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PRESS RELEASES

A fiscal governance improvement plan for a future Croatian Government

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At its session of April 30, 2014, the Government of the Republic of Croatia accepted the **Convergence Programme of the Republic of Croatia for the Period 2014-2018**, the first Convergence Programme to be drafted by the Republic of Croatia as an EU Member State. The most specific part of the Programme deals with fiscal governance, explaining key changes in the budget system, necessary for **compliance with the European Semester** requirements. Improvements in fiscal governance, achieved through the planned changes, particularly in budget planning, public debt management and expenditure control, will not be seen until 2016.

An obligation to develop a Public Debt Management Strategy as from 2016 („better late than never“). The Government has prescribed an obligation to prepare a public debt management strategy to be adopted every three years for the next three budget years. Accordingly, the Government will, in 2016 (when preparing a 2017 budget), work out a Public Debt Management Strategy for the period 2017-2019. An important novelty will be the annual implementation report, as a constituent part of the national budget execution report. It would be good if the Government could introduce a provision in the Budget Act, obliging Parliament to discuss and approve public debt management strategies.

Limitation of public debt and budget deficit growth. Under the Amendments to the Budget Act (Official Gazette 15/2015), the provision that the ratio between the amount of *national debt* outstanding at the end of a current year and GDP projection may be higher than the previous year's ratio, but may not exceed 60% of GDP, has been deleted. The public debt dynamics will be regulated by a new Fiscal Responsibility Act, providing that, instead of the national debt, *general government debt* may not exceed 60% of GDP. This definition of debt is in line with the Stability and Growth Pact and Maastricht criteria.

The relevant amount of deficit is the one approved by Parliament. As from the next budget year, *realised* budget deficit may not exceed the amount projected by Parliament (or the representative body of a local self-government unit). This provision will be applied in the preparation of the 2017 budget. Even for the 2016 budget, the amount of budget deficit will depend on the level set by Parliament (or the representative body of a local self-government unit) in the projections for 2017-18.

Issuing guarantees will be strictly subject to a restructuring plan. The Government intends to tighten the control of guarantee issuance when drafting a 2016 national budget execution act. Guarantees will be issued to budget and extra-budgetary users only subject to well-elaborated restructuring plans.

Improvements in budget preparation. Both the Convergence Programme and the National Reform Programme are included in the preparation of the 2016 budget, which will cause changes in the national budget calendar. The budgeting process for the next three-year period will start earlier, because the

Convergence Programme and the National Reform Programme must be submitted to the European Commission for consideration and evaluation by end-April. The macroeconomic scenario and fiscal policy framework will be published earlier, as part of the Convergence Programme (instead of, as before, in the Economic and Fiscal Policy Guidelines). The Ministry and other government bodies continue to be obliged to develop strategic plans as a basis for the preparation of convergence and national reform programmes. The deadline for the preparation and submission to the Ministry of Finance of *instructions for drawing up strategic plans* for a three-year period will be moved from mid-March to end-February, and the deadline for the submission of *strategic plans* to the Ministry of Finance from mid-April to end-March. The Convergence Programme and the National Reform Programme, along with the strategic plans, will provide a basis for drawing up draft economic and fiscal policy guidelines for a three-year period.

Fiscal Responsibility Statements also required from heads of companies owned by the state and local self-government units. The Fiscal Responsibility Act applies to heads of budget and extra-budgetary users of the state and local self-government units' budgets (municipality and city mayors and county prefects). In the future, this Act will also apply to the Management Board chairpersons of companies owned by the state and local self-government units, as well as heads of other legal entities established by the state or by one or more local self-government units. According to the Act, the heads are obliged to produce fiscal responsibility statements, confirming that they have ensured the legal and purposeful use of earmarked funds, as well as the efficient and effective functioning of the financial management and control system. New penalty provisions have been introduced: a head is fined between HRK 5,000 and HRK 25,000 for misdemeanour if his/her Fiscal Responsibility Statement is found to be inauthentic.

Changing the scope of extra-budgetary users in order to comply with the EU statistics requirements. According to a new definition, extra-budgetary users are extra-budgetary funds, companies and other legal entities in which the state and/or local self-government units have a decisive influence on management and which are (according to the EU methodology) classified under the 'general government sector' without being budget users. The previous scope of extra-budgetary users of the state budget included: Croatian Roads Ltd., Croatian Waters Ltd., Environmental Protection and Energy Efficiency Fund and State Agency for Deposit Insurance and Bank Rehabilitation. Since 2013, the scope has included the Restructuring and Sale Center, Croatian Radio television and HZ Infrastructure Ltd. Since 2015, the new statistical scope of government has includes Croatian Motorways Ltd., Rijeka-Zagreb Motorway and CBRD (HBOR). At the local level, these entities continue to function as county road administrations.

