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Croatia under the Excessive Deficit Procedure

Which measures should be implemented?

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Less than six months after its entry into the European Union (EU), the excessive deficit procedure (EDP) has been opened against Croatia. The government of Croatia now has to propose a corrective plan in order to bring the public deficit below 3% of GDP within a few years[2]. It is not the first time that an EDP coincides with entry into the EU. In 2004, six new members (the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia) were subject to a similar experience. But times are different. As Croatia entered the EU, the economies of its main trading partners were plagued by more than five years of crisis, and the negative risks for their projected recovery were still significant[3]. Economic conditions were comparatively much better in the EU in 2004. As a result, to bring its public deficit below 3% of GDP, a country under EDP could reasonably expect that a significant part of its adjustment would come from higher growth rather than from pure fiscal consolidation (expenditure cuts and/or tax increases). Yet, in 2004, the financial markets were aware of that and, consequently, required only minor additional risk premiums on the public debt of countries under EDP.

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2. More precisely, the EDP is activated against an EU country when the European Commission establishes that the breach of the deficit's rule (*i.e.* 3% of GDP) is neither exceptional nor temporary. The decision of the European Commission is based on the analysis of the Fiscal Notification submitted by each Member State in April and October of each year.

3. Looking at GDP projections for 2016 as published by the Ministry of Finance in September 2013 shows that growth in Croatia would become almost negligible without the contribution of exports of goods and services: it would never exceed 0.7% on a yearly basis *ceteris paribus*.

Today, Croatia cannot reasonably expect that vigorous economic growth will help it bring its public deficit below 3% of GDP. More importantly, Croatia has already done a lot in terms of fiscal consolidation and exhausted (almost) all measures involving expenditure cuts and tax increases. In this context, what other measures could be recommended? That's a tricky question, especially if we have in mind that the measures should not further depress Croatia's economy. According to the forecasts of the Ministry of Finance, the GDP of Croatia will recover only gradually in the forthcoming years, with its real growth accelerating to 2.2% in 2015 and 2.5% in 2016 (Table 1). These figures contrast sharply with those observed for the pre-crisis period (4.6% of yearly real growth over 2004-2007). The rate of unemployment currently stands at 16.5%, with employment showing only timid signs of recovery for the upcoming three years.

Table 1. Selected indicators for the economy of Croatia

In %

	2012	2013	2014	2015	2016	2004-2007
Real GDP growth rate	-2.0	0.2	1.3	2.2	2.5	4.6
Inflation rate	3.4	2.4	2.0	2.0	1.9	2.9
Unemployment rate	15.9	16.5*	n.a.	n.a.	n.a.	11.9
Employment growth	-3.1	-2.4	0.3	1.2	1.4	3.5

* Figures for the third quarter of 2013
Source: Economic and Fiscal Policy Guidelines for the 2014-2016 period, Ministry of Finance. Forecasts for 2014-2016.

Table 2 presents some figures related to the projection of public finances in Croatia, based on information available in mid-September 2013. Projections were made by Croatia's government before the EDP was initiated against the country. They reveal a clear breach of both the deficit rule (3% of GDP) and the debt rule (60%) in the forthcoming years. In 2014, the loss of revenues is mainly due to a fall in taxes on profits (due to the sluggish activity in 2013 combined with a low tax rate on reinvested profit) as well as to a fall in property incomes

Table 2. Selected data for the public finances of Croatia*

In % of GDP

	2012	2013	2014	2015	2016
Total revenues	40.0	40.5	39.6	40.1	40.2
Total expenditures	41.6	41.8	42.7	42.7	42.3
Deficit (-) or surplus (+)	-3.5	-3.5	-5.5	-5.1	-4.5
Public debt	53.7	58.1	62.0	64.1	64.7

* Figures are for the consolidated general government.
Source: Economic and Fiscal Policy Guidelines for the 2014-2016 period, Ministry of Finance. Forecasts for 2014-2016.

