INTERNATIONAL POLICY ANALYSIS

No More Buying Time: Fiscal Austerity in Croatia

VELIMIR ŠONJE
September 2012

- In the initial phase of the crisis (2008–2010) the HDZ-led centre-right government allowed a wider fiscal deficit and strong growth in public debt, although they cut public infrastructure programmes and introduced new taxes. The idea was to buy time in order not to cut public sector wages, subsidies and transfers. This fiscal strategy proved to be wrong as GDP recorded one of the sharpest contractions in Europe in this period.

- The new SDP-led centre-left government that took office in January 2012 faced two real threats: exploding public debt and a deterioration in credit ratings. In order to cope with these threats, the new government initiated stronger fiscal adjustment on the expenditure side.

- The »austerity vs. growth« debate does not seem to be a good intellectual framework for thinking about policies in the case of Croatia, as postponing austerity requires finding someone to finance the deficit at low interest rates. That may be impossible for the time being, so some degree of austerity seems to be a necessity in Croatia.

Introduction

It is easy to find reasons for postponing fiscal austerity. One may fear the weakening of the welfare state. One may argue that fiscal multipliers in a recession are high, so spending cuts may deepen the recession (IMF 2012). Another line of argument against austerity is fear of strong political resistance to fiscal cuts: resistance may undermine social cohesion and lead to a sharp social conflicts with political consequences that are hard to predict. A mixture of these arguments explains why the centre-right coalition led by the Croatian Democratic Union (HDZ), which was in power from 2004 to 2011, postponed stronger fiscal adjustment despite prolonged recession and crisis. HDZ's fiscal strategy was to implement the minimum necessary adjustment and to buy time. They thought that a somewhat expansionary fiscal policy would alleviate the recession and hoped that some (positive) external shock would push GDP and public revenues higher, providing a magic cure for otherwise serious fiscal problems.

This view turned out to be overly optimistic. The recession was particularly strong and prolonged compared to other European countries, possibly due to late fiscal adjustment.

Buying time in terms of postponement of fiscal adjustment is an option for countries such as the United States and Japan. Such countries print global currencies which are much in demand. Their governments enjoy access to large pools of diversified institutional investors who are eager to buy »safe haven« government bonds at times of general risk aversion. In contrast, small and open middle income countries such as Croatia stand at the opposite end of the financial spectrum. Their currencies are not widely used; even residents use foreign denominated deposits and securities for savings purposes while most public debt is denominated in foreign currencies. Financial wealth is thin and institutional investors underdeveloped. Credit rating agencies take these facts about financial structure into account, so there is little room to manoeuvre for the governments of such countries. Their ability to run fiscal deficits and accumulate public debt is limited. It is not possible to understand the austerity vs. growth dilemma if these basic facts about financial structure are not taken into account. When there is nobody out there willing to finance higher fiscal deficit at reasonable interest rates, postponement of fiscal adjustment may lead to a vicious circle of ever growing interest rates.

In countries with such characteristics, governments have to show fiscal prudence earlier than in the most developed countries. The coalition led by the Social Democrats (SDP), which came to power in January 2012, was aware of this fact. It initiated a fiscal adjustment programme immediately after the elections in December 2011. The main motivation was to avoid a credit rating downgrade due to fears of an additional increase in the cost of financing for the government and the economy as a whole.

It is not fair to say that the centre-right HDZ-led government did nothing while the SDP-led government did everything needed for fiscal adjustment. We shall go into more detail about early centre-right experiments with higher taxes and cuts in public infrastructure investment in 2009. After all, the centre-right government passed the Law on Fiscal Responsibility which rounded off the framework for fiscal discipline. The same legal framework is used by the Social Democrats, too. HDZ also managed to start reducing the public expenditure to GDP ratio in the second stage of the crisis (2010–2011). However, the centre-right government had insufficient political power to initiate the expenditure cuts needed to bring public debt under control. Stronger fiscal cuts started only after the Social Democrats took power and it still remains a puzzle whether these cuts will be enough to stabilise the cost of financing and prevent a deterioration of the credit rating, which remains BBB–.

