common goals are full employment, growth rate of GDP that enables previous one, stability of prices, balanced external trade, balanced distribution of income.

battle against recession. That is even more the case for creating conditions for recovery of production (turnaround of falling trend in trajectory of economic activity). To put it clearly, defence of the exchange rate stability and stability of prices cannot be a goal! Those two “anchors” only guarantee the continuation of recession and falling into deeper and deeper economic crisis. There is not a single case known in which those two “anchors” helped to stimulate growth in any of the European economies. It was already mentioned that this monetarist model does not contain variable of economic growth. The question is – how could anyone expect that the continuation of such a pattern of economic and development policy would succeed only in case of Croatian economy? If the resistance to change such a pattern is justified by the explanation that the huge amount of external debt prevents the shift in policy, than another question drops in. How is this debt expected to be repaid? Is it by constant borrowing/refinancing? In our opinion, that is certainly not a solution. It cannot last forever. The solution, therefore, is in implementing the policy of development that will gradually increase the level of utilization of available capacities for stimulating production, primarily increasing the industrial sector. Modern science and instruments of economic policy, i.e. fiscal and monetary policy, enable such orientation. That will be presented in the study that follows. On the basis of the above mentioned facts and formerly presented working hypothesis, we propose the following: stopping the recessionary trends and gradual increase of production is the fundamental goal of antirecession and development policy at the moment. That goal is objectively possible to reach, as it has already been stated, under certain conditions. By acknowledging the stated goal, the realization of the strategy of curbing the recession and directing production towards the recovery i.e. increasing trajectory is possible by implementing the appropriate programme, means, instruments and measures of economic and development policy, as proposed in further text.

### **3.3. Theoretical starting points of activity of economic-financial policy in conditions of high indebtedness**

The text that follows offers the theoretical basis of solution of economic and development policy in modern systems of market economies and institutions of the state. These institutions make decisions in the field of monetary policy and on the level of fiscal activity as well state. Also, the starting point of these policies is to break up with monetarism (especially with the concept of “three anchors”).

#### *Rejection of both the policy of “three anchors” and spooking effect of inflation*

Coming from the standpoint that instead of savings and expensive credits, withdrawal of money to reserves, denial of emissions (wisdom of “short cover”), anti-crisis policy should be rational and switch to productive use of available resources by preserving property and resources and stimulating demand, production, exports,

innovation, resourcefulness, cooperation, entrepreneurship and raising the quality of service. However, in order to succeed in making such a switch, the prerequisite is a thorough reform of the previous monetary and fiscal policy (Baletić, 2009: 7-8). This shift towards achieving such a target, and encouraging production and exports is in contrast to the previous disastrous policies that have resulted in stimulating imports and neglecting production and exports. The exchange rate policy boiled down to this under the pretext of preserving the stability of both the currency and credit rating of foreign creditors. This policy is now threatening to drag the economy deeper into stagnation, with no chance of a quick recovery. In this regard, the intention is particularly to point out two judgments:

*First*, the policy of “three anchors” was not in the interest of the Croatian economy and society in general. This policy, by definition, means to defend the interests of foreign capital and unimpaired borrowed principal and the return of the borrowed money. The fact is, the IMF is known for insisting particularly on such a policy that encourages and conducts economic and social stratification in the distribution of income and assets adequate to typical liberal societies, but inappropriate and unacceptable in Croatia that is by its Constitution socially oriented society.

*Second*, constant warning and spooking by inflation during the previous period (not only outside, but in the country as well) was a proven method of the liberal-monetarist indoctrination, although it is wide-known that inflation (due to globalization and the fall of prices and wages) is no longer a global problem (which does not mean that it cannot occur as incidental problem caused by international capital speculation).<sup>9</sup> During crisis or recovery there is no threat by inflation, but the main danger comes from deflation (falling general price level) and expensive money<sup>10</sup>. Proceeding from the propounded judgments, we will analyze the possibilities of economic policy. The first question is:

<sup>9</sup> Taking into consideration the knowledge and information gained by the experts in world market of energy sources, especially oil market including the debates at the American Congress that were announcing the commencement of investigation of oil market speculations in 2008, although the investigation has not started yet, and the estimation of some of the Croatian experts in this field, it is estimated that speculations that have direct influence, i.e. 20 -30 % on the oil price increase. For more information, reader can consult the book: Dahl, A., C. (2004) *International Energy Markets*, Tulsa, Oklahoma: PennWell.

<sup>10</sup> Issue of money in these conditions only compensates the loss of liquidity, which produces the collapse of the credit system, makes money cheaper and reduces the tendency to draw money out of circulation and thus helps maintain stability and encourage entrepreneurship (Zvonimir Baletić, op. cit., p. 8). However, it is a proper question to ask why prices in the country are so resistant toward “melting”? The lowering of prices did not come until the middle of the second half of the year, and with a lot of reasons we can say, due to political pressure!?! The reason: if the investment and personal demand fell, only the state spending remains as a factor that supported the resistance of “inflation”?

*Are the hands of economic policy tied up?*

Croatia is in a recession with a great chance to dramatically deepen the economic problem. But the solutions of the problem cannot be identical to the measures of antirecession policy relying on extensive deficit financing the consumption (Stojanov, 2009: 4). Croatian crisis is not marked by a lack of consumption. Moreover, Croatia is far from being at the level of full employment, and hence, hardly can we speak of an overheated economy. However, the issue here is excessive non-productive government spending and personal consumption. There is no doubt that economic policy has contributed to this process. Theoretically speaking, it is unacceptable that in the current situation of overstrained spending, there is a dangerous steady decline in exports, a pursuit of stable exchange rate policy and a policy of keeping all other prices flexible. There are arguments for keeping the exchange rate stable in the given circumstances, where such a policy seems inevitable due to the possible social and political consequences of any alternative policy. Therefore, at this moment, it seems that the hands of the economic policy are tied up.

Pragmatically speaking, the basic hope is the attempt of rescheduling the outstanding external debt. Otherwise, the economy has only two directions of motion: stagflation or deflation. The growth of unemployment in both variants is inevitable. The choice depends on the class relations in the Croatian society in regards to the process of decision-making (financial oligarchy, entrepreneurs, workers, citizens). We should not, however, ignore the attitude towards the EU and its demands. That is, therefore, at first glance, one of the scenarios of economic policy action.

In any case, it is necessary to consider institutional solutions and measures to relieve harmful effects of past orientations of the economic policy. It is, therefore, extremely important to act as soon as possible by coordinated measures of monetary and fiscal policy in order to stop the decline of production. Any deferral of state intervention exacerbates the situation and leads to long-term recession. Are these guidelines the right one that would allow to achieve the basic goal i.e. turn to the most important goal - to increase production? This question will try to be answered in the following discussion. But even before that, we should consider a tough problem of debt!

*The issue of debt is the central problem of economic policy action to encourage production - Is a balanced budget necessary?*

It is important to remind that the fiscal policy in the depression (financing government expenditures in state of depression), i.e. an alternative fiscal policy in conjunction with the national debt, was issue of the analysis of, for example, F. Modigliani back in the early sixties of the last century (Modigliani, 1961: 730-755). Modigliani has warned that, in the case of debt financing of government expenditures, is important to point out the position of classical economists and post-Keynesians on the issue of “non-transfer” and “non-burden” by debt and vice versa. Since these positions (by textbooks) are known, for this purpose we will set off only two conclusions (Modigliani, 1961:734):

- The costs of financing current expenditure by taxes strongly reduce the economic and financial power of taxpayers, while the financing by the debt does not burden them in the current period, and
- Debt financing will burden future taxpayers and investors in the state obligations will charge income yield from the use of physical assets to which they have invested part of their disposable income.

These two conclusions go against the assumption that the allocation of the debt load may be independent of the form of financing. Thus, there are two cases that follow: first, referring to deficit financing of expenses in a deep depression, when private financing of investment is unable to use available savings in the full sense; the other case is when financing of the war efforts is needed (which on this occasion is not in the focus of our attention). On the other hand, the implications of the first case very much occupy our attention. Therefore, somewhat deeper explanation of the consequences of this case will follow.

Contemporary theory is in a clear position that debt financing has the advantage for the present generation, but for the future one that is not the case. Future generation will bear the burden of payments of previously created debt, i.e. of anticipated spending. We will provide an explanation to such standpoint further in the text. The theory suggests that, in regards to the issues of financing, despite the “soft” monetary policy and interest rate cut at the lowest level<sup>11</sup>, the demand for private capital accumulation does not match the full absorption of available savings in the case of balanced budget policy! Thus, part of the available savings (accumulated income) for financing investment remains unused (*italics by I.S.*)? For that reason, here comes the possibility of creating debt and its utilization, as a measure, for the purposes of antirecessionary financing production. By the way, deficit financing will be of benefit for the current generation of creators of income, but it would mean the burden for the future taxpayers. Therefore, the strategy of economic policy in such a case (and it is precisely the Croatian case!) is to create the appropriate generation of the deficit and reschedule of the debt for a longer period of repayments. Modigliani analyzes the case in which, despite the “soft” monetary policy and the lowest level of interest rates, *demand for financial capital intended for investment (for private capital formation) is not sufficient to absorb the available savings in terms of a balanced budget (italics by I.S.)!* These are potential short and long-term cases. For example, the state can increase its expenditures in order to complete “deflationary gap” created as a result of the recession. For this purpose creates a budget deficit financing (Croatian economic policy should have done it much earlier, rather than open a debate on the balanced budget as an inevitable topical issue). Another

<sup>11</sup> Exactly that uniformly occurs in this time of drawing from the recessionary-depressionary vortices – among economies that are most fiercely hit by the crisis - but not in Croatia where the banking system continues to perform the extraction of income from the economy!

alternative is to opt for the policy that will support full employment without inflation; in this case, the net value is created, but the result will be the increase of total debt. The welfare of society will also increase (measured by income or social capital); otherwise these values would be lost. That is well known, but the question is whether these social gains present costs for the generation that comes (unrealistic option for the Croatian economic policy)?

The question is, in this respect, what is the actual situation in the Croatian financial system? Data in the table below clearly illustrate the relationships of financial aggregates and provide an answer to the theoretical standpoints stated above. These aggregates, at the same time, provide a warning on constant problem of deficit and debt, which narrows the maneuvering space of decisions of economic and financial policies, and point out the bitter fact that *investment demand has no reserve in available savings*. Banks spent these resources for the non-investment purposes in recent period (for such purposes they used foreign financial sources)!