(due to lower concession fees, profits of state-owned companies and revenues based on loans granted). For expenditures, financial expenses (debt servicing and inclusion of public enterprises' debt in public debt) as well as grants (contributions to the EU budget and EU co-financing) are key factors explaining the jump in 2014 onwards.

In what follows, we consider a list of measures that Croatia could envisage in order to curb its fiscal deficit and public debt. For each measure, we present the main arguments "in favor of" and "against" in general terms. Then, we discuss the relevance of the measure for Croatia.

- **Doing nothing at all** or, put differently, continuing the current course of business

The main argument "in favor" of this behavior is that the EU does not in any case have any real power to punish a country that does not respect its EU obligations. The principle of fines and sanctions would be inoperative. For instance, the freezing of EU funds would not be a credible sanction. Moreover, the Council would have no alternative but to be merciful with respect to the country under EDP if (*1*) economic times are particularly hard in the country, (*2*) unemployment stands at a high level, or (*3*) the population is reluctant to make further efforts and is engaged in street demonstrations, etc.

The main argument "against" is that financial market operators may think very differently from those advocating this behavior and, consequently, may require high risk premiums on the public bonds of countries under EDP that are not engaged in corrective plans.

Should the government of Croatia adopt this behavior? Certainly not, for two main reasons. First, taking a risk of freezing EU funds may be harmful for the country, which is to receive a significant amount of EU funds in the coming years[4]. Croatian enterprises engaged in EU co-financing would suffer from a freeze on EU funds, with spillover effects on other local enterprises. Important projects (for instance, in infrastructure) would probably have to be interrupted. Second, in recent years, financial market operators have practiced discrimination across government issuers, with some of them paying very high risk premiums on their bonds (to name a few: Greece in the worst times of the debt crisis and Latvia during its bailout by the international community in late 2008). A higher interest rate on the public debt would be costly for the Croatian economy and would exacerbate further the public deficit. Based on figures published by the Ministry of finance in September 2013, financial expenses (mainly debt servicing) would reach HRK 14.5bn in 2016, which would represent 10.2% of total public expenditures at that time (against 7.5% in 2012). Paying a higher interest on public debt would divert public funds from other (more productive) uses.

4. EU funds for the central government may reach up to HRK 8.4bn in 2016, which would represent 50% of the projected public deficit of Croatia (estimated to 4.5% of GDP). Of course, EU funds will not be used to finance the public deficit. But that computation allows scaling both the importance of EU funds and the huge need of government resources for Croatia.

- **Lowering wages** in the public sector

This measure has two main advantages. First, it would induce an immediate fall in public expenditures through a lower wage bill. Second, if labor mobility is significant across sectors, a decrease in public sector wages would spill over to the private sector, which would improve the economy's external competitiveness. Net exports and, then, growth would resume. On the other hand, the main argument "against" lower wages is that household consumption would be depressed, then exerting downward pressure on growth.

To be successful, this strategy requires vigorous external demand. Otherwise, net exports would not resume and only the negative effects of this measure would materialize (*i.e.* GDP would fall due to lower consumption). Moreover, to be fruitful, every country cannot be engaged in an internal devaluation at the same time (Levasseur, 2012). Otherwise, external demand would drop irremediably. That would be especially the case if large countries (*e.g.* Germany, France) embarked on internal devaluation.

Should the government of Croatia lower the wages of its civil servants and state agents? Certainly not. The European recovery is too timid and uncertain for Croatia to benefit from a strategy of internal devaluation. Gains in external competitiveness would translate into only minor gains of foreign market share, provided that a contagion from public to private wages has effectively occurred. The GDP of Croatia would be negatively affected due to the shrinkage of household consumption. Moreover, from 1 July 2015 (which is the expected date for lifting the restrictions on free mobility of Croatian workers within the EU), downward pressure on wages in Croatia could result in outflows toward EU countries that offer higher wages. The long-term ("permanent") migration of high-skilled workers (*e.g.* engineers) might occur as well as the short-term ("within one year") migration of low-skilled workers (*e.g.*in agriculture and construction). The migration of Croatian workers would be detrimental to long-term growth ("brain drain") and would disrupt both social and family life in Croatia.

