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Industrial Policy and State Aid in Croatia

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This article has been motivated by the Croatian Competition Agency's (CCA) Annual Report on State Aid for 2009[1]. It aims at highlighting the main trends in state aid during the 2002-2009[2] period, which reflect the industrial policy situation in Croatia. The main findings are the following:

- *During the reference period, the government invested a total of HRK 60bn (about a half of total public debt) in supporting entrepreneurs;*
- *After having reached its peak in 2007, state aid went down in the last two years;*
- *The state aid-to-GDP ratio of 1.1% in 2009 was still double the ratio in the EU;*
- *The bulk of state aid was allocated to agriculture (HRK 21bn) and certain sectors (HRK 30bn), and the smallest portion of aid was spent for horizontal and regional objectives (HRK 6bn and HRK 3.5bn respectively);*
- *82% of sectoral aid went to shipbuilding (HRK 12bn), transport (HRK 9bn) and Croatian Radiotelevision (HRK 4bn);*
- *In the area of horizontal aid, progress is yet to be made;*
- *Industrial policy in Croatia mainly relies on subsidies (70%) and guarantees (18%); and*
- *Croatia still does not have a consistent and feasible long-term industrial policy that would stimulate competitive and economically viable enterprises in the market.*

1 The opinions expressed in this article are exclusively those of the author and do not necessarily reflect the position of the Privredna banka Zagreb.

2 Croatian Competition Agency, Annual Report on State Aid for 2009, November 2010; available at http://www.aztn.hr/uploads/documents/tn/godisnja_izvjesca/godisnje_izvijesce_DP_2009.pdf

1 A BRIEF OUTLINE OF STATE AID

State aid is an industrial policy instrument representing measures through which the government influences the market position of companies. By granting aid, the government helps unsuccessful entrepreneurs to survive in the market, thus giving them advantage over their competitors, because they can offer lower prices (and/or lower-quality products). As a result, higher-quality entrepreneurs who are not given aid may be squeezed out from the market and market competition may be distorted.

State aid can be sectoral or horizontal. *Sectoral aid* distorts markets and favours one, usually less efficient enterprise, over another, thus reducing public welfare. By contrast, *horizontal aid* corrects market failures and contributes to the growth of public welfare. Horizontal aid, which includes aid for research and development, environmental protection, training aid, etc., is intended for all market participants, and has therefore much less distorting effects on market competition than sectoral aid. The granting of state aid, particularly that supporting only selected enterprises, has many drawbacks:

- Aid involves not only direct, but also indirect costs;
- The government has not enough information to distinguish between "market winners" and "market losers";
- The government does not know when to stop providing aid or how to resist various lobbyists.
- State aid leads to unfair competition;
- It can harm international trade; and
- It burdens state budgets.

All this should be kept in mind when considering the allocation of state aid.

According to the EU methodology, state aid includes, besides subsidies, some other, less explicit instruments, such as:

- State guarantees;
- 'Soft' loans extended by the Croatian Bank for Reconstruction and Development (HBOR);
- Loans for salary payment granted by the Croatian Privatisation Fund (HFP);
- Public land sales/rentals to entrepreneurs at below-market prices;
- Land sales by entrepreneurs to the state at prices higher than market prices;
- Providing free access to public infrastructure;
- Recapitalisation of enterprises by the state using the so-called risk capital under the terms more favourable than offered by private investors, etc.

State aid does not only constitute government expense, but it also reduces state revenue, for example, due to reduced corporate income tax rates applied in the areas of special state concern, or the claim write-offs by the HFP within the restructuring of enterprises from its portfolio. However, state aid does not include subsidies to households, educational institutions or hospitals, grants for general infrastructure projects, reduced VAT rate on certain goods and services and grants for defence and public works.

