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Kesner-Škreb, Marina; Pleše, Ivana; Mikić, Mia

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NEWSLETTER



Institute of Public Finance, HR-10000 Zagreb, Katančičeva 5 Croatia
P.O.Box 320, Phone: (385 1) 4819 363; Fax: 4819 365; e-mail: office@ijf.hr; www.ijf.hr

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Marina Kesner-Škreb
Ivana Pleše
Mia Mikić

State aid to enterprises in Croatia in 2001

According to the Stabilization and Association Agreement with the EU, Croatia is required to establish a transparent system of allocation and control of state aid to enterprises.

State aid to enterprises in Croatia is high and mainly directed to certain industries, primarily transport, shipbuilding and tourism. In the process of its approaching the EU, Croatia will have to gradually reduce the size of state aid and redirect it to horizontal objectives, i.e. those that are common to all enterprises such as research and development, small and medium-size enterprises, training and employment, environmental protection, etc. At the same time, the system of allocation and control of state aid as well as of recovery the aid that has been granted without the approval of the European Commission should become more transparent in order to minimize arbitrariness in the allocation of state aid.

This is the briefest conclusion of a research carried out by the Institute of Public Finance as a

contribution to the development of the Croatian state aid system. Our objective was to assess the size and structure of state aid in Croatia in 2001 by applying the EU methodology¹. This study should indicate the direction in which the state aid policy should develop in order to adjust the size and structure of aid in Croatia with the EU standards. At its meetings, starting from the one held in Lisbon in 2000 to the Brussels meeting in March 2003, the European Council called on the governments to "further reduction in state aids and the redirection of aid to horizontal objectives". It also welcomed the "Commission's intention to continue working to simplify and modernize state aid arrangements, focusing attention on the most distorting aid".

¹ The entire research is published in the journal "Financijska teorija i praksa" (Financial Theory and Practice), No. 27(3), pp. 287-330 (2003).

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>.

Box 1 What is State Aid?

According to an EU definition state aid is the aid, which:

1. is granted through state resources;
2. favors certain undertakings, sector or region;
3. is selective because it disturbs the balance between enterprises and their competitors; and
4. affects competition and trade between Member States.

State aid in the EU is classified into horizontal aid (intended for all economic subjects), sectoral aid (directed to selected industries and enterprises) and regional aid. State aid can be allocated through various instruments: grants, tax exemptions, equity participation, soft loans, tax deferrals and guarantees.

By signing the **Stabilization and Association Agreement (SAA)** Croatia committed itself to harmonizing its national legislation governing state aid with the regulations of the Treaty Establishing the European Economic Community. Croatia is required to:

1. establish an **operationally independent authority**, which will be empowered to fully implement the system of allocation, control and returning of (illicitly granted) state aid. In addition, regular annual reports will be prepared based on the EU methodology;
2. establish a comprehensive **inventory of all aid schemes** developed before the establishment of the operationally independent authority and to adjust these schemes with the EU criteria within four years from entering into force of the SAA.
3. During the first four years after entering into force of the SAA, **each state aid granted in Croatia will be assessed** based on the fact that Croatia shall be regarded as an area identical to the areas of the Community.

According to the Ministry for European Integration, most measures have already been implemented or are in the process of implementation. In 2003, the **State Aid Act** (official gazette *Narodne novine*, No. 47/03) and the Decree on State Aid (official gazette *Narodne novine*, No. 121/03) entered into force. These regulations are very similar to the provisions of the Treaty Establishing the EC, which is not surprising, given that Croatia has to harmonize its enti-

re legislation with the *acquis*. Pursuant to this Act, the **Agency for the Protection of Market Competition** became responsible for the "allocation, supervision, implementation and return of general and individual state aid". Through this, Croatia formally satisfied the requirement laid down in the SAA that an "operationally independent authority" be established to supervise the application of the rules on state aid. However, according to the European Commission, the Agency for the Protection of Market Competition, is currently not enough qualified to perform these tasks. Despite the existence of the necessary legal framework, the Croatian state administration still has to make much effort in order to implement the measures agreed under the SAA.

I.

