



REPUBLIC OF CROATIA

**CONVERGENCE PROGRAMME
OF THE REPUBLIC OF CROATIA
FOR THE PERIOD 2014-2017**

April 2014

Foreword

At its session of 24 April 2014, the Government of the Republic of Croatia accepted the Convergence Programme of the Republic of Croatia for 2014. This is the first Convergence Programme to be drafted by Republic of Croatia as a European Union Member State. The document is the result of the process in which all EU Member States are obliged to report and align their economic policies with the jointly defined goals and determinants of the EU. This alignment and reporting is carried out within the annual cycle of the European semester, in which each Member State submits its strategic documents to the European Commission by the end of April. This is followed by economic dialogue, drafting of recommendations for individual Member States, and their implementation into practice. The Convergence Programme was developed by the Ministry of Finance, in cooperation with the Croatian National Bank.

During the drafting of the Convergence Programme, not all calculations that are prepared at the EU level for all Member States and which are necessary for drafting parts of the programme were available. The necessary inputs will become available in line with their updating calendars at the EU level, and will be integrated during the development of the next programme.

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1. FRAMEWORK AND OBJECTIVES OF ECONOMIC POLICY

The economic policy of the Government of the Republic of Croatia is characterised by two key objectives: stimulating economic growth and rapid fiscal consolidation. However, the space for stimulating economic growth through economic policy measures is very limited following the deep five-year recession. Active use of monetary policy is limited by a high degree of Eurisation. Fiscal policy has also exhausted space for anti-cyclical activity, which is seen in the high fiscal deficit and rapid growth of public debt, caused by the long-term recession. In order to ensure long-term fiscal sustainability, rapid fiscal consolidation is necessary, which represents the second main objective of economic policy of the Government of the Republic of Croatia.

The described fiscal trends are a direct consequence of the deep recession and restructuring the Croatian economy has passed through, including individual state-owned companies. The macroeconomic imbalance that demands such restructuring has arisen due to poor business decisions and inadequate economic policy measures during the period of strong capital inflows prior to the financial crisis. The deepening of fiscal imbalance in 2013 and 2014 was also furthered by the fiscal costs of entry into the European Union (EU). The positive effects of membership on economic activity, and on fiscal revenues, have not yet been achieved due to the ongoing recession in Croatia and the EU. Though the implementation of fiscal consolidation will negatively impact economic recovery in the short-term, the sustainability of the public debt and public finances is necessary to create a stable macroeconomic environment necessary for ensuring sustainable economic growth in the medium and long-term.

The EU has also recognised the importance of stimulating growth and the need for rapid fiscal consolidation. In January 2014, the EU Council launched an initiative of the corrective Excessive Deficit Procedure (EDP), while in March, the European Commission (EC) confirmed the existence of excessive macroeconomic imbalances.

The Excessive Deficit Procedure fully determines the fiscal policy framework in the mid-term period as described in the Convergence Programme. In order to adopt the EU Council recommendations, in addition to the previously accepted measures adopted at the end of 2013, the Government of Croatia passed a series of additional fiscal consolidation measures. Additional measures total 3.1% GDP in 2014, 1.6% GDP in 2015 and 1% GDP in 2016. A portion of these measures have a one-off character and cannot be considered a necessary structural adjustment according to the Stability and Growth Pact. When the effect of one-off measures is excluded, the additional structural measures total 2.3% GDP in 2014, and an additional 1% GDP in each of the subsequent two years, thereby complying with the EU Council recommendations, aimed at resolving the excessive deficit. In so doing, the nominal budget deficit will be less than that set in the EU Council recommendations in 2014, and will be on track with the recommendations for 2015 and 2016. Fiscal consolidation will continue even after the closure of the excessive deficit procedure in line with the new fiscal framework, until the ultimate achievement of the medium-term budgetary objectives.

The passed fiscal consolidation measures can be divided into two groups. The first group represents short-term fiscal consolidation measures that had to be adopted urgently in order to accept the EU Council recommendations. These measures are focused on the revenue side and represent increases in certain types of taxes and contributions, and reductions in expenditures and entitlements. The

long-term fiscal consolidation measures are based on activities to increase the efficiency of fiscal expenditures through structural measures of fiscal consolidation. Furthermore, two new forms of taxes will be introduced – tax on income from interest on savings and real estate tax, which are standard forms of taxes in all other EU Member States.

The accepted fiscal consolidation measures will further reduce economic growth, which will stagnate in 2014. The projection assumes that growth will gradually accelerate towards its potential level as defined according to the EU Council methodology. Investments will be the main generator of economic growth in the short-term. On the one hand, strong investment activities are expected from state-owned companies as a result of the Investment programme of the Government of Republic of Croatia. On the other hand, the adopted acts for stimulating investments (Act on Stimulating Investments and Improving the Investment Climate¹ and the Act on Strategic Investment Projects of the Republic of Croatia²) will significantly contribute to the growth in private sector investments. Significant contribution to additional growth of all categories of the gross domestic product in the mid- to long-term will be generated by the structural changes that are necessary to improve the business environment, the improved efficiency of public administration, the gradual intensification in the usage of EU funds, and generally positive impact of Croatia's membership in the EU.

¹ Official Gazette, number 111/12, 28/13

² Official Gazette, number 133/13

2. MACROECONOMIC TRENDS

2.1. Current macroeconomic trends

The declining trend of economic activity in the Republic of Croatia continued in 2013 for the fifth year in a row. According to preliminary data of the Central Bureau of Statistics, 2013 ended with a drop in economic activity of 1.0% in comparison to 2012, which represents a cumulative drop of 11.9% in comparison to 2008. The most significant contribution to the real fall of the gross domestic product from the expenditure side in 2013 came from a 1.8% drop in exports of goods and services, and a 1.0% decline in household consumption. Furthermore, all other components from the expenditure side of gross domestic product also recorded a real year-on-year decline, with the exception of government consumption which saw a slight growth of 0.5%. The drop in household consumption in 2013 was the consequence of the exceptionally negative trends on the labour market and continued deleveraging of the household sector. After four consecutive years of strong declines, the further 1.0% reduction of gross fixed capital formation is the result of reduced private sector investments, though this was somewhat weaker than in the preceding year, and also of unimplemented investment projects of public enterprises, particularly at the end of the year. Furthermore, after positive contribution in 2012, a negligible negative contribution of net exports to economic growth was recorded in 2013 as the imports of goods and services, with a drop of 1.7%, recorded only marginally weaker real drop than the exports of goods and services. According to preliminary national accounts data, goods exports expressed in HRK at the 2013 level fell by 4.1%, while goods imports were reduced by 1.5%. This strong real reduction in goods exports under conditions of strengthened foreign demand suggests a pronounced loss of the share of Croatian companies on export markets. In line with the described trends, the deficit of foreign trade in goods was increased by 2.7% in comparison to 2012. The calculation of gross domestic product according to the production approach suggests the conclusion that in 2013, the real reduction of gross value-added was mostly due to the decrease of value-added in manufacturing (3.7%) and construction (4.3%), activities characterised by the most pronounced reductions in value-added since the start of the recession period.

A comparison of the projections from the Economic Programme of Croatia with the realizations in 2013 show significant divergence of the projections of the gross domestic product, whereas a slight growth of 0.7% was expected, while a drop of 1.0% was recorded. This divergence is largely explained by the exceptionally pronounced unfavourable deviation in gross fixed capital formation, following the substantially weaker results of the investment cycle of the general government and public enterprises than the expected, and also the somewhat weaker dynamics of private investments. For household consumption, the projected decline was approximate to the actual decline, or 0.3 percentage points weaker. It is necessary to note that the projections of household consumption included the positive effects by envisaged strong investment activity. The more favourable realizations of government consumption than projected in the 2013 Economic Programme is explained by the expected stronger expenditure-side consolidation at the general government level, while less favourable realizations of exports of goods and services reflected the weaker growth of export markets on the one hand, and unexpectedly unfavourable results of goods exports on the other, with an emphasis on certain activities, above all other transport equipment.

The divergences of imports of goods and services and the changes in inventories are largely the result of the above listed differences.

In 2013, there was a further deepening of the imbalance on the labour market. According to labour force survey data, the drop in the average number of employed persons accelerated to 3.9% despite a weaker decline in economic activity in comparison to 2012.³ This employment trend, with somewhat weaker decrease in the labour force category, led to an increased survey unemployment rate of 17.1%, which represents a year-on-year increase of 1.3 percentage points. According to administrative sources, the average number of employed was reduced by 2.2%, and the unemployment rate reached an average of 20.2%. The drop in employment in legal entities was mostly influenced by the drop in the number of those employed in trade, manufacturing and construction. In 2013, the trend of real reduction of gross wages continued, with the average monthly gross earnings in legal entities declining by 1.4%, while the average monthly paid off net earnings showed a real decline of 1.5%. In line with the above, growth of average labour productivity of 1.2% was recorded on the labour market, while the unit labour cost was reduced by 0.4%.

The average annual inflation rate of consumer prices was decelerated to 2.2% in 2013. The weak economic activity and absence of domestic cost-related pressures for several years has acted to slow inflation. Unfavourable conditions on the labour market resulted in lowered nominal unit labour costs in 2013, calculated with regard to labour force survey data (or data from administrative sources).⁴ The slowing of inflation during 2013 was due partly to short-term factors, particularly the favourable effect of the base period (tied to the increase in VAT and certain administratively regulated prices in the first half of 2012) and positive shock on the supply side, i.e. the drop in prices of food raw materials on the world market resulting from the good harvest. This led to a reduction of prices in domestic food products. Furthermore, favourable weather conditions in the country (relatively warm winter) influenced the annual drop in the prices of fruits and vegetables. Increased competition after the remaining protective tariffs were abolished following Croatia's accession to the EU also stimulated a reduction in food product prices. Inflation pressures from the world crude oil market were also reduced. An appreciation of the average nominal effective exchange rate of the HRK also favourably affected import prices.

According to preliminary data, in 2013, a positive balance of the current account of the balance of payments was recorded in the amount of 1.3% GDP, which was preceded by four years of significant deficit contractions. Further improvements to the current account balance in 2013 was mostly due to the reduction of the deficit on the factor income account, due to lower expenditures from direct equity investments, and also due to reduced interest expenditure on foreign liabilities. The continued positive trends in international exchange of services also positively affected the current account balance, which primarily refers to the growth in tourism revenues by 4.9% at the annual level. On the other hand, the deficit in foreign trade in goods was increased due to a more pronounced drop in exports than imports. This was mostly due to the unfavourable trends in the exchange of other

³ In analysing the economic drop in 2013, it should again be noted that the data on the gross domestic product are preliminary, as it is possible that the economic decline will be revised following significant legal changes, which would have an impact on the overall macroeconomic framework.

⁴ If the unit labour costs in 2013 are calculated according to the EC methodology, using data aligned with the national accounts methodology (Eurostat), the result is an increase in the unit labour costs in comparison to 2012, primarily as a result of the non-uniformity of employment data (growth in employment aligned with the national accounts indicates a reduction of 1.0%, while labour force survey data indicate a substantially higher reduction of employment of 3.9%).

transport equipment (primarily ships), whose net exports were virtually halved in comparison to the previous year. The positive balance on the current transfer account was slightly reduced due to more pronounced growth of expenditures (mostly on the basis of payments into the EU budget) over revenues, while capital transfers remained at the same level as in previous years. Capital flows with the rest of the world in 2013 were marked by strong government borrowing, which issued two bonds on the American market, valued at USD 1.5 billion in April and USD 1.75 billion in November. Meanwhile, credit institutions continued the process of deleveraging, reducing their long-term liabilities towards foreign creditors, though at a lower intensity than in the previous year. Following further restraint by foreign investors, the inflows of foreign direct equity investments in Croatia were lower than the previous year.

The international reserves of the Croatian National Bank (CNB) were increased by 14.9% in 2013, and totalled EUR 12.9 billion at the end of December. The growth in reserves is a consequence of the inflow of foreign currency to the account of the Ministry of Finance based on borrowing on the foreign and domestic markets, the net purchase of foreign currency by the government and gains from investments. Sales of foreign currency to banks in Croatia and the EC acted in the opposite direction.

Trends of indicator of price competitiveness of Croatian exports in 2013 show slowing down or even a stoppage of the trend of increasing competitiveness that was present in the past few years. As such, the real effective exchange rate of the kuna, deflated by producer prices, further depreciated, though at a substantially lower intensity than in the previous year. On the other hand, the real effective exchange rate of the kuna, deflated by consumer prices, appreciated under the influence of the growth of administratively regulated prices that do not directly influence the price of products being exported.

The exchange rate of the kuna against the euro was stable in 2013. The nominal daily exchange rate of the kuna against the euro during the year ranged from -1.6% to 1.0% around the average annual exchange rate, which was 7.57 EUR/HRK, and which was 0.7% higher than in 2012. The main instruments of monetary and exchange rate policy in 2013 were again foreign currency transactions of the central bank, which achieved net purchase of foreign currency of EUR 0.3 billion, thus creating HRK 2.6 billion of primary money. In the structure of foreign currency transactions, the purchase of foreign currency pertains to transactions with the central government (foreign currency inflow based on foreign borrowing) while the sale of foreign currency virtually completely pertains to intervention on the foreign currency market aimed at stopping depreciation pressures in April 2013.

The developments in monetary and credit aggregates in 2013 continued to reflect the lack of recovery in the real sector of the economy, despite exceptionally favourable liquidity. The net foreign assets of the monetary system increased thanks to the improved foreign position of the central bank, but also the improved net foreign position of credit institutions, with less pronounced deleveraging towards foreign creditors than in the previous year. The net domestic assets of the system recorded moderate growth, in which the highest increases in its structure was credit to the central government, while credit to other sectors (excluding exchange rate changes and one-time effects⁵)

⁵ One-time effects in 2012 relate to the takeover of shipyard loans by the Ministry of Finance and a transactions of a corporate bank which, in order to reduce partially collectable and uncollectable placements, transferred part of its claims to a company in indirect ownership of the mother bank. One-time effects in 2013 relate to the bankruptcy of Centar Bank, the methodological changes in reporting fees and another transfer in partially collectable and uncollectable placements of a corporate bank to an associated company.

remained virtually unchanged. There was a slight growth in loans to enterprises (2.0%) in 2013, while the household sector continued the deleveraging process (-1.6%). The recorded changes of the net domestic and net foreign assets resulted in an increase in the total liquid assets (M4) by 2.9%.

2.2. Mid-term macroeconomic scenario

Macroeconomic projections are based on the available statistical indicators published by mid April 2014. Assessments of the influence of all economic policy measures are built into these projections, and the effects of certain measures (as described in the National Reform Programme), primarily those for stimulating investment which have great potential for increasing growth in the short- and mid-term, were assumed to be more conservative, in order to maintain a realistic projection, and their more favourable realisations than forecast in these projections represent a positive risk for the economic growth projections. The external assumptions, such as trends in the relevant foreign interest rates, bilateral and effective exchange rates, price of primary commodities, and global economic trends in the mid-term period were taken from the *European Economic Forecast – Winter 2014* of the EC from February 2014. In comparing these projections with the prior forecasts of the EC, a negligible positive correction of the growth of the gross domestic product of the EU in all years of the projection period and a slight positive correction of growth of Croatian export markets stand out. Some of the most important Croatian export destinations (such as Slovenia and Italy) recorded significantly positive corrections of economic growth.

In 2014, the negative trend in the Croatian economy is expected to stop with a stagnation of economic activity, i.e. real change of the gross domestic product of 0.0%. The most significant positive contribution to growth is expected from exports of goods and services under the influence of accelerated growth of foreign demand, and the most significant negative contribution from imports of goods and services and household consumption. Gross fixed capital formation will also positively influence growth of the gross domestic product, thanks to investments of the broader public sector which includes public enterprises. In 2015, the gross domestic product is projected to grow by 1.2%, which in the following years will accelerate to 1.3% and 1.5%. Observing individual components of the gross domestic product on the expenditure side, the main driver of economic growth in the period 2015–2017 will be the exports of goods and services, to be followed by gross fixed capital formation. The significant negative contribution will originate from imports of goods and services, as a result of the speeding up of economic recovery with existing level of import dependence, and government consumption, which is determined by the measures required through the Excessive Deficit Procedure. After a negative contribution in 2014, household consumption will record a positive influence, though the value of its contribution will remain relatively small to the end of the projection period. The category of changes in inventories will also contribute negatively to economic growth in 2014 and positively in the remainder of the projection period, though the contributions will be negligible in all years except 2016.

Throughout the projection period, the growth of gross domestic product will be limited by the weak dynamics of household consumption, whose more significant positive contributions to economic growth is only expected at the end of the period. Primarily under the influence of continued

unfavourable trends on the labour market and a pronounced process of household sector deleveraging, but also the negative impact of certain fiscal consolidation measures, household consumption in 2014 will continue to record negative results, though its reduction will be slightly less than in 2013. During 2015, the start of gradual recovery of consumer confidence is expected, stimulated by accelerated investment activity and better overall economic conditions, particularly improved labour market trends, which is expected to foster slightly more favourable dynamics of approved consumer loans to households sector. In the following years, further slight acceleration of growth of household consumption is expected, though the contribution of this component to economic growth will remain subdued until the end of the mid-term period. In conclusion, concerning the projected trends of household consumption throughout the entire observed period, the above mentioned unfavourable effect of fiscal consolidation will be countered by a positive impact of increased investment activity.

Fiscal consolidation measures determined within the framework of the Excessive Deficit Procedure will dictate government consumption trends in the mid-term period. However, it is necessary to note that in the short-term, the multiplier of government consumption is lower than envisaged by the EC following the structure of fiscal adjustment that is distributed between revenue and expenditure side. On the other hand, an expenditure oriented fiscal consolidation would likely have a more favourable effect on the dynamics of potential growth in the longer-term period. Through virtually the entire observed period, the real drop in government consumption will be affected by reduced social transfers in kind, influenced by savings due to increased efficiency in the health care system, and reduced compensations of employees, as a result of the drop of employment and insignificant increase of labour costs in conditions of reduction in wage and increase in the contribution rate for health insurance. A significant contribution to the drop in government consumption in 2016 will come from a real reduction in the intermediate consumption of general government. In 2017, in line with the recovery of economic activity and closure of the Excessive Deficit Procedure, there could be a real stagnation of government consumption.

