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GOVERNMENT OF THE REPUBLIC OF CROATIA
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**Reference: Report on the Fiscal Policy Assessment for the Year 2013 and
Report on the Compliance with the Fiscal Rule**

In line with Article VI paragraph 1 of the Decision of the Croatian Parliament on the Establishment of the Fiscal Policy Commission and with Article 25 paragraph 1 of the Rules of Procedure for the Work of the Fiscal Policy Commission, the Fiscal Policy Commission of the Croatian Parliament produced the document entitled “Report on the Fiscal Policy Assessment for the Year 2013 and the Report on the Compliance with the Fiscal Rule”.

Pursuant to Article VI paragraph 1 of the Decision of the Croatian Parliament on the Establishment of the Fiscal Policy Commission, an integrated report is submitted to the Government of the Republic of Croatia, who shall, under Article VI paragraph 3, propose within 30 days as from the date of reception of the Report a plan of necessary measures along with the deadlines for the implementation thereof that will lead to the compliance with the fiscal rule in the year 2014.

COMMISSION CHAIRMAN
Srđan Gjurković, M.Sc. (Econ.)

Attachment:

*“Report on the Fiscal Policy Assessment for the Year 2013
and Report on the Non-Compliance with the Fiscal Rule”*

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**REPORT ON THE ASSESSMENT OF FISCAL POLICY
FOR THE YEAR 2013 AND REPORT ON THE NON-
COMPLIANCE WITH THE FISCAL RULE**

SUMMARY AND EVALUATION OF THE FISCAL RULE

Pursuant to the Croatian Parliament's Decision on the Establishment of the Fiscal Policy Commission, in the event the Commission establishes that the fiscal rule is not being met, it shall deliver a report thereon to the Government of the Republic of Croatia. In line with Article VI paragraph 1 of the Decision on the Establishment of the Fiscal Policy Commission, the Commission has produced the Report on the Non-Compliance with the Fiscal Rule for the Year 2013 upon establishing, in its Position Paper issued after the second meeting of the Commission on 5 June 2014, that the fiscal rule is not being respected. Pursuant to the same Article, the Commission is submitting this Report to the Government of the Republic of Croatia, who, pursuant to Article VI paragraph 3, shall propose, within 30 days as from the date of reception of the Report, a plan of necessary measures along with the deadlines for the implementation thereof that will lead to the compliance with the fiscal rule in the current fiscal year.

The Fiscal Policy Commission assesses that the fiscal rule for the year 2013 was not met. The fiscal rule that applied in 2013 had been set out in the Fiscal Responsibility Act, adopted by the Croatian Parliament at its session on 23 November 2010 (Official Gazette *Narodne Novine* 130/10). In order to meet the fiscal rule in 2013, it was necessary to reduce the share of total expenditures in the projected gross domestic product by one percentage point. According to the data of the Ministry of Finance, the total expenditures of the consolidated general government, adjusted in line with the cases of exclusions referred to in the Fiscal Responsibility Act, amounted to 150 billion Kuna in 2012, and to 150.6 billion Kuna in 2013. The share of expenditure for the calculation of the fiscal rule in the GDP outturn increased by 0.2 percentage points (from 45.9% of GDP to 46.1% of GDP) instead of being reduced by one percentage point. The fiscal rule from the Budget Act and the Act on the Execution of the State Budget of the Republic of Croatia for 2013 referring to the ratio of public debt in the GDP was not respected either, since the government debt was higher than the 62% share in the GDP.

The Commission points to the fact that there were two budget revisions in 2013 by which macroeconomic projections were significantly altered. During 2013 the Ministry of Finance was warned about the problem of producing overoptimistic macroeconomic forecasts that led to unrealistic projections of budgetary expenditure. The assessment of the fulfilment of fiscal rules was therefore not realistic from the aspect of expenditure execution and the amount of the nominal GDP.

In the previous parliamentary term, the Commission, which was at the time the Fiscal Policy Committee, indicated at a number of meetings that the failure to comply with the fiscal rule for the year 2013 was highly probable. In 2013 the Fiscal Policy Committee held six meetings that were attended by the highest representatives of the Ministry of Finance and indicated on several occasions there was a high risk of failing to meet the fiscal rule for

2013. The Ministry of Finance took the position that fiscal policy was in compliance with the Fiscal Responsibility Act, and hence did not propose amendments to the budget that would have rectified the trends, albeit under Article 8, paragraph 2 of the then applicable Fiscal Responsibility Act, this was the Government's obligation in instances of observing trends which could result in a failure to meet the fiscal rule.

The Fiscal Policy Commission considers that the failure to meet the fiscal rule for 2013 is an indicator of inadequate budgetary discipline and budgetary consolidation. Rather than continuing the fiscal consolidation in line with the Fiscal Responsibility Act, in 2013 the state budget expenditures increased by 600 million Kuna, instead of being reduced by 3.3 billion Kuna to fulfil the fiscal rule. Fiscal rules exist so that the fiscal authorities would adhere to them because they increase the degree of predictability and the confidence in the executive branch. In the event it is considered that the legally defined fiscal rules are not adequate for achieving the long-term development and stabilization objectives, it is necessary to start changing the legal framework on time and to adopt appropriate legislation and fiscal rules in order to avoid the situations of breaching the existing rules and compromising the credibility of fiscal policy.

The Government is expected to stalwartly implement measures that will in future ensure the compliance with the fiscal rule set by the Fiscal Responsibility Act. Since, due to the limited information on fiscal developments based on the ESA 95 methodology relevant for assessing the fiscal rules, it was only with a significant time lag that the Fiscal Policy Commission was able to establish the failure of meeting the fiscal rule for 2013, and consequently could not undertake any corrective measures that year. The fiscal authorities are therefore expected to monitor with much more attention, in 2014 and in the years to come, the indicators of budget execution and the compliance thereof with the Fiscal Responsibility Act in order to have time to take steps to ensure compliance with fiscal rules. The fiscal rule was changed in line with the Amendments to the Fiscal Responsibility Act (*Official Gazette Narodne novine* 19/2014), but the obligation remained to continuously assess the possibility of fulfilment of the fiscal rule in 2014, as well as to propose additional measures in the event that the fiscal rule cannot be met. As a necessary requirement, budget drafting and/or amendments to the budget should include a realistic assessment of all the macroeconomic and fiscal values, and an assessment of the compliance with the fiscal rule. In the event that the projections indicate a high risk of failing to fulfil the fiscal rule, the Government is obliged to propose on time the measures that should ensure that the fiscal rule is met. The Fiscal Policy Commission shall continuously monitor the implementation of fiscal policy in accordance with the available data according to the appropriate methodology compatible with the European statistical practice, and warn about cases of an increased risk of failure to meet the fiscal rule.

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1. Introduction

The state budget and financial plans of extra-budgetary users for 2013, which was adopted by the Croatian Parliament at the end of 2012 (Official Gazette *Narodne novine*, no. 139/12), were amended twice in 2013 (Official Gazette *Narodne novine*, No. 53/13 and 145A/13) due to lower revenues and increased expenditures in comparison with the plan (projection). Although the last revision of the central government budget was adopted in late 2013, the revenue outturn was finally noticeably smaller than planned, but due to lower expenditure execution, the deficit of the central government was ultimately in line with the expectations. However, it is unknown whether the expenditure execution was lower than planned as a result of unexpected savings or if such developments are mainly due to expenditure payments being deferred for future periods, given the fact that data on outstanding due obligations of the general government are not available.

The consolidated general government deficit, according to national methodology, totalled 5.3% of GDP in 2013, which is by 1.8 percentage points of GDP higher than in 2012. The trends of the general government deficit were mostly determined by the factors resulting from the effects of fiscal policy over the past years and from Croatia's accession to the EU. Specifically, the increase in expenditures was largely due to paying debts in healthcare from previous years, increased interest expenses and payments to the EU budget. The EU membership also negatively affected the developments on the revenue side of the budget because of the need to harmonize the tax and customs system with the EU *acquis*. Therefore, despite a noticeable increase in the general government deficit, we cannot infer that fiscal policy in 2013 was of an expansive nature. Another fact leading to this conclusion is that, according to ESA 95 methodology which is based on the accrual principle of recording budgetary transactions and a different coverage of the general government, the trends of the general government deficit compared to 2012 declined slightly in 2013, to 4.9% of GDP, and according to European Commission estimates, such developments result from the reduction of the primary structural deficit.

However, public debt continued to grow intensely in 2013, reaching 67.4% of GDP at the end of the year, which was by 11.2 percentage points more than in 2012. Its strong increase stems partly from the further borrowing needs of the general government in order to finance the continuous high level of budget deficit, and partly from borrowing of the general government in late 2013 with the aim of pre-financing significant amount of funds required for 2014. As the central government debt exceeded the limit of 60% of GDP, the initially adopted Act on the Execution of the State Budget for 2013 (Official Gazette *Narodne novine*, no. 139/12, according to which the permissible limit is 58%) was breached, as well as the amendments thereto (Official Gazette *Narodne novine*, no. 145A/13, under which the permitted level is 60%) and the Budget Act (Official Gazette *Narodne novine* no. 87/08 and 136/12). Also, the central government debt at the end of 2013 was higher than the maximum permissible level of government debt stipulated in the adopted Act on the Execution of the State Budget for

2014 (Official Gazette *Narodne novine*, no. 152/13), where it is set at 62% of GDP. In addition to violations in the domain of national law, the rules under the Stability and Growth Pact referring to the level of the deficit and public debt were also breached. Therefore, at the end of 2013 the European Commission proposed to the EU Council to initiate the excessive deficit procedure for Croatia and the recommendations for the correction thereof, which the Council adopted in January 2014.

The national fiscal rule for 2013 set out in the Fiscal Responsibility Act (Official Gazette *Narodne novine*, no. 139/10), adopted by the Croatian Parliament in November 2010, was not respected either. Specifically, in order to fulfil the fiscal rule it had been required to reduce by one percentage point the share of expenditures in nominal GDP adjusted for the calculation of the fiscal rule and calculated according to ESA 95 methodology, while in reality, this share increased by 0.2 percentage points compared to the year 2012. The increase of this share is mainly a result of the payments to the EU budget and of the increase in intermediate consumption of the general government, while the share's decline was caused by a decrease of the obligations of the Croatian Health Insurance Fund, this change being included in the budgetary expenditures. The executive power estimated that this rule had a significant pro-cyclical impact on economic activity in the current economic environment and the rule was therefore amended in 2014 (Official Gazette *Narodne novine*, no. 19/14).