Table 1: Investment demand and savings in the Croatian economic system

- current prices  
 - million HRK

| Year | Credits to government | Credits to the private sector | In that: loans for investment financing | Credits to population | Total domestic savings (long term deposit) | Foreign financial sources | Relation 4 : 6 | Relation 4 : 7 |
|------|-----------------------|-------------------------------|---|-----------------------|--|---------------------------|----------------|----------------|
| 1    | 2                     | 3                             | 4                                       | 5                     | 6  | 7                         | 8              | 9              |
| 2003 | 6,999                 | 49,426                        | ...                                     | 55,001                | 70,331                                     | 44,574                    | ...            | ...            |
| 2004 | 5,572                 | 53,372                        | 17,657                                  | 65,278                | 79,843                                     | 54,637                    | 0.22           | 0.32           |
| 2005 | 6,108                 | 62,080                        | 18,045                                  | 78,555                | 89,618                                     | 62,073                    | 0.20           | 0.29           |
| 2006 | 5,535                 | 78,265                        | 23,972                                  | 95,690                | 107,489                                    | 55,114                    | 0.22           | 0.43           |
| 2007 | 9,850                 | 86,267                        | 26,977                                  | 112,925               | 130,804                                    | 48,461                    | 0.21           | 0.56           |
| 2008 | 9,714                 | 96,849                        | ...                                     | 126,552               | 143,233                                    | 54,727                    | ...            | ...            |

Note: Loans for financing investments are part of the aggregate economy placements (according to the financial data of the Statistics Yearbooks of the Republic of Croatia).

Source: The Starting points of new economic policy in the conditions of recession, July 2009, p. 52, [www.zde.hr](http://www.zde.hr)

This is another constraint for economic policy decisions! That fact is also at odds from the Modigliani's analogy of the financial relationships in depression. For the purposes

of investment financing banks focused only slightly more than 1/5 of domestic savings available and 1/3 to slightly more than half of the foreign financial resources. The rest of the financial-development potential of the population was marketed for consumption, to the private sector economy for working capital purposes, and, of course, to the government. Within the banking system, therefore, the total resource of savings was available and investment demand could absorb it (to use Modigliani's analogy again) *in significantly higher level. However, these resources were utilized for other purposes*<sup>12</sup>. *This is evidence that commercial banks' policy was contrary to the interests of the development of the Croatian economy.* This policy was a powerful generator of growth in personal consumption and, in ultima linea, unemployment, since - within the dominant economic model – it ignored the production, especially industrial one. Of course, that from the standpoint (of inevitability) of creating debts, by its economic and social policy the government can impose (gross) costs to the society in future, but that does not mean that such activity should not be taken.

From the previous we can certainly *conclude* (which presents a lesson for the activity of the government in the Croatian case of fighting against recession) that eradicating the deficit by creating a surplus in the budget is difficult, if the government spending does not implement a useful policy toward the future (from the previous it results in reducing unproductive spending!). If the deficit has the effect of reducing the tax burden, with constant expenditures in the budget, as the consequence stabilization will not occur (in the sense of “built-in flexibility”, i.e. the measure of elasticity). Such an orientation of economic-financial policy is certainly not recommended. On the contrary, this policy should be based on the following strategies: first, to create the corresponding new debt acceptable in real terms;

second, to make the reallocation of the burden from current to future generations (which is the least painful in order to ensure economic growth);

third, to make redistribution of income for the purpose of rehabilitation of the current government finances (this proposal will be supported with an argument later in regard to the financial activities of the government). Such a strategy is well supported by the latest research pointing to specific conclusions about the relationship between economic growth and tolerance of the appropriate level of debt (IMF-Ter - Minassian, 2007: 18-19).

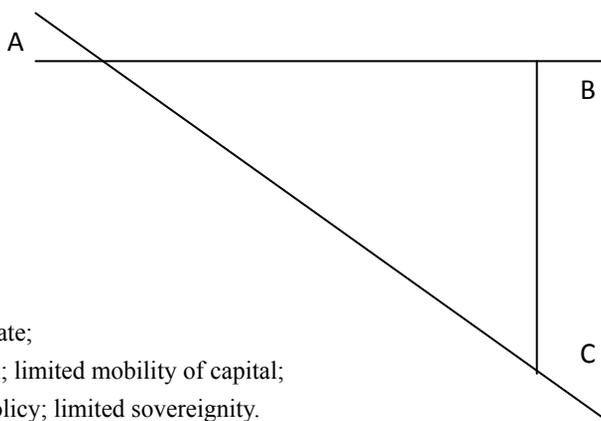
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<sup>12</sup> Please note that the data in the table featured only the total domestic savings. External financial sources from which consumption of the sectors is credited are not taken into account (this can be seen in the fact that loans granted surpass the total amount of savings).

### Croatian trinity and twin deficits - the Law of the triangle

Finally, on the example of Croatian macroeconomic system, we apply the “twin-deficit theory” and the “law of the triangle” (Zdunić, 2008)<sup>13</sup>. The law, as it is known, pinpoints the fact that there are only two peaks in the same direction. In terms of economic policy that means (in so-called relationship of trinity and twin deficit - fiscal and balance of payments deficit) that only two out of three objectives can be mutually consistent and economic policy must decide which of them will be dismissed. Figure 1 illustrates the model.

Figure 1: Trinity of macroeconomic goals



- A – Stability of exchange rate;
- B – Full mobility of capital; limited mobility of capital;
- C – Sovereign monetary policy; limited sovereignty.

Source: Op. cit., p. 55

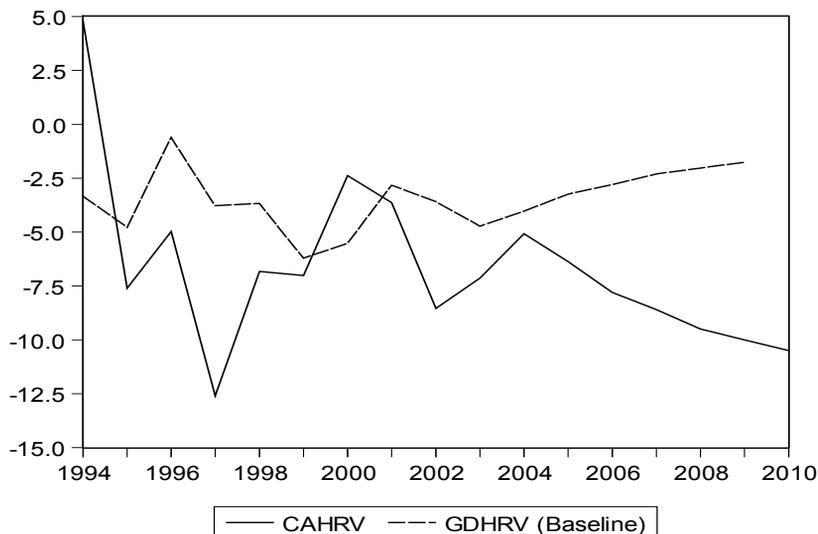
<sup>13</sup> Analysis, results and conclusions, and appropriate review of the literature the reader can follow in the study *Foundations of the new economic policy in conditions of recession*, ZDE, July 2009th, p.54-66. (<http://www.zde.hr>). Presented text (figures etc.) are the result of econometric analysis of statistical series for the period 1994 – 2007. Among other things, together with the analysis for each country, the panel analysis is applied for the group of the transition countries, it can be seen in the corresponding images. Series are marked by:

\* CA as abbreviation for the country that indicates the current account deficit; such labeling is influenced by computer programs, which are applied in the analysis;

\* GD as abbreviation for the country that indicates the fiscal deficit, as is published in the statistical databases. Our statistical source is WIIW Vienna Institute and EBRD; all the series can be found on their web site;

\* Term “Base line” indicates the basic simulation derived by econometrical evaluation of appropriate equations, i.e. equations of relation between variables GD and CA; evaluated parameters of the equation meet significance criteria, and that is valid both in the panel model as well as in the model for each country; the text highlights the cases where this is not the case and provides the explanation; alternative scenarios for this purpose are not made, because the factual characteristics of relationship between variables are stressed, and simulation of alternative policy is left for another occasion.

Figure 2: Interdependency of balance of payments and budget deficit in Croatia



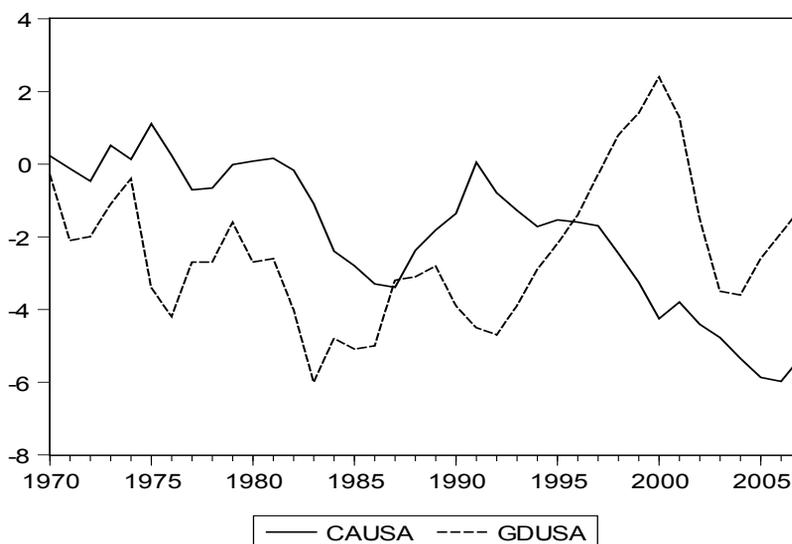
Source: Op. cit., p. 63

The figure analyzes the case of Croatian twin deficit. Model simulation clearly shows that reduction of the budget deficit basis on the increase of balance of payments deficit (illustration by Figure 2). It is obvious that the theory of “twin deficits” is valid, but in a “perverse form”: reduction of the budget deficit is related to growing balance of payments deficit. In addition, deficit of balance of payments is supported by appreciated fixed exchange rate and all kinds of liberalization policies. Thus, in current conditions, policies of reducing budget deficit were as successful as the policy of reducing the balance of payments deficit was unsuccessful. And the latest was unsuccessful to the extent to which the fixed exchange rate policy and monetary restrictions were successful. Thus, “the law of the triangle” confirmed its logic in Croatia: a fixed exchange rate and liberalization of capital flows abolished the monetary sovereignty with the consequence that it can not support the goals of national development in terms of growth rates of GDP and employment and reduce the deficit of current balance of payments account as well as the gross external debt. Croatia presents the best illustration of interdependency of balance of payment and budget deficit. The growth of the balance of payments deficit influences the reduction of budget deficit, and thus, the success of the policy of the balanced budget leaves in a sense a false impact. Policy of reviving the growth rates of GDP and employment depends on the exchange rate regime. According to the Mundell-Fleming model, the theoretical solution to increase the growth rate of GDP in terms of fixed exchange rate is the fiscal expansion. Our fiscal authority pursues the policy of zero total deficit! By such a policy it seeks to achieve a primary surplus in the amount of

interest on external debt that was already created by the government, and possibly for part of the private sector, coupled with HBOR (Croatian Bank for Reconstruction and Development) arrangements. With the “Maastricht criteria”, in a manner that we understand them and strive to achieve, it follows that the instrument of fiscal expansion can not be used to boost GDP growth and employment. Possible use of budgetary funds for investment may be financed on the charge of current expenditures of social services, pensions and salaries of public sector and increase in tax revenues and, therefore, have a very limited effect on growth. However, *the theoretical solution to increase the growth rate of GDP in terms of fluctuating exchange rates is monetary expansion, which achieves a lower interest rate than the rate in the world financial market, but depreciated exchange rate as well.* Our monetary authorities manipulate by the expansion and contraction to maintain the fixed exchange rate, and by that inflation as well, at the default level. Sterilization or the relaxation of the rate of compulsory reserves holds the exchange rate at a particular level, and interest rates come out as the consequence... This eliminates the growth of GDP as a target variable, and this growth would be possible on the basis of potential depreciation, as well as lower interest rates on the domestic market. It follows, therefore, that, theoretically speaking, neither monetary policy can be used as an instrument for stimulating growth and reviving the economy in our circumstances.

