

## Chapter 10

# STATE AID REFORM IN CROATIA

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### ABSTRACT

State aid as a part of industrial policy should be implemented cautiously, taking account of all its advantages and shortcomings. The European Union has established an elaborate system for state aid allocation and control, advocating “less and better-targeted state aid”, which has the least distorting effect on competition. This is so-called horizontal aid, which helps to establish a level playing field for all undertakings. The state-aid-to-GDP ratio is four times higher in Croatia than in the European Union, state aid being mainly targeted to particular industries. Croatia will have to reform thoroughly or reduce its sectoral aid to shipbuilding, transport (especially the railways) and the steel industry, as well as aid to rescuing and restructuring firms in difficulty. Croatia will also have to increase aid to horizontal objectives and improve significantly the transparency of state aid allocation.

**Key words:**

state aid, reform, industrial policy, European Union

## INTRODUCTION<sup>i</sup>

The objective of this paper is to give a description of the general framework of state aid in Croatia and to indicate the direction of its future development based on EU rules. This provides a general direction for state aid reform, i.e. the reform of industrial policy in broader terms.

The data on state aid were collected for the period 2001-2004 and were classified by objective (i.e. sector or industry), and by instrument (e.g. grants, soft loans, tax exemptions, guarantees, etc.).<sup>ii</sup> The authors applied the methodology used in the EU for the preparation of the State Aid Scoreboard.<sup>iii</sup>

The second part of the paper following the Introduction gives a brief presentation of state aid in the framework of industrial policy, and determines the content of state aid in the EU. The third part deals with the size and structure of state aid in Croatia in the period from 2001 to 2004, and the fourth part provides guidelines for future state aid development. The paper is focused on four selected sectors which will require the strongest adjustments to the EU standards: shipbuilding, transport (especially railways), and the steel industry, and the rescue and restructuring of firms in difficulty. In these sectors, Croatian state aid deviates sharply from that in the EU, and Croatia will have to make great efforts to harmonize it with EU standards.

## THE GENERAL FRAMEWORK FOR STATE AID

### **State aid as a part of industrial policy**

As an industrial policy instrument, state aid to enterprises can increase public welfare. However, it can distort competition and also reduce public welfare. Public welfare declines if aid is granted to less efficient companies producing low-quality products at high costs. On the other hand, public welfare increases and the economic growth accelerates if state aid is aimed at correcting market failures, i.e. situations when the market functions inefficiently. Consequently, “bad” aid distorts the market by favouring one company over another, thus reducing welfare, while “good” aid corrects market failures and thus contrib-

utes to the growth of welfare (Neil, 1990). However, it should be emphasized that state aid results in increased welfare only if the resulting efficiency improvement exceeds the direct and indirect costs of aid implementation (Nicolaidis and Bilal, 1999).

There is extensive literature about whether, when and how the state should provide aid to companies and entire economic sectors. Most authors argue that state aid can only be justified if it is aimed at correcting a market failure. The EU agrees with this argumentation, deeming that state aid should mainly be targeted at market failures (Commission of the EC, 2003). Redirecting state funds to “good” aid which is unlikely to distort market competition remains the primary strategic objective of state aid reform in the EU member states. The future reform of state aid in Croatia will have to follow the same course.

The implementation of state aid, particularly that which is the subject matter of a selective industrial policy, i.e. a policy aimed at providing assistance only to selected economic sectors or companies, offers many challenges:

- *State aid costs money.* In order to justify the implementation of state aid it is not sufficient to establish the existence of a market failure. It is also necessary to provide valid arguments that the public sector, i.e. the government, is capable of resolving the problem more successfully than the private sector (the market). Prior to the implementation of state aid it is necessary to estimate all the direct or indirect costs necessarily involved. This is because the very existence of a market failure does not necessarily mean that corrective measures should be implemented: sometimes the cure is worse than the disease (Martin and Valbonesi, 1999).
- *The state is unable to recognize “winners” or “losers”.* A selective industrial policy usually implies that the government selects economic sectors or companies needing support. These are either future “winners”, i.e. economic sectors and companies expected to achieve higher growth rates, or “losers”, i.e. industries or companies in difficulties that need government assistance for their survival and recovery. Such state intervention requires great analytical skill for a government to be able to outperform the market in selecting industries or companies that are potential winners, or decide which losers are worth saving, and determine the measures through which all this can be realized. However, the state is usually too bureaucratic and insufficiently qualified and informed to get to grips with such challenge.

- *The state cannot pick the right moment to stop providing assistance.* Owing to the shortage of information on products, prices or new technologies the state has generally proved to be inefficient. It has usually been unable to select “winners” among industries and/or major “losers” and unable to determine when to stop providing assistance, i.e. when a company becomes capable of independent operation. Its economic policy measures, often inappropriate, result in numerous distortions that reduce economic efficiency.
- *The state is incapable of resisting various pressure groups.* Under the pressure from various interest groups the state intervention network becomes more liable to corruption. Once state intervention stabilizes there is a danger of the state falling under the influence of various interest groups lobbying actively to retain state aid, although it has 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 interest groups, it is difficult to discontinue state aid; new forms of state aid are introduced, and it is hard to break this vicious circle.
- *State aid results in unfair competition.* State aid also leads to unfair competition between subsidized and non-subsidized companies. More specifically, owing to the lower prices offered by subsidized companies, not however as the result of the higher quality of their products or increased productivity, good but unsubsidized companies whose products are more expensive are forced out of the market.
- *State aid burdens the state budget.* Growing state aid increases the pressure on the state budget, thus threatening fiscal stability. As state aid is financed from tax revenues, its cost is borne by all taxpayers. Thus, despite lower prices of subsidized products, in the end consumers indirectly pay the 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. The affected country may react to state aid by taking retaliatory measures. For this reason, the EU has established a state aid control system, the intention of which is to reduce such irregularities.

The above mentioned considerations suggest that successful state aid reform is a laborious process in which account should be taken of numerous issues, from the particular economic policy measures to the existing political, economic and social environment.

## State aid in the European Union

State aid distorts competition by discriminating among companies that receive aid and those which do not. In response to this threat to the common market, the EU established a state aid control system. The system relies on the principle that state aid is incompatible with the common market, but still allows its implementation under certain circumstances. Article 87(1) of the Treaty Establishing the European Community provides the following definition of state aid: "... any aid granted by a Member State or through State resources in any form whatsoever which distorts competition by favouring certain undertakings of the production of certain goods shall, insofar as it affects trade between member states, be incompatible with the common market". Based on this provision, the EU has developed a very sophisticated system of rules defining "allowed" and "non-allowed" state aid. Over the years, these rules have been supplemented by a number of instructions, legal opinions and court rulings.

### Box 1 State aid in the European Union

According to the EU definition, state aid is any aid that: (1) is granted through the state resources, (2) constitutes an economic advantage to a certain company, economic sector or region, (3) is selective, as it affects the balance between companies receiving the aid and their competitors, (4) has an adverse effect on competition and trade between member states.

State aid in the EU is classified into horizontal aid (allocated to all enterprises in the economy), sectoral aid (provided to selected companies), regional aid and aid to agriculture and fisheries. Aid can be provided through various instruments: grants, tax exemptions and relief, equity participation, soft loans, tax deferrals (liabilities of taxpayers to tax authorities) and guarantees (issued and revoked). In all these instruments the amounts of aid are not always equal to the nominal value of the instrument. Therefore, in preparing data on state aid the EU assesses, the so-called "state aid element". This relates in particular to equity participation, soft loans, tax deferrals and guarantees, while in the case of grants, or tax exemptions their entire amount represents state aid. A more detailed presentation of this methodology is available on the Internet at: [http://ec.europa.eu/comm/competition/state\\_aid/scoreboard/conceptual\\_remarks.html](http://ec.europa.eu/comm/competition/state_aid/scoreboard/conceptual_remarks.html) and in Kesner-Škreb and Mikić (2003).

The purpose of the system of state aid control in the EU is to monitor the proposed and implemented state aid in member states and to determine whether it complies with the EU legislation and whether it distorts competition within the EU. The European Council has repeatedly called on the governments to reduce state aid and redirect it to horizontal objectives having the least distorting effect on competition, like environmental protection, education and training, research and development and incentives to small and medium-sized enterprises.<sup>iv</sup> The EU objective is to have “less and better” state aid, i.e. to reduce “bad” aid and to increase “good” aid provided for horizontal purposes.

