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17th position paper of the Croatian Parliament Fiscal Policy Commission on the application of the fiscal rules for the year 2017 and on the projected application of the fiscal rules in line with the Convergence Programme of the Republic of Croatia for the period 2018-2021

At its 25th meeting held on 12 June 2018, the Fiscal Policy Commission discussed the application of the fiscal rule for the year 2017, basing its assessment thereof on the following documents:

a) Excessive Deficit Procedure Report, Republic of Croatia, April 2018 (ESA 2010), published by the Croatian Bureau of Statistics on 20 April 2018;

b) Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2017, 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 2017, also adopted by the Government of the Republic of Croatia at its 97th session held on 24 May 2018.

The Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2017 and the Draft Annual Report on the Application of the Fiscal Rules for 2017 were submitted by the Government of the Republic of Croatia to the Speaker of the Croatian Parliament on 24 May 2018.

The Commission also assessed the macroeconomic projections and the application of fiscal rules in the Convergence Programme of the Republic of Croatia for the period 2018-2021, adopted by the Government of the Republic of Croatia on its 93rd session held on 26 April 2018.

The Fiscal Responsibility Act (Official Journal *Narodne novine* 139/10 and 19/14) defines the fiscal rules, while the Decision on the Establishment of the Fiscal Policy Commission (Official Journal *Narodne novine* 156/2013) tasks the Commission with examining and assessing the application of the fiscal rules and the macroeconomic and budgetary projections.

The Fiscal Policy Commission is of the opinion that the fiscal rule as defined in Article 5 of the Fiscal Responsibility Act was met in 2017. Article 5 paragraph 1 of the Act stipulates that "the structural balance, presented as a share in the gross domestic product (hereinafter: GDP), will be achieved according to the adjustment plan in order to reach the medium-term budgetary objective, while the growth of total expenditures shall not exceed the reference potential growth rate of GDP, increased by the expected price increase". The Commission believes that the temporary fiscal rule applied in previous years no longer applies now that the excessive deficit procedure has ended. The Commission considers that by entering the preventive arm of the Stability and Growth Pact, the Republic of Croatia assumed the obligation to bring its structural deficit to the level of the medium-term budgetary objective. In the Convergence Programme for the period 2016-2019, the Government of the Republic of Croatia accepted the medium-term budgetary objective of a 1.75% of GDP deficit adopted by the Council of the European Union, and the Convergence Programme can be considered as an adjustment plan based on which the fiscal rule in Article 5 of the Fiscal Responsibility Act is applied.

The Commission considers that in the case where the structural balance is above or at the level of the medium-term budgetary objective (the target is reached or exceeded), the second part of the rule governing the allowed expenditures (the expenditure rule) is not relevant and does not apply. This attitude is in line with the rules under the Stability and Growth Pact[1]. The fiscal rule in Article 5 paragraph 1 of the Fiscal Responsibility Act describes the necessary adjustment to reach the medium-term budgetary objective. In a situation where the medium-term budgetary objective is attained, it is considered sufficient to maintain the structural balance at or above the medium-term budgetary objective and to respect the public debt rule, but there is no explicit obligation to limit the general government expenditures.

Assessment of the fiscal rules application in 2017

[1] See: Vade Mecum on the Stability & Growth Pact: 2018 Edition, available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip075_en.pdf.

According to the Excessive Deficit Procedure Report of the Republic of Croatia, drawn up in line with the ESA 2010, in 2017, for the first time since the ESA 2010 was introduced (data available since 2002), the general government surplus amounted to HRK 2.754 million (or 0.8% of GDP) The general government surplus is a significant achievement. It is the result of favourable economic developments and several years of efforts by the executive power to consolidate public finances.

To assess compliance with fiscal rules, it is necessary to consider the state of the structural balance[2] and compare it with the medium-term budgetary objective. In its Draft Annual Report on the Application of the Fiscal Rules for 2017, the Government of the Republic of Croatia estimated that the structural balance of the general government amounted to 0.9% of GDP. The Commission has decided to base its conclusions about the compliance with fiscal rules on the methodology of the European Commission, i.e. on their estimate of the output gap and structural balance.[3] According to that estimate, the structural balance in 2017 was 0.4 % of GDP. The Council of the European Union adopted the calculation of the minimum level of the medium-term budgetary objective, which ensures for each individual country the achievement of a deficit below 3% of GDP and the maintenance or reduction of public debt below 60% of GDP in the medium term. Member States may also choose a more ambitious mid-term target than the minimum required. The minimum medium-term budgetary objective for the Republic of Croatia was set at -1.75% of GDP. This is the lowest minimum objective (i.e. the maximum deficit allowed) of all EU Member States, introduced due to the positive long-term effects of pension reform on the budget and public debt levels below 60% of GDP at the time when the objectives were set in 2015. The Government of the Republic of Croatia set this minimal medium-term budgetary objective as its own medium-term budgetary objective.

