Revising the budget in Croatia: yes, but … for whom and why?

By Sandrine Levasseur

Under the excessive deficit procedure that Croatia has been subject to since 28 January 2014, the country's government has been obliged to revise its projected budget for the forthcoming three years, which is the timeframe that has been set for putting its finances into "good order", with "good order" being understood to mean a public deficit that does not exceed 3% of GDP. This new budget is being fixed in adverse economic conditions, as the government's forecast of GDP growth for 2014 has been revised downward from 1.3% to a tiny 0.2%.

Paradoxically, the new budget could help prolong the recession in the country rather than help it recover, at least in 2014. This paradox is especially worth noting since this is also the opinion of those for whom the Croatian government is making this adjustment: first of all, the rating agencies, and second, the international institutions (or at least the IMF, as the European Commission has to keep quiet on the matter). In fact, a simple glance at the revised budget is enough to see that the fiscal adjustment being proposed by the Croatian government will not have an expansionary impact on GDP. For example, the budget provides for a hike in tax revenues, in particular through an increase in the rate of health insurance contributions from 13% to 15%.But this will also result in undermining the international competitiveness of the country's businesses, which have already been hit hard.

The wages and bonuses of civil servants will fall (by about 6%) so as to give the public finances some breathing room. But these cuts in civil servant salaries will not help perk up domestic demand, which has been anaemic due to the adjustments consumers and businesses have made in their balance sheets. To take the latest example, to help bail out the state finances the profits of state enterprises will not be reinvested in the economy. However, the country is thereby depriving itself of a source of growth since, because of their weight in the economy, these enterprises account for a large share of productive investment.

There is no doubt that Croatia's public finances need to be cleaned up. However, the horizon for the fiscal consolidation decided on by the Croatian government seems to us extremely "short-termist", as it doesn't call into question the existing model of growth or seek sources of sustainable growth. A few weeks ago, in an OFCE note we discussed the impact alternative fiscal adjustments would have on growth and the public finances. In the specific case of Croatia, the government cannot avoid the need to consider doing the following: restructuring the productive apparatus (including through privatization and concessions); improving the system of tax collection; and, more broadly, implementing an anti-corruption policy to improve the country's "business climate". In the meantime, in large part due to the fiscal decisions being taken, 2014 is likely to wind up as the sixth year in a row Croatia has been in recession. The IMF forecasts, which anticipate that the recessionary impact of the fiscal consolidation will be greater than that projected by the Croatian government, is expecting GDP to fall by about 0.5% to 1% in 2014. In total, the decline in GDP since 2009 will therefore come to between 11.6% and 12.5%. It's not exactly the stuff of dreams….

Croatia under the Excessive Deficit Procedure: which measures should be implemented?

By Sandrine Levasseur

How to put public finances on a good track when (almost) all measures regarding spending cuts and tax increases have been already exhausted? Croatia's government has been seeking to solve this tricky problem since mid-November when an excessive deficit procedure (EDP) was launched against the country. Let us explain what an EDP means: the public deficit of Croatia currently exceeds 3% of GDP; the breach is neither exceptional nor temporary; consequently, the government of Croatia has to curb its public deficit in a lasting way.

On 28 January 2014, the EU Council will propose (1) the time limits within which Croatia must reduce its deficit below 3% of GDP and (2) the average annual amounts of deficit reduction during the period. Yet, (3) the EU council will invite *formally* the government of Croatia to propose concrete measures towards reducing the deficit-to-GDP ratio below 3%.

The problem facing the government of Croatia is not straightforward since the proposed measures should not further depress the economy. Currently, only modest signs of recovery are in sight in Croatia, and its unemployment rate stands at a high level (16.5%). The country is among the poorest EU members: its GDP per capita is 62% of that of the EU-28.

Briefing Paper n° 6 aims at proposing a list of measures that an EU country under EDP such as Croatia could envisage. For each measure, we present the main arguments “in favor of” it and “against” it in general terms. Then, we discuss the relevance of every measure for Croatia. Note that our list of measures is suitable for both advanced and less advanced EU countries. More generally, our list could be used for any country facing public finance problems and looking for solutions.

Three measures (out of seven) seem to us particularly relevant in the case of Croatia:

– the use of service concession contracts;

– the privatization of some state-owned enterprises;

– the improvement of tax collection and compliance.

