Institute of Public Finance
No. 30
Zagreb
August 8, 2011

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PRESS RELEASE

Commentary on the Croatian Government's Economic and Fiscal Policy Guidelines for the 2012-14 Period

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Although the Economic and Fiscal Policy Guidelines for the 2012-14 period, adopted at the Croatian Government session of 27 July[1], were issued slightly earlier than in the previous years, their credibility is rather questionable. While emphasis is laid on the need for fiscal consolidation and structural reforms, the assumptions underlying the Guidelines are too optimistic and the projections offered lack conviction and cannot be verified, because they do not contain the data prescribed in the State Budget Act (see Box). As in the previous years, salvation is expected to come from the EU economic recovery and Croatia's EU accession. However, the EU recovery is uncertain, and the accession benefits will only be felt in the longer run, and getting them requires tremendous efforts on the part of the country. Greece provides an excellent example that such things are never easily achieved.

Nevertheless, the Government deserves to be commended for adopting the Guidelines for the 2012-14 period as early as end-July (pursuant to the State Budget Act, their issuance was scheduled for mid-June). Last year, the Guidelines were adopted in October, and two years before in September. Had it been the other way round, this would have suggested a positive trend and one could hope that the next Guidelines would be issued on time. Otherwise, it can be ascribed to the forthcoming parliamentary elections.

> The Economic and Fiscal Policy Guidelines for a three-year period constitute a serious document and a necessary framework for the annual budget adoption. Therefore, their adoption procedure and their content are strictly defined in the State Budget Act[2]. The Act stipulates that the Government should, by *mid-May* of a current year, adopt Government programme strategies for a three-year period, and, based on these strategies, issue three-year economic and fiscal policy guidelines *by mid-June*. In accordance with the Government guidelines, the Ministry of Finance submits to ministries and other government bodies at the division level of the organisational budget classification, where divisions include, for example: the Parliament, President, Constitutional Court, Government, government agencies, institutes, bureaus, commissions, etc., and to extra-budgetary users instructions for drafting a state budget proposal. This is why the guidelines, among other things, include „a proposal for the financial plan amounts by divisions of the organisational classification, which comprises financial plan amounts for the previous budget year and the current budget year, as well as a proposal for the financial plan amount for the next budget year and the next two-year period.“

[1] http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2011/142_sjednica_vlade_republike_hrvatske
[2] http://narodne-novine.nn.hr/clanci/sluzbeni/340390.html

The Guidelines emphasise, and even reiterate the essential things, i.e. the necessity of fiscal consolidation, implementation of the Fiscal Responsibility Act and Economic Recovery and Structural Reform Programme and prevention of going back to the old model of growth based on borrowing.

However, there are several reasons why the Guidelines are not trustworthy.

Why are these new Guidelines, like all others before them, difficult to trust?

According to the State Budget Act, guidelines should be drawn up based on a Government programme strategy for a three-year period, to be adopted by the Government no later than mid-May. However, by searching the relevant websites, one can only find the Government Programme Strategy proposal for 2010-12, and the current-year Government program strategies are not even mentioned in the Guidelines for the 2012-14 period. The Economic Recovery Programme is mentioned on several occasions, but, although more than a year has passed since its adoption, any mention of its potential effects is carefully avoided.

The Guidelines are half as long as in the previous years, which could perhaps be an advantage. However, numerous detailed tables, showing actual items and divisions that used to be included in previous guidelines[3] have been left out. It is therefore impossible to find out, for example, how the planned spending cuts would be achieved. Additionally disturbing is the statement at the very beginning about the „stabilising role of the fiscal policy and the need to preserve social justice, protect the most vulnerable population groups and contribute to the competitiveness of the economy, its recovery and growth", as in the past, all this ended up in expenditure growth.

The Guidelines do not even include a „proposal for the financial plan amounts by divisions of the organisational classification, which would contain the financial plan amounts for the previous and current budget years", neither does it include "a proposal for the financial plan amount for the next budget year and the subsequent two years", as explicitly provided in Article 25 of the State Budget Act. This means that the Guidelines should provide information on how much the budget beneficiaries, e.g. ministries, the Government, President, Constitutional Court, government agencies, institutes, bureaus and commissions, spent in 2010 and how much they will spend in the 2011-14 period. However, this information is missing.

