



REPUBLIC OF CROATIA

**CONVERGENCE PROGRAMME OF THE
REPUBLIC OF CROATIA
FOR THE PERIOD 2015 – 2018**

April 2015

Foreword

At its session of 30 April 2015, the Government of the Republic of Croatia adopted the Convergence Programme of the Republic of Croatia for 2015. This is the second Convergence Programme drafted by the Republic of Croatia as an EU Member State. This 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 provisions 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 an economic dialogue, drafting of recommendations for individual Member States and their implementation into practice. The Convergence Programme is also a document reporting on the efforts undertaken by the Republic of Croatia for the purpose of fulfilling the recommendations of the Council of the EU within the framework of the Excessive Deficit Procedure. The document was drafted by the Ministry of Finance in cooperation with the Croatian National Bank.

Table of Contents

Foreword	I
Table of Contents	II
List of Tables	III
List of Charts	III
1. FRAMEWORK AND OBJECTIVES OF ECONOMIC POLICY	4
2. MACROECONOMIC TRENDS	6
2.1. Current macroeconomic trends	6
2.2. Mid-term macroeconomic scenario	9
2.3. Risks of macroeconomic forecasts	15
3. GENERAL GOVERNMENT BUDGET AND PUBLIC DEBT	16
3.1. Fiscal policy	16
3.2. Budget execution in 2014	17
3.3. Excessive budget deficit reduction measures	19
3.3.1. Structural measures in 2015	23
3.3.2. Structural measures in 2016	29
3.4. General government budget in 2015	33
3.5. Mid-term budgetary framework (2016 – 2018)	37
3.6. Assessment of the cyclically adjusted budgetary balance	39
3.7. Standing and projection of trends of the public debt and standing of guarantees	39
4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMMES	43
4.1. Fiscal Risks and Public Debt Trend Sensitivity Analysis	43
4.2. Comparison with the Previous Programme	44
5. PUBLIC FINANCES SUSTAINABILITY	46
6. QUALITY OF PUBLIC FINANCES	54
7. INSTITUTIONAL CHARACTERISTICS OF PUBLIC FINANCES	63
7.1. Amendments to the Budget Act	63
7.2. Fiscal Responsibility Act proposal	67
7.3. Fiscal statistics	70
ANNEXES	81

List of Tables

<i>Table 3.1. Structural measures for excessive budget deficit reduction</i>	20
<i>Table 3.2. Council recommendations for the correction of excessive deficit</i>	1
<i>Table 3.3. Fiscal forecast – Council Recommendations have been fully adopted and embedded in Croatia's fiscal projections</i>	1
<i>Table 3.4. Bond maturity overview (Croatia) in the period 2015 – 2018</i>	42
<i>Table 3.5. Projection of public debt trends</i>	42
<i>Table 4.1. Comparison of revenue, expenditure and net lending / net borrowing of the general government</i>	45
<i>Table 5.1. Pension expenditure and pension insurance contribution for the period 2013 – 2060 (% of GDP)</i>	52
<i>Table 5.2. 1st pension pillar expenditure in the period 2013 – 2060 (% of GDP)</i>	53
<i>Table 7.1. Annual financial statements and submission deadlines</i>	Pogreška! Knjižna oznaka nije definirana.

List of Charts

<i>Chart 3.1. Movements and structure of the public debt</i>	40
<i>Chart 4.1. Public debt share trend in GDP according to specific scenarios</i>	44
<i>Chart 5.1. Older population share (65+) in total population</i>	46
<i>Chart 5.2. Expected life expectancy at birth, women (in years)</i>	46
<i>Chart 5.3. Expected life expectancy at birth, men (in years)</i>	47
<i>Chart 5.4. Comparison of age and gender population structure</i>	47
<i>Chart 5.5. Projection of the number of employees (insured persons) and the number of pensioners in the period from 2013 to 2060</i>	48
<i>Chart 5.6. Spending for health (as % of GDP)</i>	49
<i>Chart 5.7. Spending for the long-term welfare (as % of GDP)</i>	51

1. FRAMEWORK AND OBJECTIVES OF ECONOMIC POLICY

The aim of the economic policy of the Croatian Government is to stimulate a sustainable growth following a recession that has been going on for years. As opposed to the pre-crisis growth based on a substantial borrowing for the purpose of increasing personal consumption and investments into real estate, the new long-term sustainable growth model should be based on export and related investments into production. To that end, the main task of the Government is to implement structural reforms, described in the National Reform Programme, aimed at improving the business environment. There is only a limited room for manoeuvre for macroeconomic policies. Monetary policy is limited by a high degree of eurisation and a weak credit channel, whereas the fiscal policy has exhausted the space for anti-cyclic activity due to the long recession. Moreover, a rapid fiscal consolidation is necessary due to the increased public debt.

It is expected that the Croatian economy will exit the six-year crisis, in the course of which the real gross domestic product fell by over 12%. Economic recovery will be based on the export growth and related investments into production. Following the initial positive impulse of shifting the tax burden from earned income, personal spending is expected to keep growing on the basis of production growth and income in export activities. Due to the need for fiscal consolidation, government spending will continue to have a negative effect on the growth in the mid-term period. This partially refers to public sector investments, which will also have a slower growth than previously planned, primarily through the use of EU funds.

Deflation represents a major problem for the economic policy and fiscal consolidation. At the international level, the shocks abroad, primarily caused by the drop in prices of oil and of other raw materials, as well as weak domestic demand, led to the drop in year-on-year consumer price index at the end of 2014. Despite increased excise taxes on tobacco and oil derivatives, a period of relatively low inflation is expected to continue in the following few years due to weaker price increase in the environment and weaker domestic aggregate demand. Public administration reform will also have a negative impact on the government spending deflator. As a result, a weak growth of GDP deflator is also expected which, along with the slow recovery of the real growth, affects the proportionally slow growth of the nominal gross domestic product. Such circumstances complicate fiscal consolidation efforts and financing of the increased public debt. Therefore, fiscal consolidation has to be focused on the reduction of nominal amount of expenditures.

The fiscal consolidation framework has been defined by the Council Recommendations for addressing excessive budget deficit, adopted in January 2014. According to the Recommendations, Croatia was requested to adopt fiscal consolidation measures of 2.3% of GDP in 2014 and 1% of GDP in each of the following two years. Last year the Croatian Government implemented structural efforts exceeding requests from the Council recommendations, and this strong fiscal consolidation exceeding the requested measures is expected to continue in the following period.

Fiscal consolidation measures in the following period are focused on the expenditure side of the budget. Reduction in the state budget spending has been provided for in the budget for the 2015 – 2017 in the majority of main expenditure categories. Budgetary expenditures have been further

reduced due to the Croatian Government measures from April 2015. Significant savings are also expected with regard to public companies in the government sector through accelerated restructuring and reduction of planned investments.

Despite the adopted measures, general government deficit according to the European System of National and Regional Accounts (ESA 2010) amounted to 5.7% in 2014, which is much higher than expected. There are several reasons that could explain this. The first reason refers to the materialisation of negative risks and weaker economic growth, as well as to lower budgetary revenues than expected. The second reason refers to the inclusion of some infrastructural public companies and public-private partnership projects into the government sector, as well as the takeover of the guaranteed debt of HŽ Cargo upon third call. Finally, according to ESA 2010, the revenues from transferring funds from 2nd into 1st pension pillar have been excluded.

The described circumstances explain why the nominal conditions from the Stability and Growth Pact will be fulfilled one year later than expected. Nevertheless, the Croatian Government is decisive to implement a series of measures aimed at dealing with the excessive budget deficit, which is described in detail in this document.

The reform of budgetary planning and expenditure monitoring is also under way. The macroeconomic planning process has been improved and measures limiting significant deviations from macroeconomic projections with regard to forecasts of the European Commission have been provided for. Transition towards budgetary planning according to the ESA 2010 system is also under way. For the purpose of a more efficient expenditure control, as of 2016 all public companies in the government sector will be included in extra-budgetary users. For the purpose of better transparency, in the 2016 budget the expenditures for the existing projects and policies will be differentiated from the expenditures of new projects and policies. Finally, when adopting future budgets, it will be necessary to submit both a detailed plan according to the national methodology and a general government budget according to the ESA 2010 methodology. This requires an improved assessment of the impact of economic policies on categories outside the national methodology.

In addition to the improved planning process, the function of expenditure supervision has also become more significant. First and foremost this refers to the new rules on fiscal responsibility. The importance of the state audit is to be further strengthened through sanctioning the failure to act by its recommendations. Finally, the approval of further government guarantees to public companies will be closely linked to their restructuring processes.

2. MACROECONOMIC TRENDS

2.1. Current macroeconomic trends

In 2014 recession trends in the national economy have continued for the sixth year in the row. Gross domestic product recorded a real decrease of 0.4% in 2014, which represents a decrease slowdown of 0.5 percentage points in comparison to 2013¹. Domestic demand continued to decrease in 2014, while the net foreign demand had a positive effect on gross domestic product. The biggest negative contribution to the gross domestic product decrease in 2014 came from import of goods and services, which had a year-on-year increase of 3.0%. Since there was a decrease in the domestic demand, this meant that the import increase in 2014 was linked to the export. All domestic demand components had a negative effect on economic activity. Gross fixed capital formation decreased by 4.0% in real terms. Household consumption recorded a real decrease of 0.7% under the influence of continued unfavourable trends on the labour market and household deleveraging. Limited by fiscal consolidation measures, government consumption recorded a real decline of 1.9%, which is stronger than in previous years. Export of goods and services recorded a significant growth in 2014 (+6.3%) under the influence of strengthening of foreign demand and positive effects of the EU accession, but also of effects of methodological changes in the statistics of foreign trade in goods.² Export growth in 2014 exceeded the foreign demand growth, which resulted in an increase of the Croatian share in relevant export markets. Export growth in 2014 is primarily a consequence of an increased export of goods (real growth of 11.1%), whereas the export of services recorded a real growth of 1.8%. Calculation of the gross domestic product on the production side shows that in 2014 the real decrease in gross value added was primarily the result of the real decrease in gross value added in construction, which has been recording negative trends since the beginning of recession. On the other side, after five consecutive years of decline, manufacturing recorded a real increase in gross value added (+3.3%) in 2014, having the most significant positive effect on the turnaround of the total gross value added. In addition, the real 0.5% growth in gross value added was also recorded in retail and wholesale trade, transportation, storage, accommodation and food service activities.

The last year's Convergence Programme projected a stagnation of the real economic activity in 2014. The most significant deviations from the last year's projections and realisations were recorded with regard to gross fixed capital formation and international trade. The last year's Programme predicted a real 1.9% increase in gross fixed capital formation, but in fact they recorded a 4.0% decrease, which is a consequence of non-investing of the wider public sector in the planned scope, what was recognised as a negative risk of projections, but also of a slightly weaker realisation of private investments than expected. Deviations of the realised export and import of goods and services from

¹ Data on gross domestic product for 2013 and 2014 are preliminary.

² A new methodology of foreign trade in goods, which was introduced following Croatia's accession to the EU, due to interrelations between the Intrastat and the Extrastat data collection systems, leads to an increased foreign trade in goods for the quasi transit effect and, consequently, to a distortion of a series of annual change of foreign trade in goods in the first and second year of the EU membership.

their last year's projections are primarily a consequence of methodological changes in the national accounts statistics since the ESA 2010 methodology was introduced after the completion of the Convergence Programme, i.e. in September 2014, which resulted in significant corrections of international trade categories. Government spending recorded a more significant decline than the predicted one, whereas projection for the household spending was more or less accurate.

The lack of economic growth had a negative impact on employment trends in 2014. According to administrative data, the average number of total employed persons was reduced by 1.6% in 2014 and by 1.3% in January and February of 2015 on the year-on-year level. The average rate of registered unemployment was reduced from 20.2% in 2013 to 19.6% in 2014 as a consequence of a more significant relative decline in the number of registered unemployed persons³ than in the workforce. Average salaries recorded only a mild nominal increase in 2014, as well as a mild real salaries increase due to a negative inflation rate. Consequently, the average monthly gross salary of people employed in legal entities recorded a real increase of 0.4% in comparison with 2013, whereas the average monthly paid net salary recorded a 0.5% increase. However, amendments to the Income Tax Act at the beginning of 2015⁴ have led to a considerable acceleration of the real year-on-year net salaries growth in the December 2014 – February 2015 period.

The average annual inflation rate of consumer prices was slowed down from 2.2% in 2013 to -0.2% in 2014. Such trends reflected primarily the overflow of decreased prices of raw materials on the global market into the domestic consumer prices, where the decline in prices of raw food materials was particularly significant. Pressure on lowering the total annual inflation rate was exerted primarily from the prices of food products, which account for a significant 26.7% share in the basket serving as the basis for the calculation of the consumer price index. This pressure weakened in the last quarter of 2014, whereas the deflator pressure grew stronger due to a considerable price decline of oil derivatives as a consequence of a significant price decline of crude oil on the global market. Weak foreign and domestic economic activity and low core inflation in the Eurozone have also, but only slightly, contributed to the reduction of inflation in 2014. The lack of domestic cost pressure is another factor contributing to the realisation of low inflation. At the beginning of 2015 deflationary pressures in the economy have continued. The year-on-year decline in consumer prices amounted to 0.4% in the first quarter of 2015, which was primarily the consequence of the decline in energy prices.

Projections from the last year's Convergence Programme indicated positive inflation rate of 0.6% in 2014. Realisation of the lower inflation rate than the projected one is primarily the consequence of a stronger than expected decline in raw materials prices on the global market.

According to the preliminary data, surplus of the balance of payments current account⁵ decreased from 0.8% of GDP in 2013 to 0.7% of GDP in 2014. The adverse movements of the balance of primary

³ The total number of registered unemployed persons has started to drop on the year-on-year level since April 2014, and this trend has continued until the end of the year. However, the aforementioned decrease in unemployment was accompanied by an increased number of people erased from the Croatian Employment Service (HZZ) records due to the non-compliance with legal provisions.

⁴ For more details on the amendments to the Income Tax Act see Chapter 3.3.1. Structural measures in 2015.

⁵ Balance of payments is based on the sixth edition of the Balance of Payments and International Investment Position Manual, as well as on sector classification of institutional units in line with the ESA 2010.

and, to a somewhat lesser extent, secondary income accounts had a negative effect on the current account balance in 2014. Deficit increase on the primary income account is primarily a result of increased profit of companies in foreign ownership and increased total interest costs of foreign financing. More funds are being paid into the EU budget than are being used from the EU funds, which is the major factor of positive balance reduction on the second income account⁶. In contrast, growth of net export of services had a positive impact on the current account balance, which primarily refers to the increase in revenues from services provided in tourism, and decrease in negative balance on goods account due to a stronger growth of exports than of imports. Capital flows from abroad (excluding change in international reserves) in 2014 were marked by net growth of funds, i.e. net outflow of capital in the amount of EUR 0.3 billion. This is primarily the result of a significant improvement of net debt positions of credit institutions. The net liabilities of government have increased, but to a lesser extent than in the previous year. Foreign direct investments have recorded a bigger net inflow, i.e. increase in net liabilities, than in the previous year, which was primarily the result of retained earnings, particularly on the liabilities side.

At the end of 2014 international reserves amounted to EUR 12.7 billion, which is 1.7% less than at the end of the previous year. Reduction in reserves is the consequence of the decline in the government foreign currency deposit with the central bank and net sales of foreign currencies of the Croatian National Bank. Unfavourable trends have partly been mitigated by realised profits on their investment and positive exchange rate differences, due to the strengthening of the US dollar against the euro. In the first two months of 2015, gross international reserves have slightly increased and amounted to EUR 12.8 billion at the end of February.

Due to a relatively more favourable trends of prices and costs compared to the major trading partners, indicators of price and cost competitiveness of Croatian exports improved in 2014 in comparison with 2013. As such, the real effective exchange rates of the kuna with consumer and producer's prices weakened in 2014 by 1.1% on average, where the real effective exchange rates of the kuna with unit labour costs in the total economy and manufacturing depreciated by 1.4% and 4.2% respectively.

The exchange rate of the kuna against the euro was stable in 2014, with occasional fluctuations which were less significant than the previous year. The nominal daily exchange rate of the kuna against the euro during 2014 ranged from -0.9% to 0.6% around the average annual exchange rate, which was 7.63 EUR/HRK, and which was 0.7% weaker than in 2013. The main instruments of monetary and exchange rate policy in 2014 were again foreign currency transactions of the central bank, which achieved net sales of foreign currency of EUR 0.2 billion, thus withdrawing HRK 1.6 billion of primary money. In the structure of foreign currency transactions in 2014, the buyoff of foreign currency pertains to transactions with the central government (foreign currency arriving based on foreign borrowing), while the sales of foreign currency pertains to interventions on the foreign currency market aimed at stopping depreciation pressures in February 2014 and, to a larger

⁶ In the balance of payments statistics, resources from EU funds are allocated to the second income account or to capital account only after they have been paid to end users. Funds which have been received, but have not been allocated to final beneficiaries, are recorded only on the financial account. If the total received funds are taken into account, rather than only those allocated to final beneficiaries, the total net effect of transactions with the EU was a positive one in 2014.

extent, to transactions with the European Commission. Similar trends have continued at the beginning of 2015. In January and February 2015, the Croatian National Bank sold the total of EUR 0.5 billion to commercial banks in two foreign currency interventions in order to mitigate depreciation pressures. On the other hand, by the mid-March the Croatian National Bank redeemed from the central government the total of EUR 0.8 billion in foreign currency received from the issuing of foreign currency treasury bills on the domestic market and bonds on the international market.

Despite the high liquidity of the monetary system, the trends in monetary and credit aggregates in 2014 continued to reflect negative trends in the real economy sector. The net foreign assets of the monetary system increased significantly due to the improved foreign position of credit institutions, in which deleveraging abroad was more pronounced than the previous year. The net domestic assets recorded a moderate decrease, where placements to the central government increased, while placements to other sectors (excluding exchange rate changes) decreased by 3.0%. Following the growth realised in the previous year, in 2014 companies recorded a significant decrease in domestic placements (4.0%), while the household sector continued deleveraging for the sixth consecutive year (-1.6%). The achieved changes of the net domestic and net foreign assets resulted in an increase in the total liquid assets (M4) by 2.8%, i.e. 2.0%, excluding the exchange rate effect. The first two months in 2015 has recorded a significant increase in net claims on central government and a mild increase in placements to companies, while deleveraging of households has continued.

2.2. Mid-term macroeconomic scenario

Macroeconomic projections are based on the available statistical indicators published by mid-April 2015. Foreign assumptions, such as foreign exchange rate trends, price trends and global economic trends in general, as well as domestic demographic trends in the mid-term period were taken from the latest available documents of the European Commission⁷ and International Monetary Fund⁸. In the mid-term period, international environment will be characterised by relatively favourable macroeconomic trends. In comparing the European Commission's latest forecasts from February 2015 with the previous projections, there is a minor positive correction of growth of the gross domestic product of the EU in all years of the projection period and a mild negative correction of Croatian export markets growth in 2015, where, for the group of the most important Croatian export destinations, positive corrections of both economic growth and imports of goods and services are predominant.

The six-year long trend of a decrease in real year-on-year gross domestic product is expected to end in 2015, with a mild 0.4% increase of economic activity. Gross domestic product will grow as a result of positive contribution of the net foreign demand (net export). On the other hand, domestic demand will have a mildly negative contribution to the gross domestic product increase, and change in inventories will have a neutral contribution. Similar trend has also been present in the previous years, but it should be pointed out that all the contributions to growth expected in 2015 are only

⁷ „European Economic Forecast – Winter 2015“ published in February 2015 and assumptions from the „European Economic Forecast – spring 2015“.

⁸ World Economic Outlook, April 2015.

modest with regard to their absolute value. By observing individual expenditure-side components of the gross domestic product, it is evident that the increase in the economic activity in 2015 is based on the increase in export of goods and services in the conditions of a mild increase in the rate of growth of foreign demand. Household consumption will also have a mildly positive contribution to growth, where legal amendments to income taxation stand out with their positive effect. All the other expenditure-side components will make negative contributions to the gross domestic product increase, and imports of goods and services most of all.

Table 1: Macroeconomic framework for the period 2014 – 2018

	2014	Projection 2015	Projection 2016	Projection 2017	Projection 2018
GDP, current prices, HRK million	328,927	330,683	336,477	344,092	353,967
GDP, real growth (%)	-0.4	0.4	1.0	1.2	1.5
Household consumption	-0.7	0.5	0.3	0.5	1.1
Government consumption	-1.9	-1.2	-1.4	-1.0	-0.6
Gross fixed capital formation	-4.0	-1.3	1.8	3.2	3.6
Export of goods and services	6.3	3.7	4.6	4.8	4.8
Import of goods and services	3.0	2.8	4.0	4.5	5.0
Contributions to GDP growth (percentage points)					
Household consumption	-0.4	0.3	0.2	0.3	0.6
Government consumption	-0.4	-0.2	-0.3	-0.2	-0.1
Gross fixed capital formation	-0.8	-0.2	0.3	0.6	0.7
Change in inventories	-0.2	0.0	0.2	0.2	0.1
Export of goods and services	2.7	1.7	2.2	2.3	2.5
Import of goods and services	-1.3	-1.2	-1.8	-2.1	-2.4
GDP deflator, growth (%)	0.0	0.2	0.8	1.1	1.4
Consumer price index, growth (%)	-0.2	0.1	1.1	1.3	1.4
Employment, growth (%)*	-0.7	-0.2	0.1	0.8	1.3
Unemployment rate (ILO)	17.3	17.1	16.8	15.9	14.3

* Domestic concept of national accounts definition

Source: Croatian Bureau of Statistics, Eurostat, Ministry of Finance

The gross domestic product has been projected to grow by 1.0% in real terms in 2016, which in the following years will accelerate to 1.2% and 1.5%. Export of goods and services will be the main driving force of economic growth in the 2016 – 2018 period, as opposed to projections from the previous year's Convergence Programme, when it was mostly gross fixed capital formation, in line with the previously expected rapid growth in investments of public companies. However, domestic demand will again prove to be the source of growth in the last two-years of the observed period, despite the fact that it has been limited owing to a relatively high indebtedness of domestic sectors, strong and prolonged disturbances on the labour market and modest built-in expectations with regard to the economic recovery dynamics. Import of goods and services will have a considerable negative contribution to growth in the entire projection period as a result of speeding up of economic growth and a higher degree of import dependency as compared to the pre-crisis period. The contribution of household consumption to the economic growth will remain suppressed until the end of the mid-term period when it will record a mild increase. Government consumption will be characterised by mild negative contributions to growth throughout the projection period as a result

of a necessary fiscal consolidation within the framework of the Excessive deficit procedure. A more significant contribution of the investment spending is expected in the last two years, based on increased private investments fostered by transfers from the EU funds, whereas the change in inventories will have an insignificant effect on growth, except in 2016 and 2017 when it is expected to have a mildly positive contribution.

In the entire mid-term period, except in 2018, the GDP growth will be limited by weak household consumption dynamics. But in spite of that, the change in the household consumption is expected to take on a positive sign already in 2015. Recent high-frequency indicators, such as retail trade turnover in the first two months, speak in favour of that. Changes to the income taxation system have had a crucial effect on such a projection, which, with the total estimated effect on the disposable income of households in the amount of 0.6% of GDP, which will speed up the growth rate of net earnings by over 2 percentage points. However, favourable effects of taxation changes could partially be cancelled by legal amendments at the local level, and they will also be limited by a decreased propensity to consume in the household sector. Nevertheless, it should be noted that a mild weakening of the households' deleveraging is expected in 2015, and survey results on the consumer's confidence from the beginning of the year speak in favour of that. Approved loans to households will therefore again record a minor growth in 2015. The wage bill and, to a lesser extent, transfers to households and net other incomes are expected to have a positive impact on real trends of disposable income, which will grow moderately. This will primarily be the result of positive trends of net earnings despite an insignificant nominal growth in gross earnings. The decline in employment, the intensity of which will none the less decrease in comparison to previous years, will have once again an unfavourable effect on the disposable income of households. Moreover, disturbances with the Swiss franc exchange rate as well as depreciation of the kuna against other currencies will have an additional negative effect on household consumption. On the other hand, price trends will probably have a positive effect on household consumption after all, which primarily refers to the decline in energy prices. Gradual recovery of consumer's confidence, fostered by better economic conditions in general and the change of trends on the labour market, is expected to continue in 2016, so that the start of dynamising of loans to households is forecasted in that year as well. However, household consumption will still be limited by deleveraging of the household sector and a slow recovery on the labour market. The favourable base effect of taxation changes as well as the positive influence of price trends will disappear. As well as in 2015, fiscal consolidation will unfavourably affect household consumption, and social benefits will also negatively contribute to its real growth in 2016. Household consumption will gradually accelerate during the last two years of the projection period. However, household consumption growth will follow the dynamics of their disposable income during the entire forecasting period. Moreover, disposable income growth will be moderately faster in the first and the last year of the period.