In order to prevent distortion of the single market, where better off member states subsidize their enterprises and thus squeeze out entrepreneurs from "poorer countries" from the market, the EU has generally imposed a ban on granting state aid. However, to enable the EU and its member states to enforce their respective industrial policies and to raise the competitiveness of their economies, a set of rules has been developed governing the purposes of and the manner in which member states may grant state aid.

The Croatian Competition Agency is an independent body controlling all types of state aid, except aid to agriculture that is supervised by the Ministry of Agriculture, Fisheries and Rural Development. As Croatia has taken over all the EU regulations governing state aid, the CCA is competent for approving all aid (except agricultural aid) granted by government bodies to all entrepreneurs in the industrial and services sectors.

After Croatia's accession to the EU, the European Commission will take over the majority of responsibilities currently discharged by the CCA. This should not pose a major problem for Croatian entrepreneurs, as the rules currently applied by the CCA for state aid allocation are the same as those applied in EU member states. Consequently, after joining the EU, Croatia will be allowed to continue granting state aid and implementing its industrial policy in compliance with the EU rules and in accordance with its financial capacities, as it does now, but the controlling function will be exercised by the European Commission. Upon accession to the EU, the only change for Croatia will be that any form of aid granted by the EU to an enterprise will be subject to a compliance check at a request of any other entity within the EU feeling threatened by such a decision.

2 TOTAL VOLUME OF STATE AID

The CCA has published reports on state aid for as long as eight years, providing data on the volume and structure of state aid for a longer time horizon, which creates a basis for a long-term industrial policy estimate in Croatia. The aid is presented according to the methodology applied in the European Commission's documents, enabling a comparison between the Croatian and EU data.

Table 1
State aid in Croatia (million HRK)

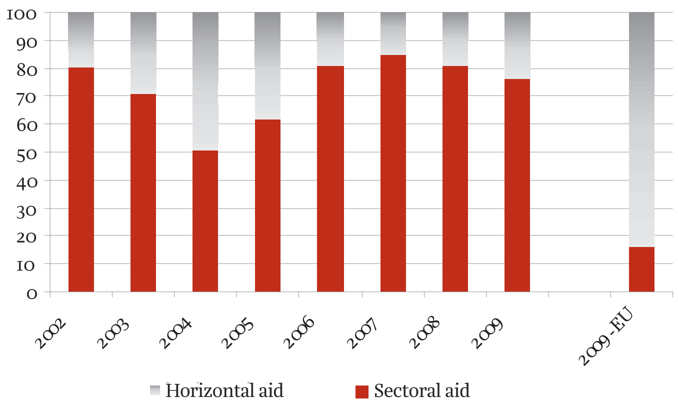
	2002	2003	2004	2005	2006	2007	2008	2009	2002-09	
									million HRK	% of GDP
Agriculture and fisheries	**1,779**	**1,950**	**1,820**	**2,125**	**2,543**	**3,275**	**3,615**	**3,671**	**20,778**	**0.9**
Industry and services	**3,398**	**4,080**	**3,326**	**2,933**	**6,935**	**8,020**	**5,947**	**5,021**	**39,660**	**1.8**
Horizontal aid	385	807	1,151	834	930	668	663	659	6,096	0.3
Sectoral aid	2,722	2,894	1,685	1,814	5,591	6,816	4,795	3,824	30,142	1.3
Regional aid	291	378	490	285	415	536	489	538	3,421	0.2
Total	**5,177**	**6,030**	**5,146**	**5,057**	**9,478**	**11,295**	**9,562**	**8,692**	**60,438**	**2.7**

Source: CCA, data processed by authors

In the 2002- 2009 period, state aid totalled HRK 60bn or 2.7% of GDP. The amount spent for supporting the economy in the eight year-period was equal to almost a half of total public debt in 2010[3]. The annual trend in state aid mainly depends on sectoral and agricultural aid, which jointly account for 84% of total aid. Sectoral aid and, consequently, total aid rose markedly in 2006 and 2007, on account of aid granted to shipyards (HRK 4.2bn) and Croatian Railways, as well as to steel industry on account of the privatisation of Split Ironworks and Sisak Steel Mill. Moreover, a continuous contribution to total aid growth was made by the growth in aid to agriculture, which doubled during the eight-year period. Over the last two years, total aid declined, and this trend is likely to continue.

