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Ott, Katarina

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PRESS RELEASE

Waiting for fiscal consolidation in Croatia

KATARINA OTT, PHD, Institute of Public Finance, Zagreb

On May 10, the Government discussed the *Annual Report on Republic of Croatia's 2011 Budget Execution*¹, expected to be the basis for drawing up a Government Programmes Strategy and 2013-2015 Economic and Fiscal Policy Guidelines, which will clearly indicate the course of fiscal consolidation policies and measures aimed at achieving more efficient government and a competitive economy.

Despite some deficiencies, the Report on the 2011 Government Budget Execution is in line with the Budget Act, and it includes the functional classification of expenditures not prescribed by law. Regrettably, the Report lacks an introduction, a summary and detailed contents, and, as it does not provide any explanations or conclusions, the reader is left to his/her own devices to understand this document of almost 1,700-pages that is even incorrectly paginated. Moreover, some of the announced topics are missing. So, for example, in the chapter "Income and expenditure account", there are no expenditures, and in the chapter "Execution of revenues receipts and expenditures and expenses for 2010-2011", expenditures and expenses are missing.

The 2011 Budget Execution Report. While the Report is more or less compliant with technical requirements, its purpose is that the Government, relevant ministries and extra-budgetary users assess to what extent their goals have been achieved, how the Budget performed within given macroeconomic conditions, which policies and programmes have to be improved and which abandoned, and that they take decisions on a future course of action. Therefore, it is not enough, for example, only to present the last year's macroeconomic situation, but it is necessary to compare initial assumptions and targets with actual outcomes, to comment on the appropriateness of the measures taken to confront the macroeconomic environment, to assess the impact of fiscal behaviour on long-term sustainability of the budget and extra-budgetary users and to draw lessons for improvement.

In this connection, it should not matter who was in power last year and who is currently. New governments must use the previous governments' experiences and learn from their mistakes.

It is time now to assess whether it makes sense to continue the old practice, or would a radical turnaround be necessary. This is why the report is published by early May, and is used as a basis for adopting a three-year Government Programmes Strategy by mid-May, and Economic and Fiscal Policy Guidelines by mid-June. The Report itself provides insufficient information to a common reader as to what extent the Government, ministries and extra-budgetary funds have achieved their targets. However, if the Government sticks to the set time limits, this, too, will soon be revealed.

¹ Vlada RH. *Nacrt prijedloga godišnjeg izvještaja o izvršenju Državnog proračuna Republike Hrvatske za 2011. godinu*. 26. sjednica Vlade, 10. svibnja 2012.

The 2011 Budget execution. In strictly technical terms, the former Government's outturns even exceeded the planned figures. Given slightly higher-than-planned revenue and lower expenditure, the deficit was also lower - HRK 14bn, instead of HRK 14.9bn. Only a more detailed analysis would show if the reallocations of funds between budget items were higher than allowed without a budget revision. Hence, this article only deals with the essence of the realised and planned figures. The idea is to induce changes, so that in years to come, planned and realised deficits could be significantly lower, since both figures were too high in 2011.

Doubts. As stated at the beginning of the Report, deficit stands at HRK 14bn, and this amount is actually derived from the entire Report. However, there is a brief note somewhere in the middle of the text, saying: "Should the total declared state budget deficit of HRK 14bn be increased by outstanding liabilities (a breakdown of which is given in the part "Explanation of the state budget expenditure") amounting to HRK 2.2bn, the state budget deficit would stand at HRK 16.2bn or 4.7% of GDP, and the general government deficit at HRK 17bn or 5% of GDP". If this note is true, which is difficult to prove as the aforementioned explanation does not make it possible, why there is no actual Budget execution Report? Why confuse the public, and what is the point in futile controversies between the former and current Governments?

The functional expenditure classification shows the purposes for which funds are spent. While savings are possible in all functions, the highest priorities should be given to the major ones, i.e. social protection, health insurance, general public services and economic affairs (see Graph).

If, of a total of HRK 47.6bn spent for *social protection*, HRK 19.7bn and HRK 12.9bn relate to old age and disability benefits respectively, then no immediate savings are possible. A pension system reform, including the extension of working life, penalising of early retirement and revision of some categories of current pensions, would ensure a slowdown in the number of retired persons. A labour market reform would accelerate the employment growth rate, thus relieving the burden of current pensions.

Due to population aging, healthcare expenditures pose a constant problem, but some measures in this respect could be taken immediately. Of HRK 19.8bn spent on healthcare, in-patient care was allocated HRK 8.7bn and out-patient care HRK 5.9bn. Hence, the current hospital payment method must be changed urgently, as it motivates hospitals to keep patients for a longer time, and primary care physicians to accept more patients. At the same time, public procurement procedures and controls should be reviewed. In the long run, it is necessary to create institutional and legal prerequisites for competitive markets in both health insurance and healthcare.