Government consumption trend will be defined by a planned fiscal consolidation during the entire projection period. As such, government consumption is expected to decline by somewhat more than 1% in each of the first three years of the forecasting period and only slightly in 2018. Real decrease in government consumption in all years of the observed period is primarily based on the contribution of the intermediate consumption category, in line with a range of planned measures aimed at rationalising business operations of public administration. Then follow compensation of employees, with a mild real reduction, in line with the projected employment trends in the public sector, which will be most significant in 2015 and then gradually weaken towards the end of the projection period.

On the other hand, when it comes to social transfers in kind, their mild real reduction is expected only in the first year of the observed period based on specific savings in the health care system. This category should then have a nominal stagnation and an insignificant contribution to real change in the government consumption. Minor contribution in the opposite direction in all years of the projection period, and a somewhat more significant in the last year, could come from other categories comprising government consumption.

Recovery of the private sector investments will continue to be limited by the need for deleveraging and restructuring of many entities, as well as by weak business optimism reflecting a significant level of uncertainty regarding future trends of aggregate demand. In addition, the financing sources, as well as prices, continue to pose a problem for many companies due to risk aversion and, consequently, strict loan conditions of the banking sector, high liquidity of which did not contribute much to the improvement of liquidity conditions in the economy nor to encouraging economic activity in the previous period. On the other hand, public investments will be limited by the deleveraging process for many public companies, for which a markedly weak dynamics of investment activity is expected during the entire projection period, while gross fixed capital formation by the general government will be constrained by the need for fiscal consolidation within the excessive deficit procedure. However, a significant contribution to investment activity of all sectors in the entire period, and particularly towards the period end, is expected from the intensification of the usage of EU funds. Based primarily on investment activity of the general government, a moderate acceleration of growth in investments of the wider public sector is expected in 2015 and 2016, which is expected to slow down in the last two years. Recovery of the private investment spending and its mild growth is expected in 2016, while a more significant intensity of its growth is anticipated only in the final two years of the projection period. The predicted strengthening of the private sector's investment activity towards the end of the observed period is based on the stronger recovery of domestic demand and the strengthening of foreign demand, in the conditions of an improved business climate, more favourable financing conditions and liquidity in the economy, as well as better results of laws aimed at encouraging investment projects and competitiveness along with a significant positive contribution of the EU funds, as has already been mentioned. The construction sector is expected to start with its recovery only in 2017.

Export of goods and services will record positive growth rates in the entire 2015 – 2018 period and, among individual GDP components, it will be the main generator of economic growth. Export projection, except on the expected strengthening of the foreign demand for domestic goods and services, is based on a positive structural change of the domestic export sector, which was primarily stimulated by entering the common EU market. It is estimated that the export of goods after entering the EU market has experienced a favourable effect of widening the base, as regards the presence on emissive markets, i.e. expanding of the domestic exporters' distribution channels. In addition, non-price competitiveness of the domestic export should be improved, having primarily in mind the positive effect of declarations of origin of goods. A certain positive impact on the price competitiveness will, particularly at the beginning of the observed period, result from a mild depreciation of real effective exchange rates. It should be noted here that there has not been any significant decline of share on the CEFTA markets, as it was previously predicted. The greatest contribution to foreign demand growth will come from stronger imports of Germany, the country with the biggest share in the Croatian export of goods and services, and, to a lesser extent, imports of Slovenia, Bosnia and Herzegovina and Italy. Due to exceptionally favourable results of export of

goods and services in the previous year, much of which pertains to the one-off effect of accessing the EU, export growth will slow down significantly in 2015, whereas it will again gradually accelerate in the years to come. As opposed to the previous three years, when the Croatian export markets share increased, the trends will again turn to the opposite direction in the following years. In other words, it is expected that domestic export growth will be weaker than the foreign demand growth during the entire projection period whereat the gap will be the smallest in 2015 and the market share decline will be at its peak in 2016. But even then, the annual share loss on relevant emissive markets of the foreign trade partner-countries will be much lower than the pre-crisis percentages. It should also be noted that the increase in export of goods during the entire period, except 2015, will significantly exceed the increase in the export of services, which will achieve a stable growth throughout the period.

Trends regarding import of goods and services in the mid-term period will be defined by the increase in final demand, which will gradually accelerate in line with the economic recovery. It should be emphasized that it appears that the elasticity of import with respect to final demand recorded permanent changes during the crisis. This primarily refers to the elasticity of import with respect to the export component, the level of which has significantly risen on a one-time basis as a direct result of the EU accession and, to a lesser extent, to other GDP components, primarily investment spending. Apart from statistical effects related to the EU accession, this primarily pertains to the change in the economic structure and shutting down of certain production capacities. Nevertheless, the elasticity of import with respect to final demand will, precisely as the result of the described effects, still be lower in the following years than in the last two years which were affected by the said EU accession. Growth of import of goods and services is expected to be lower than that of export in all years of the projection period, except in the last year, so that the net foreign demand will have a positive contribution to GDP growth throughout the period. However, its absolute value at the period end will be insignificant.

A 0.1% growth in consumer prices is expected in 2015. Price trends will mostly be determined by a significant reduction in primary commodity prices on the global market, especially of crude oil, and, to a lesser extent, by price pressures by the domestic demand. The effect of raw material price reduction on the global market on the domestic consumer price index in 2015 will be mitigated by depreciation of the kuna against the US dollar. With regard to domestic pressures on consumer prices, they should be weak due to a mild increase in household consumption and unit labour cost. Consumer prices will also be influenced by administrative decision on price decrease of natural gas, increase in excise taxes on tobacco and motor petrol, gas oil and kerosene as of April this year⁹. When observed by consumer price index components, 2015 is expected to record a decrease in energy prices, primarily due to price decrease of fuels and lubricants for personal transport equipment, which is related to the already mentioned strong decrease in crude oil prices. On the other hand, the rate of food prices change is expected to increase, as well as the consumer price index without food and energy as compared to the previous year. In the remaining years of the projection period a gradual acceleration of inflation is expected in the conditions of the domestic demand recovery and of the price increase of primary commodities on the global market. Following a repeated decline in 2015, investment deflator will gradually increase. The similar will also apply for deflators of export and import of goods and services, where foreign price trends, primarily on the

⁹ The overall contribution of those categories to the change in CPI in 2015 is predicted at 0.1 percentage point.

global market of primary commodities, play a dominant role. The government consumption deflator primarily reflects fiscal consolidation measures and, in 2015, a year-long effect of increased health insurance contributions.

Unfavourable trends on the labour market are expected to continue in 2015, but with a much lower intensity than in 2014. In line with the speeding up of economic growth, the negative trend is expected to end in 2016. Employment projection predicts a mild decrease in 2015¹⁰ and an insignificant increase in 2016, with a tendency to accelerate toward the end of the projection period. Employee category will record somewhat greater changes than the total employment throughout the period, solely as the result of a rising employment in the private sector. As a consequence of stronger real growth of the gross domestic product than the employment growth, the average labour productivity will record a mild increase, which will slow down towards the end of the projection period and in 2018 will amount to just above 0%. Unit labour cost will increase insignificantly in 2015 and record a minor decrease in 2016. However, the last two years of the projection period will record an accelerated increase in unit labour cost, which will amount to 1.6% in 2018 as a result of speeding up of growth in average earnings and slower increase in labour productivity. The real unit labour cost will record lower growth rates during the entire period. In line with the described employment trends, a continuous decrease in workforce is projected, with a minimal decline rate in 2016, where assumptions on mid-term and long-term decline rates have been taken over from the European Commission services.

Loans to other domestic sectors are expected to stagnate in 2015, while government credit financing will continue to increase. The expected growth of the broadest money aggregate (M4) in 2015 could be similar to the one achieved in the previous year. Monetary trends cannot be expected to take a turn, not even in the mid-term period for which it a graduate and mild growth acceleration of monetary and credit aggregates is projected, in line with the slow recovery of the Croatian economy.

Positive balance on the current and capital account of balance of payments could improve in 2015 and reach 2.0% of GDP, as compared with the last year's 0.8% of GDP. Such trends should largely be determined by a marked increase in net export of goods and services due to a more pronounced increase in export than import. Also, more favourable results are expected in the secondary income account as a result of strengthening of absorption capacities related to the usage of current transfers from the EU funds and similar also applies to the capital account of the balance of payments related to transfers intended for capital investments. In the conditions of deleveraging of the private sector, low interest rates and slower profit growth of companies and banks in a foreign ownership, pressures on worsening of the primary income balance should be much less evident than the previous year. Current account of the balance of payments will continue to grow slowly until 2017, expressed as a share in GDP, whereas it could record an insignificant decrease at the end of the projection period. Such trend reflects only a minor increase in primary and secondary income balances by the end of the period with strong dynamics intensification on both the primary and the secondary income

¹⁰ Data obtained according to the ESA 95 methodology were used for the total employment series (domestic concept, national accounts). The same employment figures were then used in construction of the income side of GDP. It should also be noted that, according to administrative sources, a somewhat stronger decrease in employment is expected in 2015, as well as an even greater deviation of the workforce category when comparing the respective projections.

account, in opposite directions, especially in 2016, with the beginning of a somewhat stronger recovery.

2.3. Risks of macroeconomic forecasts

Macroeconomic scenario described herein is exposed to predominately negative risks. The greatest uncertainty pertains to export of goods and services dynamics. In other words, apart from risks arising from weaker foreign demand on the relevant export markets, weaker positive effects of entering the common EU market, which mostly pertain to expansion of the export base (more precise, is related to the market presence on foreign markets), as well as the improvement of the total competitiveness, represent the main risk for the whole scenario. It has been estimated that risks related to the household consumption projection, despite many influences, the most significant of which pertain to trends on the labour market, and projections regarding import of goods and services, as well as category of inventories, are balanced. In the mid-term, investment trends will largely depend on the usage of capital transfers from the EU funds, fiscal consolidation intensity regarding investment spending of the general government, but also on positive effects of the effort regarding the improvement of business climate, private investment stimulation, price of borrowing reduction and improvement of competitiveness. Significant positive risks for the realization of aggregate investments also arise from the above. Moreover, the real GDP dynamics is closely linked to fiscal consolidation intensity and structure.

Main risks that could cause different inflation rate from the predicted one include more significant changes in oil prices and more pronounced weakening of the kuna against the US dollar than the one foreseen, as well as poorer results on the labour market than the predicted ones. Finally, it should also be mentioned that more unfavourable mid-term trends of foreign interest rates due to less pronounced monetary loosening than the expected one or to other shocks would also jeopardise growth through several possible influence channels.

3. GENERAL GOVERNMENT BUDGET AND PUBLIC DEBT

3.1. Fiscal policy

In the next mid-term period, fiscal policy will focus on two key 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 a sustainable economic growth following the six-year recession.

Therefore, mid-term fiscal policies will be based on fiscal consolidation for the purpose of dealing with the excessive budget deficit. In other words, in January 2014, at the recommendation of the European Commission (EC), the Council adopted the recommendations requiring that Croatia resolves its excessive deficit by reducing it to less than 3% of the GDP by the end of 2016, and reduces the general government debt to less than 60% of GDP two years later.

Within the framework of the European Semester, at the end of 2014 the Republic of Croatia submitted the Convergence Programme of the Republic Croatia for the period 2014–2017 as well as a National Reform Programme of the Republic of Croatia. The Convergence Programme also represents the first official report of the Republic of Croatia on the implementation of fiscal policy measures for the excessive deficit correction.

Based on the review of the aforementioned document, as well as defined measures and their implementation plan, on 2 June 2014 the European Commission established that Croatia had taken the appropriate measures for the purpose of correcting budgetary imbalances and, therefore, the excessive deficit procedure was put on hold. Due to negative risks, Croatia has to ensure that appropriate measures are defined and implemented for the purpose of complying with the dynamics and goals of fiscal consolidation, defined by the Council recommendations. Therefore, every six months Croatia has to report on the implementation of appropriate fiscal consolidation measures.

In this regard, on 31 October 2014 Croatia submitted to the European Commission the Second report on the implementation of fiscal policy measures for the excessive budget deficit correction and compliance with the Stability and Growth Pact. At the end of November that same year, based on the analysis of the submitted document the European Commission submitted to the Committee for Economy and Finances a Report on improvement regarding implementation of the Council recommendations for resolving excessive budget deficit in Croatia. Bearing in mind the bottom-up approach, the European Commission established that in 2014 Croatia had slightly exceeded the requested fiscal effort of 2.3% of GDP. However, pursuant to the data on 2014 budget execution, predicted savings were realised in the amounts above than planned ones and the estimated fiscal effort amounted to 2.5% of GDP.

In order to meet the Recommendations requirements, 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 the strengthening of fiscal adjustments over time. This framework includes the strengthening of numerical fiscal rules, strengthening of the autonomy of the Committee for Fiscal Policy and Mid-Term Budget Planning in Croatia, and a strengthening of the dialogues with the EC and EU.

In the upcoming mid-term period, activities on the revenue side of the budget will be directed at tax base expansion, creation of the preconditions for the strengthening of tax supervision efficiency, timely availability of information and modernisation of the Tax Administration organisation structure. As such, the fiscalisation process will continue in cash transactions and electronic communication with taxpayers will intensify for the purpose of a more transparent and efficient recording and fulfilment of tax liabilities. Reorganisation of the Tax Administration will also continue. As of 2016, capital gains will be subject to taxation. Due to preparation of a new form of the Reports on receipt, income tax, surtax and contributions for compulsory insurance (the JOPPD form), exchange of data on income and other receipts of citizens with other institutions is more intensified.

On the expenditures side of the budget, the focus lies on the budgetary deficit reduction, but by using the measures which do not have a negative effect on growth, while at the same time retaining the social protection for citizens and even greater focus on the use of EU funds. The 2015 budget provided for the structural savings in most expenditures categories. For the purpose of achieving additional savings, but also of increasing the efficiency of public spending, in-depth analysis of the state budget has been carried out in order to analyse the expenditures deviating from the agreed policies and the ones that are in line with them. This should serve as basis for reaching a decision on defining measures for reducing the total public spending. In order to leave some space for fiscal consolidation that stimulates growth, the priorities of public spending will also include investments in water and transport infrastructure. In conditions of high unemployment, particularly among young people, the 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 have been defined and depend on the implementation of key structural reforms in the next period; they are described in detail in the National Reform Programme.

3.2. Budget execution in 2014

In the conditions of unfavourable economic trends and the need for a stronger fiscal consolidation pursuant to the Council recommendations within the framework of the EDP, amendments to the state budget and financial plans of extra-budgetary users of the state budget were adopted in March 2014. The amendments proposed a series of measures on both the revenue and expenditure sides of the budget, and their structural effect was assessed at the level of 1.9% of GDP. However, in order to achieve the level of necessary consolidation measures of 2.3% of GDP in line with the Council recommendations, Croatia prepared additional measures of 0.4% of GDP in 2014, which were

included in the Conclusion of the Croatian Government and in the Decision on measures of temporarily suspension of the Croatian State Budget execution for 2014. Due to continued unfavourable economic trends as compared to the previously planned ones and due to additional budgetary expenses due to the floods in Eastern Slavonia, new amendments to the state budget and financial plans for extra-budgetary users of the state budget were adopted in November 2014. On this occasion, the aforementioned additional measures from March 2014 were included in these amendments.

According to the final data for 2014, total general government budget revenues were executed at the level of 42.3% of GDP. Despite unfavourable economic trends, revenues execution was somewhat better than expected. As such, the revenues from value added tax, profit tax, special taxes, excise taxes and contributions recorded better results than planned. At the same time, revenues from grants had the most significant reduction, primarily because of a weaker dynamics of extracting EU funds.

Regarding structural measures on the revenue side of the budget, two legal amendments with regard to taxation of games of chance were implemented in 2014. Health insurance contributions increased from 13% to 15%, and insured persons whose pension rights had been regulated by special regulations were given the possibility to transfer funds from the second into the first pension pillar. The payment obligation of profit share of the companies of strategic and special interest for the Republic of Croatia in the majority or minority ownership of the Republic of Croatia, i.e. of surplus revenues over expenditures of agencies, institutes and other legal entities with public authority founded by the Republic of Croatia without the budgetary user status, was introduced in March. Excise taxes on leaded gasoline, unleaded gasoline and gas oil used as a propellant were increased by 20 lipa/litre. Fees for the right to economic use of the spectrum values for public mobile networks were also increased. All of the above revenue structural measures resulted in fiscal effect of 0.8 % of GDP in 2014.

The total general government budget expenditures in 2014 were executed at the level of 48% of GDP. The majority of budget categories realised significant structural savings, with the exception of compensations of employees. In other words, the expected effects in this expenditure category have failed despite savings realised due to the termination of additional payments for people employed in civil and public services in the amount of 4%, 8% and 10%, termination of individual additional payments in the defence and judicial sectors, as well as the change in payroll calculation in the science sector. This is because for some budgetary users it was necessary to provide additional funds (science, education and sport, internal affairs, social politics and youth). Moreover, significant structural savings were realised in the intermediate consumption category, primarily on commuting expenses, maintenance costs, intellectual and personal services, overheads, information system services and expenditures for materials, raw materials and services. The biggest reduction in subsidies was recorded with regard to the Croatian Bank for Reconstruction and Development (HBOR), shipbuilding and Croatian Railways. The health care system continued to rationalise the expenses through a unified procurement of prescription drugs, better control of sick leaves and the rationalisation of business operations in hospitals, carried out in the recovery programme and in the informatisation of the health care system. A permanent measure of a 10% reduction in privileged pensions above HRK 5,000 should also be mentioned here, which was also adopted that year. Significant savings were also realised in other current and capital transfers, especially related to the

projects in the field of agriculture, regional development, science and entrepreneurship. Capital expenditures have also recorded savings due to a slower dynamics of project realisation in the health care, judicial and science sectors. All of the above expenditure structural measures have resulted in the fiscal effect of 1.3% of GDP.

Structural decrease in the deficit of extra-budgetary users amounted to 0.4% of GDP, where the greatest savings were realised in the roads and water sectors.

In comparison with 2013, the general government's deficit increased from 5.4% of GDP to 5.7% of GDP in 2014, where the central government, including extra-budgetary users, public companies, Croatian Bank for Reconstruction and Development and other adjustments according to the new statistical methodology ESA 2010, recorded a deficit of 6.1% of GDP. At the same time, the local government had a surplus of 0.1% of GDP, and social security funds had a surplus of 0.3% of GDP. See Chapter 7 Institutional Characteristics of Public Finances for more details on the introduction of the new statistical methodology ESA 2010, applying the statistical scope of the state.

3.3. Excessive budget deficit reduction measures

Since January 2014 Croatia has been in the Excessive Deficit Procedure with the defined binding recommendations for its reduction given by the Council of the EU. According to these recommendations, in 2015 Croatia has to implement additional fiscal consolidation measures amounting to 1% of GDP. Based on the European Commission's Winter Economic Forecast from February 2015, in 2015 Croatia had to adopt additional fiscal consolidation measures amounting to 0.4% of GDP. In order to fulfil the Council recommendations and to put the EDP on hold, additional measures had to be taken in addition to the ones defined by the 2015 budget. Therefore, at its session held on 16 April 2015 the Croatian Government adopted the Regulation on excise taxes on cigarettes, fine-cut tobacco and other smoking tobacco, as well as the Regulation amending the Regulation on excise taxes on motor petrol, gas oil and kerosene used as a propellant. At its session held on 23 April 2015 the Croatian Government adopted the Decision on measures to temporarily suspend the execution of the Croatian State Budget for 2015, as well as the Decision on the implementation of measures regarding the companies of a strategic interest to the Republic of Croatia included in the state sectorisation within the framework of excessive deficit reduction. It also adopted the Decision on reducing the number of agencies, institutes, funds and other legal entities with public authorities and on establishing the Committee for the implementation of the rationalisation of the system of agencies, institutes, funds and other legal entities with public authorities. On the basis of this Decision, an action plan will be prepared by 1 October 2015 at the latest and a list of agencies, institutes, funds and other legal entities with public authorities to be terminated in 2016 will be defined. Bearing in mind the structural measures defined in the 2015 budget and 2016-2017 projections, as well as the aforementioned additional measures from April this year, the total proposed structural measures amount to 1.5% of GDP in 2015 and 1.2% of GDP in 2016.

Table 3.1. Structural measures for excessive budget deficit reduction

HRK million	2014		FISCAL EFFECT		FISCAL EFFECT	
	OUTTURN/EXECUTION	% of GDP	IN 2015	% of GDP	IN 2016	% of GDP
REVENUE STRUCTURAL MEASURES						
1. Taxes on gains from games of chance	90	0.03	200	0.06		
2. Changes in pension contribution system on behalf accelerated retirement	400	0.12	250	0.08		
3. Increase of concession charges						
4. Withdrawal of revenue from profits of the state-owned companies	70	0.02	600	0.18		
5. Increase of health contributions from 13% to 15%	1,600	0.49	800	0.24		
6. Reinvested profits					500	0.15
7. Introduction of tax on savings interest			300	0.09		
8. Fees for telecommunication services	160	0.05				
9. Increase of energy excises	350	0.11	430	0.13	140	0.04
10. Increase of tobacco excises			90	0.03	60	0.02
11. Income tax reduction			-1,800	-0.54		
12. Improvement of municipal fee system					300	0.09
TOTAL REVENUE MEASURES	2,670	0.8	870	0.3	1,000	0.3
EXPENDITURE STRUCTURAL MEASURES						
1. Compensation of employees			252	0.08	446	0.13
2. Intermediate consumption	1,098	0.3	278	0.08	540	0.16
3. Subsidies	1,211	0.4	347	0.10	569	0.17
4. Social benefits and social transfers in kind	936	0.3	71	0.02	200	0.06
5. Other current transfers and capital transfers	376	0.1	255	0.08	151	0.04
6. Gross capital formation	568	0.2	215	0.06	114	0.03
TOTAL EXPENDITURE MEASURES	4,188	1.3	1,417	0.4	2,020	0.6
EXTRABUDGETARY USERS AND COMPANIES OWNED BY THE REPUBLIC OF CROATIA	1,337	0.4	1,467	0.4	315	0.1
LOCAL AND REGIONAL SELF-GOVERNMENT UNITS			1,044	0.3	200	0.06
TOTAL FISCAL ADJUSTMENT	8,196	2.5	4,798	1.5	3,535	1.1
AGENCIES, INSTITUTES, FUNDS AND OTHER LEGAL ENTITIES WITH PUBLIC AUTHORITIES			150	0.0	350	0.1
TOTAL FISCAL ADJUSTMENT	8,196	2.5	4,948	1.5	3,885	1.2

Source: Ministry of Finance

In addition to the compulsory quantitative fiscal savings defined in the Council recommendations, proposals were also adopted to improve the broader framework of public finances. Thus Croatia is taking additional measures regarding structure analysis of the state budget expenditure through in-depth analysis of expenditures for the purpose of improving the fiscal system sustainability. Activities to combat the grey economy and increase efforts to combat tax evasion are ongoing as well. Finally, the reform of public finances management framework is also under way, including the amendments to the Budget Act and a new proposal of the Fiscal Responsibility Act.

It is evident from Tables 3.2 and 3.3 that Croatia does not meet the nominally defined general government deficit requirements defined by the European Commission in the observed years. This is due to years-long negative economic trends and, consequently, lower incomes, while significant structural activities have been performed on the expenditures side with the aim of a fiscal consolidation. In addition, as of September 2014 a new statistical methodology ESA 2010 was introduced, which expanded the statistical scope of the general government sector by including individual public companies (Croatian Motorways – HAC, and Rijeka-Zagreb Motorway – ARZ) into the specified sector. Certain adjustments according to methodological requirements of the ESA 2010 system were also carried out. All of the above resulted in more unfavourable indicators of nominal deficits of the general government as compared to those requested by the European Commission.

Despite the described difficulties, the Croatian Government undertook a series of structural measures, the effect of which was estimated at 2.5% of GDP in 2014. The European Commission recognised those efforts and in June 2014 they put in abeyance the EDP for Croatia. They then adopted an opinion establishing that in 2014 Croatia made a structural effort exceeding the defined goal of 2.3% of GDP. Similar trends are visible for 2015 as well, which has still been recording

unfavourable indicators of nominal fiscal deficits due to the circumstances described above. However, pursuant to the European Commission's bottom-up approach, the planned structural effort of 1.5% of GDP exceeds the requested goal of 1% of GDP.