The share of state aid in GDP in 2009 (1.1%) was still double the share in the EU (0.5%). However, the EU made a huge investment in the financial sector rehabilitation and restructuring (EUR 4.5 trillion, from October 2008 to October 2010) and EUR 1.1 trillion in 2009[4]. This, of course, led to an increase in state aid, which picked up from 0.5% to 3.5% of GDP. Under such circumstances, the share of state aid in GDP of as little as 1.1% is not so bad. However, the problem is that the EU measures are only temporary, and are applied until end-2011, when the EU state aid is to return to about 0.5% of GDP. Croatia will have to intensify efforts to reduce its state aid, which primarily consists in structural aid rather than current aid, from the present share in GDP to the EU average.

Graph 1
Sectoral and horizontal aid as a percent of aid to industry in Croatia (2002-2009) and EU (2009) (%)



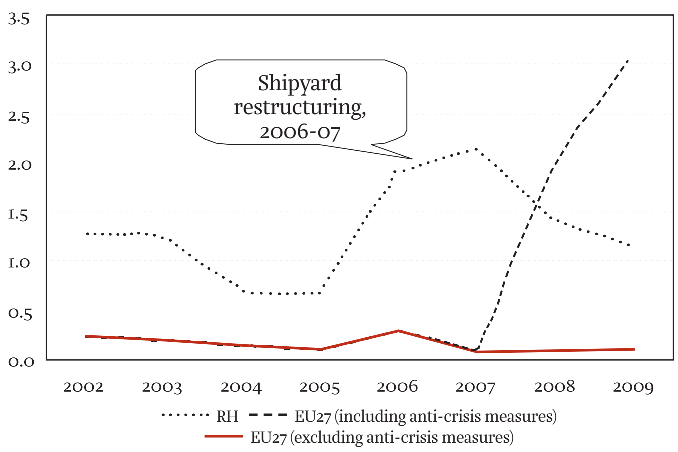
Source: CCA, data processed by authors

Most of the funds in Croatia go to sectoral aid and far less to horizontal aid. The bulk of aid to industry and services, i.e. a high average of 75% over the entire 2002-2009 period, was sectoral aid, and only 25% related to horizontal objectives[5]. The relevant EU ratios are quite opposite, so that in 2009, horizontal aid accounted for 84%, and sectoral aid for "only" 16% of total aid to industry and services. Under such circumstances, Croatia will have to redouble its efforts to reverse its industrial policy and to redirect state aid towards horizontal objectives.

3 SECTORAL AID

Sectoral aid continues to be the most significant form of government intervention in Croatia. In the 2002-2009 period, it stood at HRK 30.1bn, with the peak having been reached in 2007, and the lowest level in 2004. The largest portion of aid went to shipyards, transport and, after 2007, to the HRT. However, the last few years saw a decline in state aid, which is definitively a sign of positive movements.

Graph 2
Sectoral aid (as a % of GDP)



Source: CCA, data processed by authors

Until the break out of the financial and economic crisis in 2008, sectoral aid in EU27 was very low, about 0.2% of GDP. As the crisis arose, and as strong anti-crisis measures and programmes were put into effect (especially in 'old' EU member states), sectoral aid grew strongly in the EU, reaching 3.1% of GDP in 2009. Graph 2 also shows that the sectoral aid movements in Croatia are not the result of the crisis but of aid granted primarily to shipyards, transport and the HRT.

