The role of state intervention in tackling the cost of living crisis in Croatia: wise or not so wise step?

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The current state of inflation and its triggers

At the beginning of July 2023 Croatia witnessed the second highest annual inflation rate in the Euro area. The rate of 8.1% was only below Slovakia's rate of 10.2% (Eurostat, 2023a). The HIPC (Harmonised Index of Consumer Prices) data show that inflation rate in Croatia trailed that of the Euro area until March 2022. However, this point in time marks the beginning of divergence, when the annual inflation rate in Croatia started skyrocketing, hitting the record of 13% in November 2022 (Eurostat, 2023b). Afterwards, the gradual decrease in inflation was a welcome sign but the bad news is to be found in the much slower decrease in inflation as compared to the rest of the Euro area.

There are numerous triggers behind inflation surge in Croatia, both on the demand side, as well as on the supply side. First, on the demand side we can identify strong demand for tourist services due to Croatia's proximity to richer Central European states. Croatia's tourism has fully recovered from the pandemic and there are more visitors and overnight stays in the first seven months of this year than in the record year 2019. Second, the super election year of 2024 is drawing close. Parliamentary, European Parliamentary elections and presidential elections are related to increased responsiveness on behalf of the incumbent HDZ-led Government to various interest groups' requests for increased public spending. First and foremost, state employees hold an upper hand over the spendthrifty ruling majority willing to prolong their seven year long tenure in office.

On the supply side, the first factor pushing up inflation rate refers to a significant passthrough inflation due to Croatia's still considerable energy import dependency of 54.5% (Kotarski, 2023a). Higher prices of gas, electricity and fuels spark both the cost of living and the cost of doing business. Second, boasting one of the highest growth rates in the EU as of this writing, Croatia has a very tight labour market. In 2022 the number of employees based on the number of full-time equivalent hours increased by 3% (Šonje, 2023). Still, there are not enough workers in the construction, tourism, hospitality, cleaning and maintenance sectors of the economy, notwithstanding record-breaking immigration on work visas, especially from

Asian countries. Therefore, the bargaining position of workers in the private sector gained much strength over the last couple of months and real wages have recovered for the first time since September 2021, in spite of high inflation. Unemployment rate reached an unprecedented low of 5.6% in June 2023 (DZS, 2023). Hence, the worst outcome of stagflationary crisis has been successfully averted so far.

Overall, in almost all similar inflation episodes there would be an emergence of many dissatisfied citizens willing to engage in social protests or industrial actions, or changing their political preferences visible in regular opinion polls. However, this scenario has not materialised so far and it is very unlikely in the medium run. Apart from the fact mentioned in the previous policy brief for the Korea Institute for International Economic Policy (Kotarski, 2023b), that 85% of households own their dwellings (without mortgage) and that homeownership rates are almost equally distributed across all five income quintiles, there are also other factors contributing to remarkable social stability. One of the most important of them is the state's direct or indirect intervention in the price-setting mechanism, which will be the subject of the next section.

State intervention in price-setting mechanism in Croatia

In terms of price-setting mechanisms in Croatia we can essentially point out to the existence of a two-tiered system. On the one hand there are market-determined prices of goods such as: food and non-alcoholic beverages, clothing, consumer electronics, footwear, furniture, hotel accommodation and restaurants. Their level is significantly higher than what one would expect from Croatia's level of economic development. At the same time those prices have increased faster than the prices representing the EU-27 average over the last two years. There are a number of factors which stand behind this observation. The most important of them are: strong demand due to Croatia's heavy reliance on tourism, higher consumption taxes, barriers to entry and corresponding lack of competition, as well as a smaller market which precludes genuine economies of scale. All of this enables companies relatively higher degree of control over prices (Vizek, 2023).

On the other hand there are administratively-controlled prices such as: gas, electricity, fuels and transportation. A case in point is the Government's decision dating March 2023 to extend energy measures package comprising reduced VAT rate and excise dutires on energy products, as well as social transfers to materially deprived groups such as pensioners. It also prolonged price caps on electricity, gas and fuels. The difference between market and capped prices is financed by HEP (the state-owned company). The two-tiered pricing system for electricity is subsidised at different levels of consumption for households and companies for the period 1 April - 30 September 2023, while the gas price is subsidised until the end of March 2024 (European Commission, 2023).