Macroeconomic Framework

The period 2002–2007 was marked by the overheating of the Croatian economy. It was reflected in strong capital inflows, accumulation of foreign debt, a widening current account deficit and continuous expansion of government expenditures (Table 1). Resulting GDP growth (4.8 per cent on average in the period 2002–2007) was relatively high, largely driven by investment in infrastructure and real estate (widely intermediated by the government). Investments in technology and processes that might lead to lasting increases in productivity were lacking. The absence of investment leading to lasting enhancements in productivity and competitiveness implied that pre-crisis economic growth was largely demand and debt

Main macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
GDP per capita (Euros)	6,349	6,816	7,436	8,112	8,951	9,781	10,722	10,111	10,394	10,472
Real GDP growth (%)	4.9	5.4	4.1	4.3	4.9	5.1	2.1	-6.9	-1.2	0.0
Real GDP index	100	105.4	109.7	114.4	120.0	126.2	128.8	119.9	118.5	118.5
Real average net wage index	100	103.7	107.7	109.3	111.4	114.0	115.0	115.2	114.9	114.6
CPI inflation rate (avg)	1.7	1.8	2.1	3.3	3.2	2.9	6.1	2.4	1.1	2.3
Unemployment rate (%)	14.8	14.3	13.8	12.7	11.2	9.6	8.4	9.1	11.8	13.5
BOP C/A (% of GDP)	-7.2	-6.0	-4.1	-5.3	-6.6	-7.2	-8.8	-5.2	-1.0	-1.0
Foreign debt (% of GDP)	53.7	65.7	69.5	72.1	74.8	77.7	85.4	101.0	101.2	99.6
HRK vs EUR (end of year)	7.44	7.65	7.67	7.38	7.35	7.33	7.32	7.31	7.39	7.53
General gvt fiscal balance (% of GDP)	-4.3	-5.4	-4.2	-3.5	-3.4	-3.0	-2.1	-4.6	-5.3	-5.3
Public debt (% of GDP)	34.8	35.4	37.6	38.2	35.4	32.9	29.3	35.8	41.3	45.7
with guarantees and HBOR	n.a.	n.a.	44.8	45.3	45.8	43.5	41.9	50.5	58.7	62.5
General **gvt expenditures** (% of GDP)	42.7	42.7	42.7	40.8	40.6	41.2	41.2	42.5	41.6	40.7

Source: www.hnb.hr, Publications. Author's own calculations. www.mfin.hr for public debt figures.

driven. The hard landing that came after the crisis in the aftermath of the Lehman Brothers collapse did not come as a surprise.

Economic activity slowed down in 2008 and a recession started in late 2008/early 2009. Croatia has not seen a single year of GDP growth since then. Additional contraction of GDP (between 1 and 2 per cent) and significant growth in unemployment are expected in 2012. It is likely that real GDP as of the end of 2012 will remain approximately at the 2005–2006 level (see real GDP index in Table 1). Average real wages shall perform somewhat better, converging to the 2008 level (Table 1). The government initially reacted by postponing fiscal adjustment and the fiscal deficit went up. There was a widespread belief that recession might be avoided, partly by using fiscal stimuli. Despite a significant slowdown of economic activity in 2008, general government expenditures rose 7.8 per cent. The ratio of general government expenditure to GDP increased from 40.6 per cent in 2006 to 42.5 per cent in 2009 (Table 1). As of late 2008/early 2009 – that is, in the aftermath of the Lehman Brothers collapse – it became clear that the economy was contracting at a high rate (final real GDP for 2009 was –6.9 per cent). Expenditure stimulus was insufficient to prevent decline: public revenues were declining sharply, leading to a strong increase in the fiscal deficit, from 2.1 per cent of GDP in 2008 to 4.6 per cent of GDP in 2009 and 5.3 per cent in 2010 and 2011. The cost of government financing followed a similar path: long-term government bond yields hovered between 6 per cent and 7 per cent per annum.