Moreover, stress is laid on the shares of revenue, expenditure, deficit and public debt in GDP, where at the same time the GDP to which these percentages relate is questionable. Specifically, according to the Guidelines, GDP is expected to grow by 1.5% in 2011, 2.5% in 2012, 3.5% in 2013 and 4% in 2014.
In contrast to the Government's forecasts, the European Commission estimates the growth at 1.1% in 2011 and 2% in 2012, whereas the IMF' forecasts are: 1% and 1.8% growth in 2011 and 2012 respectively.[4] According to the IMF, GDP could gradually increase to 3%, but not until 2015, because „low confidence will restrict capital inflows, and poor competitiveness, will keep the external sector's contributions low". However, even without the gloomy forecasts made by the IMF and EC, a 0.8% drop in GDP in the first quarter of 2011, indicated in the Guidelines, hardly gives grounds for the expressed optimism. Briefly said, unless the GDP growth envisaged in the Guidelines comes true, all projections of the shares of revenue, expenditure, deficit and public debt in GDP will come to nothing.

There is also confusion about the participation of the general government deficit in GDP: while the shares forecast in the Guidelines are 4.9% in 2011, 3.8% in 2012, 2.6% in 2013 and 1.8% in 2014, the European Commission's estimates are: 6% and 5.1% in 2011 and 2012 respectively, and the IMF's: 5.7% in 2011 and 5.1% in 2012, or, inclusive of HBOR and HAC, as much as 6% and 5.4% in 2011 and 2012 respectively. There are, of course, different methodologies and scopes of data, and each figure can always be challenged, but the fact is that the figures shown in the Guidelines are more optimistic than those provided in other sources that are far from being irrelevant.

[3] See, for example, the last year's Guidelines.
[4] All the international data are taken from: IMF, *IMF Country Report* No. 11/159, June 2011 and European Commission, *EU Candidate and Pre-Accession Countries Economic Quarterly*, July 12, 2011.

Why is the Government bound to implement reforms?

Readers should therefore attach less importance to projections offered, and more to urgent structural reforms. After all, projections are easy to change, whereas the implementation of structural reforms is far more difficult and sometimes even impossible in certain countries. And why should reforms be implemented in the first place? Primarily because of an increasingly noticeable growth lag. In 2010, only Croatia (except Iceland) showed negative growth rates, and, according to EC forecasts, in 2011 and 2012 Croatia will again experience the lowest growth among EU candidate and potential candidate countries.

Due to its high costs, the Croatian economy is highly uncompetitive. However, this has very little to do with the global crisis, but it represents a permanent situation in the country. Average gross wage is the second highest after Slovenia's; it is the same as in the Czech Republic, higher than in Poland, Slovakia, Estonia and Hungary, considerably higher than in Lithuania and, particularly, Romania (where the average wage is half the Croatian average) and Bulgaria (one third of the Croatian average). Wages are too high in Croatia relative to both productivity and per capita income. This is coupled with the slowest-growing exports among peer countries and exceptionally high operating costs. Furthermore, one should have no illusions about Croatia' tourism performance: tourist arrivals rose faster in Bulgaria, not to mention Turkey.

In terms of the share of public debt in GDP in 2010, Croatia did not stand much below the average for new EU Member States and other comparable countries, but in terms of the public debt-to-exports ratio (260%), the country was by far the worst. Also low was the foreign exchange reserves coverage of public debt (only about 70%), which was lower only in Lithuania and Latvia, whereas in Romania and Poland, for example, this ratio stood at 130% and over 100% respectively.

Particularly worrying is the negative difference between real and potential GDP, which increased steadily from 1.8% in 2009 to 4.2% in 2010 and 4.7% in 2011. In simplest terms, the output gap means that our efficiency is falling, i.e. we produce increasingly less than we could.

Indeed, low competitiveness and, consequently, slow growth of Croatian economy offer plausible grounds for what is said in the last sentence of the Guidelines about the necessity of fiscal consolidation „primarily oriented towards the expenditure side of the budget“. However, neither should the revenue side be neglected. Tax and contribution arrears reached about HRK 14bn[5] in 2010, which was exactly the amount of the central government budget deficit. Although the entire amount of the arrears is unlikely to be ever collected, it is precisely through more efficient tax and contribution collection that the „preservation of social justice and protection of most vulnerable groups of population“, referred to in the first sentence of the Guidelines, could be more easily achieved.

[5] Bronić, M., 2011. "Collected and Uncollected Taxes in Croatia and the European Union". *Newsletter,* No. 57. Zagreb: Institute of Public Finance.