The growth of gross fixed capital formation in 2014 and 2015, and to a lesser extent in the last two years of the observed period, will be the result of new or previously started investment projects of the broader public sector (which includes consolidated investments of the general government and public enterprises). It is necessary to note that the investment plans of public enterprises at the start of the projection period were projected conservatively, i.e. their full realisation was not assumed, in order to maintain a realistic projection, with regard to the execution of investment plans in the past year. On the other hand, 2014 is expected to see a reduction in private sector investments about the same as that in the previous year. Namely, the recovery of private sector investments will be limited by the persistently low corporate optimism ensuing from significant levels of uncertainty over future trends of aggregate demand, but also by the certain fiscal policy measures determined within the framework of the Excessive Deficit Procedure. In 2015, a slight real recovery of private investment spending is expected, stimulated by the public investment cycle, while more significant intensity of its growth is expected only in the final two years of the projection period. The envisaged strengthening of investment activities of the private sector in the second half of 2015 and the remainder of the mid-term period is based on a more pronounced recovery of domestic and foreign demand, in conditions of more favourable corporate optimism, slightly improved financing conditions and liquidity in the economy, and efforts by the Government of Croatia to create the preconditions for a positive investment climate, primarily through laws directed at stimulating investment projects and competitiveness. It is especially worthwhile noting the strong boost in

investment activity from 2015 and beyond, particularly at the end of the observed period, which will come from the more intensive use of EU funds, whose assessment of the total effect is built into the basic scenario of the macroeconomic projections.

The positive economic trends in the international environment and in the EU economy, as Croatia's most important trading partner, will lead to a strengthening of foreign demand for domestic goods and services, in which it is necessary to point out the positive correction of the growth of gross domestic product in neighbouring countries. Therefore, relatively favourable trends are forecast for real growth of exports of goods and services which will, among individual components on the expenditure side of the gross domestic product, give the greatest positive contribution to economic growth throughout the entire projection period. Alongside this expected acceleration of foreign demand, this projection of exports assumes the continued implementation of structural reforms with positive results already in the mid-term period, and which will be reflected in the slowing down of the loss of the market share on export markets by the end of the reporting period. The partial loss of markets of CEFTA countries from mid 2013 will lead to an unfavourable base effect that will limit the growth of goods exports in the first half of the year, while positive effects of regulating EU trade relations with the CEFTA countries and third countries is expected by the end of 2014. Throughout the entire observed period, stable and favourable trends of services exports are forecast, following the results from previous years, while, regarding goods exports, a significant acceleration of growth is expected in 2015, which will subsequently stabilise at that level. In conditions of a slight recovery of final demand, the projection for 2014 is a growth in the import of goods and services generated primarily by exports and increased investment activity of the public sector. In the forthcoming years, with further acceleration of growth of final demand, accelerated growth of imports of goods and services is expected. The contribution of net exports to economic growth in 2014 will be positive as a result of stronger growth of exports than imports of goods and services, while in the remainder of the reporting period, the contribution of net exports will again take on a negative sign and will increase with a weak intensity.

Despite the stagnation of economic activity, the continuation of negative trends is expected on the labour market in 2014. The delayed slight recovery of labour market indicators should begin in the second half of 2015. With regard to projections of labour force survey indicators, in 2014 the survey unemployment rate is expected to increase to 17.9%, as a result of the drop in employment and somewhat smaller decline in the labour force. In the forthcoming years, a reduction in the unemployment rate is forecast, first to 17.7% in 2015, then to 17.3% and 16.5% in the final two years of the reporting period, respectively. It should be noted that it is expected that the decline of the labour force in 2015 will be even slightly more pronounced than the drop in employment, while in the final two years, a moderate recovery of employment and slight growth of the labour force is forecast. With regard to the delayed recovery of employment, the average labour productivity will gradually decrease from 2.4% in 2014 to 0.1% in 2017, when the most pronounced recovery of labour market indicators is expected. In line with these productivity trends, and considering that the nominal growth of compensation per employee will gradually and mildly accelerate to 2.5% in 2017, the unit labour cost will first be slightly reduced by 0.7% in 2014, while in the remainder of the reporting period its growth will gradually accelerate to 2.4% in 2017.⁶

⁶ In the calculations of average labour productivity and unit labour costs, the methodology of the EC is used, in line with the Eurostat data aligned with the national accounts; however, it should be noted that the difference between the two employment growth rates in 2013 (two methodologies: ILO at -3.9% and the domestic

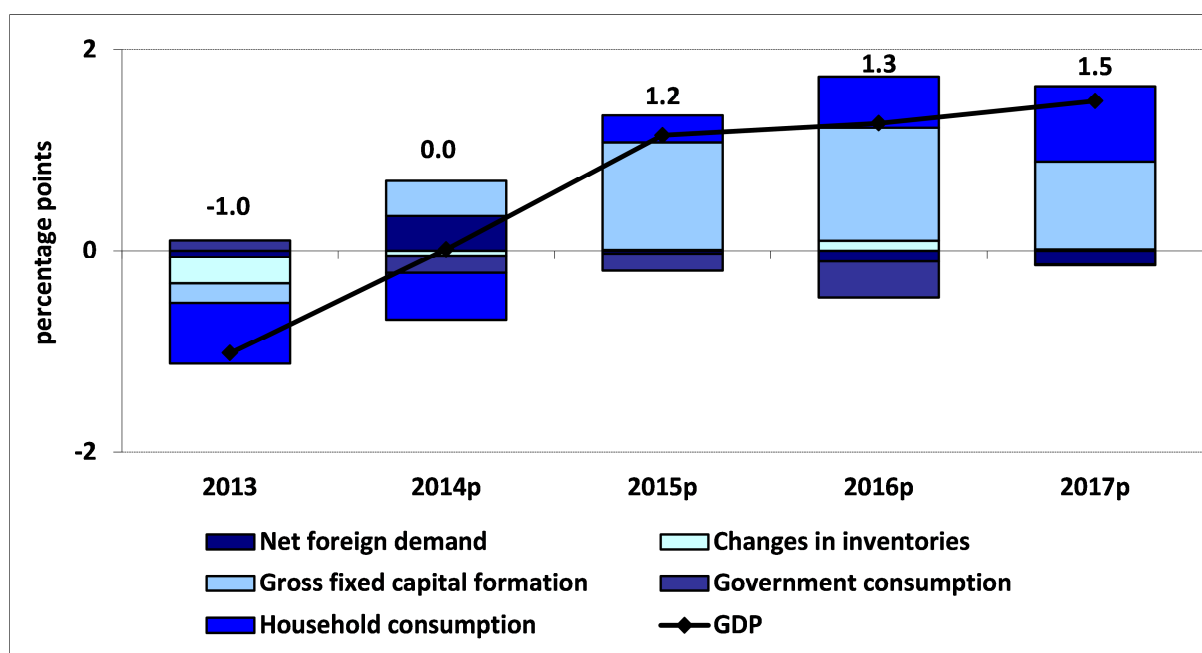
Table 1: Macroeconomic framework in the period 2013–2017

	2013	2014 Projection	2015 Projection	2016 Projection	2017 Projection
GDP - current prices (HRK million)	328,252	331,413	341,063	351,791	363,988
GDP - real growth (%)	-1.0	0.0	1.2	1.3	1.5
Households' consumption	-1.0	-0.8	0.4	0.8	1.3
Government consumption	0.5	-0.9	-0.9	-1.9	0.0
Gross fixed capital formation	-1.0	1.9	5.7	5.7	4.3
Exports of goods and services	-1.8	2.0	2.7	2.9	3.0
Imports of goods and services	-1.7	1.3	2.9	3.2	3.4
GDP, contributions to growth (percentage points)	-1.0	0.0	1.2	1.3	1.5
Households' consumption	-0.6	-0.5	0.3	0.5	0.8
Government consumption	0.1	-0.2	-0.2	-0.4	0.0
Gross fixed capital formation	-0.2	0.3	1.1	1.1	0.9
Exports of goods and services	-0.8	0.9	1.2	1.3	1.4
Imports of goods and services	0.7	-0.5	-1.2	-1.4	-1.5
GDP deflator growth (%)	0.9	0.9	1.7	1.9	1.9
CPI growth (%)	2.2	0.6	1.7	1.9	1.9
Employment growth *	-1.0	-2.3	-0.4	0.5	1.4
Unemployment rate (ILO)	17.1	17.9	17.7	17.3	16.5

* Domestic concept of national accounts definition

Source: CBS, MF, Eurostat, CBS

Figure 1: Contribution of aggregate demand categories to real GDP growth



Source: CBS, MF

In 2014, a significant slowdown of inflation which is forecast to reach 0.6%, from 2.2% recorded in 2013. In line with the expected reduction in the price of commodities on the world market,⁷ in 2014,

concept occupied population at -1.0%) reduces the credibility of these series and indicates likely inconsistency, which had certain implications on the drafting of the macroeconomic framework; the projections on unit labour costs according to the ILO methodology indicates a lower rate throughout the entire period.

⁷ According to the newest forecasts of the EC, the price of primary commodities on the world market will drop by 3.7% in 2014.

a reduction in the price of foodstuff and a deceleration of the growth of energy prices is expected in comparison with the previous year. With regard to domestic inflationary pressures, these could also be weak, due to suppressed household consumption and a slight reduction in the unit labour cost. Furthermore, the inflation trend in 2014 will be impacted by the increase in the VAT middle rate from 10% to 13%, the increase in contributions for health care insurance, the increase in excises on fuel and tobacco products, and increase in administratively regulated price of water. Their combined contribution to the increase in the inflation rate in 2014 should total about 1.1 percentage points. In the first quarter of 2014, the annual rate of change of the consumer price index was -0.3%, while in the continuation of 2014, there will be a rise in inflation under the influences of the above stated administrative changes and the disappearance of the base effect of the reduction in commodity prices on the world market in 2013. In the remaining years of the projection period, an acceleration of inflation is expected, to the level of 1.7% in 2015, 1.9% in 2016 and 2017 in conditions of recovery of foreign and domestic demand and weakening of the imported inflationary pressures.

Table 2: Price developments

	2013	2014	2015	2016	2017
1. GDP deflator	0.9	0.9	1.7	1.9	1.9
2. Private consumption deflator	1.9	0.7	1.8	2.0	2.0
3. CPI	2.2	0.6	1.7	1.9	1.9
4. Public consumption deflator	-1.0	0.4	0.8	0.9	1.9
5. Investment deflator	-0.1	0.5	1.8	1.9	1.8
6. Export price deflator (goods and services)	0.1	1.1	1.8	1.9	1.9
7. Import price deflator (goods and services)	0.2	0.3	1.6	1.8	1.9

Source: CBS, MF

The negative risks for a more significant recovery of the domestic credit activity continue to dominate, as the credit trends have been marked by the deleveraging process of the private sector. The weak recovery of the real sector and suppressed credit demand, particularly the unfavourable trends on the labour market, but also the unwillingness of banks to take risks, and the continuing trend of declining quality of bank assets are factors that limit credit growth. Under such circumstances, the projected trends in domestic credit and monetary aggregates for 2014 are only marginally more favourable than the results in the previous year, while credit activity could be more prominent only in 2015.

Further increase in the positive balance on the current account of the balance of payments is expected in 2014, which will amount to about 2.1% GDP, or somewhat higher if the current and capital accounts are considered jointly. The greatest contribution to this should come from the improvement in the balance in the international trade of goods and services. Furthermore, due to the previous drop of profitability of domestic companies and banks under foreign ownership, the pressures on the decline of the balance based on factor income should be less pronounced. In 2014, growth of the net revenues based on transfers (current and capital) is expected with more resources being disbursed from the EU funds than the ones paid into the EU budget. The positive trend for the balance of the current account, which has been present since 2009, will end only with intensification of economic recovery and strengthening of domestic demand in 2015, when its marginal reduction to 2.0% GDP is expected. In the forthcoming years, in line with the assessed slight recovery of economic activity, the profitability of companies under foreign ownership is expected to increase and, as a result, the expenditures based on equity investments will increase, and as such the balance on the account of factor income could again begin to deteriorate.

2.3. Alternative scenarios and risks

The main negative risks that the baseline scenario is exposed to are the weaker realization of investments of the broader public sector, particularly in the first two years of the projection period, and the less dynamic path of exports of goods and services than expected. Namely, the projections of gross investments are based on the individual investment plans for public enterprises that proved to be overly optimistic in the previous period, while, as for the export of goods and services, there is a risk of greater losses of the market share than assumed in the baseline scenario, taking consideration of the structural issues of the export sector and the time necessary to resolve them. On the other hand, the assumptions for drafting the projections of other components in the baseline scenario were more conservative than was the case with the two previously mentioned components of the gross domestic product, and therefore it is assessed that the risks for the realization of projections of the remaining components are balanced. As such, the alternative scenario is based on two simultaneous shocks, as shown in the table below. Clearly, the slower dynamics of economic activity in the alternative scenario brings with it repercussions to the entire macroeconomic framework.

Table 3: Trends of individual components of gross domestic product in alternative scenario

<i>% of GDP</i>	2013	2014	2015	2016	2017
Decrease in % of GDP, current prices, 2005=100					
Broader public sector investment		-0.5	-0.6	-0.1	0.0
Exports of goods and services		-0.2	-0.2	-0.2	-0.2
Gross domestic product	-1.0	-0.5	0.5	1.0	1.4
Households' consumption	-1.0	-0.9	0.2	0.7	1.3
Gross fixed capital formation	-1.0	-0.5	2.4	4.9	4.3
Exports of goods and services	-1.8	1.5	2.3	2.5	2.7

Source: Ministry of Finance

3. GENERAL GOVERNMENT BUDGET AND PUBLIC DEBT

3.1. Fiscal policy

In the forthcoming period, fiscal policy will be based on two principles. On the one hand, rapid fiscal consolidation is necessary, due to the growing public debt and costs of its financing, particularly under conditions of negative economic activity. On the other hand, it is necessary to stimulate sustainable economic growth following the deep, five-year recession.

The mid-term fiscal policy measures will be directed at fiscal consolidation aimed at adopting the EU Council recommendations, for the purpose of resolving the excessive deficit. Namely, in January 2014, the EU Council, at the recommendation of the EC, gave its recommendations that Croatia resolve its excessive deficit in such a way that it is brought to less than 3% GDP in 2016, and the general government debt put on the path to a falling under 60% GDP two years later.

The Council requested that Croatia implement a reduction to the structural deficit of 0.5% GDP already in 2014, which is the smallest possible correction envisaged by the Pact on Stability and Growth. In 2015 and 2016, further corrections of the structural deficit of 0.9% and 0.7% GDP were requested. In light of this, Croatia must adopt consolidation measures in the amount of 2.3% GDP in 2014, and an additional 1% GDP in 2015 and 2016. Such strong measures in the first year of membership were requested in order to compensate for the negative impacts of fiscal consolidation on budgetary revenues due to weaker economic activity, and which will follow after the implementation of fiscal adjustments. Furthermore, the rules within the Excessive Deficit Procedure do not consider the high costs of EU membership, which further deepened the budgetary deficit in Croatia. For that reason, the EC requested such high fiscal consolidation in 2014. In line with the above, Croatia needs to achieve the target nominal general government budget deficit at the level of 4.6% GDP in 2014, 3.5% GDP in 2015 and 2.7% GDP in 2016.

In order to meet these recommendations, the Croatian fiscal policy measures will be directed at fiscal consolidation, on both the revenue and expenditure sides of the budget. The framework of fiscal management in the EU and its adapted framework in Croatia will contribute to strengthening fiscal adjustments over time. This framework includes strengthening numerical fiscal rules, strengthening the autonomy of the Fiscal Committee and mid-term budget planning in Croatia, and a strengthening of the multilateral dialogues with the EC and EU.

Activities on the revenue side of the budget are directed at changes to the tax regulations, through increases to the rate of existing instruments, and the introduction of new forms of taxation for the purpose of increasing revenues, while also reducing the grey economy and improving collection of budgetary revenues. Short-term measures that will give an effect already in this year are based on increasing the rate and fees of existing tax and other instruments such as contributions, excises, fees, etc. In the next two years, new forms of taxes are planned to be introduced which were not previously in effect in Croatia: tax on savings interest and property tax. Both types of tax have a strongly social characteristic of taxation based on financial strength and fall within the less distortive forms of taxes. Activities to combat the grey economy and to improve the collection of revenues via fiscalisation will continue, and a single form for the collection of data on paid receipts from earnings

will be introduced. The reorganisation of the Tax Administration and Customs Administration are aimed to meet these objectives. The results of these measures are already visible in the data of the national accounts and budgetary revenues.

On the expenditure side of the budget, special attention is directed at reducing the budgetary deficit, while retaining social protection for citizens and improving the use of EU funds. In order to achieve savings already in 2014, salaries of civil and public servants were cut, and material expenditures, subsidies and public sector investments reduced. For the aim of creating additional savings and to increase the efficacy of public spending, the implementation of long-term reform measures of fiscal consolidation was initiated, which includes the majority of public spending categories. In order to leave room for fiscal consolidation that stimulates growth, the priorities of public spending will be investments in water and transport infrastructure and in health care and education. In conditions of high unemployment, particularly among youth, attention will be focused on implementing active measures on the labour market. Reforms to the health care system, judiciary, social welfare and education will continue, with the aim of improving their efficacy and sustainability.

All these targets and envisaged fiscal policy trends are specific and depend on the implementation of key structural reforms in the forthcoming period, and which are described in detail in the National Reform Programme.

3.2. Budget execution in 2013

2013 was marked by negative macroeconomic risks and, consequentially, lower economic growth than expected. Such movements were primarily caused by unfavourable economic movements in the international environment, slower investment dynamics of the public sector, and the necessity for additional budgetary savings. For those reasons, the state budget was amended twice in 2013. On both occasions, due to the reduction in expected growth, the planned revenues were reduced and the appropriate savings sought in all line items on the expenditure side. The last revision in November 2013 included the coverage of debts in the health care sector in the amount of HRK 3.3 billion. In order to reduce the budgetary deficit, additional measures were adopted aimed at increasing revenues from state assets.

The entry into the EU had a negative impact on the state budget. On the expenditure side, the half-year impact of EU membership was included, while on the revenue side, there was a permanent loss of the majority of revenues from customs and a one-time effect of the shift of payment of the VAT on products imported from other Member States. The one-time financial support of the EU to the state budget aimed to ensure a positive net position of the Republic of Croatia towards the EU budget did not compensate for the negative consequences, and the net effect of the half-year of membership was negative.

The total general government budget revenues in 2013 were collected at the level of 40.7% GDP. Reforms of tax policy continued to be focused at strengthening long-term fiscal sustainability, improving the business climate, addressing issues of insolvency and financial discipline in the economy. Tax changes primarily included the value-added tax and special taxes and excises. With the

amendments to the Value-Added Tax Act⁸ of 1 January 2013, provisions of a reduced rate of 10% came into effect for the food preparation services and the service of food and beverages in hospitality facility. Also, as of 1 January 2013, the zero rate of the value-added tax was abolished, and it was determined that products previously subjected to the zero rate tax would be taxed at a rate of 5%. Due to Croatia's entry into the EU, a one-time reduction occurred in revenues from the value-added tax due to the loss of VAT on imports of goods from EU member states, and due to different calculations due to the accession of Croatia to the EU, the VAT is no longer collected upon import, but only on the sale of an imported product or service. Losses on the revenue side are partly compensated by increased measures of collection of tax revenues, primarily old debts, and collection on the basis of reprogramming.

