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## The Croatian 2008 State Budget - Social Peace and Public Sector Expansion<sup>1</sup>

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**Macroeconomic environment.** According to the Government plan, the 2008 state budget growth should be in line with real GDP growth of 4.5%. The planned GDP growth in 2008 is based on the assumption of a stable political environment, but also of possible unfavourable movements on international financial markets. One of the reasons for such a cautious GDP estimate is the inflation growth already reaching 5%.

**The size of the general government budget.** In the current year, the Government again failed to prepare the execution and plan of the general government budget (consolidated state budget, financial plans of extra-budgetary funds and the consolidated budget of local government units). The problem that still persists is the timely consolidation between the local government unit budgets and central government budget, and the presentation of the entire general government budget according to functional and economic classifications. Given these shortcomings, it is difficult to measure the real size of the (general) government budget and to assess the possibility of achieving the deficit targets for 2008. However, based on an unpublished consolidated general government budget, the Government projected the size of the general government deficit.

*Table 1 Deficit/surplus of the consolidated general government, 2005-2010 (in mil. kn and %)*

	2005	2006	Plan 2007	Proposal 2008	Projection 2009	Projection 2010
State budget	-5,118.6	-3,703.2	-3,496.9	-3,832.3	-2,226.7	8.4
% of GDP	-2.2	-1.5	-1.3	-1.3	0.7	0.0
Extra-budgetary funds and agencies	-2,868.6	-2,688.8	-2,813.7	-2,183.6	-1,393.7	-774.0
% of GDP	-1.2	-1.1	-1.0	-0.7	-0.4	-0.2
Local government	-671.8	-583.5	-786.4	-936.5	-923.6	-937.8
% of GDP	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3
General government deficit	-9,301.5	-7,457.7	-7,457.7	-6,952.4	-4,544.0	-1,703.4
% of GDP	-4.0	-3.0	-2.6	-2.3	-1.4	-0.5

<sup>1</sup> The analysis of the Republic of Croatia (RC) state budget is based on Government budgetary documents publicly available at: [http://www.vlada.hr/hr/naslovnica/sjednice\\_i\\_odluke\\_vlade\\_rh/2008/6\\_sjednica\\_vlade\\_republike\\_hrvatske](http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2008/6_sjednica_vlade_republike_hrvatske). Additionally used were the data from the Ministry of Finance of the RC (<http://www.mfin.hr>), Croatian National Bank (<http://www.hnb.hr>), Central Bureau of Statistics (<http://www.dzs.hr>) and Official Gazette "Narodne novine" (<http://www.nn.hr>).

Source: Ministry of Finance of the RC, 2008.

The general government budget deficit is supposed to be 2.3% of GDP in 2008, down 0.3 percentage points from the 2007 plan. The Government is optimistic about further reductions in the general government deficit, although such announcements are not based on published budget estimates and projections. The state budget borrowing is to reach about 3.8 billion kuna (431 million kuna more than in 2007). The extra-budgetary funds' borrowings are estimated at 2.2 billion kuna (down 630 from 2007). The local government units' borrowing is anticipated to stand at about 931 million kuna (up 200 million on 2007). It is impossible to make realistic estimates of the size of general government deficit without a thorough analysis of potential financial risks of: maturity of issued guarantees, new health care expenditures arrears, subsidies to railways, the amount of subsidized loans granted within the university and science sectors, debt to pensioners, etc.

**Consolidated central government budget.** In 2008, budget expense of the consolidated central government (consolidation of extra-budgetary funds and state budget) is expected to exceed the revenues by about 4.5 billion kuna. The estimated deficit results from the need to finance capital transport infrastructure projects through the public enterprises Croatian Motorways and Croatian Roads. In the period from 2008 to 2010, capital construction works are expected to slow down, which will create first surpluses in the state budget.

The extra-budgetary funds' deficits to the amount of 5.5 billion kuna will partly be covered by the state budget surplus of 1 billion kuna, whereas the remaining 4.5 billion kuna will be provided from borrowing. By the Government's estimate, the consolidated central government budget will run a deficit of about 2% of GDP in 2008.

