

CHAPTER 2

CROATIA: EU-DRIVEN REFORMS AS A WIND OF CHANGE IN THE PUBLIC FINANCE LEGAL FRAMEWORK



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Abstract

The legal framework of public finance in Croatia has been under the significant influence of fiscal integration within the European Union (EU). A prerequisite for analysing the impact of EU law on national fiscal governance is a prior understanding of the national fiscal framework; thus, the introductory section of this chapter presents an overview of the legal sources relevant to public finance. Special emphasis is placed on the constitutional and statutory provisions related to the budgetary process, highlighting the Croatian Parliament's authority in adopting the central budget. In the following section, the chapter offers an overview of the constitutional foundations of fiscal federalism in Croatia. As the fiscal architecture at the subnational level is based on the two-tiered system of local self-government and regional units, this section presents the most important aspects of subnational fiscal sovereignty, remarking on the influence of EU law on fiscal decentralisation in Croatia. Thereafter, the next section explores the regulation of public debt and the tools for effective fiscal policy. Finally, this chapter investigates the interplay between EU crisis management and its implications for Croatian fiscal governance.

Keywords: *public finance law, budget law, fiscal policy, EU law*

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1. Overview of legal sources

1.1. The Constitutional provisions

The starting point for an analysis of the legal sources underpinning the public finance system in Croatia is the Constitution of the Republic of Croatia (hereinafter: ‘the Constitution’).¹ It should first be pointed out that the Constitution does not contain a specific chapter regarding public finance; instead, the provisions related to fiscal politics are scattered among its various chapters.

Regarding the budgetary system, the Constitution stipulates the division of competences in the budgetary process. Pursuant to Art. 81, the Croatian Parliament (*Hrvatski sabor*) adopts the central budget. The authority of the Croatian Parliament is reiterated in Art. 91, affirming the Constitution’s endorsement of the ‘supremacy of the parliament in budgetary matters as a widely accepted principle in all democratic countries’.² The Constitution also requires that the budget be enacted by a qualified majority vote. Statutes (*zakoni*), in contrast, are adopted with a simple majority, which highlights the paramount importance of the central budget to the state. When it comes to the government, the Constitution states that ‘governmental revenues and expenses shall be established in the central budget. Any law whose implementation requires financial resources shall provide for the sources thereof’.³

According to Art. 104 of the Constitution, if the budget is not approved in time the President may, at the government’s proposal and with the Prime Minister’s countersignature, dissolve the Croatian Parliament.⁴ If the budget for the following year is not adopted by 31 December, the Parliament shall adopt a decision on temporary financing (*Odluka o privremenom financiranju*). Further regulation of this exceptional budgetary regime⁵ is stipulated in the Budget Act;⁶ namely, that the temporary financing can last no more than 3 months. This temporary financing is allocated in proportion to the income generated in the previous year and is limited to a maximum of 25% of the total income from the previous year. During this period, the budgetary beneficiaries may not increase the number of employees beyond the number on 31 December of the previous year. All revenues and expenses realised during temporary financing are included in the subsequently adopted budget.

1 The Constitution of the Republic of Croatia, Official Gazette (‘Narodne novine’) No. 56/1990, 135/1997, 113/2000, 28/2001, 76/2010, 5/2014.

2 OECD, Journal on Budgeting, 2004, p. 19.

3 Art. 91 of the Constitution.

4 Art. 104 of the Constitution.

5 Art. 104 of the Constitution was activated only once, in 2015, as the State Budget was not adopted before 31 December, the Croatian Parliament was dissolved. The Decision on Temporary Financing was published in the Official Gazette No. 109/2015.

6 The Budget Act, Official Gazette No. 144/2021.

It might be surprising that only one constitutional provision explicitly refers to tax policy. In this respect, Art. 51 enshrines the fundamental principles underpinning the Croatian tax policy and stipulates that ‘everyone shall participate in the defrayment of public expenses, in accordance with their economic capability’.⁷ It is apparent that this provision lays down the ‘ability to pay’ principle,⁸ but it should be emphasised that it also defines the tax obligation as universal. The latter stems from the wording of the article, which begins with the term ‘everyone’ (*svatko*). Put differently, there are no specific groups who are exempted from tax liability in advance based on, for example, race, religion, gender, or political belief.⁹ Furthermore, Art. 51 explicitly stipulates that the tax system ‘shall be based upon the principles of equality and equity’.¹⁰

1.2. Constitutional foundations of fiscal federalism in Croatia

Though there are few constitutional provisions governing taxation or the budget system, the opposite situation is observed in the regulation of local and regional self-government: an entire chapter of the Constitution is dedicated to the regulation of subnational levels of government. Pursuant to Art. 4 of the Constitution, the government is limited by the right to local and regional self-government. Croatia has a two-tiered system of subnational government: the units of local self-government are towns and municipalities, whereas counties are the regional units. The capital, Zagreb, has a two-fold legal status as it is considered both a county and a city at the same time. The local government system is a result of the decentralisation process in Croatia, which was influenced by the European Charter on Local Self-Government.¹¹

Several constitutional provisions regarding the units of local and regional self-government have direct effects on their financial management. By delineating the general scope of public services under the authority of local units, Art. 129a determines their basic spending powers.¹² The competences of local units include urban planning, primary healthcare, elementary education, fire prevention, and civil protection. Meanwhile, the competences of counties, as regional units, include education, health, urban planning, economic development, traffic infrastructure, and the planning and development of networks of educational, health, social, and cultural institutions. From the perspective of fiscal federalism,¹³ the most important

7 Art. 51 of the Constitution.

8 See: Gadžo, 2015, p. 135. For an in-depth analysis of the ‘ability to pay’ principle in the EU, see: Vanistendael, 2014.