In recent years the public wage bill was kept under control. Bonuses and extra payments were frozen in 2013 and are planned to be frozen in 2014 too. Yet, for the whole economy, average *real* wages have fallen by about 3% since 2008. In this context, projected yearly (nominal) growth of 3.2% for the public wage bill over the three upcoming years (as published in the Strategy of the Ministry of Finance in September 2013) appears quite reasonable. The share of the wage bill in total public expenditures would decrease slightly to 16% in 2016.

- **Using service concession contracts** when public management is poor

There are clear arguments in favor of this measure. First, it allows modernizing and building the infrastructure necessary to maintain and improve critical public services. Second, service concession contracts may be a regular (and important) source of revenues (through receipts of concession fees) and/or savings (through lower subsidies) for the government. Moreover, service concession contracts that are associated with large investments by the operator may benefit the economy as a whole (through spillover effects).

The main argument "against" is that users of the public service will probably have to pay a higher tariff. The more the government puts priority on the reduction of its public deficit, the more likely it is to choose an operator willing to accept a low subsidy and/or a high concession fee, and the more likely the chosen operator is to charge the highest tariff.

All in all, the main point is not to ask whether concessions as a measure are good, but rather *how* a concession contract is awarded, to *which* operator and under *what conditions*. A good concession contract can be defined as follows: it should offer a service of good quality at a reasonable price to users and should comply with certain principles (in particular, protection of the environment and the cultural heritage)[5]. It means that concession contracts have to be awarded in a competitive and transparent way, so that a sufficient number of bidders are interested in becoming the operator. In this respect, openness to foreign bidders (or "investors") should be positive. Last but not least, politicians should have no interest in favoring one bidder over another. In other words, corruption should be actively fought and no bribe should allow winning the concession contract.

For several years, the government of Croatia has embarked on a process of service concessions. A New Concession Act was adopted in December 2012. Recent concessions include Zagreb's airport and Rijeka's port, while motorways and Brijuni's island have also been proposed to bidders. To the outside eye, those concession services appear an efficient way to maintain and modernize critical public services. We find service concessions, especially in the transportation sector, positive for the economy. They boost tourism and pave the way for Croatia to become a regional logistics hub in Central and Southeastern Europe.

The views of Croatian citizens may be different, though. Some of them perceive concessions as a gift to private enterprises. In particular, the concession fee for motorways has been criticized for being too low, *i.e.* EUR 3bn (or less than HRK 23bn) for a concession period of 30-50 years. This amount is to be used to pay the debts of the HAC and ARZ motorways; it is currently estimated at above EUR 4bn and cannot be rescheduled. Communication to citizens about the rationality of service concessions as well as about the way service concessions are awarded should be intensified and improved. Communication could include the consultation of the financial and technical reports that the assessment of each bidder is based on. Similar communication should be undertaken regarding the privatization of public-owned enterprises (see next point).

- **Going through the privatization of (some) public-owned enterprises**

This strategy is more radical than service concession contracts. The main advantage of privatization (compared to service concession) is that cash is immediately available to reduce debt and deficit, and potentially large amounts can be obtained from the proceeds of privatization. But privatization is an (almost) irreversible process, whereas the government can change operator at the term of

5. More precisely, a good concession contract should allow doing all of the above better/more efficiently than public entities.

the concession contract if, in its opinion, public services are being improperly provided to users.

In the case of Croatia, the privatization of state-owned enterprises that are not natural monopolies and/or of strategic importance (*i.e.* in the tourism and agriculture sectors) should be encouraged. Privatization, by changing the incentives that influence management, would enhance the efficiency of enterprises. The 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 large 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[6].