U.S. deficits show interdependent and independent movement that does not distort the autonomy of monetary and fiscal system of the country. Therefore, antirecession

Figure 3: Interdependency U.S. budget and balance of payments deficits



policy is very limited as an instrument to encourage the revival of the growth economy and employment. In basics the revival of the economy is completely left to spontaneity of action of external factors, which is otherwise characteristic of our development policy over the past decade and a half. Theoretically speaking, this situation can be explained very easily by the so-called phenomenon of “the pitfalls of the triangle”, as is shown in Figure 3. It is obvious that the two U.S. deficits show both interdependent and independent movements. This relationship, however, does not distort the autonomy of monetary and fiscal system of the country. In relation to the above illustration we applied the “triangular law” to the Croatian economy. Scheme 1 marks the relations made by such law.

Based on previous theoretical analysis, in terms of achieving “the law of the triangle” in Croatian circumstances, surely it is possible to conclude that:

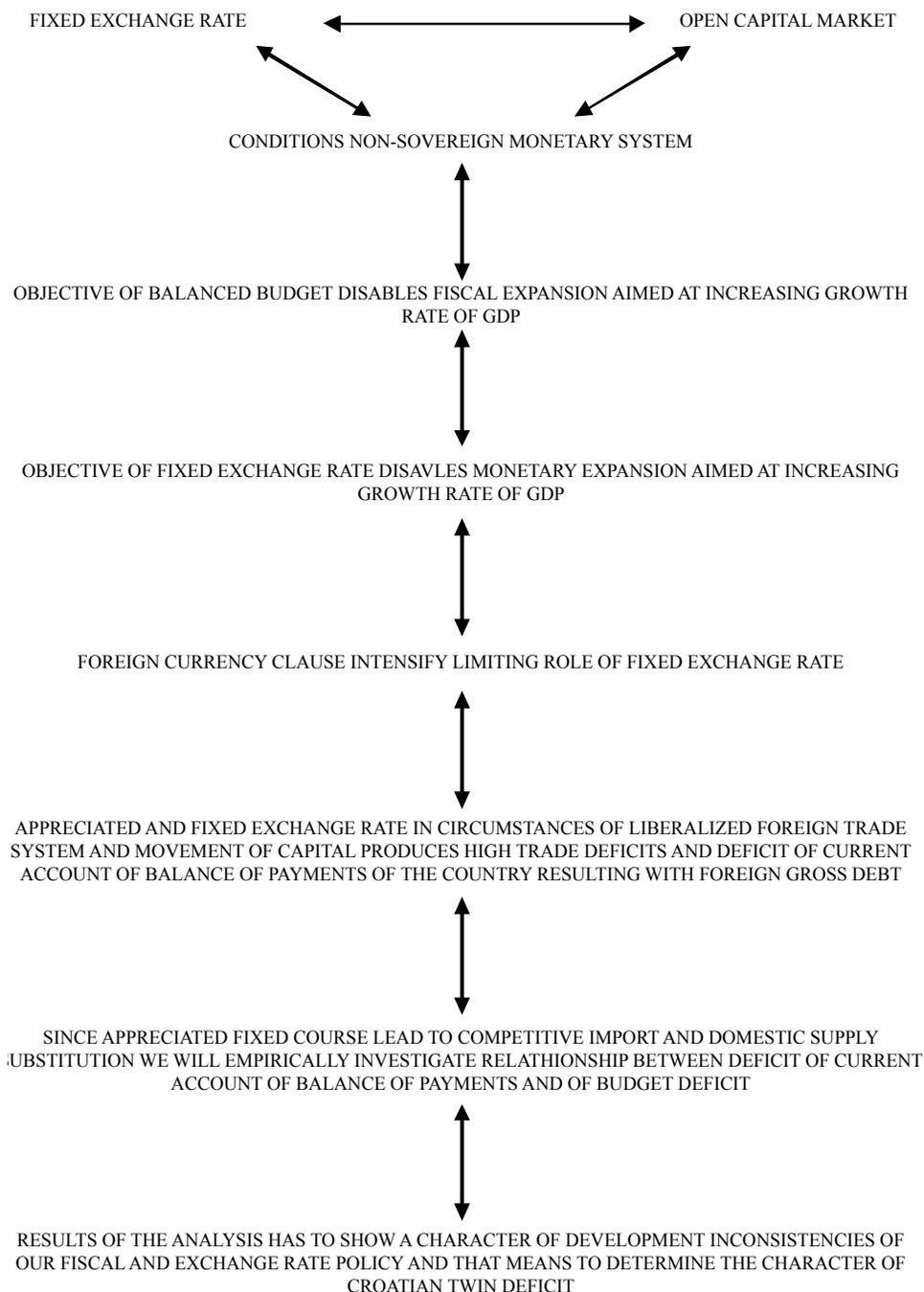
- \* Character of the relationship of the budgetary deficit and the deficit of the current account of balance of payments of the country shows features and level of monetary and fiscal autonomy of the country;

- \* Fiscal and monetary autonomy depends on the country’s exchange rate regime: a fixed exchange rate conditions lower monetary sovereignty, and free capital markets undermines fixed exchange rate regime; Maastricht criteria violate the fiscal sovereignty as a function of substitution for weakened monetary sovereignty; that occurs in the form of restrictions on the budget deficit in order to limit growth interest rates in order to reduce competition in attracting capital in a country; to avoid the control of capital movements in a fixed exchange rate regime, the restrictions are introduced on the current budget deficit and in that way fiscal sovereignty is limited;

- \* Various combinations of these constraints determine the degree of sacrifice of economic sovereignty of the country: sturdy and low current budget deficit combined with a fixed exchange rate system and the liberal movement of international capital shows a high degree of non-sovereignty of economic system of the country;

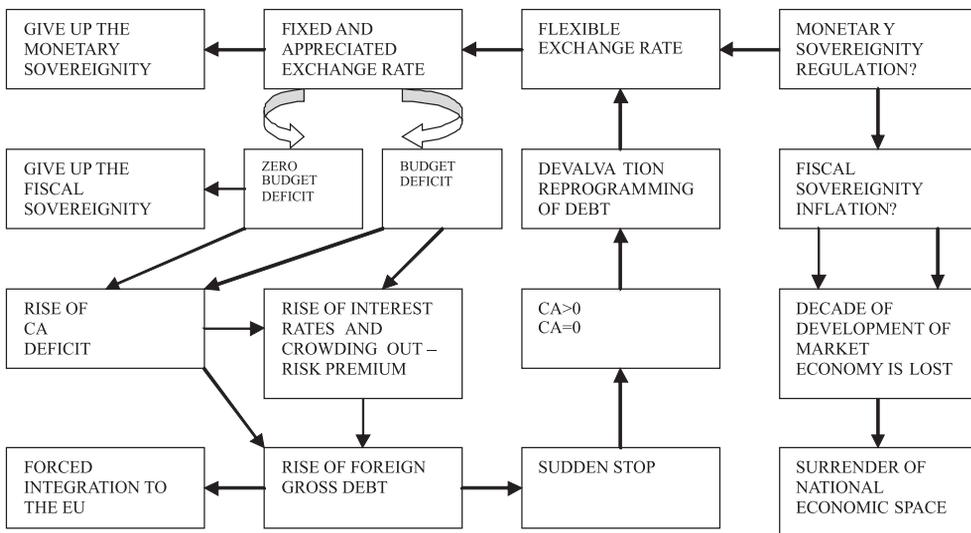
- \* As more weak the statistical correlation of the current budget deficit and balance of payments is, the more it means that the economic policy of the country follows its own objectives to a greater extent: intentional, accidental, or coerced; then it means that it enjoys greater monetary and fiscal autonomy; otherwise there is a domination of the goal of integration in the global economic system, and relationship between two deficits can have a positive or negative sign; lower budget deficit, more stable and appreciated exchange rate and liberalized markets of capital and goods implies a larger deficit of balance of payments and lower level of monetary and fiscal autonomy; that is the case of Croatia, but there is an increasing number of other countries that pursue the fixed exchange rate policy (i.e., Bulgaria and Estonia).

### Scheme 1: Croatian triangular problem



At the end of this theoretical analysis we will display only a schematic illustration of the *Law of the triangle* in the Croatian macroeconomic system. Figure outlines the trends and consequences of twin deficits in terms of regime of fixed and appreciated exchange rate, and liberal movement of capital. The purpose of a zero deficit is the “credibility” of economic policy, in order to “attract” foreign capital. According to the theory, greater interest rates and higher profits will attract more of it. In terms of growth of debt the risk premium is higher, and, therefore, interest rate that was reduced by competition now grows again. The risk of “sudden stop” increases. If that situation occurs, that is, there is absence of support and coverage of risk of foreign capital, there comes a phase of relying solely on our own resources! Our situation, objectively speaking, bases solely on our own resources! That does not change

Scheme 2: Actualization of Croatian trinity - Implication of appreciated exchange rate and budget deficit



Source: Op. cit., p. 65

regardless of budget deficit. In fact, topical question is: how to establish a model of national development, and avoid the consequences of inward oriented development, in case of absence of support from the “major players”. The support of the “major players” means the “Hungarian syndrome” and fast integration to the EU?

From the previous analysis we derive the following basic conclusions relevant to the content of a consistent national economic policy:

\* Fiscal and monetary autonomy depends on the country’s exchange rate regime: a fixed exchange rate conditions a low level of monetary sovereignty, and free capital

markets undermines the fixed exchange rate regime; “Maastricht criteria” violate the fiscal sovereignty which can not compensate weakened monetary sovereignty; that is realized in the form of restrictions of budget deficit in order to prevent the growth of interest rates. In this way, the conditions of competitiveness in attracting capital from EU countries are compensated. In order to avoid the introduction of controls on movement of capital in fixed exchange rate regime, restrictions on the current budget deficit are imposed;

\* In terms of integration of transition countries into the European economic space correlation between two deficits can have a positive or negative sign; lower budget deficit, more stable and appreciated exchange rate and liberalized markets of capital and goods implies a larger deficit of balance of payments and lower level of monetary and fiscal autonomy.

#### **4. Determinants and elements of national economic policy of curbing recession and recovery of production**

In the context of global economic model that is elaborated here in the text, there is the question of choice of the national economic model, which would enable the achievement of monetary and fiscal sovereignty, and allow the realization of national development goals: a fuller use of national resources and labour, to stop and exit the recession and the recovery of production (Zdunić, 2008). Note that this policy does not have to be in conflict with the policy of integration into the European economic system. Such a strategy has always been possible, and today it is desirable, which is reflected in support of “major players” for everyone to find the solution that leads out of crisis! It is important to note that this is a strategy question, not of an ideological form. This strategy could not be achieved without international support as is the case with the existing one as well. The difference is in the fact that it would enable the country to reach the level of international solvency. This is not currently guaranteed by the strategy.