**Box 2 International sources of data on state aid**

Apart from the European Commission which regularly publishes data on state aid in the EU member states, the data on grants are also published within the System of National Accounts (SNA), the IMF Government Finance Statistics (GFS), as well as by the World Trade Organization (WTO) and OECD.

*Under the System of National Accounts* the term “grant” only covers current direct transfers to companies from the state budget, excluding other forms of assistance like subsidized loans, tax exemptions, etc.

*The World Trade Organization* also provides data on grants. They arise from the obligation to notify those grants that include direct transfers of funds, fiscal incentives and government supply of goods and services (excluding general infrastructure). However, these data are often incomplete and incommensurable, owing to the difficulties in collecting and submitting data on grants in certain countries.

*OECD* published annual data on grants to industry for twenty five of its member states in the periods 1989-1993 and 1994-1995. These data included budget transfers, subsidized loans, inputs purchased at prices lower than the market prices, and tax revenue losses. These data are special because they rely on the net government cost principle, i.e. government expenditures for grants are reduced by repayments (e.g. of loans). However, these data only relate to grants to industry (Lee, 2002).

The Commission has recently become aware of the need for a thorough revision of the rules on state aid. The EU enlargement to twenty five member states in 2004 called for improvements in state aid management. In addition, the number of rules, exemptions and deci-

sions on state aid has increased unnecessarily over time, which resulted in a complicated and non-transparent system, as well as lengthy and complex allocation procedures. Therefore, in June 2005, the Commission unanimously adopted the *State Aid Action Plan*<sup>v</sup> for a five-year period with the purpose of carrying out a comprehensive, coherent and far-reaching reform of state aid policy, which is also expected to contribute to the re-launch of the Lisbon Strategy<sup>vi</sup>. The reform has the following four features:

- The concept of “less and better aid” constitutes the basis for the state aid reform philosophy.
- An analysis should be carried out to show that certain goals cannot be achieved on the market without state aid. This primarily relates to the identification of market failures.
- Improvement of the efficiency and transparency of procedures and acceleration of taking decisions.
- Cooperation between member states and the Commission for the purpose of timely notification of aid and the submission of complete documentation, and cooperation in the process of aid approval.

By signing the Stabilization and Association Agreement (SAA) Croatia committed itself to harmonizing its state aid legislation with the relevant EU regulations. Thus, a State Aid Act was first enacted in March 2003, and a new act to this effect was passed in December 2005 (NN 140/2005). The Regulation on State Aid (NN 121/2003 and 50/2006) has been implemented since August 2003. Given the need to harmonize the entire Croatian legislation with the EU *acquis*, these regulations are very similar to those of the EU. However, the screening process revealed certain differences, which will have to be reconciled. Moreover, Croatia entrusted the Croatian Competition Agency with the powers to approve and supervise state aid and to ensure the recovery of aid granted or utilized contrary to the regulations.

Consequently, state aid as a part of industrial policy should be implemented cautiously, taking account all of its advantages and shortcomings. The EU has established an elaborate system of state aid allocation and control, and it advocates “less and better state aid”, which is likely to have the least distorting effect on competition. This is so-called horizontal aid, which helps to establish a level playing field for all undertakings. By passing the State Aid Act and Regulation and establishing the Croatian Competition Agency, Croatia started the process of harmonizing its state aid system with that in the EU.

## THE SIZE AND STRUCTURE OF STATE AID IN CROATIA IN THE PERIOD 2001-2004

### Total state aid

In the period from 2001 to 2004, total state aid to enterprises in Croatia amounted to 32.3 billion kuna. The annual average state aid in the observed period slightly exceeded 8 billion kuna or 4.4% of GDP. Thus, the average annual amount allocated for state aid per employed person was almost 6,000 kuna. Excluding aid for agriculture, fisheries and transport<sup>vii</sup>, total aid comes to 3.3 billion kuna or 1.8% of GDP.

Table 1 Total state aid in Croatia, 2001-2004

	2001	2002	2003	2004	Average
<i>billion kuna</i>					
Total state aid	8.5	6.4	8.1	9.4	8.1
Total state aid less railways	7.4	6.2	6.0	6.4	6.5
Total state aid less agriculture, fisheries and transport	3.6	2.8	3.3	3.6	3.3
<i>% of GDP</i>					
Total state aid	5.2	3.6	4.2	4.6	4.4
Total state aid less railways	4.5	3.5	3.1	3.1	3.6
Total state aid less agriculture, fisheries and transport	2.2	1.6	1.7	1.8	1.8
<i>Index (previous year)</i>					
Total state aid		74.7	127.3	115.8	
Total state aid less railways		84.0	96.9	105.9	
Total state aid less agriculture, fisheries and transport		79.3	118.2	109.2	
<i>Per employee (thousand kuna)</i>					
Total state aid	6.3	4.7	6.0	6.8	5.9
Total state aid less railways	5.5	4.6	4.4	4.6	4.8
Total state aid less agriculture, fisheries and transport	2.6	2.1	2.4	2.6	2.4

Sources: Central Bureau of Statistics (GDP and the number of employees) and authors' calculations

It is shown that the total nominal amount of state aid expressed in kuna grew continuously, except in 2002.<sup>viii</sup> In 2003 and 2004, total state aid rose by 27.3% and 15.8% respectively.

A comparison of state aid, less agriculture, fisheries and transport, between Croatia and the EU-15 shows that Croatia is a country with a large participation of state aid in GDP. In 2003, it was four times the share in the EU.

*Table 2 State aid less agriculture, fisheries and transport, in Croatia and EU-15 (as a % of GDP), 2001-2004*

	2001	2002	2003	2004
<i>EU-15</i>	<i>0.43</i>	<i>0.44</i>	<i>0.40</i>	
Belgium	0.32	0.34	0.24	
Denmark	0.77	0.70	0.49	
Germany	0.79	0.78	0.68	
Greece	0.33	0.22	0.22	
Spain	0.63	0.57	0.43	
France	0.33	0.35	0.31	
Ireland	0.65	0.45	0.31	
Italy	0.38	0.40	0.44	
Luxembourg	0.17	0.25	0.15	
Netherlands	0.16	0.19	0.11	
Austria	0.25	0.21	0.26	
Portugal	0.90	0.87	0.96	
Finland	0.31	0.36	0.36	
Sweden	0.18	0.16	0.39	
United Kingdom	0.11	0.17	0.19	
<i>Croatia</i>	<i>2.16</i>	<i>1.58</i>	<i>1.73</i>	<i>1.77</i>

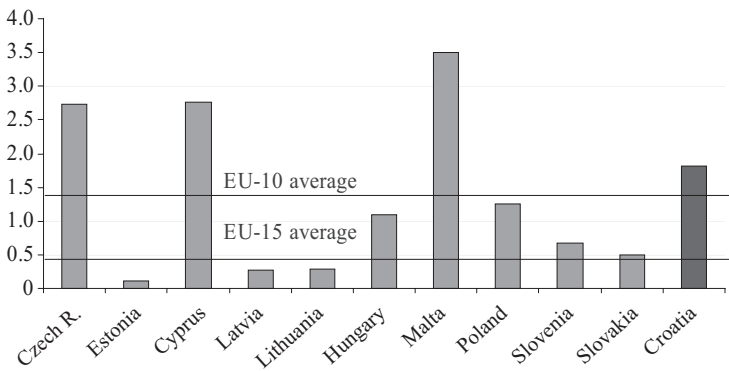
*Sources: Commission of the EC (2005); authors' calculations (for Croatia)*

In 2003, total state aid, less agriculture, fisheries and transport, accounted for 0.4% of GDP in the EU-15 and 1.73% in Croatia. In 2004 the share in Croatia rose to 1.77%. Within the EU, the largest total amount of state aid was allocated in Portugal (0.96% of GDP) and Germany (0.68%), and the lowest levels of state aid were recorded in the Netherlands (0.11%), and Luxembourg (0.15%). Ireland saw the sharpest decline in the level of aid over the three observed years (from 0.65% to 0.31%), while the most sizeable growth of state aid was recorded in Sweden (from 0.18% to 0.39% of GDP).

