



## CROATIAN PARLIAMENT

Fiscal Policy Commission

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### **18. Position Paper of the Croatian Parliament Fiscal Policy Commission on the Proposal for a Semi-Annual Report on the the execution of the State Budget of the Republic of Croatia for the first semester 2018 and the Proposal for the Semi-Annual Report on the application of the fiscal rules for the first semester 2018**

At its 26<sup>th</sup> meeting held on 19 September 2018, the Commission discussed the Proposal for a Semi-Annual Report on the the execution of the State Budget of the Republic of Croatia for the first semester 2018 and the Proposal for the Semi-Annual Report on the application of the fiscal rules for the first semester 2018, which was submitted in the form of an act to the Speaker of the Croatian Parliament by the Croatian Government on 13 September 2018.

**The fiscal rule is defined in Article 5 of the Fiscal Responsibility Act.** The structural balance denominated as the share in the gross domestic product (hereinafter: GDP) must be accomplished according to the adjustment plan for the purpose of achieving the mid-term budgetary objective, where the growth of the general budget expenditures must not exceed the benchmark potential growth rate of GDP, increased by the expected price growth. In the Convergence Programme for the period 2016-2019 the Government of the Republic of Croatia has adopted the mid-term budgetary objective of a deficit of 1.75% GDP.<sup>1</sup> In the case when the structural balance is at the level of or above the mid-term budgetary objective (objective has been met or exceeded), the second part of the rule which defines the allowed expenditure developments (expenditure rule) is not relevant and shall not apply. Since the Republic of Croatia has met the mid-term budgetary objective, the fiscal rule applies in the part relating to the structural balance amount which cannot be below (i.e. the deficit must not exceed) the mid-term budgetary objective.

#### **Assessment of the compliance with the fiscal rule in the first half of 2018**

The Semi-Annual Report on the the execution of the State Budget of the Republic of Croatia for the first semester 2018 has been stated according to the cash accounting national methodology which differs from the European system of accounts method (ESA2010), according to which the fiscal rule is defined. Since the fiscal data according to ESA2010 generally lag behind the data

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<sup>1</sup> Available at:

<http://www.mfin.hr/adminmax/docs/Program%20konvergencije%20RH%20za%20razdoblje%202016.%20-%202019.pdf>

determined by the cash accounting method, currently available is only the data for the first quarter of 2018. Thus, while assessing the fiscal rule for the first half of 2018, the Commission has taken into account the available data for the first quarter, while the assessment for the second quarter was based on the national methodology and data from the Proposal for a Report on the the execution of the State Budget of the Republic of Croatia for the first semester 2018. The Commission's focus was on (1) the achievement of the macroeconomic projections for 2018, (2) the developments of the state budget revenues and expenditures categories, (3) achievement of the budgetary balance according to the national methodology and (4) the Commission assessed the possible achievement of the fiscal risks for the remaining period of 2018.

**The Commission holds that the macroeconomic projections of the Ministry of Finance used to draw up the 2018 budget are reliable and realistic in terms of the assessment of future trends.** This is confirmed by economic developments in the first half of the year that are in line with the projections. The budget for 2018 is based on real growth of 2.9%, or nominal growth of 4.6%. The expected consumer price growth in 2018 is 1.5%. The latest projections of the Government of the Republic of Croatia contained in the Economic and Fiscal Policy Guidelines for the period 2019-2021 retain similar real and nominal growth rates.<sup>2</sup> According to the preliminary data of the Croatian Bureau of Statistics, in the first six months of 2018, compared to the same period last year, real GDP grew by 2.7% and nominal by 4.6%. The Commission considers that by the end of this budget year macroeconomic risks for the achievement of the envisaged developments are low.

**Budget revenues and expenditures are increasing slower than the projected nominal income for 2018.** Thus, the operating revenue in the first half of 2018 was by 3.0% higher than in the same period. Taxes on goods and services, which account for more than half of the state budget revenue, grow somewhat faster at a rate of 5% compared to the previous year. Contributions increased by 7.5% on the basis of wage bill growth, which is growing due to increasing nominal wage levels and number of employees. At the same time, revenues from the sale of nonfinancial assets, which likely to oscillate stronger throughout the year, are considerably reduced and are not progressing as planned. Operating expenditures in the first half of 2018 were by 3.5% higher than in the same period of 2017. Expenditure for employees recorded the highest growth (5.8%). Significant savings were made in financial expenditures, which were as much as 7% (HRK 360 m) less than in the previous year. Expenditures for the acquisition of nonfinancial assets, which are largely financed by European funds and do not affect the budget balance, are also lower than planned. Since the potential positive effect of these expenditures on the economy is significant, these "savings" actually indicate adverse developments.

**The Commission estimates that with the mentioned developments in the state budget in the first half of 2018 and with the expected developments in the second part of the year, the fiscal rule of the structural balance in 2018 will be complied with.** For the final assessment of compliance with the fiscal rules, it will be necessary to collect final data according to the

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<sup>2</sup> Available at:

<http://www.mfin.hr/adminmax/docs/Smjernice%20ekonomske%20i%20fiskalne%20politike%202019.%20-%202021.pdf>

ESA2010 methodology. According to the national methodology, the general government budget recorded a surplus in the first half of the year. However, the balance trends vary in different sectors of the general government. The central government budget recorded a deficit of HRK 1.9bn. or 0.5% of GDP. By contrast, significant surpluses were recorded by extrabudgetary users (HRK 1.8bn) and the local government (HRK 1.7bn). Thus, the total budget balance recorded a surplus of HRK 1.6 billion or 0.4% of GDP. It is expected that these users will spend a part of the achieved surplus in the second part of the year and that the planned size of the structural balance will be achieved.

**The materialisation of fiscal risks, especially the risks in the shipbuilding sector, will affect the fiscal performance in 2018.** Potential payments per issued guarantees could increase capital transfers in this and subsequent years, which would undermine the fiscal plans and reduce the scope for other fiscal measures envisaged. Furthermore, the Republic of Croatia is in a positive phase of the economic cycle, so that positive fiscal developments are largely the result of favorable cyclical movements. At this stage of the cycle, it is expected that nominal budget surpluses will be attained to keep the structural balance within the defined medium-term budgetary objective. Fiscal development projections, such as those contained in the Economic and Fiscal Policy Guidelines for the period 2019-2021, suggest that all fiscal space could be used up by 2019 and that the structural deficit could approach the permitted margin, thus reducing the possibility of stronger counter-cyclical fiscal policy in the medium term, particularly in the circumstances of a possible global and domestic economy slowdown, which would automatically deteriorate the budget balance. The Commission reminds that at the beginning of next year the Council of the European Union is to adopt the minimum medium-term budget targets for the Member States. It is likely that the new minimum balance, i.e. medium-term budgetary objective for the Republic of Croatia will be stricter than the current one, which will add further pressure for fiscal consolidation in the next period. The public debt of the Republic of Croatia is still very high and it is necessary to take advantage of favorable economic trends to reduce it as quickly as practicable.

The **Fiscal Policy Commission** recalls that for the purpose of quality monitoring of the fiscal policy status and the assessment of compliance with European and domestic fiscal rules the position of the Fiscal Policy Commission should be redefined in the direction of strengthening its independence and capacity. Therefore, it advocates the urgent adoption of a new Fiscal Responsibility Act that would strengthen the numerical fiscal rules and regulate the monitoring of their implementation.