A political crisis erupted in 2009 in parallel with the economic one. Former Prime Minister Ivo Sanader resigned and Prime Minister Jadranka Kosor (also HDZ) took office in mid-2009. Prime Minister Kosor focused on completing the EU accession negotiations (which she did successfully in spring 2011). The second priority was intra-party political battles, as corruption charges against former Prime Minister Sanader and a number of his (and her) associates multiplied. On fiscal grounds, Kosor's government was trying to prevent a deficit explosion by cutting public infrastructure investment and introducing new taxes (for more details see below). Nevertheless, the general government deficit stubbornly remained above 5 per cent of GDP because public revenues were contracting faster than the expenditure side.

Macroeconomic adjustment took place in 2010–2011 despite the practically non-existent fiscal adjustment. It is reflected in a significant reduction of the external deficit. After reaching a low of –8.8 per cent of GDP at the cyclical peak in 2008, the current account deficit converged towards –1.0 per cent in 2010 and 2011. The foreign debt to GDP ratio stopped growing at a plateau of around 100 per cent. These changes reflect strong adjustment on the side of the private sector: households reduced consumption and started to cut net debt, in other words, to save (so-called »deleveraging«). Private sector adjustment was very much under way. Theoretically, it makes sense to engage in fiscal expansion when the private sector is deleveraging in order to maintain a reasonable level of aggregate demand. However, that makes sense when deficit and debt levels are so low and private savings so high that additional supply of government bonds can easily be absorbed. Unfortunately, that was not the case in Croatia.

The nature of the macroeconomic relationship between private and public sector over the past few years is still open for debate. One theory, Keynesian in nature, assumes that slower public sector adjustment alleviated the contraction of economic activity. This theory states that the recession would have been even deeper had the government started with expenditure cuts in 2009 and 2010. Another, neoclassical theory assumes that rational private agents facing the government's vigorous spending will adjust their consumption (down) and savings (up) due to an expected increase in taxes which they expect to pay in the future (so-called Ricardo-Barro equivalence). Indeed, with the benefit of hindsight, one may say that the neoclassical story seems to be more relevant in the Croatian case: tax increases represented important parts of the fiscal adjustment programmes of both centre-right and Social Democratic governments. In this sense, agents who increased savings in 2008–2009 due to expected tax rises turned out right.

Fiscal Policy: Details

Jadranka Kosor's government, which came into office in July 2009, started with reductions of public infrastructure investment (mainly related to road construction). Transfers, subsidies and wages in the public sector were untouchable due to the widespread belief that they support domestic demand. The political sensitivity of cutting transfers and wages also played an important role. In fact, the centre-right HDZ-led government had two strong reasons for continuing with the inherited level of transfers, subsidies and wages. First, it was a coalition government that was balancing a number of conflicting interests and in a wider context of interest groups. Second, a certain degree of economic populism was needed to gain support for compromises on the external front, as the solution for a lasting territorial dispute with Slovenia (necessary condition for completion of EU negotiations) required some concessions to hardliners.[1]

In the second half of 2009 it became obvious that the recession was getting deeper and the fiscal deficit getting out of control. Persistently high yields on government bonds, exceeding 7 per cent, provided a significant warning. Expenditure cuts besides public sector investments were out of the question for the reasons elaborated above, so Kosor's government decided to increase taxes. In August 2009 the general VAT rate was increased from 22 per cent to 23 per cent and a special purpose income tax (popularly called the »crisis tax«) was introduced at 4 per cent for lower wages and 6 per cent for higher wages. Both taxes were described as temporary. The special purpose income tax was abolished (the 4 per cent rate in August 2010 and the 6 per cent rate in November 2010), but the higher VAT rate remained.

As the election year of 2011 was approaching, and being aware of the fact that neither new taxes nor some pleasant surprise would solve the fiscal problem, Prime Minister Kosor looked for a way to rebuild fiscal credibility without needing to cut transfers, subsidies and public sector wages. As a result of this political alchemy, the Law on Fiscal Responsibility was adopted in the Parliament, effective from 1 January 2011. This Law obliges the government to cut general government fiscal expenditures by 1 percentage point of GDP per annum as long as there is primary fiscal deficit.[2] When the primary fiscal balance becomes positive, the government is obliged to keep the structural fiscal deficit[3] in balance.

