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Fiscal Destimulation Instead of Fiscal Stimulation in Croatia¹

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Regular readers of my articles, if such a category exists, probably started thinking long ago that my writings are extremely repetitive. However, despite the constant repetitions of the same views, notwithstanding all the time, energy and funds invested by the Institute of Public Finance in popularly written publications that are sent free of charge to Parliament, ministries and the media, it is as though nothing has reached this targeted audience. As though only a few journalists have understood these messages. Or else everybody understands everything, because sometimes, but only sometimes, and then only to attack the current government, some sensible sentence comes from the opposition. However, when these same people come to power, they are equally ready to make and to support irrational decisions. Because of the panic that has gripped the citizens, I will once again try to summarize the currently most important topics. These are not original ideas. They come from basic economic textbooks and one would expect all economists, at least, if not all basically educated citizens to be familiar with them.

It is not necessary to argue whether Croatia is in recession or not. Even in the USA, where *National Bureau of Economic Research (NBER)*, a very competent institution officially declares the recession, an official announcement often lags behind the real situation. As announcing a recession by quarterly tracking of GDP has serious faults, economists are more and more inclined to judge whether there is a recession by observing the increase in unemployment. As Croatian unemployment was - although seasonally usually high – lower in January 2009 than in January 2008, one could easily judge that there is no recession. However, the Croatian labour market is not flexible, and a substantial part of the workforce is employed by the public sector, meaning that one should be careful with that indicator too. It is more than enough for Croatia that almost the whole world is in recession and it is not essential for us to announce we are in a recession.

Whether in recession or not, Croatia is confronted with problems that it should tackle even without the worldwide slump. Croatia has been living above its means for too long and the bills have to be paid. Unfortunately, in the circumstances of the worldwide recession, the bills are becoming more and more expensive. No Croatian government bothered with fiscal consolidation, or tried to limit the growth of the public sector or to carry out the necessary institutional reforms. The Estonian government for example did exactly that, and now thanks

¹ The same article has been published in Croatian in *Banka* magazine, March 2009, available at <http://www.bankamagazine.hr/Naslovnica/Kolumne/KatarinaOtt/tabid/136/Default.aspx>

to respectable resources can confront the recession with an expansive fiscal policy instead of the restrictive policy measures which can only worsen the situation. Quite the opposite to Estonia, Croatia now has to improve its competitiveness, decrease the budget deficit and the current account deficit and accumulate funds to repay its debts, all in the worst possible circumstances. Once again it is necessary to emphasize that there is no other possibility but to decrease expenditures. It is necessary to target the most burdensome expenditures – public sector salaries and expenditures for pensions, health and welfare - which make around 70 % of total government expenditure.

If this government, like all its predecessors, does not have the guts to decrease the most intractable expenditures, then there is no other option but to increase taxation. Revenues and expenditures have to be balanced and new debts are out of the question. If the government decides to increase taxation it should not introduce some new kinds of taxes, but simply increase the standard VAT rate and replace the zero rates with lower VAT rates, which it will sooner or later have to do anyway to satisfy the requirements of the European Union. VAT is the highest yielding, simplest and least expensive tax to collect and the most appropriate for necessary adjustments.

All discussions about fiscal stimulation should be stopped too, as Croatia, with its high debts, imbalances and demographic situation can not afford them. All those who have been fond of invoking Irish good practices can continue to do so. After some twenty years of successful social partnership with employers and trade unions, because of the decreasing GDP, increasing unemployment and fears of falling credit ratings, despite the opposition of its social partners, the Irish government unilaterally announced a fiscal consolidation program. To reach a balanced budget by 2013, the Irish government is decreasing public expenditure and increasing taxation. The government that has taken these measures might be voted out, but the measures will stay.

And what has the Croatian government been doing? It is waiting for the local elections and to win them it is ready to sacrifice the progress and wellbeing of its citizens. It is also wondering how to cover at least the part of the budget deficit by making ruinous inroads into the pension system reform, which was carried out at such an expense. Both the pension system reform, as a long term process, and the demographic situation require constant strengthening, popularization and promotion of the second and third pillar and diminution of the first pillar. Long term goals should not be sacrificed because of some short term interests. Will this government explain to citizens that funds in their personal second pillar accounts are their private property, which will be inherited directly or indirectly if it is not now donated to the budget? What will happen to the Croatian capital market and how will the stock exchange function, when the pension funds carry out around two thirds of all transactions? Luckily, almost all the banks are private; the central bank established itself as a relatively independent institution, and at least our money in the banks is safe. One could easily imagine how the government might run industrial policies and finance the insatiable shipbuilding industry through state owned banks.

One should also say something about the never-ceasing flow of crazy ideas about domestic currency devaluation, about restrictions on working on Sundays, but it is not possible to cover everything. And only one more issue – the International Monetary Fund. We certainly do not need the Fund if we are capable of fiscal consolidation on our own. However, if we do not carry out fiscal consolidation, we will have to bring in the Fund, and Fund will then oversee – fiscal consolidation.