9 Jelčić et al., 2008, pp. 190–191.

10 Art. 51 of the Constitution.

11 See: Blažević, Dobrić Jambrović and Menger, 2020, pp. 108–114.

12 Dobrić, Gadžo and Bodul, 2016, p. 312.

13 Fiscal federalism has a two-fold meaning: it addresses both the division of fiscal competencies between the different levels of government and the degree of freedom of decision-making enjoyed by regional and local authorities in the assessment of local taxes.

constitutional provision is Art. 138, which stipulates that the units of local and regional self-government shall be entitled to their own revenues and to dispose of them freely in the performance of the tasks under their purview. In addition, the article defines that their revenues should be proportionate to their powers as envisaged by the Constitution. As such, this article prescribes the basic principles with regard to the distribution of the revenue-raising powers of local units, namely: (i) the right of local units to their own resources, (ii) the principle of proportionality of income and expenditure, and (iii) the principle of solidarity, that is, the duty of the state to help financially vulnerable units. The Constitution, thus, lays the foundations of fiscal federalism in Croatia, following the principles of the Charter on Local Self-Government.¹⁴

The question of fiscal sovereignty is further addressed in the Act on the Financing of Local and Regional Self-Government Units, which prescribes that subnational units can raise revenue from local taxes, grants from the government, and, in the case of towns and municipalities, locally raised administrative charges.¹⁵ According to the Act on Local Taxes,¹⁶ local units of self-government can decide whether they will introduce one of the following taxes: surtax on income tax, consumption tax, tax on holiday homes, and tax on the use of public land. On the other hand, regional units can introduce inheritance and gifts tax, motor vehicles tax, vessels tax, and a tax on coin-operated machines for games for amusement. The crucial issue regarding fiscal sovereignty at the subnational level of government is that 'local taxes are introduced and regulated on the state level, while some elements (e.g., tax rates) are left to the local units to prescribe, within the boundaries set out by the state-level act'.¹⁷ Although the process of decentralisation began in 2001, the discrepancy between the functions conveyed to the local units and sources for their financing is still significant. To be more precise, Croatia has 428 towns and 127 counties, which equals 555 units of local self-government. There is a significant difference in the sizes of the populations among these local units, which affects their ability to collect revenue and, subsequently, their financial capacity. Data on decentralisation in Croatia show that the majority of local units did not take over the decentralised functions: more than half of the units that responded to a survey conducted in 2018 had not taken over decentralised functions at all. Furthermore, only 1% of the surveyed units had taken over decentralised functions in healthcare, 5% in social care, and 8% in education.¹⁸ All of the above supports the conclusion that without funding from the state budget, subnational units are incapable of fulfilling the public functions for which they were established, implying that Croatia remains a centralised state.¹⁹

14 Dobrić, Gadžo and Bodul, 2016, p. 312.

15 Act on the Financing of Local and Regional Self-Government Units, Official Gazette No. 127/17, 138/20, 151/22, 114/23.

16 Act on Local Taxes, Official Gazette No. 115/16, 101/17, 114/22.

17 Rogić, Lugarić and Klemenčić, 2022, p. 49.

18 See: Đulabić, 2018.

19 Dobrić, Gadžo and Bodul, 2016, pp. 290–340.

Finally, the influence of European Union (EU) law, namely, the integral parts of the Treaty of Lisbon, including the Protocol on the Application of the Principles of Subsidiarity and Proportionality and the Charter of Fundamental Rights, on domestic legislation and the process of fiscal decentralisation should be addressed. The institutionalisation of the principle of subsidiarity at the EU level subsequently narrowed the scope of state supervision over the local and regional units in Croatia, although it is still noticeable.²⁰

1.3. Domestic legislation

In general, ‘the legal framework that underlies the public finance system includes tax laws, budget system laws and local government finance laws’.²¹ This structure also applies to domestic legislation in Croatia. On the one hand, the substantive tax law is governed by a manifold of statutes that are enacted by the Parliament.²² On the other hand, the procedural tax law is, for the most part, regulated in the General Tax Act.²³ As Chapter 3 offers an in-depth analysis of the Croatian tax system and its evolution under the influence of EU law, this chapter focuses on the statutes governing the budgetary process. The statute of paramount importance is the Budget Act, which stipulates the steps in every phase of the budgetary process. However, several other statutes complement the legal basis of the budgetary process, such as the Act on Executing the Budget, the Fiscal Responsibility Act, the State Audit Act, and the Act on the Financing of Local and Regional Self-Government. The role and content of these statutes are examined throughout this chapter.

The adoption of the state budget is considered one of the most important financial and political events of the year.²⁴ The legal nature of the state budget in Croatia is rather peculiar. From the perspective of its enactment, the budget is similar to a statute (*zakon*). As mentioned above, the state budget is adopted by a qualified majority vote in the Parliament. However, the budget itself is not a statute; rather, it is defined as an Act that estimates revenues and determines expenditures and does not consist of legally binding provisions. Consequently, to ensure the fiscal discipline of the public authorities included in the budgetary process, the management of the budget is intertwined with the Budget Act as a systematic statute governing the budgetary system in Croatia. The structure of the Budget Act clearly follows the stages of the budget cycle: preparation, approval, execution, reporting, and finally, the audit. However, the Budget Act also regulates the management of assets and liabilities, the management of the public debt, and borrowing by the state and the units

²⁰ Ibid.

²¹ Lienert, 2013, p. 63.