The Size of State Aid

In 2001, state aid represented 5.25% of GDP in Croatia and 1.01% of GDP in the EU Member States.

In 2001, the total state aid to enterprises in Croatia amounted to HRK 8.5 billion or EUR 1.1 billion, which represented **5.25% of GDP**. The annual amount of state aid per employee in the Croatian economy was HRK 6,340 or EUR 849.

However, these figures must be placed in the European context in order to assess their importance more accurately. For this purpose we used the data on state aid in the EU, published in the State Aid Scoreboard (Commission of the EC, 1992, and 2003), which relate to the periods 1986-1988 and 1999-2001. The EU, then comprising twelve Member States, allocated 2.2 % of its GDP for state aid to enterprises in the period 1986-1988. Thirteen years later, i.e. in the period 1999-2001, fifteen Member States allocated only **1.01%** of its GDP for state aid, which is five times less than the share of state aid in GDP in Croatia. During the observed period, Member States halved their support to enterprises. However, the level of aid in individual EU states varies considerably, from 0.5% of GDP in Great Britain to 1.73% in Finland.

In mid-1980s, Greece allocated by far the largest share of its GDP for state aid to enterprises

(4.5%), followed by Luxembourg with 4%. Yet, since the late 1990s, both countries reduced this ratio to a little more than 1% of GDP (Greece 1.42% and Luxembourg 1.35%). Consequently, in the thirteen-year period, aid to enterprises in the two countries recorded a more than threefold decrease. Greece deserves a special attention, as the state-aid-to-GDP ratio in Croatia in 2001 was most similar to that in Greece, which had the largest share of state aid in GDP of all EU Member States in mid-1980s. Thus, the share of state aid in the Croatian GDP of 5.25% in 2001 can be compared with that in Greece several years after its accession to the European Union in 1981. At that time, state intervention in Greece in the form of granting aid to enterprises was stronger than in any other Member State, and was probably even stronger in early 1980s, i.e. before the accession to the EU. From this perspective, state aid in Croatia can be considered as rather generous, so that Croatia, just like Greece, will have to go through a long process of adjusting its state aid with the European standards. Of course, all other Member States have also gone through a similar process of state aid harmonization and the downward trend in state-aid-to-GDP ratio is observable in all these countries.

Table 1 Total State Aid as a % of GDP in Croatia and the EU

| | 1986-1988 | 1999-2001 |
|-----------------------|-------------|-------------|
| Belgium | 3.20 | 1.35 |
| Denmark | 1.00 | 1.38 |
| Germany | 2.50 | 1.23 |
| Greece | 4.50 | 1.42 |
| Spain | 2.70 | 0.76 |
| France | 2.00 | 1.17 |
| Ireland | 2.70 | 1.28 |
| Italy | 3.10 | 1.01 |
| Luxembourg | 4.00 | 1.35 |
| the Netherlands | 1.30 | 0.97 |
| Austria | n.a. | 1.00 |
| Portugal | 1.50 | 1.14 |
| Finland | n.a. | 1.73 |
| Sweden | n.a. | 0.72 |
| Great Britain | 1.10 | 0.50 |
| EU12 | 2.20 | |
| EU15 | | 1.01 |
| Croatia (2001) | | 5.25 |

Source: Commission of the EC, 1992:39; 2003:35.

Now, what is the relationship between state aid in Croatia and in the candidate countries? The report on state aid published by the European Commission in autumn 2002 covers the data on state aid in the twelve candidate countries except Malta (Commission of the EC, 2002a). In Croatia, the level of state aid is much higher than in the EU candidate countries. So, while **in 2000 state aid accounted for as little as 1.3% of GDP in the candidate countries, one year later Croatia allocated three times more funds for state aid, i.e. 3.8% of its GDP.** At the same time, Member States allocated only 0.8% of GDP for the aid to individual enterprises. It should be emphasized that this figure does not include aid for agriculture and fisheries, as the EU candidates are not required to submit reports on state aid for these two sectors, which are covered by other chapters of the European Treaties. Pursuant to the SAA, Croatia is also obliged to keep records of state aid excluding that for agriculture and fisheries. There are considerable differences in the size of state aid in individual candidate countries. Thus, in Romania state aid accounts for almost 2% of GDP, compared with only 0.4% in Slovakia. Yet many candidate countries will have to adjust the size of their state aid with that in the EU. Croatia is expected to make a particularly strong effort in this respect.