Therefore, the *elements of national economic policy* for the achievement of such a strategy should be:

- (1) Program of refinancing of external debt with the support of international financial institutions, as it already functions worldwide, the hypothesis that we do not need such a program does not stand;
- (2) Implementation of a gradual depreciation of the currency because introduction of the euro is currently not possible;
- (3) Elimination of exchange rate clauses and conversion of debtor-creditor relations to depend on Kuna and in all sectors, including population;
- (4) Limitation of the release of the national capital and savings in foreign countries;

(5) Monetary policy inflation targeting should be implemented with the support of other policies;

(6) External obligations should maintain the normal exchange rate policy character together with respecting the arrangements with the IMF;

(7) Necessary to carry out the nationalization of monetary system, i.e., central bank must follow the criteria of national development with the usual policy of stabilization of prices, to regulate interest rates that provide incentive to development, since the state turned to the sovereign monetary system, the fundamental anti-inflation policy of the CNB is to regulate the inflation targeting;

(8) Fiscal system and budget policy must be coordinated with monetary policy when it comes to national development criteria;

(9) Postponement or suspension of privatisation of large systems, such as HEP, shipbuilding, highway, railway, natural resources (land, forests);

(10) Tourism as well as every other still remaining potential export sectors of the economy should be the basis for the establishment and implementation of internal-oriented development strategy, which aims to finally enable the country to accept memberships in the EU;

(11) Arrangements reached with the EU should respect, but it is necessary to plan delay of entry into the EU;

These elements of the concept of economic policy have a strategic character that has a fundamental goal to go out of the recession and to reach the situation of full employment of national resources and human potential. Only this condition should be considered as fulfilling the criteria for entry into the EU, which we basically constantly seek for. But a false interpretation of the criteria for entry into the EU prevailed.

## **5. Tools and instruments of new economic policy**

The effectiveness of any economic policy is manifested in its disposal with the appropriate means and instruments. Not less important is to answer to the question of who makes (major) decisions. Thus, it is in the case of devising a strategy to stop the recession and to obtain funds for this activity as well. The causes and course of the current recession and the crisis showed that the decisions can no longer be left to free market games or their protagonists. It is particularly so because this is a crisis of capital relations i.e. we are faced with a constant fundamental disturbances of the system. Therefore, as soon as we realize the necessity of basic and thorough system transformation, modern society will be less exposed to unacceptable disruptions of functioning. Transformation in this regard must be addressed in two ways: *first*, in

reaffirmation of function of modern state and *second*, to encourage the restructuring of the macroeconomic system.

Ideologically unburdened economic science is aware of these needs, beginning with the assessment that this is also a fundamental precondition for overcoming the current crisis of capitalism, which applies to Croatian offspring. Any other approach will only present “cosmetics” and will result in “repeating history.”

### *Reaffirming the functions of the state - state interventionism*

First direction of transformation that was propounded is not randomly selected. It would be very wrong to accept from the science and other social component that current engagement of the state in regulating economic and social trends is just another episode of modern development. And when the storm has passed... Here we are again “firm in the saddle.” Such a note can have only liberal ideological indoctrination that (even now) insists on individualism. History has shown and proved that the state mechanism is intrinsic to the social development. Functioning of all our civilization is more and more complex, and it is a mechanism of state institutions that must establish rules of conduct in the interests of all members of the community. Nowadays, the attempts of neo-liberalism to destabilize the institution of the state has only been a repeated episode, but still strong enough to bring capitalism to the limits of destruction. It is likely that such attempts will start again from the moment when capitalist reproduction becomes at least reasonably stable.<sup>14</sup>

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<sup>14</sup> Today there has already been a belief that “the public authority left the free capitalism that returns to its crazy race.” This development is indicated, for example, by the ECB president, J. C. Trichet: “... describes the main guidelines of macroeconomic policy, after the carnival passes”. He said (statement is transferred in its entirety): “With regards to structural policies, the efforts aimed to support the potential growth in the euro zone should be more intensified. In particular, the reforms of product markets to encourage competition and accelerate restructuring and productivity growth are needed. In addition, reforms in the labor market must facilitate the process of forming a favorable wages and labor mobility between sectors and regions. *At the same time, many measures that have been taken in recent months to support some parts of the economy will have to be gradually and timely eliminated. The most important thing is that emphasis is placed on strengthening the capacity of adaptation and flexibility of the economy in the euro zone, according to the principle of open market economy in a regime of free competition*” (italics by I.S.) (BCE, press conference, 2<sup>nd</sup> July 2009, *Le Monde Diplomatique*, September 2009, p.11). A similar statement is given by Ben Bernanke head of FED who is afraid of “that the U.S. Congress does not fully give over to his well-known regulation preferences” (op. cit, p. 10).

At the same time theoretical effort in defense of liberalism does not cease. European fans of liberalism, it seems, does not want to fall behind it. Thus, for example, the *Austrian Ludwig von Mises Institute* just this year published several titles. Of course, criticism is directed toward Keynes and the state. Published editions: Ludwig von Mises *Liberty & Property* (essay of his ideas from the mid 50's in which he glorifies “revolutionary importance of capitalism in human history”); Hunter Lewis *Where Keynes Went Wrong* (where Keynes's views on the priority of spending in relation to savings to achieve prosperity, considers as a path to poverty; he disregards the circumstances of state of the economy for which Keynes pointed out such standpoint); Robert Higgs *Crisis & Leviathan* (varies sources of the strong state, the effect of the brakes (ratchet effect) and, of course, the dynamics of growth of the state and the lack of freedom ).

However, we start from the judgment and hope that this crisis will be a lesson to the most responsible elements of contemporary society and that they will know how to separate interests of the oligarchy from the interests of the majority. This is the starting point in choosing the government as the only qualified factor for strategic decision-making in stopping the recession or crisis. This factor also has the means to carry out its decisions in its hands. There is, therefore, the time (which should prove especially) for reaffirmation of the functions of modern state. More specifically, this process has been largely “on the fly.” “The wind of history has already changed the direction!” Whether the protagonists of the free market like it or not! Its activity the state should direct to the transformation of the capitalist system, and, above all, of the model of liberal economics. This is due to the fact that the doctrine of this model was intended by “lay out the future of modern societies by travelling back in a time-machine,” which proved to be “a flight over the cuckoo’s nest.”

The economic crisis gradually turns into the overall social crisis. In Croatia that crisis is more complex and deeper than in the European environment (with the exception of Hungary). Manoeuvring space for the adoption of appropriate measures, except restrictive ones narrowed. This is mainly due to the high degree of indebtedness of the economy (not so much of the state!). In such circumstances, state intervention must be more decisive and efficient. Any disposal of state intervention exacerbates the situation and leads to long-term recession. Without such intervention recessionary spiral will lead to unpredictable economic consequences. If neither typical liberal systems do not hesitate to take over (de facto to nationalize) the entire financial and productive systems (USA, Germany), why should Croatia (for the time being, there is still inverse course going on). Here we point out another important function of “resurrected” state or state interventionism (in conditional words): of appropriate planning system. For the moment, that activity of the state (Satanization from the ideological reasons, as a legacy of socialism) is substituted by terror of the so-called free market at the macro level and monopolization (“concernization”) on the lower level. Concentration (which is so emphasized in the EU, but in the Croatian economic space as well) means reducing the level of competitiveness and contraction of demand, due to “squeezing” of the price of labour. Processes in Croatia, in the above sense, move very slowly. Moreover, we are still witnessing discussions in the style of the liberal model “mindset” (desires for privatization and profit maximization are not yet collapsed), which exposes the problem of barriers of ideological and political nature. In such way we enter into the area of political interest (and, of course, decision-making). By this note, however, we do not want to leave an impression that nothing is changing. The use of functions of public-private partnership (PPP) radiates optimism, for example. It is obvious that the application of PPP follows the change of the contemporary socio-economic relations in capitalism i.e. in market economies and societies. In a way we go in line with the “third way” of development of modern societies. This path is marked, for example, as a form of “partnership capitalism”. In doing so, the role of the state and the market is understood in a manner that both

entities are more of use to entrepreneurship and (civil) society or the community (Giddens, 1999).

*Incentive to the restructuring of the macroeconomic system*

Another direction of transforming the capital relations should be directed toward the restructuring of the macroeconomic system. And this is the place to repeat the judgment that without suitable modifications of this system it is not possible to perform a successful fight against the recession and the crisis in general. The reason for this is clear: the recession and the crisis are consequences of fundamental disorders of the system of capitalism and free market. General causes, which swept the Croatian economy as well, are here added to the original or local causes. They are in conjunction with the causes which especially hinder the functioning of the macroeconomic system, and are the consequence of, first of all, the functioning of the state mechanism in form of number of failures (on which has already warned, for example, by public choice theory) such as: centralization, bureaucracy, corruption, excessive consumption, too large government apparatus, sale of vital economic infrastructure, etc. At the same time, sudden liberalization has led to the realization of a series of market failures: monopolistic and oligopolistic behaviour (high prices), inequality, deindustrialization etc. It has been shown in the previous phase of confrontation and crisis recession that the state must assume, first of all, responsibility and to act through the prism of the protection of national interests. Such a fundamental disturbance in the functioning of the macroeconomic system cannot be resolved by so-called cosmetic measures, but by *transformation of key leverages of the system*, which are:

- System of the free market inaugurated by the so-called stabilization program from 1993 has to be accommodated to the demands of new economic circumstances;
- It is important to accommodate the monetary system together with the CNB to the needs of national interests in development, and not to the interests of foreign capital;
- To put the banking system into the function of providing support for the needs of the Croatian economy, and not of the own (and only) profit interests of the banks;
- To make changes and adjustments in the system that will enable and encourage policy of reindustrialization and consolidation of production systems of the Croatian economy;
- To review the strategy of agricultural development (exclusion of political-interest components of policy in this field; to create the conditions for consolidation of production systems of direct agricultural manufacturers; to provide unquestionable stability of domestic food supply);
- To review the strategy of sustainable development of tourism with its components (legal norms in order to maintain the quality of sustainable development, to set measures in tourism development, to recognize advantages of becoming a EU member;

to stimulate SME and public-private partnerships, to identify negative occurrences in tourism such as terrorism, global warming, recession, crisis) (Bartoluci, 2009);

- Within the system of incorporated sector of entrepreneurship it is necessary to make such changes that will prevent the appropriation of the extra profits by the capital owners (shareholders), but will direct it to special funds of the company for the purpose of retraining employees and improving technological innovation (Gasparovic, 2003);

- To perform changes in the fiscal system, primarily within the tax system, by which the fundamental principles of taxation will consistently be respected (universality and justice);

- To carry out organizational-territorial reform of the public sector, make reorganization of the state apparatus, regionalization and decentralization and within which to strengthen the self-financing of local government units as the basis of active economic and financial policy activities of the local sector.

For the restructuring of the macroeconomic system in the above sense, it is necessary to ensure adequate means of public policy (i.e. of economic and development policy) and the instruments as well. Further in the text it is discussed what are these necessary resources.