²² Rogić, Lugarić and Klemenčić, 2022, p. 44.

²³ General Tax Act, Official Gazette No. 115/16, 106/18, 121/19, 32/20, 42/20, 114/22.

²⁴ As stated by the Ministry of Finance of the Republic of Croatia. See: *Proračun* [Online]. Available at: <https://mfin.gov.hr/proracun-86/86> (Accessed: 1 June 2023).

of local and regional self-government.²⁵ Put differently, this Act lays down the public sector's obligations regarding the management of state finances.

The Budget Act prescribes the guiding principles that public authorities included in the budget cycle are obliged to respect. Accordingly, the budgetary process follows the principles of unity and accuracy, annuality, multi-year planning, balance, universality, specificity, sound financial management, and transparency. The Budget Act also defines which entities are included in the budgetary process. Against this backdrop, it should be noted that the Croatian Budget Act differentiates budgetary beneficiaries and extra-budgetary beneficiaries as two similar yet different categories of entities connected to the budget. Budgetary beneficiaries are institutions whose sole founder is the Republic of Croatia or units of local and regional self-government, whose expenses are insured in the budget, and which generate more than 50% of their total revenues from the state budget.²⁶ For example, some of the budgetary beneficiaries of the state budget include public universities, museums, and national theatres. Meanwhile, extra-budgetary beneficiaries are defined as institutions, companies, and other legal entities that are not budget beneficiaries and that individually or cumulatively meet the following conditions: i) their sole founder or owner is the Republic of Croatia or a unit of local and regional self-government, provided that they also have a decisive influence on management and that they are included in the general budget; and ii) they are classified into the general government sector, according to the rules of the statistical methodology of the EU (European System of National Accounts (ESA) 2010, prescribed by Regulation (EU) 549/2013 of the European Parliament and of the Council). The extra-budgetary beneficiaries may be included in the state budget, but they usually 'function as a special fund budget funded by specific mostly earmarked revenues'.²⁷ In addition, they might be subject to different accounting rules than budget beneficiaries.

The budget cycle in Croatia lasts for 3 years. The initial stage is the preparation of the budget, in which the Ministry of Finance has a dominant role. To be more precise, after an independent body agrees upon the macroeconomic and budgetary projections, the Ministry of Finance proceeds to deliver the Convergence Programme. The Convergence Programme determines the macroeconomic and fiscal framework in the current budget year and the next 3 years.²⁸ Following the government's approval, the Convergence Programme is sent to the European Commission, in accordance with the European Semester framework. Ultimately, this programme serves as a legal basis for decisions on the budget framework for the next 3-year period. The Ministry of Finance governs the subsequent steps of the budgetary cycle and, finally, drafts the budget for the following year. If the government approves the draft budget, it will be submitted to the Croatian Parliament for possible amendments and approval.

25 Art. 1 Budget Act.

26 Art. 4 para. (45) Budget Act.

27 Rogić Lugarić and Klemenčić, 2022, p. 39.

28 Art. 22 Budget Act.

Another piece of the puzzle of budgetary law in Croatia is the Act on Executing the Budget,²⁹ which is adopted annually together with the budget.³⁰ While the Budget Act consists of provisions that address the budget cycle in general, the Act on Executing the Budget stipulates specific provisions regarding the budget each year, for example, the scope of general budget borrowing and central budget guarantees, the management of financial and non-financial assets and debt in the general budget, the use of earmarked revenues, and fines for the non-fulfilment of obligations and other issues in the execution of the state budget for the given year.

In the concluding phase of the budgetary cycle, the State Audit Office plays a crucial role. Pursuant to Art. 54 of the Constitution, the State Audit Office is an independent and autonomous supreme audit institution in the Republic of Croatia. It was founded in 1993, and its jurisdiction is regulated by the State Audit Office Act. ‘The office performs audits of government income and expenditures, financial statements and financial transactions of government sector units and local units, legal entities financed from the budget, legal entities founded by the Republic of Croatia or local units, companies and other legal entities, in which the Republic of Croatia i.e., local units have majority share ownership’.³¹ It is also authorised to audit the management of funds received from the EU.

1.4. Impact of EU legislation

The influence of the EU’s policies on national legislation commenced years before Croatia became a Member State: the Stabilisation and Association Agreement came into force in 2001 and can be seen as the first stepping stone on the road toward harmonisation with EU law. The next step toward closer economic coordination with the EU was made in 2005 when Croatia started creating Pre-Accession Economic Programmes. This process significantly improved the institutional and analytical capacities of the Croatian state administration to manage sound economic policy.³² The following year, the Act on the System of Interior Financial Control in the Public Sector came into force,³³ aiming to accomplish uniform conduct in the public sector in terms of the management of public finances. Another important step for sustainable public finance management was the adoption of the Fiscal Responsibility Act in 2010. This legislative Act aimed to increase the transparency and sustainability of public finance in Croatia. In addition, the Fiscal Responsibility Act was soon amended to reflect the criteria stipulated in the ‘Six Pack’ and ‘Two Pack’, that is, the set of EU regulations and directives that enhanced the Stability and Growth Pact (SGP). In this

29 The Act on Executing the Budget in 2023, Official Gazette No. 145/22, 63/23.

30 See: Rogić, Lugačić and Klemenčić, 2022.

31 *State Audit Office – Organisation* [Online]. Available at: <https://www.revizija.hr/root/en/pages/about-us/organisation/684> (Accessed: 1 June 2023).