In any case, abstracting from privatization, some state-owned enterprises should be restructured if they are to provide public services or goods in a more efficient manner.

▪ Improving tax collection and compliance

Uncollected taxes obviously constitute a loss of revenue for the government. But uncollected taxes also have distortion effects, since the tax burden is shifted onto those who cannot easily practice tax evasion (due to controls) or do not want to practice tax evasion (due to morality). Those benefiting from public services are not necessarily those paying taxes, which is unfair when they have a similar level of income. More generally, public goods are provided sub-optimally when uncollected taxes are substantial, and the government's capacity is reduced (Bejakovic, 2008)[7].

In the case of Croatia, increasing 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). This also means fighting corruption.

According to the Institute of Public Finance, 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 of this, it would give a little breathing room to the public finances.

▪ Lowering (up to cancelling) the corporate tax rate

The main advantage (and goal) of a low corporate tax rate is to attract foreign direct investment (FDI) in order to stimulate production in the host country. However, fiscal incentives are not generally sufficient to attract FDI. Other conditions are required in the host economy, especially a well-educated labor force

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6. See Cuckovic, Jurlin and Vuckovic (2011) on the gains and pains associated with privatization of public utilities in Croatia, LSEE External Research Project.
7. Predrag BEJAKOVIĆ (2008), Tax evasion, state capacity and trust in transitional countries: the case of Croatia.

and a friendly business environment, including respect for the rule of law. Another important condition is that other countries (and in particular, those with similar characteristics in terms of endowments, education, development, etc.) do not engage in a race to the bottom in terms of corporate tax rates. Otherwise, the tax base would shrink and no country would succeed in attracting FDI.

The outcome of this strategy in terms of fiscal revenue is uncertain. On the one hand, the corporate tax rate is reduced (or even null), which lowers (or eliminates) fiscal revenues. On the other hand, economic activity is stimulated, which results in a larger tax base for direct and indirect fiscal revenues.

In a small country like Croatia, with a labor force of 1.7 million persons, a handful of (large) greenfield FDI is sufficient for hiring a large share of the unemployed. Thus, lowering the corporate tax rate could be seen as a good measure. However, corruption in Croatia would probably deter almost all FDI even with a zero corporate tax rate. Note that there are currently some fiscal exemptions in Croatia (through free zones or no tax on reinvested profit for foreign entities) which have not yet succeeded in attracting large FDI in Croatia. The problem at stake is not the corporate tax rate, nor labor force education, but corruption. Croatia does not differ substantially from its neighbors in terms of the corporate tax rate (20% against 17% in Slovenia, 19% in Hungary and 23% in Slovakia). Like its neighboring countries, Croatia has a well-educated labor force. However, the amount of FDI hosted by Croatia is not as large as that of most of its Central and Eastern European counterparts due to a deteriorated business environment.

Activating the OMT mechanism

The "Outright Monetary Transactions" (OMT) mechanism, which is documented in Creel and Timbeau (2012), could not be activated in the case of Croatia, as it requires EMU membership (*i.e.* adoption of the euro). Anyway, a country activating the OMT mechanism would not avoid a corrective plan to curb its public deficit. Only the cost of borrowing would be reduced through a process of debt mutualization.

To summarize: in order to put its public finances on a sound track, Croatia has no alternative but pursuing the restructuring of its state-owned enterprises, through either service concessions or privatization. However, this restructuring process should be more controlled to prevent misguided choices, abuse or conflicts of interest. Civil society should be included in the process. More generally, communication to citizens on both sides of public finances (revenue as well as expenditure) should be intensified: budgetary authorities should explain *what* they are doing, *why* they are doing it, and what the long-run benefits of their actions will be.

Improving tax collection and compliance is another important measure which is highly recommended for Croatia's public finances. That calls for changes in the mentality of those practicing tax evasion through communications about the limited resources of the government. But, and perhaps more importantly, this also calls for strong anti-corruption actions to annihilate tax extortion.