**State budget.** The planned revenues and receipts of the state budget stand at 127.7 billion kuna in 2008, 6 billion kuna more than in 2007. The current balance of expense is in surplus, and the government will mainly incur debt to cover the deficit arising from capital construction and the repayment of existing debts. According to the Government plan, state budget revenues will amount to about 115.9 billion kuna (which represents an annual increase of 7 billion kuna). Given the planned expense of 118.5 billion kuna, a deficit of about 2.6 billion kuna is anticipated. The government will incur debt to the amount of 10.5 billion kuna, and ensure 1.3 billion kuna from privatisation receipts. Expenditures for debt repayment will amount to 9.3 billion kuna, down 0.5 billion kuna from 2007. The planned state budget deficit will mainly be financed by Government borrowings on foreign capital markets.

Table 2 The size of the state budget, 2006-2010, in million kuna

	2006	Plan 2007	Proposal 2008	Projection 2009	Projection 2010
<b>Total revenue</b>	<b>95,588</b>	<b>108,983</b>	<b>115,918</b>	<b>122,648</b>	<b>130,208</b>
<b>Total expense</b>	<b>97,858</b>	<b>112,042</b>	<b>118,448</b>	<b>123,664</b>	<b>129,076</b>
<b>Surplus/deficit</b>	<b>-2,270</b>	<b>-3,058</b>	<b>-2,530</b>	<b>-1,017</b>	<b>1,132</b>
Receipts from financial assets and borrowing	12,163	12,783	11,820	11,932	10,873
Expenditures for financial assets and loan repayment	11,342	9,725	9,290	10,915	12,005
Changes in deposit balances	-1,450	0	0	0	0
Net financing	2,270	3,058	2,530	1,017	-1,132
<b>Revenue and receipts</b>	<b>107,751</b>	<b>121,767</b>	<b>127,738</b>	<b>134,579</b>	<b>141,081</b>
<b>Expense and expenditures</b>	<b>109,201</b>	<b>121,767</b>	<b>127,738</b>	<b>134,579</b>	<b>141,081</b>
<b>Net surplus/deficit</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

Source: Ministry of Finance of the RC, 2008.

*State budget is anticipated to be in surplus in 2010*

According to Government projections, the state budget is expected to run a surplus of 1.1 billion kuna, the first surplus since 1998.

**Warranted optimism about budget revenues.** The planned state budget revenues (excluding receipts from borrowing) amount to about 116 billion kuna, up 7 billion on the 2007 plan. More conservative estimates are based on slower GDP growth in 2008. The main components of the state budget revenues are the revenues from taxes, particularly VAT and excise taxes, as well as social contributions. Tax revenues are expected to grow by 6 billion kuna and the revenues from social contributions by 3 billion, reaching a record high of 40.7 billion kuna. Revenues from VAT and social contributions (health and pension insurance contributions) are the main sources of financing the anticipated state budget expense. The tax revenue plan is realistic, because it is in line with real GDP growth rates. However, the Government underestimated the revenues from excise taxes and health insurance contributions. The bulk of revenues are expected from VAT and excise taxes which jointly account for about 80% of overall tax revenues. On the whole, the budget revenue plan is realistic, subject only to some upward adjustments in the planned collection of health insurance contribution and excise tax revenues.

Given the extremely successful collection of revenues, the Government should intensify its efforts to relieve the tax burden and reduce tax rates, primarily the VAT rate, on the assumption, of course, that budget expense will grow at moderate rates. The Government counts on a substantial increase in revenues based on specific regulations (the so-called hidden levies) by 2.8 billion kuna (please, note that the revenue outturns for 2006 were 1.3 billion kuna), suggesting that it does not plan any serious reform aimed at reducing numerous fees and charges for financing the (inefficient) government administration.

