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16th Position Paper of the Fiscal Policy Commission of the Croatian Parliament on the Draft Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Entities for the year 2018 with Draft Projections for the period 2019-2020

At its 22nd meeting held on 13 November 2017, the Fiscal Policy Commission of the Croatian Parliament discussed the Draft Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Entities for the year 2018 with Draft Projections for the period 2019-2020 (hereinafter referred to as: the Draft Budget), submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia on 2 November 2017.

In its position on the Draft Budget, the Commission focuses on the application of the fiscal rule in line with the Fiscal Responsibility Act (Official Journal *Narodne novine* 139/10 and 19/14). In Article 4 of the Decision on the Establishment of the Fiscal Policy Commission (Official Journal *Narodne novine* 156/2013), the Croatian Parliament entrusts the Commission with the central task to *examine and assess the application of the fiscal rule established by the Fiscal Responsibility Act in the draft state budget and financial plans of extra-budgetary entities of the state budget for the budgetary year, and in draft projections for the two succeeding years*. The Decision also tasks the Commission with *examining macroeconomic and budget projections in the documents adopted by the Government of the Republic of Croatia, proposed by the Government to the Parliament for adoption and related to the process of drafting the state budget, budgets of local and regional self-government units, financial plans of extra-budgetary users and projections for the medium-term budget period and with comparing them to the European Commission's latest available projections.*

The Draft Budget for 2018 and the Draft Projections for 2019 and 2020 have been drawn up based on the assumption that economic growth would continue, although gradually slowing down. The comparison of the Croatian Government's macroeconomic projections to the projections of the European Commission and other international and domestic institutions does not indicate any major deviations. The Commission therefore concludes that the macroeconomic projections presented in the Draft Budget can serve as a credible basis for budget planning, pointing however to certain risks in the medium term. Namely, the projections suggest that personal consumption will be the main growth generator of the

Croatian economy and that the contribution of net exports will be slightly negative. Growth based on domestic consumption raises risks for growth sustainability, especially if serious structural reforms are not implemented. Namely, the intensity of personal consumption growth is slowly diminishing as the effects of the tax reform and of the increase of wage base of civil servants and employees in the public sector subside.

For this reason, the further strengthening of exports is imperative in order to maintain economic growth. Furthermore, a slight acceleration in the growth of fixed capital investment is expected, largely due to the expected increase in funding through EU funds. However, the current level of investment is far below pre-crisis levels, and the risks arising from the corporate sector's investment, which are also linked to the crisis in *Agrokor*, are still considerable, which might delay the full recovery of investment.

Both revenues and expenditures of the state budget are expected based on the projections of economic growth. It should be noted that the Draft Budget for 2018 includes a comparison of future budget items with the 2017 Budget Plan. However, as in the meantime amendments have been proposed to the latter, it is much more relevant to make the comparison with the Draft Amending Budget for 2017. Although the Draft Amending Budget for 2017 is currently being discussed by the Croatian Parliament, this should not prevent the Croatian Government from presenting a comparison with the expected amendments to the 2017 Budget in the explanatory memorandum accompanying the Draft Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Entities for the year 2018 with Draft Projections for the period 2019-2020. To compare years 2017 and 2018 more realistically, Table 1 shows a comparison between the basic budget lines planned in the 2017 Budget, the Draft Amending Budget for 2017 and in the 2018 Draft Budget.