The attained level of public debt suggests that future fiscal consolidation has no alternative. In comparison with an equivalent group of EU Member States, i.e. Member States from Central and Eastern Europe, Croatia stands out as a country with one of the highest levels of deficit and public debt in 2013 (Charts 9 and 11), and the application of the ESA 2010 methodology, which is to come into force as early as September 2014, is likely to have a significant adverse impact on the major fiscal indicators. For all the above reasons, it is necessary to respect the adopted fiscal rules in the future in order to, *inter alia*, strengthen the credibility of fiscal policy. The purpose of fiscal rules is to ensure fiscal responsibility and the sustainability of public finances. If the rules are judged as inappropriate, they should be abolished or amended, but in the meantime the government should serve as an example of respect for the law.

2. Fiscal policy characteristics in 2013

2.1. Overview of amendments to general government budget plans and comparison with the implementation thereof in 2013

a) *The initial plan of the state budget and financial plans of extra-budgetary users for 2013* (Official Gazette *Narodne novine* no. 139/12). In early December 2012, the Croatian Parliament adopted the plan of the state budget and financial plans of extra-budgetary users for 2013. The budget plans of the central government were based on the assumption of annual

growth in real GDP of 1.8% and a relatively strong revenue growth. At the same time a substantial rise in total expenditure was envisaged, primarily due to the expected increase in interest expenses and Croatia's payments to EU budget, causing the planned deficit of the state budget to be slightly higher than the one in the year 2012, i.e. the deficit was expected to amount to -3.1% of GDP. The deficit of extra-budgetary funds was projected to amount to -0.7% of GDP, mainly due to planned deficits of the Company for managing, constructing and maintaining the state road network *Hrvatske ceste* and the Legal entity for water management *Hrvatske vode*. Since a balanced budgetary position was expected at the level of local government, the consolidated general government deficit was projected to amount to 3.8% of GDP, or about 0.4 percentage points more than in the year 2012.

Shortly after the adoption of the central government budget for 2013 two leading rating agencies lowered Croatia's credit rating to the non-investment level, due *inter alia* to the growing expected deficit in 2013, and to insufficiently ambitious medium term fiscal targets, in which consolidation was mainly based on the increase in the revenue side of the budget.

b) *First amendments to the state budget and financial plans of extra-budgetary users for 2013* (Official Gazette *Narodne novine*, 53/13). Croatia's credit rating downgrade and the macroeconomic developments that were more unfavourable than expected resulted in the adoption of Amendments to the State Budget and Financial Plans of Extra-budgetary Funds for 2013 as early as in April 2013. According to these first amendments, the expected growth in real GDP in 2013 was reduced to 0.7% of GDP, the target deficit of the state budget for 2013 was decreased from 3.2% of GDP to 3% of GDP, while slightly stronger corrections were introduced at the level of extra-budgetary funds, mainly due to deferred investment activities of the Company for managing, constructing and maintaining the state road network *Hrvatske ceste* and the Legal entity for water management *Hrvatske vode*. At the level of local government a balanced budgetary position was still anticipated and the expected consolidated general government deficit was decreased to 3.4% of GDP.

c) *Second amendments to the state budget and financial plans of extra-budgetary users for 2013* (Official Gazette *Narodne novine*, no. 145A/13). The revenue projections based on a 0.7 growth in real GDP once again proved to be overoptimistic, and at the end of 2013, there was another review of the central government budget. In addition, in June 2013 the executive power decided to settle a substantial amount of debt in healthcare, which had not been planned in the first Amendments to the State Budget of April 2013 (Official Gazette *Narodne novine*, no. 53/13). Thus, the projected state budget revenues were decreased by 2.9 billion Kuna, while total expenditure increased by 3.2 billion Kuna. Besides the increase in planned expenditures for the clearance of the obligations of healthcare institutions and the Croatian Health Insurance Fund, planned employees' costs visibly increased as well. On the other side the planned material costs, subsidies and acquisition of non-financial assets were markedly reduced. The planned deficit of extra-budgetary users was also increased, mainly because the total revenue execution was lower than expected and the expenditures of the State Agency for

Deposit Insurance and Bank Rehabilitation were higher than expected as a result of the payment of insured deposits due to the unavailability of deposits in a commercial bank. At the level of local government a balanced budgetary position was still expected. Along these lines, the planned deficit of the consolidated general government amounted to 5.5% of GDP or 1.7 percentage points higher than it had originally been planned for 2013.

Table 1. Amendments to plans and the general government balance in 2013 according to national methodology

	Outturn 2012	Plan 2013	I. Revision 2013	II. Revision 2013	Outturn 2013
in % of GDP					
State budget	-3.0	-3.1	-3.0	-4.8	-5.0
Extra-budgetary users	-0.5	-0.7	-0.4	-0.6	-0.5
Local government units	0.0	0.0	0.0	0.0	0.2
General government	-3.5	-3.8	-3.4	-5.5	-5.3
GDP – annual rate of change in real value	-2.2	1.8	0.7	0.2	-0.9

Note: The original and the amended plans of budget balance for the year 2013 are shown as a share in the estimated GDP by the Ministry of Finance for the year 2013 which was used for the calculation thereof.

Source: Ministry of Finance (www.mfin.hr as on 30.6.2014.)

According to the Report on the Execution of the State Budget of the Republic of Croatia for 2013², the general government deficit was eventually slightly lower than it had been planned in the last budgetary revision at the end of 2013 and amounted to 5.3% of GDP, mainly due to the surplus generated at the local level. However, the revenues of the state budget were significantly lower than it had been planned, mainly due to a shortfall in revenue from VAT, which was partially offset by a lower execution of cash expenditures.

² <http://www.sabor.hr/prijedlog-godisnjeg-izvjestaja-o-izvršenju-drzavno>

Table 2. Difference between the state budget outturn and the last revision of the state budget for 2013

	Last Revision 2013	Outturn 2013	Difference
in HRK millions	1	2	2-1
Operating revenues	110,251	108,585	-1,666
Income tax and surtax	1,349	1,373	24
Profit tax	6,394	6,365	-28
Value added tax	54,413	53,350	-1,064
Contributions	37,458	37,149	-309
Other	10,636	10,348	-288
Revenue from sale of nonfinancial assets	268	259	0
Operating expenditures	125,029	123,506	-1,523
Expenditure on employees	21,737	21,668	-69
Material expenditure	8,395	8,011	-384
Financial expenditure	9,994	9,883	-111
Subsidies	5,616	5,538	-78
Grants given abroad and within general budget	6,565	6,492	-164
Compensations to citizens & households based on insurance and other compensations	67,629	67,244	-385
Other expenditure	5,002	4,669	-332
Expenditure for the acquisition of nonfinancial assets	1,776	1,564	-212
State budget balance	-16,286	-16,225	69

Source: Ministry of Finance (www.mfin.hr as on 30.6.2014.)

2.2. Characteristics of fiscal policy on the revenue side of the budget presented according to national methodology

According to the information from the Ministry of Finance (GFS 2001 methodology and narrower coverage of local government)³, the generated revenue of the consolidated general government including the sale of non-financial assets in 2013 was almost the same as in 2012 (a slight decline of -0.1%). It has been estimated that the measures to reduce tax evasion and numerous changes in tax legislation in the past two years, which were implemented partly to increase the revenue side of the budget, partly to improve the competitiveness of the Croatian

³ For the purpose of analyzing the developments of the general government revenue and expenditure in 2013 according to the national methodology, data of the Ministry of Finance were used, under which local government consists of 53 largest local units which make up for about two-thirds of total revenue and expenditure of the wider local government. In the documents referring to the proposal for the execution of the state budget of the Republic of Croatia for 2013, local government is presented in accordance with the wider coverage, but detailed data on revenue and expenditure of the extended general government are not shown. In addition, the analysis uses data from the Ministry of Finance presented according to GFS 2001 methodology, while the plans and the proposed budget execution are reported in accordance with the national chart of accounts. These two methodologies have identical data coverage (except at the level of local government), but there are differences in the recording of certain expenditures within revenue categories, whose names also differ to a certain extent. The main difference stems from the fact that according to GFS 2001 methodology, employees' costs in healthcare are recorded as part of compensations of employees, while according to the chart of accounts, they are included in the fees for citizens and households within the total healthcare expenditure.

economy and partly on account of the alignment with the *acquis*, finally had a slightly negative effect on the trend of total revenues in 2013 (see Table 3).