Table 2 State Aid as a % of GDP in the Candidate Countries, (less agriculture and fisheries)

| | 2000 |
|-----------------------|------------|
| Bulgaria | 1.3 |
| Cyprus | 1.0 |
| Czech Republic | 1.5 |
| Estonia | 0.5 |
| Hungary | 1.7 |
| Lithuania | 0.6 |
| Latvia | 0.7 |
| Malta | n.a. |
| Poland | 1.1 |
| Romania | 1.9 |
| Slovenia | 1.2 |
| Slovakia | 0.4 |
| EU15 | 0.8 |
| CC12 | 1.3 |
| Croatia (2001) | 3.8 |

Note: CC - Candidate Countries.

Source: Commission of the EC 2002a:14.

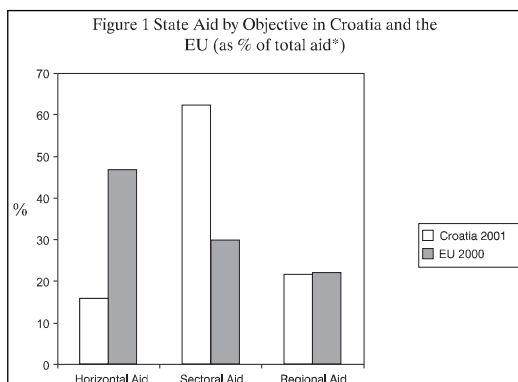
II. Objectives of State Aid

Croatia allocates twice as much funds as the EU for supporting certain industries (mainly transport, shipbuilding and tourism), and three times less for horizontal objectives than the EU.

State aid in the EU is usually classified into **horizontal, sectoral and regional aid**, as well as aid for agriculture and fisheries. However, most frequently an analysis is made of the relationship between the horizontal or the so-called "good" aid and sectoral or "bad" aid. Thus, horizontal aid is not oriented to specific sectors but is aimed at correcting market failures, and is therefore considered to have a much less distorting effect on competition than sectoral aid. The basic objectives of horizontal aid include research and development, small and medium-size enterprise, environmental protection, employment and training, etc. Therefore, this paper mainly concentrates on the two categories of aid.

Of the total state aid of HRK 8.5 billion allocated in Croatia in 2001, more than a half or HRK 4.4 billion was spent on individual economic sectors. Agriculture was allocated HRK 2.8 billion, while the smallest amount, i.e. HRK 563 million, was allocated for horizontal objectives. Regional aid accounted for HRK 776 million.

In order to make a true comparison of the structure of aid according to objective, the data should be analyzed in the EU context. Due to the limited range of data, we have only analyzed the size of state aid excluding agriculture, fisheries and transport (Commission of the EU, 2002:18). Consequently, the data for Croatia have also been adjusted in accordance with the EU principle.



*less agriculture, fisheries and transport.
Source: Commission of the EC, 2002:19.

Figure 1 shows clearly that the structure of state aid in Croatia diverges from that in the EU. The most conspicuous is the very large share of state aid for certain industries in Croatia. Around two thirds or **62.5% of total aid is allocated to particular industry**. This area will therefore require the strongest adjustment to the EU rules, i.e. the share of aid to particular sectors will have to be reduced by almost a half in order to reach the EU level in 2000, which is around 30% of total aid. On the other hand, Croatia allocates **three times smaller funds for horizontal aid**, i.e. the aid that is intended to support all enterprises and not just the selected ones. Consequently, in order to adjust the structure of state aid with that in the EU, a larger amount of government funds in the form of state aid will have to be redirected from individual sectors to horizontal and regional objectives. As suggested by the results of this research, **the most part of sectoral aid is spent on transport, shipbuilding and tourism**. Therefore, it is obvious that these sectors will be most deeply affected by the adjustment to the EU criteria. An example of the EU's treatment of illicit allocation of state aid is given in Box 2.

