The Effect of Long-term EU Budget 2021-2027 and Recovery Package on Croatia's Post PandemicEconomic Recovery

Kristijan Kotarski, PhD

Faculty of Political Science, University of Zagreb

The Impact of COVID-19 on the Croatian economy

According to the Eurostat data Croatia experienced one of the sharpest economic downturns among 27 member states (MS) of the EU in 2020 (Eurostat, 2021a). Only a handful of other MS heavily reliant on tourism such as Spain, Greece and Italy fared even worse than Croatia. Remarkably, in spite of the staggering contraction Croatia was only one among three EU member states that recorded a slight rise in the employment rate (for people aged 20 to 64) in 2020, as compared to 2019 (Eurostat, 2021b).

There are two main factors underpinning such a development that brought about the stark divergence in GDP growth rate on the one hand, and employment rate on the other hand. First, short-term working schemes and income support for workers that have been worst affected by epidemiological restrictions have shielded employment. Over 11 billion kuna was invested into the aforementioned schemes and Government spared no effort to prevent massive lay-offs (Government of the Republic of Croatia, 2021a). Second, during the second/third wave of COVID-19 infections across Europe, Croatia had been consistently imposing the least stringent epidemiological restrictions was *de facto* emulating Swedish approach from the first wave of infections.

Meanwhile, in order to cover the recordbreaking fiscal deficit of the magnitude of 8% of GDP incurred in 2020, Croatian public debt has skyrocketed above 87% of GDP (Government of the Republic of Croatia, 2021b). Nevertheless, Croatia managed to finance and re-finance its financial obligations relatively favourably and there are no medium-term fiscal constraints in sight, in light of the immense influx of EU funding in the coming years and as will be expained in detail in the next section. Furthermore, Croatia is poised to adopt the euro as a common currency in 2023 which will make its public debt even more securer and cheaper.

When it comes to the impact of the pandemic on Croatia’s future economic outlook it is very difficult to establish a very robust prediction due to myriad of known unknowns, and possibly unknown unknowns. However, in spite of a significantly lower vacination rate in Croatia as compared to the EU-27 average (34% vs. 47,34% of population being fully vaccinated), at the end of July 2021 Croatia has had the lowest daily number of confirmed COVID-19 cases per million people of all key Mediterranean destinations, which will greatly help the tourism sector (Our World in Data, 2021).

The role of Multiannual Financial Framework 2021-2027 and Recovery and Resilience Facility (RRF) in lifting Croatia's economy

As a part of a joint EU response to tackle the economic and societal crisis triggered by the outbreak of the global pandemic, Croatia was granted unparalled access to EU funding in the period between 2021-2027. There is no other MS that has been allocated more funding from the EU's one-off Recovery and Resilience Facility (RRF) as compared to its 2019 GDP level, which is primarily a consequence of allocation criteria established at the EU level.

On top of that, Croatia received more than 13 billion euro through the EU's Multiannual Financial Framework 2021-2027 (EU's long-term budget) in current prices. All in all, Croatia will be able to tap into more than 21 billion euro of EU grants from the current budget and recovery package and if necessary, will be able to take out concessional loans to the tune of 3,5 billion euro, also in current prices (European Commission, 2021).[1] Table 1 gives an overview of various sources of EU funding both in current and 2018 prices. Not to forget, Croatia has still not used 5,5 billion euro from the previous MFF 2014-2020 and will definitely be able to absorb more than 95% of it until 2023, which is set as a deadline by the EU.

Table 1: EU funding from various sources available to Croatia in the period 2021-2027

Avalaible funding in millions of EUR per component (NGEU+MFF)	**In current prices**	**In 2018 prices**
Just Transition Fund	187	169
European Agricultural Fund for Rural Development per Member State (NextGenerationEU)	201,7	187,4
European Agricultural Fund for Rural Development per Member State (MFF only)	2146,9	1911,4
European Agricultural Guarantee Fund – pre-allocations per Member State	2610,5	2315,1
Recovery and Resilience Facility (RFF)	6300	5800
Cohesion Policy allocations per Member State	9069	8042
REACT-EU for 2021 per Member State	574	541
TOTAL grants	21089,1	18965,9
Loans from NGEU (if drawed upon)	3500	3500
TOTAL available funding	24589,1	22465,9

