Fiscal Policy Commission
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1. position paper of the Fiscal Policy Commission on the Draft Annual Report on the the execution of the State Budget of the Republic of Croatia for 2018 and the Draft Annual Report on the application of the fiscal rules for 2018

At its 1st meeting held on 24 September 2019, the Commission (hereinafter: the Commission) discussed the Draft Annual Report on the execution of the State Budget of the Republic of Croatia for 2018 and the Draft Annual Report on the application of the fiscal rules for 2018, which was submitted in the form of an act to the Speaker of the Croatian Parliament by the Croatian Government on 16 May 2019.

The bases for assessing the application of fiscal rules were: a) *Report on the Excessive Budget Deficit Procedure and General Government Debt Level of the Republic of Croatia of April 2019* (ESA 2010), published by the Central Bureau of Statistics (CBS) on 20 April 2018. ; b) *Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2018*, adopted by the Government of the Republic of Croatia at its 97th session held on 24 May 2018; and c) *Draft Annual Report on the Application of the Fiscal Rules for 2018*, adopted by the Government of the Republic at its 157th session held on 16 May 2019. In addition to these, the Commission used in its assessment other documents such as the Convergence Program of the Republic of Croatia, as well as projections and analyses of the European Commission.

The Fiscal Responsibility Law (official gazette of the Republic of Croatia *Narodne novine* No. 111/2018.) defines the fiscal rules and the task of the Commission to consider and assess the application of the fiscal rules in medium-term budgetary documents and the annual report on the budget execution. The fiscal rules and the tasks of the Commission have been aligned with the EU acquis and comply with the definitions set forth in the regulations that had been applicable before the new Law was enacted.

The Fiscal Responsibility Law defines three fiscal rules (Articles 6-8) that have been taken from the Stabilization and Growth Pact. The first rule, the *structural balance rule*, is complied with when the structural balance shown in the annual report on the application of fiscal rules for the previous year is equal to or greater than the medium-term budgetary objective, or when it is achieved according to an adjustment plan defined in accordance with EU legal provisions. The second rule, the *expenditure benchmark*, limits the growth of general budget expenditure corrected for the effects of tax changes, which must not exceed the reference potential GDP growth rate. The expenditure benchmark does not apply if the structural balance rule is complied with. The third fiscal rule, the *debt rule*, limits the level of public debt to 60% of GDP, or determines the dynamics of its reduction to the benchmark.

Assessment of the application of fiscal rules in 2018

Structural balance rule. Structural balance is the deficit or surplus of the general budget that excludes cyclical economic effects and one-off and temporary measures that have an impact on the general budget's revenue or expenditure. If the structural balance is in line with the established medium-term budgetary objective, this is considered as complied with.

The calculation of the general government balance is made by the Central Bureau of Statistics and is based on a common European methodology (ESA 2010). According to the *Report on the Excessive Budget Deficit and the General Government Debt Level of the Republic of Croatia* of April 2019, the general government budget in 2018 generated a surplus of HRK 758 million or 0.2% of GDP for the second year in a row. The general budget surplus is the result of continued favourable economic developments and years of efforts by the executive branch to consolidate public finances.

In the *Draft Annual Report on the Application of the Fiscal Rules for 2018*, the Government of the Republic of Croatia estimated that the favourable cyclical environment positively contributes to 0.6% of GDP. In the same document, the Government included an adjustment by one-off measures of 0.7% of GDP as a result of a capital transfer for protested guarantees for the Uljanik shipyard in the amount of HRK 2.5 billion. However, the common methodology for calculating the structural balance renders one-off measures strictly on the expenditure side, and does not recognize this form of capital transfers as a one-off measure. Therefore, this particular one-off adjustment for paid guarantees is not appropriate.

Comparing the estimated structural balance (-0.4% of GDP) and the medium-term budgetary objective (-1.75% of GDP), the Commission concluded that the fiscal rule of structural balance has been complied with in 2018.

***Expenditure benchmark*. Given that the medium-term budgetary objective has been achieved, the part of the rule relating to expenditure growth is not applicable.** However, the Commission warns that expenditures, increased by the impact of revenue reduction due to tax changes, are growing much faster than potential growth. In this way, savings from the previous period are spent and the fiscal space for counter-cyclical fiscal policy action is reduced in the face of worsening global and domestic economic outlook. This is especially important because the Government of the Republic of Croatia, in compliance with the commitments for participating states in the European Exchange Rate Mechanism, which Croatia intends to join, set the medium-term budgetary objective in the period 2020-2022 at -1.0% of GDP. In addition, a significant part of the savings was made on the funding costs side, which, in addition to fiscal consolidation in the previous period and the partial restructuring of public debt, was also driven by favourable global financial conditions. Finally, the Commission welcomes the increase in the share of capital expenditure in public spending.

Public debt rule. The Commission also considered the public debt rule under which public debt should not exceed 60% of GDP. If the public debt exceeds this benchmark, it should be reduced at an average rate of one-twentieth per year. The share of public debt has been continuously declining since 2015 (in 2015 it was 83.7% of GDP, in 2017 it was 77.8% of GDP and in 2018 it was 74.6%). The decrease in the public debt-to-GDP ratio of 3.2 percentage points in 2018 was higher than the minimum required reduction, and **this resulted in the compliance with the public debt rule as well**.