Over the last two years Croatia witnessed one of the lowest electricity and gas price hikes for household consumers in the EU (*Figure 1* and *Figure 3*). Similarly, gas prices for non-household consumers were also heavily controlled in comparison to other EU member states (*Figure 2*). One major deviation from the overall trend is elevated electricity price for non-household consumers (*Figure 4*). Fuel prices have also been heavily-controlled since the spring of 2022 and Croatian drivers pay below EU-average petrol and diesel prices (European Commission, 2023b). Estimates of total costs related to state-controlled prices (of both state-mandated profit margins of €0.0862 per liter of petrol and diesel and reduced VAT and excise taxes) come in the range of €17 million per month (N1 Hrvatska, 2022). In sum, the European Central Bank (2023a) data show that administered prices have risen much slower in Croatia than in the Euro area. (*Figure 5*). On the other hand, market-determined prices in Croatia have shot up faster than in the Euro area (*Figure 6*). Similarly, if we disaggregate HICP data per categories of consumption, we can corroborate the previous conclusion. In all categories of consumption except for transport, electricity, gas and other fuels price hikes were much faster in Croatia than in the rest of the Euro area (European Central Bank, 2023b).

Figure 1 ***Gas prices for household consumers***

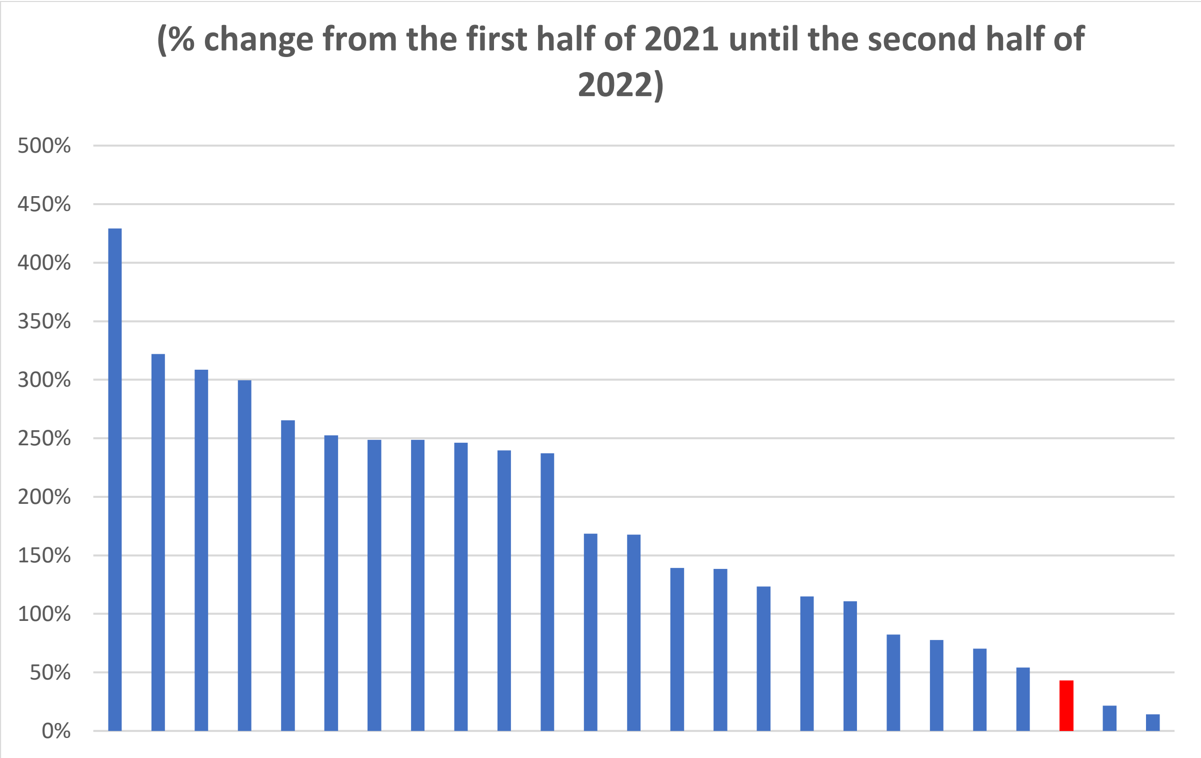


Figure 2 ***Gas prices for non-household consumers***

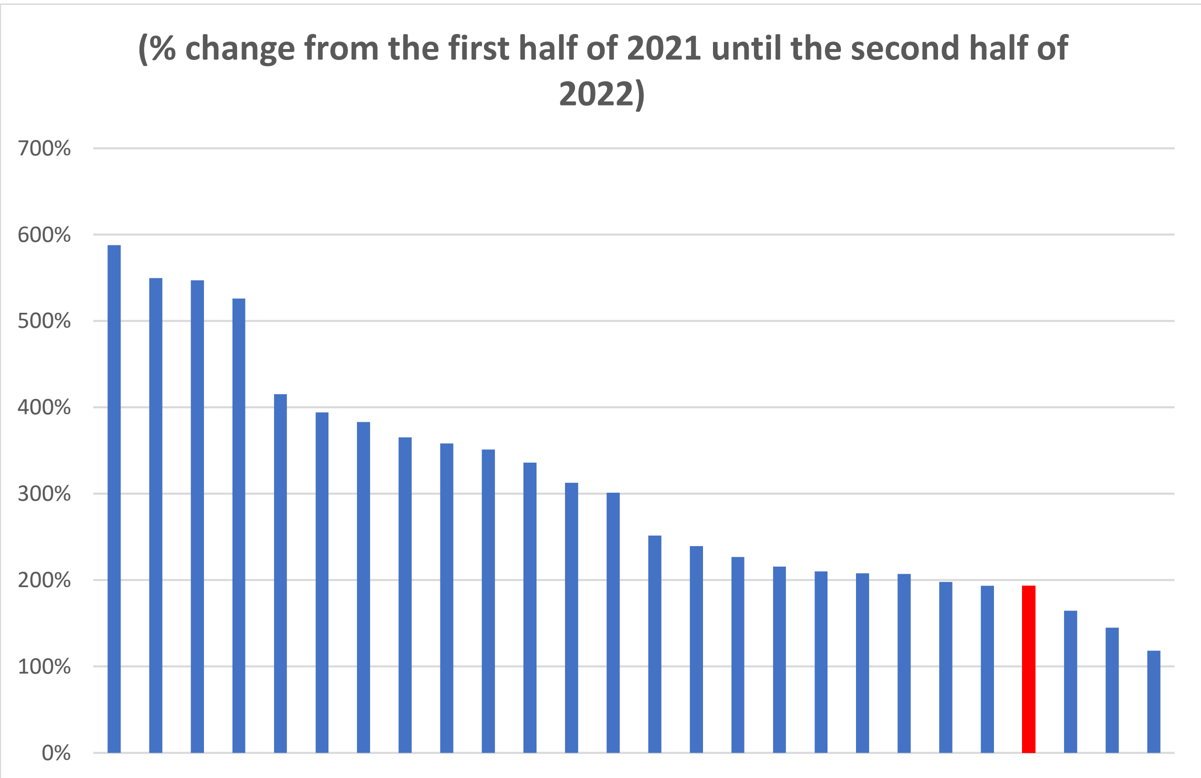


Figure 3 ***Electricity prices for household consumer***

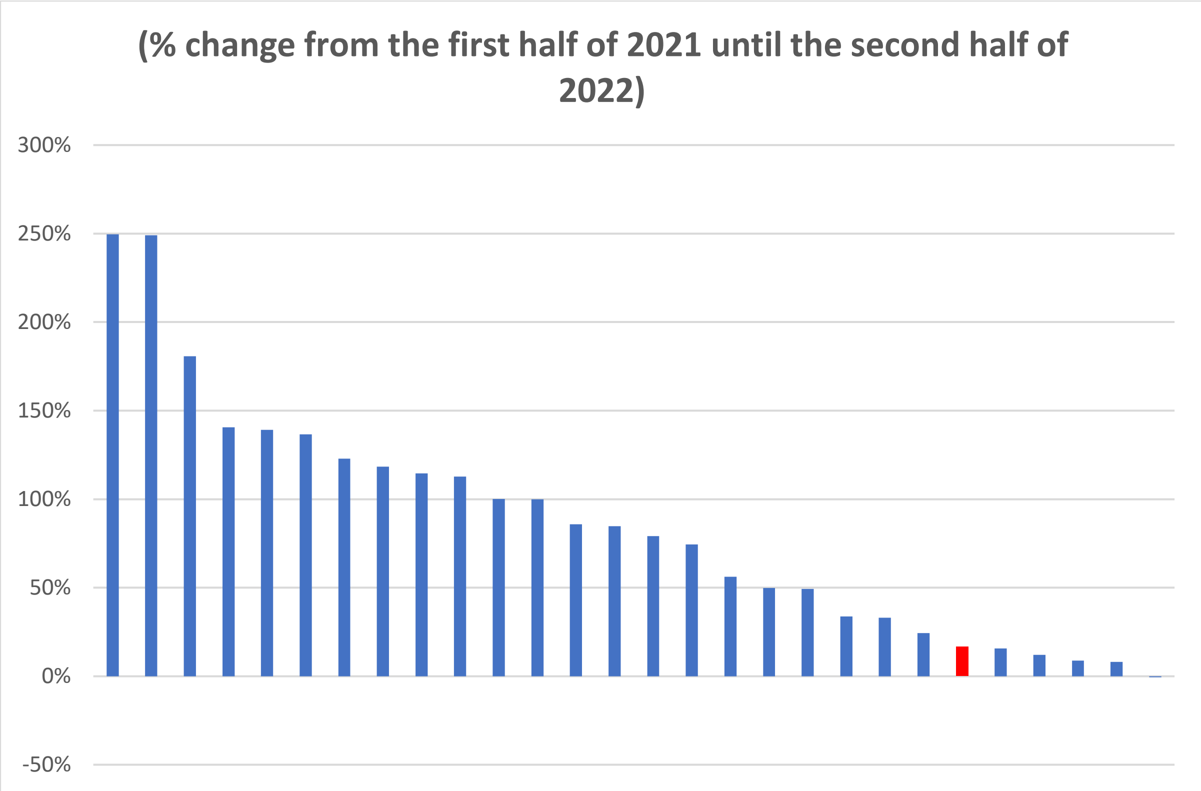


Figure 4 ***Electricity prices for non-household consumer***

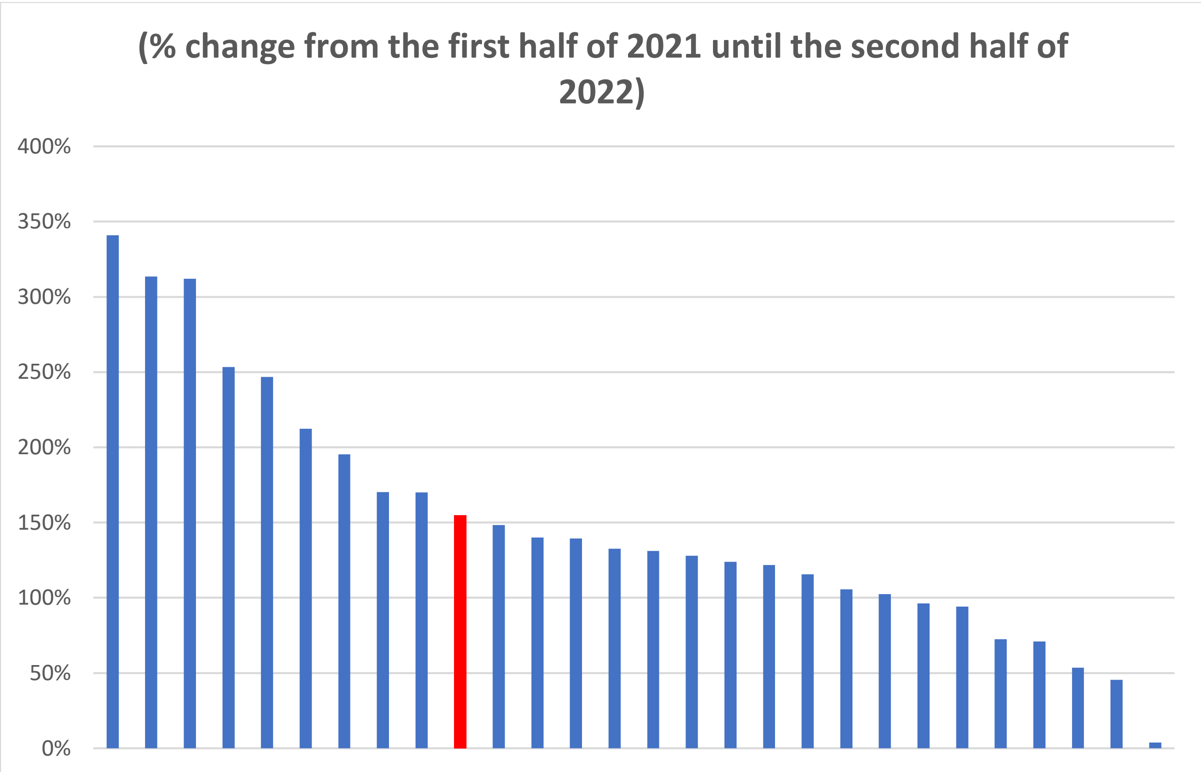


Figure 5 ***Year-on-year relative change in market-determined and state-controlled prices***