The Act on Fiscalisation in Cash Transactions⁹ came into effect, which implemented the use of fiscal cash registers aimed at better collection of tax revenues in cash transactions, which resulted in a countering of the grey economy and better tax discipline. The greatest changes in taxation in 2013 were in the excises system, i.e. with the special tax on passenger cars, excises on fuels and electricity, and excises on tobacco products. The new Excises Act¹⁰ introduced a new, combined system of taxation for passenger cars, other motor vehicles and vessels and aircraft. Excise taxation of tobacco products through the year was under the influence of the gradual increase of excises on cigarettes and bulk tobacco, with the intent to achieve full alignment with the EU *acquis communautaire* during the approved transitional period. During the year, excises were also increased on fuels, so as to achieve the minimal value of excises as prescribed by the EU legislation. Also, for the purpose of alignment with the EU legislation, on the date of accession, excises were introduced to natural gas and electricity. From 2013, amendments to the Profit Tax Act¹¹ introduced the possibility of tax breaks for reinvested profits. In these amendments to the tax system, work on analysis and the assessment of certain tax expenditures and non-tax fees was continued, so as to further spur competitiveness and unburden businesses and investors.

The total expenditures in 2013 were executed at the level of 46% GDP and were marked with increased financial expenditures, recovery costs for health care institutions, and payments into the EU budget. On the other hand, savings were achieved on expenditures for employees and subsidies. Namely, the increasing costs of servicing the public debt that arose in the preceding period and the takeover of debt of shipyards had a direct impact on the increase of expenditures for interest rates. Additional funds were envisaged for the Croatian Health Insurance Fund (HZZO), considering that in June the liabilities of health care institutions under recovery and by the HZZO in previous years were settled. With accession into the EU, Croatia became obliged to pay contributions into the EU budget, which increased other current transfers by an additional 0.5% GDP in 2013. Due to the new category of expenditures, the previous fiscal rules laid down by the Fiscal Responsibility Act¹², which was in effect during this period and which does not consider the existence of economic cycles, were not met in 2013. For more information about the fiscal rules and their amendments, see Chapter 6 - Institutional features of public finances.

⁸ Official Gazette, number 136/12

⁹ Official Gazette, number 133/12

¹⁰ Official Gazette, number 32/13, 22/13

¹¹ Official Gazette, number 22/12

¹² Official Gazette, number 139/10

In comparison with 2012, the general government budget deficit increased from 3.8% GDP to 5.4% GDP in 2013, whereby the budgetary central government recorded a deficit of 5% GDP, extrabudgetary users of 0.5% GDP, while it was assessed that the local and regional self-government units achieved a surplus of 0.2% GDP.

3.3. Excessive deficit reduction measures

In line with the EU Council recommendations, which requested that Croatia resolve its excessive budgetary deficit, in March 2014, amendments to the budget and financial plans of extrabudgetary users for 2014 were adopted. The amendments propose a series of measures on both the revenue and expenditure sides of the budget, and their structural effect is assessed at the level of 1.9% GDP. However, in order to achieve the level of necessary consolidation measures of 2.3% GDP in line with the EU Council recommendations, the Government of Croatia prepared additional measures of 0.4% GDP in 2014, which was contained in the Conclusion of the Government of Croatia, Decision on measures to temporarily cease the execution of the Croatian State Budget for 2014, and other relevant subordinate legislation. Additional structural measures were also adopted in the amount of 1% GDP in 2015 and 2016. The necessary preparatory works and changes to regulations will be adopted during 2014. In addition to structural measures, one-time measures were also taken in a total amount of 0.8% GDP in 2014 and 0.6% GDP in 2015.

Table 4: Structural measures for excessive deficit reduction

	FISCAL EFFECT IN 2014		ADDITIONAL EFFECT IN 2015		ADDITIONAL EFFECT IN 2016	
	HRK million	% of GDP	HRK million	% of GDP	HRK million	% of GDP
REVENUE STRUCTURAL MEASURES						
1. Taxes on gains from games of chance	300	0.09	200	0.06		
2. Changes in pension contribution system on behalf accelerated retirement	400	0.12				
3. Increase of concession charges	200	0.06				
4. Withdrawal of revenue from profits of the state-owned companies	500	0.15				
5. Increase of health contributions from 13% to 15%	1,600	0.48	800	0.2		
6. Reinvested profits			500	0.15		
7. Introduction of tax on savings interest			300	0.09		
8. Fees for telecommunication services	350	0.1				
9. Introduction of tax on real-estate					1,500	0.4
10. Increase of energy excises	350	0.1	130	0.04		
TOTAL REVENUE MEASURES	3,700	1.1	1,930	0.5	1,500	0.4
EXPENDITURE STRUCTURAL MEASURES						
1. Compensation of employees	108	0.03	230	0.07	101	0.03
2. Intermediate consumption	657	0.2	469	0.14	499	0.14
3. Subsidies	1,101	0.33	300	0.09	300	0.09
4. Social benefits and social transfers in kind	640	0.2	385	0.1	588	0.16
5. Other current transfers and capital transfers	466	0.14	300	0.09	460	0.14
6. Gross capital formation	335	0.1				
TOTAL EXPENDITURE MEASURES	3,307	1.0	1,684	0.5	1,947	0.6
EXTRABUDGETARY USERS	530	0.2	100	0.03		
TOTAL FISCAL ADJUSTMENT	7,537	2.3	3,714	1.0	3,447	1.0

Source: Ministry of Finance

In addition to the compulsory fiscal savings defined in the EU Council recommendations, recommendations were also adopted to improve the broader framework of public finances. As such,

Croatia is taking additional measures in the area of analysis of the structure of state budget expenditures and reducing expenses for salaries, social benefits and subsidies, in order to leave room for state investments and national participation in projects financed from EU funds. Activities to combat the grey economy and to increase efforts to combat tax evasion are ongoing. Finally, reforms of the framework for managing public finances continue. The main measures adopting the EU Council recommendations are shown in Box 1, and are described in detail in the Convergence Programme and National Reform Programme.

Box 1: EU Council recommendations for excessive deficit correction

I. Compulsory recommendations

Table 5: Council recommendations for excessive deficit correction

<i>% of GDP</i>	<i>2014</i>	<i>2015</i>	<i>2016</i>
<i>General government deficit</i>	<i>4.6</i>	<i>3.5</i>	<i>2.7</i>
<i>Structural deficit change</i>	<i>-0.5</i>	<i>-0.9</i>	<i>-0.7</i>
<i>Implementation of structural measures</i>	<i>2.3</i>	<i>1.0</i>	<i>1.0</i>

Source: Ministry of Finance

Table 6: Fiscal projections – Recommendations of the EU Council fully adopted and incorporated into the fiscal projections of the Republic of Croatia

<i>% of GDP</i>	<i>2014</i>	<i>2015</i>	<i>2016</i>
<i>General government deficit</i>	<i>4.4</i>	<i>3.5</i>	<i>2.7</i>
<i>Structural deficit change</i>	<i>0.3</i>	<i>-0.8</i>	<i>-1.2</i>
<i>Implementation of structural measures</i>	<i>2.3</i>	<i>1.0</i>	<i>1.0</i>
<i>One-off measures</i>	<i>0.8</i>	<i>0.6</i>	<i>-</i>

Source: Ministry of Finance

II. Additional recommendations – non-binding

- 1) Detailed analysis of expenditures aimed at rationalising salaries, social welfare and subsidies, for the purpose of creating fiscal space for expenditures that contribute to growth, including the co-financing of EU projects.***

Measures for fulfilling the recommendations:

- detailed analysis of budget expenditures is ongoing
- central salary calculations introduced which will include all employees in the civil and public sector
- measures for reducing and improving efficiency of social transfers
 - one-stop monetary centre – unification of all social benefits and limitations to maximum payment amounts
 - reforms to social contracting – uniform access to the social services network for all beneficiaries and service providers under the same conditions
 - uniform expert centre – standardisation of the manner of conducting expert analysis and determining health damages
- permanent abolishment of part of the state subsidies, in line with the adopted structural measures.

Box 1: EU Council recommendations for excessive deficit correction

2) Strengthening tax discipline and increasing efficiency

Measures for fulfilling the recommendations:

- reorganisation of the Tax Administration, aimed at improving efficiency and reducing tax evasion – formation of the Department for Large Taxpayers and Risk Assessment
- reorganisation of the Customs Administration, aimed at taking over and improving supervision tasks over illegal and unregistered trade, production and services provision
- continued implementation of fiscalisation of cash transactions
- introduction of the JOPPD (single form for the collection of data on paid receipts) for the purpose of attaining a complete overview of revenues and receipts of individuals
- analysis of all tax breaks is ongoing, for the purpose of deciding on their possible abolition.

3) Improvement of the institutional framework of public finances, including strengthening multi-annual budgetary planning, strengthening the role and independence of the Fiscal Policy Committee, and ensuring alignment with the fiscal rule

Measures for fulfilling the recommendations:

- implemented Council Directive 2011/85/EU
 - independent Fiscal Policy Committee established within the frame of the Croatian Parliament
 - national fiscal rules adapted to European rules
- amendments to the Budget Act and Act on Execution of the State Budget ongoing, so as to fully align the national budget calendar with the European calendar
- consultations are ongoing with the EC with respect to additional measures for full implementation of Council Directive 2011/85/EU
- continued improvement of fiscal statistics.

3.3.1. Structural measures in 2014

Revenue structural measures

Revenue structural measures include: amendments to taxation on gains from games of chance, changes in the contribution system for pension insurance based on the accelerated retirement scheme, increasing concession fees, withdrawal of revenues from profits of state-owned companies and agencies, institutes and other legal persons with public authority, increasing contributions for health insurance, increasing excises on fuels and electricity, and increasing revenues from telecommunication services.

Tax on gains from games of chance

The Government of Croatia has defined new tax brackets, with the assignment of higher tax rates to higher achieved gains. The following was determined: 1) 10% tax rate on gains from HRK 750 to 10,000; 2) 15% tax rate on gains from HRK 10,000 to 30,000; 3) 20% tax rate on gains from HRK

30,000 to 500,000; and 4) 30% tax rate on gains over HRK 500,000. The fiscal effect of these amendments to the taxation on gains from games of chance will total 0.09% GDP in 2014.

Changes in the system of contributions for pension insurance based on the accelerated retirement scheme

As of 1 April 2014, insurees whose rights are regulated by special regulations are enabled, if they desire, to transfer funds from their personal account from the 2nd into the 1st pension pillar, considering that the pensions for the said categories of insurees are calculated and paid out as though they are not included in the 2nd pension pillar. The fiscal effect of these measures totals 0.12% GDP, which is equal to the amount of increased payments into the 1st pension pillar. This should be increased by the one-time measures of transferring funds from the 2nd to the 1st pillar, which in 2014 were assessed in the amount of 0.8% GDP.

Concession fees

The Government of the Republic of Croatia will increase concession revenues by increasing fees or concession coefficients through amendments to sectoral laws and subordinate legislation. Better collection of concession debts, and amendments to concession coefficients will lead to an increase in revenues of 0.06% GDP. In the second quarter of 2014, the Government will pass a Conclusion that will ensure the implementation of these changes.

Withdrawal of revenues from profits of companies in state ownership and agencies, institutes and other legal persons with public authority

The Act on the Execution of the State Budget has introduced the obligation of sharing a portion of the profits of companies of strategic and special interest for the Republic of Croatia under majority or minority ownership of the Republic of Croatia, i.e. surplus revenues over expenditures of agencies, institutes and other legal persons with public authority of which the Republic of Croatia is a founder, and which do not have the status of budgetary users. The decision on payment of funds is made by the Government as a measure to reduce the excessive deficit. The fiscal effect of these measures is assessed at 0.15% GDP in 2014. The payment of profits pertains exclusively to profits achieved in the previous calendar year, and is not subject to the statistical treatment of superdividend.

Contributions for health insurance

As of 1 April 2014, the contributions for health insurance are increased from 13% to 15%. The fiscal effect of the changed rate in 2014 is 0.48% GDP.

Excises on fuels and electricity

With the proposed Regulation on amendments to the Regulation on the excise rates on motor petrol, gas oil and kerosene used as propellant, the tariffs were increased by 20 lipa/litre for leaded gasoline, unleaded gasoline and gas oil used as a propellant. The fiscal effect of the increase in these excises will be 0.1% GDP in 2014.

Fees for telecommunication services

It is expected that an ordinance will be passed and come into effect on 1 May 2014 that will increase the fees for the right to economic use of the spectrum values for the public mobile networks.

According to assessments based on available data, revenues of about 0.1% GDP are expected by the end of the year.

Expenditure structural measures

Expenditure structural measures include: intermediate consumption, compensation of employees, subsidies, social benefits, other current transfers, capital transfers and expenditures for gross capital formations.

Compensation of employees

As of 1 April 2014, the right to increased salaries on the basis of achieved years of service in the amount of 4%, 8% and 10% for employees in the civil and public services was revoked. Also, salaries were decreased by 6%, additions to salaries for military persons in the defence sector were decreased, as were additions for passive on-call duty in the justice system. The method of salary calculation was changed in the science sector. These measures have a structural fiscal impact in 2014 of 0.11% GDP. However, the increased rate of contributions for health insurance from 13% to 15%, with an effect of 0.08% GDP, resulted in a net structural fiscal savings in compensation of employees of 0.03% GDP.

Intermediate consumption

The structural reduction of intermediate consumption totalled 0.2% GDP, and pertains to savings that budgetary users will achieve in employee travel benefits (standardisation of rights for employee travel benefits in civil and public services, ensuing from the new Fundamental Collective Agreement), maintenance costs, intellectual and personal services (control of freelance contracts and the work of committees), overhead costs, information services and expenditures for materials, raw materials and services. During the year, procedures will be implemented to unite the public procurement of all budgetary users in individual procurement categories, as defined by the Decision of the Government of the Republic of Croatia on procurement categories. The Information system of the State Treasury will follow the dynamics of execution of these expenditures, which allows for commitment control in this cost category. This is addressed in greater detail in Chapter 5 - Quality of public finances.

Subsidies

The structural savings on subsidies in 2014 totalled 0.33% GDP. The greatest reduction pertains to the subsidies given to the Croatian Bank for Reconstruction and Development (HBOR) and for shipbuilding. The cost of subsidising interest rates by HBOR, as the difference between the interest rates approved by the commercial banks and the referential interest rate guaranteed by HBOR for exporters, was reduced, thus achieving savings of 0.09% GDP. Thus, the scope of subsidised loans will be significantly reduced in the forthcoming period, while for early approved loans, which are still in the payment stage, the total amount of necessary subsidies was reserved in the previous period. Subsidies to shipbuilding were reduced by 0.09% GDP, as shipyard owners were not able to fulfil their own contributions in the restructuring costs as defined by the restructuring plans, and therefore the amount of state contributions is smaller. At the end of the restructuring period, the ratio 60/40 must be retained in the total restructuring costs. The altered dynamics and amounts of state subsidies in restructuring will be the subject of additional contracts, in the form in which the contract was

concluded. Furthermore, subsidies to farmers were reduced by 0.04% GDP due to the smaller amount in subsidy applications in 2013, pursuant to which farmer subsidies are granted in 2014. As a result of the envisaged restructuring dynamics, subsidies to Croatian Railways were reduced in the amount of 0.04% GDP. The reduction of subsidies to entrepreneurship recorded an effect of 0.03% GDP as a consequence of the inability of many entrepreneurs to fulfil the prescribed legal obligation regarding the realisation of investment levels, i.e. the opening of a minimal number of jobs associated with investments. Other subsidies, which primarily pertain to stimulating production of biofuels, active labour market policy measures, manufacturing industry and reducing subsidies in science and education system, culture and tourism, were reduced by 0.04% GDP.

Social benefits and social transfers

In the structure of social benefits, whose structural savings total 0.2% GDP, the largest share falls on the health care system, and a smaller part on active labour market policy measures. In the health care system, savings of 0.19% GDP are planned, while significant reductions are expected on the costs of procurement of prescription medicines (0.09% GDP), better controls of sick leaves (0.03% GDP), and greater rationalisation of hospital operations (0.07% GDP). Savings in the amount of 0.01% GDP are expected in active labour market policy measures.

With regard to the procurement costs of prescription medicines, a public tender has been carried out to determine the new referential prices of medicines, based on which a new List of medicinal products has been in preparation since February 2014. During the year, public procurement will also be held for various categories of medicinal products. As of 1 September 2013, a new referral model is in effect, where doctors are given recommendations on prescribing the least expensive medicinal products. As of 1 April 2013, the manner of payments for primary health care doctors was changed, in which a part of earnings are paid based on efficiency, of which the prescription of medicinal products under the levels prescribed by the HZZO is an integral part, which also influences a reduction of medicine prescriptions. As part of the monitoring and payments of part of earnings for primary physicians based on quality, tools have also been introduced for the monitoring of chronic patients and implementing prevention measures, which account for more than 80% of all costs in the health care system.

During 2014, plans are in place to implement regular controls of sick leave, unscheduled large campaigns of controlling sick leave, and controlling hospitals, with the aim of determining whether physicians in hospitals are prescribing sick leaves, which is contrary to their rights, considering that sick leave is exclusively under the control of the primary health care physician. Furthermore, active inclusion of employers in resolving sick leave issues with a larger number of requests for unscheduled controls, and the introduction of half-day leaves, is underway.

The rationalisation of operations in hospital institutions includes the implementation of recovery programs, integrating information systems of health care systems, and a new model of contracting primarily health care. Implementing the recovery programme pertains to changes in the organisational structures of hospitals, reductions in the number of on-duty shifts, rationalisation of diagnostic procedures, increasing the activity of outpatient clinics, controls of recruitment and rationalising specialisation studies, and the development of new services based on market principles.

The new model of primary health care will increase the number of shared practices, and 250,000 patients fewer will be referred to hospitals. Furthermore, efficiency and quality indicators will be

improved, with the emphasis placed on prevention, managing chronic diseases and the association of physicians based on special skills, while additional services will be offered to patients.