32 Tišma, Samardžija and Jurin, 2012, p. 111.

33 The Act on the System of Interior Financial Control in the Public Sector, Official Gazette No. 141/2006.

regard, one of the most important reforms was the new fiscal rule, which allowed the conduct of countercyclical fiscal policy. This fiscal rule, which came to the fore in 2013, was also, expectedly, in alignment with EU law on economic governance. Thus, as negotiations with the EU gained momentum, the impact of EU law on national legislation was amplified.

1.4.1. The excessive budget deficit procedure

During the years that preceded the accession to the EU, the Croatian budget was severely affected by the financial crisis. Due to the decline in economic activity, state budget revenues decreased, while public expenditures remained at the same level or even increased. The growth of the budget deficit subsequently led to the rapid growth of the public debt, which rose to 85% of GDP by the end of 2014.³⁴ In this respect, several months after Croatia acceded to the EU in June 2013, the excessive budget deficit procedure was launched against the country. The European Council adopted the decision on the existence of an excessive deficit in Croatia on 28 January 2014.³⁵ The Council also issued recommendations to end the situation of an excessive government deficit, stating that Croatia should put an end to this issue by 2016. To do so, the Council recommended that Croatia lower the rate of its government deficit each year; specifically, the Council envisaged that Croatia should reach a headline general government deficit target of 4.6% of GDP for 2014, 3.5% of GDP in 2015 and 2.7% of GDP in 2016. Furthermore, the Council recommended the implementation and specification of the measures necessary to achieve these goals, as well as the use of windfall gains to reduce the deficit.³⁶ Croatian authorities were encouraged to review their expenditures, with a special focus on growth-enhancing expenditures, and to work on improving tax administration efficiency. All of the above matters affected the fiscal management in Croatia.

The trajectory of the steps taken by Croatian authorities to meet the Council's recommendations can be traced through the positions issued by the Fiscal Policy Commission. This Commission was established in 2013 by the Croatian Parliament 'as a professional and independent body aimed to improve the public finance system and to monitor the application of the fiscal rules established by the Fiscal Responsibility Act'.³⁷ The founding year of this Commission is indicative as it aligns with Croatia's entry into the EU, and its establishment is one of many novelties in Croatia's national fiscal policy that were caused by the accession to the EU. To be more precise, the Commission was established following the provisions of Council Directive 2011/85/

34 Šimović and Matanović, 2015, p. 31.

35 Council decision of 28 January 2014 on the existence of an excessive deficit in Croatia (2014/56/EU), OJ L 36, 6.2.2014, 13–14.

36 Council Recommendation with a view to bringing an end to the situation of an excessive deficit in Croatia 17904/13, 21 January 2014.

37 The Croatian Parliament, Decision on the establishment of the fiscal policy commission, 18 December 2013.

EU³⁸ to strengthen the role of the body authorised to supervise the implementation of the Fiscal Responsibility Act. It was necessary to establish an independent body, separate from the Ministry of Finance; thus, the Fiscal Commission replaced its predecessor, the Committee for Fiscal Policy, and took over its duties.³⁹ In this regard, the Position of the Fiscal Policy Commission from 2015 represents a valuable source of information on Croatia's national fiscal policy, especially in terms of how the European Council's recommendations to address the excessive budget deficit procedure were followed.

In the first year of the excessive deficit procedure, Croatia increased its government budget deficit; by the end of 2014, it was 5.7% of GDP. The Croatian government implemented structural measures to the extent that was agreed with the Commission; thus, it was concluded that Croatia had taken effective actions to reduce the excessive deficit. However, the implementation of these structural measures was largely focused on the revenue side of the budget, primarily: (i) an increase in the rate of contributions for health insurance, (ii) changes in the system of contributions for pension insurance based on seniority, (iii) an increase in the tax on winnings from games of chance, (iv) the introduction of fees for telecommunications services, and (v) an increase in excise duty on energy products. Conversely, no strong structural measures were implemented on the expenditure side, except for certain reductions in subsidies, intermediate consumption, social benefits, and investment expenditure. Measures aimed at increasing the efficiency of public administration and reducing structural expenditures were also absent. In addition, the Fiscal Policy Commission emphasised that the methodology of adopting structural measures did not come from a designed strategy in the medium-term budget period; instead, all of the measures were discretionary and *ad hoc*.⁴⁰ In this respect, the importance of the EU economic governance for the conduct of fiscal policy in Croatia is best illustrated by the fact that the first Convergence Programme for the period 2014–2017 points out that 'the excessive budget deficit procedure completely determines the framework of the fiscal policy in the medium term'.⁴¹ According to the Position of the Fiscal Policy Commission issued in 2015, the level of general government debt decreased from 5.4% of GDP in 2014 to 3.3% of GDP in 2015. This was made possible by an increase in revenues from indirect taxes on the one hand, and a significant reduction in expenditures for public investments on the other. In this way, Croatia reached the goal set by the Council's recommendations for 2015.⁴² The following

38 Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L 306, 23.11.2011, 41–47.

39 *Povjerenstvo za fiskalnu politiku* [Online]. Available at: <https://mfin.gov.hr/proracun-86/povjerenstvo-za-fiskalnu-politiku/613> (Accessed: 10 May 2023).

40 5th Position paper of the Fiscal Policy Commission on the application of the fiscal rule for the year 2014, 9 July 2015.

