Every year the budget story starts all over again – will this one be any different?

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The great economic and fiscal crisis at the beginning of this century has left a legacy of high public debt burden in many countries and upon many generations thus reducing the growth potential and in general social well-being of future generations. This is particularly important for countries such as Croatia which is, in addition to the old problems of the sub-optimal allocation of resources and internal structural weaknesses, facing contemporary demographic problems and the challenges of building a sustainable fiscal system.

As public debt by its definition represents the accumulation of past deficits, it is clear it is often a consequence of inappropriate past economic measures. So, in order to provide adequate solutions and to be able to face up to contemporary challenges it is necessary to obviate the causes of such a situation.

The moment we really understand how and why we find ourselves in the current situation, things may begin to change. Otherwise, mistakes tend to be repeated with the same or similar outcomes, attended by very often suboptimal results. The reason is very simple: the time in which liabilities are assumed and the consequences of an economic (political) decision, essential for sustainable growth, are often mismatched. It can take a decade before the consequences are seen. Accordingly, decision-makers are prone to quick solutions, whose time horizon almost always extends only to the next election.

The aim of this text is to provide a brief sketch of Croatian fiscal policy in the past decade in order once again to highlight the inadequacy of the measures adopted.

CROATIAN FISCAL POLICY

Since 2004 fiscal adjustment (consolidation) has been, at least normatively, an important feature within Croatian economic policy. Up until the beginning of the crisis it was reflected in a constant lowering of the budget deficit, the decrease mostly, however, being due to the growth in budget revenues. Stronger inflows into the government budget, due to more efficient tax collection, resulted largely from rather strong economic growth. However, the problem was in the growth model, which was based on foreign capital inflows (borrowing). Therefore, the decrease in the deficit in the state treasury over the pre-crisis years was accompanied with a historically record high vulnerability[1]. Thus, in the years of economic upswing, the budget deficit was mostly a consequence of increased public expenditure (salary totals, infrastructure projects, high social transfers and fees and so on), by new borrowing the government financed current consumption and big infrastructural projects of questionable usefulness. Procyclical actions thus gnawed at the flexibility of state finances and considerably shrank the future range within which fiscal policy measures could act. Fundamentally, observing this over the course of time, during the last decade few things have changed. The cost of unpro-

[1] In 2008 the current account deficit of the balance of payments reached nearly 9% of GDP, whereas throughout the period strong nominal growth in gross external debt of Croatia was recorded.

ductive expenses, such as interest, swelled, thus crippling growth potentials and reflecting total lack of care for future generations. Simultaneously, fiscal transparency has remained rather restricted even to this day, when it is actually at a lower level than in the year 2008 (IBP, 2015).

Any long-term fiscal policy should include the capacity occasionally to produce a surplus in the entry phases of the business cycle. However, a deficit has been a constant in Croatian fiscal policy. Along with the fact that over the said period there were no structural changes in public expenditure, it is evident that in the pre-crisis period Croatia did not run a sustainable long-term fiscal policy. It has to be borne in mind that, due to the absence of any political or general public consensus, the key reforms (such as the reform of the pension, health and/or educational system, and of the labour market) were either delayed or only just initiated. Maintaining the *status quo* fed the appetites of various interest groups, which reflected adversely on competitiveness as well as on the resilience and stability of the overall economy (especially in the terms of a downward cycle).The system in which the government directly or indirectly participates in the economy with around 50%, and in which 70% of the state budget expenditures are social welfare expenditures and expenses for employees (with low possibilities of changes in the already acquired rights) paired with a high tax burden, can be considered as the key causes of poor competitiveness, inadequate private investment, a weak labour market, and of the ever more significant lagging of Croatia.

THE IMPACT OF THE CRISIS

This is the system that ushered us into the crisis. In a mere three years general government deficit soared from 3% of GDP (in 2008) to over 7% of GDP (in 2011), and year-on-year public debt rose by over 55% thus burdening the government budget with a 70% higher bill for debt servicing. In the course we went from being a state with a relatively low debt (below 40% of GDP), to a state with the highest public debt among CEE countries (excluding Hungary). Furthermore, the bulk of contingent liabilities soon became overdue and needed to be settled by the central government.