Table 3. Assessed impact of major amendments to tax legislation and measures to reduce tax evasion on the trends of the general government revenue in 2013

in % of GDP	2013
Value added tax	-0.5
of which:	
Full-year effect of the increase in the base VAT rate	0.2
Abolition of the zero VAT rate and introduction of the 5% rate on the same group of products	0.2
Full-year effect of the limitations to the deduction of pre-taxes for entertainment expenses and costs of acquisition and lease of certain vehicles and the costs related to the acquisition thereof	0.03
Temporary reduction in revenue from VAT due to the time lag of VAT collection for import from EU	-0.5
Reduction in the VAT rate to 10% on food and beverages preparation and serving in restaurants and other catering facilities	-0.3
VAT refunds to entrepreneurs from the EU for the costs generated in Croatia	-0.2
Full-year effect of applying the reduced VAT rate on certain products – edible oils and fats, baby food, water delivery (except in bottles and other containers), white sugar	-0.03
Profit tax – introduction of non-taxation of reinvested profit	-0.2
Social contributions – full-year effect of reducing contributions for health insurance	-0.3
Excise duties – increase of excise duties on tobacco and petroleum products	0.1
Effect of the measures for better collection of tax revenues and social contributions	0.7
Net effect	-0.2

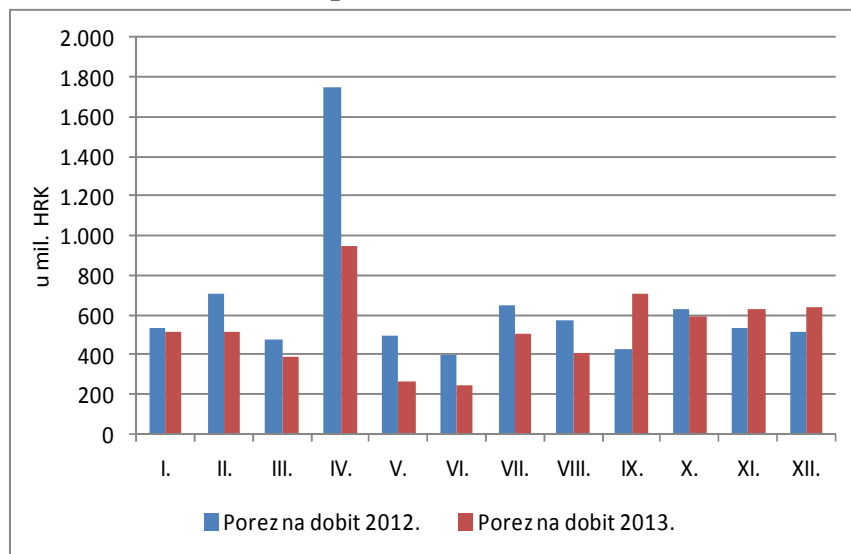
Note: The data in the table are approximate calculations based on available impact assessment of legislation changes in the time of their adoption by the Ministry of Finance and on own calculations.

Source: Ministry of Finance; own calculations

Tax revenues slightly increased (see Table 5), but this is largely a result of the reclassification of a portion of revenues from administrative fees to revenues from property taxes. The exact impact of these changes on the level of tax revenues is not known, but it was estimated that if they were adjusted in line with this reclassification, tax revenues would indicate a reduction in the annual rate of around -1.5%.

Profit tax. The reduction of tax revenues is mostly due to the drop in revenues from profit tax (Chart 1), which can be associated with the fall of economic entities' income in 2012 and 2013 (profit tax in the current year is usually paid in the form of advances calculated on the income achieved in the preceding year, but taxpayers also have the right to request the amount of advances to be changed), and to the amendments of the Profit Tax Act (Official Gazette *Narodne novine*, no. 12/22) which have been applied since January 2013, and which introduced non-taxation of reinvested profits. It is interesting to note that in the first eight months of 2013, profit tax revenues were significantly lower than in the same period of 2012, and this is mostly due to the use of tax incentives. However, in the last four months of 2013, profit tax revenues increased at an annual level, since, according to the available information, certain companies had to increase their advances for 2013, because their investment activity was lower than planned.

Chart 1. Revenue from profit tax in 2012 and 2013



Source: Ministry of Finance

In HRK millions

Blue square: Profit tax 2012

Red square: Profit tax 2013

Tax revenues were particularly adversely affected by taxes from international trade, due to the adoption of the EU customs system.

VAT. The revenues from VAT also contributed to the decline of tax revenues, their dynamics in 2013 being determined by macroeconomic developments and numerous changes in tax legislation and measures to reduce tax evasion. However, it was found that their net effect on total revenues from VAT in 2013 finally was not significant.

The implementation of the so-called *fiscalization* had a strong favourable effect on total revenues from VAT. *Fiscalization* improved the collection of total tax revenues, especially revenues from VAT, and it can be assumed that it had a major impact on reducing the grey economy. Other favourable effects come from the full-year effect of the increase in the VAT rate from 23% to 25% in 2012, the abolition of the zero VAT rate from January 2013, and the simultaneous introduction of the 5% rate on the same group of products. On the other hand, these positive effects were largely nullified by the change in the system of VAT taxation on imports of goods from the EU. After Croatian accession to the EU, VAT is not paid on the importation of goods from member countries of the EU, but after the goods have been sold, which at the beginning of the second part of 2013 resulted in a time lag of revenue collection from VAT and their strong temporary decline. Also, another significant negative impact on revenues from VAT came from the reduction in the VAT rate to 10% on food preparation and provision of food services in restaurants and preparing and serving non-alcoholic drinks and beverages, wine and beer at these facilities. According to Ministry of Finance's available estimates of potential effects of legislation changes in the VAT system on the revenue side of the budget, it seems that a significant negative impact on total revenues from VAT also came

from the VAT refunds to entrepreneurs from the EU for the costs generated in Croatia, to which they have been entitled since Croatia entered EU⁴.

Excise duties. In contrast to the negative trends in revenues from VAT, the revenue from excise duties increased, which is almost entirely due to an increase in revenues from the excise duties on petroleum products. In addition to multiple increases in the rate of excise duties on petroleum products⁵, the statistical increase in these revenues was significantly affected by the inclusion of fees per litre of fuel received by the Croatian Compulsory Oil Stocks Agency (HANDA) in the revenue from excise duties of the state budget. A slight positive effect on total revenue from excise duties came from the revenues of the excise duties on cars, other motor vehicles, vessels and aircrafts, and a special tax on coffee. On the other hand, the revenues from excise duties were strongly negatively affected by revenues from excise duties on tobacco products, although the rate of excise duty on tobacco products had also been increased several times⁶. Namely, due to the announced increase in the rate of excise duties in late 2012, there was a sharp increase in these products stocks in order to delay the payment of higher excise duties and an increase in retail prices. As deliveries in early 2013 were made from the accumulated inventories, revenues from excise duties on tobacco products were strongly reduced in the first quarter of 2013.

Income tax. Despite the unfavourable developments in the labour market, income tax revenues also increased, which can mostly be associated with better fiscal supervision and smaller returns on the basis of the filed annual income tax returns.

Social contributions. In addition to tax revenue, a strong negative impact to the fall in revenue came from revenues from social security contributions due to the base effect of reducing the contribution rate for health insurance (from 15% to 13%) and unfavourable developments in the labour market, which was also partially offset by the improved collection thereof.

Grants. On the other hand, the revenue from grants visibly increased due to the accession to the EU and the increased transfers from the EU budget. Since entering the EU on 1 July 2013 Croatia was granted the right to use funds from the EU budget under the former financial perspective of the EU, which was expiring in 2013. The amendments to the EU budget provided Croatia with the possibility to use 0.7 billion EUR based on the accrual principle (*total commitment appropriations*), while the anticipated cash payments from EU budget (*total payment appropriations*) totalled 0.4 billion EUR⁷. The majority of appropriated resources include resources from structural funds and the Cohesion Fund, which have to be

⁴ Official Gazette NN 22/12, NN 136/12, NN 73/13

⁵ Official Gazette NN 76/13, NN 109/13, NN 93/13

⁶ Official Gazette NN 76/13, NN 109/13, NN 93/13

⁷ The difference in expenditure on an accrual and cash basis is due to financing multi-year projects.

used by the end of 2016. In addition, a significant amount of funds from the EU budget was allocated on the basis of the so-called compensations, allowing the states not to be net contributors to the EU budget, mostly in the first two years of membership (the new Multiannual Financial Framework provides funding on the basis of compensation for 2014, exclusively for Croatia), and for activities to establish border crossings in accordance with the Schengen legal framework and for strengthening administrative capacities.

However, the utilized funds from the EU budget in the second half of 2013 were significantly lower than the amount available. Most of the budget was funded based on compensations while the funds on the basis of advances from structural funds and the Cohesion Fund were not used. For the whole of 2013 transfers from the EU budget which were recorded on the revenue side of the general government were slightly lower than the funds paid to the EU budget (if we analysed only the EU funds, i.e. without pre-accession programs, the amount paid into the EU budget would be visibly larger than the amount earned). However, when looking at the financial flows between the EU and Croatian budgets, they were mildly positive at the level of 2013. Specifically, the funds received from the EU funds that have not been disbursed to final beneficiaries are recorded as budgetary revenue and expenditure only when they are paid to end-users, and until then they are still recorded in the financial account in the form of deposits with the Croatian National Bank. Croatia received funds for the establishment of border crossings in accordance with the Schengen legal framework, but they were not used and are therefore not recorded as non-financial transactions.

Table 4. Financial flows between the Republic of Croatia and EU budget

	2013
in % of GDP	
Total amount of funds received from EU budget	0.6
of which:	
EU funds	0.4
Pre-accession funds	0.2
Contributions to EU budget	0.6
of which:	
GNI based	0.4
VAT based	0.1
Net financial flows	0.1

Source: Ministry of Finance

Other revenue. The so-called other revenue recorded an increase as well (when adjusted for the reclassification of revenue from administrative fees), largely because at the end of 2013 unused funds from previous years that HANDA had achieved by collecting part of the excise duties on oil products were paid in the budget.

Table 5. General government total revenue according to national methodology

	2012	2013	2013/2012
In HRK thousands and percentages			
Operating revenues	126,138	125,876	-0.2
Taxes	74,118	74,492	0.5
of which:			
Income tax	9,876	10,326	4.6
Profit tax	7,697	6,365	-17.3
Value added tax	40,652	40,253	-1.0
Excise duties	11,206	11,683	4.3
Taxes on international trade and transactions	1,754	1,159	-33.9
Property tax	803	2,351	192.9
Social contributions	37,846	37,149	-1.8
Grants	995	1,773	78.2
Other revenue	13,179	12,463	-5.4
of which:			
Administrative fees	5,748	4,266	-25.8
Revenue from the sale of nonfinancial assets	600	776	29.3
Total revenue	126,738	126,652	-0.1

Note: The local government consists of 53 largest units. Original data are shown. Revenues were not adjusted for the reclassification of a portion of revenues from administrative fees to revenues from property taxes.

Source: Ministry of Finance (www.mfin.hr as on 30.6.2014.)

2.3. Characteristics of fiscal policy on the expenditure side of the budget presented according to national methodology

According to the data of the Ministry of Finance, the consolidated general government expenditures including the acquisition of non-financial assets in 2013 were by 4.6% higher than in the year 2012. The increase was recorded by all the main categories of expenditure, except expenditure on employees and subsidies.