However, it is far more interesting to compare the state aid trends in Croatia with those in the countries with similar economic indicators, i.e. the new EU member states. The available data relate to the

period between 2000 and 2003 (immediately before the accession), in which the state aid, less agriculture, fisheries and transport, in the ten new member states accounted for 1.38% of GDP. For the sake of comparison, the average share of state aid in the Croatian GDP in the period 2001-2004 was 1.81%.

*Figure 1 State aid less agriculture, fisheries and transport, 2000-2003, average in the EU-15, EU-10 and Croatia (as a % of GDP)*



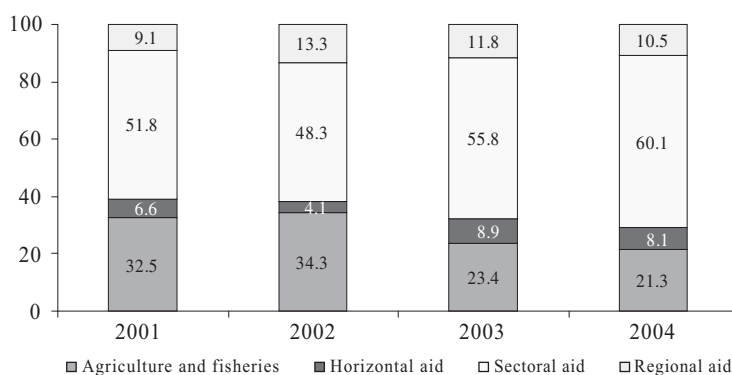
*Sources: Commission of the EC (2005); authors' calculations (2001-2004 average in Croatia)*

However, considerably higher levels of state aid than the EU-15 average in the observed period were also recorded in the Czech Republic, Cyprus and, particularly, Malta. Only three new member states were close to the EU-15 average, i.e. Estonia, Latvia and Lithuania. The levels of state aid in Slovakia and Slovenia were slightly above the EU-15 average.

## **State aid objectives and instruments**

The data set out below clearly show that, during the entire period, Croatia gave priority to sectoral aid, followed by agriculture and fisheries and regional aid, while horizontal aid was the last priority.

Figure 2 The structure of total state aid in Croatia, 2001-2004 (%)



Source: Authors' calculations

Despite the absence of a major change in the structure of state aid, the share of sectoral and agricultural aid in total aid varied from year to year. This was due to various rescue schemes for particular industries, e.g. agricultural conglomerates, ironworks or shipyards. However, in order to make a true comparison of the structure of aid according to objective, it is necessary to adjust the method of presenting the data on state aid to that in the EU, by excluding aid to agriculture, fisheries and transport.

Table 3 State aid by objective in Croatia, EU-15 and EU-10

	Amount of aid (in million euros)			Structure of aid (%)		
	EU-15	EU-10	Croatia	EU-15	EU-10	Croatia
Horizontal	20,651	902	77	52.2	14.9	17.2
Sectoral	9,816	4,608	251	24.8	75.9	56.1
Regional	9,086	560	120	23.0	9.2	26.7
Total aid*	39,553	6,070	448	100.0	100.0	100.0

\* less agriculture, fisheries and transport. Croatia: 2001-2004 average; EU-15 and EU-10: 2000-2003 average

Sources: Commission of the EC (2005); authors' calculations (for Croatia)

The structure of state aid in Croatia differs from that in the EU-15. In the period 2001-2004, average aid to individual economic sec-

tors accounted for the largest share in total aid (56% of total state aid) in Croatia, compared with only 25% of the total in the EU-15. In contrast to the EU-15, where horizontal aid participated with somewhat more than 52% in overall aid, in Croatia it accounts for as little as 17% of total state aid. A comparison of the structure of state aid between Croatia and the new member states shows that Croatia is in a favourable position, because its deviation from the EU-15 structure is significantly lower. More specifically, Croatia's assistance to certain regions is relatively more generous than that in the EU-10, and it invests more funds for horizontal purposes and less in individual sectors.

Apart from the objectives of state aid, it is interesting to look at the instruments of state aid allocation.

*Table 4 The structure of total state aid in Croatia by instrument (%)*

	2001	2002	2003	2004	2001-2004
Grants	57.5	79.7	68.4	70.5	68.3
Tax exemptions and relief	10.5	1.6	4.2	4.4	5.4
Equity participation	2.5	0.0	0.4	0.2	0.8
Soft loans	13.9	3.0	2.6	2.0	5.50
Tax deferrals	4.3	4.0	6.7	7.8	5.9
Guarantees issued	3.7	1.9	12.2	1.7	4.9
Guarantees revoked	7.5	9.9	5.6	13.4	9.2
Total	100.0	100.0	100.0	100.0	100.0

*Source: Authors' calculations*

In the observed four-year period, the largest portion (almost 70%) of aid to companies was granted through direct grants from the state budget, followed by guarantees revoked, tax deferrals and soft loans.

It is indicated that in the observed period, Croatia made a much heavier use of guarantees than the EU-15 member states, while it granted tax exemptions and relief less frequently<sup>ix</sup>. The system of guarantee provision is much less transparent than other instruments of state aid, e.g. grants. However, due to the establishment of the Croatian Competition Agency and its system of approval and supervision of state aid, this aid instrument should also become more transparent. It is interesting to note that tax exemptions and relief are mostly used in Ireland and Portugal, while grants are most frequently resorted to in Belgium, Denmark, Spain, Luxembourg, Austria and Sweden.

*Table 5 The structure of state aid to manufacturing and services sectors by instrument in the EU-15 and Croatia (as a % of the total)*

	Grants	Tax exemptions and relief	Equity participation	Soft loans	Tax deferrals	Guarantees
<i>EU-15</i>	67.0	22.7	0.7	4.8	2.6	2.2
Belgium	85.3	6.4	0.1	6.0	1.2	1.1
Denmark	94.3	5.7	-	-	-	-
Germany	64.3	29.0	1.0	1.6	-	4.1
Greece	72.6	27.1	-	0.3	-	-
Spain	93.8	-	0.2	6.0	-	-
France	59.9	26.0	-	11.3	0.1	2.7
Ireland	35.2	62.1	1.9	0.2	0.4	0.1
Italy	69.2	9.1	0.6	3.5	17.5	0.1
Luxembourg	96.3	-	-	3.7	-	-
Netherlands	63.5	18.1	-	4.9	10.1	3.4
Austria	89.8	-	-	7.2	-	3.0
Portugal	11.7	82.2	0.3	5.2	0.6	-
Finland	68.5	19.1	6.4	5.9	-	0.1
Sweden	86.5	7.9	1.0	4.6	-	0.1
United Kingdom	56.7	27.0	1.1	15.2	-	-
<i>Croatia</i>	58.7	5.9	0.4	4.3	9.6	21.2

*EU-15: 2001-2003 average; Croatia: 2001-2004 average*

*Sources: Commission of the EC (2005); authors' calculations (for Croatia)*

The situation is slightly different in the new member states as shown by the table below.

As in Croatia, the use of guarantees is relatively frequent in the new member states, led by the Czech Republic. Estonia is the only country with a more frequent use of grants than Croatia. However, the use of tax exemptions and relief is far more extensive in these countries than in Croatia, particularly in Lithuania and Latvia, as well as Hungary, Slovakia and Cyprus.

Consequently, state aid is used more frequently in Croatia than in the EU, and its share in GDP is about four times larger than that in the EU-15 and about 30% larger than in the EU-10. Croatia mainly subsidizes particular sectors providing less aid to horizontal objectives. Moreover, compared with the EU-15, the use of guarantees has been much more extensive and the use of tax exemptions and relief is less extensive in Croatia.

