

FISCAL CONSOLIDATION

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Public budget

Revenues

Revenues as a share of GDP are high in Croatia, at around 40 percent. Due to low economic activity since the financial crisis hit in 2008, revenues stagnated moderately at an annual level. A mild recovery is forecasted for 2015 and 2016 (EC 2015). Compared to Eastern European peer countries, only Hungary and Slovenia have higher revenue shares than Croatia. The largest share of revenues, with almost 60 percent in 2013, comes from taxes, while the second-largest, with 30 percent in the same year, are social security contributions.

(1) Taxation

The Croatian tax system is very much compatible with those of EU member countries. Concerning the tax burden on labor, the average tax wedge in Croatia is similar to that of the surrounding countries. Workers without children earning an average gross wage in production of HRK 7,260 and with a surtax rate of 10 percent have a tax wedge of 41.2 percent in Croatia, which is lower than in Hungary, the Czech Republic and Italy, but higher than in Slovakia and Poland (Urban 2009). Marginal tax rates, however, are high at almost all levels of income, reaching almost 60 percent at twice the average wage (Urban 2009). Further tax burden emerges from corporate taxes and indirect taxes. Indirect taxes are paid through the VAT rate, which, at 25 percent, ranks at the very top in Europe (Kesner-Skreb 2013; KPMG 2014). The corporate tax rate in Croatia is 20 percent. When looking at the tax system from a business perspective, considering all tax-

es and contributions paid by a standard company, the total tax rate¹ on corporations in Croatia is among the lowest in an international comparison (PwC 2014). Even though Croatia does not extract too much taxation from firms operating in its jurisdiction, the percentage of firms that identify the tax burden as one of the main obstacles of doing business in Croatia is higher than the regional average (World Bank 2014). On average, corporations in Croatia incur 19 different tax payments and it takes them 196 hours to comply with them (PwC 2014).

(2) Tax avoidance and the shadow economy

In 2014 the shadow economy amounted to 28 percent of the official GDP in Croatia (Schneider 2015). Out of 31 European countries, only Bulgaria and Romania have a larger shadow economy (see Figure 1). Key causes of the shadow economy are a high tax burden, low quality of state institutions and benefits, high prevalence of cash payments, and low risk of detection (A.T. Kearney and Schneider 2013). The high taxes on labor, especially at low earnings, are among key causes of the shadow economy in Central and Eastern Europe (World Bank 2012). The rate of tax avoidance in Croatia is high, estimated at between 5.5 and 7.5 percent of GDP in 2000 (Madzarevic-Sujster 2002). A consequence of tax evasion is the erosion of the tax base.

Expenditures

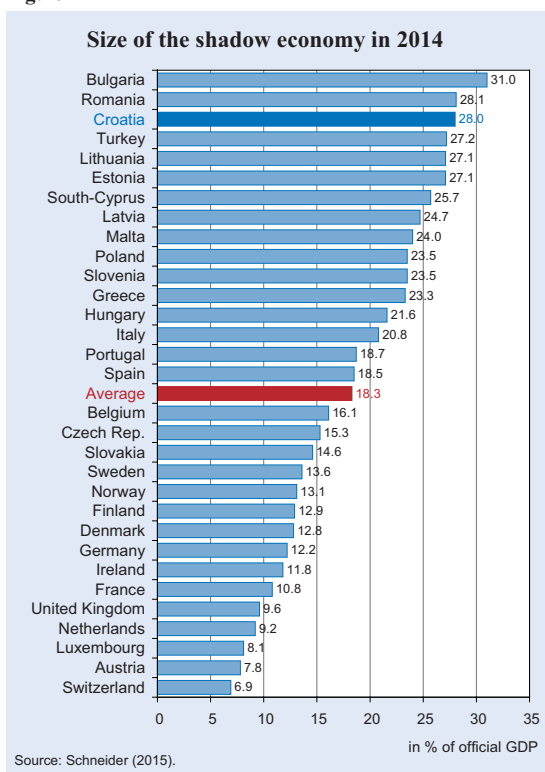
To this day, Croatia has one of the largest public sectors in the region. In comparison to peer countries, only Hungary and Slovenia had a higher expenditure-to-GDP ratio than Croatia in 2013. Projections to 2016 indicate that Croatia will have the highest expenditure share out of all peer countries. The largest share of expenditure, with 43 percent in 2013, corresponds to social benefits, while the second-largest, with 25 percent in the same year, is for the compensation of employees.

¹ The total tax rate measures the amount of taxes and mandatory contributions borne by the standard company (as a percentage of commercial profit, i.e. the profit before all taxes, which differs from the conventional profit before tax reported in financial statements) – see PwC (2014).