*Record-strong collection of tax and contribution revenues 2007*

According to the data from FINA, Croatia set new records in tax collection in 2007. Profit tax revenues stood at 9 billion kuna, up 4 billion on 2006. Such abundance of revenues was the result of favourable economic developments and of taking over the entire amount of profit tax revenues from local government units. Value added tax revenues amounted to 34.9 billion kuna in 2006, to reach 38.1 billion kuna in 2007. Revenues from excise taxes stood at 9.6 billion, exceeding the 2007 plan by 500 million kuna, and the 2008 plan by about 150 million kuna

Surprisingly successful was the collection of health insurance contributions. The revenues derived from health contributions exceeded the anticipated amount of 16.9 and pension insurance contributions collected were about 200 million kuna above the plan. The proposed plan for contribution revenues for 2008 seems to be realistic

**Expense – Where are the savings?** A rosy picture of successful revenue planning is greatly disturbed by the size and structure of budget expenditures. There are almost no budget losers, which is why the parliamentary discussions for budget adoption are likely to be an easy ride. Unfortunately, despite the warnings coming from the IMF that Croatia should save 4% of its GDP in order to ensure sustainable budget financing, the current budget proposal makes this goal unrealistic to achieve. In the budget proposal for 2008, special emphasis is put on the growth of expenditures for wages (8% relative to 2007), compensation of employees (11%), expenditures for services (particularly intellectual services, by 20%), financial expenditures (particularly interest expenses for loans received from banks, by 38%) and other unspecified financial expenditures (by 68%). The social sensitivity of the state budget is indicated by the growth in expenditures for household benefits in kind and in cash. Expenditures for non-financial assets are growing at a rate of 14%, with particular emphasis on expenditures for construction projects, facilities and equipment and transportation means. In brief, about 50% of the budget is spent on social

expenditures, 18% on wages and 8% on material expenses. This composition of expenditures is similar to those from previous years and to the projected expenditures for the period from 2008 to 2010. So, there is nothing new.

*Table 3 State budget expenditures as % of total expenditure, 2006-2010*

Budget item	Type of expenditure	2006	Plan 2007	Proposal 2008	Projection 2009	Projection 2010
<b>3.</b>	<b>Operating expenses</b>	<b>98</b>	<b>97</b>	<b>97</b>	<b>97</b>	<b>97</b>
31.	Expenditures for employees	18	18	18	18	19
32.	Material expenses	6	7	8	8	8
34.	Financial expenditures	5	4	5	4	4
35.	Subsidies	6	6	6	6	6
36.	Grants to foreign governments and to other general government units	7	8	6	6	6
37.	Insurance-based benefits to individuals and households and other benefits	51	49	49	49	49
38.	Other expenses	5	5	5	5	5
<b>4.</b>	<b>Expenditures for the acquisition of non-financial assets</b>	<b>2</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>3</b>
41.	Expenditures for the acquisition of non-produced assets	0	0	0	0	0
42.	Expenditures for the acquisition of produced fixed assets	2	3	3	3	3
43.	Expenditures for the acquisition of precious metals and other deposited valuables	0	0	0	0	0
44.	Strategic stocks	0	0	0	0	0
45.	Expenditures for additional investments in non-financial assets	0	0	0	0	0
	<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

*Source: Ministry of Finance of the RC, 2008.*

**Caution – subsidies are going up!** The Government continues to provide substantial support to both public and private companies and banks. The 2008 budget gives special prominence to the following: subsidies to companies, craftsmen, small and medium-sized enterprises outside the public sector, which will increase by 11% (and amount to about 4.9 billion kuna, up about 0.5 billion kuna); subsidies to farmers to the amount of about 3.8 billion kuna (up 12%); and subsidies to banks (growing at a rate of 11%). Sizeable growth is also anticipated in capital grants (which will amount to 2.3 billion kuna, up as much as 31%) to banks and public sector companies, as well as to farmers and small and medium-sized enterprises (amounting to about 225 million kuna, up about 800%). Indirect subsidies in the form of government guarantees, primarily to shipyards, will reach record highs. Total direct and indirect state budget grants to banks, financial institutions and public and private sector companies amount to 16.8 billion kuna. It is worth emphasizing that this type of aid hit its record high in 2007, standing at almost 22 billion kuna.