Social welfare benefits. The largest influence to the growth of total expenditures was made by the expenditures on social welfare benefits, which is primarily associated with the settlement of obligations of institutions in the health sector in rehabilitation and of the Croatian Health Insurance Fund totalling 3.3 billion Kuna. However, the increase in healthcare expenditures on an annual basis was clearly lower than the amount spent for clearing the debts in healthcare, which could partly be linked to certain savings. It seems however that in 2013 new outstanding due obligations in healthcare were created. This is also indicated by the fact that according to the amended plan of the State Budget for 2014 new rehabilitation of the health system is planned for in 2014 in the amount of 3.2 billion Kuna, 1.4 billion of which being earmarked for discharging the obligations from 2013.

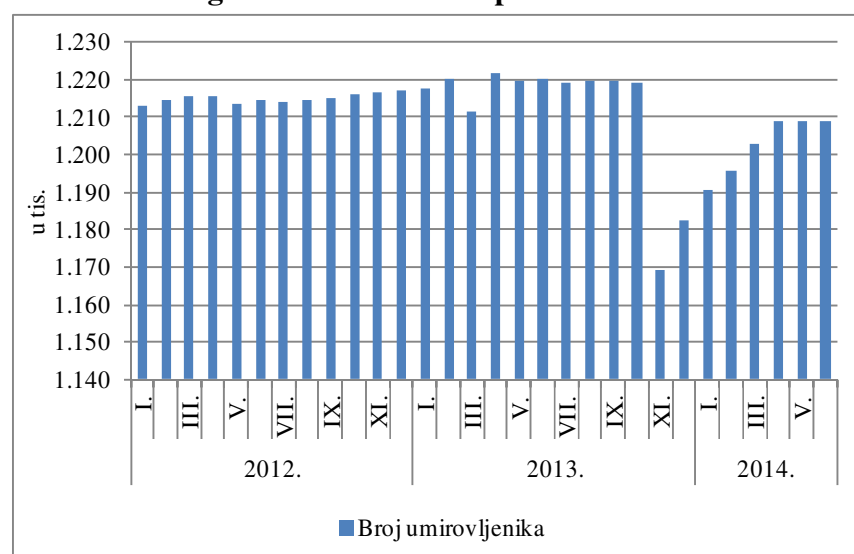
Table 6. State budget expenditures on healthcare, pensions and unemployment benefits

	2012	2013	2013-2012
in HRK millions	1	2	2-1
Healthcare*	19,714	21,650	1,936
Pensions	35,137	36,065	927
Unemployment benefits	1,538	1,682	144

*expenditures on employees in healthcare are also included

Source: Ministry of Finance (www.mfin.hr as on 30.6.2014.)

The growth of social welfare benefits was significantly influenced by the increase in pension expenditures due to the indexation of pensions conducted in line with the so-called Swiss formula (half of the sum of the rate of change of the CPI in the previous six months and the rate of change of the average gross salary of all the employed in the Republic of Croatia in the previous six months, compared to the semester that precedes it), and an increase in the number of pensioners during 2013. Pension expenditure increased by around 0.9 billion Kuna and the growth would have been even higher if at the end of 2013 the number of registered pensioners had not declined sharply (Chart 2). In fact, a significant proportion of pensioners, mostly pensioners residing abroad, did not timely file their Personal Identification Number (PIN) to the Croatian Pension Insurance Institute (CPII), which then temporarily suspended their pension payments. Upon the submission of the necessary data, the number of registered pensioners in the first half of 2014 gradually increased in comparison to the number at the end of 2013, but by the end of June 2014, it still did not return to the level of November 2013, which suggests that a part of pension payments had been received and remunerated on an illegal basis. Due to unfavourable developments in the labour market, the trends of unemployment benefits also contributed to the increase of social welfare benefits.

Chart 2. Changes in the number of pensioners

Source: Croatian Pension Insurance Institute (CPII)

In thousands

Blue square: Number of pensioners

Payments to the EU budget. The payments into the EU budget after Croatia became a full member, which in 2013 amounted to 1.8 billion Kuna, strongly influenced the growth of total expenditures.

Interest expenditure and expenditure for the use of goods and services. Due to increased borrowings, the growth in interest expenditure also contributed significantly to the increase of expenditures. The expenditures for the use of goods and services, the so-called other expenses, and the expenses for the acquisition of nonfinancial assets grew as well. The growth of the latter category is due to the increased investment activity at the level of state budget and local government, while at the level of extra-budgetary funds users, the acquisition of nonfinancial assets decreased due to lower capital investments of the Company for managing, constructing and maintaining the state road network *Hrvatske ceste* and the Legal entity for water management *Hrvatske vode*.

Expenditures for employees. On the other hand, the increase in total expenditure was significantly alleviated by the decline in expenditure for employees, mainly associated with:

- (i) reduction of salaries of employees in the public and civil services by 3% from March 2013
- (ii) abolishing the annual leave allowance to employees in public and civil services and
- (iii) base effect of reducing the contribution rate for health insurance, due to the fact that the payment of social security contributions for employees in the public and civil services are recorded both at the revenue and the expenditure side of the general government budget.

Subsidies and guarantees. Expenditures on subsidies also recorded a decline, mainly due to lower spending for subsidies in agriculture and for the development of rail transport and infrastructure. However, data on state guarantees issued in 2013 show a significant growth of state guarantees issued to *HŽ Infrastructure* (Limited Liability Company for Management, Maintenance and Building of Railway Infrastructure) for the borrowings necessary to finance the construction, maintenance and modernization of railway infrastructure. This could indicate that the reduced subsidies for the development of rail transport and infrastructure were actually translated into higher loan guarantees for *HŽ Infrastructure*, which are very likely to fall again at the expense of the state budget. According to the data on activated guarantees in 2013, payments for interests based on activated guarantees given to *HŽ Infrastructure* amounted to 55 million Kuna.

Table 7. Total expenditure of the general government according to national methodology

	2012	2013	2013/2012
in HRK millions	1	2	2/1
Operating expenditures	132,450	138,306	4.4
Compensation of employees	35,382	34,441	-2.7
Using goods and services	15,010	15,532	3.5
Interests	8,869	9,818	10.7
Subsidies	6,801	6,730	-1.0
Grants	1,823	3,522	93.2
Social welfare benefits	56,881	59,859	5.2
Other expenditures	7,684	8,403	9.4
Expenditure for the acquisition of nonfinancial assets	5,513	5,947	7.9
Total expenditure	137,963	144,253	4.6

Note: The local government consists of 53 largest units

Source: Ministry of Finance (www.mfin.hr) as on 30.6.2014.)

2.4. General government budget balance according to national methodology

In accordance with the above, the consolidated general government deficit (53 local units) in 2013 amounted to 17.6 billion Kuna or 5.4% of GDP. When full coverage of local government is included, the general government deficit amounted to 17.3 billion Kuna or 5.3% of GDP, which is by 5.8 billion Kuna or by 1.8 percentage points of GDP higher than in the year 2012. The main part of the deficit was run at the level of state budget. The deficit at the level of extra-budgetary funds was mainly due to negative business outcomes of the Company for managing, constructing and maintaining the state road network *Hrvatske ceste* and the Legal entity for water management *Hrvatske vode*, while other extra-budgetary users had almost balanced fiscal positions. The positive balance of the extra-budgetary user – the State Agency for Deposit Insurance and Bank Rehabilitation – significantly decreased compared to the year 2012 as a result of the payment of insured deposits the Agency had make due to the unavailability of deposits in a commercial bank. On the other hand, at the local government level a significant surplus was produced, due to faster growth in revenue than in expenditure, partly because of the favorable trends in income tax revenue.

Table 8. The balance of the consolidated general government according to the Ministry of Finance (full coverage of local government)

	Outturn 2012	Outturn 2013
in HRK millions	1	2
State budget balance	-10,001	-16,225
in % of GDP	-3.1	-5.0
Balance of extra-budgetary users	-1,549	-1,785
in % of GDP	-0.5	-0.5
Balance of local government units (full coverage)	47	689
in % of GDP	0	0.2
General government balance	-11,503	-17,321
in % of GDP	-3.5	-5.3

Note:

In 2012, 574 units of local and regional self-government were included (two units of local self-government failed to submit their financial reports). In 2013, 572 units of local and regional self-government were included.

Source: Ministry of Finance (www.mfin.hr as on 30.6.2014.)

2.5. General government balance according to ESA 95 methodology

The differences between the general government deficit according to the national methodology and the deficit as calculated according to the ESA 95 rules and presented in the Report on Excessive Deficit and Public Debt by the Croatian Bureau of Statistics are the result of the different scope of institutional units included in the general government and methodological differences in recording budgetary transactions.

In line with the national methodology, the general government includes state budget users, extra-budgetary users Hrvatske vode (HV), Hrvatske ceste (HC), the Environmental Protection and Energy Efficiency Fund (FZOEU), the State Agency for Deposit Insurance and Bank Rehabilitation (DAB) and the Government Asset Management Agency (GAMA, until 30 September 2013) i.e. the Restructuring and Sale Centre (RSC) since 1 October 2013 as its legal successor⁸ and the budgets of local and regional self-government units. According to the ESA 95 rules, the state-owned companies Hrvatska radiotelevizija (HRT, *Croatian Radiotelevision*) and HŽ infrastruktura (*Limited Liability Company for Management, Maintenance and Building of Railway Infrastructure*) are included in the general government, while DAB is excluded. Also, the local government includes own revenue and expenditure of local budget users, who according to the national methodology are not included in the general government.

It should be pointed out that the definitions of subsectors also differ in these two methodologies. According to the national methodology, the general government is subdivided into the state budget, extra-budgetary users and local government, whereas according to ESA 95 the general government includes the central government, social security funds (Croatian

⁸ Some of GAMA's activities have been transferred to the State Office for Government Asset Management.

Pension Insurance Institute - HZMO, Croatian Health Insurance Fund – HZZO and Croatian Employment Service – HZZ) and local governments.

Regarding the differences in recording budgetary transactions, first it should be mentioned that the revenue and expenditure of general government are presented mostly on cash basis, i.e. on cash-flow basis, whereas according to the ESA 95 standard budgetary transactions are recorded on accrual basis. Under the cash principle, a transaction is recorded at the moment the revenue is paid into the budget, i.e. the payment is executed, whereas under the accrual principle a transaction is recorded at the moment the obligation occurs (invoicing). Thus, due to the existence of a time lag from the moment of recording under one principle till the moment of recording under the second principle the results may differ.