Framework 1: EU Council Recommendations for resolving excessive budget deficit

I. Binding recommendations

Table 3.3. Council recommendations for the correction of excessive deficit

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

Source: Ministry of Finance

Table 3.3. Fiscal forecast –Council Recommendations have been fully adopted and embedded in Croatia's fiscal projections

<i>% of GDP</i>	2014	2015	2016	2017	2018
<i>General government deficit</i>	5.7	-5.0	-3.9	-2.7	-2.4
<i>Structural deficit change</i>		-0.5	-0.7	-0.8	
<i>Implementation of structural measures</i>	2.5	1.5	1.2	1.0	

II. Additional recommendations – non-binding

1) A detailed expenditure analysis for the purpose of rationalising salaries, social welfare and aids in order to make a fiscal space for expenditures contributing to growth, including co-financing of EU projects

Measures to meet the recommendations:

- in-depth analysis of state budget expenditures has been carried out
- improved implementation of the Central Salary Calculation (CSC) for the entire public sector
- measures to reduce and improve efficiency of social transfers
 - a number of separate social benefits has been consolidated within the guaranteed minimum benefit
 - unique central place for disbursing and administering cash benefits
 - drafting a report on social protection for the purpose of further consolidation of benefits and unification of criteria for their realisation by introducing income and assets control
- permanent abolition of a part of state aids pursuant to the adopted structural measures.

2) Tax discipline strengthening and efficiency increase

Measures to meet the recommendations:

- Tax Administration reorganisation in order to improve efficiency and reduce tax evasions
- introduction of the Independent Sector for Tax Fraud Detection
- continued implementation of cash transaction fiscalisation
- introduction of the JOPPD form (single form for the collection of data on paid receipts) in order to have a full insight into incomes and receipts of individuals
- Catalogue of Tax Expenditures has been prepared at the state level.

Framework 1: Council Recommendations for resolving excessive budget deficit

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

Measures to meet the recommendations:

- a new Proposal to the Fiscal Responsibility Act is being prepared
 - new fiscal rules in accordance with the EU requirements
 - greater independence of the Fiscal Policy Committee
- amendments to the Budget Act have been adopted
 - strategic documents of the European Semester have been included in the budgetary process
 - harmonisation with the European statistics requirements
 - strengthening of the mid-term budgetary framework
 - introduction of additional flexibility in budget execution
 - public debt management
- continued improvement of fiscal statistics.

3.3.1. Structural measures in 2015

Budgetary structural measures on the revenue side

Budgetary structural measures on the revenue side of the budget include: amendments to taxation of gains from games of chance, amendment to the system of pension insurance contribution on the basis of accelerated retirement scheme, extraction of revenues from profits of companies owned by the state, a year-long fiscal effect of increased rate of health insurance contributions, introduction of tax on savings interest, increase of excise taxes on energy sources and increase of excise taxes on tobacco.

Tax on gains from games of chance

Amendments to the Act on Games of Chance entered into force on 1 January 2015¹¹, pursuant to which all gains regardless of their amount are subject to taxation. Thus tax on games of chance is paid at the 10% rate for gains of up to HRK 10,000, at the 15% rate for gains between HRK 10,000 and HRK 30,000, at the 20% rate for gains between HRK 30,000 and HRK 500,000, and at the 30% rate at gains exceeding HRK 500,000. The expected fiscal effect of this measure amounts to 0.06% of GDP.

¹¹ Official Gazette, no. 143/2014

Amendments to the system of pension insurance contributions based on the accelerated retirement scheme

Reform of the pension system, which was initiated in 2014, is expected to continue in 2015 with regard to insured persons with accelerated retirement scheme and their transfer from 2nd into 1st pension pillar, since pensions for those categories of insured persons (fire-fighters, drivers and the like) are calculated and paid as if they have not been included in 2nd pension pillar. Fiscal effect of this measure amounts to 0.08% of GDP. This should be increased by the one-time measure of transfer from 2nd to 1st pillar, which in 2015 is assessed in the amount of 0.7% of GDP.

Extraction of revenues from profits of companies in state ownership

Based on the Decision of the Croatian Government within the framework of excessive budget deficit procedure, it has been planned to extract a part of profit of state-owned companies realised in 2014. The fiscal effect of this measure is assessed at 0.18% of GDP in 2015. The payment of profits pertains exclusively to profits achieved in the previous calendar year and thus is not subject to the statistical treatment of super dividends.

Contributions for health insurance

As of 1 April 2014, the contributions for health insurance were increased from 13% to 15%. An additional fiscal effect of the increased rate in 2015 amounts to 0.24% of GDP.

Tax on savings interest

Amendments to the Income Tax Act of 1 January 2015 introduced a taxation of savings interest at the 12% rate. Fiscal effect of this measure amounts to 0.09% of GDP.

Excise taxes on energy sources and electricity

Increase in excise taxes on energy sources from 2014 has been achieving additional fiscal effect of 0.04% of GDP in 2015. With the proposed Regulation on amendments to the Regulation on excise taxes on motor petrol, gas oil and kerosene used as propellant, excise taxes were increased by 20 lipa/litre for leaded gasoline, unleaded gasoline and gas oil used as a propellant. Fiscal effect of the increase in excise taxes amounts to 0.09% of GDP in 2015. Therefore, the total fiscal effect on this revenue category amounts to 0.13% of GDP in 2015.

Excise taxes on tobacco and tobacco products

Excise taxes on tobacco and tobacco products will be changed in order to implement a gradual reaching of a minimal excise tax on cigarettes required by EU relevant legislation, bearing in mind that Croatia has been granted a transitional period by 31 December 2017 for this implementation. According to EU *acquis communautaire* on taxing cigarettes, the total excise tax amounts to at least 60% of the average weighted retail price of cigarettes released for consumption, and the minimal excise tax may not be lower than EUR 90 for 1,000 cigarettes regardless of the average weighted retail price of cigarettes released for consumption. Increase in excise taxes on tobacco will result in an increase in budget revenue for about 0.03% of GDP in 2015.

Budgetary structural measures on the expenditure side

Structural measures on the expenditures side of the budget include: compensations of employees, intermediate consumption, subsidies, social benefits and social transfers, other current transfers and capital transfers and expenditures for gross capital formation. Measures also include extra-budgetary users and public companies, as well as agencies, institutes, funds and other legal entities with public authorities.

Compensations of employees

Measures introduced in 2014 are still being implemented in 2015. The revocation of rights to increased salaries on the basis of years of service in the amount of 4%, 8% and 10% for employees in the civil and public services has been prolonged until the end of 2015. At the end of March 2015 the Croatian Parliament adopted amendments to the Act on revocation of rights to increased salary on the basis of years of service¹², regulating the aforementioned reduction, as well as amendments to the Act on withholding to pay specific material rights to employees in public services, regulating the right to Christmas bonuses and vacation allowance¹³. Furthermore, salaries of state officials were reduced and additional payments in the defence and judicial systems were abolished in 2014. Thus in the defence system, amendments to the regulation on duties of active military personnel entitled to accelerated retirement scheme reduced the scope of military duties with the aforementioned rights. Due to fluctuation of active military personnel and to the implementation of a new Ordinance on bonuses to their salaries and amendments thereto¹⁴, further savings on salaries are expected. In the judicial system, further implementation of reorganisation processes and rational reassignment of duties are expected to result in additional savings in this expenditure category.

An additional measure of a further decrease of state officials' salaries was introduced in 2015. Basis for the payroll of state officials was decreased pursuant to the Decision on state officials payroll basis, starting with the salary for December 2014¹⁵. As a result, the aforementioned basis was reduced by additional 8%.

Establishment of the CSC system for all public sector institutions enabled the execution and supervision of salary payment and payroll, as well as the standardisation of job coefficients. This contributes to ensuring the basic principle of the salary system, which is equal salary for equal work, so that the same position with the same job description in the public sector cannot have multiple discrepancies in terms of salaries. Moreover, this system is in its final development phase. The remaining, smaller share of users that are still outside the system is planned to be included in 2015 (Office of the President of the Republic of Croatia, the Supreme Court, most schools of medicine, CARnet and some schools, hospitals, agencies and public institutions).

On the other hand, the increased rate of contributions for health insurance from 13% to 15% has also had an effect in the first four months of 2015. Considering all of the above, the planned net structural fiscal changes on compensations of employees amount to 0.08% of GDP.

¹² Official Gazette, no. 36/2015

¹³ Official Gazette, no. 36/2015

¹⁴ Official Gazette, no. 33, 41, 53, 114/2015

¹⁵ Official Gazette, no. 151/2014

Intermediate consumption

The planned reduction in intermediate consumption amounts to 0.08 % of GDP, and it primarily results from the reorganisation process of the judicial system and lower expenditures for services. The reorganisation implies the territorial and organisational restructuring of the judicial system, reorganisation and rationalisation of court and prosecutors' networks. This will result in a better organisation of work of the courts and faster ruling in court cases, shorter court procedures and more balanced workload of judicial bodies and officials. This process will also result in a decrease of municipal and misdemeanour courts, as well as municipal attorney's offices. In addition, this measure will also accelerate court procedures, which will reduce the pressure on paying fees for long trials.

Another measure should also be highlighted here, namely reduced costs for graphic and printing services for the production of forms due to less frequent issuing of personal documents for citizens since they have predominately been issued in the previous years due to their changed format.

Subsidies

Planned structural savings on subsidies in 2015 amount to 0.1% of GDP. The biggest reduction pertains to the abolishment of Croatian Bank for Reconstruction and Development subsidies and to the reduction of a national component of direct payments in agriculture based on its substitution with EU funds. The active employment policy in the observed period is also characterised by efforts with the aim of increased absorption of EU funds for this purpose, whereby total funds for subsidies for employment have been increased, while at the same time state budget expenditures have not increased and the scope of unemployed persons - beneficiaries of these rights have not been jeopardised. Other subsidies, primarily relating to science and education, culture, transport and tourism, will also have minor savings.

Social benefits and social transfers

Social benefits, structural changes of which amount to 0.02% of GDP, include savings pertaining to subsidies and state guarantees for housing loans, one-off aid to families of war veterans and reduction of privileged pensions exceeding HRK 5,000. Pursuant to the Act on Subsidies and State Guarantees for Housing Loans¹⁶, the Agency for Transactions and Mediation in Immovable Properties is subsidising a part of interest in the first four years of the housing loans. The subsidies were granted in 2011 and 2012. In 2015 the remaining liabilities will be paid in reduced amounts, after which there will be no more liabilities for granted subsidies.

Moreover, reduced payments of one-off aids to family members of war veterans killed in the Croatian War of Independence are also expected on the basis of amendments to the relevant Regulation¹⁷ from 2014, making conditions for the granting the right to one-off aid more rigorous. In other words, the new Regulation precisely defines the right to one-off aid which beneficiaries may be granted once per calendar year, and the total amount of one-off aids can in no case be higher than the amount of one budgetary basis (HRK 3,326). An additional fiscal effect of the 10% reduction in privileged pensions exceeding HRK 5,000, implemented in 2014, has also been included here.

¹⁶ Official Gazette, no. 31/2011

¹⁷ Official Gazette, no. 87/2014

Other current transfers and capital transfers

Measures with the total structural reduction of 0.08% of GDP in 2015 have been allocated to other current and capital transfers. Permanent savings are being realised on expenditures of the guarantee fund for industry and innovation, which will be abolished this year. In December 2014 the Act on Housing Savings and State Incentives for Housing Saving was amended pursuant to a regulation of the Croatian Government. It has changed the formula for the calculation of incentives for housing saving, significantly reducing the annual disbursement of incentives from the state budget. Moreover, it should be noted that savings have also been planned in the railway sector pertaining to the reduction of expenses for the modernisation of railway vehicles since such transfers will in the future be allocated only to Croatian Railways Passenger Transport. Furthermore, the savings are also planned for expenses regarding housing care pursuant to a more efficient implementation of the Housing Care Programme. Savings are also expected in the Entrepreneurial Impulse programme, as well as aids for innovations. With regard to tourism, i.e. promotion of tourism, reduction in expenditures is planned with regards to revenues realised by the Croatian National Tourist Board from other earmarked sources (visitors' tax and membership in tourist boards).

Expenditures for gross capital formation

The planned structural savings on capital investments amount to 0.06% of GDP. Reduction of expenditures for health care projects is expected, namely through additional procedures of unified public procurement for several healthcare institutions, as well as savings on renovation of the healthcare infrastructure and re-directing to funding from EU funds. Implementation of the unified public procurement, i.e. procurement of the same medical equipment for more users/healthcare institutions, will result in more rational capital investments regarding procurement of medical equipment (replacing equipment). Also, implementation of the Framework programme for construction, upgrading and reconstruction of public buildings under a contractual form of PPPs, adopted by the Croatian Government in April 2012, will enable more rational capital investments in construction, upgrading and reconstruction of buildings in the healthcare sector. At the same time, the biggest attention is put on a significantly more frequent usage of EU funds.

Reduction of expenditures pertaining to projects in the judiciary and science system primarily results from reduced national financing of individual projects and re-directing to financing from the EU structural funds.

Extra-budgetary users and companies owned by the Republic of Croatia

Structural deficit decrease of extra-budgetary users and companies owned by the Republic of Croatia will amount to 0.4% of GDP in 2015. Savings will be realised by Croatian Roads and Croatian Waters, mostly on investment activities. Furthermore, since on 1 January 2015 the Croatian Institute for Health Insurance (HZZO) has become an extra-budgetary user, planned structural savings in the healthcare sector are also presented here. Intensive control of prescribing prescription drugs is expected to continue in 2015, as well as the decrease of medicine prices. Moreover, continual monitoring of temporary inability to work (sick leave) will continue, and better control of the hospital system's expenditures is also planned. Also, savings based on a new model of hospital management based on the introduction of a medical and financial controlling system is expected, as well as a joint

public procurement of medicine (in particular), sanitary consumables and implants. Expenditure reduction measures also cover Croatian Motorways and Croatian Railways Infrastructure with regard to compensations of employees, intermediate consumption and investments.

In April 2015 the Croatian Government adopted a decision on additional savings of those institutions in the amount of 0.2% of GDP. Savings mostly result from the restructuring and reduced transfers and investments financed only from national funds. Measures leading to reduced compensation of employees and material expenditures are expected within the restructuring process by increasing efficiency and through a dialogue with social partners. With regard to transfers, reduction of transfers to local units and private sector is planned for the investments into water management and environmental protection projects. With regard to investments, focus on preparation of EU projects and financing from EU funds has intensified, and projects which are to be financed through local funds are being abolished. Finally, additional savings from improving the debt management system and using more favourable sources financed by international financial institutions are expected.

Agencies, institutes, funds and other legal entities with public authorities

Structural savings of agencies, institutes and funds is expected to amount to 0.05% of GDP in 2015. They will result from the measures aimed at reducing intermediate consumption (decrease of lease and overheads, control of the usage of official cars, decrease in expenditures for intellectual and personal services, control of business trips and the like).

Structural measures of local and regional self-government units in 2015

Pursuant to amendments to the Income Tax Act¹⁸, which entered into force in January 2015, personal deductions for individual categories of taxpayers were increased and tax classes for tax rates of 25% and 40% were changed. Personal deduction increased from HRK 2,200 to HRK 2,600 for employed persons and from HRK 3,400 to HRK 3,800 for retired persons. Furthermore, personal deduction on subsidised areas categorised into the so-called group I according to development degree increased from HRK 3,200 to HRK 3,500, and from HRK 2,700 to HRK 3,000 for the group II. It has also been prescribed that income tax is paid at the 12% rate on the tax base of up to HRK 2,200, at the 25% rate on the tax base difference ranging from HRK 2,200 and HRK 13,200 and at the 40% rate on the tax base of over HRK 13,200.

The main goal of these amendments was to decrease the workload and to stimulate personal spending. However, at the same time they decreased incomes realised by local and regional self-government units (hereinafter referred to as „local units“) from personal income taxation. Therefore, in order to partially compensate this income reduction, the Croatian Government adopted amendments to the Act on the Financing of Units of Local and Regional Self-Government¹⁹. These amendments increased the share of local units with the development index exceeding 75% of the Croatian average, i.e. those units not located on the subsidised areas, in incomes from income tax from 56.5% to 60%. The share of the counties increased from 16% to 16.5%. Furthermore, the

¹⁸ Official Gazette, no. 143/2014

¹⁹ Official Gazette, no. 147/2014

amendments increased the share of municipalities and cities in the real estate transfer tax from 60% to 80%, while the state's share was reduced from 40% to 20%. As a consequence, the state has lost income from this tax in the amount of about 0.1% of GDP, while income of cities and municipalities has increased by this amount. It was also prescribed that income tax revenue based on savings interest actually belongs to the state budget revenue, which the state, in the form of grants, will pay during the year to local units located on subsidised areas as income tax refund on the basis of annual tax returns of citizens in their area. Reduced share for decentralised functions from the present 12% to 6% results in a decreased income of local units earmarked for the financing of decentralised functions, which will be compensated through more grant from the state budget for the levelling of decentralised functions by increasing this position's share from the present 15.5% to 16%. It is important to mention that amendments to this Act introduced the 1.5% income tax share, which is isolated from the state budget at the position of grant for the projects co-financed by EU structural and investment funds, the holders of which are municipalities, cities and counties, i.e. legal entities in their majority ownership or co-ownership and institutions they incorporated.

In addition to the above measures, within their scope of work and authority local units have carried out a series of structural measures aimed at increasing revenues and reducing expenditures in order to avoid further deepening of fiscal imbalances and to preserve fiscal stability. In other words, according to the Budget Act, local units are limited in their borrowing, whereby their budgets are automatically harmonised. In this sense, on the revenue side certain local units have increased the surtax rate and municipal fees and sales activities of non-financial assets will intensify. Efforts aimed at a better collection of incomes have also intensified. Moreover, the focus is placed on the preparation and implementation of projects financed by the EU funds. Such measures result in a structural effort amounting to 0.1% of GDP on the revenue side of local units' budget. On the other hand, measures are being undertaken in all categories on the expenditure side. Thus, with regard to compensation of employees, certain local units have reached a decision on the reduction of the salary base for their employees. They have also decreased the dynamics of new employment and stimulated the natural outflow of their employees by providing them with severance pays. Compensations of employees, expenditures for current and investment maintenance, as well as other material expenditures, are continuously being reduced. Subsidies in tourism, agriculture and entrepreneurial sectors have also being reduced, as well as aids for public needs financing in culture and sport. Finally, it should be noted that on the local and national level there is a trend of reducing national financing of capital projects and of a greater focus on projects financed from the EU budget. Total structural savings on the expenditure side amount to 0.2% of GDP. All of the mentioned measures on the revenue and expenditure side of the local units' budget results in fiscal adjustment of 0.3% of GDP, thus compensating for the loss of revenue from income tax.

3.3.2. Structural measures in 2016

Budgetary structural measures on the revenue side

Amendments to the system of non-taxation of reinvested profit

According to the amendments to the Profit Tax Act²⁰, the standards for the usage of tax relief for reinvested profit have been tightened. Tax relief has not been abolished, but its usage is dependent on real investments in order to stimulate the economic growth. Pursuant to the above, from 1 January 2015 tax relief for reinvested profit will not be granted to the taxpayers who had reduced the number of employees in the tax period or who failed to invest into fixed assets, i.e. who postponed the investments. These legal amendments will affect budget revenue in 2016 in the amount of 0.15% of GDP.

Excise taxes on energy sources and electricity

With an increase in excise taxes on energy sources in 2015, an additional fiscal effect of 0.04% of GDP will be achieved in 2016.

Excise taxes on tobacco and tobacco products

An additional fiscal effect of increasing excise taxes on tobacco and tobacco products in 2016 amounts to about 0.02% of GDP.

Municipal fees

Pursuant to the National Reform Programme, the improvement of the system for the calculation and collection of municipal fee is primarily aimed at local units, focusing on the review and application of the Public Utilities Act regarding the efficiency of municipal fee collection.

Local units obtain their revenue from three sources: their own sources (including own taxes), joint taxes and grants from the state and county budget. Municipal fees also belong to own income, the determination and collection of which is fully in the competence of local units. The base for the collection of municipal fees has been narrowed down due to the keeping of records that were not updated and to a wide range of exemptions and relieves. Therefore, the measure is aimed at stimulating the utilisation of the maximum possibility of collecting municipal fees in local units' revenue, i.e. a more efficient management of the municipal fee system.

Local units are currently implementing the analysis of the share of revenue from municipal fees in their own revenue structure. The goal of this analysis is to establish measures for reducing deviations of record data (based on which municipal fee is currently being calculated) from the established average. The results of this analysis are expected by mid-2015, and they will serve as the basis for amendments to the Public Utilities Act and for the Decision on municipal fee in local units until the end of 2015.

A new model of collecting municipal fees would first be implemented in 2016, and it has been estimated that this measure will increase the general government budget revenue by 0.09% of GDP (which implies an increase in revenues from municipal fee by 15%). It should be noted that those are preliminary conservative calculations, and their more precise values will be known in the middle of the year.

²⁰ Official Gazette, no. 143/2014

Budgetary structural measures on the expenditure side

Compensations of employees

Salaries system in public administration and public services is expected to undergo a reform in 2016, which implies the preparation of systematisation of existing job positions according to the new classification, standardisation of implementation planning system of work tasks and employee evaluation, adoption of a legal framework relating to salaries and conclusion of new basic collective agreements. Fiscal effect of this measure has been estimated in the amount of 0.13% of GDP.

Intermediate consumption

The predicted fiscal effect of structural savings on intermediate consumption will amount 0.16% of GDP in 2016. A larger portion of measures pertains to a continued reform in the judicial system, reduction in services of current and investment maintenance, IT services, expenditures for material and energy, as well as other services of all budgetary users. A part of the savings will result from the extension of competence of the State Office for Central Procurement for the postal services categories and from the new electrical energy supply procedure for about 600 additional users (in addition to the present 4 categories), which will lead to a further reduction of costs and will facilitate operations for a large part of additional public procurements users.

Expenditures for subsidies

Structural changes on subsidies have been projected at the level of 0.17% of GDP. They primarily refer to a further reduction of national funds for direct payments in agriculture. Furthermore, in 2016 savings are also planned for the measures for stimulating investment activities in the entrepreneurial sector in the part that is not co-financed from EU funds.

Social benefits and social transfers

Consolidation of social benefits through the Guaranteed Minimum Benefit (GMB) has resulted in the pooling of extended cash benefits (which have until now been regulated by the Act on Mediation in Employment and Rights during Unemployment), support aid (which was regulated by the Social Welfare Act), and rights to war veterans' cash benefits (which are regulated by the Act on the Rights on Croatian Homeland War Veterans and their Family Members and the Act on Protection of Military and Civilian War Invalids). The creation of the GMB represents the beginning of the pooling of social benefits, which should lead to the Guaranteed Minimum Standard (GMS), a type of social benefit which will ensure higher and better level of protection of the poorest groups in society. Consolidation of benefits through the pooling of benefits and a unique application enabling a transparent management and supervision will result in the expected savings of 15% of total funds for the benefits to be pooled within the GMS and for their administration. Furthermore, the consolidation of social benefits will also be implemented through the Unified Benefits Centre (UBC), i.e. through creation of a unified central place for disbursement and administration of cash benefits within the existing network of state administration offices in the counties. The goal of this measure is to create a single administrative point for citizens-state relations with regard to exercising the right to benefits. The aforementioned benefits should result in fiscal effect of 0.06% of GDP.

Other current transfers and capital transfers

Structural savings in this expenditure category are expected to amount to 0.04% of GDP in 2016. Most savings pertain to the projects in agriculture, particularly with regard to irrigation and regional development, as well as in construction of municipal and social infrastructure. Moreover, projected reduction of expenditures for the projects in culture should also be mentioned, primarily with regard to construction and maintenance of cultural institutions. Lower costs are also planned in the railways sector due to a slower dynamic of railway infrastructure modernisation. A part of structural changes pertains to projects in education and entrepreneurship sector since even greater attention is given to a better and greater usage of EU funds.

Expenditures for gross capital formation

Structural savings in this category amount to 0.03% of GDP and they mainly result from a decreased dynamics of investments in projects in healthcare, science and housing care, and reduced investments in real estate of the state.