Of HRK 14bn spent for *general public services*, more than a half relates to public debt, which has been incurred through unreasonable spending in the past and has to be repaid. More rational operation, both currently and in the future, will finally result in debt reduction, but not so soon, unfortunately. In both 2011 and 2012, the government took loans and issued guarantees. The Report does not include a breakdown of public debt and liabilities arising from issued guarantees by maturity year, but the amounts to be repaid in both the 2020s and 2030s will be quite substantial. In addition to the debt incurred with so far-reaching consequences, the government also issued guarantees (e.g. to the Port of Ploče, in the amount of EUR 50m, falling due in 2034, or to Croatian Motorways, EUR 60m, falling due in 2031). As in 2011 alone, the government issued guarantees worth HRK 14.7bn, and also took loans amounting to HRK 14bn, a continuation of such behaviour would pose a threat to the future of our children and grandchildren.

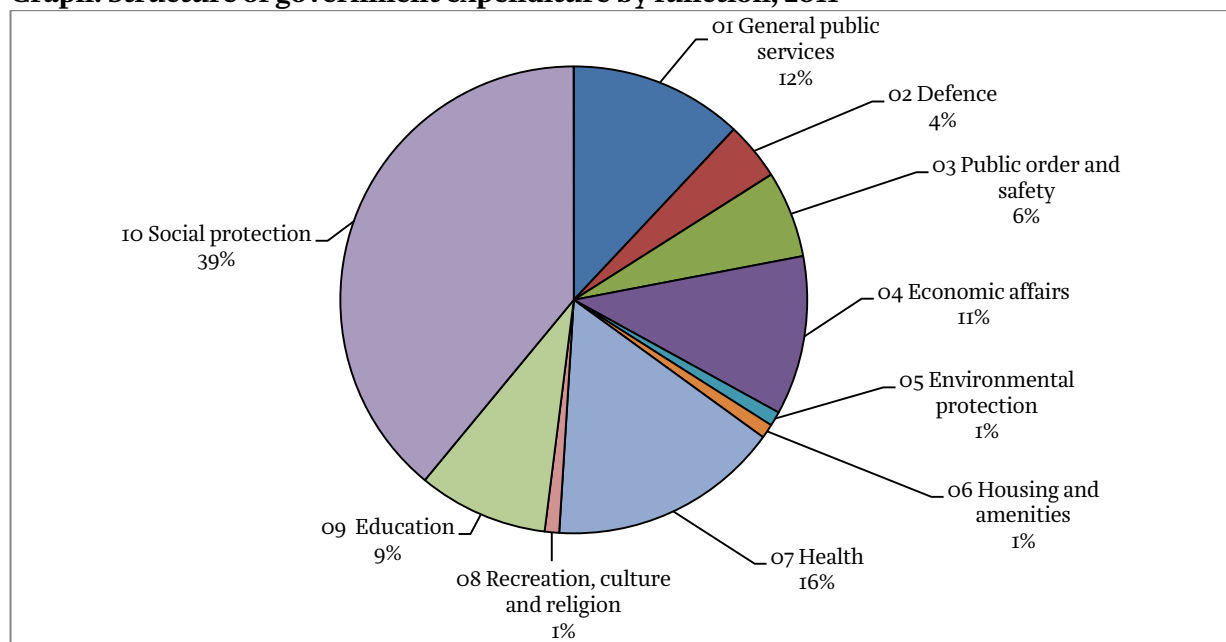
Out of HRK 13bn of expenditures for *economic affairs*, transport accounted for HRK 5.7bn (HRK 2.9bn and HRK 2bn went to the road transport and rail transport respectively), and agriculture for HRK 4.6bn. All other industries spent HRK 236m, while as little as HRK 117m was spent on R&D.

Despite a deficit of HRK 800m, incurred in 2011, Croatian Roads took additional loans worth HRK 2.13bn in 2012. Without a radical turnaround in the financing of both road and rail transports, public debt will continue to grow.

Of a total of HRK 4.6bn spent for agriculture, subsidies accounted for HRK 3.7bn. Regrettably, the Government stated in the Pre-Accession Economic Programme that it would neither reduce subsidies

to agriculture, nor improve their structure, until more substantial aid from European sources is made available to their beneficiaries. However, according to the 2012 Budget, agricultural subsidies will be reduced by over 20% from the previous year. Should the Government be able to resist the pressures in this respect, it would be a step in a good direction.

Graph: Structure of government expenditure by function, 2011



Source: Ministry of Finance, RC, Annual Report on RC's 2011 Budget Execution, April 2012.

Waiting for fiscal consolidation. It is to be hoped that the Government's Strategy and the Guidelines will offer:

- more realistic macroeconomic projections - of either economic growth or a downturn, including the components of such growth or downturn, employment, prices, current account balance and interest rates, with explanations of the underlying parameters and of how the government finance will fit into these projections;
- long-term economic and fiscal policy goals and their role in the macroeconomic policy;
- borrowing and government guarantees issue plans, along with their maturity calendars;
- specific short-term and long-term objectives and measures for budget and extra-budgetary users and public companies, with exact time tables, in order to monitor their implementation.

The Government can offer both an optimistic and a pessimistic scenario, with elaborated policies and measures to be implemented depending on the macroeconomic environment. This is, of course, worse than realistic estimation, but it is still better than burying one's head in the sand.

While no instant miracles are possible, the Government is still expected to disclose, explain and implement short-term and long-term policies and measures, as the deficit and public debt can only start to decrease once an efficient government and a competitive economy have been achieved.