*Table 4 Direct and indirect state budget grants to banks, financial institutions and public and private sector companies, 2006-2010, in million kuna*

	2006	Plan 2007	Proposal 2008	Projection 2009	Projection 2010
1 Subsidies	5,671	6,583	7,146	7,036	7,135
2 Capital grants	1,426	1,766	2,321	2,624	2,853
3 Guarantees issued*	9,370	13,598	7,400		
Total	16,467	21,946	16,867		

Source: Ministry of Finance of the RC, 2008.

\*Guarantees issued are not included in state grants in the full amounts.

**Budget winners and losers.** Forty-two budget users can be considered as real winners. Particularly strong is the growth in expenditures of the following entities: Government, Constitutional Court, Office for Development Strategy, Office for E-Croatia, Office for State Property Management and Child Ombudsman, as well as of the Ministries of: Defence, Environmental Protection, Science, Education and Sports, Veterans' Affairs, Agriculture, Economy and European Integration. Some of them have raised their expenditures by over 30%. Compared with 2007, budget losers are the following: Parliament, Ministry of the Interior, Ministry of the Sea, Tourism and Development (due to the setting-up of a new ministry), the regional development and employment funds, Agency for the Protection of Market Competition, Central State Administration Office for Public Administration, Croatian Academy of Sciences and Arts (HAZU), State Office for Metrology, Croatian Standards Institute, State Intellectual Property Office and Croatian Accreditation Agency. Nine budget beneficiaries account for 87% of total expense and the remaining 44 beneficiaries participate with 13% in the total. The largest spending agency is the Ministry of the Economy, Labour and Entrepreneurship (36.2 billion kuna (up about 3 billion kuna).

*Table 5 State budget expenditures in the period 2006-2010, according to organizational classification, in million kuna*

	Ministry	2006	Plan 2007	Proposal 2008	Projection 2009	Projection 2010
1	The Economy, Labour and Entrepreneurship	30,610	33,090	36,288	37,959	40,044
2	Health and Social Welfare	19,399	22,551	22,469	23,284	24,081
3	Finance	19,841	19,313	19,030	21,484	21,925
4	Science, Education and Sports	9,597	10,782	11,716	12,699	13,794
5	Defence	4,041	4,519	5,400	6,055	7,105
6	The Interior	3,689	4,557	4,326	4,474	4,713
7	Agriculture, Forestry and Water Management	3,028	4,057	4,546	4,588	4,726
8	The Family, Veterans' Affairs and Intergenerational Solidarity	3,236	3,906	4,139	4,368	4,545
9	Regional Development, Forestry and Water Management	0	0	2,018	2,100	2,183
	Total of 9 ministries	93,440	102,775	109,931	117,012	123,115
	Remaining 44 beneficiaries	15,761	18,992	17,097	17,568	17,965
	Total	109,201	121,767	127,028	134,579	141,081
	Expenditures of 9 ministries as % of total expenditure	86	84	87	87	87
	Expenditures of the 44 beneficiaries as % of total expense	14	16	13	13	13
	Total (%)	100	100	100	100	100

Source: Ministry of Finance of the RC, 2008.

**State Budget Borrowing.** Total receipts from financial assets stand at 11.8 billion kuna. The Government plans to incur debt by issuing bonds to the amount of 8.5 billion kuna and by taking on credits and loans from domestic financial institutions to the amount of about 2 billion kuna. Privatization receipts (from the sale of shares) amount to about 1 billion kuna (down 600 million kuna from the 2007 plan). Receipts from borrowing exceed those in 2007 by 9%. This mainly relates to the growth in credit and borrowing from business banks (by 14%). Expenditures for debt repayment stand at 9.3 billion kuna. Particularly fast growth was recorded in expenditures for the repayment of loans to non-profit institutions, organizations, retail clients and households (by about 122%), for the repayment of loans received from foreign governments (which go up 6% and amount to 1.3 billion kuna), as well as for the repayment of the principals for loans received from banks (by 20%).