Other current transfers and capital transfers

Measures were distributed within the other current and capital transfers, with a total structural reduction in the amount of 0.14% GDP in 2014. The Croatian development policy will be directed at continued reduction of national funds from the state budget and their replacement with resources from EU funds. As such, EU funds will be used to finance support measures in the food processing industry, and measures to develop competitiveness in the wood sector, active labour market policy measures and integral development of the local community. Funds for financing the reconstruction and maintenance of drainage and irrigation systems will be financed by Croatian waters instead of the state budget, pursuant to the Waters Management Plan from February 2014. Furthermore, with the cessation of the obligation to co-finance salaries of employees taken over in counties and cities, the aid is permanently reduced to those local communities that perform tasks of issuing documents concerning the implementing documents of spatial planning and construction, as defined in the new Physical Planning Act.¹³ These activities will be taken over from the state by local governments, and the total cost taken on by the same will be reduced as the procedure has been substantially simplified with the new Act. Permanent savings are also expected in expenditures for the guarantee fund for industry and innovation, and for the development of entrepreneurial infrastructure. Furthermore, reductions are expected in expenditures in the railways, due to the revision of initial cost assessments for the preparation of implementation of EU projects (i.e. land purchased, amendments to physical plans, administrative taxes) and a share of the costs have been directed to the financing from EU funds. In the science system, the participation of students in food costs was increased, and significant rationalisation of costs intended for student subsidised food costs was implemented. After the implemented changes, continued operations of the student centre were secured, without the generation of new losses and with lower entry costs. Other structural reductions pertain to reductions in maintenance and equipping cultural institutions and the protection of cultural monuments, savings on tourism promotion, housing care and projects in entrepreneurship.

Expenditures for gross capital investments

The structural savings in capital investments totalled 0.1% GDP. Lower expenditures are planned for the construction of border crossings due to public procurement and reduced prices following increased competition on the construction market. Furthermore, reductions are expected for projects in health care through the continued procedures of joint public procurement for multiple health care institutions, and reduced costs of replacing old equipment. Additional savings are expected in the justice system due to the redirection of financing by using EU funds for projects to build the information system of the judicial system, construction of additional penitentiary capacities, and to rebuild the judicial infrastructure. Furthermore, equal access to the financing of certain projects will be implemented in the science system.

¹³ Official Gazette, number 153/13

Extrabudgetary users

Structural reductions of the deficit of extrabudgetary users will total 0.2% GDP in 2014. Savings primarily pertain to Croatian Roads and Croatian Waters, and mostly regard investment activities.

3.3.2. Structural measures in 2015 and 2016

Revenue structural measures

Budgetary structural measures in 2015 include: a full-year fiscal effect of revenues from taxes on gains from games of chance, full-year fiscal effect of contributions for health insurance, full-year fiscal effect of excises on fuels and electricity, changes in the system of non-taxation of reinvested profits, and introduction of the tax on savings interest. The structural measure on the budgetary revenues side in 2016 is the introduction of the property tax.

Tax on gains from games of chance

With amendments to the taxation of gains from games of chance in 2014, an additional fiscal effect in 2015 of 0.06% GDP was achieved.

Contributions for health insurance

An additional fiscal effect of raising the rates of contributions for health insurance in 2015 will total about 0.2% GDP.

Excises on fuels and electricity

With an increase in excises on fuels and electricity in 2014, an additional fiscal effect of 0.04% GDP in 2015 will be achieved.

Changes in the system of non-taxation of reinvested profits

With the amendments of the Profit Tax Act¹⁴ the use of tax breaks on profit will be defined in a way that tax breaks may be used only for the share of the profits entered into the equity, and also reinvested in long-term assets. Considering the amendments to the Act in 2014, the effects of reduction of the use of these tax breaks would be reflected in 2015 in the amount of 0.15% GDP.

Tax on savings interest

The tax on savings interest will be introduced through amendments to the Income Tax Act, at a rate of 12%, with the exception of taxation of interest gained on housing savings. According to an assessment based on available data on the total savings of citizens in Croatian banks, with the application of a 12% rate (as the lowest rate of income tax), revenues of about 0.09% GDP are expected per year, beginning from 1 January 2015. In the analysis of the introduction of taxation of savings interest, particular attention will be paid to the monitoring of non-financial effects of introduction of this tax, in the form of citizens' behaviour towards financial institutions.

¹⁴ Official Gazette, number 148/13

Changes in the system of contributions for pension insurance based on the accelerated retirement scheme

In 2015, pension reforms will continue in the area of insurees on the accelerated retirement scheme, and their transfer from the 2nd to the 1st pension pillar. These measures are expected to bring a one-off effect of 0.6% GDP, with a structure effect of greater payments into the 1st pension pillar.

Property tax

In 2016, the introduction of a value tax on property is envisaged. This would be based on the principle of fairness, meaning that the value of the tax will depend on the value of the property. With its introduction, the existing contributions would be abolished, i.e. municipal fees and tax on vacation houses, which are the revenue of the local and regional self-government units. With that, the revenue from the property tax would in full belong to the local units, which would be used to finance the expenditures of health care directed to the local hospitals, and which are currently financed from the state budget. The fiscal effect of the said structural measure is assessed at about 0.4% GDP.

Expenditure structural measures

Compensation of employees

The termination of additions for loyalty to service, the termination of additions in the defence and judicial systems, change of the calculation of additions to the basic salary in the science system, and reduction of the salaries of officials in 2014 will have a further fiscal effect in 2015 of 0.08% GDP. The increase of the rate of contributions for health insurance from 13% to 15% will have an effect in the first four months of 2015 of 0.02% GDP. Further savings on expenditures for employees in the amount of 0.01% GDP in 2015 will be ensured by restructuring of the schools network and programmes as a long-term measure from the Project plan of reforms, whereby the total structural savings on expenditures for employees is 0.07% GDP. Restructuring schools and programmes that will begin in 2015 will have an additional fiscal effect in 2016 of 0.03% GDP.

Intermediate consumption

In 2015, the structural savings on intermediate consumption will total 0.14% GDP. A higher share of these measures pertains to unified public procurement for four procurement categories (fixed and mobile telephone services, fuel and electricity) in the total amount of 0.1% GDP, the integration of auxiliary services in the amount of 0.02% GDP and the reorganisation of the justice system in the amount of 0.02% GDP. The integration of auxiliary services includes the unification of accounting services and IT support performed by bodies of state and public administrations, i.e. the separation and transfer of those services to a company for which this is the core activity. The reorganisation of the justice system implies the territorial and organisational reorganisation of the judiciary, and reorganisation of court and prosecutors' networks. The continuation of implementation of these measures in 2016 will bring additional savings of 0.14% GDP. Through the measure of unification of public procurement, an effect of 0.11% GDP is expected, while the integration of auxiliary services will have an effect of 0.02% GDP and reorganisation of the justice system of 0.01% GDP.

Expenditures for subsidies

In 2015, the structural savings on subsidies will total 0.09% GDP, and pertain to the reduction of national funds for direct payments in agriculture. The proposed reduction of the national components of direct payments in agriculture and their substitution with EU funds for 2016 will result in an effect of 0.09% GDP.

Social benefits and social transfers

In 2015, the structural reduction of this category of expenditures will amount to about 0.1% GDP. The highest share pertains to savings in the science system of 0.06% GDP as the result of redistribution of own earnings of institutions in the science system for financing own costs. Furthermore, it is necessary to note the effect of the establishment of the one-stop monetary centre for four social benefits and unemployment benefits, child benefits, maternity benefits and the guaranteed minimum benefit, in the amount of 0.02% GDP. Furthermore, the reform of social contracting that will set out to restructure and redefine the network of social services, the manner of contracting social welfare services, and the manner of their financing, will achieve savings in the amount of 0.03% GDP. In 2016, the structural fiscal effect of social benefits and social transfers is assessed at 0.16% GDP, of which the highest savings of 0.11% GDP are expected from the Master plan of the hospital system. In this year, additional fiscal effects are also expected from the establishment of the one-stop monetary centre, in the amount of 0.04% GDP and reforms of social contracting in the amount of 0.01% GDP.

Other current transfers and capital transfers

Structural savings in the category of these expenditures in 2015 are envisaged in the amount of 0.09% GDP, of which the majority of savings pertain to the science system due to the redistribution of own revenues to financing these categories of expenditures. In 2016, the structural fiscal effect will total 0.14% GDP. One of the savings measures pertains to the termination of incentives for housing savings and voluntary pension funds, with an effect of 0.05% GDP. The legal amendments for the proposed measures will be adopted in 2015, with entry into force on 1 January 2016. An additional effect of 0.09% GDP is expected to be achieved with continued implementation of unified public procurement.

Extrabudgetary users

Structural reductions of the deficit of extrabudgetary users in 2015 total 0.03% GDP.

3.4. General government budget in 2014

Revenues of consolidated general government

Pursuant to the forecast macroeconomic indicators and described structural measures on the budgetary revenue side, in 2014, the total budget revenues of the consolidated general government

are planned at the level of 43% GDP. The most significant budget revenues are comprised of revenues from the value-added tax, which is planned at the level of 12.7% GDP. The trends of these revenues is under the influence of the expected negative trends of personal consumption and the legal amendments that entered into effect on 1 January 2014 which raised the reduced VAT rate from 10% to 13%. The fiscal effect of raising the VAT mid-rate is 0.2% GDP. The span between the general and reduced VAT rate in Croatia was larger than the span in other Member States, and therefore this measure also approaches the practice of other EU Member States. Furthermore, in 2014, there will be a full-year effect of the application of fiscalisation which was gradually introduced in 2013 in three phases, with the aim of preventing fiscal non-discipline in cash transactions. Revenues from customs and duties, which since 1 July 2013 have been declining due to the abolishment of customs and duties on imports from EU countries, are projected at 0.1% GDP.

In the category of tax on products, in addition to the VAT and customs, the expected revenues from taxes on gains from games of chance are also included, which are defined by new tax rates and new tax brackets. Revenues from special taxes and excises will total 3.7% GDP. Namely, the changes in the excise system primarily relate to changes in the excise taxes on tobacco and excise taxes on fuels. At the beginning of the year, excise adjustments were made for tobacco products in line with the commitments taken on by the Republic of Croatia to achieve full alignment with the EU *acquis communautaire* during the approved transition period. The fiscal effect of these measures was 0.1% GDP. Furthermore, as part of the additional structural measures, excises on fuels were also increased, which was previously outlined in the structural measures on the revenue side of the budget.

In the structure of total revenues, it is necessary to mention property income that totalled 0.5% GDP in 2014. Namely, property income, with permanent revenues, includes increases on the basis of ownership that the Republic of Croatia has in certain companies, and which is assessed at a level of about 0.2% GDP.

The assessed revenues of personal income tax will be 3.8% GDP, while revenues from corporate income tax are expected in the amount of 1.7% GDP in 2014.

The second most significant group of revenues for the general government budget are social contributions, which are planned at the level of 12.9% GDP. Their dynamics are determined by movements on the labour market, and in the legal amendments carried out in 2014, aimed at reducing the structural deficit. In addition to increasing the rate of contributions for health insurance from 13% to 15%, changes are also envisaged in the system of contributions for pension insurance, i.e. for insurees on the accelerated retirement scheme. Namely, with the amendments of the Act on Compulsory and Voluntary Pension Funds¹⁵ from 2003, it is prescribed that members of the compulsory pension fund achieving pensions according to more favourable conditions or achieving retirement based on the accelerated scheme, the pension is calculated as though they were insured only in the 1st pension pillar. Therefore, upon entering into retirement, the funds from the person account are transferred into the state budget and the insuree obtains the pension in the 1st pillar. From the above, it is clear that there is no valid reason for which these persons would continue to be insured under the 2nd pillar. For these insurees, the system of pension calculation is not changed, only the future payments that will be paid out fully from the state budget are changed, while the

¹⁵ Official Gazette, number 103/03

accumulated funds in the 2nd pillar will be transferred into the state budget during 2014 and 2015. Here it is necessary to stress that with these changes, the state has not taken on any new financial obligations. In the future, the contributions for the 2nd pillar for these insureds (5% + additional contribution for the accelerated scheme) will be paid only into the 1st pillar. Pursuant to this, in 2014, an increase in the regular payment of contributions for pension payment is expected in the amount of about 0.1% GDP, which was also previously outlined in the section on structural measures. The transfer of funds of accumulated savings for persons on the accelerated retirement scheme from the 2nd to the 1st pillar is planned in the amount of 0.8% GDP in 2014, and in the amount 0.6% GDP in 2015.

The category of other current transfers and capital transfers planned at the level of 1.8% GDP includes revenues from the assistance of EU institutions and bodies which are directly tied to projects financed from the EU pre-accession and accession funds, construction of Schengen facilities, and direct payments in agriculture.

Expenditures of consolidated general government

Compensation of employees in the public and civil services are planned at the level of 10.8% GDP in 2014. The planned amount of these expenditures was largely determined by the effects of structural measures, i.e. the termination of additional payments for loyal service, reduction of salaries of state officials by 6%, termination or amendment of individual additional payments in the defence, judicial and science systems, and increasing the rate of contributions for compulsory health care insurance from 13% to 15%. In 2014, there is no planned payment of reimbursements and Christmas bonuses for employees in the public and civil services, which is regulated by the annex to the Collective Agreement of December 2013. Furthermore, continued restrictions of new employment are in effect, i.e. recruitment is only permitted to work posts that have been emptied, with the application of the 2 for 1 clause, meaning that it is possible to employ one new employee only upon the termination of labour relations by two employees. Further implementation of the Central Salary Calculation (CSC) system is ongoing, and its completion is envisaged in the final quarter of 2014. This system will enable better control of payments of salaries, and a new method of reporting on paid salaries from the state budget.

Expenditures for intermediate consumption, which mostly include structural savings on compensations for employee travel, overhead costs, information system services, intellectual and personal services and expenditures for materials, raw materials and other services, are recorded at a level of 5.9% GDP. Furthermore, these include other reductions that are not directly tied to structural, i.e. permanent measures, but to reductions ensuing from a change in the dynamics and scope of implementation of certain activities.

Expenditures for subsidies are planned at the level of 2% GDP, in which the largest share of structural savings is in the sectors of agriculture, shipbuilding, railways, HBOR, entrepreneurship and recruitment.

Expenditure for property income records a share of 3.5% GDP. This category of expenditures is mostly determined by the movements of expenditures for interest rates in line with the financing needs envisaged in 2014.

Social benefits and social transfers account for the most significant category of total general government budget expenditures, at a level of 18.2% GDP. The movements of these expenditures are mostly determined by movements of expenditures for pensions, expenditures for health care, maternity benefits, social welfare benefits, child benefits and unemployment benefits. In 2014, expenditures for pensions were planned at the level of 10.9% GDP, which is largely determined by the trends in numbers of pensioners and the new manner of aligning pensions according to the adjustable model, as described in detail in Chapter 5 – Quality of public finances. Expenditures for health care, which include the recovery of liabilities of county health care institutions and other unrecovered obligations of state health care institutions from previous years and recovery of matured liabilities of health care institutions arising in 2013 recorded a level of 4.1% GDP. However, structural savings in this system are planned at the level of 0.2% GDP through the previously mentioned savings on procurement of prescription medications, better controls of sick leaves and greater rationalisation of hospital operations. Maternity benefits are planned at the level of 0.6% GDP, social welfare benefits that include the guaranteed minimal benefit in the level of 0.6% GDP, child benefit at the level of 0.5% GDP and unemployment benefits in the amount of 0.5% GDP.

Other current transfers and capital transfers are planned at the level of 4.3% GDP in 2014, in which structural savings on projects in agriculture, regional development, entrepreneurship, railways, science, culture, tourism and active labour market policy measures account for about 0.1% GDP. Furthermore, through this category of expenditures activities to finance projects from EU pre-accession and accession funds are carried out. Also, these expenditures are largely determined by the payments of own contributions of the Republic of Croatia into the EU budget, which amounts to 1.1% GDP.

The expenditures for gross capital formation are planned at the level of 2.3% GDP, in which structural savings total 0.1% GDP. The largest part is determined by activities tied to capital investments of all general government budget units, particularly in water, road and rail transport.

Net lending/borrowing

The planned fiscal consolidation will result in a reduction of the consolidated general government budget deficit from 5.4% GDP in 2013 to 4.2% GDP in 2014, considered according to the ESA 95 methodology and based on the budget scope. This budgetary deficit, like the public debt, differs from the amount included in the Fiscal report published by Eurostat in April 2014, as it includes additional measures of fiscal consolidation adopted after the completion of the Fiscal report. Therefore, the state budget deficit will total 3.8% GDP, extrabudgetary users 0.4% GDP and the budget of 576 local and regional self-government units will be balanced. When the general government budget is viewed based on the statistical scope¹⁶, the deficit in 2014 totals 4.4% GDP.

¹⁶ For the full statistical scope, it is necessary to exclude certain units that are included in the budgetary scope but not in the scope by the ESA methodology (e.g. State Agency for Deposit Insurance and Banks Rehabilitation), and to add data of units that are in the scope by the ESA methodology, but are not in the budget scope (such as Croatian Radio-Television and Croatian Railways).

3.5. Mid-term budgetary framework (2015–2017)

Revenues of consolidated general government

In the period 2015–2017, the revenues of the general government budget will be determined by the gradual recovery of economic activity and fiscal effects of the previously described structural measures. As such, it will record a level of 42.5% GDP in 2015, 42.6% in 2016 and 43.1% in 2017.

Revenues from the value-added tax, which follow the expected recovery of personal spending in the forthcoming years, will move at the average level of 12.4% GDP. Taxes and duties on imports excluding VAT will stay at the same level of 0.1% GDP in the observed period. Taxes on products, except VAT and import taxes, mostly include special taxes and excises and revenues from taxes on gains from games of chance, which will achieve an average share of 3.5% GDP and 0.1% GDP respectively. Property income will gradually reduce their share in the gross domestic product of 0.4% in 2015 to 0.2% in 2017. Furthermore, the revenues from personal income tax in the mid-term period will record an average level of 3.8% GDP, and revenues from corporate income tax, with included changes in the system of non-taxation of reinvested profits, will be at a level of 1.8% GDP. Increasing the rate of contributions for health insurance and the shift of contributions for the pension insurance for persons in the accelerated retirement scheme from the 2nd to 1st pension pillar in 2014 will also influence the projection of social contributions in 2015. With that, their share in the forthcoming years will decreased from 12.6% GDP in 2015 to 11.9% GDP in 2016 and 2017. Other current transfers and capital transfers follow the projects of revenues from grants, which are primarily tied to the financing of projects from EU funds. They are forecast at a level of 1.9% GDP in 2015, 2.8% GDP in 2016 and 3.5% GDP in 2017.

Expenditures of consolidated general government

In 2015, the expenditures of the general government budget are projected at a level of 45.7% GDP, 45% GDP in 2016 and 45.2% GDP in 2017.