Extra-budgetary users

Within the framework of the healthcare system, it is predicted that further structural measures will be implemented in 2016, pertaining to better control of hospital system expenditures, unified public procurement, abolishment of certain provisions of internal bylaws of institutions relating to salaries which are not in compliance with the Salaries Act, Basic Collective Agreement, Sectoral Collective Agreement and Regulation on Job Complexity Coefficients and Job Titles. Implementation of the National plan for the development of clinical hospital centres, clinical hospitals, clinics and general hospitals in the Republic of Croatia will also result in additional savings in the healthcare system regarding the planned rationalisation of the bed occupancy rate, reduction of hospital treatment duration and improvement of access to hospital treatment, as well as the increase of the quality and outcomes of health care services. The expected fiscal effect of the aforementioned measures amounts to 0.1% of GDP in 2016.

Agencies, institutes, funds and other legal entities with public authorities

The expected fiscal effect of structural measures in 2016 with regard to these legal entities amounts to 0.1% of GDP and it results from the measures of reducing the material costs and status changes including mergers, terminations and transfers of a part of business operations under the competence of ministries.

Additional note regarding measures provided for in the national reform programme

It should be pointed out that in the context of structural efforts the National Reform Programme also provides for a reduction of para-fiscal levies, which will to the same extent be compensated with the reduction of expenditures of the users of these levies, which implies their neutral fiscal effect.

Structural measures of local and regional self-government units in 2016

Due to the circumstances which occurred in 2015 and which are described in detail in the chapter on local units structural measures for 2015, amendments are expected to local unit budgets for 2015, which will have additional fiscal effects in 2016. The planned more intensified implementation of structural measures by local units should also be pointed out. All of the above should result in structural savings in the amount of 0.06% of GDP.

3.4. General government budget in 2015

Methodological changes

Draft budget for 2015 was adopted in November 2014. It introduced significant statistical and methodological changes affecting the scope of institutions and the scope of funds within the state budget, as well as the application of the gross principle in certain revenue categories. These changes are based on the principles of transparency and comprehensiveness of the state budget, thus making the budgetary presentation of revenues and expenditures more similar to statistical presentation.

The expected revenues were changed on several bases. Budgetary users have thus expressed an increase of the expected use of EU funds. Also, revenues include own and earmarked revenues of budgetary users, which have previously not been planned in the budget. The method of expressing income tax refund for taxpayers with registered offices in the areas of special state concerns has also undergone changes this year. As opposed to the net principle according to which state budget revenues have been decreased by paid returns, as of this year the gross principle applies, according to which the total amount of collected taxes is recorded, and then local units are provided with the funds for tax returns through transfers from the state budget.

The expected expenditures have been corrected for the described revenue increase. As a consequence, revenues have been increased on the basis of planned own and earmarked revenues of budgetary users and increased amount of used EU funds.

The amount of revenues and expenditures of the state budget is strongly dependant on implementation of the Mandatory Health Insurance Act²¹, prescribing that on 1 January 2015 the Croatian Institute for Health Insurance shall leave the State Treasury system. The Croatian Institute for Health Insurance thus became an extra-budgetary user of the state budget, the financial plan of which is subject to the approval of the Croatian Parliament. Revenues from health insurance contributions, revenues from participation in costs and supplementary health insurance, and other revenues of the Croatian Institute for Health Insurance according to special regulations have been excluded from state budget revenues. These revenues, as well as expenditures covered by them, are a constituent part of the financial plan of the Croatian Institute for Health Insurance. The transfer of the Croatian Institute for Health Insurance was presented in the state budget in the amount of 0.7%

²¹ Official Gazette, no. 80/2013

of GDP pursuant to Article 72 of the Compulsory Health Insurance Act. On the other hand, state healthcare institutions were for the first time included in the state budget.

Revenues of the consolidated general government

Revenue projection of general government budget in 2015 are based on the expected mild recovery of economic activity, bearing in mind the changes in tax policies aimed at unloading the taxation on personal income from labour and taxation of small companies, thus stimulating the economic growth. In addition to the above, the projections also include measures adopted by the Croatian Government in the first half of 2014 and in 2015 for the purpose of implementing the excessive budget deficit procedure. The total revenues of the consolidated general government budget were planned at the level of 42.9% of GDP. The most significant budget revenues are comprised of revenues from value added tax, which is planned at the level of 12.5% of the GDP, and is projected on the basis of the expected trend of nominal personal spending. Such amount is then increased by fiscal effects of legal amendments in the VAT system, but also by the results of efforts to prevent tax evasion. The aforementioned amendments to the Value Added Tax Act²² prescribe the possibility of calculating VAT according to the charged realisation for all taxpayers with deliveries of up to HRK 3 million, thus enabling about 120,000 entrepreneurs to independently choose their preferred way of VAT calculation. Moreover, a lower rate for all prescription drugs has been introduced, as opposed to before, when the lower rate applied only to medicines on the Croatian Institute for Health Insurance list. Also, in the next mid-term period the Ministry of Finance will additionally intensify the activities aimed at improving tax collection, preventing tax evasion and gradual resolving of tax liabilities. Revenues from customs and custom duties have been projected in the amount of 0.1% of GDP.

The tax on products category, apart from VAT and customs, also includes the expected revenues from tax on gains from games of chance, defined by new tax amendments, i.e. by introducing tax on all gains from games of chance and revenues from special taxes and excise taxes. Revenues from special taxes and excise taxes will amount to 3.9% of GDP. These revenues have been fully projected on the basis of the expected trend of consumption of products subject to excise taxes. Year-long effects on changes to excise taxes on energy sources in 2014 have been taken into account, as well as effects of an additional increase in excise taxes on energy sources during 2015 and increase in excise taxes on tobacco, for the purpose of decreasing the excessive budget deficit. The total fiscal effect of the aforementioned changes amounts to 0.16 % of GDP.

Property income amounted to 1.3% of GDP in 2015. Namely, property income, in addition to permanent revenues, also includes increased revenues based on the ownership of the Republic of Croatia in specific companies, which are estimated at the level of 0.2% of GDP.

The assessed revenues from income tax will be at the level of 3.7% of GDP, while revenues from profit tax are expected in the amount of 1.7% of GDP in 2015. Revenues from income tax have been planned on the basis of the expected trend on the labour market, and they include amendments to the income taxation system, which entered into force at the beginning of 2015. Pursuant to the amendments to the Income Tax Act (for more details see Chapter 3.3.1. Structural measures in

²² Official Gazette, no. 143/2014

2015), personal deduction was increased for employed and retired persons, as well as for subsidised areas of the first and second group. Tax classes for the application of the 25% and 40% tax rates have also changed. The aforementioned changes will protect the taxpayers with the lowest income and increase available revenue for the middle class, which will consequentially lead to increased spending, therefore positive trends in the economy may be expected.

Amendments to the Income Tax Act²³ of 1 January 2015 have also introduced taxation of savings interest at the 12% rate. In order to equalize the taxation of all types of income from capital, the usage of benefits for dividends and shares for the profit of up to HRK 12,000 has been cancelled. Considering the fact that the employment income in the Republic of Croatia has been burdened by tax rates significantly higher than in the case of income from capital, fairness in taxation and tax base expansion is achieved by the introduction of the savings interest taxation. Since 2015, no-netting principle has been introduced for the income tax, which means that the income tax refund is planned and recorded on the expenditure side of the budget. Until this year tax refunds were recorded as income tax reduction.

The second most significant group of revenues for the general government budget are social security contributions, which are planned at the level of 11.8% of GDP. Their dynamics is determined by the trends on the labour market and in the legal amendments carried out in 2015, aimed at reducing the structural deficit. In addition to the year-long impact of the increase of the rate of contributions for health insurance from 13% to 15%, changes have also been planned in the system of contributions for pension insurance, i.e. for insurees on the accelerated retirement scheme. In 2015 pension reforms initiated in 2014 will continue in the area of insurees on the accelerated retirement scheme, and their transfer from 2nd to 1st pension pillar. The amendments of the Act on Compulsory and Voluntary Pension Funds²⁴ from 2003 prescribed that for the members of the compulsory pension fund achieving pension rights according to more favourable conditions or achieving insurance of a prolonged duration, the pension is calculated as though they were insured only in 1st pension pillar. Therefore, upon retirement the funds from the personal account are transferred into the state budget and the insuree obtains the pension in 1st pillar. It is thus clear that there is no valid reason on the basis of which these persons would continue to be insured in 2nd pillar. For these insurees the system of pension calculation is not changed, but the future payments are and they will be a part of the state budget, while the accumulated funds in 2nd pillar will be transferred into the state budget. It should be pointed out here that with these changes the state has not undertaken any new financial obligations. In the future, the contributions for 2nd pillar for these insurees (5% + additional contribution for the so called accelerated scheme) will be paid only into 1st pillar. Accordingly, an increase in the regular payment of contributions for pension insurance is expected in 2015 in the amount of about 0.08% of GDP, which has also been previously outlined in the section on structural measures. The transfer of funds of accumulated savings for persons on the accelerated retirement scheme from 2nd to 1st pillar is planned in the amount of 0.7% of GDP in 2015.

The categories of other current transfers and capital transfers planned at the level of 5.3% of GDP include revenues from the assistance of EU institutions and bodies which are directly tied to the projects financed from the EU funds, as well as direct payments in agriculture.

²³ Official Gazette, no. 143/2014

²⁴ Official Gazette, no. 103/2003

Expenditures of the consolidated general government

Compensations of employees in the public and civil service are in 2015 at the level of 11.5% of GDP. The planned amount of these expenditures is mostly defined by structural measure impacts. They include the withholding of salary increase by 4%, 8% and 10% on the basis of loyalty to service, salary reduction of state officials by 8%, as well as annual effects of eliminating the bonuses in the defence and judiciary systems and payroll method changes in the science system. Year-long effect of the rate increase of the compulsory health insurance contribution from 13% to 15% should also be singled out. In 2015 the payment of reimbursements and Christmas bonuses for employees in the public and civil services has not been planned. Furthermore, continued restrictions of new employment are still in effect, i.e. recruitment is only permitted to job positions 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. The Central Salary Calculation will still be implemented.

The expenditure for intermediate consumption, mostly including structural savings regarding intellectual and personal services and other service category, are at the level of 7.9% of GDP. Furthermore, these include other reductions that are not directly tied to the structure, i.e. permanent measures, but also with reductions ensuing from a different dynamics and scope of implementation of single activities.

Expenditures for subsidies are at the level of 2% of GDP, where most of it consists of structural savings in agriculture, employment and Croatian Bank for Reconstruction and Development, as well as in science, education, culture and tourism systems.

Expenditures for property income recorded a share of 3.6% of GDP. This category of expenditures was mostly determined by the expenditure trends for interest rates in line with the financing needs envisaged in 2015.

Social benefits and social transfers account for the most significant category of total general government budget expenditures, at a level of 16.5% of GDP. The trends of these expenditures are mostly determined by the trends of expenditures for pensions, expenditures for health care, maternity benefits, social welfare benefits, child benefits and unemployment benefits. In 2015 the expenditure for pensions has been planned at the level of 11% of GDP, which is mostly determined by pensioner number trend. The expenditure for health is becoming a part of the Croatian Institute for Health Insurance financial plan on the basis of their exit from the State treasury system and is at the level of 6.2% of GDP. Structural savings in this system are planned at the level of 0.1% of GDP through the previously mentioned savings on the control of medication prescription, better control of sick leaves and a better rationalisation of hospital business operations. Maternity benefits are planned at the level of 0.6% of GDP, social welfare benefits that include the guaranteed minimal benefit at the level of 0.7% of GDP, child benefit at the level of 0.5% of GDP and unemployment benefits at the level of 0.5% of GDP.

Other expenditure, mostly referring to current and capital transfers, have been planned at the level of 2.6% of GDP in 2015. In the specified case, structural savings on projects in economy, tourism,

entrepreneurship, traffic, housing care and reduced incentives of housing savings amount to 0.08% of GDP. Furthermore, activities of financing projects from the EU funds are carried out through these expenditure categories. 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% of GDP. In the state budget, this category also includes the transfer to the Croatian Institute for Health Insurance in the amount of 0.7% of GDP, and in line with the rules the insurees exercise based on the compulsory health insurance.

The expenditures for gross capital formation have been planned at the level of 3.8% of GDP, in which structural savings amount to 0.06% of GDP. The largest part has been determined by activities connected with capital investments of all general government budget units, particularly in water and road transport, as well as in environmental protection sector.

Net lending/borrowing

The planned fiscal consolidation will result in a reduction of the consolidated general government budget deficit from 5.7% of GDP in 2014 to 5% of GDP in 2015, considered according to the ESA 2010 methodology and based on the statistical scope. At the same time, the state budget deficit will amount to 5.0% of GDP, the deficit of 576 local and regional self-government units will amount to 0.1% of GDP, while the budget of extra-budgetary users and public companies will be balanced.

3.5. Mid-term budgetary framework (2016–2018)

Revenues of the consolidated general government

In the period 2016–2018, the revenues of the general government budget will be determined by the gradual recovery of economic activity and fiscal effects of the structural measures. As such, they will record a level of 43.3% of GDP in 2016, 43.7% of GDP in 2017 and 43.5% of GDP in 2018.

Revenues from the value added tax, which follow the expected recovery of personal spending in the next years, will move at the average level of 12.5% of GDP. Customs and tariffs will stay at the same level of 0.1% of GDP in the observed period. Taxes on products, with the exception of VAT and customs, mostly include special taxes and excise taxes and revenues from taxes on gains in games of chance, and in the mid-term period they will amount to about 4% of GDP in 2016 and 3.8% of GDP in 2018. In the mid-term period, the property income will keep its share in the value of the gross domestic product of 1.2% of GDP. Furthermore, the revenues from income tax in the observed period will record an average level of 3.7% of GDP, and revenues from profit tax, with included amendments in the system of non-taxation of reinvested profits, will be at a level of 1.8% of GDP. Pursuant to the amendments to the Income Tax Act (for more details see Chapter 3.3.2. Structural measures in 2016), the standards for the usage of tax relief for the reinvested profit have been

tightened. These legal amendments will affect budget revenue in 2016 after submitting annual tax reports.

Increasing the rate of contributions for health insurance and the shift of contributions for the pension scheme for persons in the accelerated retirement scheme from 2nd to 1st pension pillar in 2015 have also influenced the projection of social security contributions in the mid-term period. The share of revenue from social security contribution from 2016 to 2018 will achieve the level of about 11.8% of GDP. Other current transfers and capital transfers follow the projections of revenues from aid, which are mostly tied to the financing of projects from the EU funds. They are projected to achieve a level of 5.6% of GDP in 2016, 6.0% of GDP in 2017 and 5.8% of GDP in 2018.

Expenditures of the consolidated general government

In 2016, the expenditures of the general government budget are projected at a level of 47.3% of GDP, 46.4% of GDP in 2017 and 45.9% of GDP in 2018.

Compensations of employees, with the share of 23.8% in total expenditures, form the second largest group of expenditures of the general government budget, which are primarily determined by the trend in the number of public and civil servants. In 2016 they are projected to achieve a level of 11.3% of GDP, and in the following two years they will be reduced by 0.5 percentage points to a level of 10.8% in 2018. The projections of these expenditures, with the exception of structural measures planned in 2016, also include the increase in the basic work salary for the past labour, while, as in 2015, there is no plan to pay out material benefits such as Christmas bonuses and reimbursements. In the following two years, further restrictions of employment in state and public services are predicted. Expenditures for intermediate consumption record a reduced share in the value of the gross domestic product from 7.6% in 2016 to 7.2% in 2018. Apart from the effects of the centralised public procurement for standardised goods and services for all budgetary users and justice system reorganisation, further continuation of the application of rationalisation measures and savings on all line items is assumed. Expenditures for subsidies will in 2016 be at the level of 1.8% of GDP, where a reduction to 1.7% of GDP is planned in the next two years. The expenditures for property income, which are mostly determined by the movements of expenditures for interest rates in line with the costs of servicing the public debt, will have an average level of 3.8% of 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 34.5%. By the end of 2018, a continued reduction of its share to the level of 16.1% of GDP is expected. Apart from the described structural measures, further implementation of health system reform is expected with the aim of strengthening its efficiency and sustainability. Other expenditure, mostly other current transfers and capital transfers, decrease their share in the value of gross domestic product by 0.2 percentage points, i.e. from 2.5% in 2016 to 2.3% in 2018. The expenditure for gross capital formation of all general state budget units will be at the level of 4% of GDP during the observed mid-term period.

Net lending/borrowing

In line with the projected trends of expenditure and revenue of the general state budget, the deficit of 3.9% of GDP is expected in 2016, 2.7% of GDP in 2017 and of 2.4% of GDP in 2018. The state budget will contribute to the total deficit since extra-budgetary users and public companies and local units are expected to have a balanced budget in the period 2016–2018.

3.6. Assessment of the cyclically adjusted budgetary balance

The calculation of the potential GDP is based on the production function methodology used by the EC. This calculation indicates the presence of a negative output gap in the entire projection period. The potential GDP in 2015 is expected to remain almost unchanged compared to 2014, where the capital component's contribution to the potential GDP growth is expected to be positive, labour component's contribution negative, and the total factor productivity contribution will be neutral. In the continuation of the projection period, a growth of potential gross domestic product is expected, which should amount to 0.1% in 2016 and accelerate to 0.3% and 0.6% in 2017 and 2018. The capital component and, to a smaller extent, the total factor productivity will contribute to the potential GDP growth the most. It is expected that the labour component will generate a negative contribution to the potential GDP growth during the whole projection period.

The calculation of the cyclically adjusted balance is based on the EC methodology and calculations for the 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 security insurance and non-taxable contributions, while on the expenditures side, these include the unemployment benefits. These calculations indicate that the cyclically adjusted budget deficit, corrected for one-off measures, i.e. the structural deficit, will be at the level of 3.7% of GDP in 2015, which is 0.5 percentage points lower than the structural deficit in 2014. General government budget deficit, according to ESA 2010 methodology, was in 2014 at the level of 5.7% of GDP according to the Croatian Bureau of Statistics calculations. In 2016 structural deficit will continue to decrease by 0.7 percentage points and will amount to 3.0% of GDP, and in 2017 it will be reduced by 0.8% and will amount to 2.2% of GDP, thus achieving a significant structural adjustment in the observed period.

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

Standing of public debt and guarantees

Negative economic trends in combination with the restructuring of individual sectors, considerable assumption of liabilities of public companies and budget deficit accumulation have led to a sharp public debt increase in the previous period. Also, a significant adjustment occurred due to transition to the usage of ESA 2010 methodology and inclusion of public companies dealing with road traffic

(Croatian Motorways (HAC) and Rijeka-Zagreb Motorway (ARZ)) in the general government sector, thus resulting in the average increase of the debt in GDP by about 9 percentage points in the period 2008–2013. Furthermore, by applying the new methodology the Croatian Bank for the Reconstruction and Development (HBOR) debt has been reclassified as a general government debt, thus increasing the public debt by additional 4.4% of GDP.

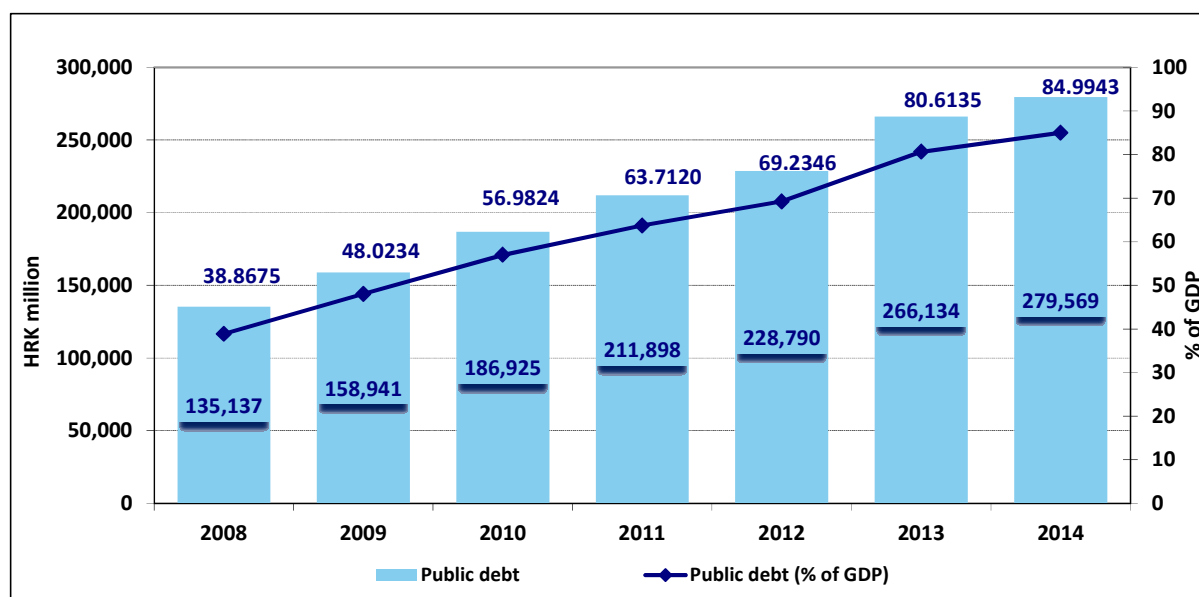
In line with the specified above, according to the Fiscal Notification Report from April 2015, and based on ESA 2010 methodology, public debt amounted to HRK 279.6 billion or 85% of the GDP at the end of 2014, which presents an annual increase of HRK 13.4 billion. The debt increase has been noticeably slower in comparison with the same period last year, and in comparison with the recorded deficit levels in 2014 because funds from the deposit account, provided by borrowing at the end of 2013, were used for settling new liabilities. The foreign component of the public debt has been increased in comparison to 2013 by HRK 4 billion, while the domestic component of the public debt in the same period recorded an increase of about HRK 9.5 billion.

When viewed by the level of government, most of the public debt refers to the central government, in the amount of HRK 274.3 billion while the debt of local and regional self-government units amounts to HRK 5.3 billion, and only an insignificant portion of HRK 3.5 million pertains to social security funds. According to the ESA 2010 methodology, social security funds include the Croatian Pension Insurance Institute, Croatian Institute for Health Insurance and Croatian Employment Bureau.

Viewed in terms of borrowing instruments, the largest share of the public debt has been generated by borrowing in long-term securities, i.e. bonds (53.2%), then borrowing via loans (37.9%) and short-term securities (10.7%).

The currency structure of the public debt shows that a significant part of the debt has been denominated in foreign currency, in which the debt in euro accounts for 74.4%, the debt in HRK to 21.5% and the debt in dollars for 4% of the total debt. A small part of the debt (0.1%) has been denominated in Swiss francs. 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.

Chart 3.1. Trend and structure of the public debt



Source: CNB, CBS

The total issued guarantees of the Republic of Croatia at the end of 2014 amounted to HRK 8.7 billion, or 2.7% of GDP, which is HRK 712.1 million more than at the end of 2013. Such an amount of total guarantees is, first of all, the result of the specified adjustment with ESA 2010 methodology and the reclassification of some public companies, i.e. the Croatian Bank for Reconstruction and Development (HBOR) to the general government sector, whereby their debt has been included in the public debt, but it is also the result of the transfer of Croatian Railways Cargo liabilities into the public debt.

The Act on Execution of the 2015 State Budget of the Republic of Croatia²⁵ establishes that the annual value of new financial guarantees for 2015 amounts to HRK 6 billion, out of which HRK 2.5 billion pertain to extra-budgetary users of the state budget.

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

The financing method of budgetary requirements in the following period will depend on the financial market circumstances, and the total level of such requirements will be determined by fiscal deficit trend, financial assets trend, as well as general government budgetary liabilities that are falling due in the observed period. The need for financing of the total budget deficit and matured liabilities will be ensured on domestic and foreign financial markets, while in the sense of borrowing mechanisms in the observed period, the focus will lie on instruments with a longer maturity, primarily bonds. Special attention will be paid to the adjustment of future maturities by their amount and due dates, while creating an additional room for financing other sectors. Borrowing by loans will primarily focus on domestic financial market, while foreign financing by loans pertains to project loans of international financial institutions. On the side of financial assets, in the period 2015–2018 revenues are expected from the privatisation in the average amount of 0.5% of GDP per year.

²⁵ Official Gazette, no. 148/2014

Most of maturing liabilities in the period 2015–2018 pertain to nine maturities of bonds, of which six are domestic and three are foreign. Regarding domestic bonds, one has been denominated in euro, in the amount of EUR 350 million, while 5 bonds have been denominated in HRK in the total amount of HRK 24.5 billion. Foreign matured liabilities pertain to three Eurobonds, the first in the amount of EUR 750 million, with a due date in 2015, and the second one in the amount of EUR 1.5 billion, converted to EUR at the time of issuing, with a due date in 2017. The third bond in the amount of EUR 750 million matures in 2018. Regarding the loans, the biggest maturities in the observed period refer to the syndicated loan maturities issued on domestic financial market and to the international financial institution loans. Thus total loan maturities are somewhere between HRK 9.3 billion in 2015, HRK 12 billion in 2016, HRK 6.1 billion in 2017 and HRK 3 billion in 2018.