Source: European Commission (Directorate-General for Budget). (2021). The EU's 2021-2027 long-term budget & NextGenerationEU. https://op.europa.eu/en/publication-detail/-/publication/d3e77637-a963-11eb-9585-01aa75ed71a1/language-en

Given the staggering scale of EU funds (EU's long term budget and RRF) that are expected to flow into the country, the economy is projected to record a durable period of economic growth, even under the assumption of policy-inertia or no significant economic reforms undertaken over the course of next years. Absent a large exogenous shock or a major policy-blunder, Croatia will enjoy the best decade of economic growth in its modern history. As

[1] Therefore, Croatia will be able to tap into 24,5 billion euros from the the EU's pot totalling 1824 billion euro (1074 billion euro from the EU's 7-year long-term budget and 750 billion euro from the Recovery and Resilience Fund created to alleviate effects of the COVID-19.

compared to the period before the GFC of 2008-2009 when Croatian economy was characterised by twin-deficits, the economic recovery recorded in the 2015-2019 period made a sharp reversal from this dangerous trend of rising macroeconomic imbalances. The historic opportunity to use 30 billion euro of EU funds (21+3,5+5,5) over the next 10 years will more than likely reinforce the 2015-2019 growth pattern.

Apart from those encouraging news not everything looks like borrowed from the Goldilocks economy. If we observe the 2020 Eurostat data, Croatia has the 3rd lowest GDP per capita ratio as of EU-27 average and only Bulgaria and Greece score lower, which leads to both a heightened brain-drain and a looming demographic crisis (Eurostat, 2021c). Croatia is namely among the member states that have recorded the largest population loss in relative terms since its EU accession in 2013, both due to emigration and negative natural change. This worrisome trend has been primarily the reflection of a clientelistic polical system often beset by corruption, of a weak legal system incapable of fully protecting property rights and finally, of a cumbersome administration. E.g. posts in the public administration are too often filled by political loyalists in total disregard for the principle of meritocracy and corruption scandals engulfing high-profile politicians and managers of state-owned enterprises, without a clear judicial epilogue, are a frequent occurence. Unfortunately, the latter set of factors negatively affects Croatia's absorption capacity or the capacity to turn available EU funds to the most productive projects supporting digitalisation, energy transition, social cohesion, entrepreneurship and climate resilience. Hence, in order for the increased flow of EU funding to significantly boost Croatia's potential growth rate and initiate structural transformation of its economy, Croatia needs to pass important decisions pertained to the legal and regulatory framework governing EU funds. Furthemore, it also needs to launch an ambitious set of economic reforms, with the goal of creating a synergy between those two processes, that will be shortly mentioned in the concluding part.

When it comes to the most important changes to the existing regulatory and legal framework affecting absorption capacity in Croatia one has to mention two major problems. First, the Croatia's National Recovery and Resilience Plan (NRRP) as a formal plan that bundles together reforms and investment activities, and being a formal prerequisite to tap into the EU's RRF, was greenlighted by the European Commission (EC) and approved by Council of Ministers of the EU at the end of July, contains a skewed distribution in the allocation of available funding between private and public sector in Croatia. The document that is more than 1000-pages long and at times too complex to navigate envisages insufficient funding for prospective and existing entrepreneurs. The document plans to allocate approximately 10% of the 6,3 billion euro in grants directly to various businesses (Kotarski, 2021). Given Croatian Employers' Association estimate that creation of a single durable job necessitates an investment in the range from 100.000 – 120.000 euro (Grgas, 2021), the existing allocation would only suffice for the creation of 5250-6300 jobs by private sector alone. Hence, the bulk of EU funds from the RRF will be channeled to public sector. Even though private companies may participate in various public procurements related to projects, the multiplier effect of those investments will be lower than for private investments and not all tenders will be won by domestic companies.