1. The solution of this problem was a necessary condition for EU entry, as Slovenia was blocking the negotiation process.

2. Primary deficit equals overall deficit plus interest costs.

3. Structural fiscal deficit equals overall deficit minus a cyclical component which is positive during expansion and negative during recession.

The Croatian fiscal rule is more stringent than the EU's Fiscal Compact because it provides for a explicit expenditure reduction target and does not allow for any deficit in the long run (the EU Fiscal Compact and the German Constitutional rule allow a structural deficit of 0.5 per cent of GDP). Such an aggressive fiscal rule reflects the belief – which was more widespread in professional than in political circles – that mild fiscal adjustment will not be enough to regain control over public debt, which was constantly rising.

The fiscal rule has helped in the adjustment of general government expenditures (which declined from 42.5 per cent of GDP to 40.7 per cent of GDP between 2009 and 2011). However, the public debt to GDP ratio was constantly rising. In the last year of the HDZ government (2011), nominal expenditures recorded a nominal decline of 0.2 per cent but the public debt to GDP ratio (with government guarantees counted as an addition to the stock of public debt) increased further, crossing over the Maastricht criterion of 60 per cent (Table 1). This was perceived as a major threat, as well as opening up the possibility that Croatia's credit rating (currently on the verge of BBB–) may be lowered by a notch or two. The two threats prompted the incoming Social Democratic government (actually a coalition led by the SDP) to undertake stronger fiscal adjustment measures.

Their 2012 budget plan envisages total expenditure cuts of 0.9 per cent, with major components planned as follows:[4] salaries –6.2 per cent; transfers –1.4 per cent; subsidies –16.4 per cent; material costs +1.6 per cent. The only item which is expected to have significant growth are financial (interest) expenditures (+5.3 per cent), driven by higher costs of funding and a higher level of public debt. At present, the government is in the midst of tough negotiations with public sector trade unions, trying to cut public sector workers' fringe benefits (allowances for food, transportation and so on) in order to meet budgetary targets on salaries in the public sector in 2012.

A number of novelties were introduced on the revenue side by the new government. The general VAT rate was increased from 23 per cent to 25 per cent. A new income tax on dividend payouts (12 per cent + local surcharge) was introduced, increasing the effective tax rate on profits (if paid out) from 20 per cent to 31.3 per cent (in the case of the City of Zagreb). Income brackets for application of the higher income tax rates (the highest income tax rate in Croatia is 40 per cent) were lowered, making an already progressive income tax system even more progressive. On the other hand, health contributions paid on gross wages were cut from 15 per cent to 13 per cent in order to lower the cost of labour by reducing direct taxation. The idea is to substitute direct taxes on labour by higher indirect taxes, in the hope of boosting competitiveness.[5]

Structural Reforms

The Social Democrats made a U-turn with respect to **subsidies** which are expected to decrease significantly in nominal terms (recall the –16.4 per cent 2012 budget plan mentioned above). Shipbuilding, railways and agriculture are the main recipients of subsidies in Croatia. Historically, they have proved to be very inefficient (both the sectors and the subsidies). Subsidies did not lead to restructuring or innovation but rather supported the status quo in inefficient sectors. The Social Democratic government is trying to initiate restructuring in order to accompany cuts in subsidies with permanent consolidation of industries which depend on taxpayers money.

The **pension system** recorded a deficit of 5 per cent of GDP on average, thereby representing by far the most important generator of the fiscal deficit in the long run. Population aging and low activity rates produced one of the worst dependency ratios (number of employed per pensioner) in Europe (1.2). Pension system reform based on a three-pillar system started a decade ago, but it was not sufficient to solve the fundamental problems. For that reason the centre-right HDZ government extended the pension age for women (gradual adjustment to 65 years by 2030) and introduced penalties for early retirement. Several cases of corruption concerning entry points to the pension system were prosecuted. The new government declared its intention to raise the percentage of the gross wage which is paid into the second pillar pension funds (currently at 5 per cent), but it is highly

4. Numbers based on the consolidated central government budget plan in contrast to the actual implementation of the 2011 budget.

