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NEWSLETTER

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Towards 'Less and Better' State Aid in Croatia¹

Sectoral state aid accounts for 56 percent of total aid in Croatia, and "only" 25 percent in EU-15. Can subsidized sectors in Croatia expect generous aid also in the future? This paper tries to explain the negative effects of state aid, the relevant EU requirements and practice and desirable future trends in the size and structure of state aid in Croatia.

1 State Aid Effects

State aid is an industrial policy instrument enabling the government to directly influence the course of development of certain enterprises or economic sectors. By providing aid, the government favours certain enterprises or economic sectors, thus steering their development. However, this does not mean that individual aid, although beneficial to a particular enterprise, would result in overall economic growth. Overall economic growth even weakens if aid is directed to less efficient businesses, producing low-quality goods at high costs. Similarly, economic growth accelerates if aid is aimed at correcting market failures, i.e. dealing with market disturbances.

Selective aid has a number of adverse effects. State aid, particularly that which serves for the implementation of selective industrial policy, i.e. the policy of providing assistance only to selected sectors or enterprises, can be considered as "bad" aid, because it has a number of negative effects. Many researchers argue that:

- The government is unable to select 'winners' or 'losers', or to stop providing assistance. Selective industrial policy is implemented in the way that the government selects industries or enterprises needing support. These are either prospective 'winners', i.e. industries or enterprises expected to grow at high rates, or 'losers', i.e. industries or enterprises in difficulties which need government assistance for survival and recovery. Owing to its inadequate administrative capacities and a lack of necessary information on products, prices or new technologies, the government has generally proved inefficient in allocating aid. Most frequently, it has been unable to select 'winners' and/or major loss makers among industries, or to pick the right moment to stop providing assistance, i.e. determine when an

¹ The complete study was published under the title: "State Aid Reform in Croatia" in: K. Ott, ed. *Croatian Accession to the European Union - the Challenges of Participation*. Zagreb: Institute of Public Finance and Friedrich Ebert Foundation, 2006, pp. 227-264; Available from: <http://www.ijf.hr/Eu4/jovic-skreb.pdf>.

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industry becomes capable of operating independently. By applying inappropriate economic policy measures, the government has often caused distortions in the economy, thus impairing its efficiency. Long-term provision of subsidies to loss-making enterprises which are unable to operate efficiently turned out to be a waste of the taxpayers' money.

- The government is incapable of resisting various pressure groups. In response to the pressure from various lobbies, the state intervention network becomes more sophisticated and the state administration increasingly liable to corruption. Once the state intervention stabilizes, there is a danger that the state would fall under the influence of various interest groups lobbying hard to retain state aid, even though it ceased to be economically justifiable. Moreover, there are always new prospective beneficiaries who 'could make good use' of state aid. Owing to the influence of such interest groups, it is difficult to discontinue state aid and new forms of state aid are introduced, making it difficult to break this vicious circle.
- State aid also results in unfair competition between subsidized and non-subsidized enterprises. More specifically, owing to lower prices offered by subsidized companies, yet not as the result of quality or productivity improvements, good but unsubsidized companies with more expensive products are forced out of the market. This can gradually lead to monopolistic structures of the market.
- Lack of motivation to improve production. Enterprises protected by state aid are unmotivated to reduce costs, modernize production and raise the quality of their products. This leads to lower efficiency and reduces competitiveness of the overall economy.
- State aid burdens the state budget and threatens its fiscal sustainability. As state aid is financed from tax revenues, its cost is borne by all taxpayers. Thus, despite the lower prices of subsidized products, in the end consumers indirectly pay their full, non-subsidized prices through higher taxes.
- State aid can create problems in international trade. Subsidizing domestic production by state aid provides a basis for the implementation of predatory policy and appropriation of international market shares. In response to such policy, the affected country may introduce retaliatory measures.