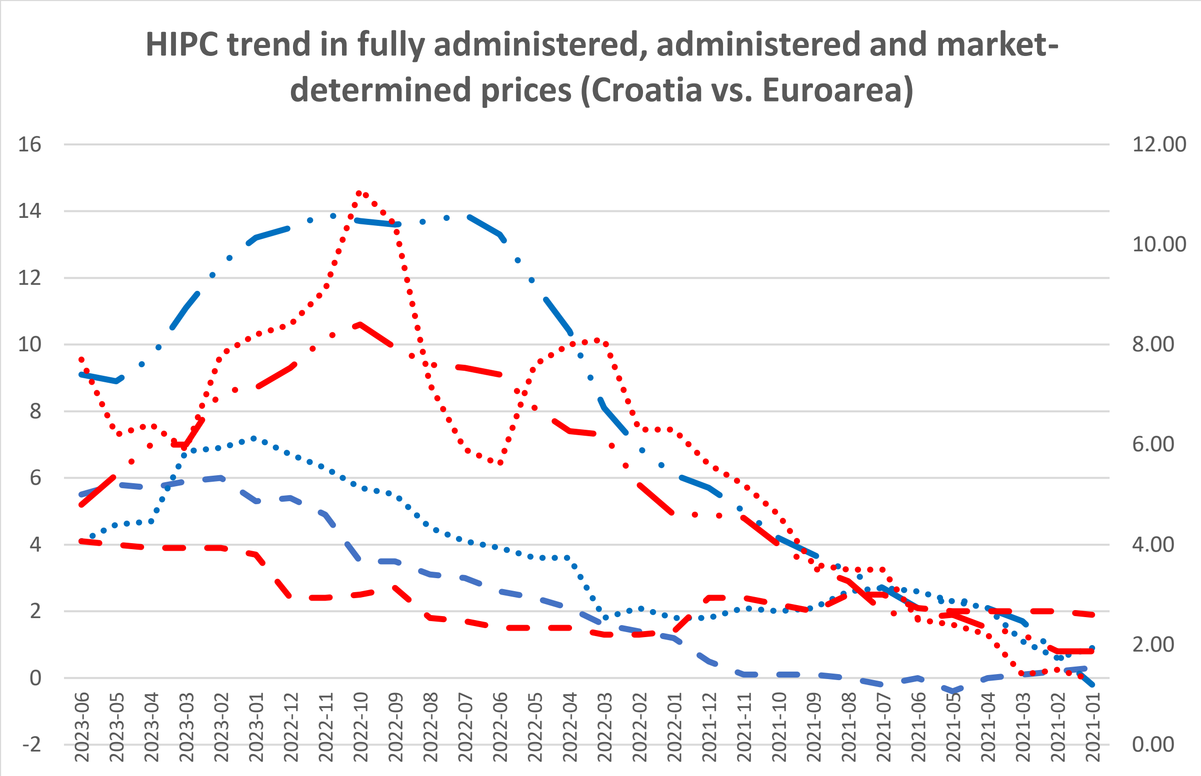