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Figure 1



These expenditures are also the primary source of the emerging fiscal deficits. Furthermore, these sectors are affected by major efficiency issues.²

(1) Social security

Pension payments made up 62.7 percent of social expenditures in 2012. As revenues from contributions barely cover 60 percent of the current expenditure on pensions (World Bank 2011), the pension system has become a major source of fiscal stress. Health spending has grown as well due to increasing costs, decreasing number of health insurance contributors, and high contribution exemptions. The level of co-payments in the health sector is comparably low (World Bank 2002).

(2) Public sector employment

General government expenditure for the compensation of employ-

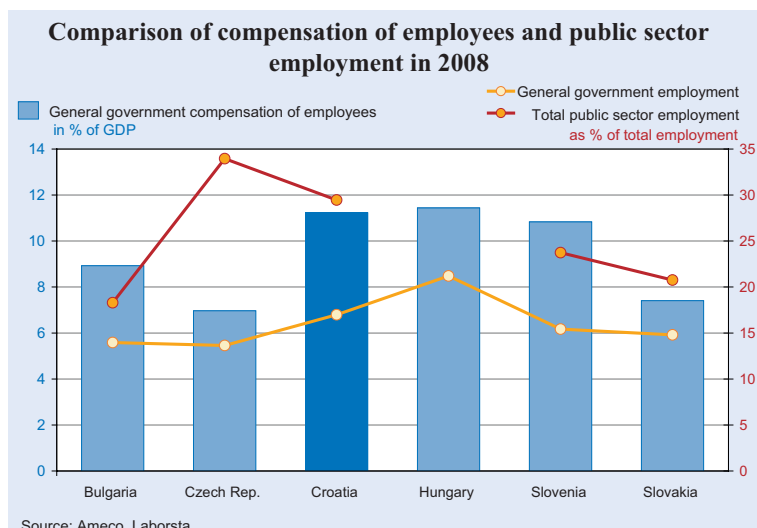
² Also the amount of subsidies is high in Croatia compared to all other EU members. But there is little evidence that subsidies helped improve the performance of the recipients, especially in agriculture and railroads. Large state-owned companies, such as Croatian Railways, tend to be uneconomic and thus not competitive in the EU.

ees rose from 11.2 percent of GDP in 2008 to 12.01 percent of GDP in 2013, a high level compared to peer countries: in 2008 only Hungary had higher spending than Croatia (see Figure 2), while in 2013 Slovenia's and Croatia's expenditures were the highest out of the peer group. Public sector employment in Croatia consists of general government employees and employees in state-owned enterprises. Employment in the general government sector was around 278,000 in 2008, amounting to 17 percent of all people in work (Laborsta 2015).³ Croatia's general government employment is in line with the European average (Bejaković *et al.* 2010). Among its peer countries (Bulgaria, Czech Republic, Hungary, Slovenia and Slovakia), the level ranged from 13 to 17 percent of total employment in 2008 in all countries except Hungary, where it reached 21.2 percent (Laborsta 2015). Where Croatia does stand out is in the high employment in state-owned enterprises, which, at around 12.5 percent of total employment, is twice the EU average (Bejaković *et al.* 2010). Hence, when looking at Croatia's total public sector employment, including general government employment and employment in state-owned companies, Croatia and the Czech Republic had the highest share of public sector employment among the peer countries (see Figure 2).

The reason for high expenditure on the compensation of employees is not mainly the unusually large level of employment in the public sector, but the high salaries in this sector in comparison to the manufacturing sector and to other economies (World Bank 2002), as

³ Comparable data on general government, state-owned companies and total public sector employment are only available until 2008 at Laborsta.

Figure 2



well as overstaffing in non-civilian areas (Vidačak 2004). Public sector wages in Croatia are based on job complexity coefficients, introduced by the 2001 Law on Wages in Public Services. The base wage is subject to collective bargaining, which is commonly preceded by union pressure and strikes. Trade union density in the public sector is about 60 percent, with a high concentration of membership in strong national unions (Franičević and Matković 2013). Coefficients and supplements have also been a subject of public pressure and informal lobbying, leading to frequent changes. This results in a complex and nontransparent setting of wages and coefficients. In Croatia people employed in the public sector seem to earn more than they would earn in the private sector with the same personal characteristics and qualifications. Hence, there seems to be a public sector wage premium. The public sector pay gap in Croatia seems to be in line with most EU countries. Serbia, for instance, had a higher premium, of 17.9 percent, in 2011 (Nikolic *et al.* 2014). But studies find large differences of the wage premium along the pay distribution. Higher premiums prevail at the lower half of the pay distribution, but top-paid workers earn higher wages in the private sector than in the public sector.