3 According to the "Public Debt Management Strategy for the period 2011-2013", available at http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2011/108_sjednica_vlade_republike_hrvatske.
4 At end-2008, the Commission adopted measures to mitigate the consequences of the economic crisis, aimed at temporary relaxing the rules on state aid. These measures are set out in the *Temporary Community Framework for State Aid Measures to Support Access to Finance in the Current Financial and Economic Crisis* (*Temporary Framework*) and were supposed to remain in force till end-2010. The Commission has extended the measures until 31 December 2011 (cited from http://ec.europa.eu/competition/state_aid/legislation/temporary.html).

5 Horizontal and sectoral aid taken together.

Tabe 2

Sectoral aid (million HRK)

	2002	2003	2004	2005	2006	2007	2008	2009	2002-09	
									million HRK	Structure
Sector	**2,722**	**2,894**	**1,685**	**1,814**	**5,591**	**6,816**	**4,795**	**3,824**	**30,142**	**100.0**
Steel manufacture	2	4	29	17	1	196	0	2	252	0.8
Transport	**1,351**	**1,158**	**423**	**415**	**1,395**	**1,407**	**1,453**	**1,309**	**8,910**	**29.6**
Shipbuilding	**653**	**1,047**	**530**	**643**	**2,798**	**3,125**	**1,892**	**1,153**	**11,840**	**39.3**
Tourism	62	213	87	182	261	181	172	165	1,322	4.4
Radio and TV-broadcast	**0**	**0**	**0**	**0**	**959**	**1,014**	**1,069**	**1,133**	**4,174**	**13.8**
Other sectors	383	158	26	56	41	51	135	59	908	3.0
Financial services	272	130	0	0	0	0	0	0	402	1.3
Rehabilitation and restructuring	0	184	591	502	137	842	75	3	2,334	7.7

Source: CCA, data processed by authors

Table 3

Financial and performance guarantees to shipyards (million HRK)

	2002	2003	2004	2005	2006	2007	2008	2009	2002-09	
Financial guarantees									million HRK	Structure
Viktor Lenac	163	121						614	**898**	6.5
Uljanik		64			53	321	339	0	**776**	5.6
Kraljevica		49		109	195	361		158	**872**	6.3
3. maj		329	52	370	859	1,929	612	256	**4,407**	32.0
Brodotrogir		114		150	382	340	502	337	**1,826**	13.3
Brodosplit		99	122		1,418	1,526	1,100	651	**4,915**	35.7
BSO Brodosplit					36	26		7	**69**	0.5
Total	**163**	**776**	**175**	**630**	**2,943**	**4,503**	**2,552**	**2,022**	**13,764**	**100.0**
Performance guarantees										
Uljanik				200	616				816	8.4
Kraljevica			110		101				211	2.2
3. maj			2,024	1,006					3,030	31.2
Brodotrogir			934	443	245				1,623	16.7
Brodosplit			1,667	1,810	391				3,868	39.9
BSO Brodosplit			39		111				150	1.5
Total			**4,774**	**3,458**	**1,465**				**9,697**	**100.0**

Source: MoF, data processed by authors

3.1 SHIPBUILDING

Shipyards are the largest single beneficiaries of state aid, with HRK 11.8bn of aid received in the 2002-2009 period, of which one-half relates to the shipyard rehabilitation period from 2006 to 2007. Over the last two years, aid to shipyards declined markedly, as a result of a drop in orders for shipbuilding projects due to the global economic and financial crisis. State guarantees account for the largest portion of aid to shipyards (almost HRK 8bn), the majority of which relates to rescue loans. However, there is a great likelihood that the government will have to take over the repayment of the loans received against rehabilitation guarantees, so that the burden of these loans will be shouldered by all taxpayers[6].

6 A total of HRK 13.7bn in financial guarantees and HRK 9.7bn in performance guarantees were issued, with substantial aid elements amounting to over 58% and over 34% in the case of financial and total guarantees respectively.

Besides state guarantees, direct subsidies are the most frequent aid instrument to shipyards, but their volume has declined over the last three years.