### **Possible means of economic-financial and development policy**

Regardless of the depth of the crisis and the difficulties arising from it, we should not faint-heartedly conclude that the state does not have a proper means to counteract current socioeconomic difficulties. It is just the opposite of that! The state has a powerful potential means but that does not mean it has all the necessities. It can act by means that are at its disposal. These funds can be both subjective and discretionary in nature. The implementation will depend on the political options of government. Here is the review of the *potential resources* of economic-financial and development policy:

- Making social pact (an agreement) between the fundamental subjects of Croatian society: state-labour-capital-pensioners;

- Means of fiscal policy (laws and other regulation on changes in the tax system and tax policy);

- Strategies: the development of productive activities, industry, agriculture, construction, tourism development, socio-economic relations in the Croatian society;

- Investment activities;

- Redefined functions of the monetary policy and the CNB;

- Redefined functions of the banking system;

- Redefined the position of joint-stock companies by intervention in distribution system of profits;

- Changes in accounting standards<sup>15</sup>.

Analysis of the depth of economic and social crisis and controversies in the Croatian society reinforce the conviction about necessity of the consensus of all the fundamental components of Croatian society in order to stop the economic recession and situation of crisis and focus on the orientation of the acceleration of economic growth. These components are particularly the state, labour, capital, science and pensioners. A general social understanding of these components is essentials. For this purpose, it is necessary to make preparations for the achievement and ratification of social agreement (pact) as the basic means of regulating relations and assume liabilities for the relevant obligations and rights important for future development of society. European societies, which functioned in such a form, which is, de facto, the social model of society, even today are the most stable components of Europe and enjoy the fastest economic growth. These societies also showed very high degree of resistance to the problems of recession and crisis in general. That is well known model, above all, of the “Scandinavian societies” (Caratan, 2008).

Fiscal policy, as the most important tool of the whole antirecessionary state policy must be focused in two directions (Drezgić, 2009):

*The first direction* refers to orientation on short-term measures for the stabilization of the economy. It is necessary to identify opportunities for implementation of expansive fiscal policy, primarily in the direction of government spending and infrastructure investment with high multiplicative effects. Problems with public debt present a barrier to such policy – in form of current high repayments. It is therefore necessary to rescheduling the public debt. The growth of aggregate demand based on consumption of the population enabled by borrowing should be discouraged. It is also necessary to determine the tax and non-tax benefits to companies. Significant savings are possible within the structure of the budget.

*The second direction* should mark a radical structural reform. This course requires a longer time period, but the beginning of reform is needed immediately. Even the overcoming of the current crisis requires a radical reform that will set the Croatian economy hale and hearty. Therefore, it is necessary to radically revise the organization of the state apparatus, implement rationalization of territorial organization, and of functionality of operations of the state institutions as well.

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<sup>15</sup> Despite the unstable conditions, subject to constant changes in the system of international accounting standards, we should seek to provide international standards that enable reporting by “fair” value in order to improve consumer information. At the same time, it is necessary to abandon the practice of fragmentation of accounting standards in Croatia (example: Accounting standards for small and medium-sized enterprises) and accept the system of international standards in general, especially in segment of standardization of small and medium-sized enterprises, which constitute 99% of all Croatian companies. All the more because Croatia will experience increase of entrepreneurs and investment flows whose owners insist on the application of such standards (thanks to the opinions and suggestions of distinguished experts Stjepan Tadijančević, retired Full Professor, Faculty of Economics, University of Zagreb, and Josipa Mrša, Full Professor, Faculty of Economics University Rijeka).

Designing and drafting the strategy of development of the economy is important prerequisite for successful policy of recovery of production in the long run. The basic task of such a strategy, besides agriculture, is to make the concept of the development of manufacturing industries. For the improvement of the manufacturing sector itself it is necessary to achieve more complex tasks that present the assumption of the implementation of operational plan of the manufacturing industry:

*first* is the existence of the concept of economic relations, which would imply systematically approach to the issues of technological development and forecasting, as this way would provide answers to selection of appropriate technologies relevant to Croatia<sup>16</sup>. This question makes educational planning easier as well;

*second* is the existence of analytical base for the analysis of the manufacturing. This is a problem of lack of accurate input - output tables by which would be possible to observe the material resources expended for the production of new products and services within the sectors according the national classification of activities;

*third* is a coordination between measures that are taken even within the same economy. For example, the measures proposed by this “operational plan” in our circumstances largely relate to small and medium enterprises. These companies constitute a large part of Croatian economy, while operating plan of development of small and medium enterprises already exist. This question rests directly on the overall effectiveness of past development programs related to the manufacturing industry.

In the market economies *function of monetary-banking system and policy of the central bank* is of crucial importance. It can, as a matter of fact, turn to be the most crucial factor of economic development and growth. This was particularly shown on the example of the Croatian economy (Lasić, 2009). This means that money dictates the patterns of development (the one who manages with it!), and not the interests of society (more specifically the interests of national economy). In all of the both developed and developing economies a major role in solving the crisis and recession has the central bank or central financial institutions (Bindseil, 2004; Akerloff & Shiller; 2009). Central banks are taking measures to resolve problems or to encourage faster development of the economy.<sup>17</sup> Starting from the analysis of the condition of the economy, HNB (Croatian national Bank, henceforth, HNB)

<sup>16</sup> This primarily refers to all the industry that will enable development, application and commercialization of biotechnology and nanotechnology.

<sup>17</sup> The central banks, as well known, significantly affect on the following: (1) level of interest rates of commercial banks through the level of the central bank's discount rate; (2) the volume of money for boosting the liquidity of economic entities; (3) exchange rate policy for strengthening the competitive ability of the economy on domestic and international markets; (4) the rate of return on securities in order to cheapen the use of resources for investment and current financing.

For instance, from the appearance of the recession and the global crisis, the central monetary authorities substantially decreased discount rates: Federal Reserve (FED) - 0.25%, European Central Bank (ECB) - 1.00%, Bank of England - 0.50%; Japan Central Bank - 0.10%, Swiss National Bank - 0.25% (Source: EUROSTAT).

however, at the same time applied the discount rate of 9% ([www.hnb.hr](http://www.hnb.hr))! Since the commercial banks refer to the level of that rate of HNB in their policy of interest rates (defending foreign exchange rate) it is obvious that this is one of the causes of too high and inappropriate interest rates of Croatian commercial banks to socio-economic relations in this time of recession and crisis. When analyzing the long-term practice of HNB we can observe as follows: that the HNB did not accept enough the economic situation, and did not brought the appropriate measures to resolve problems in the economy as well; in addition, there was a lack of measures in the function of accelerated development of the Croatian economy. Therefore, together with proposing different and more active economic policy of the state, it is certainly necessary to include the HNB in scope of antirecessionary activities. HNB should be an active element in an appropriate adjustment of interest rate policy of commercial banks in the future process of antirecession activities (primarily for raising the marginal efficiency of capital in order to encourage investment). These banks use their oligopolistic position not only for profit maximization in the current economic situation, but they acquire the typical extra profits at this stage of “hunger” for the credit or illiquidity. And this happens, neither more nor less, with the support of government (guaranteeing savings deposits) and, of course, HNB policy of holding (unrealistic) stable exchange rates.

Such behaviour of banks is possible to overcome by: lax monetary policy (foreign exchange reserve base and reserve requirement of banks); by setting limits (ceilings) of interest rates of commercial banks; the direct relationship between the HNB and the company through the purchase of securities at a fixed interest rate (in order to avoid production blockade by commercial banks)(The Economist, 2008: November 1<sup>st</sup>; De Fiore, Teles, Tristani, 2009). The average weighted interest rate of Croatian commercial banks, for example, in March 2009, was at 10.25% (HNB Bulletin). That is more than in most of the countries in which monetary policy supports the function of sustainability and development of the national economy, as can be seen from the data table. Given the capabilities of the Croatian economy, interest rates should be much lower, starting from the fact of extremely high profitability of commercial banks (which would not cause the loss for their business activities). The reason for such a policy of interest rates, as it is justified, that the conditions of funding from abroad are tougher, is difficult to accept. Commercial banks in the European environment are also financed from the same source! For the purposes of providing arguments for doubt on the correctness of recent policy of interest rate of the commercial banks it is important to recall the suggestions of the theory of interest rates (Bindseil, 2004; Sharp & Alexander, 1990:5-6; Williams, 2003:1-3).

Table 2: Comparison of the level of interest rates on loans in Croatia and European environment in 2009

- in percent (%)

| Type of credit        | Croatia | EURO zone | E U  | Czech Republic | Poland | Great Britain | USA  | Japan |
|-----------------------|---------|-----------|------|----------------|--------|---------------|------|-------|
| 1                     | 2       | 3         | 4    | 5              | 6      | 7             | 8    | 9     |
| MARCH:                |         |           |      |                |        |               |      |       |
| Credits in:<br>*Kuna: |         |           |      |                |        |               |      |       |
| - Short-term          | 8.20    |           |      |                |        |               |      |       |
| - Long-term.          | 7.91    |           |      |                |        |               |      |       |
| *EUR:                 | 7.31    |           |      |                |        |               |      |       |
| <i>Weighted</i>       | 10.25   | 1.64      | 1.95 | 2.49           | 4.30   | 1.83          | 1.27 | 0.62  |
| M A Y:                | ...     | 1.28      | ...  | ...            | ...    | 1.53          | 0.82 | 0.53  |

Source: Op. cit., p. 99

We will simplify the issue by warning given by equilibrium theory of interest rates of the national economy. The theory suggests, for example, the interest rate that equals the marginal rate of return on capital. During the economic development the interest rate should rotate approximately at the level of the trend rate of growth of GDP. From these remarks it is useful to draw the appropriate conclusions for the effective change of conditions in the monetary-banking sphere of Croatian economic system. Of course, the interest rates in this crisis can not be negative, but neither should they be several times above the rate of GDP, as is the case in Croatia (regardless of the constraints imposed by balance of payments).

### Strategy of rehabilitation and stabilization of government finances

Given the complexity of economic and financial situation in Croatia, which should be aimed at restraining the recession and recovery of production in conditions of very high external debt, it is necessary to determine the appropriate strategy for rehabilitation and stabilization of the state finance and state budget. As a result of evaluation of state finance and difficulties that have to be expected in the financing, the urgency of devising strategies and determination of the strategy of financing follows. It should be based on the following framework (Sever and Drezgic, 2009):

*First*, it is inevitable to create a reasonable volume of current borrowing, but only to (direct) financial support for production (firms);

*Second*, use the mechanism of refinancing and the reprogramming of obligations under debt up to the point where the path of growth rates of GDP will recover i.e. sinusoidal trajectory will change the minus sign (-) to plus (+);

*Third*, to use the so-called “Golden rule” under which the budgetary financing will establish the balance of current funding, and eliminate net investment from the financing programs and particularly those that do not provide effects in the short term and do not have multipliers that are high enough; in that purpose lending of money is allowed;

*Fourth*, to redistribute the total mass of income by changing the tax system and taxation policy in order to balance the current financing (the balance of the operating budget)

Highlighted strategy of the state budget resource utilization has a foothold in theoretical respects, but it is verified in practice the of economic and financial policy as well. Regarding the first starting point of strategy and short-term activities of government finances nowadays there are solid methods that have been applied since the late 2008s in the whole series of countries<sup>18</sup>. One of the basic measures is directing the financial activities of the state toward direct support of production (firms). We will not engage into the presentation and analysis of these activities here. State institutions must govern the instruments of that policy.