*Table 6 Aid to manufacturing and services sectors by instrument  
(as a % of total)*

	Grants	Tax exemptions and relief	Equity participation	Soft loans	Tax deferrals	Guarantees
<i>EU-15</i>	61.2	26.8	1.6	5.4	2.4	2.6
<i>EU-10</i>	18.4	33.6	4.9	3.5	1.7	37.8
Cyprus	17.9	80.9	-	-	-	1.2
Czech R.	11.7	3.3	5.7	1.3	0.4	77.7
Estonia	68.6	14.5	-	0.2	-	16.7
Hungary	31.7	66.7	0.1	0.6	-	0.9
Lithuania	3.0	65.4	2.0	1.4	3.2	25.0
Latvia	4.9	50.2	27.6	8.9	6.1	2.3
Malta	17.5	41.1	-	30.0	2.7	8.7
Poland	20.7	47.9	8.3	7.2	6.5	9.5
Slovenia	41.4	36.7	11.5	6.4	-	4.0
Slovakia	10.2	69.7	-	-	-	20.1
<i>Croatia</i>	58.7	5.9	0.4	4.3	9.6	21.2

*EU-10: 2000-2003 average; Croatia: 2001-2004 average*

*Sources: Commission of the EC (2005); authors' calculations (for Croatia)*

## STATE AID REFORM IN CROATIA

As the share of state aid to companies in GDP is more than four times larger in Croatia than in the EU, and aid is mainly targeted at certain economic sectors rather than at horizontal objectives, in the process of its EU accession Croatia will have to carry out extensive reform of its state aid. This will include downsizing overall aid and redirecting aid from selected sectors to horizontal objectives, e.g. environmental protection, education and training, research and development and support to small and medium-sized enterprises. The most radical changes will affect those economic sectors that currently receive the largest amounts of state aid and that come under special EU-rules. They include shipbuilding, transport, the steel industry and the rescue and restructuring of firms in difficulty which accounted for almost 80% of total sectoral aid in the period from 2001 to 2004.<sup>x</sup> The strategic development of these sectors will have to include reductions in the amount of

state aid and its harmonization with the EU rules. These sectors will be the main subjects of the Croatia-EU negotiations on state aid, and will have to undergo the heaviest adjustments to the EU rules. It is important to note that the aid awarded to these economic sectors will not be abolished, but will have to be restructured significantly during the harmonization process. The situation regarding state aid in the aforementioned four sectors (i.e. shipbuilding, transport, steel industry and the rescue and restructuring of firms in difficulty) and a summary of EU rules governing these sectors are set out below, followed by some estimates of the future developments of state aid in Croatia in the context of its harmonization with the EU rules.

*Table 7 Sectoral state aid in Croatia, 2001-2004*

	2001	2002	2003	2004	2001-2004
	100	100	100	100	100
Steel industry	3.71	0.08	0.82	0.94	1.45
Shipbuilding	11.96	24.67	12.32	12.65	14.49
Transport	49.57	44.21	63.39	66.31	57.53
Railways	25.21	4.65	45.80	53.15	35.83
Other transport	24.36	39.55	17.59	13.17	21.70
Trade	1.57	1.48	3.45	1.76	2.09
Other manufacturing	10.72	8.95	6.75	5.24	7.64
Tourism	6.82	2.61	6.72	2.29	4.61
Rescue and Restructuring	5.45	11.32	1.64	1.51	4.24
Culture	6.32	1.26	0.08	0.00	1.82
Other	3.88	5.44	4.83	9.30	6.13

*Source: Authors' calculations*

## **Shipbuilding**

### *The economic position of the industry*

Shipbuilding has been traditionally considered one of the strategic industries and claimed to have multiplier effects on the overall economy. It accounts for a significant share in Croatian exports and provides a large number of jobs. However, this industry has operated at a loss for many years; it is mainly state-owned and is technologically lagging behind economically competitive countries.

Unfortunately, Croatian shipbuilding is characterized by a slow restructuring process and lack of modernization. The numerous rescue attempts and subsidies from the state budget have still not resulted in the rationalization of production and investment in the development of the industry, so that its non-profitable production is mainly focused on technically less sophisticated vessels.

**Box 3 Some data illustrating the advantages and shortcomings of the Croatian shipbuilding industry<sup>xi</sup>**

- 82% to 100% of shipyards are state-owned.
- The shipbuilding industry provides jobs to its 15,000 employees and 5,000 workers in sub-contractors.
- The multiplier effect of the industry was 2.8% in 2003, which means that its annual production capacity of 0.8 billion US dollars generated domestic demand worth 2.3 billion US dollars.
- The share of domestic substance in the cost price of ships completed in 2003 was 65%.
- With exports worth 500-700 million US dollars, shipbuilding accounts for 12% to 15% of total exports. Along with the chemical, foodstuffs, clothing and oil derivatives industries, shipbuilding is one of the five top exporting industries that together account for about 50% in total Croatian exports.
- According to the world's stocks of orders, Croatian shipbuilding takes the fourth position in the world (followed by Japan, South Korea and China), and accounts for 1.5% to 2.3% of the total world's shipbuilding output. With Poland, Germany and Denmark, Croatia counts itself among the strongest shipbuilders in Europe.
- A total of 12 billion kuna was spent on five rescue programs for shipbuilding companies carried out by 2002. In 2002, the Government decided to increase subsidies to shipbuilding to 10% of the realized selling price per ship.
- According to the financial operating results of undertakings in 2004, losses amounted to 2.6 billion kuna, so that shipbuilding accounted for 43% in overall losses in manufacturing. However, owing to transferred losses, the majority of shipyards are permanently insolvent.
- Croatian shipyards are technologically underdeveloped, producing low-value ships (1.45 euros per ton), while the shipyards in the Scandinavian countries, as well as in Spain produce highest-value ships, i.e. of over 3,200 euros per ton.

### *State aid*

In the period from 2001 to 2004, total state aid to shipbuilding amounted to somewhat more than 2.5 billion kuna, accounting for 0.34% of GDP on average per year.

*Table 8 State aid to shipbuilding, 2001-2004*

	2001	2002	2003	2004	2001-2004
Shipbuilding (million kuna)	529.6	761.3	559.4	716.2	2,566.6
% of GDP	0.32	0.42	0.29	0.35	0.34

*Source: Authors' calculations*

Grants that account for 60% of total state aid include aid of 10% of the contract value per ship and direct transfers from the state budget to finance the shipbuilding rescue and restructuring programs. After 2001, when they accounted for 28% of total aid, guarantees issued stabilized at about 16% on average, while the amounts of guarantees revoked varied the most. Soft loans dropped to as low as 1% of total aid in 2004, and were about 10 times below their level in 2001. They were granted within the Croatian Bank for Reconstruction and Development (CBRD) exports crediting scheme, and were used for the financing of new shipbuilding (in 2001 and 2002) or as bridging loans in the cases of current insolvency of shipyards (in all years).

State aid to shipbuilding in the EU-15 declined from an annual average of 1.2 billion euros in the period 1999-2001 to 0.7 billion euros in the period 2001-2003. In 2003, total aid to shipbuilding amounted to of 635 million euros and was mainly allocated to shipyards in Germany (55%), France (13%) and Demark (8%). Aid to shipbuilding accounted for 2% of total aid in the EU-15 (Commission of the EC, 2005)<sup>xiii</sup>. Of the new member states, the largest amount of aid to shipbuilding was allocated in Poland, about 6% of total aid (Commission of the EC, 2005a).

*Table 9 State aid to shipbuilding by instrument (%)*

	2001	2002	2003	2004	2001-2004
Grants	55.2	45.1	82.6	60.2	59.6
Tax exemptions and relief	-	-	-	-	-
Equity participation	-	-	-	-	-
Soft loans	10.2	11.2	1.9	0.9	6.1
Tax deferrals	-	-	-	-	-
Guarantees issued	27.8	10.3	13.5	15.2	16.0
Guarantees revoked	6.8	33.3	1.9	23.7	18.3
Total	100.0	100.0	100.0	100.0	100.0

*Source: Authors' calculations*

Compared with EU-15, where aid to shipbuilding accounted for 2% of total aid, in the period 2001-2004, Croatia allocated almost 20% of total state aid<sup>xiii</sup> to shipbuilding, i.e. almost 10 times more than the EU.

### *State aid to shipbuilding in European Union and in Croatia*

According to the EU rules, current aid to shipbuilding can be used in the form of subsidies related to the contract value of ships and long-term aid for the development and modernization of facilities.