The expenditure presented in accordance with the accrual principle should be equal to the value only of those expenditures that accrued in the observed year, regardless whether they were paid in the same year or not. For the revenue side of the budget, the modified accrual principle is applied, i.e. the recording of general government revenue according to ESA 95 methodology is conducted on the so-called time adjusted cash basis. This means that with this method the cash revenue is ascribed to the period when the tax obligation accrued. Provisions of tax legislation are applied in order to determine the moment of its accrual. For instance, for revenue from VAT according to the time adjusted cash basis principle, a shift of one month is used, considering that the accrued and declared VAT must be paid by the last day in the month following the accounting period. Thus, for instance, the revenue from VAT in 2013, presented according to the time adjusted principle, will correspond to the cash revenue from VAT achieved in the period from February 2013 till January 2014 (with an exception of VAT revenue from import taxes for which no shift is used, which have to be paid in accordance with the payment term for customs duties, i.e. ten days after import)⁹. According to the available information, the one-month shift is also applied on most excise duties revenue, income tax revenue and insurance premium revenue, whereas a four-months shift is applied for profit tax revenue, because profit tax is paid into the state budget in the current year in the form of advance payments and the final account is made by the end of April of the next year.

Aside from the differences arising between the cash and accrual principle of recording budgetary transactions, the ESA 95 methodology also treats differently individual transactions in terms of their recording as revenue, expenditure or financial assets. According to the data announced so far, the different treatment of guarantee payments had a significant impact on the difference of budgetary deficit amount between these two methodologies. According to the national methodology, payments performed on the basis of activated

⁹ Considering the fact that the Croatian Bureau of Statistics uses VAT data collection sources other than that used by the Ministry of Finance, there are small differences in the VAT revenue with a one-month shift as announced by the Ministry of Finance and the data published by the Croatian Bureau of Statistics for a particular year.

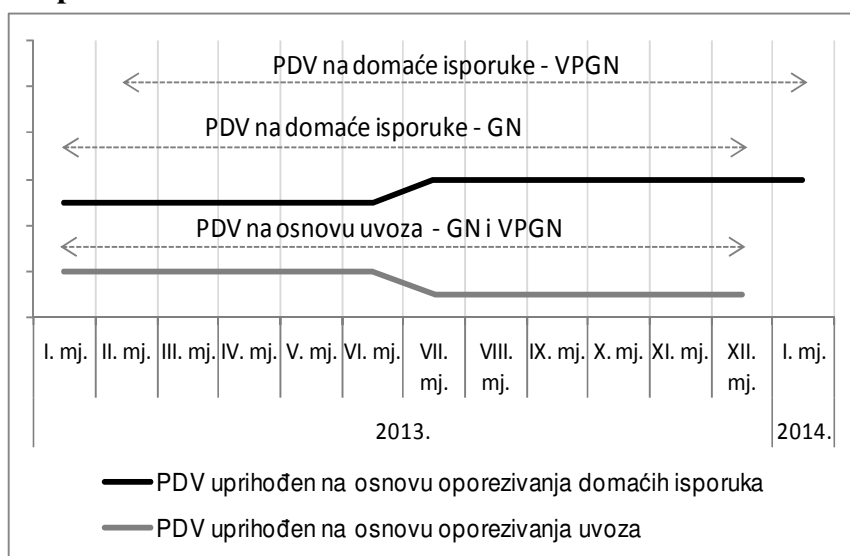
guarantees as well as returns based on previously paid guarantees (usually insignificant) are recorded within net granted loans, i.e. as a transaction within financial assets, while according to the ESA 95 methodology these transactions are recorded as revenue or expenditure respectively and as such affect the general government fiscal balance. Additionally, in the third year of guarantee activation the remaining borrower's debt for which the state is the guarantor is included in the public debt and recorded as expenditure, i.e. as capital transfer. Due to the aforesaid rule, in 2011 a large portion of the shipyards' debt, with the government as guarantor, that was recorded as capital transfer, was taken over and this led to a significant difference between the deficit according to the ESA 95 methodology and the deficit as noted according to the national methodology. Moreover, the expenditure according to the ESA 95 methodology also includes the costs of recapitalization of the Croatian Bank for Reconstruction and Development (CBRD), which according to the national methodology are recorded as costs of shares, thus not affecting the amount of the budget balance. The costs of annual repayment of debt to pensioners have also been evaluated as capital transfer, as according to the national methodology such costs are not included in the general government coverage, as well as other similar transactions which according to the national methodology do not belong on the expenditure side. On the other hand, state budget expenditure for the Fund for Indemnification of Deprived Property (FNOI) from which current repayments are made, i.e. global bonds according to the ESA 95 methodology are paid, are excluded from the expenditure and recorded in the budget financial account, while capital transfers include the amount of the indemnification of deprived property that the state must return when such amount has been endorsed by a court. A slight difference between the deficit according to the national methodology and the deficit as presented according to the ESA 95 methodology arises also due to the inclusion of the tourist tax in the state budget revenue, because it has been evaluated that it represents tax revenue. However, as the revenue from tourist tax mostly remains at the disposition of tourist boards, which are not covered by the general government, a significant portion of these revenues is recorded also on the expenditure side of the budget, so that the favourable effect on the budget according to the ESA 95 methodology is insignificant.

Accordingly, and in line with the current year's spring fiscal notification of the Croatian Bureau of Statistics, the general government deficit according to the ESA 95 methodology in 2013 amounted to 16.2 billion Kuna or 4.9% of GDP, which is 1.2 billion Kuna (0.4% of GDP) less as compared to the deficit presented according to the national methodology.

Less difference in deficit according to ESA 95 was mostly due to the revenue adjustment according to the time adjusted principle, mainly of VAT revenues. After Croatia's accession to the EU on 1 July 2013, revenue earned from VAT on the basis of taxation of goods import from the EU is paid only after an imported product is sold. Therefore, the amount of VAT related to the taxation of domestic deliveries in January 2014 was statistically significantly higher than the VAT that was paid in the budget in January 2013, whereas the revenues from VAT earned on the basis of import taxation was significantly lower. With regard to the fact

that VAT on domestic deliveries is time-adjusted for one month and for revenues from VAT paid into the budget on the basis of import taxation no time lag is applied, total revenues from VAT in 2013 according to the ESA 95 methodology were statistically significantly higher than revenues earned according to the cash basis principle. In addition, the data indicate that in January 2014 VAT collection was better than in 2012. Aside from the VAT revenues, according to the ESA 95 methodology the accrual-type adjustment of revenues from profit tax also had a favourable effect on the budget balance.

Chart 3. Impact of change in calculation of VAT on goods import from the EU and VAT adjustment based on the time-adjusted cash principle on revenues in 2013 – example



Note: VPGN – time-adjusted cash principle; GN- cash principle

Source: own calculation

VAT on domestic deliveries – VPGN

VAT on domestic deliveries – GN

Import-based VAT – GN and VPGN

Dark line: VAT earned from domestic deliveries taxation

Light line: VAT earned from import taxation

Also, in line with the accrual principle of recording budget transactions according to which, as already mentioned, the expenditure should be equal to the values of the expenditures that accrued in the observed year, the deficit according to the ESA 95 methodology does not include the payments of the obligations of the Croatian Health Insurance Fund (HZZO) from earlier years, but includes new obligations from 2013. Therefore, the deficit in 2013 according to the ESA 95 methodology is lower in relation to the deficit according to the national methodology by 1.5 billion Kuna.

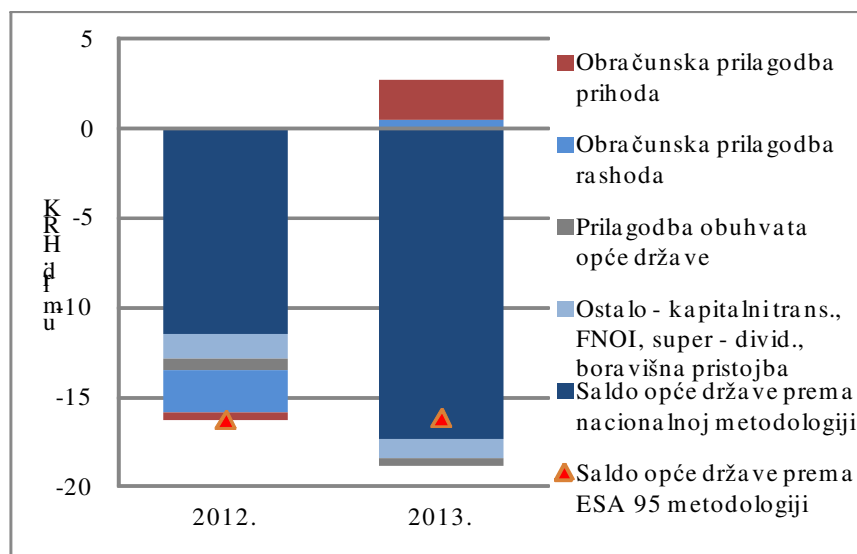
A slightly positive impact on the balance according to the ESA 95 methodology was observed due to the adjustment for the Fund for Indemnification of Deprived Property

(FNOI). On the other hand, the accrual-type adjustment of other revenues resulted in a somewhat higher deficit according to the ESA 95 methodology.

Also, expenditure according to the ESA 95 methodology increased additionally by 1.3 billion Kuna due to the recording of certain transactions which do not belong on the expenditure side according to the national methodology as capital transfer of the government. Approximately half of the said amount consists of costs of recapitalisation of the Croatian Bank for Reconstruction and Development. The remaining amount mainly refers to the payment of the last annual instalment of the debt owed to pensioners, payment of activated guarantees and taking over of a portion of the debt of the state-owned company HŽ Putnički prijevoz (*HŽ Passenger Transport*). The revenues downward adjustment due to the super-dividend test had a slightly unfavourable impact on the balance of the general government according to the ESA 95 methodology. Specifically, if the payment of a state-owned company into the state budget in a particular year is higher than the company's profit earned on the basis of its business operations, for example when the funds have been paid from accumulated reserves, it is treated as a transaction in financial assets. Based on the different general government coverage the deficit according to the ESA 95 methodology was adjusted upwards in relation to the deficit according to the national methodology by approx. 0.5 billion Kuna, partly due to the deficit made by HŽ infrastruktura and the exclusion of DAB's surplus.