2 State Aid Policy in the European Union and in Croatia

State aid is basically prohibited in the EU, but their restricted application can still be authorised. Given the above drawbacks of state aid, the EU basically prohibits all forms of aid, allowing only those that are specified by EU regulations. Consequently, the EU has adopted a highly elaborated set of rules implemented under the supervision of the European Commission, which are binding upon all Member States. These rules are particularly restrictive to sectoral state aid. Such selective aid distorts competition and postpones the exposure of businesses to the market which only rewards successful enterprises, thereby improving overall European competitiveness. In contrast to sectoral aid, horizontal state aid (allocated for research and development, environmental protection, energy conservation, employment, professional improvement, etc.) is viewed favourably, because it is equally allocated to all market participants and is much less distortive to competition than sectoral, i.e. selective aid.

State aid in the EU is trending towards less, but better targeted aid. A new business philosophy has been developing in the EU, advocating a level playing field for all undertakings on the market. A partnership between the market and public sector is expected to strengthen competitiveness and boost economic growth. In pursuing this philosophy, the European Commission adopted a "State Aid Action Plan" for the period 2005-2009, with the main objective of achieving less and better targeted aid by:

- reducing the share of total aid in GDP;
- redirecting aid from sectoral to horizontal objectives; and
- establishing a more transparent and efficient system of state aid allocation and control.

State aid in Croatia is subject to the supervision of the Croatian Competition Agency. Pursuant to the State Aid Act of 2003, the Agency was charged with the approval, supervision and recovery of state aid as a body competent for the allocation of state aid to all business entities, excluding subsidies and fiscal incentives to agriculture and fisheries. Over the past period, the administrative capacities of the Agency strengthened markedly, enabling it to take a number of measures aimed at informing state aid providers and beneficiaries of the state aid regulations². Through these regulations Croatia took over the entire *acquis communautaire*

² The key regulations governing state aid in Croatia include: the State Aid Act (Official Gazette 140/05), Regulation on State Aid (Official Gazette 50/06) and Decision on the Publication of Rules on State Aid (Official Gazette 121/06).

related to state aid, consisting of a rather large number of rules on about 365 pages. This accelerated the harmonisation of the Croatian legislation with that of the EU. Upon accession of Croatia to the EU, the supervision of state aid will become the responsibility of the European Commission, like in all Member States.

In the pre-accession period, Croatia needs to reduce and restructure state aid. In order to make timely adjustments to the European state aid system, which is fully controlled by the European Commission, Croatia will have to gradually reform its state aid system. This particularly includes reducing the state aid-to-GDP ratio and redirecting aid from selected sectors to horizontal objectives. However, it should be noted that subsidies to individual sectors will not be completely abolished, but will be granted exclusively in compliance with the state aid rules taken over from the EU. This fact should be borne in mind when formulating any future industrial policy of this country. Moreover, it is necessary to develop a transparent system of approval, supervision and recovery of state aid within the Agency.

3 The Size and Structure of State Aid in Croatia

The size of state aid in Croatia, measured by its share in GDP, is four times larger than in the EU. In the period 2001-2004, total aid excluding transport, agriculture and fisheries, accounted for 1.8 percent of GDP on average, compared with about 0,45 percent of GDP in EU-15.

Table 1. The Share of State Aid, Excluding Transport, Agriculture and Fisheries, in GDP (%)

| | 2001 | 2002 | 2003 | 2004 | average 2001-2004 |
|---------|------|------|------|---------------|----------------------|
| EU-15 | 0.46 | 0.51 | 0.41 | 0.42 0.43* | 0.45 |
| Croatia | 2.20 | 1.60 | 1.70 | 1.80 | 1.81 |

* Relates to EU-25.

Source: European Commission and authors' calculation.

The structure of state aid is unfavourable. The size of state aid is not the only problem facing Croatia in the pre-accession period, as the structure of aid differs from that in EU-15. In the period from 2001 to 2004, the largest portion of state aid (56 percent on average) in Croatia was allocated to selected economic sectors, while in the EU-15, sectoral aid accounted for only 25 percent of total aid. Differences were also noted in horizontal aid, while the data on regional aid for Croatia

largely correspond with those for the EU. Compared with the ten new Member States, the structure of state aid in Croatia is closer to that in EU-15 than in EU-10.