It should be noted that, in the current phase of restructuring, Croatian shipyards are subject to a special aid regime, i.e. large shipyards in difficulty may not be granted horizontal aid until they recover. They can be given exclusively rescue and restructuring aid under the following conditions:

- The enterprise must prepare a feasible restructuring plan;
- The enterprise must provide its own contribution;
- The aid must be limited to the minimum;
- The plan must envisage reductions in capacity; and
- The granting of aid cannot be repeated before the expiry of ten years.

3.2 TRANSPORT

The largest beneficiary of aid to transport in the 2002-2009 period was the Croatian Railways (47% on average), followed by maritime transport (36%) and air transport (8%). The rest relates to state guarantees, but there is no information as to which transport sectors received them.

Rail transport. Funds allocated to Croatian Railways before the market liberalisation in 2006 are not considered as aid, whereas the funds allocated after that constitute aid to rail transport[7]. Currently, state aid represents funds for providing for labour surpluses, incentives to passenger and combined transport, and funds for the procurement of new and modernisation of existing rail vehicles. Over the last eight years, state aid to the Croatian Railways totalled HRK 4.2bn, excluding investments in railway infrastructure, which are not considered as aid.

Maritime transport. About 95% of aid extended to maritime transport in 2009, related to line shipping within the Programme of subsidies for transport connections between islands and mainland and among islands. The rest of the aid was granted within the Jadrolinija passenger fleet reconstruction programme and the Programme of fuel price subsidies to ship-owners in inland navigation. Total aid to maritime transport over the last eight years stood at HRK 3.2bn.

Air transport. The largest portion of aid to the air transport sector, totalling HRK 746m in the period 2002-2009, went to Croatia Airlines d.d. in the form of transport connection maintenance subsidies; this company also received the majority of state guarantees in 2009.

3.3 CROATIAN RADIOTELEVISION

In 2009, Croatian Radiotelevision received a total of HRK 1.1bn in state aid, the same as shipyards. The radio and television fee, obligatory for all radio and TV set owners, represents the allowed state aid intended to promote public radio and TV broadcasting. However, it should be noted that what we have here is not the state aid allocated directly from the budget, but rather an indirect support in the form of an obligatory fee stipulated by the Croatian Radiotelevision Act. Subscribers do not pay this obligatory fee into the budget, as is the case with taxes, but directly to the CRT, which thus receives "off-budget" aid. By collecting the fee, the CRT enjoys economic advantages over other commercial TV and radio broadcasters.

4 HORIZONTAL AID

Horizontal aid is still low in Croatia. Compared with the EU that allocates 84% of total aid to industrial and services sectors for horizontal aid, Croatia allocates as little as 25% of the total for horizontal objectives[8]. A more intensive use of horizontal aid in Croatia in the coming period could help create a new industrial policy focused on raising the competitiveness of all enterprises and removing "losers" from the market.

Tablica 4.
Aid to transport (million HRK)

	2002	2003	2004	2005	2006	2007	2008	2009	2002-09	
									million HRK	Structure
Rail transport	493	450	0	0	822	906	857	710	4,238	47.6
Other land transport	6	44	3	4	0	0	0	0	57	0.6
Maritime transport	388	389	320	387	418	431	496	407	3,236	36.3
Air transport	169	152	100	0	56	70	100	99	746	8.4
Guarantees	294	122	0	24	98	0	0	94	633	7.1
Total	**1,351**	**1,158**	**423**	**415**	**1,395**	**1,407**	**1,453**	**1,309**	**8,910**	**100.0**

Source: CCA, data processed by authors

7 The implementation of amendments to the Railway Act (OG 30/2004) provided a basis for market liberalization as of 1 January 2006.