(3) Public administration

According to the Global Competitiveness Report 2014/15, among the most problematic factors in Croatia are the inefficient government bureaucracy and corruption (Schwab 2014). When looking at the overall government effectiveness indicator, which measures the quality of public and civil service and its independence from political pressures, Croatia was at a low level compared to its peer countries in 1996 (only Bulgaria did worse), but has caught up over time, reaching the midfield ahead of Bulgaria and Hungary by 2013. Due to the inefficient public administration, firms in Croatia bear high administrative burdens in terms of time and costs. Croatia does worst in the Doing Business 2015 report (World Bank 2015) in the fields starting a business, dealing with construction permits, registering property and trading across borders (see article in this issue). Public administration in Croatia is characterized by poor coordination and duplicated structures among the different units. A tendency of over-politicization of the administrative system exists (Koprić 2011). According to public perception, corruption is widespread.

Policy recommendations

Fiscal consolidation can be achieved through a mixture of revenue measures and expenditure cuts. Countries in need of fiscal consolidation should set deficit or debt targets, announce a consolidation plan, and ensure credibility by detailing consolidation measures and how targets will be met. Expenditure-based measures often take longer to be fully implemented, while increasing tax revenues can provide immediate gains. These, however, are offset by the equity-efficiency trade-off and the existence of the shadow economy. Fiscal consolidation can also include limiting the size of government in general. The privatization process of state-owned companies can effectively contribute to limiting the scope of government. Overall budget consolidation in Croatia should aim towards long-term sustainability via structural reforms rather than short-term fiscal adjustments.

Revenue measures

Revenue measures should initially concentrate on broadening the tax base in order to limit tax-induced distortions that are detrimental to growth. The general tax level in Croatia is in line with the European average. The government of Croatia should ensure continuity of the tax system to increase confidence in legislation and government. However, this does not mean that the tax system should stay as it is in all details.

A government must choose the right structural incentives for people to join and stay in the official market. As discussed in the sub-section on labor market reforms, both the tax and public benefit systems should aim at increasing labor market participation and activating the unemployed. Distortions introduced by taxes should also be eliminated by reducing both the number of taxes as well as the number of tax exemptions. The number of tax procedures and their simplification by further promoting e-filing of tax returns and electronic communication with tax authorities must be undertaken in order to lower tax compliance costs. This would have the added benefit of removing opportunities for corruption.

Broadening the tax base can also be achieved through zero tolerance of tax avoidance and of the shadow economy. The likelihood of detecting tax evasion must be increased significantly. To ensure this, the

number of tax administration personnel tasked with performing audits should be increased, and their training and case selection methodology improved. In addition, there should be more consistent imposition of statutory penalties for tax evasion, particularly by courts. When it comes to the shadow economy, better co-operation between the tax administration and other government bodies is essential. A recommendation related to the financial sector is to incentivize cashless payments. Furthermore, the education and public information system must be enlisted to increase public awareness of the adverse effects of the shadow economy and so improve tax morality. An improvement in the quality of public goods and services provided by the state would also contribute to achieving this goal.

There is also scope to broaden the tax base by eliminating any tax expenditures that are distorting, poorly targeted, and contribute to a lack of transparency. The most costly tax expenditures are typically those aimed at boosting retirement savings, promoting homeownership, health insurance and charitable donations (OECD 2010). Publicly available tax expenditure reports that help identify potential areas for broadening the tax base and enhance transparency should be produced.

Expenditure cuts

Besides fiscal consolidation measures such as structural reforms in the health and social benefit systems and old-age pensions, a consolidation strategy should include measures that aim at reducing a government's running costs. These measures include wage or staff reductions, government reorganization, and across-the-board efficiency enhancements in the administration.

The government should implement a law on public administration salaries that provides an easy system of wage determination. The budget could be relieved by reducing the wage premium prevalent in the public sector and state-owned enterprises, which in turn could lead to a reduction of wages in the same segment in the private sector, opening up new employment opportunities for a portion of the labor market that is characterized by extremely high unemployment. Wage-setting in the public administration may well serve as a role model for wage-setting in the private sector, boosting the competitiveness of the Croatian economy due to lower wage costs.

To facilitate an efficient and speedy handling of government services, Croatia must concentrate on developing digital procedures and bringing all levels of public agencies to an e-government operational status. Besides increasing efficiency, this would reduce red tape and remove opportunities for corruption. Efficiency of the public administration should be further increased through the elimination of duplicated structures as well as the number of public employees, which currently places a heavy burden on the public budget.

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