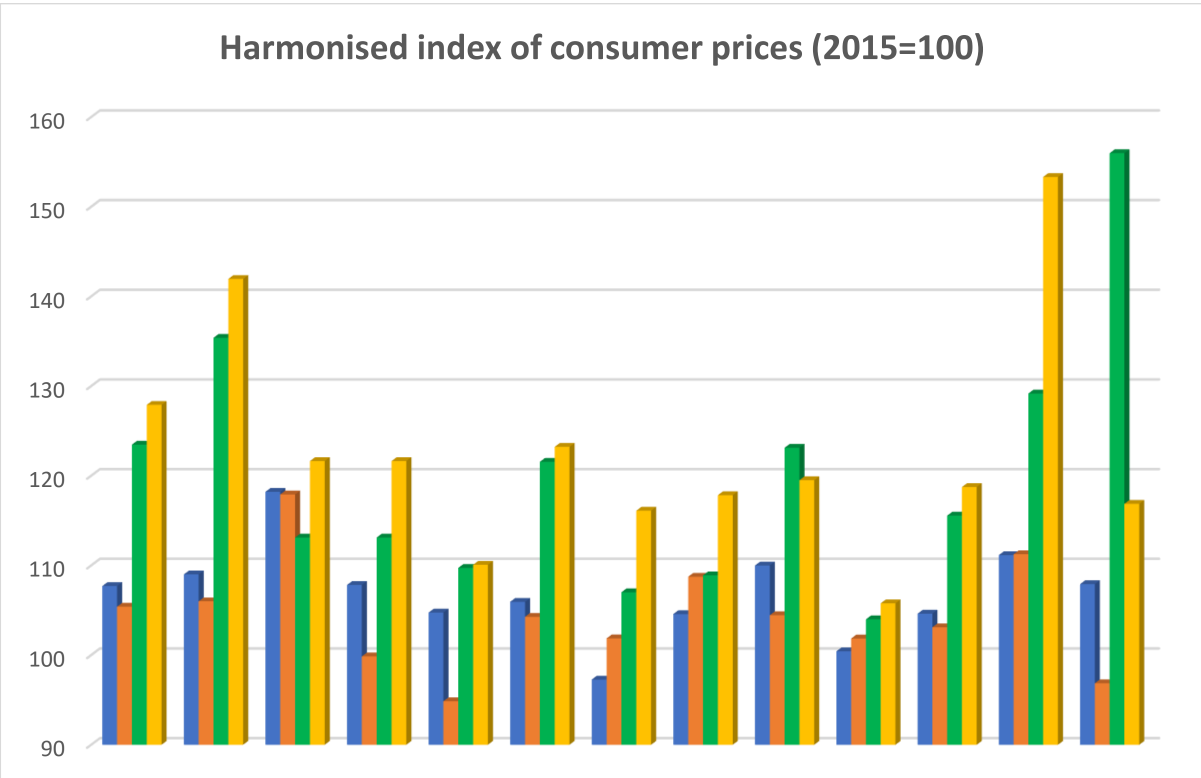