[2] Structural balance is a deficit or surplus of the general government that does not include the cyclical economic effects and one-off and temporary measures that have an impact on the revenue and expenditure of the general government. In accordance with the provisions of the Stability and Growth Pact, it is calculated according to the methodology of the European System of National and Regional Accounts (ESA 2010) and is defined in Article 4, Paragraph 1, item 6 of the Fiscal Responsibility Act.

[3] European Commission (2018), “Assessment of the 2018 Convergence Programme for Croatia”, available at https://ec.europa.eu/info/sites/info/files/economy-finance/11_hr_2018_cp_assessment.pdf

By comparing the estimated structural balance (surplus of 0.4% of GDP) and the medium-term budgetary objective (deficit of 1.75% of GDP), the Commission concludes that in 2017 the fiscal rule regarding structural balance was met. Since the medium-term budgetary objective was achieved, the part of the rule referring to the expenditure growth is not relevant for assessing the implementation of the fiscal rule.

The Commission examined the compliance with the rule on public debt, which is an integral part of the Stability and Growth Pact, although this rule is not specified in the Fiscal Responsibility Act. According to the Stability and Growth Pact, public debt should not exceed 60% of GDP. If the share of public debt is higher, the difference between the public debt share in GDP and the reference share of 60% has to decrease at the average rate of one twentieth per year. Croatia's public debt in 2015 amounted to 83.8% of GDP; 80.6% of GDP in 2016, and 78% of GDP in 2017. The realized reduction of public debt in GDP by 2.6 percentage points in 2017 was higher than the minimum required reduction, meaning that the rule of public debt was also observed.

Assessment of macroeconomic projections and the implementation of the fiscal rules in the fiscal projections from the Convergence Programme for 2018-2021

The Commission also examined the macroeconomic projections and assessed the implementation of the fiscal rule in the fiscal projections of the *Convergence Programme of the Republic of Croatia for the period 2018-2021*, adopted by the Government of the Republic of Croatia on 26 April 2018.

The Commission considers that the macroeconomic projections underlying the Convergence Programme are realistic and do not deviate significantly from the European Commission's projections. Certain differences are present in the calculation of potential growth and output gap, whereby the Government of the Republic of Croatia anticipates significantly more favourable developments. General government balance projections from the Convergence Programme point to a lower balance (i.e. a larger deficit) than the spring forecast of the European Commission. The general government balance is projected to -0.5% of GDP in 2018, -0.4% of GDP in 2019, 0.0% of GDP in 2020 and 0.5% of GDP in 2021.

In its assessment of the Convergence Programme's compliance with the fiscal rules, the Fiscal Policy Commission adjusted the nominal projection of the budget balance with the European Commission's assessment of output gap. Such adjustment shows that the structural balance in 2018 will considerably worsen and will amount to -1.6% of GDP, which is close to the medium-term budgetary objective. Further deterioration is expected in 2019, when the structural balance will reach the mid-term budget objective, or slightly below that level, and will remain at the same level in 2020, with a slight improvement in 2021 (Table 1).

The Commission is of the opinion that the fiscal rule was met in the fiscal projections of the *Convergence Programme of the Republic of Croatia for the period 2018-2021*, emphasizing however that there are considerable risks of failing to comply with the rules as early as 2019.

In order to ensure the compliance with the fiscal rules and to reduce the risk of non-compliance in the coming period, the Commission underlines the need to find room for potential savings this year, and especially when preparing the budget for the next year. Also, when drafting the budget for 2019-2021, the Government of the Republic of Croatia should explore the existing risks and adjust the plans of state budget users and other institutions within the scope of the general government.

Regarding the compliance with the fiscal rules in the coming years, the Commission recalls that in line with the stated intention of introducing the euro as the official currency in the Republic of Croatia, it is advisable to show willingness to conduct a stricter fiscal policy by adopting a more ambitious medium-term budgetary objective, such as the one of at least -1% which is now mandatory for all members of the euro area. Additionally, the Council of the European Union is soon expected to adopt new levels of minimum medium-term budgetary objectives whose implementation will start in 2020. The current consultation process suggests that this objective for the Republic of Croatia will be stricter than the previous -1.75% of GDP. In such a situation, the projected structural deficit of -1.8% of GDP for 2020 would no longer be sufficient, and the Government of the Republic of Croatia should, as soon as possible, correct the fiscal balance to avoid the need for hasty adjustments in 2020.

Table 1: Calculation of the structural balance rule (in % of GDP)

	2017.	2018.	2019.	2020.	2021.
General Government Balance	0,8	-0,5	-0,4	0,0	0,5
One-off measures	-0,1	-	-	-	-
Cyclically-adjusted balance	0,3	-1,6	-1,8	-1,8	-1,7
Structural balance	0,4	-1,6	-1,8	-1,8	-1,7

Sources: Croatian Bureau of Statistics (general government balance for 2017); European Commission (calculation of the cyclically-adjusted balance and the structural balance based on the data on fiscal balance in the Convergence Programme 2018-2021); Ministry of Finance (fiscal balance for 2018 and 2019 from the Convergence Programme 2018-2021); Fiscal Policy Commission's own calculation.