8 Horizontal and regional aid taken together.

Table 5
Horizontal aid (million HRK)

	2002	2003	2004	2005	2006	2007	2008	2009	2002-09	
									million HRK	Structure
Horizontal objectives	**385**	**808**	**1,151**	**834**	**930**	**668**	**663**	**659**	6,097	100.0
R&D	0	28	124	129	139	161	210	139	930	15.2
Environment and energy saving	0	6	0	7	24	21	37	65	160	2.6
SME	27	33	55	45	241	53	172	228	855	14.0
Training	0	0	130	75	101	183	69	54	612	10.0
Employment	178	485	475	268	335	195	136	43	2,114	34.7
Culture	0	16	41	75	90	55	39	36	353	5.8
Other objectives	180	240	326	235	0	0	0	0	981	16.1
Supporting access to finance in times of crisis								94	94	1.5

Source: CCA, data processed by authors

The largest portion of funds is allocated for employment, research and development and small and medium-sized enterprises, as analysed below.

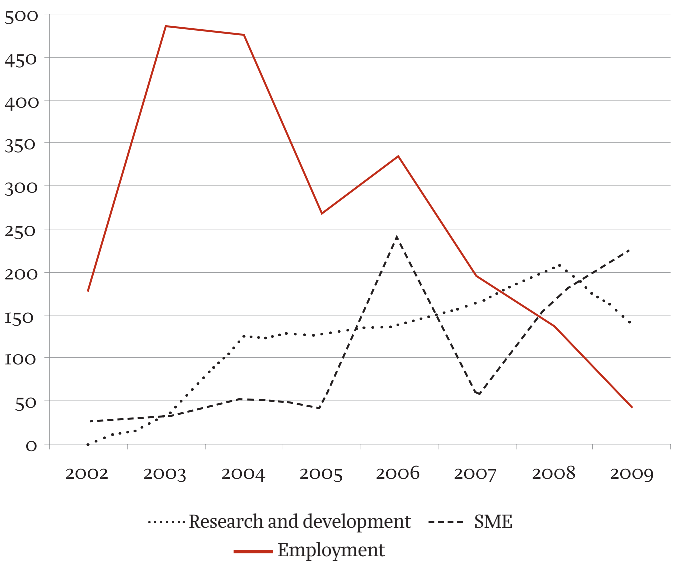
Employment. The most substantial horizontal aid, employment aid, has been on the decrease, and was eleven times lower in 2009 than in 2003. It accounts for barely 6.5% of total horizontal aid and is mainly granted in the form of subsidies within the National employment plan, and corporate income tax relief.

Research and development. Research and development is mainly supported through tax relief in accordance with the Act on scientific activity and higher education. This form of aid has grown gradually over the reference period, except in 2009, when it shrank, probably due to the economic crisis. In the coming period, however, efforts should be made to accelerate its growth, as science and technology development is the main prerequisite for a long-term enhancement of entrepreneurial competitiveness.

Small and medium-sized enterprises. Aid to small and medium-sized enterprises showed fluctuations during the eight-year reference period, suggesting continuous changes in the SME policy. However, its marked increase from HRK 53m in 2007 to a high of HRK 228m in 2009, thanks primarily to subsidies provided by HBOR and the Ministry of Regional Development, Forestry and Water Management.

In 2009, the so-called 'crisis aid' was introduced, to facilitate access to finance in the time of crisis. However, given its relatively small volume (HRK 94m), this aid had no major impact on the dynamics and structure of horizontal aid. It is granted under the EU Temporary Framework, accepted by Croatia, to be applied until end-2011, which involves temporary relaxation of state aid rules. This aid is mainly extended in the form of subsidies to reduce greenhouse gas emission from road transport via the Environmental Protection and Energy Efficiency Fund.

Graph 3
Trend in aid for selected horizontal objectives (in million HRK)



Source: CCA, data processed by authors

5 STATE AID INSTRUMENTS

Industrial policy in Croatia is mostly implemented through subsidies and guarantees. In the 2002-2009 period, subsidies accounted for almost 70% of total state aid (including aid for agriculture and fisheries), followed by guarantees (18% of total aid).