Table 3.4. Overview of the bonds maturity of the Republic of Croatia) in the period 2015–2018

Bond	Date of issue	Amount (in million)	Intrest rate	Date of maturity
DOMESTIC BONDS				
Serija 09 D-15	14.7.2005	EUR 350	4.25%	14.7.2015
Serija 10 D-15	15.15.2005	HRK 5,500	5.25%	15.12.2015
Serija 16 D-16	22.7.2011	HRK 3,500	5.75%	22.7.2016
Serija 15 D-17	8.2.2007	HRK 5,500	4.75%	8.2.2017
Serija 12 D-17	25.11.2010	HRK 4,000	6.25%	25.11.2017
Serija 18 D-18	10.7.2013	HRK 6,000	5.25%	10.7.2018
FOREIGN BONDS				
Euro - EUR VII	5.6.2009	EUR 750	6.50%	5.1.2015
Euro - USD IV	27.4.2012	USD 1,500	6.25%	27.4.2017
Euro - EUR VIII	8.7.2011	EUR 750	5.875%	9.7.2018

Source: Ministry of Finance

In accordance with the planned deficit of consolidated general government budget , i.e. the funding requirements in 2015, it is expected that the public debt will eventually amount to HRK 296.9 billion or 89.8% of GDP.

The projected trends of the public debt show that, in the course of further implementation of measures of fiscal consolidation in the framework of the Excessive Deficit Procedure, the trend of public debt growth will stabilise at the level of 92.5% of GDP in 2017, after which its share in 2018 in the gross domestic product is expected to decline to 92.4%.

Table 3.5. Projection of public debt trends

% of GDP	2013	2014	2015	2016	2017	2018
Public debt	80.6	85.0	89.8	92.0	92.5	92.4
Foreign	33.3	34.6	36.1	37.9	37.5	37.4
Domestic	47.3	50.4	53.6	54.1	55.0	55.0

Source: CBS, CNB, MFin

4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMMES

4.1. Fiscal Risks and Public Debt Trend Sensitivity Analysis

Fiscal projections for the medium-term period rely on the described macroeconomic assumptions and in that sense, the risks connected to the lower level of economic activity in relation to the presented macroeconomic scenario in this programme would have significant implications on the expected fiscal value trend and results in the following period. Such changes in the revenue and expenditure trends would have a direct influence on the general government budget deficit, and ultimately on the public debt standing.

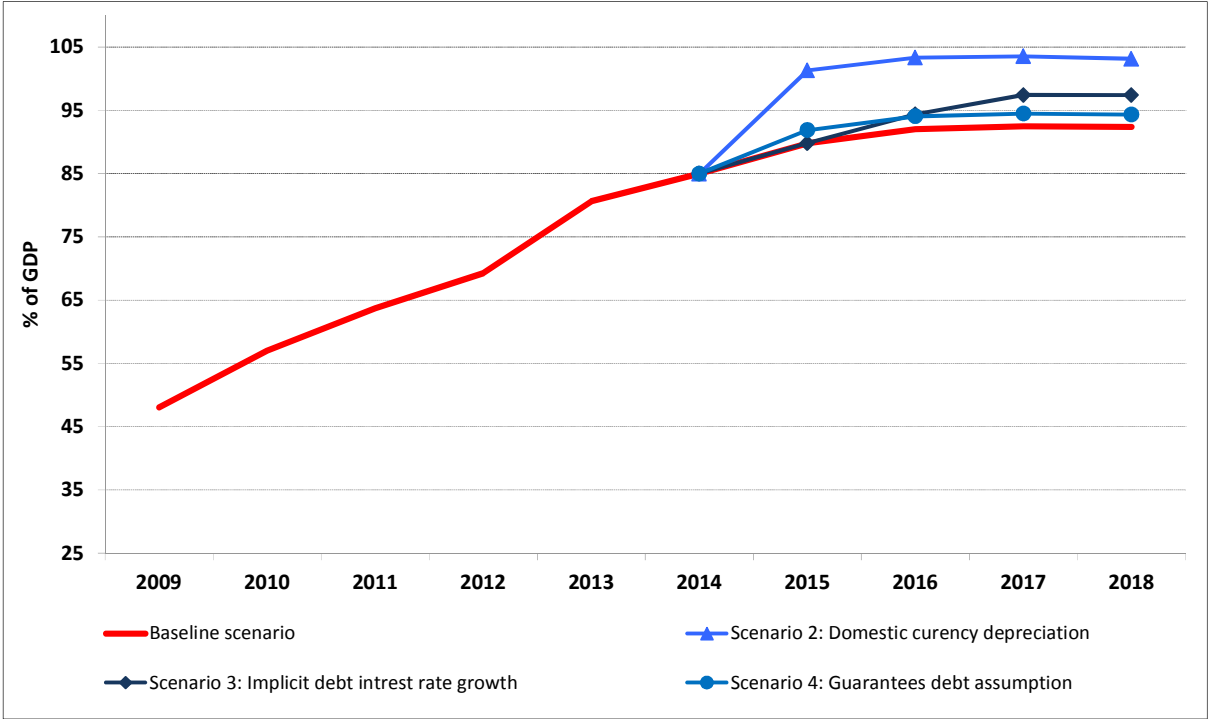
Regarding the negative effects on the public debt trend in the medium-term period, the risk of a considerable change in the domestic currency exchange rate should be singled out. Indeed, having in mind that almost 80% of public debt has been denominated in a foreign currency, domestic currency depreciation would result in a higher public debt level, as well as in more difficult debt service. The sensitivity test performed shows that the depreciation of 15% of kuna against euro increases the public debt level to over 103% of GDP in the period from 2016 to 2018.

Also, the increase in the cost of financing due to the liquidity deterioration or return of a negative mood towards risk on international financial markets would lead to the increase of the debt and interest payment burden, putting thus more pressure on the current state operations. Thus, in a scenario where the average implicit interest rate on the debt would increase by two percentage points in 2016 and 2017, public debt would increase above the projected one and at the end of the projection period it would reach the level of 97% of GDP.

Public companies still present a potentially big risk for public finances, especially if we consider the activation of guarantees, i.e. the assumption of state company debts to the public debt in the previous years. Therefore, in the assumed scenario of conditional liabilities transfer to the public debt in the amount of 2% of GDP, the public debt would exceed the level of 94% of GDP in the period from 2016 to 2018. Consequently, the utmost importance lies in the continuation of the implementation of the business operation restructuring process among the users of government guarantees in order to increase the efficiency and the sustainability of their business operations, thus reducing potential risks of activating government guarantees reflected in a negative impact on fiscal aggregates, i.e. budgetary deficit and public debt.

To sum up, debt sensitivity analysis has shown that in order to avoid specified fiscal risks and to ensure a fiscal sustainability, the predicted structural reforms under the National reform programme should definitely be implemented for they will influence the decrease of expenditure level share in the value of the gross domestic product and the correction of excessive deficit, stabilising also the public debt trend.

Chart 4.1. Public debt share trend in GDP according to specific scenarios



Source: Ministry of Finance

4.2. Comparison with the Previous Programme

The comparison of total revenue, expenditure and deficit of a consolidated general government in a new and previous Convergence Programme shows considerable differences. The differences arise from the different levels of the nominal gross domestic product, changes in policy of managing the revenue and expenditure sides of the budget and the application of new statistical ESA 2010 methodology since September 2014, which introduced, for the first time, a statistical general government scope into Convergence Programme 2015–2018. At this point, it should be mentioned that the Convergence Programme 2014–2017 used general government budget scope.

The Convergence Programme 2014–2017 rested on the assumption of a real growth of the gross domestic product of 1.2% in 2015, 1.3% in 2016 and 1.5% in 2017. The Convergence Programme from 2015 expects lower economic growth, thus in 2015 there is a projection of 0.4% of a real growth, 1% in 2016, 1.2% in 2017 and 1.5% in 2018. Also, the deflator was reduced due to lower actual and expected price trends.

The differences in single fiscal values in these two programmes also arise from other reasons specific for revenue and expenditure. During 2014, due to negative macroeconomic trends, revenues were below the planned ones, while there were some considerable savings on the expenditure side.

In 2015 and 2016 the differences of the projected values of revenues and expenditure in both documents arise from the modified level of nominal gross domestic product, but also from the necessary structural adjustments required by the Council within the framework of Excessive deficit procedure. Different revenue projections are the consequence of legal amendments in the tax system and in the social security contribution system that have come into effect in 2015, and that will cumulatively influence a different revenue level in the following period. On the other hand, apart from the nominal gross domestic product, the projected expenditure level is also influenced by structural measures projected in all expenditure categories, which has been explained in detail in the text.

Table 4.1. Comparison of revenue, expenditure and net lending/borrowing of the general government

	2013	2014	2015	2016	2017
CP RoC 2015-2018 (% of GDP)					
Total revenue	42.3	42.9	43.3	43.7	43.5
Total expenditure	48.0	47.9	47.3	46.4	45.9
Net lending/borrowing	-5.7	-5.0	-3.9	-2.7	-2.4
CP RoC 2014-2017 (% of GDP)					
Total revenue	43.0	42.5	42.6	43.1	
Total expenditure	47.2	45.7	45.0	45.2	
Net lending/borrowing	-4.2	-3.2	-2.4	-2.2	
Difference					
Total revenue	-0.7	0.4	0.7	0.6	
Total expenditure	0.8	2.2	2.3	1.2	
Net lending/borrowing	-1.6	-1.9	-1.5	-0.6	

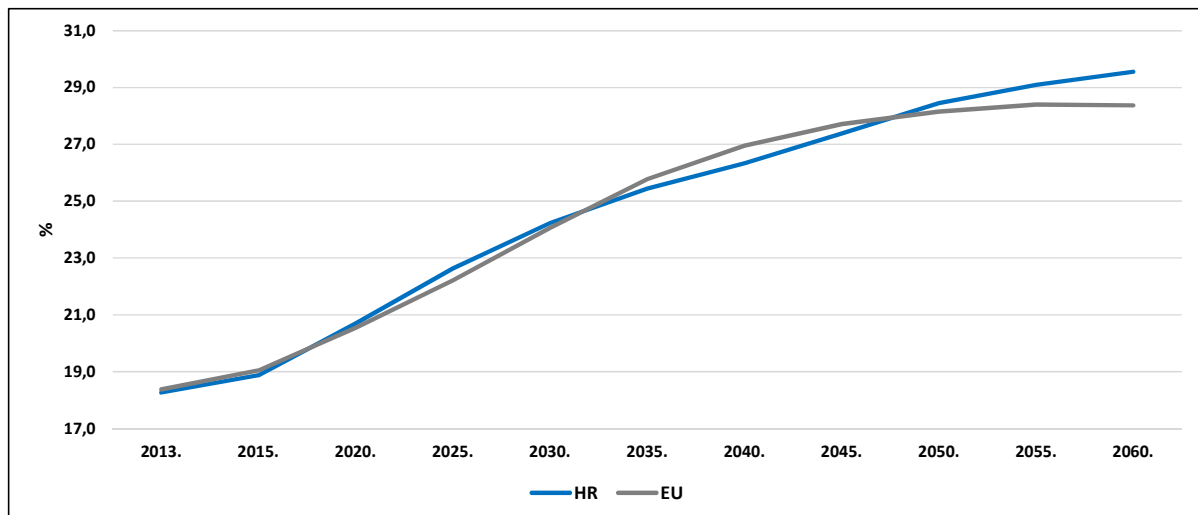
Source: Ministry of Finance

5. SUSTAINABILITY OF PUBLIC FINANCES

Like all EU states, Croatia has also been considerably influenced by accelerated demographic trends that primarily refer to the ageing of the population and life expectancy increase. The same may be observed in the following charts comparing Croatia and the EU in the period up to 2060.

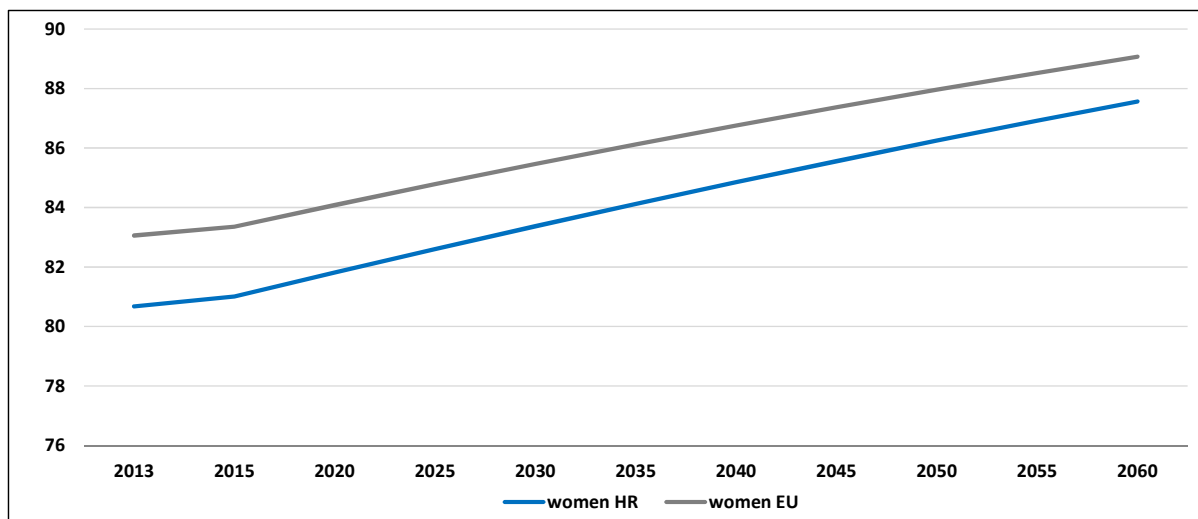
In the period 2013 - 2060, the population number decrease by 13% has been projected, that is, from 4.3 to 3.7 million. The life expectancy has, at the same time, significantly increased; in the period specified above, the remaining life expectancy will at the age of 65 be increased by 5.8 years in men and by 5.5 years in women. Such demographic trends will create a strong pressure on the public finance sustainability.

Chart 5.1. Older population share (65+) in total population



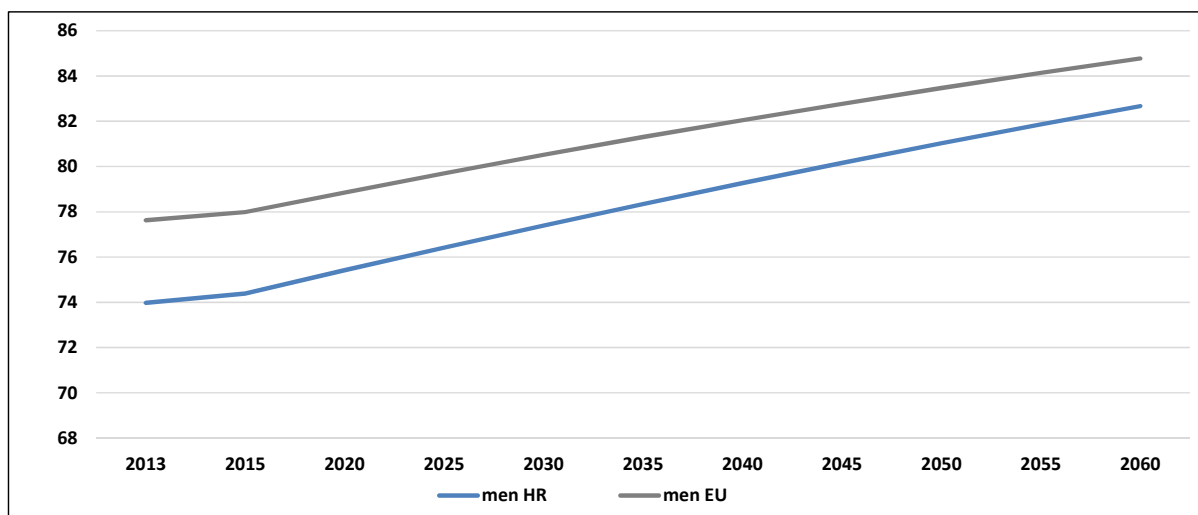
Source: Ageing Report 2015, EUROPOP2013

Chart 5.2. Expected life expectancy at birth, women (in years)



Source: Ageing Report 2015, EUROPOP2013

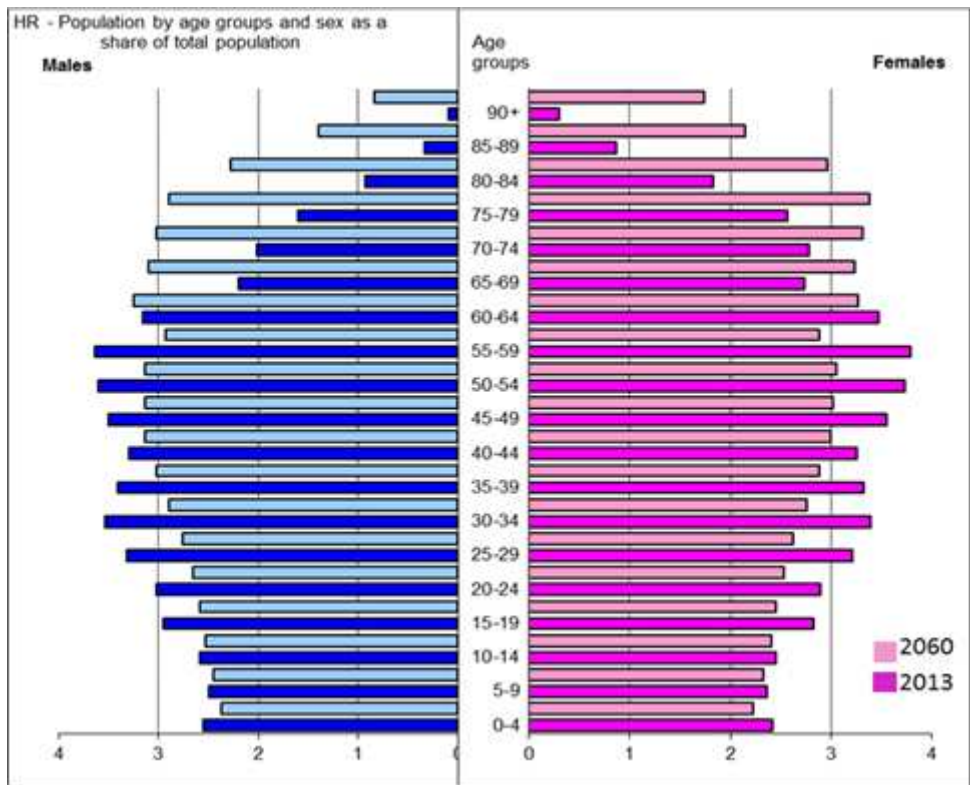
Chart 5.3. Expected life expectancy at birth, men (in years)



Source: Ageing Report 2015, EUROPOP2013

Such unfavourable demographic trends will result in a strong pressure on generation solidarity system. Gradual equalisation of retirement age for women and men by 2030, as well as working lifetime extension up to the age of 67 in the period from 2030 to 2038 should somewhat release the pressure. Chart 5.4 shows the comparison of age and gender population structure in 2013 compared to 2060.

Chart 5.4. Comparison of age and gender population structure

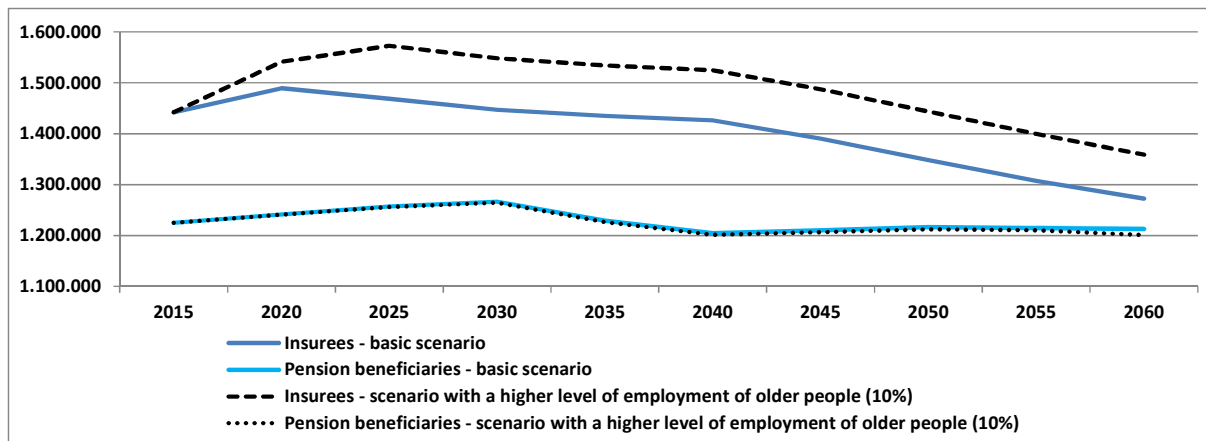


Source: The European Commission

The Republic of Croatia has also been characterised by a low activity rate and a low population employment rate. This especially refers to older population (55 – 64 and 65 – 74). Activity and employment rates of workers between 55 and 64 will be increased by 2040, with their peak in 2041, after which there will be a gradual decrease. With the activity rate increase by 10% and employment rate increase by 11% in the observed period, both rates will amount to only 50% by 2060. Activity rate and employment rate for the workers between 65 and 74 will almost double in the observed period, from 5.9% in 2013 to 13.8% in 2060, with its peak in 2048. Workforce age median gradually increases to 41 years in 2026, when it remains constant.

Chart 5.5. shows a projection of the number of employees (insured persons) and the number of pensioners in the period from 2013 to 2060, as well as one of alternative scenarios that includes a higher activity rate of older workers.

Chart 5.5. Projection of the number of employees (insured persons) and the number of pensioners in the period from 2013 to 2060



Source: Ministry of Labour and Pension System, March 2015

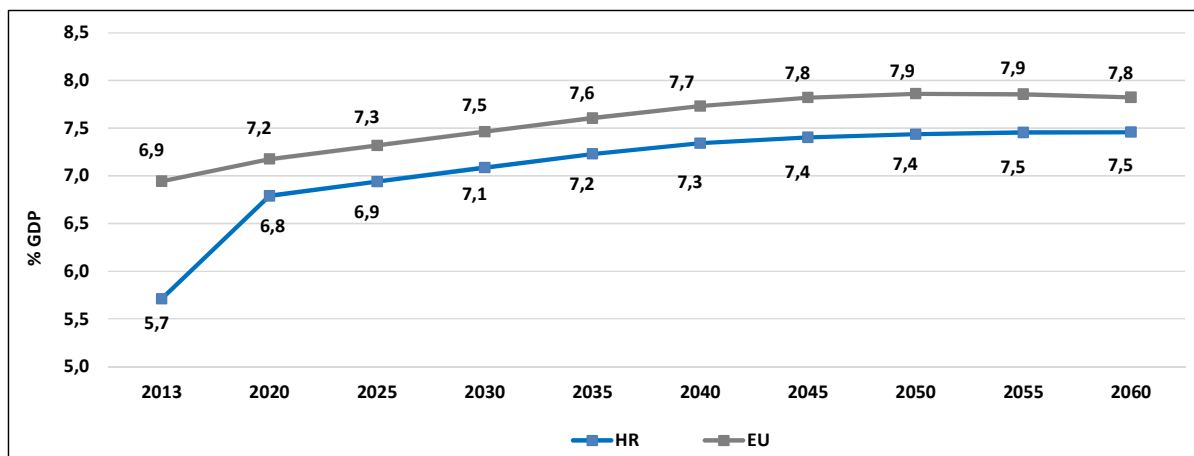
Sustainability of Public Finances- Health System

From the health system perspective, demographic changes considerably affect the health care services demand.

Within the AWG-EPC working group activities, projections regarding public finances in the health and long-term care sectors have been made with all EU Member States for the period 2013 – 2060.

According to the report of this working group (*Ageing Report 2015*), the total spending for health in the Republic of Croatia in 2013 amounted to 5.7% of GDP, which is somewhat lower than the EU average that amounts to 6.9%. By comparing the changes in spending during the period up to the year 2060, it may be seen that the share of the planned costs for health in GDP at the level of the Republic of Croatia has been growing faster than the costs at the EU level (growth of 1.7 against 0.9 percentage points).