Table 1 Plan of the state budget revenue and expenditure and general budget balance, in million HRK and in %

	2017 plan	2017 review	2018 plan	C – B	C / B (growth rate in 2018, in %)
	A	B	C		
Total revenue	**121.574**	**122.450**	**129.030**	**6.581**	**5.4**
Operating revenue	121.013	121.740	128.231	6.490	5.3
Tax revenue	72.793	75.111	75.304	193	0.3
Personal income tax and surtax	2.027	2.027	0	-2.027	-
Corporate income tax	7.165	8.177	8.316	139	1.7
Value added tax	46.199	47.513	49.575	2.063	4.3
Excise duties	15.219	15.242	15.376	134	0.9
Contributions	23.086	23.144	24.253	1.109	4.8
Grants	11.174	9.251	13.803	4.552	49.2
Other revenue	13.961	14.233	14.868	635	4.5
Revenue from sale of nonfinancial assets	560	709	800	90	12.7
Total expenditure	**128.390**	**126.779**	**133.349**	**6.569**	**5.2**
Operating expenditure	124.362	123.573	129.314	5.741	4.6

Wage bill	26.503	26.774	27.940	1.166	4.4
Material expenditure	12.525	12.472	13.153	681	5.5
Financial expenditure	10.633	9.839	9.917	78	0.8
Subsidies	6.517	6.234	6.555	321	5.2
Compensation to citizens and households	46.129	46.065	47.776	1.711	3.7
Grants	15.687	15.584	16.499	916	5.9
Other expenditure	6.368	6.605	7.473	869	13.2
Expenditure for acquisition of nonfinancial assets	4.027	3.207	4.035	828	25.8
State budget balance	**6.816**	**-4.330**	**-4.319**	**11**	**-0.3**
% GDP	-1.9	-1.2	-1.1		
Consolidated general government according to national methodology					
Balance in % GDP	-1.5	-1.0	-0.8		
Consolidated general government according to ESA2010 methodology					
Balance in % GDP	-1.3	-0.6	-0.5		

Source: Ministry of Finance

The total state budget revenue for 2018 is planned at the level of HRK 129.0 billion. The implementation of the new Act on the Financing of Units of Local and Regional Self-Government will have the greatest impact on revenues in the next year. Starting from next year, the new Act will turn over all income tax revenue to local and regional self-government units, so no revenue is planned at this line in the state budget. Grant revenue should contribute significantly to the growth of total revenue, but there is a need to be cautious due to its poor performance in 2017. Namely, it is expected that grant revenue could rise by HRK 4.6 billion and reach the level of HRK 13.8 billion, which is related to the expectation of a considerably better use of European Union funds.

As for the expenditure side, since in 2018 a significant increase in grant revenue is expected, expenditures financed from these revenues are increased as well, which means that this particular increase does not affect the budget deficit. Total expenditure in 2018 is planned at the level of HRK 133.3 billion, while the Draft Amending Budget for 2017 projects this amount at HRK 126.8 billion. Total expenditure increased by HRK 6.6 billion, of which expenditures financed from EU funds and own and assigned revenues increased by HRK 5.1 billion, and expenditures financed from sources affecting the deficit level by 1, 5 billion. An increase in the cost of compensation to citizens and households, due to the anticipated pension indexation and the overall effect of increasing pensions by special regulations, accounts for the largest share in the growth of expenditures affecting the deficit. Significant contributions to the growth of expenditures in 2018 also include the wages of civil servants and employees in the public sector due to the full-year effect of the wage increase. On the expenditure side, a decrease is expected at the grant expenditure line due to smaller transfers to local units on the basis of income tax. A decrease in interest expenditures is expected due to favourable financing conditions and the continued improvement of the general government balance. In the years ahead, a slight growth in expenditure is expected, which should be closely monitored with the aim to control the budget deficit and public debt.

According to the above plans, the budget deficit in 2018 should be reduced to 1.1% of GDP, to 0.5% in 2019, while a surplus of 0.4% is expected in 2020. A deficit of 0.8% GDP is projected at the general government level in 2018, of 0.3% in 2019, while in 2020 a 0.7% GDP surplus is planned. According to the ESA2010 methodology, a deficit of 0.5% is expected in 2018, while in 2019 the Republic of Croatia should have a balanced general government budget. Compared with the original budget for 2017, strong fiscal consolidation is expected to continue in 2018. However, the comparison with the Draft Amending Budget for 2017 indicates that the planned deficit reduction in 2018 is very small. Namely, for the year 2017, a budget deficit of 1.2% of GDP is planned and the general government deficit of 1% according to the national methodology (or 0.6% of GDP according to ESA2010 methodology).

