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Fiscal Policy Commission

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13th Position paper of the Fiscal Policy Commission of the Croatian Parliament on the application of the fiscal rules for the year 2016

At its 17th meeting held on 27 June 2017 the Fiscal Policy Commission reconsidered the application of the fiscal rules for the year 2016. The bases for assessing the application of fiscal rules were: a) Report on excessive budget deficit and general government debt level in the Republic of Croatia (ESA 2010) issued by the Croatian Bureau of Statistics on 24 April 2017; B) Proposal of the Annual Report on the Execution of the State Budget of the Republic of Croatia for 2016, adopted by the Government of the Republic of Croatia at its 38th Session on 25 May 2017, and c) Proposal of the Annual Report on the Application of the 2016 Financial Rules, which Government of the Republic of Croatia also adopted at its 38th session held on May 25, 2017.

The Fiscal Responsibility Act (Official Gazette 139/10 and 19/14) establishes fiscal rules, while the Decision on the Establishment of the Fiscal Policy Committee, adopted by the Croatian Parliament at its session of 18 December 2013, defines, inter alia, the Commission's task to consider and evaluate the application of the fiscal rules established by the Fiscal Responsibility Law in the proposal of the half-yearly and annual report on the execution of the State Budget and the Financial Plans of Extra-budgetary users of the State Budget.

According to the ESA 2010 methodology, general government deficit fell by HRK -11,346 million (-3.4% of GDP) in 2015 to HRK -2,757 million (- 0.8% of GDP) in 2016. The increase in revenues from indirect taxes (excise and VAT) in 2016 and modest growth in expenditures and decrease of interest expenditures from 11.9 to 11.2 billion HRK had the greatest impact on reducing the general government deficit in 2016.

Due to a general government deficit reduction in 2016, the primary surplus of the general government budget deficit (general government deficit increased by 2.5% of GDP) was recorded. The general government surplus shows that in 2016 the State did not have to borrow for the entire interest payment.

Despite the positive trends in public finances in 2016, the fiscal imbalance is still present. Namely, the reduction of the general government deficit is largely a result of automatic stabilizers and more favourable macroeconomic indicators in the services sector that have been achieved thanks to foreign demand. This means that the structural causes of the deficit are still not resolved and that it could again reach an excessive level in the event of a deterioration of the economic situation. Furthermore, the reduction of the budget deficit has been partly achieved by the reduction of public investment, which is not sustainable and the public sector has a need for investments. In the future, there will be pressure to increase the budget deficit.

According to the Council's decision on the existence of an excessive deficit in 2014 and the recommendations of the Council of the European Union to address the state of excessive budget deficit, Republic of Croatia should, by 2016, resolve the state of excessive budget deficit by reducing the general government deficit to 4.6% GDP in 2014, 3.5% GDP in 2015 and 2.7% in 2016. According to official data on the general government deficit for 2016, the 2016 target is entirely met because the deficit is 0.8% of GDP. At the meeting of the Economic and Financial Affairs Council held on 16 June 2017 Croatia's exit from the excessive deficit procedure was confirmed.

According to the Law on Fiscal Responsibility in 2016, a provisional fiscal rule is applied. This rule stipulates that the year-on-year growth rate of general budget expenditures may not be higher than the annual growth rate of projected or estimated GDP at current prices, allowing exemptions for certain categories of expenditure. Thus, the total general government budget expenditures for estimating fiscal rules do not include interest expenditures, expenditures for EU programs and changes in expenditure due to changes in the institutional scope of the general budget. In the Proposal for the Annual Report on the Application of Fiscal Rules for 2016, the Government of the Republic of Croatia stated that these corrected expenditures were increased by 2% GDP, while the nominal GDP in 2016 increased by 2.8 %. Therefore, the Government in its Proposal Report concluded that the fiscal rule for 2016 was met.

Table 1: Calculation for the fiscal rule for the year 2016, in million HRK and %

Expenditure of the general government according to ESA2010 (1)	2015	2016
	162,237,20	166,014,88
Expenditures to be excluded:		
- interest expenditure (2)	11,925,19	11,162,05
- programme support expenditure EU (3)	2,560,40	5,046,74
- changes in expenditure due to institutional changes (4)	not available	
= (1) - (2) - (3) - (4)	147,751,61	149,806,09
Change in expenditure due to fiscal rule calculation		1.4%
Nominal GDP	333,837	343,195
Change in GDP due to fiscal rule calculation		2.8%

Source: Croatian Bureau of Statistics, own calculations

The Fiscal Policy Committee has come to the same conclusion in its estimates, although there are certain doubts about the calculation relevant to the assessment of compliance with the fiscal rule. The Commission has considered the coverage of general government budget expenditures relevant to the calculation of the fiscal rule and considers that total expenditures should not be adjusted (reduced) for refunds from EU agricultural direct payments aid as it is

about replacing domestic financial resources with resources from the EU. The estimate of expenditures according to the Commission's Position Paper is shown in Table 1. Based on such calculations, total expenditures relevant to the calculation of fiscal rules increased by 1.4% while nominal GDP rose by 2.8%. Based on this, the Commission concludes that the 2016 provisional fiscal rule will be fulfilled.

The Republic of Croatia should move as soon as possible to the process of adopting the amendments to the Fiscal Accountability Act in order to strengthen the Fiscal Policy Commission's independence and redefine the numerical fiscal rules, which was one of the recommendations of the Council. This is also the commitment from this year's Council of the EU. The Commission reiterates that the amendments to the Budget Act of February 2015 (Official Gazette 15/2015) left Croatia without any legal control of the public debt. Namely, the above mentioned amendments abolished provisions regulating allowed public debt, which reached 84.2% of GDP in late 2016. The slowdown in public debt growth is positive, but there is still a great threat to the sustainability of Croatian public finances due to its high level. Ten years ago public debt stood at 38% of GDP, which was at the same level of comparable countries, while today with a share of 84.2% of GDP it is significantly above the average of comparable countries. In this way, a high level of public debt can become an irresistible burden on public finances in the event of a deterioration of liquidity in the global financial market.

The Commission proposes to the Government of the Republic of Croatia, in 2017 and 2018, to make additional efforts to further reduce the structural deficit of the general budget (according to the European Commission projections, the structural deficit in 2017 could amount to 1.7% of GDP, and in 2018 structural deficit could increase to 2.1% of GDP). Namely, in its spring projections, the European Commission expects an increase in the

structural deficit in 2017 and 2018. The Commission considers that the stricter obligation to comply with the structural deficit of the general state budget should be embedded in the Fiscal Accountability Act or another specific law. Many European countries have a structural budget deficit that cannot be more than 1% of GDP incorporated in the law, and the signatories of the Fiscal Compact have tighter structural deficit rules up to 0.5% of GDP. Determining a more stringent goal would keep the focus of fiscal policy on sustainable public finance reforms. The Commission proposes to the Government of the Republic of Croatia, as soon as possible, to join the Fiscal Compact as an indispensable part of the ongoing efforts to regulate public finances and prepare for the introduction of the euro.