*Table 6 State budget financing account, 2006-2010, in million kuna*

Budget item		2006	Plan 2007	Proposal 2008	Projection 2009	Projection 2010
	<b>Net financing</b>	<b>2,270</b>	<b>3,058</b>	<b>2,530</b>	<b>1,017</b>	<b>-1,132</b>
	Change in the state budget deposit balance	-1,450	0	0	0	0
<b>8.</b>	<b>Receipts from financial assets and borrowing</b>	<b>12,163</b>	<b>12,783</b>	<b>11,820</b>	<b>11,932</b>	<b>10,873</b>
81.	Received payments (repayments) of the principals of loans extended	205	291	189	202	220
82.	Receipts from the sale of securities	6,200	8,987	8,500	10,862	9,968
83.	Receipts from the sale of shares and stakes in principals	2,678	1,602	1,050	0	0
84.	Receipts from borrowing	3,080	1,904	2,081	868	685
<b>5.</b>	<b>Expenditures for financial assets and loan repayment</b>	<b>11,342</b>	<b>9,725</b>	<b>9,290</b>	<b>10,915</b>	<b>12,005</b>
51.	Expenditures for loans extended	1,038	806	745	685	667
53.	Expenditures for shares and stakes in principals	248	244	440	432	428
54.	Expenditures for the repayment of the principals of loans received	6,025	3,269	3,193	4,572	3,916
55.	Expenditures for the repayment of the principals of securities issued	4,032	5,406	4,913	5,225	6,994

*Source: Ministry of Finance of the RC, 2008.*

**The size of public debt.** For 2008, the Government determined that total government debt (debt of the consolidated state budget excluding government guarantees) may not exceed 48% of GDP. This seems to be a realistic target. Specifically, total direct debt (credits, bonds and outstanding liabilities) and potential debt of the general government (i.e. of the state budget, extra-budgetary funds and local government units) could reach 46.7% of GDP. Excluding guarantees (issued by the state and local government units), this debt could amount to 40.6% of GDP. Consequently, the government has made room for possible borrowing, but it would not exceed the specified debt limits.

Table 7. Public debt as % of GDP, 2002-2008

Year	State debt and guarantees					Local government debt and guarantees			Public debt
	Central government internal debt	Central government external debt	Total central government debt	Guarantees exercised	Outstanding liabilities	Local government Debt	Guarantees	Outstanding liabilities	
2002	17.3	23.9	41.3	9.0	0.3	0.8	0.0	0.1	51.5
2003	17.5	25.2	42.7	7.9	0.5	0.8	0.0	0.1	51.9
2004	19.3	25.8	45.1	5.8	0.6	0.8	0.8	0.1	53.2
2005	23.8	22.4	46.2	5.4	0.4	0.8	0.9	0.1	53.8
2006	23.8	19.5	43.3	5.7	0.6	0.8	0.8	0.1	51.3
XI. 2007*	23.6	17.9	41.5	5.8	0.4	0.8	0.9	0.1	49.4
2008**	n/a	n/a	39.3	5.4	0.4	0.8	0.8	0.1	46.7

Source: Author's calculations based on the MoF and CNB data, 2008.

Note: \* balances in November, \*\* estimate, n/a – data not available.

The issues that remain open are the size of potentially exercised government guarantees and their maturities, the size of the outstanding liabilities of health care institutions and of the local government units' debt, because there is no coherent information on the liabilities incurred through public utility companies.

**Public debt management.** Relatively large expenditures for the repayment of debt principals and interest, coupled with high subsidies and loans to both public and private sector institutions require more efficient management of potential and direct public debt. This particularly relates to credit substitution by government bond issues on the domestic financial market. Public debt management cannot reduce the already incurred liabilities, but it can reduce or minimize the borrowing costs (interest rates), at least on short-term loans and treasury bills. The Government incurs short-time debt mainly by issuing treasury bills. Interest rates on treasury bills with maturity of 364 days are 0.22 percentage points higher on average than those on the bills with maturity of 186 days. The Government has still not introduced cash and liquidity management, which would provide a possibility to reduce short-term interest on borrowings, particularly in the form of treasury bills with longer maturities. The accumulated short-term budget surpluses are deposited in an account held with a business bank offering the most favourable interest rate on short-term time deposits, whereas the deficits are covered by incurring debt in the form of treasury bills at higher interest rates.