*Refinancing of the borrowing* in principle is useful and provides relaxing financial operation for the state finances and should be (still) applied. At the same time rescheduling of obligations is not always popular or not popular at all. However, the severity of economic and financial situation dictates such an operation. Weakened capacities of the national economy today objectively require postponement of some obligations to future time in which the expected level of economic activity will be able to absorb the liabilities of the economy that are unacceptable at the moment.

Together with *the applications of “golden rule” principle* and the objective need for short-term borrowing and probable economic effects, it should be noted that such a policy of financing depends on the liquid property of the public sector as a whole, which must be on a sustainable level (not below) of 40% of GDP. Data tables illustrate trends in the current financing and at the level of total liquid property defined in the previous sense.

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<sup>18</sup> Scientific basis of such activities is given in a study: Fiscal Policy for the Crisis, which was prepared by: Antonio Spilimbergo, Steve Symansky, Olivier Blanchard, and Carlo Cottarelli, IMF Staff Position, Note, December 29, 2008, SP/08/01

Table 3: The financial savings of the consolidated central government and the total liquid assets of public sector

- current prices

- in m. HRK

| Year | Budget revenues | Budget expenditure | Total   | Non-financial assets (net) | Foreign currency reserves | Liquid property of the public sector | Share in BDP = 100 |
|------|-----------------|--------------------|---------|----------------------------|---------------------------|--------------------------------------|--------------------|
| 1    | 2               | 3                  | 4       | 5                          | 6                         | 7 (2 + 6)                            | 8                  |
| 2000 | 66,735          | 74,432             | - 7,697 | - 229                      | 28,410                    | 95,145                               | 53.8               |
| 2001 | 70,846          | 74,889             | - 4,044 | 693                        | 39,312                    | 110,158                              | 57.7               |
| 2002 | 75,074          | 75,448             | - 384   | 6,129                      | 42,043                    | 117,117                              | 56.2               |
| 2003 | 80,787          | 80,715             | 71      | 7,996                      | 50,138                    | 130,925                              | 57.7               |
| 2004 | 87,019          | 86,941             | 78      | 8,374                      | 49,364                    | 136,383                              | 55.3               |
| 2005 | 92,642          | 92,332             | 310     | 6,699                      | 54,892                    | 147,534                              | 55.8               |
| 2006 | 100,392         | 98,751             | 1,641   | 6,109                      | 64,129                    | 164,521                              | 57.5               |
| 2007 | 113,386         | 109,075            | 4,311   | 7,811                      | 8,220                     | 181,606                              | 57.8               |
| 2008 | 109,530         | 103,817            | .712    | 3,059                      | 6,766                     | 176,296                              | 51.5               |

Source: Op. cit., p. 111

At the end of the 2008 the ratio of liquid assets and GDP was satisfactory. However, this relationship obviously deteriorates over the past months of 2009. These tendencies intensify the problems of budget operations and jeopardize debt capacity, rating of the public sector and the economy as a whole. Relaxation of the state finances must be followed by the application of the above-mentioned policy of “golden rule”. All investments that are not essential for short-term effect on production and do not rise the aggregate supply should cease. That refers especially to those that have low multiplicative effects (Zandi, 2009)<sup>19</sup>.

Implementation of rehabilitation and stabilization of public finance (budget) is possible only by (necessary) reallocation of the total mass of the created income. Croatian Constitution defines the Republic of Croatia as a social society. Does Croatian society come close to such a goal?<sup>20</sup> Arguments for that solution (income

<sup>19</sup> It is necessary to provide certain explanation of such evaluation i.e. proposition. Multiplicative effect of investment in infrastructure facilities (especially those traditional or capital ones) is great. Thus, for example, it is predicted that multiplier of investment in infrastructure equals 1.59 (one dollar of investment is expected to make \$1.5 increments of GDP) in the “package” of investment for the recovery of the U.S. economy. However, investments in infrastructure (which in general refer to long term period) engage a great mass of money that is necessary for the short-term financial support to production. It is important to acknowledge this fact in creating the policy of battle against the recession.

<sup>20</sup> If 800 to 900 thousand members of the society have an opportunity to claim only 9-10% of the total (gross) mass of the income, than such a society is far away from such social goals.

redistribution) are located in the relations of distribution of the total mass of income. Data in the table illustrate these relationships the, and figure provides visual explanation.

Table 4: Relations in the distribution of income by groups of income holders in thirds by the period 2000 - 2007

- in percent (%)

| Thirds of income holders | 2000. |       | 2001. |       | 2002. |       | 2003. |       | 2004. |       | 2005. |       | 2006. |       | 2007. |       |
|--------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
|                          | gross | net   |
| I.                       | 9.2   | 11.4  | 10.2  | 12.3  | 9.9   | 12.0  | 9.7   | 11.8  | 9.9   | 12.0  | 10.6  | 12.8  | 10.2  | 12.4  | 10.5  | 12.8  |
| II.                      | 23.3  | 25.8  | 24.4  | 26.7  | 24.5  | 26.8  | 24.1  | 26.4  | 24.3  | 26.8  | 24.8  | 27.2  | 24.7  | 27.2  | 24.5  | 27.0  |
| III.                     | 67.5  | 62.8  | 65.4  | 61.1  | 65.6  | 61.1  | 66.2  | 61.7  | 65.8  | 61.2  | 64.7  | 60.1  | 65.1  | 60.4  | 65.0  | 60.2  |
| Total                    | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

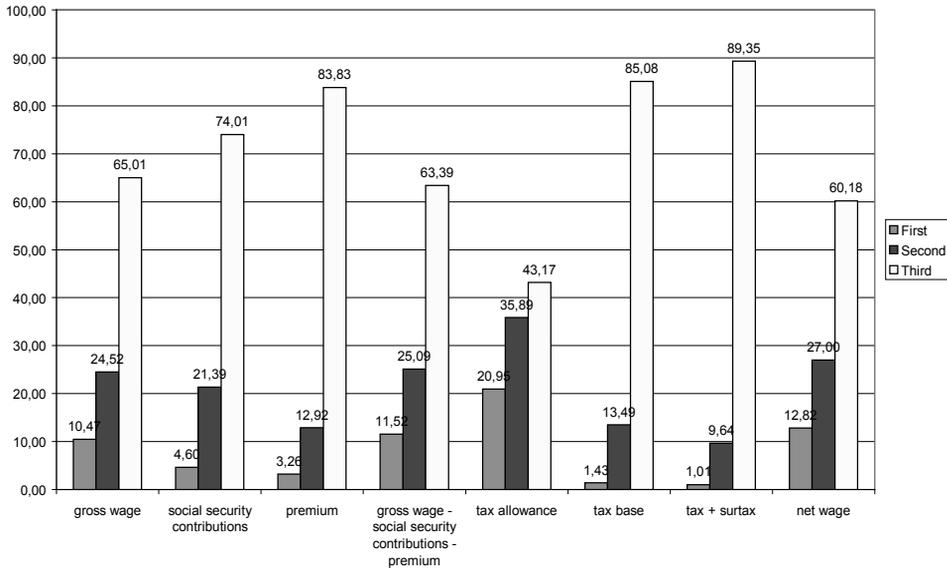
Note: Gross income includes taxes, contributions and surtaxes.

Source: Op. cit., p. 112

Relative relations in distribution of income among thirds of income groups show essentially the stability in the distribution of both the gross (included commitments), and of net income (after taxes paid, contributions, etc.). Thus, the paid liabilities (by the richest part of society) do not significantly disturb the relations in the distribution of income. However, due to the correctness it is important to look in more detail in the structure of payment obligations under income-thirds. Figure visually illustrates the relations imposed by burden. Global net distribution of income in certain extent changes by capital incomes (dividends, interest and capital gains), which in our tax system are not taxable, and by income redistribution through the instruments of social policy. Distortion of the basic relations obtained in this way is not subjected to discussion. From these relationships, however, we derive some other very important conclusions. Thus, since the income distribution is a function of factors of production (capital, labour costs and, therefore, wages and rents), it follows that the relations among these factors did not virtually changed a bit in the previous period of functioning of the capital-system in the Croatian economy. On the contrary, it was insisted on the expansion and strengthening the platform of capital-relations at the expense of labour costs (there is a whole range of evidence, and this recession just reinforces that even more). Distribution of income in the Croatian economic system is suitable to typical liberal social models and not to the models (left) of social societies in Europe.

The question is why that is the case? Response, however, should be found in the ideological and doctrinal commitments or policies of the ruling social structure. And that is beyond of discussion of this scientific discourse. It follows, therefore, that the

Figure 4: Distribution of income and tax burden by thirds in 2007



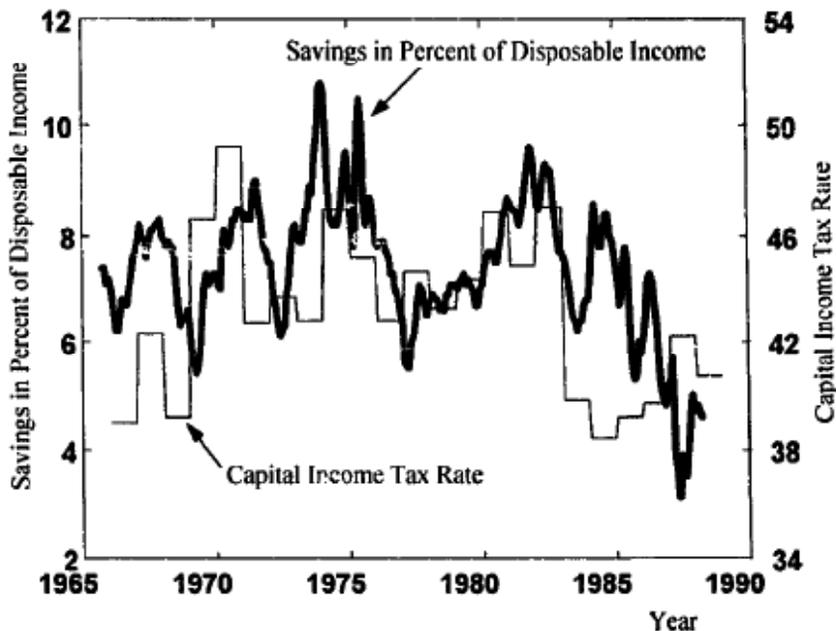
Note: income = gross income minus contributions; gross income includes taxes, contributions and additional tax.

Source: Op. cit. p. 114

redistribution of the mass of income in function of recovery and stabilization of the current financing by mediation of state budget, it is necessary to perform changes of the tax system and taxation policies and do this by combination of property taxes, income from capital and the extra profits. Dividends, shares in profits, interest from capital and other stock speculation, speculation in real estate property taxes, etc. - in the Croatian tax system, these categories are generally not taxable. In this respect, the principles of the theory, and even more of current economic-fiscal policy which is that in depression-recession phase of economic activity, entrepreneurship is not burdened with new fiscal responsibilities. At the same time, however, fiscal relaxation of labour factor is necessary in order to protect savings and ensure economic growth.

