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PRESS RELEASES

About Guidelines on the Preparation of the Croatian National Budget for 2016 and Projections for 2017-18

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The Croatian Government on February 25, adopted **Guidelines on the Preparation of the National Budget for 2016 and Projections for 2017-18** which, regrettably, failed to fulfil what is expected from any government, especially a new one. They do not contain clear economic policy goals or describe how the Government would respond to challenges posed by changes in the macroeconomic and fiscal frameworks. Moreover, the difference between the resources necessary for the implementation or modification of current programmes and activities and those needed for the new ones is only given in aggregate terms and without adequate substantiation. Yet the most important part is the planned budget deficit, by far the lowest among the deficits we have become inured to lately. At least this should inspire hope, provided that it rests on realistic assumptions. While the adoption of the 2016 budget is perceived as „a matter of life and death“ for both the country and Government, a timely, complete and fully transparent budget process for the period 2017-19 is equally, if not even more, important for restoring order in the country and establishing clear economic and fiscal policies. After all, according to the Budget Act, this process should already have started.

Legal and methodological deficiencies

The first thing that catches the eye is the document name. According to the **Budget Act**, it should not be *Guidelines on the Preparation of the National Budget*, but *Economic and Fiscal Policy Guidelines*. Given that the former Government in July 2015 adopted the **Economic and Fiscal Policy Guidelines for the Period 2016-17**, the intention of the new Government may have been that the two documents should also differ in name. However, the name simply does not comply with the legally prescribed nomenclature. Since there is no indication in the new Guidelines that they supersede the previous ones, and the budget is prepared on the basis of the Economic and Fiscal Policy Guidelines which, according to the Budget Act, provide a basis for drawing up Instructions for Drafting a Budget Proposal, in the end it will be unclear on what basis the budget is actually prepared.

Although the content of the Guidelines is stipulated by Article 25 of the Budget Act, some of the relevant requirements are not met. While the goals of the new Government are, indirectly and partly, suggested in the introduction and throughout the Guidelines, the document lacks the mandatory part with a clear definition and structured presentation of the economic policy goals for a three-year period. Similarly, the section dealing with macroeconomic and fiscal framework does not include the mandatory part about potential changes in circumstances relative to those defined in the Convergence Programme. By

the way, there is even no mention of the Convergence Program, the Strategic Plans or the National Reform Programme, on which the Guidelines should be based, as specified in the Budget Act.¹

A special problem is that the Guidelines are based on the national methodology, different from the one used in the EU, which leads to further disputes and arguing over figures and hampers a comparison of the Guidelines with the documents to be submitted to the EU. This is even indicated in the Guidelines themselves: „*The national budget revenues and expenditures, receipts and outlays, as well as the calculation of the national budget deficit are expressed in accordance with the national methodology, which differs from the European statistical methodology ESA 2010, used for reporting to the EU. This methodology is based on the accrual principle, whereas the national budget planning relies on the cash principle. Discrepancies also arise from a different scope of budget and extra-budgetary users, which is narrower than the statistical scope.*” Pending the full adoption and implementation of the ESA methodology in all budget documents, the data according to the national methodology should always be presented, including in the Guidelines, in parallel with the data according to ESA. This requirement has also been reiterated by the Fiscal Policy Commission.

What do the presented figures suggest?

Below is an analysis of: the amounts of the budget adopted in December 2014, the former Government's Guidelines issued in July 2015 and the Guidelines adopted by the new Government in February 2016. As concerns 2015, a comparison is made between the *planned* amounts (those stated in the December 2014 budget) and *outturns* (stated in the Guidelines of February 2016).² According to the Budget Act, the Government is required to submit to Parliament the final budget outturns for the previous year not earlier than June 1, 2016. Therefore, the *outturns* must be treated with the utmost caution.

A key figure in the Guidelines is the planned deficit which is much lower than usual. The budget deficit plan and outturns for 2015 stood at HRK 12,542m and HRK 12,526m respectively. The deficit planned in the former Government's Guidelines for 2016 stood at HRK 10,462, compared with HRK 7,485m, planned by the new Government (Table 1). While this figure is also far from negligible, it is questionable whether it can really be achieved.