The share of subsidies in total aid to industry and services in Croatia is almost equal to that in EU27 (50%). However, the utilisation of tax exemptions and relief, tax and contribution debt forgiveness and tax benefits is much more

Table 6

Total state aid by instrument[9] (million HRK)

	2002	2003	2004	2005	2006	2007	2008	2009	2002-09	
									million HRK	Structure
A1 subsidies	3,448	3,920	4,310	3,450	5,378	6,211	6,902	7,010	40,628	67.2
A2 tax exemptions, tax debt and contribution debt forgiveness	86	119	481	920	723	1,300	411	372	4,412	7.3
B equity participation	421	205	161	45	404	508	515	106	2,365	3.9
C1 soft loans	180	1,163	94	28	214	242	42	49	2,012	3.3
D guarantees	1,028	625	100	614	2,760	3,034	1,692	1,154	11,007	18.2
Total	**5,164**	**6,031**	**5,146**	**5,057**	**9,478**	**11,295**	**9,562**	**8,692**	**60,425**	**100.0**

Source: CCA, data processed by authors

Table 7

State aid by activity and instrument, 2002-09 (million HRK)

	A1	A2	B	C1	D	Total
Agriculture and fisheries	19,650	0	247	225	656	20,778
Horizontal aid	3,426	2,011	0	655	6	6,097
Sectoral aid	15,665	1,234	2,079	897	10,268	30,142
Regional aid	356	1,165	0	190	0	1,711
Local aid	1,533	3	39	47	90	1,711
Total	**40,628**	**4,412**	**2,365**	**2,012**	**11,020**	**60,438**
Structure	67.2	7.3	3.9	3.3	*18.2*	*100.0*
Total (excluding agriculture)	**20,978**	**4,412**	**2,118**	**1,788**	**10,363**	**39,660**
Structure	52.9	*11.1*	5.3	4.5	*26.1*	*100.0*
EU27 (2007-09)	**50.6**	**43.7**	**0.6**	**3.4**	**1.6**	**100.0**

Source: CCA, data processed by authors

intensive in the EU, whereas the most used instruments in Croatia are state guarantees. This is due to a considerable share of aid to shipyards (state guarantees) in total aid. A disproportionate use of tax benefits, tax exemption etc., is due to the tax system structure, so that there are sharp contrasts in the use of this aid instrument even within EU27 itself (it accounts for 45% of the total in EU15 vs. 31% in EU12).

6. CONCLUSIONS

Croatia still has no consistent and sustainable long-term industrial policy that would promote the growth of competitive and viable enterprises in the market. The bulk of aid is used for debt rehabilitation of shipyards, steel manufacture companies and the Croatian Railways, as well as for supporting the operation of the Croatian Radiotelevision, whereas much less is spent for the promotion of research and development, environmental protection, energy saving and small and medium-sized enterprises, which could provide a basis for healthy growth. Croatia's accession to the EU will induce changes in accordance with the rules and policies of the EU, which supports "less but better aid". Consequently, state aid will have to be reduced and directed to horizontal objectives.

Despite reductions in overall state aid volume during the reference period, the structure of aid still deviates from the EU average, so that further changes are called for in this area. Given the large share of structural aid, which involves all kinds of rescue and restructuring 'cases', and requires the keeping of inefficient enterprises artificially in business, the efficiency of aid granted so far is questionable. Unfortunately, there have been no efficiency analyses of state aid in Croatia, nor does the country have any elaborated national industrial policy. Also questionable is the awareness of domestic entrepreneurs of the "rules of the game" within the EU market. In view of all this, the reform of the system, involving reductions in sectoral aid and increases in horizontal aid, poses a considerable challenge for economic policy makers. There is hardly an economic policy area that would reflect a country's long-term economic strategy more transparently than does state aid. However, it is hard to say with certainty if this also applies to Croatia.

9 State aid is granted through the following instruments: subsidies (A1), tax exemptions and relief, tax and contribution debt forgiveness and tax benefits (A2), equity participation (B1), soft loans (C1) and state guarantees (D). For each of these instruments there is a prescribed methodology for the aid element calculation.