**Unrealistic plans for government guarantees.** For 2008, the Government planned to issue financial guarantees worth 7.4 billion kuna for loans received (mainly) by public companies in the shipbuilding and transport sectors. Regretfully, the Government stuck to the imposed limits only in 2005, whereas in other years the amounts of given financial guarantees exceeded the planned amounts. It should be mentioned that a record-high amount of financial guarantees, around 13.6 billion kuna, was given in 2007. Guarantees issued for borrowing abroad accounted for the largest share. The Government imposed no restrictions on the issue of performance guarantees. According to the CNB data, exercised guarantees in 2007 amounted to about 15.3 billion kuna. Instead of providing direct subsidies to 'old' loss-running companies, the government focused on giving indirect grants by issuing financial guarantees for more favourable borrowing. The potential maturity dynamics of guarantees by year is still unknown, and potential maturity projections have not been published. Given the government orientation, besides for direct expenditures of the Ministry of the Economy, financial guarantees will also be provided to the business and



shipbuilding sectors. In 2007 alone, financial guarantees provided to these two sectors totalled 13 billion kuna.

*Table 8 State guarantees, 1996-2008, in million kuna*

Year	Plan	Guarantees issued					Guarantees exercised
		Financial 3 = (1+2)	Domestic (1)	Foreign (2)	Performance (4)	Total (3+4)	
1996	2,500	830	122	708	1,361	2,191	-
1997	3,000	3,159	1,379	1,780	2,966	6,126	-
1998	1,000	5,076	1,245	3,831	3,351	8,426	9,074
1999	3,000	5,910	1,154	4,755	1,787	7,696	9,090
2000	-	5,395	5,023	372	4,344	9,740	13,663
2001	-	7,255	3,041	4,689	5,893	13,149	15,314
2002	-	8,388	5,687	2,701	2,856	11,244	16,293
2003	5,900	9,003	5,035	3,967	2,722	11,724	15,608
2004	4,900	5,773	2,942	2,830	4,769	10,541	12,430
2005	4,000	3,710	2,742	967	3,458	7,168	12,595
2006	4,000	9,370	4,817	4,554	1,465	10,836	14,284
2007	4,900	13,598	4,465	9,133	n/a	13,598	15,346
2008	7,400						

Sources: Official Gazette and CNB, 2008.

**Fiscal decentralization.** The government set an upper limit on local government units' borrowing, i.e. 2.3% of a government unit's operating revenues. This could be about 460 million kuna in 2008. The City of Zagreb is likely to enter into new borrowing for the refinancing of existing debt, thus reducing the borrowing potential of other local government units. Given the impossibility to finance capital projects by taking on loans, local government units will continue to incur debt through public utility companies. In doing so, they will avoid budgetary constraints imposed by the central government, affecting even those local government units that have strong fiscal capacities. Instead of numerous criteria for the distribution of current and capital grants from the state budget, the government adopted a simple criterion of the number of inhabitants per square kilometre. Of course, it is open to question why the assessment of the amount of grant per capita is based on a (less reliable) criterion of the number of inhabitants according to the 2001 census, and not on the updated figures from the Ministry of Interior.

## Conclusions

1. The 2008 state budget has 43 winners and 8 losers.
2. Social expenditures account for about 50% of the state budget expense.
3. Subsidies and grants to companies in both public and private sectors are on the increase. This applies to direct grants, but also guarantees and loans taken on by public and private companies.
4. The planned revenues from excise taxes and health insurance contributions are low.
5. Given the rather heavy state budget expense, the tax burden is unlikely to decrease. This particularly relates to the announced cut in general VAT rate, which is not economically feasible.
6. The announced reductions in non-tax revenues are questionable. Judging by the anticipated administrative revenues, the government will not easily give up this abundant source of revenue.
7. Government financial guarantees issued have reached a record high.
8. Fiscal decentralization is stagnant. Investment construction in local government units mainly occurs through the responsible ministries and public utility companies. Grants are still misdirected without making any analyses of fiscal capacities, and government revenue is distributed among all local government units in the areas of special state concern, highland and mountain and island areas.
9. The plan envisages the expansion of foreign borrowing. It is necessary to reduce the cost of borrowing and to substitute loans with government bonds.