Compensations of employees, with their share of 23% in total expenditures, form the second largest group of expenditures of the general government budget, which are primarily determined by the movements in the number of public and civil servants. In 2015, they are envisaged at a level of 10.5% GDP, and in the following two years will be reduced by 0.4 percentage points to a level of 10% in 2017. The projections of these expenditures, with the exception of structural measures planned in 2015 and 2016, also include the increase in the basic work salary while there is no plan to pay out material benefits such as Christmas bonuses and reimbursements in 2014. In the following two years, the Excessive Deficit Procedure envisages further restrictions of employment in state and public services. Expenditures for intermediate consumption record a reduced share in the value of the gross domestic product from 5.8% in 2015 to 5.6% in 2017. In addition to the effects of the unified public procurement, the integration of auxiliary services and reorganisation of the justice system, the further continuation of the application of rationalisation measures and savings on all line items is assumed. Expenditures for subsidies will move at the average level of 1.8% GDP, while in the following two years, continued reductions are envisaged in the agriculture sector, while in other sectors, subsidies are expected at the level projected for 2014. The expenditures for property

income, which are mostly determined by movements of expenditures for interest rates in line with costs of servicing the public debt, will record an average level of 3.7% GDP in the following mid-term period. Social benefits and social transfers account for the most significant category of total expenditures, with a share of 37%. To the end of 2017, a continued reduction of its share to a level of 16% GDP is expected. In addition to the previously described structural measures, further alignment of pensions with the costs of living are expected, as are further implementation of reforms to the health care system. In 2016, with the introduction of the property tax, the transfer of the financial part of costs of local hospitals to the local and regional self-government units is expected. Other current transfers and capital transfers will increase their share in the value of the gross domestic product by 1.1 percentage points, i.e. from 4.6% in 2015 to 5.8% in 2017. Such trends are the result of payments into the EU budget and the financing of planned projects from EU funds. Expenditures for gross capital formation of all general government budget units will move at an average level of 2.2% GDP in the observed mid-term period.

Table 7: Most important categories of revenue and expenditure of the general government in the period 2013–2017

ESA 95	% of GDP	2013	Projection 2014	Projection 2015	Projection 2016	Projection 2017
TR	Total revenue	40.7	43.0	42.5	42.6	43.1
	<i>Main components of total revenue:</i>					
P.11+P.12	Market output and output for own final use	3.8	3.8	3.7	3.6	3.6
D.211	Value-added tax	12.3	12.7	12.5	12.3	12.3
D.212	Taxes and duties on imports excluding VAT	0.4	0.1	0.1	0.1	0.1
D.214	Taxes on products, except VAT and import taxes	4.5	4.8	4.7	4.6	4.5
D.214a	- of which : excises	3.6	3.7	3.6	3.5	3.4
D.4R	Property income, receivable	0.3	0.5	0.4	0.2	0.2
D.5R	Current taxes on income, wealth etc., receivable	6.2	5.8	5.9	5.9	5.9
D.51A	- of which : personal income tax	4.0	3.8	3.9	3.8	3.8
D.51B	corporate income tax	1.9	1.7	1.8	1.8	1.8
D.61R	Social contributions, receivable	11.6	12.9	12.6	11.9	11.9
D.7R	Other current transfers, receivable	0.7	1.2	1.4	1.8	2.4
D.9R	Capital transfers, receivable	0.3	0.5	0.6	1.0	1.1
TE	Total expenditure	46.0	47.2	45.7	45.0	45.2
	<i>Main components of total expenditure:</i>					
D.1P	Compensation of employees	11.0	10.8	10.5	10.2	10.0
P.2	Intermediate consumption	5.8	5.9	5.8	5.6	5.6
D.3P	Subsidies, payable	2.1	2.0	1.8	1.7	1.8
D.4P	Property income, payable	3.0	3.5	3.7	3.8	3.7
D.62P	Social benefits other than social transfers in kind, payable	14.4	14.1	13.8	13.3	13.0
D.631	Social transfers in kind	4.2	4.2	3.2	3.0	3.0
D.7P	Other current transfers, payable	2.2	2.6	2.5	2.5	2.5
D.9P	Capital transfers, payable	1.4	1.7	2.2	2.8	3.3
P.5	Gross capital formation	2.0	2.3	2.3	2.1	2.3
B.9	Net lending/net borrowing	-5.4	-4.2	-3.2	-2.4	-2.2
EDP B.9	Net lending/net borrowing	-4.9	-4.4	-3.5	-2.7	-2.5

Source: Ministry of Finance

Net lending/borrowing

In line with the projected movements of revenues and expenditures of the general government budget according to the budget scope, a deficit of 3.2% GDP is expected in 2015, 2.4% GDP in 2016 and 2.2% GDP in 2017. The greatest contribution to the total deficit will come from the budgetary central government, which in 2015 will record a deficit of 2.8% GDP, then 2.1% GDP in 2016 and 1.9% GDP in 2017. The deficit of extrabudgetary users will move from 0.3% GDP in 2015 to 0.2% GDP in 2017. Local and regional self-government units will record a balanced budget in the period 2015–

2017. According to the statistical scope, the budget deficit of the consolidated general government will reduce its share in the value of the gross domestic product from 3.5% in 2015 to 2.7% in 2016 and 2.5% in 2017.

Table 8: Net lending/borrowing by government levels in the period 2013-2017

ESA 95	% of GDP	2013	Projection 2014	Projection 2015	Projection 2016	Projection 2017
Budgetary central government - unconsolidated						
TR	Total revenue	33.1	35.4	35.1	34.5	35.2
TE	Total expenditure	38.1	39.2	37.9	36.6	37.2
B.9	Net lending/net borrowing	-5.0	-3.8	-2.8	-2.1	-1.9
Extrabudgetary users - unconsolidated						
TR	Total revenue	1.6	1.9	2.0	2.3	2.1
TE	Total expenditure	2.1	2.3	2.3	2.6	2.4
B.9	Net lending/net borrowing	-0.5	-0.4	-0.3	-0.3	-0.2
Local government - unconsolidated						
TR	Total revenue	7.3	7.1	7.0	7.4	7.3
TE	Total expenditure	7.1	7.1	7.0	7.4	7.3
B.9	Net lending/net borrowing	0.2	0.0	0.0	0.0	0.0
Consolidated general government						
TR	Total revenue	40.7	43.0	42.5	42.6	43.1
TE	Total expenditure	46.0	47.2	45.7	45.0	45.2
B.9	Net lending/net borrowing	-5.4	-4.2	-3.2	-2.4	-2.2
EDP B.9	Net lending/net borrowing	-4.9	-4.4	-3.5	-2.7	-2.5

Source: Ministry of Finance

3.6. Assessment of cyclically adjusted budgetary balance

The calculation of the potential GDP is based on the production function methodology used by the EC.¹⁷ This calculation indicates the presence of a negative output gap in the entire projection period. It is expected that the slight reduction in the potential GDP in 2014 will mostly be due to the labour component, while the capital component and the total factor productivity will work in the opposite direction. In the continuation of the projection period, a growth of the potential gross domestic product is expected, with the greatest contribution coming from the capital component, and to a somewhat lesser degree from the total factor productivity. It is expected that the labour component will generate a negative contribution to growth until 2016, and a slightly positive contribution in 2017 and 2018.

¹⁷ In order to obtain the potential GDP, the Cobb-Douglas production function is applied, in which the natural unemployment rate and TFP are obtained using the GAP program. Derogations from the EC methodology are the assumption of a constant share of investments in the potential GDP in the mid-term period, instead of using an auto-regressive model that results in a more expressed increase of that share in comparison to the assessments of the Ministry of Finance. An additional derogation is the use of own projections of the participation rates in the entire projection period, considering that the forecasting mid-term movements of the series with auto-regressive models resulted in an overly pronounced reduction of the rate which is not in line with the expected effect of the legal measures, which stimulate the longest possible stay in the labour market, and considering the shortness and the form of the series which proved to be inadequate for the modelling with an auto-regressive model.

The calculation of the cyclically adjusted balance is based on the EC methodology and calculations for EU Member States. The cyclically sensitive components on the revenue side of the observed period are the personal income tax, corporate profit tax, indirect taxes, contributions for social insurance and non-taxable contributions, and on the expenditure side, the compensation of employees. These calculations indicate that the cyclically adjusted budgetary deficit, corrected for one-time measures, i.e. the structural deficit, will be at the level of 4.1% GDP in 2014, which is 0.3 percentage points higher than the structural deficit in 2013. Namely, the budget deficit of the general government in 2013 according to the calculations of the Central Bureau of Statistics, was recorded at the level of 4.9% GDP, which indicates a significant fiscal correction already implemented in 2013. In 2015 and 2016, the structural deficit is projected at a level of 3.3% GDP and 2.1% GDP, whereby a significant structural adjustment of 1.9 percentage points GDP will be achieved in two years time.

3.7. Standing and projection of trends of the public debt and standing of guarantees

Standing of public debt and guarantees

The high budget deficits caused by the long-term recession, together with restructuring and the takeover of debt in a series of sectors such as shipbuilding, railways, airline carriers and health care, have led to a strong increase in the public debt in the preceding period. Despite the recorded consolidation of public finances and reduced general government budget deficit in 2012, following the significant need for financing and continued high budget deficit and restructuring costs, the public debt surpassed the level of 60% GDP in 2013.

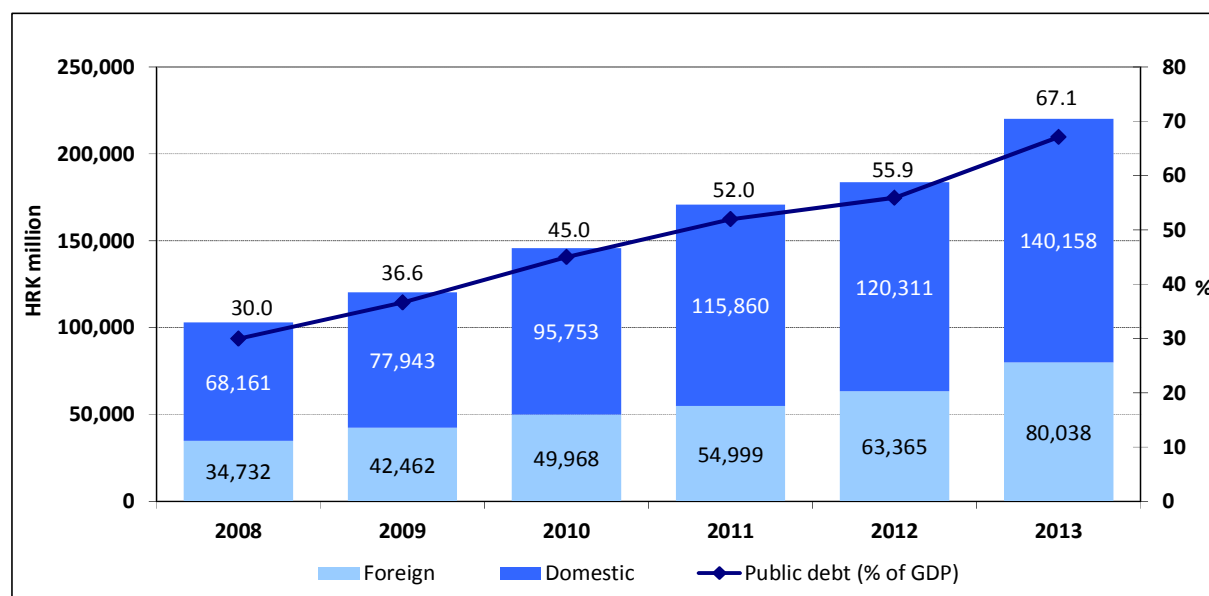
At the end of 2013, according to the Fiscal Notification Report from April 2014, in line with the ESA 95 methodology and the Eurostat Manual on Government Deficit and Debt, the public debt totalled HRK 220.2 billion or 67.1% GDP, which represents an annual increase of HRK 36.5 billion, or an increase of 11.2 percentage points of gross domestic product. A significant amount of funds acquired by borrowing in 2013 (primarily funds from bonds issued on the American capital market in the amount of USD 1.75 billion in November 2013) was pledged as a deposit for financing needs in 2014. The foreign component of the public debt was increased in comparison to 2012 by HRK 16.7 billion, while the domestic component of the public debt in the same period recorded an increase of HRK 19.8 billion.

When viewed by the level of government, the majority of the public debt falls on the central government, in the amount of HRK 215.6 billion, the debt of local and regional self-government units amounts to HRK 4.6 billion, while only an insignificant portion of HRK 900 thousand pertains to social security funds. According to the ESA 95 methodology, social security funds include the Croatian Pension Insurance Fund (HZMO), Croatian Health Insurance Fund (HZZO) and Croatian Employment Bureau (HZZ). Furthermore, Croatian Radio-Television (HRT) and Croatian Railways – Infrastructure have been transferred from the subsector of public non-financial companies into the subsector of the central government.

The central government primarily borrowed on the domestic market, with the domestic component of its debt recording a share of 62.9%. For local government 97% of the total debt falls on the domestic component, while the overall debt of social security funds falls on domestic debt.

Viewed in terms of borrowing instruments, the largest share of the public debt was generated by borrowing in long-term securities (60.2%), then borrowing via loans (29.1%) and short-term securities (10.7%).

Figure 2: Movements and structure of the public debt



Source: CNB, CBS

The currency structure of the government debts shows that a significant part of the debt is denominated in foreign currency, in which the debt in euro accounts for 69%, the debt in dollars for 5%, and debt in kuna for 26% of the total debt. The debt denominated in euro has been gradually increasing in recent years, and is largely the result of the issuance of domestic and foreign bonds denominated in euro, borrowing on the domestic market via syndicated loans, and use of project loans of international financial institutions.

In terms of the interest structure of the foreign debt, the share of debt with a fixed interest rate is 84%, primarily due to borrowing via the issuance of bonds, while 16% pertains to debt with a variable interest rate, from borrowing via loans.

The total issued guarantees of the Republic of Croatia, including guarantees granted to HBOR, amounted to HRK 53.7 billion, or 16.4% GDP, which is HRK 636.1 million less than at the end of 2012. The majority are foreign guarantees, accounting for 61.8% of the total issued guarantees of the Republic of Croatia. At the end of 2013, the total issued guarantees of HBOR totalled HRK 16.7 billion or 5.1% GDP, with 69.3% as foreign guarantees.

The Act on Execution of the State Budget of the Republic of Croatia for 2014¹⁸ established that the annual value of new financial guarantees for 2014 was HRK 5 billion, of which HRK 3 billion pertain to extrabudgetary users of the state budget.

¹⁸ Official Gazette, number 152/13

Financing the general government budget and projected trends of the public debt

The manner of financing budgetary needs in the forthcoming period will depend on the circumstances on the financial market. Particular attention will be directed at extending the average maturity period, reducing the share of short-term debt in the total amount of debt, introducing measures to protect against foreign currency risks, and the development of a yield curve on the domestic and foreign markets.

The total level of necessary financing in the forthcoming mid-term period will be determined by the trends of the fiscal deficit, financial assets and budgetary liabilities of the general government that mature in the observed period. The need for financing the total budget deficit and matured liabilities will be met on the domestic and foreign financial markets, while in the sense of debt mechanisms, in the observed period, this will be directed towards instruments with longer maturity periods, primarily bonds. Borrowing by loans will primarily be focused on the domestic financial market, while foreign financing loans will pertain to project loans of international financial institutions. The financing plan for 2014 includes the transfer of funds (pre-financing) in the amount of HRK 6.2 billion to cover part of the liabilities in 2015.

On the side of financial assets in the period 2014–2017, receipts are expected from privatisation in the average amount of 0.5% GDP per year.

The majority of maturing liabilities in the period 2014–2017 pertain to nine maturing bonds, of which six are domestic and three are foreign. Of the domestic bonds, two are denominated in euro, the first in the amount of EUR 650 million, and the second in the amount of EUR 350 million, while four bonds were denominated in kuna in the total amount of HRK 18.5 billion. Foreign matured liabilities pertain to two eurobonds, the first in the amount of EUR 500 million, which matures in 2014, and the second in the amount of EUR 750 million which matures in 2015. In 2017, a eurobond in the amount of USD 1.5 billion will mature, which was converted to euro at the time of issuance. On the side of loans, the largest maturing obligation in the observed period refers to the maturity of syndicated loans issued on the domestic financial market.

Table 9: Overview of the bonds of the Republic of Croatia maturing in the period 2014–2017

Bond	Date of issue	Amount (in million)	Interest rate	Date of maturity
DOMESTIC BONDS				
Series 05 D-14	10.2.2004	EUR 650	5.50%	10.2.2014
Series 09 D-15	14.7.2005	EUR 350	4.25%	14.7.2015
Series 10 D-15	15.15.2005	HRK 5,500	5.25%	15.12.2015
Series 16 D-16	22.7.2011	HRK 3,500	5.75%	22.7.2016
Series 15 D-17	8.2.2007	HRK 5,500	4.75%	8.2.2017
Series 12 D-17	25.11.2010	HRK 4,000	6.25%	25.11.2017
FOREIGN BONDS				
Euro - EUR VI 2014	15.4.2004	EUR 500	5.00%	15.4.2014
Euro - EUR VII 2015	5.6.2009	EUR 750	6.50%	5.1.2015
Euro - USD IV	27.4.2012	USD 1,500	6.25%	27.4.2017

Source: Ministry of Finance

Pursuant to the planned budget deficit of the consolidated general government, i.e. the financing needs for 2014, and the fact that the state plans to transfer a portion of funds in the amount of HRK

6.2 billion or almost 2% GDP to cover part of liabilities in 2015, it is expected that the public debt at the end of the year will amount to HRK 237.7 billion or 71.7% GDP.

The projected trends of the public debt show that, following the implementation measures of fiscal consolidation in the framework of the Excessive Deficit Procedure, the trend of public debt growth will stabilise to the level of 71.2% GDP in the period 2016–2017, after which its share in the gross domestic product is expected to decline.

Table 10: Projection of public debt developments in the period 2012-2017

% of GDP	2012	2013	2014*	2015*	2016*	2017*
Public debt	55.9	67.1	71.7	71.0	71.2	71.2
Foreign	19.3	24.4	27.3	26.9	28.1	27.7
Domestic	36.6	42.7	44.4	44.1	43.1	43.5

** Projection*

Source: CBS, CNB, MF

4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMME

4.1. Fiscal risks

The intensity and long-term negative economic trends since 2009 have resulted in a strong deterioration of all fiscal indicators. Therefore, the most significant risk for achieving the expected directions and results of fiscal policy are the achievement of trends of macroeconomic variables. Fiscal risks associated with lower economic activity have proven to be one of the most important sources of potential barriers to the baseline fiscal projections, while conditions in which lower economic growth would be retained over a longer time period would have multiplicative negative impacts on the movements of fiscal indicators in the forthcoming period. Changes in the movements of revenues and expenditures have a direct influence on the general government budget deficit, and ultimately on the standing of the public debt.

In the forthcoming mid-term period, a reduction is expected in the share of the level of expenditures in the value of the gross domestic product, on which a great influence will have the dynamics of implementation of structural reforms envisaged under the National Reform Programme. Slower implementation of planned key structural reforms directed at fiscal sustainability in the mid-term could lead to an expansion of fiscal imbalances, and threaten the path of fiscal adjustments envisaged in the Excessive Deficit Procedure.

Public enterprises are a potentially great risk for public finances. The lack of, or slow implementation of the process of restructuring the problematic state enterprises could have a negative impact on fiscal aggregates or the budget deficit and the public debt, due to the takeover of potential liabilities and future expenditures in the form of subsidies and capitalisation costs.