Chart 5.6. Spending for health (as % of GDP)



Source: Ageing Report 2015, AWG basic scenario

Main challenges in the health sector are reflected in the need for the adjustment of health care provision method because a greater number of older people with more chronic diseases will require different treatment and a different method of health service provision. Therefore, it is important to strengthen the health-care sector cost-efficiency, focusing on hospitals. In this sense, one of the measures which should help considerably in achieving the savings is the implementation of unified public procurement for public hospitals (e.g. for medicinal products, medical devices and the like), as well as hospital reorganisation. The key strategic document for the future development of hospitals is the National plan for the development of clinical hospital centres, clinical hospitals, clinics and general hospitals in the Republic of Croatia in the period 2015 – 2016²⁶. Strategic framework for the development of hospitals is focused on the health care coordination improvement, avoidance of excess resource spending and the improvement of the financing system. Also, changed conditions require better coordination between different levels of health care, a faster information flow and more efficient strategy that would ensure the responsibility of all stakeholders, and especially high flexibility of hospitals and their resources in order to respond quickly to the current needs of the Croatian citizens. The implementation of improvement of the existing information and communication systems, and the development of new ones, as well as the primary health care reorganisation with the aim of improving and equalising the quality and availability of health care should also be mentioned here.

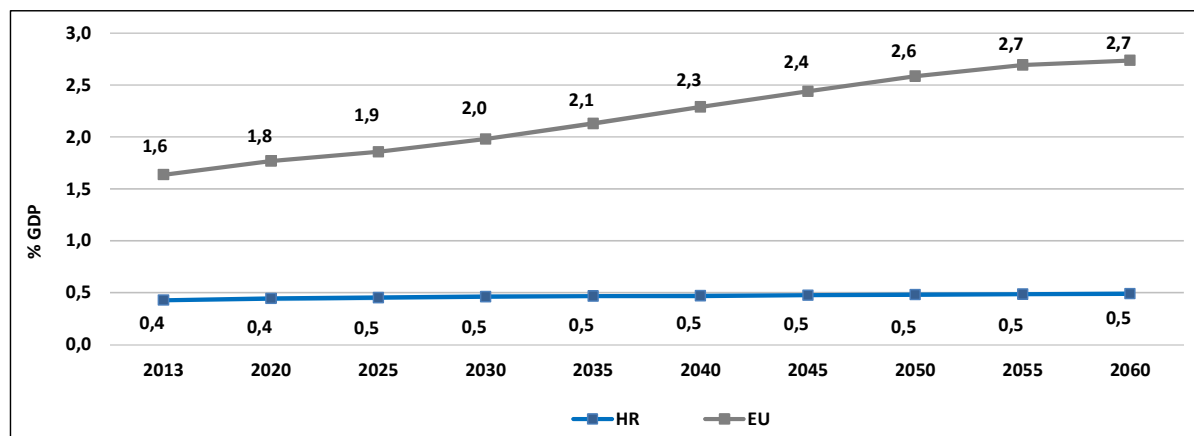
Regarding the long-term care, Croatia still doesn't have a comprehensive long-term care strategy and the long-term care is still dispersed between the health system and the social welfare system. There are different types of benefits in the social welfare system: social benefits in kind, cash benefits and social services. The role of the state in the social welfare system cannot be defined unilaterally because the state has the role of a social service provider and the role of the one who finances the services, but is also the "dam" for preventing the poverty and social exclusion. Croatian social welfare system is based on the subsidiarity principle and in that way the state has the role of the one who finances it only if a person does not have enough revenue or property for financing the costs of the services or if he/she is not in the position of getting help from their family members or by other

²⁶ Official Gazette, no. 26/2015

means. The project of modernising social care system is under way with the aim of improving its efficiency and cost-effectiveness.

AWG-EPC working group has drafted a public spending projection for the long-term welfare for the period 2013 – 2060 based on a harmonised methodology and available data, explained in detail in the working group report (*Ageing Report 2015*). Better comparison of Croatia and EU member states will be made possible by establishing and improving the social welfare system through a transparent cost monitoring.

Chart 5.7. Spending for the long-term welfare (as % of GDP)



Source: *Ageing Report 2015, AWG basic scenario*

Sustainability of Public Finances - Pension System

As already mentioned, life expectancy is increasing, and taking into consideration unfavourable natural growth expectations and net migrations, the share of older population is increasing as well, thus affecting the cost-increase in the pension system.

A large proportion of Croatian population has already retired. There are many reasons for that. Discouragement policy regarding early retirement by an efficient penalisation system for early retirement did not exist in the past. Rather, it was relatively easy to acquire a right to a disability pension. Also, a considerable number of war veterans from the Croatian Homeland War retired at a younger age which has considerably reduced the population basis that was supposed to produce new pensioners. Currently 28.6% of Croatians are retired.

On the other hand, there are important factors that will reduce the pension system cost. As shown in Table 5.1, the basic scenario anticipates a continuous reduction in appropriations for pensions in the public system, measured as a GDP share, from 10.9% in 2013 to 7% in 2060.

By introducing a mandatory 2nd-pillar pension system in 2027, most new pensioners will receive their basic pension from 1st pillar and the pension from 2nd pillar. This means that the expenditure for pensions paid from 1st pillar will gradually be reduced. This reduction will be even more

significant because the pensioners receiving pensions from both pillars will not have a supplement of 27% for the part of the pension paid from 1st pillar.

Legal age for retirement for women has been gradually increasing by 3 months a year, and in 2038 it will be 67 years of age. Legal age for retirement for men will increase from 65 to 67 in the period 2030 – 2038. The introduction of this measure will reduce the inflow of new pensioners.

A significant reduction in the number of disability pension beneficiaries by 2060 has been projected. This is the result of a more stringent implementation of rules that allow the usage of disability pensions. War veteran disability pensions have reached their maximum, but their number is expected to decrease gradually. The share of family pensions will also gradually decrease in the total number of pensioners. This is due to demographic trends and increasing rate of female employment.

Table 5.1. Pension expenditure and pension insurance contribution for the period 2013 – 2060 (% of GDP)

Pension expenditure	2013	2020	2030	2040	2050	2060	Peak
Expenditures of 1st pension pillar	10.9	10.3	9.6	7.9	7.2	7.0	2014
Expenditures of 2nd pension pillar	0.0	0.0	0.3	0.8	1.3	1.6	2060
Total pension system expenditure	10.9	10.4	9.9	8.6	8.5	8.6	2014
Pension insurance contribution	2013	2020	2030	2040	2050	2060	Peak
Contribution paid into 1st pillar	5.9	5.9	5.6	5.6	5.6	5.6	2016
Total paid contributions	7.5	7.5	7.5	7.5	7.5	7.5	2017

Source: Ministry of Labour and Pension System, March 2015

Mandatory pension savings in 2nd pillar will gradually become more important. The pensioners have the possibility of returning to 1st pillar by 2027. The projections show that their pension from 1st pillar will be somewhat higher than the combined pensions from 1st and 2nd pillar, and most people will probably exercise this option. After 2027, all people born after 1962 will not have the option of moving to 1st pillar and the number of pensions paid from 2nd pillar will gradually increase.

The revenue from pension insurance contribution in 2013 amounted to 5.9% of GDP, and the projections show a mild decline to 5.6% of GDP in 2030. The reason for this lies primarily in the increase of the number of employed who exercise their pension insurance right in both pension pillars (15% contribution from the salary is paid into 1st pillar and 5% is paid into 2nd pillar). After 2030, when 2nd pillar will take hold completely, the revenue from pension insurance contribution in 1st pillar will be stabilised at 5.6% and it will remain at this percentage until the end of the projection period. The difference between the collected contribution and the pension expenditure amounted to 4% of GDP in 2013, and by 2060 this difference will decrease to 1.4% of GDP.

Table 5.2. shows the projected expenditure values for single pension types. The data in the table indicate that the disability pension share is quite high – for example, disability pension in 2013 constituted 2.5% of GDP, and old age and early retirements constituted 5.1% of GDP. A large proportion of disability pensions results from the lenient criteria for acquiring the right to a disability pension in the previous period, as well as from a relatively large number of war veterans, but also due to the fact that disability pensions haven't been turned into old age pensions when a pension beneficiary lived to the age for the old age pension. This practice has changed in 2015, resulting in a sharp decline of expenditure for disability pensions for the period 2013 - 2020. Further reduction of expenditure for disability pensions has been caused by more strict eligibility criteria, as well as by the reduction of the number of war veterans.

Other pensions refer to minimum pensions acquired through a general pension system, as well as some types of pensions acquired according to special regulations, such as a minimum veteran pension amounting to 45% of an average salary. Expenditures for this pension category will rise until 2030, primarily due to a larger share of minimum veteran pensions.

Expenses for old age and early retirement pensions will increase by 2024, after which they will be reduced due to a more significant payment share from 2nd pension pillar.

Table 5.2. 1st pension pillar expenditure in the period 2013 – 2060 (% of GDP)

Pension types	2013	2020	2030	2040	2050	2060	Peak
Expenditures of 1st pension pillar	10.9	10.3	9.6	7.9	7.2	7.0	2014
Old age and early retirement pensions	5.1	5.8	5.6	4.3	3.8	3.7	2024
Disability pensions	2.5	1.3	0.7	0.6	0.5	0.5	2013
Family pensions	1.6	1.3	1.1	1.0	1.0	0.9	2013
Other pensions	1.7	1.9	2.2	2.0	1.9	1.9	2030

Source: Ministry of Labour and Pension System, March 2015

6. QUALITY OF PUBLIC FINANCES

Strategic framework

A long-time recession has had a negative impact on the long-term state of public finances. Such circumstances limited the fiscal policy scope of action, which also reflected in a high budget deficit and rapid increase of public debt. In order to strengthen the fiscal stability but without having a negative impact on economic growth, it is necessary to continue with the implementation of a number of activities. In this regard, the Government of the Republic of Croatia will be focused on the formation of the fiscal policy with the goal of promoting competitiveness, increasing the public sector efficiency, as well as strengthening public finance management, both on the revenue and expenditure side of the budget.

Revenue measures

With the aim of improving the efficiency and the quality of tax procedures, a number of measures have been implemented, including: 1) tax base expansion, 2) making prerequisites for the strengthening of the tax supervision efficiency, 3) timely information availability for taxpayers and 4) modernisation of the Tax administration organisational structure.

The changes in legislature in 2014 introduced the savings interest taxation in the tax system, which came into effect on 1 January 2015, and capital gain taxation effective as of 1 January 2016, after system adjustment and structuring of the records necessary for their timely collection.

In 2014, a tax expenditure catalogue (of tax exemptions and tax benefits) was created in the tax system. A committee whose goal was to review the effects of individual tax expenditures on labour market and investments was established, as well.

During two years of cash transactions fiscalisation enforcement, significant results have been achieved in both tax collection, as well as in the change of behaviour of the citizens. By including the citizens in the monitoring process of fiscalisation implementation by way of reporting irregularities, the citizens act as an additional monitoring mechanism. In 2015 the Tax administration will continue with the fiscalisation process improvement by strengthening the application support for risk analysis and by taxpayer behaviour tracking.

The JOPPD form (Report on receipts, income tax, surtax and contributions for compulsory insurance) has been applied since 1 January 2014 and has replaced six forms, thus significantly simplifying the procedure for tax and contribution identification. The form is used for tracking of liabilities and the schedule of payments made. It has helped to create the prerequisites for a systematic definition of annual income tax and surtax liability for a big group of taxpayers. As of 1 January 2016, i.e. tax year 2015, the citizens will not be required to submit the annual income tax return since the Tax administration will define annual tax liabilities. By creating the annual tax liability, the Tax

administration is prepared for an electronic data exchange on income and other receipts for citizens, thus abolishing the need for the citizens to request the certificates from the Tax administration if they want to exercise their rights. In 2015, the Tax administration will conduct pilot projects for the data exchange with other institutions, the application of which will spread in the years to come.

As of 1 January 2015, the Tax administration has been intensifying the data exchange with other EU member states. This expands the tax base, but also the image of taxpayer operations. In June 2014, Croatia also became a member of OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, an international body whose purpose is to ensure an effective implementation of international transparency standards and information exchange for tax purposes with the aim of tax evasion and fraud prevention. Furthermore, the Ministry of Finance has founded an Independent Sector for Tax Fraud Detection with the aim of a systematic data analysis from different sources and a quick response in defining tax liabilities and preventing tax frauds. In order to achieve effective results it is necessary to monitor taxpayers according to their risk degree, and the implementation of risk analysis establishment project will contribute to the fulfilment of tax liabilities (CRMS project).

In 2015, there will be some changes in the implementation of the pre-bankruptcy settlement proceedings due to the Bankruptcy Act amendments. With the purpose of an early remedy of entrepreneur insolvency and a timely restructuring, the concept of pre-bankruptcy settlement has been included in the Bankruptcy Act in order to put the whole process under the jurisdiction of the courts. In order to protect small and medium entrepreneurs' receivables, the claims of creditors that are contrary to the financial restructuring plan and that do not participate in the proceedings can be reduced by 20% maximum (interest included), with the repayment deadline of up to 2 years. Proceedings duration deadlines will be strictly prescribed by legal provisions.

In the last period, the Tax administration has invested a considerable effort in creating partnership relations with the taxpayers. The submission of almost all accounting applications, as well as delivery of all important notification to taxpayers, can be performed electronically. In 2015, one of the priorities of the Tax administration will be setting up business processes for the enforcement of binding opinions, tax settlements and administrative contracts. The changes in legal regulations will enable the issuing of binding opinions which will significantly increase the legal safety of taxpayers, while the introduction of tax settlement and administrative contract system will enable the inclusion of taxpayers in the procedure of tax liabilities establishment and fulfilment. Amendments to the Administrative Fees Act are also planned, with a purpose of regulating electronic payment of administrative fees regardless of the amount, the so called ePristojbe system. The aforementioned represents one of the measures of the Government of the Republic of Croatia for establishing a quicker, more modern and easier communication between entrepreneurs and the public sector.

For the purpose of preventive action of the Tax administration, Monitoring action announcement started in 2014 with the goal of its establishment in 2015. The Tax administration wishes to draw the taxpayer's attention to the need for proper application of tax regulations and to monitor changes in the taxpayers' behaviour by using the fiscalisation data during the Action, as well as to direct targeted supervision thereafter. Special attention will be paid to the cooperation with the Customs administration in checking newly founded companies (as well as those with the changes in the

ownership structure) and company groups marked as high-risk companies, as well as to the cooperation with other competent state bodies.

The Tax administration has also carried out a reorganisation process. In this sense, the Tax Administration has been restructured by the functionality principle, i.e. tasks of national significance are executed at the national level, tasks of regional significance at the level of regional offices and tasks of local significance at the level of branch offices. The new Tax administration organisation model includes the field office network rationalisation, i.e. the reduction of the number of regional and branch offices. The reorganisation process in 2015 also includes further improvement of speed, cost-effectiveness and efficiency of business processes.

Budgetary expenditure measures

Measures aiming at strengthening the sustainability and fairness of the pension system have been implemented in order to ensure social security of the pensioners. Pension Insurance Act is being implemented in order to additionally ensure the pension system stability and to improve the efficiency within the system. The reform of the existing system of insurance period with extended duration (*staž s produljenim trajanjem*) is under way and it will encompass the revision of professions and jobs entitled to this type of insurance. Thus, instead of the existing system of accelerated retirement scheme where the insurance period for specific jobs was increased from two to six months, a professional pension will be introduced. The workers who are today in the accelerated retirement scheme system could exercise the right to professional pension at a certain age, depending on profession characteristics. However, professional pension would not mean that they are leaving the labour market since they could, if they want to, continue to work in another profession and in that way acquire a part of the pension according to general rules. The most adequate calculation method of this pension type is currently under consideration. Furthermore, pension system of active military personnel, police officers and authorised officials will be redefined by equalising the criteria and harmonising the system, which will also stimulate their longer presence on the labour market.

With regards to the labour market, it should be mentioned that the application and the analysis of the effects of Labour Act have been monitored and an ordinance in line with the Labour Act is being drafted. The expected effects are analysed in line with the Act's goals in the field of collective labour relations, but also in connection to the restructuring of the employer, flexible organisation of working hours and flexible forms of work. The body which has been monitoring the application of the Labour Act comprises the representatives of the government of the Republic of Croatia, social partners and chambers. The application of the Act is supposed to accelerate the possibility of employer restructuring by the changes in the concept of employment contract termination and notice period redefinition. Reduction of duration of planned post-lay off procedure and the elimination of administrative obstacles during the employment contract termination will reduce the costs of worker dismissals. The labour market flexibility will increase, enabling a faster reconstruction and recovery of economic operators. The amendments to the working hour provisions (by creating average working hours) will enable employer internal work organisation flexibility and a faster adjustment to the current changes on the market. Flexibility regarding the work performed outside the work place, consistent application of *pro rata temporis* principle (consistency principle) for

working part-time and a re-design of the temporary employment contract will stimulate new employment in atypical forms of work.

In order to make the social welfare system more equitable, the Action plan for the Social benefit revision has been drafted. The revision will include all social protection benefits with their expenditure and programme beneficiaries. The plan will enable the insight into the existing situation regarding benefits at the level of the central government and local units, the division of social protection costs by beneficiary groups, terms and criteria of acquiring the rights and the role of a social planning at the local and regional level, as well as the recommendations for the rationalisation and future role of social protection benefits (unification of benefits/programmes in the future period).

Consolidation of social benefits through the Guaranteed Minimum Benefit (GMB) has resulted in the pooling of extended cash benefits (which have until now been regulated by the Act on Mediation in Employment and Rights during Unemployment), support aid (which was regulated by the Social Welfare Act), and rights to war veterans' cash benefits (which are regulated by the Act on the Rights on Croatian Homeland War Veterans and their Family Members and the Act on Protection of Military and Civilian War Invalids). The creation of the GMB represents the beginning of the pooling of social benefits, which should lead to the Guaranteed Minimum Standard (GMS), a type of social benefit which will ensure higher and better level of protection of the poorest groups in society. Consolidation of benefits through the pooling of benefits and a unique application enabling a transparent management and supervision will result in the expected savings of 15% of total funds for the benefits to be pooled within the GMS and for their administration. Furthermore, the consolidation of social benefits will also be implemented through the Unified Benefits Centre (UBC), i.e. through creation of a unified central place for disbursement and administration of cash benefits within the existing network of state administration offices in the counties. The goal of this measure is to create a single administrative point for citizens-state relations with regard to exercising the right to benefits.

The intention of the application of the National hospital development plan within the healthcare sector is to achieve better efficiency, performance and rationality regarding business operations of the hospital system. For example, the reduction of the number of acute hospital treatments will try to rationalise bed occupancy rate, reduce the length of in-hospital stay, will improve the access to hospital treatment and increase the quality of health services. By the end of 2015, the hospitals should implement the approved Implementation plan of the National plan and align the number of beds with the National plan. A new model of contracting and paying for hospitals will be introduced, as well as a new model of hospital management which involves the separation of business and medical affairs at hospital administration level. The system of financial and medical controlling and improvement of financial planning and reporting will be introduced for the transparency and cost efficiency control purposes. Also, new (lower) salary increments primarily for non-health personnel will be defined, and the payment of bonuses for scientific titles will be regulated. The number of overtime working hours is expected to decrease with a better organisation of business processes and job positions.

A full application of e-health is expected by the end of 2015 (e-findings, e-discharge letter, e-DTS, e-referrals, A5 referral), which would include linking of financial software applications of all hospitals.

The introduction of A5 referrals, related to the consultations without a patient present, is expected to reduce the referrals to secondary health care level, while the development of the linking of financial software applications will enable access to specific operative data of hospital business operations (financial, material, personnel, etc.). It is expected that a complete e-health system implementation will create health protection of a better quality.

More intensive application of the model of unified public procurement in the health system is planned for the following period. IT solution required by the public procurement system will be created by the end of 2015. Changes in the organisation and powers of the Agency for Quality, which will become the Agency for Quality and Logistics, will result in the Agency assuming all public procurement duties and assessment of medical technology significant for the capital investment planning with the objective of cost rationalisation. Also, the strengthening of the primary health care role and a more efficient management of health system personnel has been planned. Regular and additional sick leave controls with the aim of reducing the sick leave rates to an optimal level are being carried out. Also, medicine prescriptions are also being controlled based on defined indices. The equipping and investing in the building expansion of health centres is also planned in order to reduce the referral to specialist health care services. With the human resources management in line with the needs of the health care system, planning of education and professional training and a continuous training of health care workers, deficient health care expert training, particularly in deprived areas, will be additionally financed.

For a more efficient management of the state assets and monitoring of public companies, improvements of state assets management and recordings are being made, including the setup of a supervision system over companies founded by local and regional self-government units, and their branch offices. A framework for their business operations tracking has also been defined. Furthermore, the system of state real estate usage for the stimulation of investment is being developed and further privatisation of the state portfolio is carried out, as well as the rationalisation and restructuring of the number of state-owned companies. The privatisation of Luka Vukovar d.o.o. and Imunološki zavod d.d. is currently under way, and the privatisation of Đuro Đaković Holding d.d., Petrokemija d.d. and Hrvatska poštanska banka d.d. is planned too. The efforts are made in order to try to make the procedure of selling minority packages of stocks and shares simpler and faster. Also, there is a tendency of reducing the number of companies that are of strategic and special interest.

Expenditure control

With the purpose of improving and strengthening public finances management, the following reform measures have been proposed: 1) fiscal responsibility improvement; 2) budgetary framework improvement; 3) State Audit Office (SAO) capacity strengthening and sanctioning of the refusal to act in line with the SAO recommendations; 4) internal financial control system strengthening; 5) public debt management system improvement; 6) improvement of the framework for issuing State warranties and guarantees and 7) improvement of the system for calculation and collection of municipal fees.

According to the Fiscal Responsibility Act, the heads of budgetary and extra-budgetary users of both state budget and local unit budget, head officers, mayors and county prefects, management board

chairmen of companies owned by the Republic of Croatia, i.e. one or more local units, head officers of other legal entities founded by the Republic of Croatia, i.e. one or more local units, are to submit the Statement on fiscal responsibility. It is the way of confirming that in their work they have ensured lawful, allocated and purposeful use of funds and an efficient and effective functioning of the financial management and control system. Among other things, the statement is given on the basis of the Fiscal Responsibility Questionnaire containing the questions in the field of planning, execution, accounting, reporting and public procurement. The statement of fiscal responsibility will be elaborated in detail in chapter 7 Institutional characteristics of public finances of this document.

The new proposal of Fiscal Responsibility Act includes the provisions referring to the further adjustment of the fiscal rules with the provisions of Directive 2011/85/EU on requirements for budgetary framework of the Member States, and to the strengthening of the independence and role of the Fiscal Policy Committee. The new Act will also include the amendments regarding further improvement of the budget framework that will set up a better control of the planning and execution of budgetary and extra-budgetary user expenditure. The adoption of this Act is planned for the September 2015, and the competent ministry acts (planned to be adopted by the end of 2015) will ensure the consistency of the strategic and financial plans, as well as more realistic planning of budgetary expenditure with the definition of sanctioning mechanisms regarding non-compliance with the planned budgetary limits. With the aim of complying with the budget limit by the users, the proposed changes will also refer to the introduction of provisions according to which the amount of the financial plan in the following budget year will be reduced to the users by the amount of created liabilities exceeding the amount planned in the state budget if the liabilities have been created with the due date exceeding the amount planned in the state budget. Therefore, and with the aim of strengthening the fiscal discipline, it has been proposed to adopt the Instructions for Expenditure Planning aimed at determining an optimal level of costs according to their type and application. Also, the standards for the number of workplaces in general (support) services will be determined in order to harmonise the real needs of agencies with other budgetary and extra-budgetary users.

Further improvement of expenditure control system is planned through the strengthening of the capacity and role of the State Audit Office (SAO), i.e. through defining a system for sanctioning failure to act upon the recommendations of the State Audit Office in order to further enhance the financial statement credibility control system, compliance with laws and regulations and strengthening of the efficient use of budget funds. The existing legislative framework allows the SAO to conduct follow-up audits after establishing irregularities, and as of 2013 the SAO requires each audited subject to submit data after the implementation of the audit on the measures taken upon the audit results in the form of the Implementation Plan of Orders and Recommendations, with the specification of the planned activities (measures) for the implementation of such orders or recommendations, persons responsible for the implementation and planned final implementation deadline (State Audit Office Act²⁷). That is why the further upgrading of the system and the role of the SAO will be realised through the following: 1) the process of strengthening the SAO capacity and related professional education and training, for which the adoption of the Action Plan in April 2015 has been planned, and 2) the development of the model of sanctioning the failure to act upon the SAO

²⁷ Official Gazette, no. 80/2011

recommendations and the draft proposal of amendments to the existing legislative framework the adoption of which is expected by the end of 2015.