Dual limit in expenditure planning. In its budget preparation guidelines for ministries and other budget users at the section level of the organisational budget classification, the Government has set limits on expenditures. So far, the limits related to the total estimated expenditures of the sections, divided into classes under the economic classification (operating expenditures, and expenditures for the acquisition of non-financial assets), which have been financed from general revenues and receipts, contributions and earmarked receipts. As of 2016, a new way of setting the limits will be introduced, i.e. instead of one limit, two limits will be laid down for the section level of the national budget. The first limit will depend on the funds necessary for the implementation of existing programmes (activities) and the second will be set in accordance with new, or changes in the existing, programmes (activities). It will be possible to distinguish the costs of existing programmes from those of new programmes (the costs of changes in the level and type of services). Dual limit will also apply to local self-government units.

More flexibility in budget execution. The 2015 Budget Act provides that funds under budget line items may be reallocated up to a maximum of 15% (instead of the previous 5%) of expenditures and outlays under the budget line item adopted by Parliament (or a representative body), if so approved by the Minister of Finance (or a municipality mayor, a city mayor or a county prefect). The higher reallocation percentage is due to the necessary participation in the financing of projects co-financed from the EU funds. The purpose of stepping up flexibility is to encourage the preparation and ensure efficient implementation of projects co-financed from the EU funds.

Fiscal rule correction. In line with a country-specific recommendation of the Council of the EU, Croatia has embarked on formulating a proposal for a new Fiscal Responsibility Act. The current Fiscal Responsibility Act envisages corrective measures only in respect of deficit, but not the regulation of general government debt. Hence, in addition to the deficit rule, it is envisaged to introduce a debt rule in compliance with the Stability and Growth Pact. As a country undergoing an excessive deficit procedure, Croatia will have to reduce by one twentieth annually the portion of its general government debt that exceeds the 60% of GDP benchmark.

Improving the expenditure control system through strengthening the role of the State Audit Office (SAO). After 2013, the SAO has required that each audited entity should submit information on the measures taken, in the form of a Plan for the Implementation of Orders and Recommendations, accompanied by a list of activities (measures), competent persons and implementation deadlines. An amendment to the legal framework, planned for end-2015, envisages the strengthening of the SAO capacities, through professional education and training and the development of a model of penalising users who do not comply with the recommendations.

All the proposed measures are a step in the right direction, which the Government should have taken at the beginning, rather than at the end of its term of office. Just like previous Governments, this Government has postponed the reforms, shifting the responsibility for their implementation onto some other future Government. According to the European Commission's Spring Forecast data, Croatia will not get out of the excessive deficit procedure before the end of 2017. The Commission and the Council of the EU will extend the procedure until the end of 2017, as confirmed by differences between the Commission's Spring Forecast data and the Croatian Government's forecasts indicated in the Convergence Programme. The Government underestimated the amount of deficit by 0.6 and 1.8 percentage points in 2015 and 2016 respectively. It also underestimated the amount of the general government gross debt in 2015 and 2016, by 0.7 and 1.9 percentage points respectively (Table 1).

Croatia is again facing the challenge of the appropriate professional staffing of the public finance management system, as a consequence of using more sophisticated fiscal governance techniques. This technically more complex public finance system requires highly professional Government employees. Croatia once again needs to strengthen its administrative capacities which have been criticised by the European Commission in every Progress Report during the EU accession process. Today, the Croatian society suffers the consequences of taking the recommendations lightly, i.e. accepting them only formally, without materially following them. Croatia neither has time, nor can it afford the luxury of waiting for the heads of its ministries to learn the essence of fiscal governance (which will probably not happen before the end of their terms of office).

Table 1 A comparison between the European Commission' and the Croatian Government's GDP, deficit and general government gross debt forecasts

		2014	2015 plan	2016 plan
Real GDP growth (%)	European Commission	-0.4	0.3	1.2
	Government of the RC	-0.4	0.4	1.0
	Difference	0.0	-0.1	0.2
General government deficit (% of GDP)	European Commission	5.7	5.6	5.7
	Government of the RC	5.7	5.0	3.9
	Difference	0.0	0.6	1.8
General govt. gross debt (% of GDP)	European Commission	85.0	90.5	93.9
	Government of the RC	85.0	89.8	92.0
	Difference	0.0	0.7	1.9

Sources: European Commission's Spring 2015 Economic Forecast and Convergence Programme of the RC, 2015-2018.