Institute of Public Finance
No. 40
Zagreb
September 3, 2012
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PRESS RELEASE

A Commentary on the Croatian Economic and Fiscal Policy Guidelines for the 2013-15 Period

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In mid-July (with a two-month delay), the Croatian Government published its Strategy of Government Programmes for the 2013-15 Period[1], and early in August (a month and a half behind the schedule), it published Economic and Fiscal Policy Guidelines for the 2013-15 Period[2]. Immediately after the Guidelines (i.e. with a one-month delay), the Ministry of Finance published Instructions for Drafting a National Budget Proposal for the 2013-15 Period[3]. These documents are of utmost importance, as they decide the destiny of the country in the coming period, and it is good that they are publicly available. However, they involve many problems.

As the legally prescribed deadlines have been missed, there is less opportunity to consult and take the best decisions, especially given that it is August, the usual vacation season.

The Government's Strategy 2013-15, regrettably, offers the same vision of the future, the same strategic goal and twelve general objectives that the Croatian Democratic Union (HDZ) offered for the 2010-12 period[4]. Since the Guidelines are prepared on the basis of the Strategy, the lack of a new, improved vision and goals has affected them as well. Hence, the Guidelines reflect a kind of a *status quo*. It is true that, as indicated in the Guidelines, "strategies should be devised for a long period of time, they should not be changed each year and that priorities could be established more easily by ranking the goals". Nevertheless, is it reasonable to insist on strategies that produce poor results? As concerns the ranking of goals, compared with the HDZ's Strategy, the current one gives higher rankings to health, environmental protection, and regional development, whereas the strengthening of the law-based state and the rule of law and promotion of knowledge, excellence and culture are ranked lower on the list. Of course, establishing priorities has always been difficult, but it is really hard to understand that, in a country like Croatia, the strengthening of the law-based state and the rule of law, and the promotion of knowledge and excellence (let us ignore culture, as it is "just part of the package") can be of lower priority. The non-functioning of the law-based state and of the rule of law, inadequate education levels and lack of excellence in practically all areas, represent serious obstacles to the growth of Croatian economy.

According to Government forecasts, the economy will grow at rates of 0% in 2012, 1.8% in 2013, 3% in 2014 and 3.5% in 2015. These forecasts are too optimistic, especially those for the first two years, but they are also too modest. Given the Government's unpreparedness to assume power, little can be

[1] Government of the RC, 2012. *Strategy of the Government Programmes for the 2013-15 Period*. 39th Government Session of July 12, 2012.
[2] Government of the RC, 2012. *Economic and Fiscal Policy Guidelines for the 2013-15 Period*. 44th Government Session of August 2, 2012.
[3] Ministry of Finance of the RC, State Treasury. *Instructions for Drafting a Proposal for the Republic of Croatia's National Budget, 2013-15*. Zagreb, August 2012.
[4] Ott, K., 2012. „Vlada nema viziju, a strategiju je prepisala od HDZ-a“. *T-portal*, July 31, 2012.

 ISSN: 1848-4085 | doi: 10.3326/pr.2012.40

done in the current year 2012. However, after a series of bad years, such modest increases in GDP, even if realised, would not have much effect. Nevertheless, radical turnarounds are still possible, as shown by the average value for Estonia, Latvia and Lithuania. GDP in these countries fell by 16% in 2009 from 2008, but went up 6.3% in 2011 relative to 2010.[5]

The Government has announced its "commitment to implement fiscal consolidation and enforce the Fiscal Responsibility Act, while continuing to replace direct taxes by indirect ones and further reducing the tax burden on labour. The necessity of the fiscal consolidation is unquestionable, but the problem is that indirect taxes (VAT and excise taxes) in Croatia are too high already (higher than the averages for both old and new EU Member States). Property tax to be introduced is a direct, rather than an indirect tax; and reducing the tax burden on labour is impossible without effective and thorough reforms on the expenditure side of the budget. But now comes the main problem. According to the Strategy and, consequently, the Guidelines, focus is placed on technical savings rather than on substantial changes. Privatisation and private sector strengthening are not even mentioned, and emphasis is obviously placed on government intervention, even as concerns the creation of an optimal playground for competitive business development. The goals, e.g. in the health sector, are reduced to savings and supervision, without even mentioning a radical health care reform (the revision of the health system financing, sick and maternity benefits and co-payment scheme in health care, introducing competition in the health care market and, even more important, in the health insurance market). As long as employers must bear the health insurance burden for almost the entire population, labour cost cannot be brought down. It is further envisaged that "structural reforms should be implemented within each ministry", but the truth is that substantial changes, e.g. in the health insurance funding, cannot be implemented "within a single ministry", but as part of the strategy and goals of not only the entire Government but of the country as a whole.

Health care is mentioned here only as an example of a poorly considered and insufficiently resolute approach, obstructing radical changes, and all this applies to other expenditure items of the budget as well.