Compensation for reduced revenues is provided by taxation of capital incomes (which are not taxable at the moment). New research has in fact proved that there is no need to fear of taxation of capital income from the standpoint of endangering savings and economic growth (as is often pointed out as contra argument) (Uhlig & Janagawa, 1996). This tax does not jeopardize savings! But under the right conditions: relaxation of labour income taxation! The Figure 5 illustrates the relationships between rates (personal) of savings and the income tax rates on capital in the USA (so far the only published study of this kind).

Figure 5: Relationship of savings and tax rate on income from capital in the USA



Source: Op. cit., p. 124

It is very easy to visually observe a good harmony of movement and dynamics of the path of savings and tax rate. Obviously this is not controversial (at least in terms of fiscal and financial system of the SAD). It is important, however, to compare and to face with a level of burden of labour income in the Croatian fiscal system. We will substantiate that “level” with credible facts. That is emphasized in the table 5.

It is possible to conclude that it is not a problem in the taxation of income from capital, but in the fiscal burden of labour. That burden blocks the swing of savings as well. Therefore, a relaxation of labour from fiscal obligations opens a wide space for taxation of various income taxes on capital and compensation for the lost budget revenues. In scientific terms that is certainly clear. Decisions have to be made by politics. It is important to mention the following. Although previous judgements and claims remain, it should be noted that there are other possible different solutions in the tax system and taxation policy. To be scientifically correct, it should be said that these positions are of relative importance. Because within the tax system it is possible to include tax on extra profits as much more efficient solution than from the capital gains taxation. Solutions in the field of property taxation can automatically eliminate part of the taxation of capital gains that relate to the real estates.

Table 5: Comparison of the labour costs of OECD, EU and Croatia

- in percent (%)

| Association/<br>Country      | Personal<br>income tax in<br>gross wage | Contributions<br>of employees in<br>gross wage | Personal income tax<br>and contributions of<br>employees in gross<br>wage | Personal income tax<br>and contributions of<br>employees and employers<br>in labour force costs |
|------------------------------|---|--|---|---|
| 1                            | 2                                       | 3  | 4   | 5   |
| OECD                         | 15,9                                    | 10,7   | 26,6  | 37,7  |
| EU-15                        | 20,0                                    | 11,4   | 29,5  | 39,3  |
| EU-19                        | 16,8                                    | 12,5   | 29,3  | 42,6  |
| Croatia                      | 10,0                                    | 20,0   | 30,0  | 40,3  |
| Croatia<br>(VII - IX. 2008.) | 9,34                                    | 20,0   | 29,3  | 39,7  |

Source: Op. cit., p. 125

Finally, it is logical to conclude that thorough reform of the tax system of the Republic of Croatia is necessary and has to proceed without delay. Theoretically speaking, the decision makers allocated the burden of financing public expenditures from direct (asset and income) to indirect sources of taxation (consumption). Data in table 6 illustrates this allocation. Therefore, at this point of efforts to repair and stabilize state finances we suggest intervention in the field of taxation of property and capital gains. With the absence of taxation of income from capital, lack of principles in the taxation of property and capital gains are logical reasons for the imbalance in the distribution of total income. The fact is that the Croatian tax system burdens more indirect fiscal resources (consumption: VAT), and relaxes direct ones as the allocation of collected tax revenue shows (table).

Table 6: Relative allocation of collected budget revenues - structure

- in percent (%)

| Collected Revenues               | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   | 2008   |
|----------------------------------|--------|--------|--------|--------|--------|--------|--------|
|                                  | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| Personal Income Tax              | 8.72   | 8.06   | 8.05   | 7.59   | 7.85   | 7.84   | 7.99   |
| Corporate Profit Tax             | 4.48   | 4.83   | 4.56   | 5.40   | 6.38   | 6.96   | 7.84   |
| Property Taxes                   | 0.75   | 0.68   | 0.76   | 0.74   | 0.86   | 0.91   | 0.91   |
| Value Added Tax                  | 31.31  | 31.49  | 30.97  | 31.27  | 31.11  | 29.79  | 30.66  |
| Excises                          | 11.86  | 11.74  | 11.02  | 10.61  | 10.30  | 9.60   | 8.81   |
| Social Security<br>Contributions | 30.40  | 30.71  | 30.57  | 30.36  | 30.17  | 29.36  | 30.21  |

Source: Op. cit, p. 117

Population is particularly taxed by tax and surtax paid by taxpayers “out of and on salary”. This system, therefore, protects members of society who control the largest mass of income and value of assets and wealth. Or in other words, the tax system relaxes capital and holders of larger part of the mass of income in submitting proportional burden in financing of public expenses, which is contrary to one of the fundamental principles of taxation that one must bear the burden fairly to his economic strength. Such a functioning of the tax system, i.e. in general terms the system of income distribution, generates unacceptable social differences in the Croatian society and destabilizes the overall social and economic system.

### **Instruments of economic-financial and development policy**

Starting from the completed analysis and determined strategies, further in the text we will highlight set of selected instruments and measures of economic, monetary, fiscal and development policy. This selection certainly does not contain all the necessary measures to combat the recession, but only certain instruments and measures classified into two basic groups:

#### *Economic-monetary and development policy:*

- Introduce *flexible exchange rates of euro and U.S. dollar* in order to achieve gradual reduction of imports, rise of insufficient exports and to stop further growth of foreign indebtedness.
- CNB should take the *following measures*: to lower the discount rate to the level of the rate set by ECB; to gradually synchronize Euro exchange rate with the movement of the index of retail prices; to lower the rate of return on securities on the level of the rates applied by the ECB; through HBOR and HPB place funds to companies that have more pronounced problems with liquidity.
- To adopt a special *law on debt* for each program of spending (as is usual in some other countries).
- Adopt simultaneous measures to *synchronize all the accompanying consequences* that could occur by introducing flexible exchange rate, as some states have successfully resolved long time ago (i.e., the Republic of Slovenia).
- *Establish a national bank with an investment function*, due to the long period of lack of investments in Croatian manufacturing sector, as well as because the fact that the current foreign-owned banks are not inclined to finance the development of Croatian economy.<sup>21</sup>

<sup>21</sup> Germany is taken as an example of different levels of government shares in the assets of banking system over 40% within the period before the crisis ( Compare: The Economist, October 3<sup>rd</sup> 2009, A special report on the world economy, p.20).Just for this fact the banking system of the Germany has been stable in the course of the serious economic crisis as the one in the 1990s.

- In relation to the functioning of capital markets: to include the pension funds in purchase of bonds and commercial securities of the companies in order to compensate for the lack of credit money. For a long time Croatian pension system will not have significant repayments and therefore that can be allowed; more power and strengthening of the HBOR is necessary in order to directly credit, secure and provide guarantees to the Croatian manufacturing sector; to suspend the latest Law on securities, restore public joint stock companies, enable a wider scope of investment for investment and pension funds; Zagreb Stock Exchange needs to increase its demands for transparency and to implement obligation of publication of quarterly financial results for all companies on the stock market regardless of the stock exchange listing; freezing of MIFID-A13<sup>22</sup> (as he is designed to reduce the number of competitors in the market of financial intermediaries, and thus allows the monopoly of banks, which ultimately increases the cost of trading and reduces the financial mass on the market).

- *Stop any attempts of privatization* of large systems, banks and companies (the task of the central government, regional and local levels of government). It is important to direct capital to engage in entrepreneurship, investing and establishing a new business, banks, financial institutions and more. That particularly refers to the attempts of alienation of national systems, such as the Croatian Electric Power Industry, Croatian Forests, Croatia Insurance, Croatian Roads, Croatian Highways, shipyards, etc.

- *Measures to restrain imports of goods and services* (with the change of exchange rate policy). Many states have threatened to Croatia because of potential attempts to regulate the imports, because Croatia upsets the principles of free trade, and these countries were the first ones that during the recession and the crisis brought drastic measures to protect their production. It is obvious that Croatia must take all possible means and measures to protect the domestic industrial and agricultural production.

- Regenerate former *large companies*, because they have building permits, built infrastructure and the memory of domestic and foreign customers of the former high-quality of their products;

- To include *extra profits of corporations to special funds* and in that way prevent their transfer for the benefit of shareholders;

<sup>22</sup> MIFID - Markets in Financial Instruments Directive represents the law of the European Union which aims the harmonization of regulations in the 30 member countries of the European Economic Area (27 EU member states plus Iceland, Norway and Liechtenstein). The main objectives of the directive should be to increase competition and consumer protection in the financial sector. Although it was expected that MiFID will increase price transparency, due to the fragmentation of markets and trading platforms that this directive imposes, the opposite effect was accomplished. While earlier every investor could see all the information related to the price of a particular financial instrument from the only one stock market now he needs to collect information from many multilateral trading platforms, the system internalizers and other stock markets in the European Economic Area. This makes the whole process of trading a lot more expensive, less transparent and opens space for market manipulation by market makers.

- Prevent further “privatization” of companies and banks (the majority of privatization has turned to a real estate sales and abandonment of the original activity).

- Adopt *effective measures* to ensure that money which was transferred abroad is returned. One of the causes of chronic insolvency of the entire Croatian economic and social system is in drawing huge piles of money from Croatia.

*Budget financing and tax system:*

Regarding the antirecessionary effects of the budget, it is important to highlight several aspects and objectives of the measures themselves. Within revenue and expenditure sides one should pay attention to short-term and long-term effects, but also to those of economic, fiscal and social features. At the outset it is therefore important to give a description of usage of budget resources. Allocation of expenditures by the criterion of economic and functional classification provides insight into the features of this usage.

We recall to the fact that the main sources of budget revenues are taxes on consumption (VAT and excise duties, as previously stated). A significant share of revenues belongs to social security contributions. Such revenue structure provides clear answers on the nature of their effects. All of the above revenues are abundant. However, they exert strong regressive effects.