41 Deskar-Škrbić, 2018, p. 12.

42 9th Position paper of the Fiscal Policy Commission on the application of the fiscal rule for the year 2015, 11 November 2016.

year, the target for the 2016 government deficit was also fully met, with the deficit amounting to 0.8% of GDP. Finally, at the Council for Economic and Financial Affairs meeting held on 16 June 2017, Croatia's exit from the excessive budget deficit procedure was confirmed.⁴³

1.4.2. *The European Semester*

After its accession to the EU, Croatia also became part of the European Semester, another essential part of the EU economic governance framework. The two integral elements underpinning the European Semester are the SGP and the Macroeconomic Imbalance Procedure (MIP).⁴⁴ Regarding the latter, Croatia faced macroeconomic imbalances following the financial crisis. These were potentially harmful as such macroeconomic imbalances – ‘if uncorrected over time – make the national savings-investment balance so untenable that it self-corrects abruptly, thereby causing significant adjustment shocks’.⁴⁵ If macroeconomic imbalances are prolonged, they can lead to the accumulation of public debt. To avoid these negative repercussions, Croatia was subject to the MIP⁴⁶ from 2014 until 2018. Specific monitoring reports after the initial year of the MIP indicated slight progress in the implementation of the Commission's recommendations. However, in terms of the measures for long-term fiscal sustainability, ‘very limited steps towards increasing the alignment of budgetary projections to ESA standards [had] been taken to tackle the issue of reconciling the differences between ESA definitions and national budgetary definitions’.⁴⁷ In 2014, the government also undertook the preparation of the expenditure review but did not decide on a deadline for its implementation. The next year, the government introduced the following measures related to public finance management: (i) the adoption of a new standard form for the fiscal impact assessment of the legislation, (ii) an increased budget for the State Audit Office, and (iii) the drafting of the new Fiscal Responsibility Act. In addition to the fiscal measures, the government also implemented various new measures in areas such as labour law, public administration, and the business environment.⁴⁸ However, excessive imbalances were still

43 *Potvrđena odluka o izlasku Republike Hrvatske iz Procedure prekomjernog proračunskog manjka*, 2017.

44 At the EU level, a macroeconomic imbalance is defined in Art. 2 of Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the Prevention and Correction of Macroeconomic Imbalances, OJ L 306, 23.11.2011, 25–32, as follows: ‘[A]ny trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole’. Macroeconomic imbalances are also defined as ‘severe imbalances, including imbalances that jeopardise or risk jeopardising the proper functioning of the Economic and Monetary Union’.

45 Pierluigi and Sondermann, 2018, p. 6.

46 The MIP was introduced in 2011 as an integral part of the European Semester.

47 European Commission, 2014.

48 European Commission, 2015.

present in Croatian public finance during 2015.⁴⁹ There was some small progress regarding economic activity in 2016, although the country still needed to tackle the high public, corporate, and external debt, as well as high unemployment rates.⁵⁰ Nevertheless, the ratio of general government debt to GDP and the unemployment rate both declined, indicating progress that was heavily influenced by the Commission's recommendations. As a result, in 2017, Croatia 'came out of its six-year long recession and economic activity has been accelerating steadily since then'.⁵¹ Finally, in 2018 Croatia was no longer subject to the MIP.

The impact of the European Semester on Croatia's national legislation is undoubtedly noticeable in the Budget Act. For example, an explicit reference to the requirements of the SGP can be found in Art. 4 of this Act, with the draft budget plan being defined as follows:

An act of the Government which is drawn up based on the SGP and which defines the macroeconomic and fiscal framework of an individual Member State of the euro area in the next budget year and which the Member States of the euro area submit to the European Commission to ensure a coordinated economic policy.⁵²

Furthermore, the Directive 2011/85/EU on the requirements for the budgets of euro area countries, which was an upgrade of the SGP, was implemented in the Budget Act. However, the European Semester addresses aspects beyond fiscal oversight, with a specific focus on structural policies, public administration, and the business environment. Namely, at the end of the European Semester cycle, the Council formally approves recommendations tailored to each participating Member State. These country-specific recommendations encompass five main policy domains: fiscal matters and taxation; the financial sector; labour market dynamics, social inclusion, and education; structural policies and public administration; and the business environment.⁵³ As such, in the latest country-specific recommendations for Croatia, the Council emphasised that the nation should 'continue to pursue a medium-term fiscal strategy of gradual and sustainable consolidation, combined with investments and reforms conducive to higher sustainable growth, to achieve a prudent medium-term fiscal position'.⁵⁴ The Council also suggested a reduction of dependence on fossil fuels by promoting sustainable solutions, such as the electrification of road transport. This suggests that EU policies have an impact not only on economic governance but on every aspect of national politics. In addition, the immediate fiscal implication of

49 European Commission, 2016b.

50 European Commission, 2016a.

51 European Commission, 2017.

52 Art. 4 para. (25) Budget Act.

53 Keppenne, 2020, p. 853.

54 European Commission, Recommendation for a Council Recommendation on the 2023 National Reform Programme of Croatia and delivering a Council on the 2023 Stability Programme of Croatia, COM(2023) 611 final, 24.5.2023, p. 10.

accession to the EU was that customs duties were no longer a source of revenue for the state budget. ‘The EU has exclusive competence regarding the determination of the scope and structure of customs duties, and the revenues that are collected accrue directly to the EU budget after a 25% (since 2021) deduction, which is supposed to remunerate for collection costs’.⁵⁵ As a result, in 2013, the revenue from customs duties decreased; however, conversely, there was an increase in income from international aid due to the inflow of funds from the EU.⁵⁶

2. Regulation of public debt

The legal architecture of public debt regulation in Croatia is based upon three statutes: the Act on the Conclusion and Execution of International Agreements, the Act on Credit Transactions with Foreign Countries, and the Budget Act. Among these statutes, the Budget Act features provisions that are specifically related to public debt, whereas the other two are more general.⁵⁷