On the other hand, the deficit of the general government according to the ESA 95 methodology in 2012 was evidently higher compared to the deficit according to the national methodology, which is largely a consequence of the accrual-type adjustment of expenditure. Expenditure according to the ESA 95 methodology increased for the most part due to the increase of the balance of financial obligations of the Croatian Health Insurance Fund and the accrual-type adjustment of interests. Namely, according to the accrual-type adjustment interest expenses are allocated during the entire validity period of a debt instrument, whereas according to the cash principle they are recorded when paid. The recording differences in the previous years resulted in significant deviations in level and trends of interest expenses according to the ESA 95 methodology and according to the national methodology. The amount of adjustment related to capital transfers and general government coverage was at the almost equal level as in 2013, while the accrual-type adjustment of revenue had a slightly negative impact on the ESA 95 deficit, as opposed to the strongly positive impact in 2013.

Chart 4. Adjustment of the general government deficit from the national methodology to the ESA 95 standard



Note: In the documents related to the Report on the Execution of the State Budget for 2013, the local government balance varies to a certain extent from the balance presented in the tables related to the current year's April Report on Excessive Budget Deficit and General Government Debt¹⁰. Therefore the adjustment of general government coverage slightly differs from the adjustment as presented by the Croatian Bureau of Statistics in the tables related to the said fiscal report.

Source: Croatian Bureau of Statistics; own calculations

On the left side: HRK billions

Red square: accrual-type adjustment of revenue

Blue square: accrual-type adjustment of expenditure

Grey square: General government coverage adjustment

Light blue square: Other – capital transfer, Fund for Indemnification of Deprived Property (FNOI), super-dividend, tourist tax

Dark blue square: General government balance according to national methodology

Red triangle: General government balance according to the ESA 95 methodology

Accordingly, inter-annual trends in expenditure and revenue vary significantly between these two methodologies. According to the ESA 95 methodology, total revenue in 2013 increased by 0.5%, mainly due to the increase in indirect taxes and other current revenue, which on the other hand is a result of increased transfers from the EU budget. Revenue from VAT increased by 1.2%, while according to the cash principle the revenue dropped by -1.0%. Revenue from direct taxes (mainly revenue from income tax and profit tax) also increased according to the ESA 95 methodology, whereas according to the national methodology it visibly decreased, although more specific data on direct taxes according to the ESA 95 methodology are not available yet. Further, the general government total expenditure according to the ESA 95 methodology only slightly increased when compared to 2012, which is mainly the consequence of the increase in other current transfers due to the obligation to

¹⁰ http://www.dzs.hr/Hrv_Eng/publication/2014/12-01-03_01_2014.htm

make contributions (payments) to the EU budget. The general government intermediate consumption also increased noticeably, including material costs, energy costs and expenses for various services. An increase was also observed in general government investments, mainly due to the increased purchase of non-financial assets at the level of state budget and local government. The difference in relation to the national methodology arises to the most part from the trends of expenses for social benefits. This is mainly the consequence of including the changes in balance of HZZO's obligations in social benefits according to the ESA 95 standard. The decrease of these obligations in 2013 caused a strong drop of expenses from social benefits, while according to the national methodology they noticeably increased. It should be pointed out that the difference also arises from a different coverage of expenditure included in this category. A noticeably less increase in relation to the data according to the national methodology was recorded for interest expenses as well.

Table 9. General government revenue, expenditure and balance according to the ESA 95 methodology

	2012	2013	2013/2012
HRK millions	1	2	2/1
Total revenue	133,945	134,651	0.5
Direct taxes	20,171	20,639	2.3
Indirect taxes	59,945	60,982	1.7
Social contributions	37,846	37,149	-1.8
Other	15,983	15,881	-0.6
Total expenditure	150,232	150,823	0.4
Social benefits	53,650	51,852	-3.4
Subsidies	7,177	6,744	-6.0
Interests	9,861	10,074	2.2
Compensation of employees	39,718	39,082	-1.6
Intermediate consumption	24,456	25,549	4.5
Investments	6,469	7,281	12.5
Other current and capital transfers	8,901	10,242	15.1
	1	2	2-1
General government deficit / surplus, thereof:	-16,288	-16,172	116
Central government	-15,280	-17,892	-2,612
Local government	56	238	182
Social security funds	-1,105	1,496	2,601

Note: Interest expenses include settlements on the basis of swap and forward contracts.

Source: Croatian Bureau of Statistics; Croatian National Bank

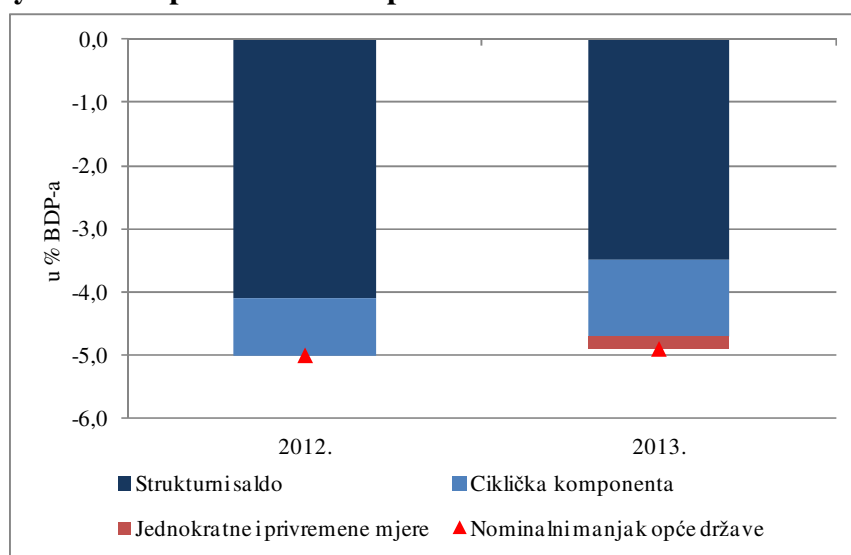
2.6. General government structural deficit

The European Commission (EC), as well as other international institutions, when following fiscal developments, pay particular attention to the general government structural balance developments, i.e. developments of the balance excluding cyclical trends of economic

activity and one-off and provisional measures, with regard to the fact that it better reflects the trends in the „real“ fiscal position of the country. Thus the structural balance terminology defines a part of the fiscal rules of the European Union and since 2014 also the national fiscal rule as defined in the new Fiscal Responsibility Act (official gazette of the Republic of Croatia “*Narodne novine*” No. 19/14).

According to the European Commission, the structural deficit in 2013 improved from 4.1% of GDP in 2012 to 3.5% of GDP. However, its reduction was neutralised to a great extent by unfavourable cyclical developments of economic activity and by the negative impact of one-off and provisional measures, which can be related to the temporary fall of revenues from VAT in mid-2013 due to the changed calculation of VAT on imports from the EU.

Chart 5. Decomposition of the nominal general government deficit into structural, cyclical and provisional component



Source: EC

In % of GDP

Dark blue square: Structural balance

Red square: One-off and provisional measures

Light blue square: Cyclical component

Red triangle: Nominal general government deficit

2.7. General government debt

The methodology of the debt statistics prepared by the Croatian National Bank (CNB) is adjusted to the ESA 95 methodology, i.e. to Eurostat's Manual on Government Deficit and Debt¹¹. According to CNB's data, the public debt at the end of 2013 amounted to 220.2 billion HRK or 67.4 % of GDP, which is an increase of 36.5 billion HRK or approx. 11.2

¹¹ http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-RA-13-001/EN/KS-RA-13-001-EN.PDF

percentage points of GDP from the same period in 2012. Potential government debt in the form of issued treasury bonds was slightly reduced when compared to 2013 and amounts to 16.4% of GDP.

Table 10 shows the key determining factors of the change in public debt expressed as a share in the GDP. The change in public debt expressed in % of GDP can be presented as the sum of the primary balance ((-) debt increase), the effect arising from the difference between the interest rate on the public debt and the nominal GDP growth rate (so-called snowball effect); (+) debt increase)¹², and other factors not reflected in deficit developments ((+) debt increase).

Table 10. Determinants of general government debt developments, 2008-13

	2008	2009	2010	2011	2012	2013
in percentage points						
Primary balance – ESA 95	-0.3	-3.5	-4.1	-5.2	-2.0	-1.9
Effect of the difference between the interest rate and the nominal GDP growth rate	-1.0	3.3	2.8	1.9	3.3	3.1
Other factors	-2.6	0.0	1.3	-0.2	-1.1	6.2
Public debt	-3.3	6.8	8.2	7.0	4.2	11.2

Source: CNB; own calculations

Table 10 reveals that the strong increase of the public debt in 2013 was mainly the result of operation of other factors and of unfavourable differences between the interest rate and the nominal GDP growth rate, i.e. the interest rate on the public debt is visibly higher than the nominal GDP growth rate. A strong effect of other factors is mainly reflected in the fact that significant funds allocated from the borrowing at the end of 2013 were deposited with the CNB and transferred into 2014 for the purpose of deficit financing and liabilities refinancing in the current year. According to state audit instructions and in line with the Ordinance on Budgetary Accounting and Chart of Accounts (“*Narodne novine*“, No. 114/10 and 31/11), a portion of the time-deposit funds from issuing foreign bonds intended for the budget financing needs in 2014 was recorded under the item *issued loans* and not within deposit changes. Since the primary balance in table 10 is presented according to the ESA 95

¹² The change in public debt-GDP ratio can be recorded as $\Delta d_t = ps_t + \left(d_{t-1} * \frac{i_t - y_t}{1 + y_t} \right) + o$, whereas t