Figure 6 ***Relative change of HICP in Croatia and Euro area***



Croatia's household final consumption expenditure amounts to 72% of the EU-average, which means that Croatia citizens are significantly poorer than their EU peers. At the same time, Eurostat (2023g) data show that in all categories of consumption (except for education, health, housing, electricity, gas and fuels) Croatian prices are higher or significantly higher than the national purchasing power (*Table 1*). Furthermore, in some categories of consumption such as food and non-alcoholic beverages the Croatian price level is even higher than that of the EU, potentially causing a severe cost of living crisis for certain groups of citizens. Hence, besides state-controlled prices for electricity, gas and fuels we should point out to state-provided services such as healthcare and education, which prevent rising costs of living from spiraling out of control. This means that the state budget and balance sheets of state-owned enterprises have the overarching goal of ensuring social stability. State intervention directly affects more than 20% of the average consumer basket, while indirectly affects an even higher share, if we take into account the link between energy costs and costs of food production (Eurostat, 2023h). Precisely this political economy structure largely compensates for higher prices of internationally-tradable goods.

Table 1 ***Price level index (2022), EU=100; Consumption structure of average Croatian household***

	Relative to EU average	**Share of category in household expenditures**
Communication	109.00%	4.10%
Consumer electronics	107.00%	1.50%
Household appliances	103.10%	0.60%
Food and non-alcoholic beverages	101.10%	19.50%
Footwear	97.40%	0.90%
Personal transport equipment	96.10%	7.60%
Clothing	96.00%	3.20%
Alcoholic beverages and tobacco	89.40%	7.80%
Transport services	84.90%	1.50%
Restaurants and hotels	83.50%	13.60%
Furniture	82.40%	1.40%
Recreation and culture	81.10%	8.50%
Education	54.60%	0.9%
Health	53.90%	4.80%
Housing. electricity. water. gas. fuels	41.30%	16.2%

Conclusion: the long-term unviability of state intervention in combating cost of living crisis

Unfortunately, the above elaborated political economy structure is not developmental in the long-run and is clearly unsustainable if external funding, such as the massive transfers from the EU budget and Recovery and Resilience Facility come to a dribble. Surely they will start decreasing as a percentage of GDP from 2026 onwards, but as of this writing they are able to paper over large and unaddressed structural problems such as the level of hospitals debt, currently at €1.94 billion and rising at a rate of €13.3 million monthly (Glas Slavonije, 2022; Udruga poslodavaca u zdravstvu Hrvatske, 2023).

While the balance sheet of state-owned HEP helped to stabilise the initial price shock, which was commendable in order to buy some precious time for reforms and adjustment, price controls have been too rigid and too long. Hence, HEP posted an enormous loss to the tune of €779 million in 2022 (Litvan, 2023). This is the first loss since 2007 which was at that time paltry sum of €140.000. Therefore, this loss will significantly hamper HEP's invaluable role in facilitating energy transition. Indeed, the Government plans to cover the aforementioned loss by recapitalization with 700-900 million euro, at a cost very dear to taxpayers. If we take the lower bound and divide it with Croatia's population this amounts to 185 euro per capita (Kotarski, 2023b). Furthermore, while trying to deflate the inflationary balloon by administering prices, the Croatian Government is simultaneously contributing to strong demand by major increases in social transfers and salaries of 219.000 public sector employees (Vlada Republike Hrvatske, 2023).

Having in mind everything stated in the paragraphs above, state intervention in price-setting mechanisms, plus increased social transfers and salaries, will carry over the incumbent Government safely into the next super election year. Nevertheless, it won't help in creating a more resilient and dynamic economic structure to ward off the next crisis. Fiscal interventions and price regulations should always be timely, targeted and temporary. At the same time, only structural reforms aimed at boosting productivity, ensuring fair market competition[1], attracting FDI, reducing energy import dependency, increasing the skill level of native and immigrant workers and rationalising bloated state expenditures in categories such as subsidies and intermediate consumption, can create a sustainable foundation of prosperity. Nobody and never got rich off state intervention and suppressed volatility, which if kept for too long, leads to heightened instability and misery.

In light of these considerations, it is evident that the reliance on external funding has cast a shadow over the sustainability of the current political economy structure. While the substantial transfers from the EU budget and Recovery and Resilience Facility have temporarily masked structural vulnerabilities, the impending reduction of these funds after 2026 brings into stark relief the unaddressed challenges, including the escalating hospital debt and its implications for the healthcare sector's stability.