The Budget Act defines public debt as the debt of the general government, which is calculated according to the methodology of the ESA (ESA, 2010).⁵⁸ Put differently, the umbrella term of public debt encompasses the financial obligations of the general government as an institutional sector, which, in the Republic of Croatia, consists of sub-sectors of the central state, local state, and social security funds.⁵⁹ An agreement on public debt can be concluded only for one of the purposes specifically prescribed in the Budget Act. Namely, the state can enter into public debt to finance: (i) the deficit of the central budget; (ii) investment projects and special programmes, as approved by the Parliament; (iii) current debt repayments of the central budget; (iv) the settlement of overdue payments in connection with state guarantees; (v) for budget liquidity management; and (vi) for the needs of the Croatian National Bank for the international reserves. Debt financing can also be achieved by taking credit, a loan, or issuing securities.⁶⁰

However, there are additional conditions for debt financing by local and regional units of self-government. These units can borrow in the short term exclusively to bridge gaps created by the different dynamics of the inflow of funds and the maturity of obligations, for a maximum of 12 months, without the possibility of further reprogramming. On the other hand, in the case of long-term borrowing by local and regional units, several additional conditions must be met. Namely, local units

55 Traversa, 2021, p. 63.

56 Deskar-Škrbić, 2018, pp. 3–13.

57 Arbutina et al., 2022, p. 366.

58 Art. 4 para. (21) Budget Act.

59 Rogić Lugarić and Klemenčić, 2022.

60 Art. 4 para. (71) Budget Act.

can borrow on financial markets only for investments previously incorporated into their budgets, for capital assistance to companies and other legal entities in their ownership, and for the realisation of investments that are co-financed by EU funds. In addition, units of local and regional self-government need approval from the government to enter into an agreement resulting in public debt. Finally, the Budget Act provides the threshold for the maximum amount of annual public debt for each local and regional self-government unit, which is set to 20% of the unit's total income from the previous year. An additional limitation is established regarding the total indebtedness of all units of local and regional self-government. The government decides upon this threshold every year.

The issue of indebtedness came to the fore in light of Croatia's accession to the Economic and Monetary Union. The biggest obstacle for Croatia was the criterion of the sustainability of public finances as its public debt exceeded the reference value of 60% of GDP prescribed in the Maastricht criteria. However, the ratio of public debt to GDP in Croatia continuously decreased from 2014 until 2019. Ultimately, the criterion of sustainable public finances was met based on a decrease of public debt at a satisfactory pace.

3. Fiscal rules and other instruments of sound fiscal policy

The centrepiece of sound fiscal policy management in Croatia is the Fiscal Responsibility Act.⁶¹ The purpose of this Act is to determine the rules that limit the level of expenditure and the deficit of the general budget, to regulate public debt, and to strengthen the responsibility for the use of budget funds.⁶² The Fiscal Responsibility Act encompasses three numerical fiscal rules, which are harmonised with the provisions of the revised SGP: (i) the structural budget balance rule, (ii) the expenditure rule, and (iii) the public debt rule.⁶³ In this regard, Art. 6 of this Act provides that the structural balance, expressed as a share in the GDP, is realised according to the adjustment plan to reach the medium-term budget goal defined by EU law. This fiscal rule is considered fulfilled when the structural balance shown in the annual report on the application of fiscal rules for the previous year (i) is equal to or greater than the medium-term budget goal or deviates from that goal by an amount that is not significant, or (ii) ensures convergence to the medium-term budget goal according to the established adjustment plan or deviates from the planned adjustment plan by an amount that is less than the amount from Art.

61 The Fiscal Responsibility Act, Official Gazette No. 111/18, 41/20, 83/23.

62 Art. 2 Fiscal Responsibility Act.

63 See: Grubišić, 2020, p. 242.

10 para. 1 of this Act.⁶⁴ Furthermore, the expenditure rule is stipulated in Art. 7 of the Fiscal Responsibility Act. This article prescribes that the annual growth of general government expenditure must not exceed the reference potential growth rate of GDP, which is determined following the legal provisions of the EU. In terms of the public debt fiscal rule, this Act implements the general rules of the EU fiscal policy. For example, it provides that the share of public debt in the GDP may not exceed the reference value of 60%, following EU legal provisions. This limit is an obvious reflection of the Maastricht criteria in Croatia's national legislation. In addition, the Act stipulates that whenever it refers to 'the law of the Union' in the context of fiscal responsibility, this formulation covers the SGP and all of its subsequent amendments. However, in March 2020, following a recommendation from the European Commission, the Council invoked the general escape clause within the SGP for the first time. This was done to allow Member States the flexibility to implement emergency measures for tackling the economic downturn caused by the COVID-19 pandemic.⁶⁵ As a consequence, Croatia's national public debt fiscal rule was also temporarily suspended,⁶⁶ with a similar justification as it was at the EU level; specifically, the government decided on the suspension 'due to extraordinary circumstances because of the epidemic of the disease COVID-19 (SARS-CoV-2) in the territory of the Republic of Croatia'.⁶⁷ Although the fiscal rule is prescribed in the Fiscal Responsibility Act, the legal basis for its suspension was not an amendment to the Act but a decision by the government, which is in accordance with the Act itself. Furthermore, it is interesting to note that though the Croatian government declared the end of the COVID-19 pandemic on 11 May 2023,⁶⁸ the suspension of the public debt fiscal rule is ongoing.