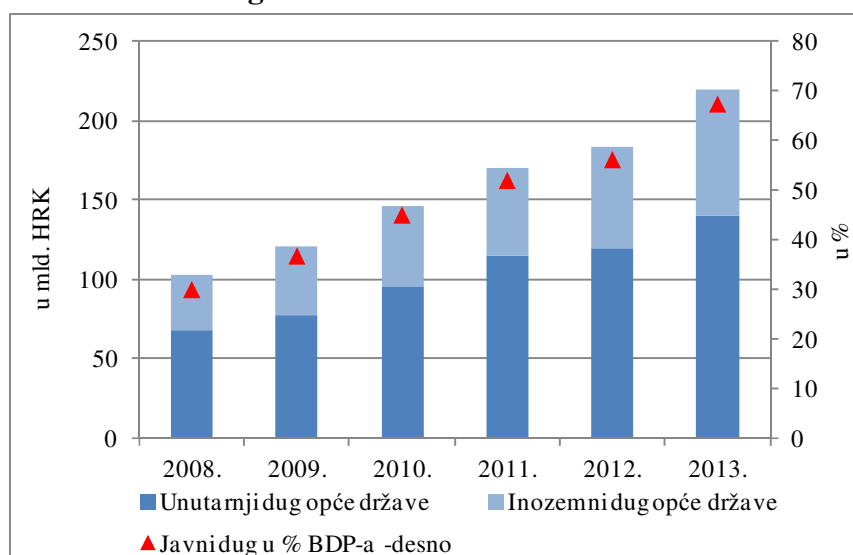
stands for the time period, d -public debt in percentage of GDP, ps -primary balance, i -implicit interest rate on the public debt, y - nominal GDP growth rate, o -other factors. The term in the brackets represents the so-called snowball effect, which shows the common effect of interest expenses and economic growth on the public debt expressed in percentage of GDP. The implicit interest rate on public debt in the current year (t) is calculated as the ratio of the interest expenses in the current year and the public debt in the previous year.

methodology, other factors imply also an increasing need for borrowing by the government for the purpose of settling debts in the health sector and due to lower cash revenue. Generally, the deficit according to the cash principle better reflects the needs for general government borrowing in a particular year than the deficit according to the accrual principle. The HRK-exchange rate depreciation in relation to the Euro also had a negative impact on the statistical increase of the public debt.

The general government domestic debt increased in 2013 by 20 billion Kuna (Chart 6) or by 16.5% compared to 2012, but due to a faster increase of the foreign debt its share in the total debt was decreased from 65.3% at the end of 2012 to 63.5% at the end of 2013 (Chart 7). The increase of the domestic debt was largely the result of borrowings through issuing long-term domestic bonds. Thus in July 2013 five-year domestic bonds in the amount of 2.75 billion Kuna were issued, as well as bonds in the amount of 750 million EUR with currency clause and maturity in July 2024. The increase of the short-term domestic debt based on the issuance of short-term securities amounted to almost 5 billion Kuna. A similar increase was recorded for domestic borrowings from banks.

Foreign debt increased mainly due to two issues of foreign bonds in the US capital market. The first issue was accomplished in April 2013 and amounted to 1.5 billion USD for a period of ten years. Foreign bonds in the amount of 1.75 billion USD were issued at the end of 2013, with maturity at the beginning of 2024. Foreign loans were increased by a little over 2 billion Kuna, largely on the basis of loans in the amount of 200 million EUR from the Goldman Sachs Group.

Chart 6. General government debt



Source: CNB

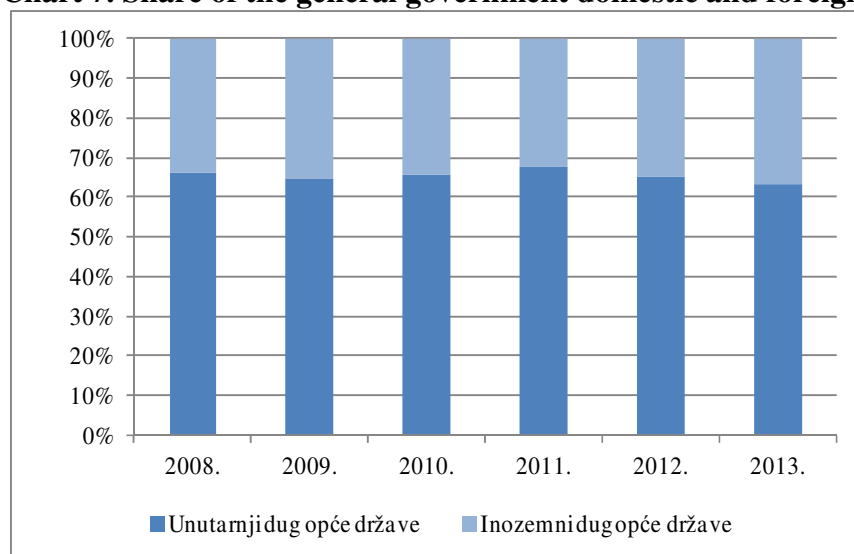
In HRK billions

Dark blue square: General government domestic debt

Light blue square: General government foreign debt

Red triangle: Public debt in % of GDP – on the right
On the right side: In %

Chart 7. Share of the general government domestic and foreign debt in the total debt

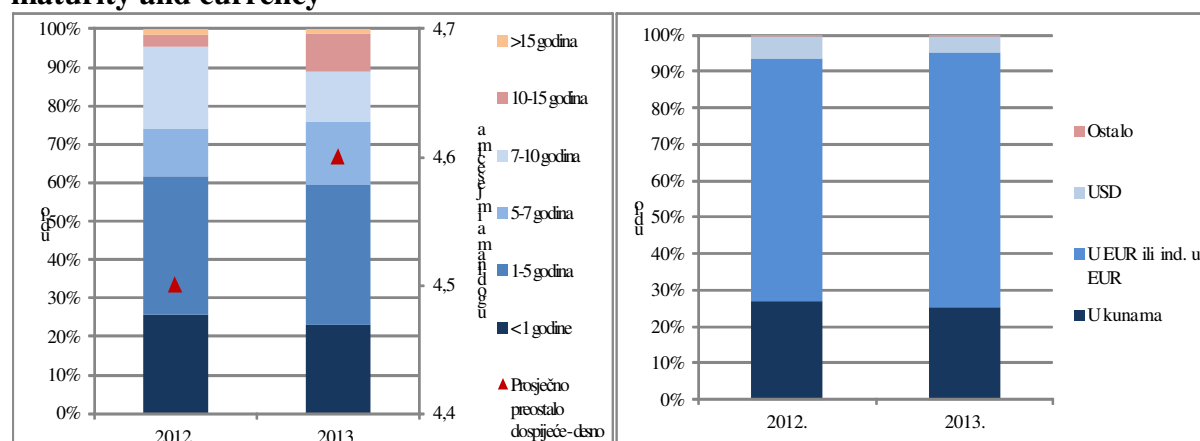


Source: CNB

Dark blue square: General government domestic debt
Light blue square: General government foreign debt

The fact that the average remaining period to maturity of the public debt slightly increased as compared to the end of 2012 from four years and five months to four years in six months is a positive development (Chart 8). The public debt structure according to the remaining period to maturity shows that the largest portion of debt becomes due in the period between one to five years. The share of short-term debt according to the remaining period to maturity mildly decreased as compared to 2013 and amounted to slightly above 20%. The share of debt with remaining period to maturity of 10-15 years increased significantly, which is the result of bonds issues in the foreign and domestic capital markets. The currency structure of the public debt did not change significantly as compared to 2012. The largest share of debt is still denominated in a foreign currency, mainly in Euro, and only one fourth of the public debt is issued in HRK. For this reason the small change in the HRK-exchange rate in relation to the Euro significantly influences the statistical increase/decrease of the public debt. For example, the depreciation of the HRK in relation to the EUR of 1% statistically increases the public debt by approx. 1.5 billion Kuna.

Chart 8. General government debt structure according to the remaining period to maturity and currency



Source: CNB

Share (on the left)

In years and months (on the right)

Orange square: > 15 years

Coral square: 10-15 years

Light blue square: 7-10 years

Light blue to blue square: 5-7 years

Blue square: 1-5 years

Dark blue square: <1 year

Red triangle: Average period to maturity – on the right

Share (on the left)

Coral square: Other

Light blue square: USD

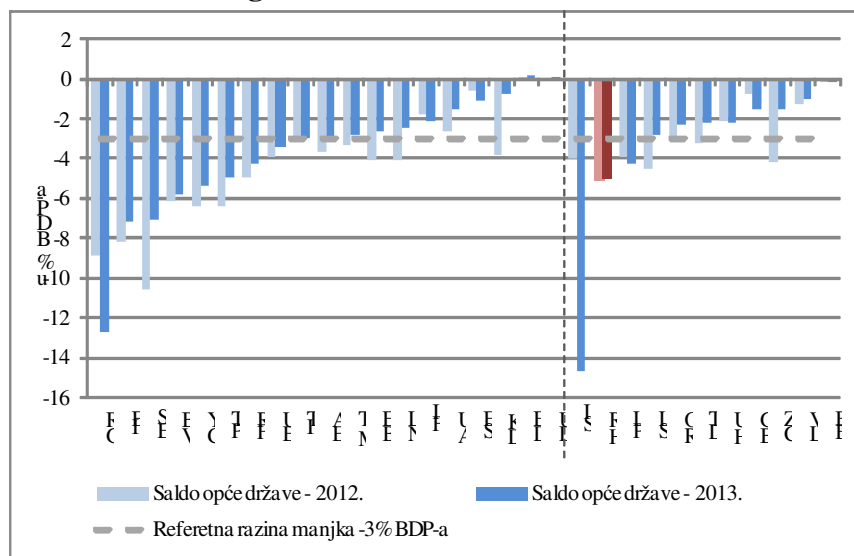
Blue square: in EUR or ind. in EUR

Dark blue square: in HRK

2.8. International comparison

According to Eurostat (Chart 9) most EU states improved their fiscal balance in the last year as compared to 2012, and the number of states with general government deficit above 3% of GDP significantly decreased. 10 EU member states, including Croatia, run a deficit above the reference value, while in 2012 17 EU member states had a deficit of above 3% of GDP. Belgium, Slovakia, Czech Republic and Denmark reduced the deficits below the threshold within the term stipulated according to the excessive deficit procedure. Malta and the Netherlands corrected their respective excessive deficit one year before deadline. Lithuania also reduced its deficit below 3% of GDP, but the EDP was abrogated already in mid-2013 because the EC assessed that the deficit run in 2012, which was a little above 3% of GDP, was not excessive when taking into account the pension reform costs. When considered in relation to a comparative group of EU member states (Central and Eastern European countries), Slovenia and Croatia had the highest general government deficits.