However, even though it is too late to significantly change the allocation of funds as stipulated in the originally approved document (NRRP), the remaining 13 billion euro from the MFF 2021-2027 should be programmed until the end of 2021. Namely, Croatia needs to negotiate a new Partnership agreement with the EC which outlines the precise contours of how Croatia aims to spend that money. In spite of the fact that the MFF 2021-2027 offers a modicum of flexibility to modify the plan down the road, Croatian Government needs to allocate far higher sums of available funding to boosting competitiveness of S&M businesses and stimulating their R&D activities. The hitherto experience with the MFF 2014-2020 shows that Croatian businesses are eager to tap into available funding and are far more efficient in turning them into new products, patents, jobs and tax revenues, than the public sector is. Over the last couple of years, there were multiple instances where businesses oversubscribed for available EU funds in public tenders, but the Croatian Government could not retroactively change the Partnership agreement. The Government would do well to do the new programming in a smarter way this time around and avoid past mistakes. Finally, even when there is a healthy and necessary portion of EU funding going to the public sector to support the creation of public and merit goods within various projects, they are too often plagued by lack of expediency, coordination and inefficiency, all of which negatively affects absoption capacity. Namely, numerous infrastructure projects are lagging behind because of poorly designed and executed public tenders and/or due to slowness in the procedure of getting a building permit.

The Future Direction of the Croatian Economy

The above mentioned section elaborated on the main institutional, legal and regulatory bottlenecks to successful absorption of a record-breaking sum of EU funding that will be available to Croatia over the next decade. In ten years time Croatia will undoubtedly become a richer country in absolute terms, thanks to immense EU funding. However, the real question remains whether Croatia will succeed in narrowing its development gap with the rest of the EU, in order to stem the emigration of its brightest citizens and to attract new talents from abroad. This can be averted by smarter and more efficient use of EU funds. Furthermore, EU funds are not a panacea and they can only work their true magic if complemented by an ambitious set of economic and political reforms. Unless current and future Croatian Governements do not commit to pro-market reforms and the burgeoning public sector remains at the core of state-led growth model, the historical opportunity to catch-up more developed EU peers will be irreparaby lost.

Therefore, the current Croatian Government should institute far more ambitious reforms than those outlined in the NRRP. EC will definitely track Croatia's progress within the European Semester and institute potential sanctions if cases of egregious misuse of EU funds occur or no reforms at all are implemented. However, it is not reasonable to expect that the EC shall use its power to press any Croatian Government to focus on high-hanging fruits, or reforms that contain the biggest potential to significantly lift Croatia's potential growth rate. This is only and alone up to a reform-minded Croatian Government that knows how to compensate opponents of those reforms by major financial shot in the arm from the long-term EU budget and RRF. Over next three years there are no elections in sight. This is the right opportunity and timing to embark on this reform agenda for the sake of all Croatians and their European peers.

Bibliography:

European Commission (Directorate-General for Budget). (2021). *The EU's 2021-2027 long-term budget & NextGenerationEU*. https://op.europa.eu/en/publication-detail/-/publication/d3e77637-a963-11eb-9585-01aa75ed71a1/language-en

Eurostat. (2021a). *Real GDP growth rate – volume*. https://ec.europa.eu/eurostat/databrowser/view/tec00115/default/table?lang=en

Eurostat. (2021b). *Employment - annual statistics*. https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Employment_-_annual_statistics

Eurostat. (2021c). *GDP per capita in PPS*. https://ec.europa.eu/eurostat/databrowser/view/tec00114/default/table?lang=en

Government of the Republic of Croatia. (2021a). *Over 11 billion kn was invested into job saving measures, now it's time to focus on creation of new jobs*. https://vlada.gov.hr/news/over-11-billion-kn-was-invested-into-job-saving-measures-now-it-s-time-to-focus-on-creation-of-new-jobs/32441

Government of the Republic of Croatia. (2021b). *Program konvergencije Republike Hrvatske za razdoblje 2022. – 2024.*https://ec.europa.eu/info/sites/default/files/2021-croatia-convergence-programme_hr.pdf

Grgas, G. (2021, 3 July). Koordinator HUP-a za Nacionalni plan oporavka: 'Evo zašto tražimo pet milijardi od EU bespovratno'. *Jutarnji list*. https://www.jutarnji.hr/vijesti/hrvatska/koordinator-hup-a-za-nacionalni-plan-oporavka-evo-zasto-trazimo-pet-milijardi-od-eu-bespovratno-15085272

Kotarski, K. (2021, April 16). Nacionalni plan oporavka i otpornosti: prijelomna točka za konkurentnost hrvatskog gospodarstva. *Udruga Lipa*. https://www.barometar.hr/ocjene-mjera/nacionalni-plan-oporavka-i-otpornosti-prijelomna-tocka-za-konkurentnost-hrvatskog-gospodarstva/

Our World in Data. (2021). Coronavirus Pandemic (COVID-19). https://ourworldindata.org/covid-vaccinations