How long is the Excessive Deficit Procedure for Croatia going to take?

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PRESS RELEASES

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Due to Croatia's general government deficit in excess of 3% of GDP, the European Commission prepared and released on December 10, 2013 three documents for the country: a Commission Opinion on the existence of an excessive deficit in Croatia, a Proposal for a Council Decision on the existence of an excessive deficit in Croatia and a Recommendation for a Council Recommendation to end excessive deficit situation in Croatia, accompanied by a Commission staff working document entitled "Analysis by the Commission services of the budgetary situation in Croatia" . All these documents are actually proposals rather than final versions which are yet to be published on the Commission's website.

Testing sentiment for reform. There is general awareness among the professional and scientific communities, as well as the wider interested public in Croatia that an excessive deficit procedure (EDP) has been opened for Croatia, with a view to reducing the deficit below 3% of GDP. However, the huge deficit is not the only reason for opening the procedure: it is also the excessive general government debt. By issuing the draft documents, the Commission has been testing the sentiment of the Croatian Government and public for potential deep cuts in public finances. The proposed reduction in government deficit in the first year of EDP implementation is relatively modest and is not likely to lead to any public debt reductions in that year. On the contrary, budget deficit cuts result, to some extent, in public debt growth, because of the heavy due debt refinancing obligations, especially in 2014 and 2015, and possible new borrowing. Public debt is not expected to decline before 2016, when the deficit falls below 3% of GDP.

Lower deficit but higher general government debt. In its working document, the Commission has specified government deficit targets for the period ending in 2016. The deficit levels recommended by the Commission are lower than projected by Government in its Explanation of the 2014 Budget: by 0.9% in 2014, 1.1% in 2015 and 0.8% 2016 (Table 1). Expressed in kuna, the deficit should be lower by HRK 3.1bn in 2014, almost HRK 4bn in 2015 and about HRK 3bn in 2016, than the levels projected by Government. This means that the total deficit reduction should be HRK 10bn more than envisaged by the Government (Table 2). Of course, the actual deficit reduction will greatly depend on the quality of the Government's GDP, deficit and public debt projections. Judging by the quality of Government's projections so far, even deeper deficit cuts, particularly in the first year of the EDP, should come as no surprise. The Commission will insist on strict compliance with the set budget deficit limit. The burden of potential reforms has been evenly distributed across the years, without setting as an imperative that sharp cuts be made and structural reforms be carried out in 2014, but only in the pre-election year 2015, whereas more substantial reductions in the post-election period are expected to be made by a newly appointed Government. At present, one thing is certain: the Government must prepare a budget revision as early as the beginning of next year.

Problem of the growth and management of public debt. The Commission envisages deficit reductions, but also a substantial increase in public debt to almost 67% of GDP in 2016. A possible decrease in debt, to 65% of GDP, is hardly expected before 2018. Only from 2014 to 2016, public debt could rise by more than HRK 22bn. However, the amount of debt is less concerning than its surveillance and control. It is difficult to keep the general government debt under control if there are perpetual problems with the borrowing records, especially as concerns the amount and structure of credit liabilities and maturity of other potential liabilities, e.g. guarantees. All this creates uncertainty which spills over to the private sector, undermines the credibility of the Government and the state and increases the cost of foreign borrowing. Any austerity measures and efforts to reduce expenditures can be easily ruined by imprudent management of public debt. Investors can punish such behaviour by requiring higher yields on bonds (which increases debt costs).

Definition and targeting of austerity measures. Fiscal austerity measures must not only relate to the state budget, but also to public enterprises (especially as concerns subsidies, material expenses and expenses for employees), extra-budgetary users, local government units and utility companies.[1] The Government should have prepared a list of measures and estimated their impact on deficit reduction back in 2012. In contrast to the previously proposed reforms targeted on state budget users, the new ones should be more closely focused on reducing the expenditures of the general government and public enterprises.

Croatia will remain under an EDP for more than three years. The reason is simple: the country is supposed to cut its budget deficit below 3% of GDP by 2016. Regrettably, pre-election and election years have never been good years for any thorough reforms and saving in Croatia. These have usually been the years of only negligible „cosmetic“ changes to the revenue system, with minor fiscal effects. It remains to be hoped, however, that political decision- makers are fully aware of the serious fiscal problems and that they will, even in the pre-election period, support cuts in general government spending.

However, one thing is certain: on 28 January, the EU Council is supposed to adopt a Decision on the existence of an excessive deficit in Croatia and a Recommendation to end an excessive deficit situation. The Recommendation will include: (1) the time limits within which Croatia must reduce its deficit below 3% of GDP; (2) the average annual amounts of deficit reduction during a certain period; and (3) an invitation to the Government of the Republic of Croatia to propose concrete measures towards reducing the deficit to GDP ratio below 3%.

Table 1 *General government deficit and debt, 2012-2016 (% of GDP)*

	2013*	2014*	2015*	2016*
a. General government deficit, European Commission	5.4	4.6	3.5	2.7
b. General government deficit, Government of the RC	3.4	5.5	4.6	3.5
Difference between EC and Government of the RC (a-b)	**2.0**	**-0.9**	**-1.1**	**-0.8**
1. General government debt, European Commission	63.1	63.9	66.1	66.8
2. General government debt, Government of the RC	58.1	62.0	64.1	64.7
Difference between EC and Government of the RC (1-2)	**5.0**	**1.9**	**2.0**	**2.1**
GDP, in million HRK	336,326	347.178	361.730	378.010

**projections*

Sources: Government of the RC: Explanation of the budget proposal of the RC and the financial plans of extra-budgetary users for 2014 and projections for 2015 and 2016; and European Commission.

[1] A more detailed explanation of the types of reform measures implemented in the EU Member States is given in the Bajo, A. (2013). Fiscal reforms and consolidations under Excessive Deficit Procedure. *Newsletter* No. 82. Institute of Public Finance, November 2013.

Table 2 *General government deficit and debt, 2012-2016 (in million HRK)*

	2013*	2014*	2015*	2016*
a. General government deficit, European Commission	18,162	15,970	12,661	10,206
b. General government deficit, Government of the RC	11,435	19,095	16,640	13,230
Difference between EC and Government of the RC (a-b)	**6,727**	**-3,125**	**-3,979**	**-3,024**
1. General government debt, European Commission	212,222	221,847	239,104	252,511
2. General government debt, Government of the RC	195,405	215,250	231,869	244,572
Difference between EC and Government of the RC (1-2)	**16,816**	**6,596**	**7,235**	**7,938**

**projections*

Sources: Author's calculation based on the RC Government data; Explanation of the budget proposal of the RC and the financial plans of extra-budgetary users for 20¸4 and projections for 2015 and 2016; and European Commission, 2013.