Chart 9. General government balance of EU member states



Source: Eurostat

In % of GDP (*on the left*)

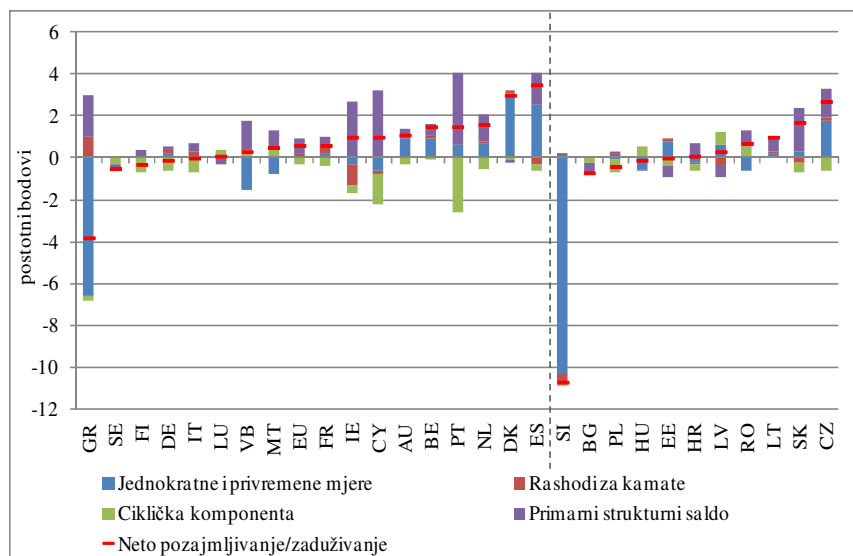
Light blue bar: General government balance – 2012

Blue bar: General government balance – 2013

Dashed line: Reference deficit level – 3% of GDP

The decomposition of nominal general government balance developments according to the EC (Chart 10) for primary structural balance change, interest expenses, cyclical components and provisional and one-off measures shows that in Slovenia and Greece the nominal deficit was significantly increased on a temporary basis, which is the consequence of financial assistance to the banking sector. It is also evident that in many countries the cyclical component had an unfavourable effect on the general government balance, especially in the case of Portugal and Cyprus, where unfavourable cyclical developments largely neutralised the strong improvement of the primary structural balance and in such way decreased the nominal deficit adjustment.

Chart 10. Determinants of change in nominal general government balance of EU member states



Source: EC.

Blue square: One-off and provisional measures

Red square: Interest expenses

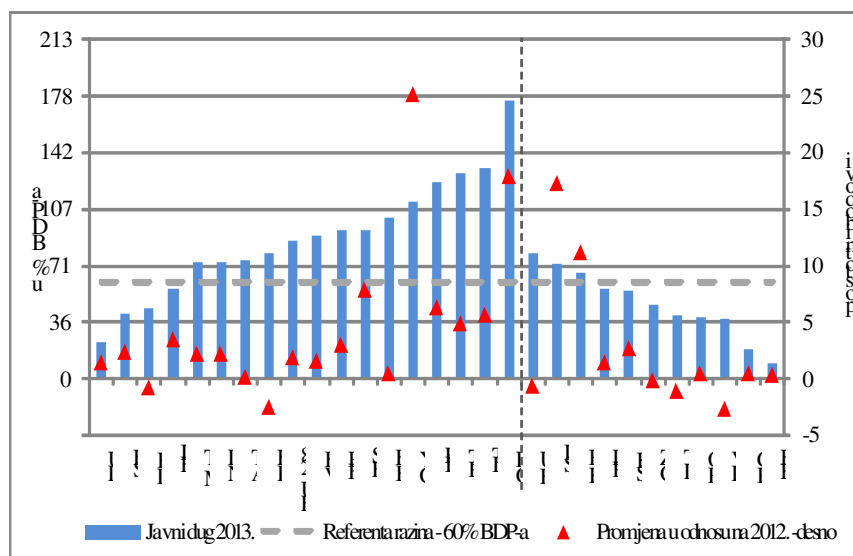
Green square: Cyclical component

Violet square: Primary structural balance

Red dash: Net lending/borrowing

The public debt continued growing in most member states (Chart 11), with the largest increase in Cyprus, Greece and Slovenia, while on the other hand most new EU member states reduced their respective deficit or managed to maintain it at 2012 levels. Croatia, together with Slovenia, is among Central and Eastern European countries with highest public debt levels, with the increase in 2013 being among the strongest.

Chart 11. General government debt of EU member states and its change as compared to 2012



Source: Eurostat

On the left: In % of GDP

On the right: percentage points

Blue bar: Public debt in 2013

Dashed grey line: Reference level – 60% of GDP

Red triangle: Change as compared to 2012 – on the right

3. Analysis of compliance with the fiscal rule for 2013

The Fiscal Responsibility Act, enacted by the Croatian Parliament at its session held on 23 November 2010 (“Narodne novine”, br. 130/10), defines the fiscal rule for 2013, according to which:

1. total expenditure of the general budget expressed as a share in the estimated gross domestic product shall annually be reduced by no less than one percentage point;
2. the reduction of total expenditure expressed as a share in the estimated gross domestic product shall be conducted until the point when the general government primary fiscal balance is equal to nil or positive, in nominal terms;
3. from the point when the nominal general government primary fiscal balance is equal to nil or positive, the objective shall be reaching a cyclically-adjusted primary fiscal balance of the general budget at nil level or positive during the cycle in order to achieve stabilisation and reduction of the ratio of public debt to gross domestic product.

The increase in general government expenditure directly related to natural disasters, epidemics and environmental accidents as well as to the financing of projects which are co-funded from pre-accession assistance programmes and European funds in the process of Croatia's accession to the European Union and in the first three years of membership are exempted from the established fiscal rules.

The fiscal variables required for the calculation of the said rules are based on the ESA 95 methodology. The evaluation of the fiscal rule was conducted on the basis of data produced by the Croatian Bureau of Statistics for the purpose of the current year's April Excessive Deficit Procedure Report for April¹³. The nominal GDP as estimated by the Croatian Bureau of Statistics for the relevant years was used to calculate the expenditure share in the GDP.

However, the Decree on the Fiscal Responsibility Statement and the Fiscal Rules Application Report Production and Submission (“Narodne novine”, br. 78/11) stipulates, *inter alia*, that

¹³ http://www.dzs.hr/Hrv_Eng/publication/2014/12-01-03_01_2014.htm

when submitting the annual report on the fiscal rule application the respective annual nominal GDP (the same that was used for drafting the state budget and the state budget amendments) shall be used for the calculation of the expenditure share in the GDP in the year for which the report is submitted. Thus the compliance with the fiscal rule has been additionally analysed on the basis of the assessed nominal GDP that was used for drafting the State Budget Revision for 2013.

According to ESA 95, the 2012 general government primary balance, that is equal to the difference of total revenue and total expenditure less interest expenses, amounted to -6.4 billion HRK or -2% of GDP. Thus, in order to meet the fiscal rule the share of total expenditure in the estimated GDP had to be reduced in 2013 by one percentage point or approx. 3.3 billion HRK.

According to the Ministry of Finance, the expenditure increase that is exempted from the calculation of the fiscal rule amounted to 0.2 billion Kuna in 2012 and 2013. This amount entirely refers to the expenditure increase related to the financing of projects which are co-funded from pre-accession assistance programmes and European funds in the process of Croatia's accession to the European Union and after accession. Thus, the total consolidated general government expenditure, after adjustment with respect to the exemptions, amounted in nominal terms to 150 billion Kuna in 2012 and 150.6 billion Kuna in 2013. The general government expenditure for the calculation of the fiscal rule, expressed as a share in the *planned* GDP amounted to 44.8% of GDP in 2013, which is 0.6 percentage points of GDP less than in 2012.

The development of share in the GDP *outturn* is even more unfavourable, i.e. the expenditure share used for the calculation of the fiscal rule in the GDP outturn was increased by 0.2 percentage points. It has to be mentioned that the Croatian Bureau of Statistics in the meantime revised the GDP assessment for 2012. All this leads to the conclusion *that the fiscal rule for 2013 has not been fulfilled.*

The total expenditure increase is largely the consequence of payments made into the EU budget, while the payments of debts in the health sector from previous years did not have any impact on the non-fulfilment of the fiscal rule, because these debts, in line with the accrual principle of recording budgetary transactions, are not included in the budget expenditure according to the ESA 95 methodology.

Table 11. Assessment of compliance with the fiscal rule for 2013

	Execution in 2011	Execution in 2012	Execution in 2013
HRK billions	1	2	3
1. Total general government expenditure	158,2	150,2	150,8
2. Inter-annual change in expenditure exempted from fiscal rules in line with the Fiscal Responsibility Act	0,2	0,2	0,2
3. General government expenditure for the calculation of	157,9	150,0	150,6

the fiscal rule (1-2)			
4. Nominal GDP used for drafting 2013 budget amendments	328,7	330,2	336,3
5. Nominal GDP	328,7	327,0	326,8
in % and percentage points			
6. Expenditure share for the calculation of the fiscal rule in GDP used for drafting 2013 budget amendments (3/4)	48,0	45,4	44,8
7. Annual change of expenditure share of consolidated general government for the calculation of the fiscal rule in GDP used for drafting 2013 budget amendments	-	-2,6	-0,6
8. Expenditure share for the calculation of the fiscal rule in the GDP outturn (3/5)	48,0	45,9	46,1
9. Annual change of expenditure share of consolidated general government for the calculation of the fiscal rule in the GDP outturn	-	-2,2	0,2

Sources: Ministry of Finance; Croatian Bureau of Statistics; own calculations

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