The EU is aware that, in the long run, tough competition can only be sustained through long-term investment in innovation, but also through the elimination of inefficient production capacities. In December 2003, the Commission published new rules on state aid to the shipbuilding sector which superseded the rules issued in 1998. The new rules are applicable from 1 January 2004 to 31 December 2006<sup>xiv</sup>. According to the definition comprised in the new Commission rules, state aid constitutes aid to any shipyard granted directly or indirectly for building, repair or conversion of ships. The Commission considers the following to be compatible with the common market: the aid granted for research, development and innovation, aid for the closure of shipyards, employment aid, aid in the form of export credit facilities, development aid and regional aid.

By providing short-term aid to shipyards of up to 6% of the contract value per ship, the EU tries to help them face tough competition from Korean shipyards. This measure, known as the temporary defence

mechanism, ceased to be valid on 31 March 2004. However, as the dispute with Korea was still not settled because it had not met its obligations, the temporary defence mechanism was prolonged until 31 March 2005. About 55% of total aid to shipbuilding relates to defensive aid approved by the Commission as an extraordinary and temporary aid granted directly at the time of negotiations for the building of particular types of vessels.

**Box 4 The case of public shipyards in Spain**

In May 2004, the European Commission decided that the aid provided to the public Spanish shipyards was not in line with the EU rules governing state aid to shipbuilding. The Commission established that in 1999 and 2000, the state holding company *Sociedad Estatal de Participaciones Industriales* (SEPI) granted aid worth 500 million euros to the public shipyards that are currently owned by a private company, IZAR. The aid took the form of a capital injection of 252.4 million euros, a loan of 192.1 million euros and a selling price for three shipyards that was 55.9 million euros above their market value. The Commission concluded that the above measures constituted further state aid which, after the approval of a final restructuring package in 1997, could no longer be approved under the EU rules governing aid to shipbuilding. As IZAR paid back the loan amounting to 192.1 million euros, it is required to reimburse other aid to the amount of 308.3 million euros plus interest.

*Source: European Commission, 2004*

Aid to shipbuilding accounts for 2% of total aid in the EU-15, and 20% in Croatia<sup>xv</sup>. This means that Croatia supports its shipbuilding sector tenfold more than Europe. As suggested by the data from the order book, Croatia is the top shipbuilder in Europe, whose aid to shipbuilding is very generous. It can therefore be expected that, during the accession negotiations, there will be strong pressures for the reduction of aid to this sector. Croatia should strive to reduce its aid to shipbuilding to the levels prescribed by the EU state aid structure, which implies a manifold reduction in its amount. Croatia will not only have to considerably reduce subsidies to this sector but will also be required to redirect state aid from rescue programmes, which have so far been the main motives for state aid allocation, to those forms of aid that are in line with EU rules, e.g. aid for the closure of shipyards, aid aimed at providing for workers made redundant and aid to innovation, research and development.

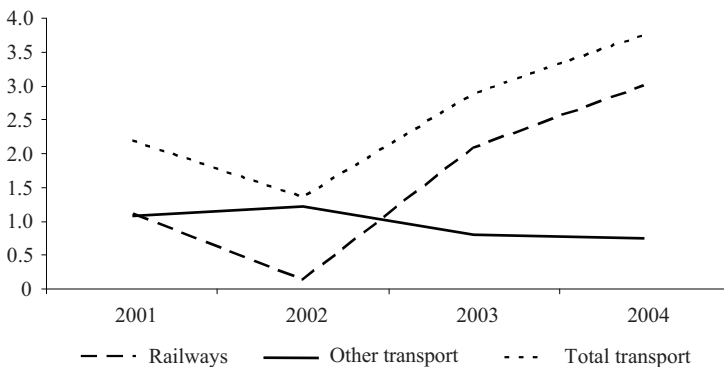
The implementation of the program for the restructuring and rehabilitation of Croatian shipbuilding<sup>xvi</sup>, which is in the preparatory stage, and the privatization of shipyards will finally result in downsizing state aid in the long run, improving its transparency and focusing on the improvement of shipyard efficiency.

## Transport

### *State aid*

In view of Croatia's geographic and traffic-related position, the transport industry and infrastructure play an extremely important role in the overall economic and social development of the country. The current transport situation in Croatia is generally unsatisfactory, particularly as concerns the railway, port and sea and river shipping industries. Aid to transport accounts for the largest share in total sectoral aid. According to the 2001-2004 data, it accounted for almost 60% of total aid to selected economic sectors. State aid to transport is mainly allocated to the railways. It is interesting to note that aid to transport declined in the observed period, both as a share of sectoral aid and overall state aid. The figure below shows the developments in aid to transport with a noticeable growth in aid to railways and a decline in aid to other types of transport.

*Figure 3 Developments in state aid to transport (billion kuna)*



*Source: Authors' calculations*

## Railways

Railways account for the largest share in state aid to transport. In the period 2002-2004, total aid to the transport sector amounted to 10.2 billion kuna. Of this total amount, 6.4 billion kuna was related to Croatian Railways and 3.8 billion kuna to other types of transport.

The data for 2004 show that aid to Croatian Railways accounted for slightly more than 3 billion kuna of total state aid, i.e. 1.5% of GDP. However, in 2003, aid to the railways exceeded 2 billion kuna, which equals about 1% of GDP. For the entire observed period, aid to Croatian Railways amounted to 6.3 billion kuna.

*Table 10 State aid to Croatian Railways, 2001-2004*

	2001	2002	2003	2004	2001-2004
Railways (million kuna)	1,116.5	143.6	2,080.1	3,008.9	6,349.1
% of GDP	0.67	0.08	1.08	1.45	0.82

*Source: Authors' calculations*

Aid does not normally include government investment in railway infrastructure and the share in loans for this purpose. It is noticeable that there was a break in the series for aid granted to Croatian Railways during 2002. This was due to a shortage of detailed information on the schedule for loan principal repayment related to the Ministry of Finance, which is why it was impossible to establish clearly whether the item constitutes state aid or investment in infrastructure. Aid to Croatian Railways includes funds used for severance payments to employees, incentives for passenger and combined transport, as well as aid for the payment of wages to employees. It is worth noting that the collection of data on state aid to Croatian Railways for 2003, and particularly 2004, was greatly facilitated by a more detailed and transparent presentation of this aid in the government budget.

Looking at the instruments of state aid to Croatian Railways, it is obvious that the aid was mainly granted in the form of direct transfers from the state budget, state guarantees issued (with a 100 percent probability of being revoked), and state guarantees revoked. The available data indicate that, during the observed four-year period, state aid in the form of soft loans was allocated only once, by CBRD in 2003.

*Table 11 State aid to Croatian Railways by instrument, 2001-2004 (%)*

	2001	2002	2003	2004	2001-2004
Grants	98.2	100.0	55.7	70.1	71.0
Tax exemptions and relief	-	-	-	-	-
Equity participation	-	-	-	-	-
Soft loans	-	-	1.1	-	0.3
Tax deferrals	-	-	-	-	-
Guarantees issued	1.8	-	43.2	-	14.5
Guarantees revoked	-	-	-	29.9	14.2
Total	100.0	100.0	100.0	100.0	100.0

*Source: Authors' calculations*

### Transport less railways

The last two years saw a decline in aid to other types of transport, so that in 2003 and 2004, aid amounted to 800 million kuna and 750 million kuna respectively. Thus, aid as a proportion of GDP halved over these two years, i.e. it went down to 0.36% of GDP in 2004 compared with 0.68% of GDP in 2002.

*Table 12 State aid to transport less railways, 2001-2004*

	2001	2002	2003	2004	2001-2004
Transport (million kuna)	1,079.0	1,220.7	798.7	745.5	3,843.9
% of GDP	0.65	0.68	0.41	0.36	0.52

*Source: Authors' calculations*

As with the railways, aid in the form of grants from the state budget also prevails in the remaining part of the transport sector, and accounts for over 90% of total transport aid. However, this aid is much more frequently allocated through other instruments, e.g. tax deferrals and state guarantees revoked. It is interesting to analyse the dynamics of these instruments. While aid to transport in the form of grants from the budget trended downwards in the last two years, tax deferrals and guarantees revoked showed no clear trend, which leads to the conclusion that these aid instruments are more often used by enterprises in financial difficulties.