5. Similar measures were introduced in France under the aegis of »internal devaluation«.

unlikely that this can be done in the current election cycle due to a need to achieve fiscal consolidation in the short to medium term.

The health system's contribution to the fiscal deficit is not comparable to that of the pension system, as the accumulated debt, based on ad hoc information, is around 1.5 per cent of GDP. However, cuts in health contributions will lead to a higher deficit unless met by reforms aimed at greater efficiency. For the time being, health system reforms are focusing on better organisation and cost controls as it seems that the fundamental principles of general and affordable health insurance for all are strongly supported by the incumbent government.

The attitude towards the health system illustrates the principle of maximising efficiency within the limits of the welfare state, which seems to be a general principle of Zoran Milanović's Social Democratic government. Sometimes it is accused of neoliberalism due to its insistence on austerity, but for the time being the government is avoiding severe cuts in public sector employment, especially in narrowly defined public services such as education, health and the judiciary. Restructuring efforts are aimed at state-owned enterprises where inefficiencies seem to be high, while employment and potential cuts in public administration and public services are analysed more thoroughly and implemented slowly. It remains to be seen which direction the government shall take in relation to **public administration reform**. The same holds for education, a critical area in which the new government did not deliver a clear reform plan. It remains to be seen whether this slow and balanced approach towards public sector employment and the welfare state is a luxury which will not last for long.

Privatisation and product market regulation reforms were the weakest reform points of Jadranka Kosor's government. Zoran Milanović's government seems to be following a similar route, as only two companies in the financial sector – the largest insurance company and the last state-owned bank – have been announced for privatisation (albeit without any clear time schedule). After eight months in power, the Social Democrats presented no clear privatisation targets and milestones, not to mention a broader privatisation programme.[6] They are clear regarding what *cannot* be privatised – natural resources and the like – but it is not clear, for example, what the government's intentions are in relation to promoting competition and liberalising product markets.

Among the structural reforms in sectors which do not have a significant direct fiscal impact, two stand out: the labour market and the energy sector. **Labour market regulation** is rigid in Croatia but the government is not eager to reform labour law. Some minor amendments are still expected, but the general impression is that the government does not believe they can produce more benefits than costs. Rather, they see it as a concession to credit rating agencies which listed reform of labour market regulation among the key criteria for maintaining the credit rating.

Energy sector reform is badly needed because Croatia imports half of its energy, while at the same time it has barely started to utilise renewable energy sources (except water). Lack of production capacities is a direct consequence of the low relative price of energy, which has not attracted investment for years. The new government announced plans to stimulate both public and private (and public-private) investment in energy, but a major prerequisite for this plan was the adjustment of retail prices. The price of electricity for households was adjusted by +25 per cent in one step in the midst of the crisis (April 2012), which contributed to strong consumption contraction in the second quarter of 2012.

Other reforms are lacking. Besides the already mentioned fuzzy situation regarding education, privatisation, product and labour market reforms, for the time being it is not clear what the new government plans to do in order to improve the investment climate, as there is no comprehensive plan to cut the cost of business regulation and eliminate administrative barriers to investment and business. A clear plan for judiciary reform is also lacking.

6. Exceptions are companies such as Dioki, but these are forced privatisations where the government assists in ownership restructuring in formerly private companies or sells loss-making companies that it cannot turn around.

The Main Actors and Their Ideas

The higher cost of borrowing associated with the threat of losing the BBB– investment grade is the strongest and most widely accepted motivation for fiscal reforms. Even public sector trade unions, usually the most pronounced critics of the government, seem to be aligning with that goal. The main actors are aware that continuous growth of public debt, coupled with higher interest rates, represents an explosive combination, leading to the transfer of ever more national resources abroad in the form of growing interest payments. Academics and opinion makers seem to support this view, too.