In observing possible additional negative effects on the public debt movements in the forthcoming period, the risk of significant changes in the domestic exchange rate should be pointed out, since more than 70% of the total public debt is denominated in foreign currency. Furthermore, the increase of financing costs due to a deterioration of conditions on the financial market and reduction of availability of capital would lead to an increase in the burden of payoff of debt and payment of interest, thereby presenting a greater pressure on the current state operations.

In the case of materialisation of negative risks, it will be necessary to adopt additional measures of financial consolidation, so as to achieve the set correction of the excessive deficit.

4.2. Sensitivity analysis of net lending/borrowing movements

The movements of the general government budget deficit are under the influence of positive and negative risks. In the conditions in which strict controls were introduced over the execution of expenditure limits for budget users, the highest fiscal risks are found on the side of achieving budgetary revenues. Therefore, the analysis is shown of the influence of the realisation of macroeconomic negative risk of reduced personal spending and negative trends on the labour market on the main revenues categories.

Considering that revenues significantly reacted in crisis conditions, and particularly revenues from taxes which are tied to personal consumption, in the first test, the influence of a lower growth of nominal personal consumption than planned on the movements of the value-added tax was observed. In the second test, it was observed how the negative trends on the labour market influence personal income tax and social insurance contributions. These sensitivity tests assume an unchanged expenditure side of the budget, though the occurrence of changes in certain components of the observed revenues would, to a certain extent, lead to changes in government spending.

In the first test of the influence of materialisation of macroeconomic risk on the VAT, a growth of nominal personal spending of 5% less than that planned in 2014 is assumed, i.e. only half the growth than that assumed in line with the basic projection for 2015. The results indicate that in this scenario, the fiscal deficit would worsen by 0.6 percentage points in 2014 and 0.7 percentage points in the following mid-term period.

In the second test, the determinant of movements of revenues from the personal income tax and social insurance contributions in the mid-term period changed in a manner that would cause a deterioration of the nominal annual growth rate. With this, the year-on-year growth rate was reduced by 2.5% in 2014 and 1% in 2015. The results of these assumptions indicate a deterioration of the level of the fiscal deficit by 0.4 percentage points in 2014, and by 0.5 percentage points in the remainder of the mid-term period.

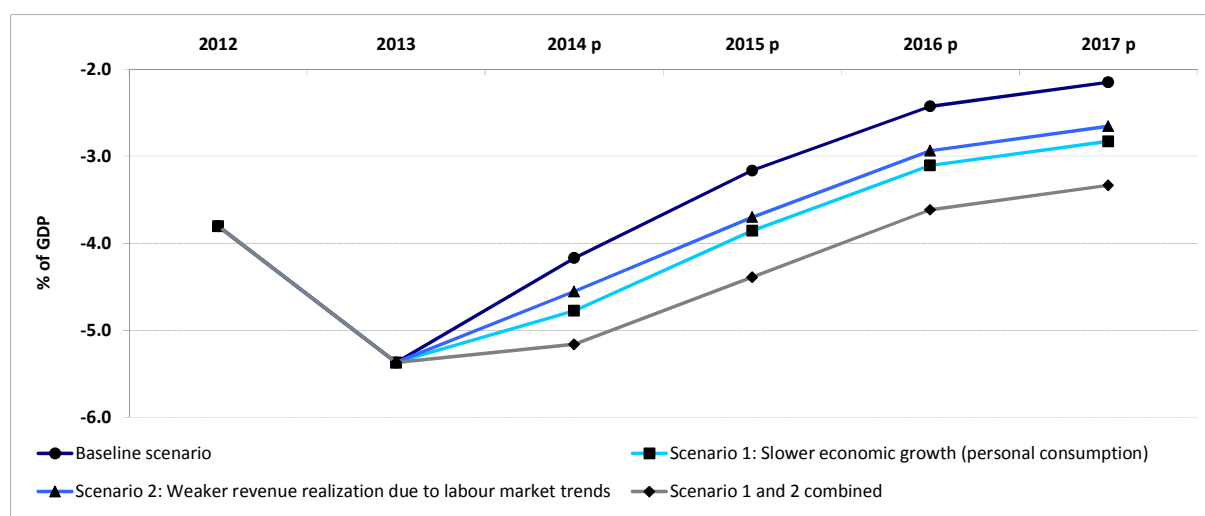
A third scenario was also created, which assumes the simultaneous occurrence of the above described deteriorations – in personal consumption and employment on the realisation of observed revenues. Under such conditions, the fiscal deficit would show a significant deterioration of 1 percentage point in 2014 and 1.2 percentage points until 2017.

Table 11: Results of sensitivity analysis of net lending/borrowing developments

% of GDP	2013	2014 p	2015 p	2016 p	2017 p
Net lending (+)/borrowing (-)					
Baseline scenario	-5.4	-4.2	-3.2	-2.4	-2.2
Scenario 1: Slower economic growth (personal consumption)	-5.4	-4.8	-3.9	-3.1	-2.8
Scenario 2: Weaker revenue realization due to labour market tr	-5.4	-4.6	-3.7	-2.9	-2.7
Scenario 1 and 2 combined	-5.4	-5.2	-4.4	-3.6	-3.3

Source: Ministry of Finance

Figure 3: Movements of the share of the general government budget deficit in the GDP according to certain scenarios



Source: Ministry of Finance

4.3. Sensitivity analysis of public debt movements

Sensitivity analysis of public debt movements were conducted by setting a baseline scenario of debt movements based on mid-term macroeconomic and fiscal projections. A series of alternative scenarios were then carried out, where the assumed variables are subjected to various shocks. Shocks are typically tied to the historical value of the observed variables and their variability, but can also be arbitrary. Sensitivity analysis of public debt movements to various factors is of exceptional importance, in order to consider all the consequences of possible changes in the assumptions that determining the projections of public debt movements in the mid-term period, and thereby represent the highest risk. For the purpose of conducting sensitivity analysis of the public debt in the mid-term period to the occurrence of negative macroeconomic risks, three alternative scenarios were considered: currency depreciation, increasing of financing costs, and takeover of the debt of public enterprises.

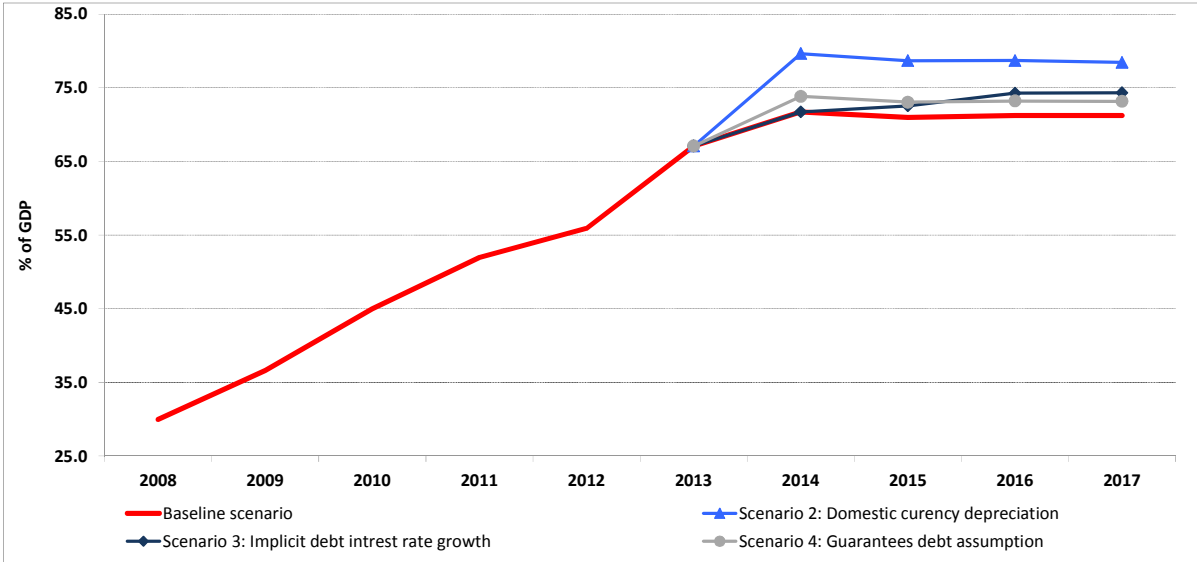
Sensitivity analysis of the public debt indicates that the greatest influence on its growth would come from depreciation of the domestic currency, particularly towards the euro. From the analysis, it is shown that a depreciation of the kuna by 15% would raise the level of the public debt to over 78% GDP in the period 2014–2016, which reflects the high share of debt denominated in this foreign currency.

The influence of increasing the costs of financing was assessed with the assumption of an increase in the average implicit interest rate on debt by two percentage points in 2015 and 2016. Such a scenario would lead to an increase in the servicing costs of the existing debt, and also the new debt and the interest expenditures would experience a significant increase in comparison to the plan. This would negatively act on the movements of the public debt that would achieve growth over forecasts, and by the end of the mid-term period, would reach a level of about 74% GDP.

Finally, the inability of fulfilment of the credit obligations of public enterprises, for example in the transport sector, which are covered by guarantees of the Republic of Croatia, would lead to the takeover of a part of their debt into the public debt. Such a scenario was recorded in 2012, when the Republic of Croatia took over the debt of shipyards into the public debt, which also impacted an increase in interest expenditures in the forthcoming period. The assumed shock of taking over conditional liabilities into the public debt in the amount of 2% GDP would raise the level of debt to 73.2% GDP in 2016. Therefore, it is of particular significance to implement the restructuring process in public enterprises, including privatisation and concessions, which will have a favourable effect on public finances, due to the reduction in potential liabilities and possible future expenditures.

To conclude, the debt sensitivity analysis indicates that the ratio of public debt in the gross domestic product can only be stabilised if fiscal adjustment is achieved and maintained, i.e. correction of the excessive deficit, which is planned via the implementation of fiscal consolidation measures within the framework of the Excessive Deficit Procedure.

Figure 4: Movements of public debt share in GDP according to different scenarios



Source: Ministry of Finance

4.4. Comparison of Convergence Programme and 2013 Economic Programme of the Republic of Croatia

A comparison of the total revenues, expenditures and deficit of the consolidated general government according to the Economic Programme from 2013 and Convergence Programme from 2014 shows significant differences. This arises from the different levels of the nominal gross domestic product, changes in policy of managing the revenue and expenditure sides of the budget, and broader coverage of local and regional self-government units. The Economic Programme from 2013 rests on the assumption of real growth of the gross domestic product of 2.4% in 2014, to 3.5% in 2015 and 2016. The Convergence programme from 2014 expects lower economic growth, such that the

projection for 2014 is stagnation, with growth of 1.2% in 2015, 1.3% in 2016 and 1.5% in 2017. Also, the deflator was reduced, due to lower actual and expected price movements.

The differences of individual fiscal sizes in these two programmes are due also to other reasons specific for revenues or expenditures. During 2013, due to negative macroeconomic movements, weaker revenues were achieved than expected, and did not include either the one-off effect of the shift of payment of VAT on the import of products from other Member States beginning with accession into the EU. On the other hand, budget expenditures included the costs of recovery of health care institutions in the amount of 1% GDP, which was not envisaged in the Economic Programme. In the Convergence Programme, all 576 local government units were included, while the Economic Programme included only the 53 largest units, which accounts for some 70% of the total revenues and expenditures of all local government budgets.

In 2014 and 2015, the differences in the projected sizes of revenues and expenditures in both documents arises from the changed level of the nominal gross domestic product, and from the necessary structural adjustments in the period 2014–2016 which the EU Council requested in the frame of the Excessive Deficit Procedure. The different revenues projections are the result of legal changes in the tax system and social contribution system which entered into effect during 2014, and which will cumulatively influence the different level of revenues in the forthcoming period. On the other hand, the projected expenditure levels are affected by the level of the nominal gross domestic product and the structural measures envisaged in all categories, as well as the high costs of recovery of liabilities of health care institutions, interest expenditures and EU membership expenditures, which was described in detail earlier in this document.

Table 12: Comparison of revenues, expenditures and net lending/borrowing of the general government based on the Economic Programme of the Republic of Croatia (EP RH) and the Convergence Programme of the Republic of Croatia (CP RH)

	2013	2014	2015	2016	2017
EP RH 2013-2016 (% of GDP)					
Total revenue	40.7	43.0	42.5	42.6	43.1
Total expenditure	46.0	47.2	45.7	45.0	45.2
Net lending/borrowing	-5.4	-4.2	-3.2	-2.4	-2.2
PEP 2012-2014 (% of GDP)					
Total revenue	38.4	37.9	37.7	37.2	
Total expenditure	42.0	41.3	40.8	39.9	
Net lending/borrowing	-3.6	-3.4	-3.1	-2.6	
Difference					
Total revenue	2.3	5.1	4.8	5.3	
Total expenditure	4.1	5.9	4.9	5.1	
Net lending/borrowing	-1.8	-0.7	0.0	0.2	

Source: Ministry of Finance

5. QUALITY OF PUBLIC FINANCES

Though the fiscal policy over the past two years has unfolded in very unfavourable macroeconomic conditions, the Republic of Croatia has already undertaken substantial fiscal consolidation on both the revenue and expenditure sides of the budget. However, due to the intensity of the recession which very negatively impacted the state of public finances, and the fiscal costs of entry into the EU, it is necessary to continue with stronger fiscal consolidation measures in order to meet the determinants of the Pact on Stability and Growth.

In the observed mid-term period, activities will be continued directed towards strengthening the quality of public finances on the revenue and expenditure sides of the budget. An analysis of tax expenditures and other categories of public spending is currently underway, in order to improve efficacy, credibility and quality of public finances, and to continue combating the grey economy.

Revenue measures

For the purpose of increasing the competitiveness of the Croatian economy, tax reforms have been ongoing since 2012 through the reallocation of the tax burden from labour to spending. From May 2012, the rate of the contribution for compulsory health care insurance was reduced from 15% to 13%, thereby reducing the cost of labour. Other non-tax contributions were also reformed, such as a 50% decrease of water contribution, 50% decrease of the fee for use of the general use function of forests, and the payment of indirect monument rent for certain activities. Furthermore, reform efforts continued to update the Register of non-tax contribution, which now includes 239 forms. This resulted in the abolishment of 52 forms of non-tax contributions, in the value of HRK 380 million. Furthermore, in 2013, additional tax measures were taken to improve competitiveness of the private sector and ensure unhindered market conditions. The value-added tax for hospitality services was reduced from 25% to 10%, the tax basis for reinvested profits was reduced, and fiscalisation was introduced for cash transactions. However, due to the launch of the Excessive Deficit Procedure, the Republic of Croatia was required to pass additional fiscal consolidation measures, which on the revenue side included increasing the reduced VAT rate from 10% to 13% and increasing the health care contribution to 15%. For the purpose of further unburdening of taxation on personal income, the introduction of a tax on savings interest and property tax are planned.

The process of fiscalisation, pursuant to the Act on Fiscalisation in Cash Transactions¹⁹ was introduced in three phases for all enterprises in the Republic of Croatia, for the purpose of supervising cash transactions and reducing tax evasion. The full effects of fiscalisation will be visible in the second quarter of 2014 after the submission of the annual personal income tax returns and corporate income tax returns for 2013. Fiscalisation represents a control mechanism for records of total operations and the establishment of tax obligations for enterprises. With better collection of the VAT, positive effects are expected in the corporate income tax and personal income tax. To date, the verification of accounts has collected a multitude of unrecorded data on operations of taxpayers (e.g. daily transactions, cancelled transactions, corrections, daily derogations, inappropriate tax

¹⁹ Official Gazette, number 133/12

rates, work days, employee work hours, etc.) which are used to verify data on operations. An analysis of samples of the collected data indicate the existence of illegal forms of conduct in company operations, and enable further improvements in the quality of planning, guiding and implementing tax supervision.

With the said activities of strengthening competitiveness, the Republic of Croatia has taken a series of measures directed at improving fiscal sustainability, which include: the possibility of reprogramming tax debt, publication of the list of those owing taxes, and introduction of the procedure of pre-bankruptcy settlements.

The procedure of pre-bankruptcy settlements was introduced via the Act on Financial Operations and Pre-bankruptcy Settlements²⁰ with the following aims: 1) restructuring companies with economic potential to preserve jobs, and 2) exclusion of companies from the market who perform various economic and legal activities but cannot settle their own liabilities thereby creating great damages to the market. The pre-bankruptcy procedure is a procedure under the supervision of the court or administrative body in which the debtor in financial difficulties is offered the opportunity for restructuring in the pre-bankruptcy phase so as to avoid the start of the bankruptcy proceedings in the classic sense. The pre-bankruptcy settlement procedure, in comparison with bankruptcy, is characterised by a shorter procedure time, better collection of debts by employees and creditors, and significantly lower procedural costs, and a bankruptcy manager or commissioner. Giving entrepreneurs the opportunity to continue operations whilst restructuring debts and redefining business plans contributes to the re-initiation of sustainable business activities, saving jobs and stimulating the economy as a whole. Giving a “second chance” for re-initiating sustainable business activities and saving jobs are key elements in the new approach to resolving the problems of companies facing financial difficulties. At the end of 2011, 72,654 business entities employing 61,066 workers had frozen accounts, with total liabilities of HRK 44.5 billion. The state of insolvency and long-time account freezes of business entities that generate an internal uncollectable debt in the state and create very negative consequences on the functioning of the economy as a whole, demanded the establishment of an efficient and effective legal framework, with a limited legal implementation time, for resolving the financial difficulties of debtors in order to allow them to return to participate in economic activities. Since the said Act has been in effect, the influence of the pre-bankruptcy settlement procedures on a total reduction of insolvency in the Republic of Croatia since 1 October 2012 has been visible, in the amount of HRK 9.8 billion. According to the data of the Financial Agency (FINA), to 14 March 2014, 6,323 applications to initiate pre-bankruptcy proceedings have been filed, with a total debt level of HRK 56.2 billion and a total of 48,084 employees. Of these filed applications, until 14 March 2014, 918 settlements have been completed in the total debt amount of HRK 16.5 billion. The debtors that closed settlements employ a total of 17,595 workers. Through the pre-bankruptcy settlement proceedings and improving the possibility of rehabilitating companies, the Republic of Croatia has taken a stance towards the insolvent debtor that resembles the existing stance of EU Member States.

For the purpose of reducing tax evasion in the payment of compulsory employer contributions, the payments of salaries are no longer possible without the prior payment of contributions into the state budget. In March 2012, the general rate of the VAT was increased from 23% to 25%, with a simultaneous decrease of the rate to 10% and 13% in 2014 of children's food, oils and fats, sugar and

²⁰ Official Gazette, number 108/12, 144/12, 81/13, 112/13

water supply. Other changes in tax policy are the result of further alignment with EU regulations, particularly in the part of one-time reductions of revenues from the VAT due to entry into the EU, increasing excises on tobacco and fuels, and termination of the zero rate of the VAT and introduction of a 5% rate. As of 1 April 2014, taxation on gains from games of chance over HRK 750 was introduced.