*Table 13 State aid to transport less railways, by instrument (%)*

	2001	2002	2003	2004	2001-2004
Grants	89.1	98.3	98.0	89.1	93.9
Tax exemptions and relief	-	-	0.2	0.2	0.0
Equity participation	-	-	-	0.0	0.0
Soft loans	0.0	-	0.0	-	0.0
Tax deferrals	4.9	-	1.0	9.4	3.4
Guarantees issued	-	0.6	0.0	-	0.2
Guarantees revoked	5.8	1.1	0.7	1.2	2.4
Total	100.0	100.0	100.0	100.0	100.0

*Source: Authors' calculations*

In the period 2001-2003, in the EU-15 around 1.5 billion euros per year was awarded to the transport sector less railways. This represents an increase of over 50% relative to the period 1999-2001. Two-thirds of total transport aid (about 1 billion euros per year) was awarded to the maritime transport sector, the most sizeable amounts being granted by Denmark, France, Italy, the Netherlands, Sweden and United Kingdom.

The favourable treatment of the railway sector is also reflected in figures. Thus, the EU allocates several times larger amounts of aid to railways than to other transport. Over 2004, the EU-15 allocated as much as 25 billion euros to railways, almost sixteen times more than to other transport. The most sizeable amounts of aid to railways were allocated by France (6.2 billion euros), Italy (3.9 billion euros), Germany (3.5 billion euros), United Kingdom (3.1 billion euros) and the Netherlands (2.7 billion euros) (Commission of the EC, 2005a).

### *State aid to transport in European Union and in Croatia*

The EU rules governing the control of state aid to the transport sector are far more complex than those related to other sectors<sup>xvii</sup>. These issues fall within the competence of two EU Commission Directorates, i.e. *DG Competition* and *DG Transport*.

Aid to the transport sector is focused on the following three areas:

- compensation for the provision of services of general economic interest (SGEI),
- investment in infrastructure, and
- state aid to railways.

The Commission adopted a package related to the compensation for the provision of SGEI. The package provides that undertakings can receive public funds to cover all costs, including reasonable profit, of the provision of public services defined and delegated to them by public authorities, without causing the payment of excessive compensation, which is likely to threaten competition. The public funds used for the provision of SGEI do not constitute state aid to the transport sector.

Similar treatment is given to investment in infrastructure. Infrastructure is open to all users on a non-discriminatory basis, and not to a particular undertaking or economic activity, and as such does not meet the criteria for state aid. Consequently, compensation for the provision of SGEI and infrastructure does not normally constitute state aid and need not be notified to the Commission.

#### **Box 5 State aid to the United Kingdom rail sector**

In 2002, the Commission took some important decisions related to the infrastructure management of the national railway network in the United Kingdom. First, it approved a financial rehabilitation package to ensure the continued provision of railway services, without which the UK railways risked collapsing. After that, the Commission approved funds to allow a newly established company, *Network Rail*, to take over the responsibility for managing the UK rail network on a non-profit basis. The Commission deemed the total amount of about 36 billion pounds not to constitute state aid but compensation for the provision of services of general economic interest.

*Source: Commission of the EC, 2005*

State aid to railways is given a special treatment. In view of its environmental awareness, the Commission has marked railways as a strategic industry. In principle, the Commission has followed a favourable approach to aid in the rail sector, both as regards rail services and investments, which are not viable without public co-financing. For this reason, actually, a major portion of the state subsidies to railways need not be notified to the Commission. This may be due to the fact that,

given the lack of competition in this sector, such financing is not considered to be state aid, or because it represents either compensation for SGEI or investment in infrastructures. However, member states are required to report to the Commission their overall public expenditures for the railways. The Commission considers the revitalization of the railway sector to be one of the focal points of the EU transport policy. It maintains that state aid control is of crucial importance for the competitiveness and efficiency of railways (Commission of the EC, 2005).

In 2004, aid to transport in Croatia accounted for almost 65% of total sectoral aid, or about 40% of overall state aid. As the largest amount of transport aid was granted to the railways, this sector is expected to come under close scrutiny from the EU. Therefore it will be necessary clearly to determine which subsidies to this sector constitute compensation for the provision of services of general economic interest or investment in infrastructure, because these do not constitute state aid. Similarly, as concerns the rail sector in particular, a clear-cut distinction will have to be drawn between the subsidies for investments and those provided for covering current losses incurred by the Croatian Railways. Currently, there is no such distinction. It can be considered that subsidies to Croatian Railways do not constitute state aid, given the current monopolistic position of this company, owing to which such subsidies do not distort competition. However, it can also be argued that this monopolistic position only exists in terms of railway transport and not in relation to the other transport.

## **Steel industry**

### *The economic position of the industry*

In 2004, manufacture of metals and metal products accounted for about 6.5% of gross domestic industrial production. This division also accounted for 11.3% of total employment in manufacturing. The Croatian metal manufacturing industry comprises the manufacture of welded and seamless iron tubes, reinforcement steel, rolled wire and reinforcement steel nets for construction purposes, as well as aluminium processing and casting of metals.

A significant portion of metal processing facilities is still in state ownership, operating at a loss. Their losses are covered by transfers from the state budget.

*Željezara Sisak (Sisak Ironworks)* has reduced its production over time. Its production capacities are underutilized, its technological processes are obsolete and currently there is no demand for its products. After a number of failed attempts to privatize and “re-nationalize” the plant, the only viable solution for the survival of the plant would be its takeover by a serious purchaser from this industry.

*Željezara Split (Split Ironworks)*. Owing to high electricity prices, growing imports of electrodes and ferro-alloys, expensive short-term loans and low utilization of production capacities, the company reduced its production and raised its consumption standard. This resulted in a 65% increase in production costs and losses. After bankruptcy was declared, the government invested sizeable funds in the modernization of the company’s facilities. However, given its accumulated losses, the plant has not succeeded in finding a new owner, despite a number of international tenders, but its privatization prospects are still better than those of the Sisak Ironworks.

*TLM Šibenik* is the only producer of aluminium and aluminium products. Its production facilities are also obsolete and its annual turnover fell significantly (to 19% of the turnover recorded in 1989). The company imports 95% of its raw materials (from the aluminium factory in Mostar) and exports 75% of its total output. Owing to insufficient working capital, TLM Šibenik mainly operates at reduced capacity.

Despite stronger performance in recent years, the members of *Duro Đaković Holding* company dealing with metal processing still rely excessively on the state, i.e. the majority of their activities depend on government investments in road construction and railways.

### *State aid overview*

In the period 2002-2004, state aid to steel industry totalled 257.1 million kuna, the largest amount of 164.2 million kuna being allocated in 2001. According to the available data, the amount of state aid decreased to 2.3 million kuna over 2002, and in 2003 and 2004, it stabilized at 37.3 million kuna and 53.3 million kuna respectively.

Of the total amount (164.2 million kuna) of aid allocated to ironworks in 2001, as much as 160 million kuna was spent on the consolidation of Sisak Ironworks through the write-off of government and public enterprise claims. The remaining 4.2 million kuna relate to aid in the form of state guarantees issued for the benefit of TLM Šibenik.

Table 14 State aid to ironworks, 2001-2004

	2001	2002	2003	2004	2001-2004
Ironworks (million kuna)	164.2	2.3	37.3	53.3	257.1
% of GDP	0.10	0.00	0.02	0.03	0.04

Source: Authors' calculations

The entire amount (2.3 million kuna) of aid allocated during 2002 related to state guarantees issued to Split Ironworks. State guarantees revoked accounted for the largest portion (25.9 million kuna) of total aid allocated in 2003, which amounted to 37.3 million kuna. The remaining 11.4 million kuna related to state guarantees issued for the benefit of TLM Šibenik and Split Ironworks. The smallest amount of aid allocated in 2003, 133 thousand kuna, related to soft loans extended during that year, particularly the loan granted by the Croatian Privatization Fund, to Split Ironworks. The structure of aid in 2004 was similar. The largest portion of total aid, 27.8 million kuna, was allocated in the form of state guarantees revoked in that fiscal year. The amount of 19.2 million kuna was granted in the form of financial transfers for equity participation, and the remaining 6.3 million kuna related to state guarantees issued for the benefit of TLM Šibenik.