This Government is more optimistic than the previous one. It forecasts a 5% increase in revenues and a 2% increase in expenditures in 2016, relative to the amounts planned in the former Government's 2016 Guidelines. It also envisages 4% higher revenues and almost unchanged expenditures relative to the 2015 outturns. However, a comparison between the 2015 budget plan and its outturns shows that revenues and expenditures went up only 2% and 1% respectively in that year.

Assuming no major deviations of the final 2015 budget outturns from the figures stated in the Guidelines, among major revenue items, the Government expects an increase in tax revenues (by 5%) but a decrease in social security contributions by 5% in 2016 relative to 2015. As concerns items with minor shares in total revenues, receipts from the sale of non-financial assets are expected to boom (by 40%); as are revenues from fees and compensation (by 31% and 24% respectively). It should be remembered, however, that the former Government planned to raise HRK 1.2bn from the sale of non-financial assets in 2015, but the actual amount realised was as little as HRK 450m or 39%. The shortfall is not so large when it comes to aid: the realised revenues are only 3% lower than those planned, whereas the current Government expects an increase in these revenues of 24%.

All revenue items are planned in higher amounts than those planned by the former Government, except for revenues from the sale of products and goods, revenues from services rendered and donations, as well as from fines and administrative sanctions. However, these revenues are of less importance in the total revenue structure, so that their lower planned levels will not significantly affect the overall revenue picture. The most important in the revenue structure are taxes and social security

¹ *Strategic Plans* for three-year periods comprise mission and vision statements, strategic goals and methods of achieving them, including their links to the organisational and programme classifications, as well as result evaluation measures. A *National Reform Programme* lays down the strategic framework for structural reform implementation in the current year and the next three years. A *Convergence Programme* sets up the macroeconomic and fiscal framework of the Republic of Croatia in the current year and the next three years (for more details see Articles 23 and 24 of the Budget Act).

² Also available are the [Ministry of Finance's data on the outturns for 2015](#). However, given their preliminary character, in this analysis, preference is given to the February 2015 Guidelines data.

contributions. Hence, should the planned economic growth be realised, revenues from these sources could increase.

Higher total revenues in 2016 are planned on the basis of their outturns for 2015, but also on the basis of stronger economic growth planned for 2016, faster privatisation and more efficient use of EU funds. While the latter two measures are expected from any government, including the current one, it is only after the actual budget outturns for 2015 are published that it will be known whether realised revenues are higher than those planned in 2015. On the other hand, the realisation of the planned economic growth in 2016 will depend on internal and maybe even more, on external factors (e.g. EU economic growth, oil prices, political crises, etc.). Therefore, it cannot really be said that the 2016 budget revenues have been planned too cautiously.

The deficit is likely to depend mostly on the expenditure side of the budget. The Government plans to keep expenditures around the levels of their 2015 outturns, but it plans 2% higher expenditures than the previous Government. It should be reiterated, however, that the outturns for 2015 are not final. Planned subsidies are 10% higher than the 2015 outturns and even 27% higher than those planned by the former Government. Also worrying are the planned cuts in expenditures for employees. As they represent the second largest total revenue item, the arguments that what is meant here are employees financed from EU funds and that this amount also includes the seniority allowance hardly offer any comfort. Particularly worrying is the fact that expenditures for employees are planned to grow continuously during 2017 and 2018, as a result of adjustments for seniority allowances and the expected employment growth. The largest expenditure item, i.e. benefits to citizens and households, which accounts for almost 40% of total operating expenditures, also shows no downward trend; it is even going to rise slightly from 2015. The planned 2% reduction in material expenditures again calls for caution, because the outturns for 2015 exceeded the plan by as much as 6%.

The Guidelines say nothing about fiscal rules, or the compliance or non-compliance with them, despite a repeated request by the Fiscal Policy Commission that the rule compliance assessment be included in all key budget documents³. Also, there is no table showing the general government debt projections. Given the crucial importance of the fiscal rules and public debt for the country, this is surprising, to say the least.

