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**Fiscal Policy Commission**

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**14th Position paper of the Fiscal Policy Commission of the Croatian Parliament on the Proposal of the Half Year Report on the execution of the State Budget of the Republic of Croatia for the first half of 2017 and the Proposal of the Half Year Report on the Application of Fiscal Rules for the first half of 2017**

At its 20th session held on September 26, 2017, the Commission discussed the Proposal of the Half Year Report on the execution of the State Budget of the Republic of Croatia for the first half of 2017 and the Proposal of the Half Year Report on the Application of Fiscal Rules for the first half of 2017 submitted by the Government of the Republic of Croatia to the Speaker of the Croatian Parliament, Act of 14 September 2017.

The Commission's position on the Proposal of the Half Year Report on the execution of the State Budget of the Republic of Croatia for the first half of 2017 and the Proposal of the Half Year Report on the Application of Fiscal Rules for the first half of 2017 is primarily based on the application of the fiscal rule in accordance with the Fiscal Responsibility Act. Namely, the

Croatian Parliament, by its Decision on the Establishment of the Fiscal Policy Commission, Item 4, precisely as a true task of the Commission specifies "examining and assessing the application of the fiscal rule established by the Fiscal Responsibility Act in the draft semi-annual and annual report on the state budget execution and financial plans of extra-budgetary users of the state budget;".

The Republic of Croatia, according to the EU Council Decision of 12 June 2017, is no longer in a situation of excessive fiscal deficit. This means that the Republic of Croatia has met the Council recommendations in 2014 and has corrected the state of excessive deficit within three years. It is a significant achievement that points to the necessary responsibility in managing fiscal policy over the past three years. However, the Republic of Croatia continues to be bound by the provisions of the Stability and Growth Pact in terms of fiscal discipline, only that fiscal surveillance is no longer carried out through the corrective, but through the preventive arm of the Pact. Thus, according to the Council Decision abrogating Decision 2014/56/EU on the existence of an excessive deficit in Croatia, the following is warranted: "As from 2017, the year following the correction of the excessive deficit, Croatia is subject to the preventive arm of the Stability and Growth Pact. Having reached its medium-term objective already in 2016, Croatia should avoid deviating from it and comply with the debt criterion, in accordance with Article 2(1a) of Regulation (EC) No 1467/97". The preventive arm of the Pact is related to the obligation to reach the mid-term budgetary objective set in terms of structural deficit, as well as to reduce public debt to a satisfactory level at the 60% limit of GDP and to limit the growth of expenditures.

Fiscal Responsibility Act (Official Gazette No.139 / 10 and 19/14) established fiscal rules in line with European rules, where they are applied: "after the Government of the Republic of Croatia sets out the adjustment plan ... for the purpose of meeting medium-term budgetary target, and upon the recommendation of the Council of the European Union". Until then, a

temporary fiscal rule is applied, according to which "the inter-annual general budget expenditures growth rate shall not be higher than the inter-annual growth rate of the projected, that is, of the estimated GDP in current prices." The Commission considers that by exiting the excessive deficit procedure the conditions are met for applying the regular fiscal rules in the Fiscal Responsibility Act already in 2017. But in order to apply them, the Government of the Republic of Croatia must adopt an adjustment plan to meet the mid-term budgetary target. Until then, a temporary fiscal rule from the Fiscal Responsibility Act will remain applicable, as well as obligations deriving from the preventive arm of the Stability and Growth Pact.

The Commission proposes to the Government of the Republic of Croatia to adopt a medium-term budget adjustment plan as soon as possible. The mid-term structural budget target for the Republic of Croatia is set at a deficit level of 1.75% of GDP. Structural deficit in 2016 amounted to 0.3% of GDP, which means that the goal was achieved with a significant positive difference. However, according to the expectations of the European Commission and this Commission, the structural deficit in 2017 could be somewhat lower than the medium-term budgetary objective, while in 2018 there are risks that the deficit will be higher than the medium-term budgetary goal, which is why the adjustment plan foresees measures to be taken in order to continue with this target in the next year as well.

Proposal of the Half Year Report on the execution of the State Budget of the Republic of Croatia for the first half of 2017 shows extremely favourable execution of the general government budget which is in surplus. 2017 Budget Guidelines adopted by the Government foresee an adjusted budget of -1.3% of GDP. However, the data presented relate to fiscal indicators according to the national methodology which is somewhat different from the ESA methodology that assesses compliance with the rules from the Stability and Growth Pact as well as the fiscal rules of the domestic Fiscal Responsibility Act. The European Commission's

Spring 2017 Economic Forecast for May expects the general government balance of -1.1% of GDP and the structural balance of -1.7% of GDP. Fiscal Policy Commission points out that the documents of the Government of the Republic of Croatia do not have available information on the expected structural balance of the general government budget for this year.

In the Proposal of the Half Year Report on the Application of Fiscal Rules for the first half of 2017, the Government of the Republic of Croatia states that the fiscal rule for 2017 will be met. Considering the macroeconomic and fiscal developments in the first half of this year, as well as expected trends by the end of the year, the Commission agrees with this assessment of the Government of the Republic of Croatia on meeting the provisional rules of the Fiscal Responsibility Act this year. Regardless of the favorable state of the budget, with the currently positive cyclical state of the economy, the structural balance for this year could be at the margins of achieving the medium-term budgetary objective, and achieving that goal is a commitment from the Stability and Growth Pact. Therefore, the Commission continues to recommend prudent fiscal policies, particularly on the expense side.

Fiscal Responsibility Act stipulates that the Government of the Republic of Croatia adopts a decision on the adjustment plan upon the Council Recommendation, and although the Council has delivered its Recommendation, the Government of the Republic of Croatia has not adopted its decision yet. Fiscal Policy Committee can only rely on the latest available projections from the 2017 Budget Guidelines by the Government and consider them as an official document illustrating the adjustment plan. This plan foresees meeting the Council's recommendations by maintaining the budget deficit below the medium-term budgetary target of 1.75% of GDP, but does not specify concrete measures to address the risk of deviations in 2018.

Fiscal Policy Committee welcomes the positive efforts of the Government of the Republic of Croatia in order to reduce the budget deficit and reduce the public debt, and proposes to the Government of the Republic of Croatia to:

- urgently adopt the Decision on the adjustment plan on structural balance pursuant to Article 5 of the Fiscal Responsibility Act;
- urgently adopt Fiscal Responsibility Act, which will incorporate independent Fiscal Policy Commission, strengthening the fiscal framework;
- prepare appropriate policies ensuring the structural deficit in 2018 to remain at the level of the mid-term budgetary target. At the same time, it is necessary to ensure continued reduction of public debt in GDP.
- sign the European Fiscal Compact and set the lower limit of the mid-term budgetary target following the model of euro area countries, which would strengthen the credibility of Croatia's expected request to participate in ERM II mechanism and the overall preparation process for joining the euro area.