Creating an optimal playground for competitive business development is (correctly) a highly ranked goal, with special prominence given to the restructuring and development of particular industries (although governments have never proved to be too successful in that area), active labour market policy measures (also arguable), investment climate promotion and changes in the legislative framework (being actually the most important issue). The government's bible should be the World Bank's *Doing Business*[6] report, because the ease-of-doing-business scale presented there shows that the highest-ranked countries usually have the most successful economies. Croatia, regrettably, ranks 143 in the world for dealing with construction permits, 133 for protecting investors, 192 for registering property and 100 for cross-border trading. It can only be hoped that all the newly appointed people in the ministries and government agencies will have enough experience and determination to improve, quickly and effectively, Croatia's ranking on the scale. This is by no means an "impossible mission". Latvia and Estonia, for example, rank 21 and 24 respectively in the world on the total ease-of-doing-business index.

Should doing business in Croatia be facilitated, which can be achieved relatively quickly, provided there is political will and know-how to do so, even the modest GDP increase planned would not depend on "starting an investment cycle in the broadly defined public sector", but there would definitely be much more private investments, so that the country would far less depend on the "continuation of favourable economic trends in the environment". The almost exclusive reliance on "the contribution of gross fixed capital formation to economic growth" gives little hope that such growth would really come true, because it will be "generated by starting a public enterprise investment cycle, which is expected to spur private sector investments". However, as public enterprises are hardly known for their good performance and regularity of operation, it is feared that their starting of an investment cycle would create new uncertainties and place an additional burden on taxpayers. It is therefore questionable whether private sector investments will follow at all. The

[5] Ott, K., 2012. „Hrvatska se mora izvući iz južnjačke letargije“. *T-portal*, June 5, 2012.
[6] World Bank, 2011. *Doing Business – Measuring Business Regulations.* Washington: The World Bank.

government should improve the investment climate and thus encourage private investment, rather than invest itself.

The Guidelines suggest that the bulk of the fiscal consolidation burden will be on the expenditure side, i.e. that, in order to comply with the Fiscal Responsibility Act, the share of general government expenditure in GDP will be cut by at least 1 percentage point annually. However, the problem is that this expenditure is forecast to rise steadily (from HRK 138.5bn in 2012 to HRK 148bn in 2015), while the planned GDP growth, and, consequently, the share of budget expenditure in GDP, are questionable. Unless the planned government investments are realised and favourable economic trends in the environment (providing a basis for GDP growth) continue, it will be difficult to comply with the Fiscal Responsibility Act. The Guidelines provide well-elaborated projection realisation risks, but unfortunately, there is no information as to what the Government plans to do, should any of those risks materialise. It is therefore inexcusable that expenditure cuts were not planned in absolute figures, but only in relative terms (as a percentage of GDP).

The reader would much easier understand what will actually happen, if (1) the determinants of budget revenue were explained in the Guidelines in the same way as they are explained in the Instructions, or in the way the determinants of expenditure are explained in the Guidelines, and if (2) the determinants of the revenues and expenditures of extra-budgetary users and the units of local and regional self-government were also explained, especially as extra-budgetary users are expected to see an enormous increase in some expenditure categories. Unfortunately, the latter information is not provided in the Instructions either.

Although the Budget Act provides that the Guidelines should offer an "estimate of revenues and expenditures and receipts and outlays for all levels of the general government", this has only been done for the state budget, but not for extra-budgetary users or units of local and regional self-government. When analysing the state budget expenditures, the reader can see why some expenditures grow (e.g. liabilities to the European Union and shipbuilding) but he/she can hardly see why extra-budgetary users, in the 2011-15 period, will be faced with increases in, e.g., aid (215%), subsidies (157%) and other expenditures (139%). By the way, "other expenditures" of extra-budgetary users for 2015 account for as much as 30% of total operating expenses. How can such a large percentage of anything be classified as "other"? The reader also does not understand why "compensation to citizens and households" in extra-budgetary user's budgets is reduced from HRK 395.5m in 2011 to HRK 1.5m in 2015. All transfers from one item to another should be explained.

Total state budget expenditure, just like the general government budget expenditure, is expected to increase each year (from HRK 117bn in 2012 to 127bn in 2015). As expenditures for the repayment of debt interest and principals, payments into the EU budget and subsidies to shipyards in accordance with their restructuring plans are fixed and cannot be reduced, more severe cuts are expected in major expenditure items, notably expenditures for pension and health insurance and for employees, which account for about 70% of total operating expenses. Regrettably, pension and health insurance expenditures are expected to grow steadily from year to year, while those for employees will only fall in 2013 relative to the previous year, but will continue to rise afterwards. However, expenditure reductions, so desperately needed, require a clear vision of and a sound strategy for fundamental reforms, which can be found neither in the Strategy nor in the Guidelines. Futile attempts to make savings and to control spending are not enough, and they result in even larger expenditures.

Neither the Guidelines nor the Strategy offer much hope. Miracles can always happen, of course, but that would require much more ambitious goals than just improving revenue collection and, only allegedly, cutting expenditures, i.e. the carrying out of thorough structural reforms of the national budget expenditures and expenditures of extra-budgetary funds.