Each government, especially a new one, is expected to present in its guidelines, in a clear and structured way, its economic policy goals and future behaviour within the existing, but also a potentially changed macroeconomic and fiscal framework, and to adequately support them by figures presented in the financial plans. Where there are differences between the funds necessary for the implementation of current programmes and activities and those needed for the implementation of new programmes, a detailed explanation is required of the programmes and activities and their expected effects. Since there is no such thing in the Guidelines, one should wait for a budget proposal to be drafted. However, should the proposal bring no real surprises, one will get the impression that either no major structural reforms are planned, or that reforms, if any, will be implemented at a very slow pace.

What should be the purpose of the Guidelines?

In view of the practices followed by both the previous and current governments, the importance of the guidelines can never be overstated and the reasons for discussing them by not only the Government but also Parliament can never be explained enough. According to the OECD **Best Practices for Budget Transparency**, the guidelines should incorporate the Government's strategic objectives for a future period and instigate budgetary discussions. This would enable the public, economy and investors to create adequate expectations and understand the link between the policies to be implemented and budget revenues, expenditures, borrowing and debt servicing. The better the guidelines, the more efficient the budget, because its formulation within the government structures and budget users themselves is more successful. Without an appropriate discussion on the guidelines, the budget process comes down to setting limits for budget users, with too much of the budget being left to the discretion

³The purpose of the *Fiscal Rules* is to contribute to ensuring and maintaining fiscal discipline and to provide for medium-term and long-term sustainability of public finances. The application of the Rules is reviewed and evaluated by the *Fiscal Policy Committee* (for more details see the **Fiscal Responsibility Act**).

of the finance minister and Government. This encourages budget users to make excessive demands, trying to wheedle more than the limited amounts.

In many countries, guidelines are discussed in parliament. For example, Canada, which was facing serious fiscal challenges in mid 1990s, involved its Parliament, including the opposition parties, in the guidelines debate, wishing to sensitize the public to these issues and create a positive environment to carry out painful reforms. Since then, the Canadian finance ministers have regularly presented the guidelines to the parliamentary committee, and this is **one of the most important parts of the Canadian annual budget process** which has the widest media.

In order to ensure parliamentary debate on the guidelines, changes should be made to the budget calendar determined under the Budget Act, with a view to speeding up the issuance of the guidelines. As the National Reform Programme and Convergence Programme are bound to be finished by end-April of a current year, there is no reason why the guidelines could not be issued before end-July. So, in the case of the above mentioned change, the Government would have enough time to consider the opinions of both the MPs and the public, while budget users would have time to submit well-considered budget proposals. This would change the practice, repeated year after year (notably because of the almost regularly delayed issuance of guidelines), that requires them to submit the proposals overnight, sometimes even in only a few hours.

Furthermore, in order that the guidelines may provide a solid basis for effective budget formulation, according to the **Guide to Transparency in Government Budget Reports**, they should include the following: Government's expectations for domestic and external macroeconomic conditions and indicators; long-term economic and fiscal policy goals, including the description of the role of fiscal policy in the economic policy; an analysis of different scenarios and estimates of the borrowing needs and debt servicing; strategies for new sectoral policies and the impact of the budget on particular sectors; the functional and economic classifications of expenditures, inter-governmental transfers (grants) and differences between the preceding year and the planned period; expectations for tax and other revenues and an analysis of potential impacts on their outturns; and the estimates of expected costs of all new policies to be implemented in the planned period. It is not good news that most of these items have never been included in the Croatian guidelines, or, if some of them have, then they have only been partially specified. Given the described deficiencies, again, more will be known when the Government comes out with the 2016 budget proposal. Let us hope that at least this document will bring some pleasant surprises.

Next steps

In the long run, the Government should set an earlier date on the budget calendar for issuing the guidelines and impose the obligation to discuss them in Parliament. Moreover, government finances in all government sectors should be managed according to the ESA 2010 methodology. Until this is achieved, at least all aggregate amounts in all budget documents should be expressed according to both the national and European methodologies.