The provisions of the Fiscal Responsibility Act refer both to the state budget and the budgets of local and regional self-government units, as well as the financial plans of budgetary and extra-budgetary beneficiaries.⁶⁹ It is also applied to the financial management of legal entities that are, according to the statistical methodology of the ESA 2010, classified in the general government sector.⁷⁰ The Act provides that the individual who is either the head of the budget and extra-budgetary beneficiaries or the head of the local and regional self-government units is accountable for the lawful use of budgetary funds. These individuals also have the responsibility to

64 Art. 10 para. (1) of the Fiscal Responsibility Act states: 'A deviation from the fiscal rule from Article 6, paragraphs 1 and 2 of this Act is, in accordance with the legal provisions of the European Union, significant if the deviation from the medium-term budget goal or the adjustment plan for reaching the medium-term budget goal is at least 0.5% of GDP in a single year or at least an average of 0.25% of GDP per year in two consecutive years'.

65 Fabbrini, 2022.

66 Odluka o privremenom odgađanju primjene fiskalnih pravila, Official Gazette No. 41/20.

67 Odluka o privremenom odgađanju primjene fiskalnih pravila.

68 See: Odluka o proglašenju prestanka epidemije bolesti Covid-19 uzrokovane virusom SARS-COV-2, Official Gazette No. 51/2023.

69 For the definition of budgetary and extra-budgetary beneficiaries, see *supra*, 1.2.

70 Art. 3 Fiscal Responsibility Act.

ensure the efficient and effective functioning of the internal control system within the framework of the funds determined by the budget or financial plan. Each year, the head of the institution is obliged to draw up a Statement of Fiscal Responsibility for the previous budget year for the period during which she held office (i.e. performed leadership duties). If the Statement on Fiscal Responsibility is not drawn up or delivered in time, the Act prescribes a monetary fine.

Another important segment of sound fiscal policy in Croatia is the Commission on Fiscal Policy. Before this commission was established, a similar function was vested with the former Committee for Fiscal Policy. However, the Committee for Fiscal Policy was not considered an independent body as it was overseen by the Ministry of Finance. Hence, the Commission on Fiscal Policy was founded in 2011 and works on assessments of national fiscal policy. The President and members of this commission are appointed by the Croatian Parliament. It should be emphasised that candidates for the Commission on Fiscal Policy must not be members of a political party either currently or for the last five years up to the date of their candidacy. Moreover, a member of this commission cannot have held office in representative or executive bodies at the state level as an independent candidate, or in local or regional self-government.⁷¹ According to the Fiscal Responsibility Act, if the Commission on Fiscal Policy decides that there is a risk of significant deviations from the fiscal rules, it will prepare a report and submit it to the government. Within 45 days of receiving this report, the government is obliged to declare the existence of risks related to the fulfilment of fiscal rules. If the government assesses that a risk exists, it is obliged to propose a plan of necessary measures with implementation deadlines, which will lead to the fulfilment of the fiscal rules. This plan will be applied immediately after its adoption, and the Commission of Fiscal Policy is authorised to monitor its implementation.⁷²

4. Impact of EU crisis management instruments on Croatian public finances

The global financial crisis had a significant influence on fiscal integration in the EU, which subsequently affected the public finance systems of all Member States. Though Croatia was not a Member State when the global financial crisis hit the EU, the legislation adopted as a result of EU crisis management nevertheless had an impact on Croatian economic governance.

During the global financial crisis, the spillover effect within the Eurozone highlighted the need for budgetary coordination at the EU level, which led to reforms of

71 Art. 16 Fiscal Responsibility Act.

72 Art. 24 Fiscal Responsibility Act.

the legal framework and the strengthening of the SGP.⁷³ The SGP was strengthened through the so-called ‘Six Pack’ and ‘Two Pack’.⁷⁴ The ‘Six Pack’ and ‘Two Pack’ introduced a new procedure in the field of macroeconomic imbalances, established a framework for dealing with states experiencing difficulties with financial stability, and codified budgetary surveillance in the form of the European Semester. The latter influenced the budgetary process in all Member States, including Croatia. As a result of compliance with the requirements of the European Semester, Croatia’s budgetary process now includes the adoption of the Convergence Programme, which is subsequently sent to the European Commission. Based on the Convergence Programme, the Ministry of Finance prepares a draft of the budget plan for the next budget year, which the government adopts by conclusion and submits to the European Commission no later than 15 October of the current year. The draft budget plan is drawn up according to the rules of the European statistical methodology (ESA 2010) and is based on the fiscal goals defined in the Convergence Programme in accordance with the special recommendations of the Council for the Republic of Croatia. The Commission’s opinion on the draft budget plan is taken into account when preparing and adopting the state budget. Hence, the EU economic surveillance tools implemented before Croatia became a Member State unquestionably served – and continue to serve – as a vital resource for shaping Croatia’s national fiscal policy.

Furthermore, the outbreak of the COVID-19 pandemic in 2020 caused another economic downturn that urged EU institutions to adopt new legal instruments. Among the instruments adopted to tackle the economic implications of the pandemic, the NextGenerationEU (NGEU) recovery plan stands out as the most important. This recovery plan combined several instruments worth more than EUR 800 billion, which were disbursed to Member States. The central element of the NGEU legal architecture is the Recovery and Resilience Facility (RRF). The criteria for the allocation of the RRF funds differ, depending on whether they will be allocated as a grant or a loan. Moreover, the allocation of funds through the RRF can be suspended if a Member State does not comply with its obligations under the SGP or the Macroeconomic Balance Procedure.⁷⁵ To obtain financing from the RRF, Member States must submit National Recovery and Resilience Plans (NRRPs) to the Commission. However, all investments that will be financed with RRF funds must be aligned with EU goals for faster recovery, including (i) green transition; (ii) digital transformation; (iii) smart, sustainable, and inclusive growth; (iv) social and territorial cohesion; (v) health and economic, social, and institutional resilience;

73 See: Lionello, 2020, p. 24; Fromage, 2021, p. 386.

74 The ‘Six Pack’ consists of five regulations and one directive that define the concept of significant deviation from the medium-term budgetary objective and sanctions if the deviation is not reduced. The ‘Two Pack’ comprises two regulations that introduce additional elements to strengthen the fiscal surveillance of Member States, particularly those facing difficulties with financial stability.

