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Fiscal Policy Commission

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12th Position paper of the Fiscal Policy Commission on the State Budget Proposal and financial plans for extra-budgetary users for the year 2017 and projections for 2018 and 2019

At its 17th meeting the Fiscal Policy Commission reconsidered the State Budget Proposal and financial plans for extra-budgetary users for the year 2017 and projections for 2018 and 2019 submitted by the Croatian Government to the Croatian Parliament on 8th December 2016.

Commission will focus its position on the Draft Budget primarily on the implementation of fiscal policies in compliance with the Fiscal Responsibility Act. Croatian Parliament's Decision on the Establishment of the Fiscal Policy Commission Article 4 states the real task of the Commission "*to consider and evaluate the application of the fiscal rules established by the Fiscal Responsibility Act in the State Budget Draft and financial plans of extra-budgetary users of the state budget for the fiscal year and projections for the next two years*."

Fiscal policy for the year 2017 cannot be measured in accordance with Article 5 of the Fiscal Responsibility Act, according to which Croatian Government by a decision determines the plan of adjustment of the budget as recommended by the Council. The Fiscal Responsibility Act states that the fiscal rule in Article 4 of this Act shall be applied after the Croatian Government determines a plan of adjustment in order to achieve the medium-term budgetary objective, and on the recommendation of the EU Council. Given that the Government has not defined the adaptation plan as recommended by the EU Council, the basic rule still cannot apply but the relevant temporary fiscal rule. This rule provides that the expenditure of the general government should not grow faster than gross domestic product.

However, European fiscal rules are relevant for Croatia as well, and during the excessive deficit procedure those are the recommendations of the EU Council in the context of this procedure and the European semester. Therefore, the Fiscal Policy Commission recalls that the EU Council of 12 July 2016 (*Official Journal of the European Union 18 August 2016)* recommended Croatia to exercise fiscal adjustment of at least 0.6% of GDP in 2017 and to use an unexpected increase in budget revenues completely to reduce the deficit and public debt.

Draft State Budget for 2017 on a cash basis estimates achieving fiscal adjustment of consolidated general government budget amounting to only 0.1% of GDP, and reducing the budget deficit of the general government from 1.7% to 1.6% of GDP. In this context, it is expected that in 2017 the budgets of local government units and extra-budgetary funds will record a surplus, and the state budget will increase the deficit by 0.3% of GDP compared to 2016.

The proposed budget for 2017 continues its pro-cyclical trend confirmed by the projection of an increase in the structural deficit in 2017 to around 0.5% of GDP. According to estimates by the Commission structural budget deficit in 2016 will be around 1.2% of GDP while the proposed budget for 2017 increases the structural deficit to a level of around 1.7% of GDP. This is due to narrowing the gap in GDP in 2017 (Table 1) thus to achieve reduction of the structural deficit below the level achieved in 2016 it would be necessary to significantly reduce the general government deficit. The Commission considers that the budget for 2017 should have started a counter-cyclical fiscal policy, which means saving in the period of growth of budget revenues for the period when budget revenues due to the recessionary cycle stagnate or decline.

Table 1: Calculation of the structural balance

	% GDP ESA 2010	2015	2016	2017
(1)	Budgetary balance	-3.3	-1.9	-1.8
(2)	GDP gap	-2.9	-1.7	-0.3
(3)	Cyclical component	-1.1	-0.7	-0.1
(4)	Temporary measures	0.0	0.0	0.0
(5)	Structural balance (1)-(3)-(4)	-2.2	-1.2	-1.7

Source: European Commission, own calculations

The proposed budget is based on optimistic projections of economic growth. The projection of real GDP growth estimated by the Croatian Government for 2017 is 3.2%, while the European Commission recently on 9 November 2016, published a projection of real GDP growth for Croatia of 2.5%. In addition to the optimistic growth forecasts, Fiscal Policy Commission estimates that the projection of budget revenues for 2017 is very ambitious, which raises the risk for the planned figures not to be reached, which would then lead to higher deficits and higher borrowing needs.

In this context, it would be desirable for the Government in its Explanatory Notes to indicate the items where the expenses will be reduced in case the planned revenues would not be achieved. Besides the risk of lower revenues than planned holds a risk on the growth of expenses in case of partial or complete fulfilment of the demands of trade unions or initiated lawsuits.

Explanation of the Draft State Budget submitted by the Government does not state the extent to which the draft budget for 2017 and projections comply with the Fiscal Responsibility Act. Although such estimate has not been strictly stipulated as Government's obligation, if the assessment of fiscal rules respect was incorporated in the explanation it would clearly indicate the importance the Government attaches to the Fiscal Responsibility Act and that it takes into account the fiscal rules that are outlined in it. It should be recalled that the Fiscal Policy Committee during its mandate, on every draft budget or proposed amendments to the budget, repeatedly asked for the documents submitted to the Parliament to incorporate Government's assessment of fulfilling the fiscal rule. It is very important for the deputies of the Croatian Parliament to become more familiar with the risks taken by the adoption of the proposed budget from the standpoint of compliance with the Fiscal Responsibility Act.

Fiscal Policy Commission points out that the Explanatory budget still holds a problem in the application of the fiscal rules of the general government according to ESA methodology, making it extremely difficult to monitor the implementation of fiscal rules, whether those defined by the Fiscal Responsibility Act or European fiscal rules related to Stability and Growth Pact. The proposed budget and plans for extrabudgetary users are available only at the central government level, in a much narrower scope than the one applied by ESA standard, and on a cash basis, unlike the ESA methodology applying the accounting principle. It should be stated that at this point it is not entirely clear what will be the fiscal policy implemented in 2018 and 2019, even under the existing law. Main fiscal rule is related to the adjustment plan adopted by the Government, and it is expected for this plan to finally be adopted for the first time during the year 2017, so in 2018 and 2019 it should be applied. However, application of this fiscal rule depends on whether Croatia will end the excessive deficit situation. Most of the recommendations provided by the EU Council within the framework of these procedures have probably been completed in 2016. Although there are no definitive data, the general government deficit according to ESA methodology is likely to fall below the required 2.6%, public debt projections point to its decline in the next two years. However, it seems that Croatia did not fully respect the recommendation on reducing the structural deficit, which may or may not represent an obstacle to end the procedure, the decision taken by the EU Council upon the recommendation of the European Commission. Decision on the existence or ending the procedure is expected in mid-2017. However, even after ending the procedure Croatia will be faced with the need to continue fiscal consolidation because it will become compulsory to respect the preventive part of the EU fiscal rules which are focused on the structural deficit and expenditure control.

Compliance with these rules is operationalized by the plan of adjustments for achieving medium-term fiscal objectives. As it is unclear whether Croatia would exist in excessive deficit procedure, adjustment plan has not been adopted yet therefore it is not possible to assess the compliance of projections for 2018 and 2019 with this plan, that is the compliance with fiscal rules in those years.