The Fiscal Responsibility Act stipulates that the *basic fiscal rule* shall be based on the Adjustment Plan for the purpose of achieving the medium-term budget target and that the Adjustment Plan shall be determined by the Government of the Republic of Croatia on the recommendation of the Council of the European Union. Since the Government of the Republic of Croatia has not established the Adjustment Plan, the basic rule cannot yet be applied, and a temporary fiscal rule is applied instead which stipulates that the general budget expenditure growth rate shall not be higher than the growth rate of the gross domestic product, whereby general budget expenditure does not include expenditures for interest rates and expenditures for the implementation of EU programmes.

The Fiscal Policy Commission is of the opinion that the Draft Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Entities for the year 2018 complies with the fiscal rule under the Fiscal Responsibility Act.

The Republic of Croatia is also obliged to respect fiscal rules set out in the preventive arm of the Stability and Growth Pact of the European Union. One of the key indicators for assessing compliance with European fiscal rules is structural deficit. According to the European Commission estimates, Croatia’s structural deficit could rise from 0.9% in 2017 to 1.9% in 2018. Thus, the Republic of Croatia would have a deficit higher than its medium-term budgetary target, which is set at the maximum level of a 1.7% GDP structural deficit. The European Commission also expects a mild growth in the structural deficit to 2.0% of GDP in 2019. If this were the case, the trend would be in the wrong direction. The projections of the Ministry of Finance presented to the Fiscal Policy Commission also indicate an increase in the structural deficit, but somewhat lower than -1.5% of GDP in 2018, thus keeping the Republic of Croatia within its mid-term budgetary target. The Commission warns that an increase in the structural budget deficit in 2018 might entail fiscal risks as well as undermine the credibility of the intention to introduce the Euro, and calls on the Government of the Republic of Croatia to monitor the developments regarding structural deficit and to ensure it remains within the targeted limits.

Croatian Government’s Projections annexed to the 2018 Draft Budget indicate a reduction in public debt which should fall below 70% of GDP by 2020. This is a positive trend towards fiscal consolidation and complies with the requirements of the Stability and Growth Pact of the European Union.

To conclude, the Commission considers it positive that the Government of the Republic of Croatia has proposed a budget aimed at reducing the nominal deficit and reducing public debt, which is extremely important for establishing fiscal balance. However, the Commission also considers it necessary to start implementing a counter-cyclical fiscal policy i.e. to make savings in the period of budget revenue growth for the period when budget revenue stagnates or falls due to recession cycles. In this context, it would be advisable for the Government of the Republic of Croatia to define in the explanatory memorandum accompanying the Draft Budget which category of expenditure they will reduce if the planned revenue is not achieved. In addition to the risk of collecting lower revenues than planned, there is a risk that expenditures could increase in the event of partial or full compliance with trade union requirements or instituted lawsuits.

The Commission proposes that future explanatory memoranda accompanying drat budgets submitted by the Government to the Croatian Parliament should clearly state the extent to which the draft budget and projections are aligned with the Fiscal Responsibility Act. Although such an assessment is not required by law, the Commission considers that the inclusion of an assessment of compliance with fiscal rules in the explanatory statement of the budget would clearly show the importance attached by the Government of the Republic of Croatia to the Fiscal Responsibility Act and the fiscal rules set forth therein. It is worth recalling that the Commission has repeatedly requested that the documents submitted to the Croatian Parliament contain the Government's assessment of the compliance with fiscal rules. This is extremely important for MPs in the Croatian Parliament to better understand the risks ensuing from draft budget adoption from the standpoint of compliance with the Fiscal Responsibility Act.