In the short run, besides the preparation of the 2016 budget, account should also be taken of the 2017 budget and projections for 2018-19. The 2016 budget is currently (and justifiably) considered to be „a matter of life and death“ for both the state and Government, but, if it is intended to finally bring order to the budget process and ensure efficient budget planning, the budget calendar, determined in the current Budget Act, must be strictly complied with. This implies that the following documents should be adopted as early as 2016:

- Instructions for Drafting Strategic Plans for 2017-19 - by end-February;
- Strategic Plans - by end-March;
- A National Reform Programme and a Convergence Programme - by end-April;
- Economic and Fiscal Policy Guidelines - by end-July; and
- Instructions for Drafting a Budget Proposal - by 15 August.

With the help of **A Brief Guide to the National Budget Process**, Members of Parliament, the media and the public can monitor the 2017-19 budget process. In this context, they should require that everything – from issuing Instructions for Drafting Strategic Plans to publishing Instructions for Drafting a Budget Proposal – be done in compliance with the Budget Act, and that the documents be complete, adopted

on time and then presented in a timely and transparent manner in accordance with the best practices of international institutions, such as **OECD**, **IMF**, **GIFT** and **OBS**.

Table 1 Total government revenue, expenditure and deficit, in million HRK

	2015		2016		Indexes		
	Enacted budget	New Govt.'s Guidelines	Old Govt.'s Guidelines	New Govt.'s Guidelines	4/3x100	2/1x100	4/2x100
	1	2	3	4	5	6	7
Total revenue	106,433	108,191	107,440	112,951	105	102	104
6 Operating revenues	105,265	107,741	106,979	112,321	105	102	104
61 Tax revenues	64,001	65,803	65,748	68,864	105	103	105
62 Social security contributions	23,375	23,218	21,601	22,128	102	99	95
63 Aid received from abroad and from entities within general government budget	7,292	7,088	8,473	8,823	104	97	124
64 Revenues from assets	2,490	2,714	2,518	2,558	102	109	94
65 Revenues from administrative fees, fees pursuant to special regulations and compensation	2,081	2,575	2,570	3,368	131	124	131
66 Revenues from the sale of products and goods, from services rendered and donations	1,045	1,405	1,068	934	87	134	66
67 Revenues from the relevant budget and from the Croatian Health Insurance Fund arising from contractual obligations	4,326	4,339	4,348	5,064	116	100	117
68 Fines, administrative sanctions and other revenues	656	599	653	582	89	91	97
7 Revenues from the sale of non-financial assets	1,168	450	461	630	137	39	140
Total expenditure	118,975	120,717	117,902	120,436	102	101	100
3 Operating expenditures	115,715	117,306	115,527	117,150	101	101	100
31 Expenditures for employees	24,676	25,052	24,321	25,017	103	102	100
32 Material expenditures	10,141	10,758	9,501	10,505	111	106	98
34 Financial expenditures	11,092	11,129	11,299	11,187	99	100	101
35 Subsidies	6,054	6,592	5,714	7,283	127	109	110
36 Aid extended abroad and within the general government	12,374	12,716	12,483	12,298	99	103	97
37 Insurance-based benefits to citizens and households and other benefits	45,022	45,331	44,806	45,595	102	101	101
38 Other expenditures	6,355	5,728	7,403	5,265	71	90	92
4 Expenditures for the acquisition of non-financial assets	3,26	3,411	2,375	3,287	138	105	96
Total revenue	106,433	108,191	107,440	112,951	105	102	104
Total expenditure	118,975	120,717	117,902	120,436	102	101	100
Deficit	12,542	12,526	10,462	7,485	72	100	60

Sources: 1 State Budget of the Republic of Croatia for 2015 and Projections for 2016-17 (2 December 2014)

2 and 4 Guidelines for the Preparation of the State Budget of the RC for 2016 and Projections for 2017-2018 (25 February 2016)

3 Economic and Fiscal Policy Guidelines for the Period 2016-18 (30 July 2015)