The process of strengthening of the internal financial control system for public sector will be completed by the adoption of a new Public Internal Financial Control System Act, which is scheduled for June 2015. Pursuant to the proposed amendments to the legislative framework, the obligation to comply with the applicable Act will include companies owned by the Republic of Croatia, that is one or more local units, and to other legal entities founded by the Republic of Croatia, i.e. one or more local units. The practical implementation of the internal control system shows the need for additional strengthening of the management responsibility of managers. The provisions of the new Act, namely the part regulating the internal control system, will therefore prescribe in detail the responsibilities of head officers responsible for budgetary and extra-budgetary users of the State Budget and the budget of local units, heads of municipalities, mayors, county prefects, management board chairmen or directors, i.e. managers, and the responsibility of managers of internal organisational units for the development and implementation of internal control systems.

Also, the aforementioned amendments to the Act will define the role of organisational units responsible for the finances in budgetary users more clearly in the coordination of the development of internal control systems. It is necessary to do so in order to enable them to provide adequate support to other managers who should develop a system of internal controls within their jurisdiction for a better management of business-related financial effects. A framework for the development of internal control system, which will include the components of internal control system with an overview of internal control principles, methods and procedures, based on the internationally accepted internal control framework (COSO) will be adopted. With regard to the establishment of internal audit, the relationship between budgetary users at the section level, i.e. LC(R)SGU and competent institutions, will be more clearly defined, with the obligation that the internal audit established at the section level of the state budget, i.e. LC(R)SGU, also performs such internal audit within institutions under its jurisdiction. This will be appropriately applied to companies owned by the Republic of Croatia, that is one or more LC(R)SGUs, and other legal entities founded by the Republic of Croatia, that is one or more LC(R)SGUs and their subsidiaries.

In the period of six months from the adoption of the Act, secondary legislation stipulating the obligations of organisational units responsible for the finances of budgetary users will be adopted, the content of the framework for the development of internal audit systems will be prescribed and the methodology of internal audit within the framework of risk assessment will be regulated. Also, the focus will be laid on the assessment of internal control systems in the areas for which substantial funds are appropriated or in which income is collected, in order to direct the activities on the improvement of internal control systems and management processes in areas with significant financial impact.

The system of improving the public debt management will be ensured through the adoption of the Strategy for Public Debt Management for the period 2017-2019, which is elaborated in more detail in chapter 7 of this document.

In order to reduce potential risks incurred by the activation of state guarantees concerning budgetary and extra-budgetary users and in order to stimulate the process of restructuring of business operation among existing and potential users of state guarantees and warranties, the Act on the

Execution of the State Budget for 2016 will be prepared. The proposed amendments will prescribe that the process of issuing state guarantees and warranties will depend on the restructuring implementation plan of potential users of government guarantees and warranties.

An integral part of the reform measures regarding the control over expenditures entitled "Improving the System of Billing and the Collection of Municipal Fees" refers to measures aimed at local self-government units, with the focus on the review and application of the Public Utilities Act in parts concerning the efficiency of collecting municipal fees.

Local units obtain their revenue from three sources: their own sources (including own taxes), joint taxes and grants from the state and county budget. Municipal fees also belong to own income, the determination and collection of which is fully in the competence of local units. The base for the collection of municipal fees has been narrowed down due to the keeping of records that were not updated and to a wide range of exemptions and relieves. Therefore, the measure is aimed at encouraging the utilisation of the maximum possibility of collecting municipal fees in local units' revenues, i.e. a more efficient management of the municipal fee system.

The proposal for the implementation of this measure will be carried out in several phases and will start by analysing the share of revenue originated from municipal fees in the overall revenue structure of local self-government units in June 2015, and by the adoption of the Action Plan for local self-government units that deviate from the average established in September 2015. The completion of the implementation of the proposed measure refers to the adoption of the Act on the Amendments to the Public Utilities Act and the Decision on Municipal Fees in Local Self-government Units and is planned to be realised in the fourth quarter of 2015.

In-depth analysis of state budget expenditure

In-depth analysis of expenditure, according to the OECD definition, presents a formal process of drafting the analysis of public policy, programme/activities and/or organisations with a clear aim of identifying potential savings in the budget at all levels of public administration.

The EU's Economic and Financial Affairs Council reached a decision at the meeting held on 28 January 2014 stating that the Republic of Croatia is currently in the Excessive Deficit Procedure and shall undertake to take measures with the purpose of achieving public finance sustainability by the end of 2016. The specified measure proposals are included in the EU Council Recommendations for the solving of excessive budget deficit issue and in country-specific recommendations for the Member States that Croatia had received within the European Semester for 2014. Based on the specified Recommendations, the Government of the Republic of Croatia at its session held on 30 July adopted the Implementation plan for country-specific recommendations for the Republic of Croatia for 2014, that, among other things, include the implementation of the in-depth analysis of the state budget expenditure with the aim of reducing total public spending.

With the aim of fulfilling the recommendation on expenditure in-depth analysis, the Government of the Republic of Croatia adopted the decision on the implementation of the analysis²⁸ at its session

²⁸ Official Gazette, no. 124/2014

held on 22 October 2014. The aim of the adoption of the Decision was to draft a package of measures for the reduction of total public spending, by increasing, at the same time, the efficiency of budget funds spending with the least adverse effect on the existing level of public services in Croatia. This Decision provides the creation of a number of measures that will result in an annual reduction by 10% in each of the defined categories in comparison with the actual plan for 2014.

The categories included in this analysis are the following: 1) expenditures for employees which are paid from the state budget; 2) subsidies, except agriculture; 3) health system; 4) business operations of agencies, institutes, funds and other legal entities with public authority; 5) tax expenditures.

Thus all expenditures for employees which are paid from the state budget have been analysed, including subsidies under the competence of Ministry of Finance, Ministry of Economy, Ministry of Maritime Affairs, Transport and Infrastructure, Ministry of Labour and Pension System, Ministry of Entrepreneurship and Crafts, Ministry of Culture, Ministry of Science, Education and Sports and Ministry of Tourism. The health sector includes business operations of its budgetary users in line with the Register of budgetary and extra-budgetary users of the state budget, business operations of the Croatian Institute for Health Insurance, as well as the most significant activities in the budget according to the financial standards. Furthermore, the in-depth analysis includes the business operations of agencies, funds and other legal entities with public authority, as well as business operations of regulatory agencies founded by special legislation but which are neither included in the state budget, nor are they budgetary users. Tax expenditure (expenses) have also been analysed, and they were mostly identified by the Ministry of Finance, Ministry of Regional Development and EU funds, Ministry of Entrepreneurship and Crafts, Ministry of Social Politics and Youth, Ministry of Labour and Pension System, Ministry of Agriculture and Ministry of Veterans' Affairs.

In line with the Decision on conducting an in-depth analysis of expenditure, and on the basis of the Report by the Central Commission for the analysis implementation, the Government of the Republic of Croatia will in its conclusion adopt the recommendations of the in-depth analysis of the state budget expenditures. The recommendations will lead to the reduction of the total public spending and will be implemented in the mid-term budgetary documents. The Conclusion identifies the need for a comprehensive reform of expenditures for employees that are paid from the state budget, as well as expenditure for employees, material and other expenditure in the health system. Regarding the in-depth analysis of agencies, institutes, funds and other legal entities with public authority, it has been established that it is necessary to carry out their rationalisation.

7. INSTITUTIONAL CHARACTERISTICS OF PUBLIC FINANCES

7.1. Amendments to the Budget Act

Amendments to the Budget Act²⁹, adopted in February 2015, were implemented in order to strengthen the mid-term budgetary framework, which at the same time presents one of the recommendations of the EU Council in the European Semester cycle for 2014.

The amendments of the Act have a number of novelties regarding the inclusion of the European Semester documents in the budgetary process, alignment with the European statistics requirements, strengthening of the mid-term budgetary framework and introduction of additional flexibility in the execution of the budget, as well as public debt management.

Inclusion of strategic documents of the European Semester in the budgetary process

Since the participation in annual cycles of the European Semester is the obligation of all EU Member States, and thus also Croatia, drafting of strategic documents included in this cycle had to be incorporated in the budgetary process, which has actually been done by the amendments to the Act. During the European Semester annual cycles, each Member State is obliged to draft two strategic documents: the Convergence Programme and the National Reform Programme. The inclusion of these two documents in the process of budget preparation has resulted in budget calendar modifications. Budget process for the following three-year period will start earlier since these documents should be delivered to the European Commission for consideration and assessment by the end of April. Macroeconomic scenario and fiscal policy framework will thus be published earlier than usual in the convergence programme, and not in economic and fiscal policy guidelines as before. The ministries and other state bodies at the level of organisational classification sections still have to draft strategic plans, but they will also be the basis for drafting the two specified documents. The deadline for compiling and delivering instructions for the preparation of strategic plans for a three-year period will be moved from mid-March to the end of February, and the deadline for the delivery of strategic plans to the Ministry of Finance from mid-April to the end of March. These two documents, together with strategic plans, become the basis for drafting the guidelines of economic and fiscal policy for the three-year period.

The specified changes in the budget calendar have also resulted in the changes of the deadline for the submission of instructions for drafting the state budget proposal and of instructions for drafting local and regional self-government unit budget from the end of June to the 15 August. Since the

²⁹ Official Gazette, no. 15/2015

guidelines now have to be adopted by the Croatian government Conclusion by July at the latest, and the guidelines are the basis of these instructions, it was also necessary to adjust the deadlines for their drafting and delivery. Following the changes, the deadlines by which budgetary users of the state budget had to submit the proposals of financial plans to ministries and other state bodies at the level of organisational classification sections were changed from 15 July to 15 September. In line with the changes, extra-budgetary users of the state budget and local units should also submit their financial plan proposal to a competent ministry, i.e. competent administrative body by 15 September. The deadline by which the ministries and other state bodies at the level of organisational classification section have to deliver the adjusted financial plan proposals to the Ministry of Finance was also changed from the end of July to the end of September.

Extra-budgetary users of local units will from now on have to submit their financial plan proposals to a competent local unit administrative body and not to an administrative body for finance, as before. This completely aligns the process of drafting the financial plans of extra-budgetary users of local units with the process of drafting the financial plans of extra-budgetary users of the state budget.

All the specified changes in the planning process will be applied for the first time in budgetary processes connected with the drafting and adopting of the budget and financial plans for 2016 and projections for 2017 and 2018.

Harmonisation with the European statistics requirements

The availability of timely and reliable fiscal statistics is the basis for the implementation of the EU fiscal supervision and it enables the comparability among Member States and the creation of a comprehensive and a reliable image regarding their financial and economic position. European statistical methodology ESA 2010 contains special rules for the classification of units in institutional sectors of the society, which also includes general government sector with its sub-sectors. All statistical reports, including a Fiscal report that tracks the criteria fulfilment on state deficit and debt, have to be submitted to Eurostat according to the scope of these sectors. This statistical scope of the general government sectors and their sub-sectors is not identical to the scope used for budgetary purposes in most EU countries. However, the aim is to have as similar scopes as possible because otherwise their significant differences have to be quantified and explained.

The most significant differences in the budgetary system of the Republic of Croatia have been determined within the scope of extra-budgetary users which is, according to the Register of budgetary and extra-budgetary users, considerably narrower than the sectoral scope. In order to align the extra-budgetary user scope from the Register with the sectoral classification as much as possible, it was necessary to expand the definition of extra-budgetary users. This has actually been done by the aforementioned amendments to the Budget Act. In line with the new definition, extra-budgetary users are extra-budget funds, companies and other legal entities in which the state, i.e. local self-government units, have a decisive influence on the management and that are, in line with the EU statistical methodology rules, classified as general government sector but they are not budgetary users. According to the new scope, extra-budgetary users of the state budget would be Croatian Roads, Croatian Waters, Environmental Protection and Energy Efficiency Fund, State Agency for Deposit Insurance and Bank Rehabilitation, Restructuring and Sale Centre and Croatian Radio-

Television, Croatian Motorways, Rijeka-Zagreb Motorway and Croatian Railways – Infrastructure. At the level of local self-government units, this would still include county road administrations.

Also, in order to enable more efficient processing of the fiscal data, the aforementioned legal amendments have provided a possibility for the Ministry of Finance to impose the delivery of budgetary documents in the electronic form on to the local self-government units, as opposed to the present practice of delivering the documents only in paper form

Strengthening of the mid-term budgetary framework

Furthermore, in order to ensure a fiscal discipline, it is necessary to provide a mid-term budgetary frame that would enable the achievement of public finance sustainability. Recent amendments to the Budget Act have strengthened the budgetary framework in different ways.

First of all, the importance of budget projections adopted by the Croatian Parliament, i.e. representative body, has been strengthened. Article 12 of the Amendments prescribes a new fiscal rule providing that the deficit defined by the budget for the following budget year should not be higher than the deficit defined by the projection that the Croatian Parliament, i.e. representative body of a local self-government unit, has adopted in the previous year for that budget year³⁰. This provision will be applied for the first time during the drafting of the budget for 2017 for which the budget deficit amount will be determined by a budget deficit amount that the Croatian Parliament, i.e. representative body, defined in its projection for 2017 when adopting the budget for 2016 and projections for 2017 and 2018.

Another key method for the strengthening of a mid-term fiscal framework is the introduction of the so called dual limits. The Government has so far been defining so called limits in its guidelines for the ministries and other budgetary users of the state budget of the organisational classification section level.³¹ The specified limits have so far included the estimation of the total section expenditures that have been classified in classes according to the economic classification: 3 - business operation expenditure and 4 - expenditure for the procurement of non-financial assets, and they have been financed from the financing source: general revenue and receipts, contributions and earmarked receipts. However, in order to strengthen the political responsibility in fulfilling the mid-term strategic goals and allocations for the specified goals, as well as fiscal discipline, the method of determining the limit has also been changed. Consequently, the aforementioned amendments to the Act prescribe that for the state budget section level two instead of one limit should be determined. One limit will be determined depending on the funds necessary for the implementation of the existing programmes, i.e. activities (stemming from the regulations that are currently in effect) and the other, depending on the funds necessary for the implementation of the new or the change of the existing programmes, i.e. activities. The costs of implementing the existing programmes include the costs of maintaining the existing levels of services, taking into account the expected changes in the

³⁰ The Budget Act that preceded these amendments prescribed that the Croatian Parliament, i.e. representative body, was to adopt projections for the following two years, together with the budget for the following budget year, but that the projections were not binding. Since that situation did not contribute to the financing predictability and the strengthening of a fiscal discipline, a new rule has been introduced.

³¹ These are the appropriated fund amounts within which persons under obligation, including the users within their competence, would draft financial plan proposals that they would then enter in the state treasury system.

number of users and, for example, current costs of capital projects that will be completed during the planned period. The costs of new programmes also include the costs of the change of level and service type, for example, introduction of after-school stay for school children.

Defining of the so called dual limits is also applied by the local self-government units, including the proposal of the financial plan amount by budgetary users which contains the amount of the financial plan for the previous and current budget year, and the proposal of the financial plan amount for the following budget year and the two following years.

Budget execution flexibility

Amendments and modifications to the Budget Act have also introduced an additional flexibility to the budget execution.

The possibility of a re-allocation of budget funds as a mechanism which gives flexibility to the budget execution process at both the state and the local level was already introduced by the Budget Act in 2003. However, the accession of Croatia to the EU as a full member has not only brought the obligations but also the possibility of disposal regarding the Structural and Cohesion Fund. In order to prepare and then also efficiently implement the projects co-financed from the EU funds, there is also the possibility of a high level of flexibility of implementation of such projects.

The Budget Act provisions prescribe that the re-allocation of funds on budget items with budgetary users or between budgetary users and extra-budgetary users can be executed to the maximum of 5% of the expenditure and expenses on a budget item adopted by the Croatian Parliament, i.e. representative body, which may be reduced subject to the approval of the Minister of Finance, i.e. heads, mayors, county prefects. These amendments to the Act enable the re-allocation of funds of up to the 15% due to the increased funds of the national share planned in the budget for the financing of the projects that are co-financed from the EU funds, if this is approved by the Minister of Finance i.e. heads, mayors, county prefects.

Furthermore, Article 14 leaves the decision on the necessity of drafting monthly financial plans to the Ministry of Finance and to the local self-government unit. Monthly plans that the budgetary users of the state budget have been entering in the state treasury system have lost their meaning and significance they used to have. In other words, since the beginning of 2011, the process of budget execution has changed considerably. The entry and release of revised monthly plan and the approval of the provision have been abolished, but systematic controls have been introduced to the process of creating budgetary liabilities by mandatory provision of funds based on decisions regarding the commencement of public procurement process, framework contracts (for central procurement procedures), contracts and purchase orders. Instead of payment request, invoices debited to the general ledger are entered in the IT system of the state treasury. The process of state budget execution has been separated from the accounting. That is exactly why monthly plans have lost their meaning and importance so by these amendments to the Budget Act, the decision on the necessity of drafting monthly financial plans is left to the budget, and the decision will certainly depend on the method of organising the control system over budgetary user financial plan execution. In case a

decision on the necessity of monthly financial plans is reached, the deadline for their drafting remains unchanged, i.e. the plans have to be drafted by 15 January of the current year.

These changes to the Budget Act enable the budgetary users who have been paying their revenue to the appropriate budget, be it state or local, to transfer the unspent own revenue from one budget year to another. That transfer has so far been possible only for earmarked revenues and receipts. However, due to, among other things, the entry of a big number of users into the system of VAT and liabilities settlement, on that grounds and from this financing source, this flexibility will now be enabled even for the disposal of own revenue. Furthermore, it has been prescribed that a user may assume and pay liabilities only in the amount actually paid, that is, available, own revenue, regardless of the funds presented in the budget. Also, paid and transferred and less planned own revenues can be executed above the amount defined in the budget, and up to the amount of the paid, i.e. transferred, funds. The first carrying forward of unspent own revenue from the previous to the next year is the one from 2014 to 2015, according to the transitional and final provisions of the Budget Act amendments.

Public debt management

In order to ensure the fulfilment of the required dynamics regarding the excessive deficit procedure and in order to have a better control of the budget deficit and a longer deadline for it, the obligation of drafting a public debt management strategy has been introduced. The goal of public debt management is to collect the necessary financial funds for the budget deficit financing, but with an acceptable relation of costs and risks, taking into account the exposure of debt structure to risks. That is why the obligation of drafting a public debt management strategy has been introduced. The Government will adopt the strategy every three years for the next three budget years, and this will considerably reduce the risks of the Republic of Croatia connected with liquidity, settlement, loans and the like. This provision will for the first time be applied in 2016 during the drafting of the budget for 2017, when the first public debt management strategy for the period from 2017 to 2019 will be drafted. The implementation of this strategy will be tracked via an annual report on the implementation that will form an integral part of the report on state budget execution.

The Budget Act provision prescribing that ratio of unsettled state debt amount at the end of the year in relation to the gross domestic product projection may not be higher than the ratio of the previous year, where the specified ratio may not be higher than 60% of the gross domestic product, shall be deleted by these amendments... In other words, the public debt dynamics will be laid down in a new Fiscal Responsibility Act that is currently being drafted and the debt definition is being adjusted with the Stability and Growth Pact and Maastricht criteria.

7.2. Fiscal Responsibility Act proposal

Fiscal rule

The Fiscal Responsibility Act³², which entered into effect on 1 January 2011, introduced fiscal rules and rules for the strengthening of the fiscal discipline, and the obligation of drafting a statement on fiscal responsibility for the heads of budgetary users at the state, i.e. regional and local levels. The initial fiscal rule prescribed the reduction of expenditures of the general budget, presented as a share in the gross domestic product by at least one percentage point per year until the primary balance at the level of zero or a positive amount (in nominal terms) is achieved. In the conditions of a deep recession and negative production gap, such a rule, due to its cyclic nature, further threatened the chances for growth. Alignment with the EU requirements connected with the new framework for managing the economic policy in the EU, and which is aimed at strengthening the implementation of the Stability and Growth Pact, was another reason for changing the rule.

Accordingly, in the second half of 2013, amendments to the Fiscal Responsibility Act³³ were prepared which came into effect in February 2014. The Act amendments changed a fiscal rule in a way that the target value of a new fiscal rule became a mid-term budget goal that will be realised according to the adjustment plan. Also, expert and independent body who monitors the fiscal rule application, and whose tasks have been defined by a special rule, has been introduced.

In the second half of 2014, based on a country specific recommendation no. 1 for the Republic of Croatia for the further adjustment with Stability and Growth Pact and Council Directive 2011/85/EU requirements, the drafting of a new Fiscal Responsibility Act was initiated. The reasons for a review of the Fiscal Responsibility Act include the necessity to 1) introduce debt rules and to 2) strengthen the independence and extension of competence of the Fiscal Policy Committee.

This proposal to the Act is first of all supplementing the fiscal rule. The fiscal rule has so far prescribed that structural balance, expressed as a share in gross domestic product, should be realised according to the adjustment plan in order to achieve a mid-term budget goal. However, general budget revenue growth should not exceed a referential potential growth rate of the gross domestic product, increased by the expected price growth. The Fiscal Responsibility Act in force provides corrective measures only in the part concerning the rules regarding the deficit, and not in the part concerning public debt. This Act proposal provides the introduction of a temporary fiscal rule during the Excessive Deficit Procedure, the fulfilment of which is connected to the complying with the Council recommendations with the purpose of correcting the aforementioned deficit. Apart from the deficit rule, the debt rule has also been introduced in a way that the debt exceeding a reference rate of 60% has to reduce 1/20 of the amount above 60% of GDP per year, and in line with the Stability and Growth Pact.

Also, the provisions connected with the deviations from fiscal rule application are described in detail, in line with the Stability and Growth Pact.

Independent body for monitoring the implementation of Fiscal Responsibility Act

³² Official Gazette, no. 139/2010

³³ Official Gazette, no. 19/2014

The Fiscal Policy Committee was established pursuant to the 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 the 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, on 18 December 2013 the Croatian Parliament passed the decision³⁴ establishing the Fiscal Policy Committee as a second working body of the Croatian Parliament. The Committee of the Croatian Parliament replaced the previous Fiscal Policy Committee. The members of the Committee, with the exception of the chairperson, were appointed by the Croatian Parliament at the proposal of the Committee for Finance and State Budget, for a five-year mandate.

The proposal of this Act strengthens the independence and expands the competence of the Fiscal Policy Committee in more detail by prescribing their tasks in the part of reviewing and assessment of fiscal rules and macroeconomic projection application, reporting method on the views taken during the task performance, member selection and Croatian government responsibility in the implementation of their recommendations.

The Act proposal is currently in the consultation process with the European Commission technical services.

Fiscal responsibility statement

According to the Fiscal Responsibility Act³⁵ in force, the heads of budgetary and extra-budgetary users of both state budget and local unit budget, head officers, mayors and county prefects, management board presidents of the companies owned by the Republic of Croatia, i.e. one or more local and regional self-governing units, head officers of other legal entities founded by the Republic of Croatia, i.e. one or more local units, undertake to submit the fiscal responsibility statement. It is the way of confirming that in their work they have ensured lawful, allocated and purposeful use of funds and an efficient and effective functioning of the financial management and control system. Among other things, the statement is given on the basis of the Fiscal Responsibility Questionnaire containing the questions in the field of planning, execution, accounting, reporting and public procurement. The questionnaire is used for the testing of minimal requirements, by process, for good financial management. All the answers are tested on a sample, as defined in the Questionnaire for each individual question. Questions that were significant from the expenditure control point of view are also included in the Questionnaire, and here are the most important ones:

- The procedure of creating contractual obligations has been clearly defined and is available to all organisational units/administrative departments;
- The funds have been spent in line with the budget, i.e. financial plan;

³⁴ Official Gazette, no. 156/2013

³⁵ Official Gazette, no. 19/2014

- Payment of funds was based on a credible documentation;
- Earmarked payment of donations, aids and subsidies, as well as their usage, has been monitored and controlled to the final user phase;
- During the equipment delivery/work execution, all the necessary checks have been carried out, and the like.