Table 15 State aid to ironworks by instrument (%)

	2001	2002	2003	2004	2001-2004
Grants	-	-	-	-	-
Tax exemptions and relief	97.4	-	-	-	62.2
Equity participation	-	-	-	36.0	7.5
Soft loans	-	-	0.3	-	0.0
Tax deferrals	-	-	-	-	-
Guarantees issued	2.6	100.0	29.8	11.8	9.3
Guarantees revoked	-	-	69.9	52.2	20.9
Total	100.0	100.0	100.0	100.0	100.0

Source: Authors' calculations

In the period 2001-2004, aid in the form of tax exemptions and relief accounted for the largest share in total state aid to this sector, owing to its large amount in 2001. However, aid in the form of state guarantees revoked gained in importance in the last two years, and was

allocated to Split Ironworks (26 million kuna and 27.8 million kuna in 2003 and 2004 respectively).

The EU-15 has sharply reduced its aid to ironworks, from an annual average of about 2 billion euros in the mid-90s to 12 million euros in 2004, when aid was mainly allocated for environmental protection. Among the new member states, the largest amounts were allocated for this purpose by the Czech Republic, Slovakia and Poland (Commission of the EC, 2005a).

### *State aid to steel industry in European Union and in Croatia*

The rules governing state aid to the steel sector are no longer in force, so that this area is now subject to the rules regarding rescue and restructuring aid or regional aid<sup>xviii</sup>. The rules governing regional aid to large investment projects prohibit the allocation of investment aid to this sector. Similarly, according to the rules on rescue and restructuring aid and closure aid for the steel sector, rescue and restructuring aid is also considered incompatible with the common market. The only allowed aid is the aid for the closure of enterprises in this sector subject to certain conditions, i.e. the aid for covering retirement costs of redundant employees, and aid to ironworks that stop production completely. The European Commission considers that the allocation of such aid would undermine the efforts of the steel industry to reduce its costs and strengthen competitiveness.

It is obvious that state aid to the steel industry in Croatia is mostly targeted at financial rehabilitation and consolidation or at issuing guarantees. Therefore, this segment of state aid will have to be harmonized with the EU rules, which prioritize aid aimed at reducing costs and strengthening competitiveness of businesses and aid for closing down low-performance production facilities and providing for redundant labour over aid for the rescue of existing business facilities. The forthcoming National Ironworks Restructuring Programme will finally define the state aid policy for this industry.

**Box 6 Reduction of tax concession granted to the Slovakian Ironworks US Steel Košice**

Pursuant to the EU Accession Agreement, Slovakia was granted permission to continue to grant tax exemptions to US Steel Košice until the end of 2009. In order to compensate for the company's competitive advantage resulting from the aid, as from 2002 a cap for production, and as from the date of the EU accession also a cap for sales were established. However, US Steel Košice did not respect the production cap in 2002 and 2003. In order to counterbalance the effect of the overproduction, the Slovak government requested a significant reduction in state aid and asked the Commission to revise the conditions for granting the transitional period. On 22 September 2004 the Commission decided that the tax exemption should be reduced from 500 million to 430 million US dollars and that the beneficiary should make a tax payment of 32 million dollars to the Slovak government.

*Source: European Commission, 2004*

## **The rescue and restructuring of firms in difficulty**

### *State aid overview*

It should be noted that aid for rescue and restructuring of a specific industry was classified to that industry. However, aid related to rescue and restructuring, where the sector was not clearly indicated, was classified as general rescue and restructuring aid. For example, all amounts of aid aimed at rescuing and restructuring shipyards were classified as aid to the shipbuilding sector and not as rescue and restructuring aid. The purpose of this was to classify aid as accurately as possible according to the final beneficiary. In view of this it can be concluded that the total amount of rescue and restructuring aid in Croatia was much larger than reported. For example, total aid to shipbuilding and Croatian Railways, amounting to almost 9 billion kuna (50% of total sectoral aid) in the period 2001-2004, was allocated for the rescue and restructuring of these sectors.

In the last four years, state aid allocated for various rescue and restructuring schemes amounted to somewhat more than 750 million kuna or 0.1% of GDP. The largest amount (about 590 million kuna)

was allocated in 2001 and 2002, and the remaining 160 million kuna relates to 2003 and 2004. Such developments in state aid were partly due to the course of the privatization process, as the number of businesses needing to be rescued by the state was decreasing.

*Table 16 Rescue and restructuring aid, 2001-2004*

	2001	2002	2003	2004	2001-2004
Rescue and restructuring (million kuna)	241.2	349.3	74.5	85.5	750.6
% of GDP	0.15	0.19	0.04	0.04	0.10

*Source: Authors' calculations*

*Table 17 Rescue and restructuring aid by instrument (%)*

	2001	2002	2003	2004	2001-2004
Grants	7.1	82.4	-	32.0	44.3
Tax exemptions and relief	-	-	-	-	-
Equity participation	-	-	-	-	-
Soft loans	54.3	17.6	100.0	68.1	43.3
Tax deferrals	-	-	-	-	-
Guarantees issued	38.6	-	-	-	12.4
Guarantees revoked	-	-	-	-	-
Total	100.0	100.0	100.0	100.0	100.0

*Source: Authors' calculations*

The most frequent aid instruments are grants from the state budget and soft loans. In 2004, grants from the budget for the rescue and restructuring of firms were given by the Ministry of Economy within its re-industrialization programme and by the Croatian Development and Employment Fund for the revitalization of the company Diona d.d. in Bankruptcy. The largest amount of budget subsidies for this purpose was allocated in 2002, mainly for the restructuring of the Croatian Postal Bank.

Over the observed period, state aid for rescuing and restructuring purposes was largely financed by soft loans. These were the CBRD loans extended throughout the observed four-year period within the Loan Programme for the Development of the Economy and Loan Programme for the Financial Restructuring of Business Entities. These programmes are intended for the restructuring of business entities, modernization of the existing and introduction of new technologies, and are

available to all beneficiaries in Croatia who are engaged in various business activities. The loans were not intended for the restructuring of any particular sector but of all sectors and were classified as general rescue and restructuring loans. The amount of aid allocated through this instrument has decreased continuously, falling from 130 million kuna in 2001 to 58 million kuna in 2004. State guarantees for these loans were only issued in 2001, to various domestic banks for the benefit of the Croatian Privatization Fund. The most generous subsidies were provided in 2002 for the rehabilitation of the Croatian Postal Bank.

The last EU State Aid Scoreboard with separately presented data on rescue and restructuring aid for 2000 was issued in 2002.<sup>xix</sup> In this year, rescue and restructuring aid in the EU-15 accounted for barely 1% of total aid and was mainly granted in Spain.<sup>xx</sup> In Croatia, this aid accounted for 6.7% of total aid in 2001, but decreased to 2.3% of total aid in 2004. Consequently, within the structure of total aid in Croatia, rescue and restructuring aid is still above EU levels.

### *Rescue and restructuring aid to enterprises in difficulties in European Union and in Croatia*

The EU considers rescue and restructuring aid sectoral aid, because it is believed that this aid has the most distorting effect on competition and that state support must not be provided as a rule any time an enterprise gets into financial difficulties.<sup>xxi</sup> It is natural that low-efficiency enterprises should withdraw from the market, and the state is not allowed to keep them artificially in operation.

In October 2004, the EU introduced new, clearer and more transparent rules on rescue and restructuring aid, which will apply till 2009. Such aid is still allowed, subject to the following basic rules:

- Aid allocation is based on the “*one time, last time*” principle, meaning that the aid can only be allocated once in a 10 year period.
- Rescue aid can be provided for the maximum of six months. Aid provided after this period is considered to be restructuring aid.
- The Commission considers that the recipient of the restructuring aid must participate in financing the restructuring.

**Box 7 Rescue aid in favour of MG Rover Group Ltd.**

In 2004 MG Rover Group Ltd. was supposed to be taken over by Shanghai Automotive Industry Corp. However, due to a lack of confidence about the solvency of MG Rover, there was no reasonable prospect of a deal. In order to support the company, the UK Ministry of Trade and Industry agreed to provide a 6.5 million pounds loan for one week to cover the costs of staff wages and salaries. The European Commission considered that this loan was state aid because MG Rover Group Ltd. would not have obtained it on commercial conditions. The Commission also considered that this state aid was allowed. More specifically, it was granted for an area defined by Article 87(3)(c) of the Treaty, which allows aid for the development of underdeveloped regions. Moreover, the loan was granted for the duration of one week, which was much shorter than the allowable duration of 6 months, at an interest rate of 7.5%, considered as market rate. The loan was granted on the grounds of serious social difficulties (possible job loss for 6,100 employees and 12,200 sub-contract workers). MG Rover had only a limited share in the car market; the United Kingdom had committed to submit the liquidation plan within 6 months; MG Rover had not received rescue aid on an earlier occasion. In view of the above, in 2005 the Commission decided that the rescue aid concerned was compatible with the common market.