In order to improve the efficiency of combating the grey economy, a single form for the collection of data on paid receipts from earnings (JOPPD) was introduced, and reorganisation of the Tax and Customs Administrations is underway. The JOPPD form replaces the five existing forms, which enables information on the payment of taxable and non-taxable receipts of taxpayers in real time, thereby enabling a rapid reaction of the Tax Administration in the case of non-payment of salaries or contributions. Data from the forms enable the provision of comprehensive records on the earnings and receipts of individuals, which enables better quality execution of all other tasks of the Tax Administration: control of origin of assets, the right to exemptions and breaks in the tax system, and control over the entitlement to social rights.

The new Tax Administration Act²¹ implements changes in the organisation and authorities of the Tax Administration, with the aim of increasing efficiency during the establishment and collection of tax revenues, reducing the grey economy, reducing the labour costs of the state administration and entrepreneurs, and security in executing planned budget revenues. In 2014, tasks in the Tax Administration will be organised on the principle of functionality, i.e. tasks of national significance will be executed at the central level, tasks of regional significance at the level of district offices, and tasks of local significance at the level of branch offices. The new organisation model of the Tax Administration includes rationalisation of the field office network, i.e. the reduction of the number of district and branch offices. Instead of 20, there will be five district offices (Centre, North, East, West and South) seated in the cities of Zagreb, Varaždin, Osijek, Rijeka, Split. Furthermore, district offices will be equalised in terms of size and staff workloads and will be organised based on a functional approach. The number of branch offices was also reduced from 124 to 55. Further activities of the Tax Administration in the area of administrative cooperation and the exchange of information were directed at the development of administrative capacities and further cooperation between the state as an important instrument in combating international tax fraud. The new organisation will also receive IT support in the sense of risk analysis, which will be achieved through the World Bank project during the period 2014–2016.

As part of the EU accession process, the reorganisation of the Customs Administration was implemented, with the aim of efficient customs supervision and combating the grey economy. Reorganisation and rationalisation of operations was carried out, customs supervision was strengthened, and the tasks of the customs service were expanded: strengthening the system of e-customs, managing the system of own EU resources, improving the system of excise supervision, combating contraband, unregistered activities and the verification of legality in trade of goods, in line with the concessions regulations.

²¹ Official Gazette, number 148/13

Expenditure measures

In the fiscal consolidation activities to date, the Government of the Republic of Croatia achieved savings in 2012 on compensation of employees, material costs and subsidies. As such, compensation of employees were reduced following the non-payment of the Christmas bonus and reimbursement, reduction of the coefficient on the gross amount of the salary of 3% and introduction of the Central Salary Calculation (CSC) system. Upon completion of the project in the final quarter of 2014, the CSC system will enable reporting on payments paid at the level of the entire public sector, and for individual institutions and employees. Subsidies have been recording a constant declining trend, particularly in the sectors of agriculture and railways. Meanwhile, the increase in expenditures has been recorded for interest rates due to the high costs of financing the public debt, assistance due to the payment of contributions into the EU budget, and social compensations for the recovery of health care, alignment of pensions with the cost of living, and increasing unemployment benefits. Other expenditures, primarily capital, also recorded increases due to the implementation of projects financed by EU funds. The Government of the Republic of Croatia is implementing the programme of Structural measures of fiscal consolidation, which will enable continued savings on the salary mass, material costs, social benefits and subsidies, while increasing public services.

Key structural reforms

With the new Pension Insurance Act²² that entered into effect on 1 January 2014, significant changes regarding age for old age retirement were introduced for men and women, which will gradually increase from 65 to 67 by the end of 2037. Pensions achieved by special regulations were reduced by 10%, and may not be lower than HRK 5,000. There was also a separation of worker's pensions (ZOMO) from pensions achieved according to special regulations. The alignment of pensions according to special regulations will be carried out exclusively if the real growth of the gross domestic product in each of the three consecutive preceding quarters is at least 2% in comparison to the same quarter of the previous year, and if the budget deficit is less than 3% GDP.

For the purpose of better protection, and the improvement of the standard of living for pensioners, a new model of pension alignments was proposed, which would also take into account the growth of the average salary and consumer prices, but in a manner that is more favourable for pensions than the previous pension alignment model, both in terms of economic growth, when salaries grow faster than consumer prices, and in conditions of economic crisis when the opposite is true. Namely, it is proposed that the actual value of the pension (AVP), which is applied from 1 January 2014, and is determined on 1 July of each calendar year, such that the AVP is aligned at a rate which is obtained as half the sum of the rate of changes of the average consumer price index in the previous half-year period, and the rate of change of the average gross salary of all employed in Croatia in the previous half-year period in comparison to the preceding half-year period (fixed formula 50%:50%). The final rate of alignment of the AVP which is applied from 1 January each calendar year, beginning from 1 January 2015, is determined based on the variable share of the rates of the consumer price index and gross salary of all employed in Croatia in the previous year, in comparison to the preceding year (70:30, 50:50 or 30:70, whichever is more favourable), and is aligned with the aligned AVP determined six months prior to that date. In the case when the rate of alignment is equal to or less than zero, the pensions are not aligned. This means that in conditions of declining consumer prices

²² Official Gazette, number 157/13

and/or salaries in the observed half-year period, pensions will not be aligned in comparison to the previous half-year period.

With regard to labour market reforms, the second phase of amendments to the Labour Act²³ is currently underway, and its adoption in the Parliament is expected in the second quarter of 2014. The Act would shorten and simplify the procedure of collective care for surplus workers, and the course of the termination period is accelerated. The organisation of work hours has been simplified, and a transparent system of organising work hours that will disable abuses in practice introduced. Part-time work and employment via temp agencies has been made easier.

For the purpose of increasing the efficiency of the social benefits system from 1 January 2014, the Social Welfare Act²⁴ has come into effect. The objective of the Act is to direct monetary benefits to the most vulnerable citizens through the institution of the guaranteed minimum benefit (GMB) which unites all four previous social benefits. This is a new form of social benefit in which the state guarantees that each year, pursuant to the available resources, it will determine the amount to which each person or household with insufficient revenues and assets for achieving the fundamental life needs will be entitled. The introduction of the guaranteed minimum benefit represents the start of unification of all social benefits, and a step in the direction of defining a single administrative body for several different social benefits that are currently implemented by social welfare centres, district offices of HZZO, HZMO and HZZ, and state administration offices. According to the activity plans, the role of the single body that will administer the different benefits will be taken on by the state administration offices as of 1 September 2014.

Furthermore, limits to payments of social benefits will be introduced (the amount of the GMB for households may not exceed the gross minimum salary in the Republic of Croatia, which a Decree of the Government of the Republic of Croatia set at HRK 3,017.61 for 2014). This is aimed to motivate employment capable users to return to the labour market. The GMB will stimulate the work activation of those unemployed who are work capable who receive the GMB in the uninterrupted duration of at least one year in a manner that the assistance, from the date of employment, is not terminated in the first month, i.e. achieved earnings are not reduced, while they are gradually reduced in the second and third months. The Act also introduced the possibility of registering a note on the property owned by the GMB user or user of room and board services, which in addition to the property in which they live with their immediately family members, also have a second property or other assets, whose sale could secure resources for supporting oneself and one's family, or to participate in the payment of room and board services, while that second property is not able to be sold or leased. This note is deleted if the repayment of matured claims would endanger the material position the heirs, meaning that there is not right to registering a note on the first property in which the benefit user lives.

The SocSkrb application that was put into function in all social welfare centres in early 2014 enabled the creation of a single database of all users. Using the personal identification number (OIB), data is exchanged with other institutions, such as the Tax Administration, FINA, Ministry of Interior and others, so as to reduce administration procedures and prevent the abuse of the entitlement to social welfare.

²³ Official Gazette, number 149/09, 61/11, 82/12, 73/13

²⁴ Official Gazette, number 57/13

As part of the health care system reforms, measures are being implemented to rationalise the operations of hospital institutions, on which the majority of health care costs are spent. The measures are directed at rationalising operations, and are being carried out through changes to the organisation structure, reduction of expenditures (e.g. revision of on-duty days, rationalisation of diagnostic procedures, increasing the activity of outpatient centres), better human resource management (e.g. reviews of specialisations, control of recruitment), administrative measures (control of efficiency and quality of work of organisational units) and increasing revenues (improvement of collection of claims, additional work in afternoon shifts, development of new services on a market principle).

The national hospital reorganisation plan (Master Plan) defines in detail the future structure, necessary capacities and functionalities of the hospital system in Croatia. This significantly alters the current model of providing hospital services, and is aligned with the best European practice. The national plan includes 31 hospitals – clinical hospital centres, clinical hospitals, clinics and general hospitals, of which the Republic of Croatia is a founder, and those founded by the local and regional self-government units. These are hospitals that provide the most complex forms of health care services, employ the largest number of health care workers, have the largest number of patients treated, and the highest share in the total health care costs. The National plan did not encompass special hospitals and health spas. The National plan envisaged the functional integration of hospitals and the gradual introduction of changes over a three-year period, from 2014 to 2016. This is based on four non-administrative regions that are defined for the purpose of easier planning, organisation and financing of the hospital systems, i.e. for the purpose of reducing current differences and large derogations in hospital capacities and treatment modalities. These non-administrative regions are: 1) Northern/central region, which includes the City of Zagreb and the following counties: Bjelovar-Bilogora, Karlovac, Koprivnica-Križevci, Krapina-Zagorje, Međimurje, Sisak-Moslavina, Varaždin and Zagreb; 2) Eastern region, which includes the counties: Brod-Posavina, Osijek-Baranja, Požega-Slavonia, Virovitica-Podravina and Vukovar-Srijem; 3) Southern region, which includes the counties: Dubrovnik-Neretva, Split-Dalmatia, Šibenik-Knin and Zadar; and 4) Western region, which includes the counties: Istria, Lika-Senj and Primorje-Gorski Kotar. In examining all the hospitals encompassed by the National plan (31), functional integration is planned for 21 hospitals (67.7%), while the remaining 10 hospitals will not be functionally integrated. Through this functional integration, centres of excellence can be developed for individual health care activities, the mobility of the health care staff will be increased, and better planning for the procurement of new medical equipment will be possible. Lower costs are expected for expendable materials, medicinal products, diagnostics, anaesthesia and more.

The project to unify public procurement in health care has already achieved significant savings, while retaining the high quality criteria for the procured goods and services. At the end of 2013, the Decision was passed on the compulsory joint procurement for institutions founded by the Republic of Croatia and health care institutions for which the founding rights have been transferred to the Republic of Croatia for the purpose of concluding framework agreements for certain procurement cases (public procurement categories). According to the joint procurement model, each hospital has obtained for its scope products that it will procure both for itself and for the remaining hospitals. This has achieved equalisation and a reduction of prices, while also maintaining the quality of procured products or services in all included hospital institutions.

In the area of privatisation, further activities are ongoing. In March 2014, an agreement was signed on the sale of shares in Croatia osiguranje (Croatia Insurance) between the Government of the Republic of Croatia and Adris Group. This company has agreed to pay HRK 905 million for 39.05% of the regular shares of Croatia's largest insurance company, or EUR 970.45 per share, thereby paying above the book value. It also offered capitalisation in the amount of EUR 110 million.

Furthermore, despite the activities taken, the privatisation of the Croatian Postal Bank (Hrvatska poštanska banka) has not been carried out.

Measures to control contractual obligations

With the amendments to the budget, through Article 43 of the Budget Act,²⁵ the Government received the possibility to pass temporary measures to balance the budget. If new obligations for the budget should arise during the calculation year or changes to economic movements increase or reduce expenditures and/or payments or revenues and/or receipts, the Government may, at the proposal of the Ministry of Finance, halt the execution of certain expenditures and/or expenses for a maximum of 45 days. Through these measures, the takeover of contractual obligations and/or redistribution of budgetary funds can be stopped, particularly those pertaining to the takeover of additional obligations.

With the above, further control over the takeover of obligations of state budget users was established through Article 44 of the Budget Act. State budget users may take over obligations at the burden of the state budget in the current year only for the intents and to the amount established by the budget, and contractual obligations that demand payments in the coming years only with the consent of the Government.

Exceptionally, if the total contractual obligations do not exceed an amount of HRK 10 million, consent is given by the Minister of Finance (prescribed by provisions of the Act on the Execution of the State Budget).

Furthermore, the Ministry of Finance is implementing a project aimed at strengthening controls in the creation of contractual obligations, through the State Treasury information system. The recent EU PHASE 2006 project, entitled *Integration of Financial Management Informatics System of the State Treasury and Budget Users* co-financed the building of a single, integrated accounting and financial system, in which local financial management systems of budget users are linked to the information system of the State Treasury, for the purpose of electronic exchange of documents in reservation of funds and accounts. The reservation system defines two categories of reservations, depending on the phase of creating contractual relations:

- reservation of resources that announces and reserves budgetary funds in the earliest phase, prior to the conclusion of contracts in the public procurement procedure;
- reservation of resources that is based on signed contracts after the implementation of the public procurement procedure.

The said integration of information systems has enabled that each creation of a contractual obligations is recorded, and not only after the issuance of the invoice, in one place in the central State Treasury, and is available to all.

²⁵ Official Gazette, number 87/08, 136/12

The key role of the reservations system, and the entire system of control of contractual relations, is to ensure that budget users enter only those procurement procedures for which there is coverage in the annual plan (current budget), or the consent of the Government for the creation of multi-annual budgetary obligations (projections for the next two years). Reservation becomes the means for managing obligations.

6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The Fiscal Responsibility Act,²⁶ which entered into effect on 1 January 2011, introduced fiscal rules and rules for strengthening fiscal discipline, and the obligation of drafting a Report on fiscal responsibility for budget users at the state, regional and local levels. With the Annual statement on the execution of the State Budget of the Republic of Croatia for 2012, and the Semi-annual statement on the execution of the State Budget of the Republic of Croatia for the first-half of 2013, the reports on the application of fiscal rules are also submitted to the Croatian Parliament. For the purpose of monitoring the implementation of the Fiscal Responsibility Act and the application of fiscal rules, the Fiscal Policy Committee held six meetings in 2013 and published three positions and one press release.

In the second half of 2013, amendments were prepared to the Fiscal Responsibility Act²⁷ which entered into effect on 8 February 2014. In that context, the following measures are envisaged in 2014 in the part regarding further development and the improvement of the institutional framework of public finances:

- alignment of the Regulation on preparation and submission of the Fiscal Responsibility Statement and reports on the application of the fiscal rule, with the provisions of the Act on Amendments to the Act on Fiscal Responsibility;
- strengthening the independence of expert body responsible for monitoring the implementation of the Fiscal Responsibility Act, and
- improvement of fiscal statistics.

6.1. Act on the Amendments to the Fiscal Responsibility Act

Fiscal rule

The amendments to the Fiscal Responsibility Act have altered the fiscal rule. The initial fiscal rule envisaged the reduction of expenditures of the general budget, expressed in the share in the gross domestic product by at least one percentage point per year, till achieving the primary balance at the level of zero or a positive amount (in nominal terms). In the conditions of a deep recession and negative output gap, such a rule due to its cyclic nature further threatened chances for growth. Alignment with the EU requirements tied to the new framework for managing the economic policy in the EU, and directed at strengthening the implementation of the Pact on Stability and Growth, was a further reason for changing the rule. The target value of the new fiscal rule becomes the mid-term budgetary objective, which will be achieved according to the adjustment plan, at the recommendations of the EU Council, in which the year-on-year reduction of the structural balance must be at least 0.5% GDP. The mid-term budgetary objective is determined as the value of the

²⁶ Official Gazette, number 139/10

²⁷ Official Gazette, number 19/14

structural balance, which ensures that the general budget deficit does not surpass 3% GDP, and the public debt 60% GDP. In the sense of sustainable expenditure movements, a provision was introduced that the annual growth of general budget expenditures must not surpass the referential potential rate of growth of the gross domestic product as defined by the EC, increased by the expected price growth, in which exceptions are permitted for certain expenditure categories. Furthermore, the Act on Amendments to the Fiscal Responsibility Act defines the circumstances in which the fiscal rule will not be applied, under the condition that this does not threaten the fiscal sustainability in the mid-term period. These circumstances are limited to catastrophic situations and larger economic disturbances, which have significant financial influence on the state of the general budget, which is in line with the provisions of the Pact on Stability and Growth. The existence of these circumstances is determined by the Fiscal Policy Committee.

This fiscal rule will be applicable only after the Government of the Republic of Croatia adopts the Adjustment Plan, for the purpose of achieving the mid-term budgetary objectives, at the recommendation of the EU Council. Until that time, the interim fiscal rule will be applicable in the Republic of Croatia, according to which the year-on-year rate of growth of expenditures of the general budget may not exceed the year-on-year rate of growth of the projected or assessed gross domestic product in current prices. Moreover, the expenditures of the general budget do not include expenditures for interest rates, expenditures for the implementation of EU programmes without national co-financing and the annual change in expenditures following changes in the institutional scope of the general budget.

Transposing of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States

Considering the entry into full EU membership in July 2013, the Republic of Croatia was obliged to transpose Council Directive 2011/85/EU into the national legislation by the end of the year as part of the six-pack, thereby achieving alignment with budgetary discipline according to the requirements of the Agreement on the Functioning of the EU. In one part, the provisions of the Directive were transposed by the Act on Amendments to the Fiscal Responsibility Act, which defines the standards of fiscal planning in documents pertaining to the drafting of the state budget, and projections made by the Republic of Croatia, or which the Government of the Republic of Croatia proposes for adoption to the Croatian Parliament. In this way, fiscal transparency is increased through the public availability of macroeconomic and budgetary projections, as well as the assumptions and relevant parameters upon which those projections are based.

These amendments to the Act also prescribe the obligation to publish information on the effect of tax expenditures on revenues, and information on potential obligations with a significant effect on the budget, such as state guarantees, which also ensues from Council Directive 2011/85/EU.

Fiscal responsibility

The Fiscal Responsibility Act introduced the Fiscal Responsibility Statement by which the head of the budgetary and extrabudgetary user of the state budget and budgets of local and regional self-government units and heads of local and regional self-governments once per year confirm that in

their work they ensure the legal, intentional and purposeful usage of resources, and the efficient functioning of the financial management system and controls within the framework of funds allocated in the budget or financial plan. Amendments to the Fiscal Responsibility Act introduced the obligation to compile and submit the Fiscal Responsibility Statement of companies and other legal entities under ownership of the Republic of Croatia, and for companies and other legal persons in the ownership of one or more local and regional self-government units. This amendment to the Act is very important in the context of Croatia's full membership in the EU, which opened numerous opportunities for using EU funds, and the above stated companies and other legal persons are the greatest potential users of these funds. Considering the obligations that must be met prior to and during the usage of EU funds, a transparent system of financial management and control is demanded of the potential users of those resources.