Competent ministries and local units are obliged to carry out formal and essential verifications of fiscal responsibility statement, and the Ministry of Finance checks the statements of competent ministries and local units. In 2015 and 2016, the Ministry of Finance will control fiscal responsibility statements more frequently, but it also require from the competent ministries to submit written reports on the performed controls of fiscal responsibility statements of the users within their competence, including state-owned companies owned , which have submitted fiscal responsibility statements for the first time in 2015. The provisions regarding misdemeanour offences have also been prescribed in connection with the verification of fiscal responsibility statements. A head officer will be imposed a fine in the amount of HRK 5,000.00 to 25,000.00 for the misdemeanour offences if the Ministry of Finance, competent ministries and local self-government units or other competent bodies during the verification of the fiscal responsibility statement content find that the documentation on the basis of which the fiscal responsibility statement is given is unreliable.

7.3. Fiscal statistics

The activities defined by the Strategy of reforms of the financial reporting system were carried out in 2014. The Strategy was adopted in 2013 with the aim of improving the quality of financial statements and the method of their collection, in line with the Conclusions and action points ensuing from the pre-accession dialogue visit of Eurostat in June 2013. Pursuant to the recommendations from the Action point 5 of the specified document, the Strategy determined the measures to improve the quality of financial statement data regarding:

- Improvements in reporting which will appropriately resolve the load of reporting units, statistical and consolidation targets;
- Adjustment of reporting deadlines to the requirements of the Fiscal Notification, and
- Improvement of the quality of data in financial statements.

Based on the planned measures, the new Ordinance on budgetary accounting and chart of accounts³⁶ was adopted in 2014. The new Ordinance applies to the accounting records as of 1 January 2015, provided that the economic classification based on the new Chart of Accounts was already used while preparing the budget for 2015 and projections for 2016 and 2017.

Key changes refer to the introduction of:

- 1) accrual principle also for expenditures for subsidies and capital grants;

³⁶ Official Gazette, no. 124/2014

The cost of subsidies is recorded when the documents issued by a competent body comes into effect (decision and the like) on the basis of which a subsidy is granted, provided that the subsidy amount is measurable and that it refers to the reporting period. Capital grants are recorded according to the accrual principle, i.e. when a competent body's decision on granting a capital grant is reached, provided that the capital grant amount is measurable and that it refers to a reporting period.

- 2) special principles of revenue recognition for funds from the EU and new revenue and expenditure accounts that follow the implementation of EU programs and projects;

Revenue and expenditure in the budgetary accounting are expressed with the application of a modified accrual principle. This principle, inter alia, means that the revenues are recognized in the reporting period in which they became available and provided that they are measurable, and that expenditures are recognized on the accrual principle and in the reporting period to which they refer to, regardless of the payment. However, the aforementioned principle in recognising revenue cannot be applied for the funds obtained from the EU. In line with the European statistics requirements, grants from the EU institutions and bodies and grants from the state budget based on EU funds transfer (current and capital) are recognised as the revenue of the reporting period in proportion to the implementation costs of the contracted programmes and project. Besides the specified principles of revenue recognition from the EU, novelties are connected with the introduction of new revenue and expenditure accounts that follow the implementation of EU programmes and projects.

- 3) transfer accounts for funds transferred from budgets to budgetary users in their jurisdiction;

This will provide the possibility for the statisticians to independently draft consolidated financial statements identical to the ones drafted by the local unit, using the financial statements of local units and their budgetary users. The former system has not provided a simple consolidation process at all levels. The drawback was not only connected with the consolidation methodology, but also with the inability in the financial statements of local units to separate the data on revenues and expenditures of those units from the revenues and expenditures achieved by their budgetary users.

- 4) new accounts in the Chart of Accounts on which the Croatian Institute for Health Insurance tracks its payables and related expenditures towards health care institutions that are budgetary users separately from the ones towards privately owned health institutions.

This is necessary for the expenditure consolidation between the Croatian Institute for Health Insurance and health institutions that are budgetary users of either state budget or local unit budget, in order to avoid duplication of expenditure.

Due to the changes in Chart of Accounts and the adjustment of financial statements content to the statistics requirements, but also due to the needs of shortening the deadlines for financial statement submission, a new Ordinance on Financial Reporting in Budgetary Accounting³⁷ was adopted in 2015. The Ordinance regulates the form and the content of financial statements, periods for which such statements are drafted, as well as the obligations and the deadlines for their submission.

The periods for which financial statements are drafted remain the same: monthly, from 1 January to 31 March, from 1 January to 30 June, from 1 January to 30 September and from 1 January to 31 December, i.e. budget year.

All budgetary users, either of state budget or of local unit budget, as well as extra-budgetary users of local units, had been drafting, for period from 1 January to 31 March and from 1 January to 30 September, abbreviated Report on revenue and expenditure of budgetary users (form: S-PR-RAS). Due to the need for additional data for statistical compilation, as of 1 January 2015 all those subjects have to draft Report on revenue and expenditure, receipts and outlays (form: PR-RAS), for all reporting periods as all local units and extra-budgetary users of the state budget have already been doing.

The Ordinance has changed considerably the provisions on the deadlines for submitting financial statements for a budget year. All the deadlines have been shortened from 15 days to one month, depending on persons under obligation. These provisions have already been applied to the submission of annual financial statements for 2014.

³⁷ Official Gazette, no. 3/2015

Table 7.1. Annual financial statements and submission deadlines

Person obligation	under Annual Financial Statements 2014	Annual Financial Statements 2015 and on	Old deadlines	New deadlines for the submission of ann.fin.stat.	Submission
budgetary users of the state budget	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (form: PR-RAS), - Report on changes in value and volume of assets and liabilities (P-VRIO form) - Explanatory notes 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (form: PR-RAS), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on expenditure on functional classification (RAS-funkcijski) - Explanatory notes 	by 15 February	by 31 January	<ul style="list-style-type: none"> - to section - to a competent regional office of the State Audit Office - to a regional office of the Financial Agency (FINA)
state budget sections consolidated reports	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and 	by 31 March	by 28 February	<ul style="list-style-type: none"> - to a regional office of the Financial Agency (FINA)

	<p>expenditure, receipts and outlays (form: PR-RAS),</p> <ul style="list-style-type: none"> - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on expenditure on functional classification (RAS-funkcijski) - Explanatory notes 	<p>expenditure, receipts and outlays (form: PR-RAS),</p> <ul style="list-style-type: none"> - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on expenditure on functional classification (RAS-funkcijski) - Explanatory notes 			
state budget	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (PR-RAS form), - Report on expenditure on functional classification (form: RAS-funkcijski), - Cash flow statement (form: NT), - Report on changes in value and volume of assets and liabilities (P-VRIO form) - Explanatory notes 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (PR-RAS form), - Report on expenditure on functional classification (form: RAS-funkcijski), - Report on changes in value and volume of assets and liabilities (P-VRIO form) - Explanatory notes 	by 15 March	28 February	<ul style="list-style-type: none"> - to a regional office of the Financial Agency (FINA) - to the State Audit Office

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Person obligation under	Annual Financial Statements 2014	Annual Financial Statements 2015 and on	Old deadlines	New deadlines for the submission of ann.fin.stat.	Submission
budgetary users of local and regional self-government units budget	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (form: PR-RAS), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form: OBVEZE) - Explanatory notes 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (form: PR-RAS), - Report on expenditure on functional classification (form: RAS-funkcijski), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form: OBVEZE) - Explanatory notes 	by 15 February	by 31 January	<ul style="list-style-type: none"> - to the local/regional self-government unit whose budget users they are - to a competent regional office of the State Audit Office - to a regional office of the Financial Agency (FINA)
local and regional self-government units	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and 	by 28 February	15 February	<ul style="list-style-type: none"> - to a competent regional office of the State Audit Office

	<p>expenditure, receipts and outlays (PR-RAS form),</p> <ul style="list-style-type: none"> - Report on expenditure on functional classification (form: RAS-funkcijski), - Cash flow statement (form: NT), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form: OBVEZE) - Explanatory notes 	<p>expenditure, receipts and outlays (PR-RAS form),</p> <ul style="list-style-type: none"> - Report on expenditure on functional classification (form: RAS-funkcijski), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form: OBVEZE) - Explanatory notes 			<ul style="list-style-type: none"> - to a regional office of the Financial Agency (FINA)
<p>local and regional self-government units</p> <p>consolidated reports</p>	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (form: PR-RAS), - Report on expenditure on functional classification (form: RAS-funkcijski), - Report on changes in value and volume of assets and liabilities (form: P-VRIO), 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (form: PR-RAS), - Report on expenditure on functional classification (form: RAS-funkcijski), - Report on changes in value and volume of assets and liabilities (form: P-VRIO), 	<p>by 31 March</p>	<p>by 28 February</p>	<ul style="list-style-type: none"> - to a regional office of the Financial Agency (FINA)

	<ul style="list-style-type: none"> - Report on liabilities (form: OBVEZE) - Explanatory notes 	<ul style="list-style-type: none"> - Report on liabilities (form: OBVEZE) - Explanatory notes 			
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Person obligation under	Annual Financial Statements 2014	Annual Financial Statements 2015 and on	Old deadlines	New deadlines for the submission of ann.fin.stat.	Submission
extra-budgetary users of the state budget	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (PR-RAS form), - Report on expenditure on functional classification (form: RAS-funkcijski), - Cash flow statement (form: NT), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form: OBVEZE) - Explanatory notes 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), - Report on revenue and expenditure, receipts and outlays (PR-RAS form), - Report on expenditure on functional classification (form: RAS-funkcijski), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form:OBVEZE) - Explanatory notes 	by 28 February	15 February	<ul style="list-style-type: none"> - to a competent regional office of the State Audit Office - to a regional office of the Financial Agency (FINA)
extra-budgetary users of local and regional	<ul style="list-style-type: none"> - Balance sheet (form: BIL), 	<ul style="list-style-type: none"> - Balance sheet (form: BIL), 	by 28	15 February	<ul style="list-style-type: none"> - to the competent

self-government units' budget	<ul style="list-style-type: none"> - Report on revenue and expenditure, receipts and outlays (PR-RAS form), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form: OBVEZE) - Explanatory notes 	<ul style="list-style-type: none"> - Report on revenue and expenditure, receipts and outlays (PR-RAS form), - Report on expenditure on functional classification (form: RAS-funkcijski), - Report on changes in value and volume of assets and liabilities (P-VRIO form), - Report on liabilities (form: OBVEZE) - Explanatory notes 	February		<p>local/regional self-government unit</p> <ul style="list-style-type: none"> - to a competent regional office of the State Audit Office - to a regional office of the Financial Agency (FINA)
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Source: Ministry of Finance

The new electronic forms of the financial statements contain logical and mathematical controls for data entry. The Financial Agency (FINA), which collects financial statements for the Ministry of Finance, receives only those financial statements for which all control requirements have been met.

The Ordinance also stipulates the obligation of publishing financial statements for all persons who are obliged to draft and submit them, on their internet pages or on the pages of a competent budget, i.e. section, and within 8 days of their submission to the Financial agency.

The application of new bylaws will be monitored in the following period. Furthermore, the prerequisites for the necessary improvements in the method of collecting and storing financial statements in the part of application set-up for the submission of financial statements that can be accessed via Internet by using a structured data format (XML). The financial reporting forms would be created in a prescribed electronic format, and during the uploading into the application, formal and logical data checks would be performed and incorrectly filled out financial reports rejected.

ANNEXES

Annex 1a. Macroeconomic prospects

	ESA Code	2014 (level)	2014 (rate of change)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)	2018 (rate of change)
1. Real GDP	B1*g	328,815	-0.4	0.4	1.0	1.2	1.5
2. Nominal GDP	B1*g	328,927	-0.4	0.5	1.8	2.3	2.9
Components of real GDP							
3. Private consumption expenditure ¹	P.3	198,828	-0.7	0.5	0.3	0.5	1.1
4. Government consumption expenditure	P.3	64,914	-1.9	-1.2	-1.4	-1.0	-0.6
5. Gross fixed capital formation	P.51	61,161	-4.0	-1.3	1.8	3.2	3.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	-0.7	-0.7	-0.7	-0.4	-0.2	-0.1
7. Exports of goods and services	P.6	150,646	6.3	3.7	4.6	4.8	4.8
8. Imports of goods and services	P.7	144,436	3.0	2.8	4.0	4.5	5.0
Contribution to real GDP growth							
9. Final domestic demand		324,904	-1.6	-0.2	0.3	0.7	1.2
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-2,299	-0.2	0.0	0.2	0.2	0.1
11. External balance of goods and services	B.11	6,210	1.4	0.5	0.4	0.3	0.1

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

¹ Includes final consumption expenditure of non-profit institutions serving households.

Source: CBS, MFin

Annex 1b. Price developments

	2014 (rate of change)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)	2018 (rate of change)
1. GDP deflator	0.0	0.2	0.8	1.1	1.4
2. Private consumption deflator¹	-0.4	0.1	1.1	1.3	1.4
3. HICP	n.a.	n.a.	n.a.	n.a.	n.a.
4. Public consumption deflator	0.4	0.1	0.2	0.5	1.2
5. Investment deflator	-0.1	-0.4	0.6	1.2	1.4
6. Export price deflator (goods and services)	-0.1	-0.2	1.4	1.6	1.7
7. Import price deflator (goods and services)	-0.6	-0.6	1.7	1.7	1.7

¹ Includes final consumption expenditure of non-profit institutions serving households.

Source: CBS, MFin

Annex 1c. Labour market developments

	ESA Code	2014 (level)	2014 (rate of change)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)	2018 (rate of change)
1. Employment, persons¹		1,405,294	-0.7	-0.2	0.1	0.8	1.3
2. Employment, hours worked ²		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)³		17.3	17.3	17.1	16.8	15.9	14.3
4. Labour productivity, persons⁴		224,643	0.3	0.5	0.8	0.4	0.2
5. Labour productivity, hours worked ⁵		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees⁶	D.1	159,597,015	0.3	0.6	0.9	2.3	3.2
7. Compensation per employee		129,202.2	1.1	0.7	0.8	1.4	1.7

¹ Occupied population, domestic concept national accounts definition. The number for 2014 is a projection; the number for 2013, according to Eurostat, is 1,415,200.

² National accounts definition.

³ According to ILO methodology.

⁴ Real GDP in constant previous year prices (2010 = 100), per person employed.

⁵ Real GDP by hour worked.

⁶ Data for 2014 level is in HRK 000.

Source: CBS, Eurostat, MFin

Annex 1d. Sectoral balances

	ESA Code	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	0.8	1.9	2.7	2.9	3.0
<i>of which:</i>						
- Balance on goods and services		2.1	2.7	3.0	3.2	3.2
- Balance of primary incomes and transfers		-1.4	-1.3	-1.3	-1.4	-1.4
- Capital account		0.2	0.6	1.0	1.1	1.2
2. Net lending/borrowing of the private sector	B.9	5.2	5.3	4.9	3.8	3.7
3. Net lending/borrowing of general government	EDP B.9	-5.7	-5.0	-3.9	-2.7	-2.4
4. Statistical discrepancy		1.4	1.7	1.8	1.8	1.8

Source: CNB, MFin

Annex 2a. General government budgetary prospects

	ESA Code	2014 (level, HRK billion)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-18.8	-5.7	-5.0	-3.9	-2.7	-2.4
2. Central government	S.1311	-20.0	-6.1	-5.0	-3.9	-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	0.3	0.1	-0.1	0.0	0.0	0.0
5. Social security funds	S.1314	0.8	0.3	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	139.1	42.3	42.9	43.3	43.7	43.5
7. Total expenditure	TE ¹	157.9	48.0	47.9	47.3	46.4	45.9
8. Net lending/borrowing	EDP B.9	-18.8	-5.7	-5.0	-3.9	-2.7	-2.4
9. Interest expenditure	EDP D.41	11.5	3.5	3.6	3.8	3.9	3.9
10. Primary balance ²		-7.4	-2.2	-1.4	-0.2	1.1	1.4
11. One-off and other temporary measures ³		0.3	0.1	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		80.8	24.6	24.4	24.7	24.7	24.8
12a. Taxes on production and imports	D.2	61.4	18.7	18.9	19.1	19.2	19.2
12b. Current taxes on income, wealth, etc	D.5	19.3	5.9	5.5	5.6	5.6	5.6
12c. Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	38.7	11.8	11.8	11.8	11.8	11.8
14. Property income	D.4	3.7	1.1	1.3	1.2	1.2	1.2
15. Other ⁴		16.0	4.9	5.3	5.6	6.0	5.8
16=6. Total revenue	TR	139.1	42.3	42.9	43.3	43.7	43.5
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) ⁵		119.4	36.3	36.2	36.4	36.5	36.5
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	64.9	19.7	19.4	18.9	18.4	18.0
17a. Compensation of employees	D.1	38.4	11.7	11.5	11.3	11.0	10.8
17b. Intermediate consumption	P.2	26.4	8.0	7.9	7.6	7.4	7.2
18. Social payments (18=18a+18b)		54.4	16.5	16.5	16.3	16.1	16.1
of which Unemployment benefits ⁶		1.5	0.5	0.5	0.4	0.4	0.4
18a. Social transfers in kind supplied via market producers	D632	7.2	2.2	2.1	2.1	2.1	2.0
18b. Social transfers other than in kind	D.62	47.2	14.3	14.3	14.2	14.1	14.1
19=9. Interest expenditure	EDP D.41	11.5	3.5	3.6	3.8	3.9	3.9
20. Subsidies	D.3	6.7	2.0	2.0	1.8	1.7	1.7
21. Gross fixed capital formation	P.51	11.9	3.6	3.8	4.0	4.0	4.0
22. Capital transfers	D.9	4.2	1.3	1.2	1.0	1.0	1.0
23. Other ⁷		4.3	1.3	1.4	1.4	1.3	1.3
24=7. Total expenditure	TE ¹	157.9	48.0	47.9	47.3	46.4	45.9
p.m.: Government consumption (nominal)	P.3	64.6	19.7	19.3	18.8	18.3	17.9

Source: CBS, MFin

*Annex 2b. No-policy change projections**

	2014 (level, HRK billion)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)
1. Total revenue at unchanged policies	139.1	42.3	42.5	42.7	43.0	42.8
2. Total expenditure at unchanged policies	157.9	48.0				

* Note: The cut-off date is February 2015.

Source: CBS, MFin

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

	2014 (level, HRK billion)	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)
1. Expenditure on EU programmes fully matched by EU funds revenue	1.2	0.4	0.9	1.2	1.7	1.7
2. Cyclical unemployment benefit expenditure¹	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Effect of discretionary revenue measures²		0.1	n.a.	n.a.	n.a.	n.a.
4. Revenue increases mandated by law	4.1	1.2	0.8	0.3	n.a.	n.a.

Source: CBS, MFin

Annex 4. General government debt developments

	ESA Code	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)
1. Gross debt¹		85.0	89.8	92.0	92.5	92.4
2. Change in gross debt ratio		4.4	4.8	2.2	0.5	-0.1
Contributions to changes in gross debt						
3. Primary balance²		2.2	1.4	0.2	-1.1	-1.4
4. Interest expenditure³	EDP D.41	3.5	3.6	3.8	3.9	3.9
5. Stock-flow adjustment*		-1.3	-0.3	-1.7	-2.3	-2.5
<i>of which:</i>						
- Differences between cash and accruals ⁴						
- Net accumulation of financial assets ⁵		0.3	0.6	0.6	0.6	0.3
<i>of which:</i>						
- privatisation proceeds		0.3	0.6	0.6	0.6	0.3
- Valuation effects and other ^{6*}						
p.m.: Implicit interest rate on debt⁷		4.3	4.3	4.3	4.3	4.3
Other relevant variables						
6. Liquid financial assets ⁸						
7. Net financial debt (7=1-6)		85.0	89.8	92.0	92.5	92.4
8. Debt amortization (existing bonds) since the end of the previous year						
9. Percentage of debt denominated in foreign currency						
10. Average maturity				-	-	-

Source: CNB, CBS, MFin

Annex 5. Cyclical developments

	ESA Code	2014 (% of GDP)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)
1. Real GDP Growth (%)		-0.4	0.4	1.0	1.2	1.5
2. Net Lending of general government	EDP B.9	-5.7	-5.0	-3.9	-2.7	-2.4
3. Interest expenditure	EDP D.41	3.5	3.6	3.8	3.9	3.9
4. One-off and other temporary measures¹		0.1	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		0.0	0.0	0.1	0.3	0.6
contributions:						
- labour		-0.2	-0.3	-0.4	-0.4	-0.3
- capital		0.4	0.3	0.3	0.4	0.5
- total factor productivity		-0.2	0.0	0.2	0.3	0.4
6. Output gap		-3.2	-2.8	-1.9	-1.1	-0.2
7. Cyclical budgetary component		-1.5	-1.3	-0.9	-0.5	-0.1
8. Cyclically-adjusted balance (2 - 7)		-4.2	-3.7	-3.0	-2.2	-2.3
9. Cyclically-adjusted primary balance (8 + 3)		-0.7	-0.1	0.8	1.6	1.5
10. Structural balance (8 - 4)		-4.3	-3.7	-3.0	-2.2	-2.3

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

Source: CBS, MFin

Annex 6. Divergence from previous update

	ESA Code	2014	2015	2016	2017	2018
Real GDP growth (%)						
Previous update		0.0	1.2	1.3	1.5	n.a.
Current update		-0.4	0.4	1.0	1.2	1.5
Difference		-0.4	-0.8	-0.3	-0.3	n.a.
General government net lending (% of GDP)						
Previous update	B.9	-4.4	-3.5	-2.7	-2.5	n.a.
Current update		-5.7	-5.0	-3.9	-2.7	-2.4
Difference		-1.4	-1.5	-1.2	-0.3	n.a.
General government gross debt (% of GDP)						
Previous update		71.7	71.0	71.2	71.2	n.a.
Current update		85.0	89.8	92.0	92.5	92.4
Difference		13.3	18.8	20.8	21.2	n.a.

Source: CBS, MFin

Annex 7. Long-term sustainability of public finances

	2013 (% of GDP)	2020 (% of GDP)	2030 (% of GDP)	2040 (% of GDP)	2050 (% of GDP)	2060 (% of GDP)
Total expenditure						
Of which: age-related expenditures						
Pension expenditure	10.9	10.3	9.6	7.9	7.2	7.0
Social security pension	1.7	1.9	2.2	2.0	1.9	1.9
Old-age and early pensions	5.1	5.8	5.6	4.3	3.8	3.7
Other pensions (disability, survivors)	4.1	2.6	1.8	1.6	1.5	1.4
Occupational pensions (if in general government)						
Health care	5.7	7.3	8.2	8.1	7.7	7.7
Long-term care (<i>this was earlier included in the health care</i>)	0.4	0.4	0.5	0.5	0.5	0.5
Education expenditure	3.7	3.5	3.4	3.2	3.3	3.4
Other age-related expenditures						
Interest expenditure						
Total revenue						
Of which: property income						
Of which: from pensions contributions (or social contributions if appropriate)	5.9	5.9	5.6	5.6	5.6	5.6
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
Systemic pension reforms¹						
Social contributions diverted to mandatory private scheme ²	1.6	1.6	1.9	1.9	1.9	1.9
Pension expenditure paid by mandatory private scheme ³	0.0	0.0	0.3	0.8	1.3	1.6
Assumptions						
Labour productivity growth	0.5	1.4	1.8	2.2	2.0	1.5
Real GDP growth	-1.0	1.5	1.5	1.8	1.4	1.0
Participation rate males (aged 20-64)	73.6	72.9	72.4	72.7	73.0	73.2
Participation rates females (aged 20-64)	63.4	65.0	66.5	67.3	67.1	67.3
Total participation rates (aged 20-64)	68.5	68.9	69.4	70.0	70.1	70.3
Unemployment rate	16.9	12.9	9.8	7.1	7.1	7.1
Population aged 65+ over total population	18.3	20.7	24.2	26.3	28.4	29.6

Source: Ministry of Labour and Pension System, Croatian Institute for Health Insurance, AWG

Annex 7a. Contingent liabilities

	2014 (% of GDP)	2015 (% of GDP)
Public guarantees	2.7	n.a.
Of which: linked to the financial sector	n.a.	n.a.

Source: CBS, MFin

Annex 8. Basic assumptions

	2014	2015	2016	2017	2018
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)	1.3	1.1	1.1	1.1	1.1
Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-vis the € (annual average)	7.63	7.66	7.66	7.66	7.66
World excluding EU, GDP growth	3.7	4.0	4.4	n.a.	n.a.
EU GDP growth	1.3	1.7	2.1	n.a.	n.a.
Growth of relevant foreign markets	3.8	3.9	5.4	5.5	5.5
World import volumes	2.6	4.3	5.3	n.a.	n.a.
Oil prices (USD/barrel)¹	96.2	58.1	65.7	69.7	71.8

¹ Average of U.K. Brent, Dubai and West Texas Intermediate, equally weighted.

Source: EC, IMF, MFin