Table 2. State Aid by Objective in Croatia (2001-04), EU-10 and EU-15 (2000-03) (%)

| | EU-15 | EU-10 | Croatia |
|------------|-------|-------|---------|
| Horizontal | 52.2 | 14.9 | 17.2 |
| Sectoral | 24.8 | 75.9 | 56.1 |
| Regional | 23.0 | 9.2 | 26.7 |
| Total aid* | 100.0 | 100.0 | 100.0 |

* Excluding agriculture, fisheries and transport.

Source: European Commission and authors' calculation.

Transport, shipbuilding, ironworks and the rescue and restructuring of businesses account for almost 80 percent of sectoral aid. It is these sectors that will have to undergo the sharpest changes during the EU-accession period and the harmonisation with the EU acquis in the field of competition. However, it should be reiterated that the goal of the reform is not to completely discontinue aid to these sectors but to restructure it substantially in terms of its size and objectives. The table below shows the total amounts of sectoral aid in Croatia and EU-15 and its respective shares in total aid.

Aid to transport can be classified into two groups: aid to railways and aid to other transport services. In the period 2001-2004, aid to railways in Croatia stood at 6.3 billion kuna, accounting for 80 percent of total aid to the transport sector. In line with the raised environmental consciousness, the EU has viewed railways as a strategic sector and has therefore subsidized them generously (aid allocated to railways amounted to about EUR 25 billion in 2004). Therefore, Croatia will have to reform its state aid to railways, by drawing a strict line between supporting the services of general economic interest or investments in infrastructure, which is not considered as state aid, and transfers for the covering of current losses. A similar restructuring process is necessary for road, sea, river and air transport. In the observed period, aid to these modes of transport approximated 3.8 billion kuna, or 11.6 percent of total state aid in Croatia (about 2 percent in EU-15).

Croatian shipbuilding industry is a strongly subsidized economic sector. Compared with EU-15, in which shipbuilding accounts for about 2 percent of total aid, state aid to shipyards in Croatia accounts for a high 20 percent of the total. State aid to this sector needs to undergo a comprehensive reform, particularly because, the relevant EU rules, only allow the aid

Table 3. Sectoral Aid in Croatia and EU-15

| Objective | Croatia (2001-2004, million kuna) | Share in total aid (2004, %) | |
|----------------------------|--------------------------------------|---------------------------------|-------|
| | | Croatia | EU-15 |
| Railways | 6,349.1 | 30.9 | ... |
| Transport (excl. railways) | 3,843.9 | 11.6 | 2.0 |
| Shipyards | 2,566.6 | 20.0 | 2.0 |
| Ironworks | 257.1 | 1.5 | 0* |
| Rescue and restructuring | 750.6 | 2.3 | 1 |

* i.e. EUR 12 million.

Source: European Commission and authors' calculation.

granted for research and development, innovation or closure of shipyards, and related aid aimed at job creation, exports or development, as well as regional aid for investment in improvement or modernisation of existing facilities. In no way does this include aid for financial restructuring. It is for this reason that Croatia will have to reduce and restructure aid to shipyards, i.e. downsize the rescue aid provided to this sector.

The problem with iron industry is far less serious than with the previous two sectors. Here, adjustments will include reducing the amounts of aid and restructuring its objective towards covering the cost of surplus labour and the complete and final closure of ironworks. This is in line with the practice of the EU, which reduced state aid to iron industry from an annual average of EUR 2 billion (in mid-1990s) to as low as EUR 12 million in 2004, with the aid mainly targeted on environmental protection. In the period 2001-2004, aid to

ironworks in Croatia amounted to about 257 million kuna, about 1 percent of total state aid.

Aid to rescue and restructuring of enterprises has the most distorting effect on competition and is subject to special rules within the EU. Pursuant to these rules, aid is allocated according to the 'one time, last time' principle, i.e. it can only be allocated once in ten years. The rules further provide that rescue aid can be granted for a maximum of six months. After that, it is considered as restructuring aid, and the recipient is supposed to participate in financing its own restructuring. In the period 2001-2004, rescue and restructuring aid in Croatia slightly exceeded 750 million kuna, accounting for 2.3 percent of total aid (1 percent in EU-15). Consequently, Croatia will have to reduce the size of its rescue and restructuring aid, harmonize the relevant rules with the EU regulations and improve the transparency of state aid allocation in this area.

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