Box 2 Brussels Investigates Spanish Aid to a Shipyard

EU regulators investigate a cash injection of EUR 1.5 billion provided by the Spanish government to Izar, the second largest shipbuilding company in Europe. Despite the Spanish argument that the European Commission has no jurisdiction over that aid, Izar will have to return the money should the investigation prove that it was awarded illicitly.

This is a politically sensitive case, as the state-owned Izar is the biggest employer in Spain, which is considered to be the reason why the European regulators postponed the investigation to the end of local elections in that country.

It is believed that the subject of investigation is the aid received by Izar in the period between 2000 and 2002, by which it gained an unfair advantage over its EU competitors. The shipyards owned by Izar allegedly received aid to the amount of EUR 800 million in 1997, and would not be entitled to any additional subsidies by 2007.

According to the *Financial Times*, Spain is expected to argue that the new aid was earmarked for military shipbuilding, which was beyond the competence of the European Commission.

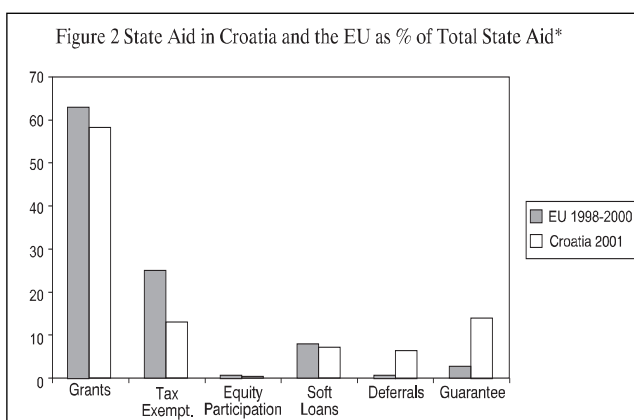
Source: BankaMagazine, 2003.

III. State Aid Instruments

Compared with the EU, Croatia allocates less aid in the form of grants from the budget and tax exemptions but more in the form of tax deferrals and guarantees.

Like the EU, Croatia supports its enterprises mostly through budgetary transfers like grants and tax exemptions (mainly those allowed under the Profit Tax Act). However, the tax exemptions also include write-offs of state claims arising from taxes, contributions and customs duties, granted by the Croatian Government to enterprises like agricultural and processing plants, Croatian Radio and Television, TLM Šibenik and "Slobodna Dalmacija" during 2001.

However, special attention should be brought on a relatively large share of soft loans, which were mostly granted within the Croatian Bank for Reconstruction and Development credit program. But this category also includes rescheduled loans and loans taken over pursuant to the decisions of the Croatian Government about the assuming of credit liabilities of Agricultural and Processing Plants during 2001. Issued and called guarantees were mainly given to enterprises in agriculture, shipbuilding and tourism.



*less agriculture and fisheries.

Source: Commission of the EC, 2002:25.

For the comparison of state aid categories between Croatia and the EU we exclude the data on agriculture and fisheries, because these two sectors are al-

so excluded from the EU classifications. The basic difference in the implemented forms of aid between Croatia and the EU is that **in the EU, grants and tax exemptions represent a much larger share in total state aid than in Croatia** (almost 90% compared with 72% in Croatia). In contrast to this, as shown in Figure 2, **state aid in the form of tax deferrals is much more frequent in Croatia than in the EU (6.4% vs. 0.6%). The same applies to guarantees (14.1% vs. 2.8%)**. However, the level of transparency of these particular forms of aid is relatively low, as they are mainly granted on the basis of arbitrary decisions taken by the Government or the responsible ministries. Unlike them, grants and tax exemptions allocated within the budgetary process are subject to a closer control of all participants in the preparation and execution of the budget. It can therefore be expected that, within its approaching the EU, Croatia will have to increasingly allocate state aid within the budgetary process instead of relying on other less transparent forms of aid.

In the process of its state aid reforms, Croatia will have to make great efforts and show political will to adjust the level and structure of this form of state intervention with the standards of modern European market economies.

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