The first two measures are related to the need to restructure state-owned enterprises that are inefficient due to poor management. In particular, state-owned enterprises which are neither natural monopolies nor of strategic importance (*i.e.* in the tourism and agriculture sectors) should be privatized. Privatization of other state-owned enterprises should be envisaged more carefully, but not excluded. Croatia is the first country to join the EU with such a high share of state-owned enterprises (25%), and the slow pace of privatization has hindered growth. More privatizations will result in (long-run) gains even if causing (short-run) pains, in particular layoffs among the workforce. Service concession contracts are another way of restructuring the state-owned sectors. The impact on public finances is different, though. Services concession contracts provide a regular source of revenues for the government (through receipts of concession fees) and/or of savings (through lower payments of government subsidies). By contrast, immediate and potentially large amounts of cash can be obtained from the proceeds of privatization.

Recommending a restructuring of state-owned enterprises in

Croatia is not a novelty. The International Monetary Fund, the World Bank and the European Commission have repeatedly stated that the pace of privatization or service concessions should be accelerated to raise the efficiency of the economy. Currently, the government of Croatia is actively engaged in accelerating such a process, in particular for service concessions. A few recent concessions include Zagreb's airport and Rijeka's port, while motorways and Brijuni's island have also been proposed to bidders.

Croatia's citizens do not always support the restructuring process. To obtain greater public acceptance of privatization and service concessions, communication should be improved and intensified. In particular, the budgetary authorities should explain *what* they are doing, *why* they are doing it, and what the long-run benefits of their actions will be. Otherwise, the restructuring of state-owned enterprises will be perceived as a gift to the private sector. Last but not least, the process of privatization and service concessions should be more controlled to prevent misguided choices, abuse or conflicts of interest. That also means fighting corruption.

The improvement of tax collection is the third measure that we advocate to curb Croatia's public deficit. According to the Institute of Public Finance, the cumulated uncollected tax revenues in Croatia would amount to HRK 40bn, which represents more than twice the projected public deficit for 2014 (HRK 19.3bn). Should the government be capable of collecting at least a portion, it would give a little breathing room to the public finances. In Croatia, increasing the tax collection means several interrelated things: fighting the grey economy (since unreported incomes are untaxed incomes) and prosecuting tax fraud (otherwise, rules and procedures are useless). Again, tighter control means fighting corruption.

By contrast, other measures such as wage cuts in the public sector or low corporate tax rates do not appear suitable to put the public finances of Croatia on track.

Further details can be found at http://www.ofce.sciences-po.fr/pdf/briefings/2014/briefing6.pdf .

Croatia in the European Union: an entry without fanfare

By Céline Antonin and Sandrine Levasseur

On 1 July 2013, ten years after filing its application to join the European Union, Croatia will officially become the 28th member state of the EU and the second member country from former Yugoslavia. Given the country's size (0.33% of the GDP of the EU-28) and the political consensus on its membership, Croatia's accession should pass relatively unnoticed. However, there are challenges posed by its entry. Indeed, at a time when the European Union is going through the worst crisis in its history, legitimate questions can be raised about whether Croatia is joining prematurely, particularly as it is experiencing its fifth successive year of recession. The latest OFCE Note (no. 27, 26 June 2013) reviews two of the country's main weaknesses: first, a lack of competitiveness, and second, a level of corruption that is still far too high to guarantee steady and sustainable growth.

With 4.3 million inhabitants, Croatia initially experienced a period of strong economic growth up to 2008, based on the strength of its tourist industry and on consumption that was largely underpinned by lending from foreign capital. The crisis revealed, yet again, the limitations of this development model and highlighted the country's structural weaknesses: a high level of dependence on foreign capital, the vulnerability of a system of (quasi) fixed exchange rates, an unfavourable environment for investment and wide-scale tax evasion.

Even though negotiations thankfully addressed some of these problems, others are still unresolved. For instance, with respect to the economy, the domestic market is still not open enough to competition, with the result that the country suffers from a lack of competitiveness. At the legal level, the progress made in the fight against corruption, tax evasion and the underground economy has been woefully inadequate, depriving the country of the foundations for robust growth. Following on the heels of Romania and Bulgaria, the entry of Croatia may unfortunately endorse the idea that curbing corruption is not a prerequisite for joining the EU. In view of the repeated institutional crises that have hit the European Union since 2009 and widespread Euroscepticism, it is now urgent for the EU to makes its priority deepening rather than widening.