Table 7: Functional allocation of the state budget expenditure - relative structure in the period 2002 - 2008

- in percent (%)

|                               | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   | 2008   |
|-------------------------------|--------|--------|--------|--------|--------|--------|--------|
| <i>Total Expenditures</i>     | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| Compensation To Employees     | 27.28  | 27.57  | 27.05  | 26.54  | 26.19  | 26.20  | 25.81  |
| Goods And Services            | 12.02  | 10.88  | 10.27  | 10.82  | 12.35  | 12.79  | 12.72  |
| Interests:                    | 4.63   | 4.63   | 4.69   | 5.08   | 5.08   | 4.68   | 3.86   |
| - Foreign                     | 2.37   | 2.37   | 2.33   | 2.39   | 2.22   | 1.88   | 1.22   |
| - Domestic                    | 2.26   | 2.25   | 2.36   | 2.69   | 2.85   | 2.79   | 2.65   |
| Incentives:                   | 5.10   | 5.63   | 6.04   | 5.97   | 6.09   | 6.32   | 6.24   |
| - Public Sector               | 2.69   | 2.88   | 3.63   | 3.42   | 3.16   | 3.19   | 3.23   |
| - Private Sector              | 2.41   | 2.75   | 2.41   | 2.55   | 2.93   | 3.13   | 3.01   |
| Donations                     | 0.66   | 0.64   | 1.07   | 1.38   | 1.36   | 1.43   | 1.77   |
| Social Security Compensations | 44.43  | 43.82  | 43.51  | 42.25  | 41.61  | 41.03  | 40.90  |
| Other Expenditures            | 5.89   | 6.84   | 7.38   | 7.95   | 7.32   | 7.55   | 8.70   |
| Capital                       | 2.74   | 2.19   | 4.04   | 4.21   | 3.94   | 3.92   | 5.13   |

Source: Op. cit., p. 129

Table 8: Economic allocation of the budget - relative structure in the period 2002 - 2007

- in percent (%)

|  | 2002         | 2003         | 2004         | 2005         | 2006         | 2007         |
|--|--------------|--------------|--------------|--------------|--------------|--------------|
| <i>Total Expenditures</i>                      | <i>100.0</i> | <i>100.0</i> | <i>100.0</i> | <i>100.0</i> | <i>100.0</i> | <i>100.0</i> |
| General Public Services                        | 9.9          | 10.4         | 10.6         | 11.4         | 11.1         | 10.7         |
| Defense  | 5.9          | 5.2          | 4.4          | 4.0          | 4.1          | 4.1          |
| Public Order And Safety                        | 6.5          | 6.5          | 6.5          | 6.5          | 6.4          | 6.6          |
| Economic                                       | 7.7          | 8.4          | 9.3          | 9.4          | 12.4         | 13.9         |
| Envinromental Protection                       | 0.4          | 0.4          | 0.3          | 0.2          | 0.3          | 0.3          |
| Services Of Housing And Community Improvements | 1.9          | 2.3          | 3.0          | 3.2          | 2.5          | 2.2          |
| Health Services                                | 14.4         | 14.7         | 15.0         | 14.4         | 14.4         | 15.2         |
| Recreation, Culture And Religion               | 1.3          | 1.4          | 1.5          | 1.5          | 1.5          | 1.6          |
| Education                                      | 8.5          | 8.6          | 8.5          | 8.5          | 8.4          | 8.4          |
| Social Protection                              | 43.4         | 42.2         | 41.1         | 40.9         | 38.8         | 37.1         |

Source: Op. cit., p. 129

Budget expenditures have a feature of so-called inertial consumption. However, increase of state activity within the field of economic activity is clear, which relates primarily to increased investment. At the same time, it can be seen that the financing of education, as a function related to basics of long-term economic growth, was not increased in relative terms. This raises the question of justification of such a high investment activity particularly from the standpoint of strategy of antirecessionary policy and in very complex circumstances of financing of rigid current programs. Another question follows: the justification of performing a large part of the investment program, because at the state level, as far as we know, there is no program of capital planning being implemented and there is no prioritization of investment with respect to economic effects. At this stage of recession counteracting this is of crucial importance. It follows that in the structure of budget expenditures it is still possible to make a number of savings and increase the effectiveness of their use. Finally, the result of the overall budget activity is pro-cyclical orientation of revenue structure, serious social consequences of action of the fiscal system, encouraging savings in speculative purposes, uncertain economic effects of both short and long term character. Based on these remarks, proposed instruments and measures of the implementation of previous strategy are as follows:

(1) *Short-term:*

- It is important to urgently suspend investment in new infrastructure projects in the foreseeable future (investing in big infrastructure should be continued only in case of those projects where that is necessary in order to ensure rationality of closure of the construction site);

- Correction in the field of income taxation; even though richer income groups pay the most of the amount of income taxes, it is necessary to further unload much of the population with low level of income;
- Social security contributions create high burden of income from work and have regressive effect; therefore it is also possible to introduce progressive rates (in the first pillar);
- Introduce taxation of extra-profits; this measure has short and long term character<sup>23</sup>;
- Reallocation of budgetary expenditures; the analysis of all state expenditures and their rank according to their economic effects (multipliers) must be conducted. In particular, this applies to government infrastructure projects that are still very extensive;
- Government debt is not too high; the problem related to government debt is in inappropriate policy of public debt management; it is possible to reprogram debt payments in a way to ease the current illiquidity of the public sector; attention should be focused on spending financed by deficit sources (can not be used for current financing at this stage of anti-recession efforts).
- To start preparations for a thorough reform of the tax system; that activity has short, but long-term characteristics as well. It is necessary to provide a thorough discussion and preparation of project of the reform.

## *(2) Long-term*

These previously stated measures that have a short-term action have long-term effects as well. Corrections related to taxes are primarily related to the social effects - facilitating position of lower income groups. However, the unloading of the tax burden on the labour factor can have positive effects on aggregate supply in the long term. The reallocation of budgetary expenditures according to a higher level of efficiency has particularly important long-term effects.

- To make additional investments in education; the modern theory of economic growth suggests that the interaction of educated population and economic activity leads to higher rates of economic growth in the long term.

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<sup>23</sup> Extra-profits are defined as the case where the return on investment is much higher than “normal” return on a market. The term “normal” usually denotes an average rate of return depending on the activity. It is interesting that in Croatia during the great global crisis many companies achieve very high profits, while at the same time in developed countries some corporations that achieve minimum rates of return are well respected. In Croatia that particularly refers to banks. One conclusion might be that these companies realize the benefits of monopoly or oligopoly advantage. And it is clear what that means for the economy as a whole. In addition, banks are powerful enough that, despite this situation, expose clear threats to the state by increases in interest rates (even despite the expansionary measures of monetary policy). The question is what interest has the state to allow achievement of such high (and harmful) rates of return?

- Increase the role of property taxation in the tax system; the effects of this measure are also predominantly social; assets and income from capital are almost entirely outside of control of the fiscal system (as was indicated earlier in analysis), which opens the possibility for higher income groups to reallocate its resources towards more capital and thus avoid paying taxes.
- Taxation of income from capital (solution in this regard would not give substantial fiscal effects, but it is necessary in the long term perspective).<sup>24</sup>
- A comprehensive reform of the public sector and territorial reform is required (the rational model that takes into account economic and social factors, and not political ones) as an assumption of implementation of successful decentralization.

## 6. Final remarks

By the preliminary analysis and presentation of the research results, we tried to substantiate a working assumption (hypothesis) *that it is possible to stop the recession of the Croatian economy and stimulate economic activity towards growth, as a strategic goal, but under certain conditions*, which are distinguished and analyzed.

Due to the fact that here the entire framework of antirecessionary economic policy is addressed the creation of certain conditions is essential for the achievement of this assumption. Starting from the assessment that Croatian economic crisis was partly consequence of external factors such as declining marginal efficiency of capital (MAC), insufficient demand, the privileged status of the dollar and its dual use, universal inevitability of transformation of the modern capitalist system is proved. Otherwise, repair of the financial system can only be a temporary measure and achieve only short-term goals.

In terms of evaluation of the causes of recession and crisis of the Croatian economy, it was found that the main problem for Croatian society and economy is not a global recession. Over-indebtedness of the state and of economic entities, which disturbs all economic balances, is the fundamental problem. It is a consequence of application of the so-called stabilization program of 1993, which was based on the neoliberal model of economic policy that is, above all, “monetarist”. On this basis, the policy

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<sup>24</sup> Note that private capital that was accumulated in Croatia, in principle was not directed at the real investment but had speculative purposes only, and therefore, potentially had even negative effects, because the financial market had the purpose in itself (and not transmission of routing savings in the real sector); negative effects are possible in case that the part of the capital that would otherwise be invested in real investments was used for speculative purposes, i.e. to achieve the return on the capital market as was evidenced by a mass phenomenon of borrowing by citizens used for trading on the stock exchange; in addition, income from capital of non-residents that are not taxed in Croatia, shall be taxed in domicile countries thus Croatia provides donation for the fiscal systems of other countries and tax savings for the investor do not exist.

of unrealistic exchange rate of stable domestic currency was carried on. Croatian monetary authority manipulates by the expansion and contraction to maintain the fixed exchange rate, and by that keeps the inflation at the default level as well. Sterilization or relaxation of the rate of compulsory reserves holds the exchange rate at a particular level and interest rates are randomly formed by this process... This eliminates the growth of GDP as a target variable on the basis of possible depreciation, as well as possible lower interest rates on the domestic market. It follows, therefore, that, theoretically speaking, neither monetary policy can be used as an instrument for stimulating growth and reviving the economy in our circumstances, which is too important need of Croatian society. At the same time, such a policy is now a unique case of antirecessionary activity. Therefore, recent policy is very limited as an instrument of recovery and stimulating the growth of production and employment. The fundamental need is in fact completely left to spontaneity of action of external factors, which is otherwise characteristic of our development policy over the past decade and a half. On the other hand, the blockade of the production came from the commercial banking system.

The research suggests that for the prevalence of the propounded problems in the Croatian economy it is necessary to determine the appropriate strategy for socio-economic development. That strategy can be implemented by provisions of (new) economic policy with the configuration of the contents and instruments and measures mentioned in the text before.

Highlighted problems and limitations of the antirecession and active economic policy, require that further research focuses not only in the area of economic system, but in the overall social and economic system. The aim is to scientifically investigate and determine the basic conditions to overcome the obstruction of objectively necessary solutions. Surely, from the politico-economic point of view, that implies overcoming the limitations of liberal-monetarist socio-economic model of management of socio-economic system. And that means consistently and to the end. Also, for the purposes of scientific correctness and reliability it is necessary to execute the simulation model of the overall program in order to determine the effects of individual solutions.

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## Polazišta nove ekonomske politike u uvjetima recesije<sup>1</sup>

*Ivo Sever i suradnici<sup>2</sup>*

### **Sažetak**

*Svrha je ovog istraživanja predložiti teorijsku i programsku podlogu novoj ekonomskoj politici radi prevladavanja recesije i oporavka proizvodnje u hrvatskom gospodarstvu. Također, cilj je pokazati da rezultati ove studije daju ekonomskoj politici mogućnost usmjeravanja konzistentnom i izravnom odgovoru na važna pitanja u razrješavanju nepovoljnog aktualnog stanja u hrvatskoj ekonomiji, ali i pitanja, koja su dugoročne naravi. Do istaknutih ciljeva dolazi se znanstvenom metodom analize prisposobljenoj aktivnosti ekonomske politike i zasada suvremene teorije od kojih ona polazi, osobito njezinog fiskalnog i monetarnog sadržaja te njihovog suvremenog pragmatizma. Rezultati istraživanja pokazali su da su uzroci recesije i ekonomske krize u Hrvatskoj samo dijelom vanjskog podrijetla, ali su prevalentni oni domaće provenijencije. Među potonjim temeljni je uzrok primjena tzv. "stabilizacijskog programa" od 1993.g, a osobito politika nerealnog i stabilnog tečaja domaće valute. Glavni je zaključak istraživanja da je neophodno napustiti ekonomsku politiku neoliberalizma, a u tom okviru njezin monetaristički sadržaj (politiku sidra). Bez napuštanja te politike nije moguće zaustaviti recesiju i proizvodnju usmjeriti prema oporavku.*

**Ključne riječi:** *recesija, cilj, ekonomska politika, sredstva ekonomske politike, državne financije, instrumenti i mjere*

**JEL klasifikacija:** *E02, E21, E22, E23, E24, E31, E50, E62, G01, H0*

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