*Source: Commission of the EC, 2005b*

As rescue and restructuring aid is still sizeable in Croatia compared with that in the EU-15, it seems likely that it will be reduced in the forthcoming period. In addition, this aid will have to be adjusted to the EU rules providing that aid can be granted to an enterprise only once in ten years and that the enterprise must participate in financing the restructuring costs. The implementation of the EU rules will also improve transparency of state aid allocation in this area where arbitrary and *ad hoc* decisions have been taken too frequently.

## CONCLUSION

State aid is a part of industrial policy and one of the measures used by the state to influence the market position of particular industries and/or enterprises. “Bad aid” distorts competition giving priority

to one enterprise over the other, and thus reduces public welfare, while “good aid” corrects market failures and thus contributes to the growth of welfare. The allocation of state aid, particularly that which is the subject to selective industrial policy, i.e. the policy aimed at providing help only to selected economic sectors or companies, offers many challenges, e.g.: state aid involves direct and indirect costs; the state has insufficient information to be more successful than the market in selecting “winners” and “losers”, and it cannot pick the right moment to stop providing assistance; it is incapable of resisting various lobbies; state aid results in unfair competition; it can harm international trade; and, finally, state aid imposes a burden on the state budget. All the above-mentioned challenges have to be borne in mind when deciding on the implementation of a particular form of state aid.

This paper presents an overall picture of the size and structure of state aid in Croatia and indicates the direction of its future development following EU rules. This provides a general framework for Croatian state aid policy, i.e. Croatian industrial policy in broader terms. The recommendations given for particular sectors relate to the harmonization of state aid with the EU rules and practices, and to improving transparency in state aid allocation, especially as concerns the avoidance of *ad hoc* authorizations of aid to “rescue” certain enterprises.

The state aid-to-GDP ratio in Croatia is four times higher than that in the EU, and aid is mainly targeted at “problem sectors” like shipbuilding, transport (particularly the railways) and the steel industry, as well as rescue and restructuring of firms in difficulty. The harmonization of these sectors with EU standards will need the greatest effort. By contrast, aid to horizontal objectives (e.g. small- and medium-sized enterprise, research and development, education and training, environmental protection) will need to be increased, aid allocation transparency will need to be improved, and it will have to be ensured that state aid regulations are consistently applied by all system participants. Being aware of the necessity for these adjustments, the Government of the Republic of Croatia in its Pre-accession Economic Programme 2006-2008, drawn up in December 2005, committed to reduce state subsidies<sup>xxii</sup> from the 2.5% of GDP in 2006 to 2.2% of GDP in 2008 (particularly those granted to Croatian Railways).

In its latest State Aid Scoreboard (Commission of the EC, 2006), in which Croatia is mentioned for the first time, the European Commission calls attention to the crucial tasks facing Croatia in its state aid

reform. This particularly relates to sectoral state aid to shipbuilding and steel industry.

- *Shipbuilding*. A sustainable program to restructure the shipbuilding sector should be adopted as soon as possible, following the EU rules and taking account of the importance of this industry for Croatia.
- *Steel sector*. Croatia has not fulfilled its obligation from the SAA to adopt a programme to restructure its steel industry by March 2004. As aid to shipyards and ironworks continues to be allocated, the stated programmes should be adopted without delay.

The Commission points to the necessity to implement short-term measures aimed at improving the transparency of the state aid system, e.g.: to strengthen the administrative capacity of the Croatian Competition Agency, to ensure the efficient implementation of all aid-related measures, to harmonize the Croatian legislation with the acquis, to establish a comprehensive list of state aid including all measures related to state aid which are adopted at all levels of authority. The restructuring and privatization of the Croatian economy, particularly in the area of shipbuilding and steel industry<sup>xxiii</sup>, and the promptness in harmonizing the Croatian state aid system with the EU rules will have a significant influence on the opening of the negotiations on Chapter 8 of the acquis dealing with competition, which also includes state aid.

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- \* *The authors would like to thank the referees who anonymously reviewed this paper.*
- i *We express our gratitude to the Ministry of Finance of the Republic of Croatia for providing financial support and permission to publish these data.*
- ii *The data for the period 2001-2002 were collected independently by the Institute of Public Finance, and the data for the following two-year period were gathered within the research project developed by the Institute of Public Finance for the purposes of the Ministry of Finance. The data originate from various sources, e.g.: Ministry of Finance, Tax Administration, Croatian Government, Croatian Bank for Reconstruction and Development, Croatian Privatization Fund, etc.*
- iii *The essentials of the methodology applied in State Aid Scoreboard are available on the EU website: [http://europa.eu.int/comm/competition/state\\_aid/scoreboard/conceptual:remarks.html](http://europa.eu.int/comm/competition/state_aid/scoreboard/conceptual:remarks.html).*
- iv *The European Council's meetings in Stockholm (2001), Barcelona (2002) and Brussels (March, 2003).*
- v *State Aid Action Plan: Less and Better State Aid: A Roadmap for State Aid Reform 2005-2009; available at: [http://europa.eu.int/comm/competition/state\\_aid/others/action\\_plan/saap\\_en.pdf](http://europa.eu.int/comm/competition/state_aid/others/action_plan/saap_en.pdf).*
- vi *A set of common strategy rules adopted at the European Council meeting in Lisbon in 2000, according to which, by 2010, the EU should become the world's most competitive and dynamic economy based on knowledge and capable of sustainable economic growth, with the highest employment rate and strong economic and social cohesion.*

- vii *This way of presenting state aid is used in the EU State Aid Scoreboards.*
- viii *The 2002 figures are based on the available data, which are less detailed than the data for other years. Therefore, it is not quite accurate to compare the amounts of state aid in 2002 with those granted in other years.*
- ix *A comparison between Croatia and the EU by aid allocation instrument is only possible for aid to manufacturing and services, because it is so presented in the EU State Aid Scoreboard.*
- x *Sizeable amounts of state aid are allocated to tourism and other industries. However, as they are not subject to any special EU regulation and are governed by general rules on state aid, they are not specifically mentioned here.*
- xi *The sources of data: Croatian Chamber of Economy (<http://www.hgk.hr>) and Hrvatska brodogradnja Jadranbrod d.d. Zagreb.*
- xii *Total aid less agriculture, fisheries and transport.*
- xiii *Total aid less agriculture, fisheries and transport.*
- xiv *Framework on state aid to shipbuilding; available at: [http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/c\\_317/c\\_31720031230en00110014.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/c_317/c_31720031230en00110014.pdf).*
- xv *Total aid less agriculture, fisheries and transport.*
- xvi *The obligation set out in the Pre-Accession Economic Program, 2006-2008 of the Government of the Republic of Croatia; available at: <http://www.mfin.hr/str/102/>.*
- xvii *Available at: [http://europa.eu.int/comm/competition/state\\_aid/legislation/](http://europa.eu.int/comm/competition/state_aid/legislation/).*
- xviii *Available at: [http://europa.eu.int/comm/competition/state\\_aid/legislation/](http://europa.eu.int/comm/competition/state_aid/legislation/).*
- xix *Subsequently, the data were not presented separately but were included in other sectors (Commission of the EC, 2002).*
- xx *Total aid less agriculture, fisheries and transport.*
- xxi *Available at: [http://europa.eu.int/comm/competition/state\\_aid/legislation/](http://europa.eu.int/comm/competition/state_aid/legislation/).*
- xxii *Including subsidies to agriculture, but excluding other aid instruments (guarantees, tax exemptions and relief, etc.), which are included in state aid according to the EU methodology.*
- xxiii *The National Programme for the Rehabilitation and Restructuring of Croatian Shipbuilding should be completed by 15 June 2006. The National Program for the Rehabilitation and Restructuring of the Iron and Steel Industry has been completed and submitted to the EU (--, 2006).*

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