Apart from political responsibility, the misdemeanour responsibility of heads of all levels was also introduced in order to place an emphasis on the credibility of the issued Statements on Fiscal Responsibility and strengthening the system of responsibility.

Regulation on the compilation and submission of Fiscal Responsibility Statements and reports on the application of the fiscal rule

The most recent amendments to the Fiscal Responsibility Act established a deadline of ninety days for the Government of the Republic of Croatia to align the Regulation on the compilation and submission of Fiscal Responsibility Statements and reports on the application of the fiscal rule with the provisions of the Act. The Regulation will prescribe the form and content of reports on the application of the fiscal rule, and documentation pursuant to which the Fiscal Responsibility Statement is based.

6.2. Independent body for monitoring the application of Fiscal Responsibility Act

The Fiscal Policy Committee was established pursuant to a Decision of the Government of the Republic of Croatia on the establishment of the Fiscal Policy Committee in 2011, and the Committee members were appointed by virtue of a decision of the Government of the Republic of Croatia. Due to the need to strengthen the independence of the Committee, in line with the provisions of Council Directive 2011/85/EU, and the strengthening of the role of the Committee as a supervisor over the implementation of the Fiscal Responsibility Act, the Croatian Parliament passed the decision establishing the Fiscal Policy Commission as a second working body of the Croatian Parliament. The Commission of the Croatian Parliament replaced the previous Fiscal Policy Committee. The members of the Commission, with the exception of the chairperson, were appointed in late February 2014 by the Croatian Parliament at the proposal of the Committee for Finance and the State Budget, for a five-year mandate.

The fundamental task of the Fiscal Policy Commission is to monitor the implementation of the fiscal rule established under the Fiscal Responsibility Act. In the case the Commission establishes that the fiscal rule is not being met, a report thereof is drawn up and delivered to the Government of the Republic of Croatia. The Government of the Republic of Croatia is obliged, within a period of thirty days from receipt of such a Report, to propose a plan of necessary measures with implementation deadlines, which will lead to the meeting of the fiscal rule.

Pursuant to the prescribed tasks, during the process of drafting the state budget and budgets of local and regional self-government units, and financial plans of extrabudgetary users for the mid-term period, the Fiscal Policy Commission will consider and compare the macroeconomic and budgetary projections of the Government of the Republic of Croatia, with the most recent available projections of the EC. If the Commission, in the comparison of the macroeconomic and budgetary projections, should determine significant derogations in the period of at least four consecutive years, it shall compile a report thereof and submit it to the Government of the Republic of Croatia. The Government of the Republic of Croatia is obliged to align the macroeconomic and budgetary projections in above listed documents.

6.3. Fiscal statistics

In the second half of 2013, the Strategy of reforms of the financial reporting system was prepared so as to improve the quality of financial reports and their manner of collection, in line with the conclusions and action points ensuing from pre-accession dialogue visit of Eurostat from June 2013. The objective of the visit was to review the source of data used for drafting the tables of the Fiscal Notification and to explain outstanding issues pertaining to the Fiscal Notification from April 2013. Pursuant to the recommendations from the action point 5 of the above document, the Strategy determined measures to improve the quality of data from the financial reports. These measures refer to:

- improvements in reporting which will appropriately resolve the burden of reporting units, statistical and consolidation targets;
- adaptation of reporting deadlines to the requirements of the Financial Notification, and
- improvement of the quality of data in financial reports.

One of the measures to improve reporting as envisaged by the Strategy is an analysis and supplementation of the content of the calculation plan for budgets and budgetary users and financial reports. As part of these measures, the Ministry of Finance, in cooperation with the Central Bureau of Statistics and the Croatian National Bank, and based on the experiences in compiling the Fiscal report, will during 2014 reanalyse the need for data in the financial reports and pursuant to the findings of the analysis, to adjust the calculation plan and reporting forms. For the purpose of continuity of accounting records, the new calculation plan will come into effect as of 1 January 2015, though it will already be in use during the preparation of budgets and financial plans for the period 2015–2017. Furthermore, the burden of reporting units will be analysed, i.e. it will be determined whether there is a need to introduce the obligation of submitting additional reports, or the need to

possibly reduce the number of financial reports and/or reporting periods for individual levels of bodies required to submit these documents.

The current system of financial reporting does not allow for a simple consolidation process at all levels. The greatest shortcoming pertains not to the consolidation methodology, but to the inability in the financial reports of local and regional self-government units to separate data on revenues and expenditures of those units from the revenues and expenditures achieved by their budgetary users. In order to improve the quality of data in the consolidated financial reports, efforts will be invested to remove these shortcomings, with the aim of ensuring that the financial reports of individual entities show only their total revenues and expenditures, and that consolidation reports can be compiled from the individual reports of the local and regional self-government users and the entities under their jurisdiction.

The electronic forms of the financial reports contain logical and mathematical controls for data entry. FINA, which collects financial reports for the Ministry of Finance, receives only those financial reports for which all controls are met. This control system has been under development since 2002, with the objective of improving the quality of data in financial reports. Since the drafting of the April 2013 Financial Notification, the Ministry of Finance prepared additional (logical) controls that were built into the electronic financial reporting forms on two occasions (prior to the submission of the financial reports for the period January–June 2013 and January–September 2013).

Furthermore, it is necessary to consider modification of the manner of collection and archiving of financial reports. One of the possible ways to improve this system is the establishment of an application for the submission of financial reports which can be accessed via the Internet using a structured data format (XML). The financial reporting forms must be in the precisely prescribed electronic format, and during “uploading” into the application, formal and logical data checks would be performed, and incorrectly filled out financial reports rejected.

The analysis would consider at least the following: 1) what the value would be of development of such an application given the number of users, 2) what the cost would be of using electronic signing of financial reports as a guarantee of authenticity and unchangeability of the submitted data, and 3) what the possibilities are for improvements, taking into account the administrative capacities of all participants in the reporting process.

APPENDICES

Table 1a. Macroeconomic Prospects

	ESA Code	2013 (level)	2013 (rate of change)	2014 (rate of change)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)
1. Real GDP	B1*g	325,234	-1.0	0.0	1.2	1.3	1.5
2. Nominal GDP	B1*g	328,252	-0.1	1.0	2.9	3.1	3.5
Components of real GDP							
3. Private consumption expenditure¹	P.3	196,576	-1.0	-0.8	0.4	0.8	1.3
4. Government consumption expenditure	P.3	65,644	0.5	-0.9	-0.9	-1.9	0.0
5. Gross fixed capital formation	P.51	60,483	-1.0	1.9	5.7	5.7	4.3
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	0.2	0.2	0.1	0.1	0.2	0.3
7. Exports of goods and services	P.6	140,884	-1.8	2.0	2.7	2.9	3.0
8. Imports of goods and services	P.7	139,026	-1.7	1.3	2.9	3.2	3.4
Contribution to real GDP growth							
9. Final domestic demand			-0.7	-0.3	1.2	1.3	1.6
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		-0.3	-0.1	0.0	0.1	0.0
11. External balance of goods and services	B.11		-0.1	0.3	0.0	-0.1	-0.1

Note: GDP and all of its components expressed in real terms are in constant previous year prices, HRK million

¹ Includes spending of non-profit institutions that serve households.

Source: CBS, MF

Table 1b. Price developments

	2013 (rate of change)	2014 (rate of change)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)
1. GDP deflator	0.9	0.9	1.7	1.9	1.9
2. Private consumption deflator*	1.9	0.7	1.8	2.0	2.0
3. HICP¹	2.2	0.6	1.7	1.9	1.9
4. Public consumption deflator	-1.0	0.4	0.8	0.9	1.9
5. Investment deflator	-0.1	0.5	1.8	1.9	1.8
6. Export price deflator (goods and services)	0.1	1.1	1.8	1.9	1.9
7. Import price deflator (goods and services)	0.2	0.3	1.6	1.8	1.9

*Note: Includes consumption of non-profit institutions that serve households.

¹ Consumer price index, national methodology

Source: CBS, MF

Table 1c. Labour market developments

	ESA Code	2013 (level)	2013 (rate of change)	2014 (rate of change)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)
1. Employment, persons¹		1,415,200	-1.0	-2.3	-0.4	0.5	1.4
2. Employment, hours worked ²		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)³		17.1	17.1	17.9	17.7	17.3	16.5
4. Labour productivity, persons⁴		229,815	0.0	2.4	1.6	0.7	0.1
5. Labour productivity, hours worked ⁵		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees⁶	D.1	161,946,700	0.8	-0.2	1.6	2.4	3.5
7. Compensation per employee		130,151	1.9	1.7	2.0	2.1	2.5

¹ Occupied population, domestic concept national accounts definition.

² National accounts definition.

³ Level; unemployment rate is calculated as a share of unemployed according to the ILO methodology in labour force which represents sum of unemployed according to the ILO methodology and employed according to the national accounts data.

⁴ Real GDP in constant previous year prices per person employed.

⁵ Real GDP per hour worked.

⁶ Data for 2013 level is in 000 HRK.

Source: CBS, MF

Table 1d. Sectoral balances

	ESA Code	2013 (% of GDP)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	1.4	2.3	2.2	1.7	1.2
<i>of which:</i>						
- Balance on goods and services		1.3	1.8	1.9	1.9	1.8
- Balance of primary incomes and transfers		0.0	0.3	0.0	-0.4	-0.8
- Capital account		0.1	0.2	0.2	0.2	0.3
2. Net lending/borrowing of the private sector	B.9	4.1	4.6	3.4	2.1	1.3
3. Net lending/borrowing of general government	EDP B.9	-4.9	-4.4	-3.5	-2.7	-2.5
4. Statistical discrepancy		2.2	2.1	2.3	2.3	2.3

Source: CNB, MF

Table 2a. General government budgetary prospects

	ESA Code	2013 (level, HRK billion)	2013 (% of GDP)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-16.2	-4.9	-4.4	-3.5	-2.7	-2.5
2. Central government	S.1311	-17.9	-5.5	-4.3	-3.5	-2.7	-2.4
3. State government	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	0.2	0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	1.5	0.5	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	133.5	40.7	43.0	42.5	42.6	43.1
7. Total expenditure	TE ¹	151.1	46.0	47.2	45.7	45.0	45.2
Net lending/borrowing	B.9	-17.6	-5.4	-4.2	-3.2	-2.4	-2.2
8. Net lending/borrowing	EDP B.9	-16.2	-4.9	-4.4	-3.5	-2.7	-2.5
9. Interest expenditure	EDP D.41	10.1	3.1	3.5	3.7	3.8	3.7
10. Primary balance ²		-6.1	-1.9	-0.8	0.1	1.0	1.3
11. One-off and other temporary measures ³		0.0	0.0	0.8	0.6	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		78.8	24.0	24.0	23.9	24.0	23.8
12a. Taxes on production and imports	D.2	58.4	17.8	18.2	18.0	18.1	17.9
12b. Current taxes on income, wealth, etc	D.5	20.4	6.2	5.8	5.9	5.9	5.9
12c. Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	37.9	11.6	12.9	12.6	11.9	11.9
14. Property income	D.4	1.0	0.3	0.5	0.4	0.2	0.2
15. Other ⁴		15.7	4.8	5.6	5.6	6.5	7.2
16=6. Total revenue	TR	133.5	40.7	43.0	42.5	42.6	43.1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) ⁵		116.8	35.6	36.9	36.5	35.9	35.7
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	55.4	16.9	16.8	16.3	15.8	15.6
17a. Compensation of employees	D.1	36.3	11.0	10.8	10.5	10.2	10.0
17b. Intermediate consumption	P.2	19.2	5.8	5.9	5.8	5.6	5.6
18. Social payments (18=18a+18b)		60.7	18.5	18.2	16.9	16.3	16.0
of which Unemployment benefits ⁶		1.6	0.5	0.5	0.5	0.5	0.4
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	13.6	4.2	4.2	3.2	3.0	3.0
18b. Social transfers other than in kind	D.62	47.1	14.4	14.1	13.8	13.3	13.0
19=9. Interest expenditure	EDP D.41	10.1	3.1	3.5	3.7	3.8	3.7
20. Subsidies	D.3	6.8	2.1	2.0	1.8	1.7	1.8
21. Gross fixed capital formation	P.51	6.3	1.9	2.3	2.3	2.1	2.2
22. Capital transfers	D.9	4.6	1.4	1.7	2.2	2.8	3.3
23. Other ⁷		7.1	2.2	2.7	2.5	2.5	2.6
24=7. Total expenditure	TE ¹	151.1	46.0	47.2	45.7	45.0	45.2
p.m.: Government consumption (nominal)	P.3	58.0	17.7	17.6	16.2	15.6	15.4

¹ Refers to general government budget scope, so that TR-TE=B.9. Budget scope – all budgets and budgetary and extrabudgetary users in Republic of Croatia – is determined in Budgetary and extrabudgetary users' register (RKP), which is regulated by Budget Act, and outlined in greater detail in the corresponding Rule book.

² The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9)

³ A plus sign means deficit-reducing one-off measures.

⁴ P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

⁵ Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

⁶ Includes cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.

⁷ D.29+D.4 (other than D.41) + D.5+D.7+P.52+P.53+K.2+D.8.

Source: CBS, MF

Table 2b. No-policy change projections *

	2013 (level, HRK billion)	2013 (% of GDP)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)
1. Total revenue at unchanged policies	133.5	40.7	41.3	42.1	42.7	n.a
2. Total expenditure at unchanged policies	151.1	46.0	47.1	47.0	46.4	n.a

* Note: The cut-off date is February 2014.

Source: CBS, MF

Table 2c. Amounts to be excluded from the expenditure benchmark

	2013 (level, HRK billion)	2013 (% of GDP)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)
1. Expenditure on EU programmes fully matched by EU funds revenue	1.7	0.5	1.2	1.4	2.1	2.9
2. Cyclical unemployment benefit expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Effect of discretionary revenue measures	n.a.	n.a.	0.8	0.6	0.0	0.0
4. Revenue increases mandated by law	0.8	0.3	1.6	0.6	0.4	0.0

Source: CBS, MF

Table 4. General government debt developments

	ESA Code	2013 (% of GDP)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)
1. Gross debt¹		67.1	71.7	71.0	71.2	71.2
2. Change in gross debt ratio		11.2	4.6	-0.7	0.2	0.0
Contributions to changes in gross debt						
3. Primary balance²		1.9	0.8	-0.1	-1.0	-1.3
4. Interest expenditure³	EDP D.41	3.1	3.5	3.7	3.8	3.7
5. Stock-flow adjustment*		6.3	0.3	-4.2	-2.5	-2.5
<i>of which:</i>						
- Differences between cash and accruals ⁴						
- Net accumulation of financial assets ⁵		3.0	2.5	0.6	0.6	0.3
<i>of which:</i>						
- privatisation proceeds		0.1	0.6	0.6	0.6	0.3
- Valuation effects and other ^{6*}		3.0	1.9			
p.m.: Implicit interest rate on debt⁷		5.4	5.3	5.3	5.5	5.4
Other relevant variables						
6. Liquid financial assets ⁸						
7. Net financial debt (7=1-6)		67.1	71.7	71.0	71.2	71.2
8. Debt amortization (existing bonds) since the end of the previous year						
9. Percentage of debt denominated in foreign currency						
10. Average maturity				-	-	-

* The amount in 2013 refers to USD bond issued in November 2013 for financing needs in 2014 while the amount in 2014 refers to issuance for financing needs in 2015.

¹ As defined in Regulation 479/2009 (not an ESA concept)

² Cf. item 10 in Table 2.

³ Cf. item 9 in Table 2.

⁴ The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

⁵ Liquid assets (currency), government securities, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

⁶ Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

⁷ Proxied by interest expenditure divided by the debt level of the previous year.

⁸ AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Source: CBS, MF

Table 5. Cyclical developments

	ESA Code	2013 (% of GDP)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)
1. Real GDP Growth (%)		-1.0	0.0	1.2	1.3	1.5
2. Net Lending of general government	EDP B.9	-4.9	-4.4	-3.5	-2.7	-2.5
3. Interest expenditure	EDP D.41	3.1	3.5	3.7	3.8	3.7
4. One-off and other temporary measures¹		0.0	0.8	0.6	0.0	0.0
5. Potential GDP growth (%)		-0.3	-0.1	0.4	0.7	0.9
contributions:						
- labour		-0.7	-0.7	-0.3	-0.1	0.0
- capital		0.3	0.4	0.5	0.5	0.5
- total factor productivity		0.1	0.2	0.3	0.3	0.3
6. Output gap		-2.8	-2.7	-2.0	-1.4	-0.8
7. Cyclical budgetary component		-1.2	-1.1	-0.9	-0.6	-0.3
8. Cyclically-adjusted balance (2 - 7)		-3.7	-3.2	-2.7	-2.1	-2.1
9. Cyclically-adjusted primary balance (8 + 3)		-0.7	0.3	1.0	1.6	1.6
10. Structural balance (8 - 4)		-3.7	-4.1	-3.3	-2.1	-2.1

¹ A plus sign means deficit-reducing one-off measures.

Source: CBS, MF

Table 6. Divergence from previous update*

	ESA Code	2013	2014	2015	2016	2017
Real GDP growth (%)						
Previous update		0.7	2.4	3.5	3.5	n.a.
Current update		-1.0	0.0	1.2	1.3	1.5
Difference		-1.7	-2.3	-2.3	-2.2	n.a.
General government net lending (% of GDP)						
Previous update	B.9	-3.6	-3.4	-3.1	-2.6	n.a.
Current update		-5.4	-4.2	-3.2	-2.4	-2.2
Difference		-1.8	-0.7	0.0	0.2	n.a.
General government gross debt (% of GDP)						
Previous update		56.2	57.5	57.5	57.0	n.a.
Current update		67.1	71.7	71.0	71.2	71.2
Difference		10.9	14.2	13.5	14.3	n.a.

* Previous update is 2013 Economic Programme of Croatia.

Source: CBS, MF

Table 7a. Contingent liabilities

	2013 (% of GDP)	2014 (% of GDP)
Public guarantees	16.4	n.a.
<i>Of which: linked to the financial sector</i>	n.a.	n.a.

Source: CBS, MF

Table 8. Basic assumptions

	2013	2014	2015	2016	2017
Short-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.33	1.36	1.36	1.36	1.36
Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-vis the € (annual average)	7.6	7.6	7.6	7.6	7.6
World excluding EU, GDP growth	3.6	4.1	4.4	n.a.	n.a.
EU GDP growth	0.1	1.6	2.0	n.a.	n.a.
Growth of relevant foreign markets	1.4	4.1	5.6	5.8	5.9
World import volumes	2.5	4.9	6.0	n.a.	n.a.
Oil prices (Brent, USD/barrel)	108.8	104.1	99.6	94.6	91.5

Source: EC, IMF, MF