75 Art. 10 of Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, OJ L 057, 18.2.2021, 17–75.

and (vi) policies for the next generation, such as education.⁷⁶ These policy pillars affect the macroeconomic plans of all Member States, including Croatia, and are considered ‘the progressive emergence of a fully-fledged EU economic policy’.⁷⁷ As a consequence, the Croatian NRRP mirrors the above-mentioned goals set at the EU level. In this regard, ‘40.3% of the plan will support climate objectives, while 20.4% of the plan will foster the digital transition’.⁷⁸ It is important to underline that the value of the Croatian NRRP amounts to EUR 6.5 billion, and approximately 86% of this value will be financed through the RRF grants. The impact of the RRF financing in Croatia will be far-reaching, affecting not only economic governance but also a plethora of different areas, such as education, healthcare, transport, the energy sector, and the labour market.⁷⁹ The possible advantages of the NGEU financing are significant: the ‘NGEU’s fiscal stimulus can help to preserve the economy’s supply-side capacity in the aftermath of the COVID-19 shock, facilitate the adaptation of the economy to the post-pandemic environment and mitigate possible transition costs of reforms’.⁸⁰ On the other hand, keeping in mind the intensity of the NGEU’s imprint on Member States’ fiscal policy management, it is unsurprising that it raised the question of possible limitations to national parliaments’ budgetary powers.⁸¹ As Allemand et al. point out regarding the NGEU, ‘any coordination of fiscal policies reduces parliamentary budgetary power at the national level, both quantitatively and qualitatively’.⁸² However, criticism in this regard was not observed at the national level in Croatia.

5. Summary

A comprehensive overview of the legal framework governing public finances in Croatia must begin with an analysis of its constitutional provisions. The Constitution does not include a dedicated section on public finance; instead, relevant provisions are scattered across various chapters. However, the Constitution does highlight the pivotal role of the Croatian Parliament in the budgetary process. In addition,

76 Art. 2 of Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, OJ L 057, 18.2.2021, 17–75.

77 Dermine, 2020, p. 352.

78 *Croatia’s recovery and resilience plan* [Online]. Available at: <https://shorturl.at/oGHrH> (Accessed: 6 May 2023).

79 European Commission, Commission staff working document: Analysis of the recovery and resilience plan of Croatia – Accompanying the document Proposal for a Council Implementing Decision on the approval of the assessment of the recovery and resilience plan for Croatia, Brussels, 8.7.2021, COM(2021) 401 final, p. 82.

80 Bańkowski et al., 2022, p. 10.

81 See, for example: Allemand et al., 2023.

82 Allemand et al., 2023, p. 8.

the Budget Act stands out as a key statute, dictating every phase of the budgetary process, which has been under the influence of various EU legal instruments. For example, the excessive budget deficit procedure, which Croatia underwent due to the financial crisis, and the subsequent measures taken to rectify the situation significantly influenced sound fiscal management. The establishment of the Fiscal Policy Commission in 2013 was a crucial development in Croatia's fiscal policy, aligning it with EU directives. In addition, Croatia's involvement in the European Semester, an integral part of EU economic governance, impacts various aspects of its national politics, even beyond economic governance itself.

The legal framework for public debt regulation in Croatia is based on three key statutes: the Act on the Conclusion and Execution of International Agreements, the Act on Credit Transactions with Foreign Countries, and the Budget Act. Following the ESA 2010 methodology, the Budget Act defines public debt as a financial obligation of the general government, encompassing the central state, local state, and social security funds. Public debt agreements can only be made for specific purposes outlined in the Budget Act, which also prescribes additional conditions for local and regional self-government units regarding short-term and long-term borrowing. During Croatia's accession to the Economic and Monetary Union, addressing the sustainability of public finances has been crucial, especially in light of the Maastricht convergence criteria. The public debt level continuously declined from 2014 to 2019, ultimately meeting the criteria for sustainability.

The cornerstone of sound fiscal policy in Croatia is the Fiscal Responsibility Act, which encompasses three numerical fiscal rules: the structural budget balance rule, the expenditure rule, and the public debt rule. These rules are harmonised with the provisions of the revised SGP, thus aligning Croatian fiscal policy with EU standards. This Act applies not only to the state budget but also to local and regional self-government units, as well as the financial plans of budgetary and extra-budgetary beneficiaries. It holds heads of budgetary beneficiaries accountable for the lawful use of funds and requires the creation of an annual Statement of Fiscal Responsibility.

While Croatia was not an EU member during the global financial crisis, it was affected by legislation resulting from EU crisis management. Various reforms, including the 'Six Pack' and 'Two Pack', strengthened the SGP, introduced procedures for macroeconomic imbalances, and established the European Semester, subsequently influencing Croatia's budgetary process. In addition, the COVID-19 pandemic prompted the adoption of new legal instruments. The RRF, a key element of the NGEU recovery plan, allocates funds based on specific criteria and the submission of NRRPs. The impact of NGEU financing in Croatia is expected to be far-reaching, affecting various sectors such as education, healthcare, and energy. This brief overview of the public finance legal framework and its development in Croatia presents a paramount example of the accelerating process of fiscal integration in the EU.

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