At the beginning of the crisis most of the European states used government spending to mitigate the severity of the global crisis, consciously increasing their deficits and public debt at the same time. Stimulating government spending in a recession environment is a classic instrument of economic policy, used to substitute for personal consumption, which usually plummets in economic downturns, causing also a fall in inventories, production, and finally a spike in unemployment. Government spending, stimulation of consumer optimism and a generally expansive fiscal as well as monetary policy are classic instruments of countercyclical action in developed market economies, because an aggregate increase in saving in a recession environment leads to the so-called paradox of thrift, i.e. a fall in production and employment. Leaving the situation to develop along the lines of the free market, or a further fall in consumption, can also cause general deflation, which ultimately intensifies the crisis. Therefore, in a recession the well-tested cure for economy resuscitation in the form of stimulating spending, consumer optimism and investments is applied. Therefore, a huge number of economic stimulation programs in the USA and in the euro zone are moves expected from economic policy agents.

On the other hand, the economic crisis also impacted the taxation systems of the European Union countries strongly. In general, most governments decided to effect crisis mitigation through their taxation policy by decreasing the tax burden, primarily by lowering income tax rates and increasing tax categories. However, the exceptionally hard fiscal situation and the questionable viability of public finance in several countries them (Latvia, Lithuania, Ireland, Hungary) to raise the tax pressure by increasing particular tax rates.

INABILITY OF FISCAL POLICY DURING CRISIS

At the very beginning of the crisis it was doubtful whether Croatia would fit into the classic Keynesian recipe oriented towards demand. Moreover, at the time of the crisis any countercyclical actions of fiscal policy were thwarted by past burdens, or by delays in implementing reforms. Further, public expenditure expansion over the pre-crisis years had not yielded the expected multiplication impact of increasing production due to the relatively high marginal bias of the economy towards imports, and thus such a policy had not resulted in increased domestic production, imports being financed through new borrowing.

Further, the ability to implement the policy of stimulating demand was curbed also by the inadequate structure of government expenditures, as the structure is pervaded dominantly by current expenditures consisting mostly of social welfare expenditures, transfers and costs of government administration and employees. The very rigidity and restricted quality of government budget expenditures became prominent during the crisis, when a strong decrease of revenues at the beginning of the crisis concurrent with maintenance of the same consumption level forced the very fiscal policy creators to undertake procyclical measures as well (such as implementation of the crisis tax), in order to patch up the gaping holes in the budget. Another restriction to countercyclical measures within the fiscal policy framework came from the direction of the European Commission, which put Croatia into the Excessive Deficit Procedure (EDP). Moreover, Croatia was pushed under the watchful eye of the Commission within the framework of the Maroeconomic Imbalances Procedures (MIP), which aims at removing any macroeconomic imbalances detected.

…AND AGAIN INSUFFICIENT MEASURES

That is, throughout the period the changes that occurred in the area of public finances were directed dominantly at the budget revenue side, and often the taxation system was modified without proper overall analyses, which further stirred up uncertainty thus negatively impacting the business climate and the economy. The

2017 year also started with a comprehensive tax reform. The aim was to create a stable, simple and sustainable taxation system and to alleviate the tax burden of entrepreneurs and households at the same time. Along with the lowered tax burden, a positive impact should also come from growth in potential GDP. However, experience has shown that fiscal adjustment should by no means be primarily oriented to revenue (tax) reform, which implies a necessarily higher focus on public expenditures. Active fiscal policy management is the more relevant when we know that the automatic fiscal policy stabilizers have a rather weak impact in Croatia. Fiscal policy should take a proactive role in lowering overall public consumption, and, which is more important, in effectuating structural changes in this area. Naturally, throughout the process it is essential to ensure performance optimization. Otherwise fiscal policy will remain a millstone around the neck of sustainable economic growth and development.

CONCLUSION

Thus the story is right at the beginning again, on the expenditure side of the budget, which requires changes in the normative framework of protected interest groups, the implementation of reforms in the pension, health and/or educational systems, the removal of administrative barriers and the creation of an adequate and efficient public administration corresponding to a country the size of Croatia. Only then can the sources of sustainable growth, which are currently missing, be created. The key to the story lies in the fact that the level of national prosperity is not increased through fast-achieved but through sustainable economic growth. However, reaching that point requires further structural reforms. Opportunities are out there, they just need to be seized.

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