Trade unions as well as the far left and far right parties (which are also represented in the Parliament) sometimes set this big picture aside. When particular issues are discussed, such as public sector wages or certain public infrastructure projects, they sometimes use populist arguments emphasising the idea of »fairness«, disregarding current economic realities. In the context of long-lasting economic crisis this may lead to a stronger concentration of votes at the extremes of the political distribution. However, this shift is gradual. For the time being it does not endanger the Social Democrats in power and centre-right conservatives as leaders of the opposition. However, the longer the crisis lasts, the higher the probability that things will change.

In the past, there have been talks to involve the IMF in the fiscal adjustment programme in order to boost international credibility (with the primary aim of cutting the cost of funding). However, the idea of involving the IMF faces strong popular resistance in Croatia. Key political personalities of the past few years (former PM Jadranka Kosor, present PM Zoran Milanović and former governor of the Croatian National Bank Željko Rohatinski) all spoke publicly about the IMF in negative terms, emphasising the ability and know-how of Croats with regard to resolving the crisis. However, as these abilities so far have proved insufficient, the mood seems to be changing. More recently, Minister of Finance Slavko Linić spoke about the IMF in more positive terms. New central bank governor Boris Vujčić is also known for being more pragmatic in this respect. Hence IMF involvement in the near future cannot be ruled out, especially if the Eurozone crisis reaches the next stage, with negative spillovers into the Croatian economy. The next wave of the crisis has the potential to undermine current efforts aimed at fiscal adjustment, in which case Croatia would need the IMF's assistance in order to remain on track with at least some potential to control the public debt and achieved growth in the medium term.

Concluding Remarks: The Consequences of Fiscal Reform

It is very hard to discuss the consequences of fiscal reforms as they involve a counterfactual: what would have happened had there been no fiscal reforms? A simple view based on oversimplification is reflected in the »austerity vs. growth« debate: this simplified view holds that less fiscal adjustment would lead to more aggregate demand, more growth and more employment. However, there are two caveats related to this view. First, fiscal expansion in the initial stages of the crisis did not help the Croatian economy to alleviate its impact. It is not clear how longer lasting fiscal expansion would benefit the economy. Second, if it is pretty clear that higher spending and deficit would imply ever higher costs of borrowing, potentially with nobody willing to finance the deficit, fiscal reforms may represent a gradual but less painful way of adjustment. At least it would help to avoid a full blown financial crisis of the Greek type.

In this respect, the austerity vs. growth debate is grossly misplaced in the Croatian context. The search for growth should focus on searching for the most efficient and effective measures to boost entrepreneurship, private investment and employment. More government spending may seem to be a good way to realise these goals in the short run, but its price in the long run may be too high. On the other hand, given that, as Keynes said, »in the long run we are all dead«, maybe the long-run price is not relevant for decision-making. The only problem is that, in this case, long-run death may come as a consequence of short-run excess. How to avoid fiscal excess without killing the economy by austerity remains an art (or a matter of luck?) rather than science.

About the Author

Velimir Šonje, Arhivanalitika d.o.o. and Zagreb School of Economics and Management.

Imprint

Friedrich-Ebert-Stiftung
Central and Eastern Europe
Hiroshimastraße 28 | 10785 Berlin | Deutschland

Responsible:
Dr. Ernst Hillebrand, Head, Department of Central and Eastern Europe

Tel.: ++49-30-26935-7726 | Fax: ++49-30-26935-9250
http://www.fes.de/international/moe

Orders / contact:
info.moe@fes.de

Friedrich Ebert Foundation will publish in the coming weeks a loose series of papers on the economic and fiscal policies pursued by various European governments in the wake of the financial and Euro zone crisis.

Recently have been published:

Austeritätspolitik in Europa: Spanien
by Lothar Witte, FES Internationale Politikanalyse, August 2012

Austerity Policies in Europe: The Case of Poland
by Gavien Rae, FES International Policy Analysis, August 2012

The Consequences of Austerity Policy in Portugal
by José Castro Caldas, FES International Policy Analysis, August 2012

Austerity and Structural Reforms in Romania
by Victoria Stoiciu, FES International Policy Analysis, August 2012

Austerity Policy in Europe: Spain
by Lothar Witte, FES International Policy Analysis, September 2012

EFQM
Committed to excellence

ISBN 978-3-86498-269-9