CROATIAN PARLIAMENT
[1]Fiscal Policy Commission
Class: 021-19/15-10/04
Ref. No.: 6521-05-1/15-
Zagreb, 9 June 2015

Re: Position paper of the Fiscal Policy Commission on the application of the fiscal rule for 2014

At its 9th meeting held on 29 May and 9 June 2015 the Fiscal Policy Commission considered the application of the fiscal rule for 2014. The following documents were used as the basis for the assessment: a) Report on the Excessive Budget Deficit and General Government Debt in the Republic of Croatia (ESA 2010), published by the Croatian Bureau of Statistics on 20 April 2015; b) Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2014, which was submitted to the Croatian Parliament by the Croatian Government on 21 May 2015; c) Draft Annual Report on the Application of the Fiscal Rule for 2014, which was submitted to the Croatian Parliament by the Croatian Government on 21 May 2015. The Fiscal Responsibility Act (official gazette "*Narodne novine*" No. 139/10 and 19/14) sets the fiscal rule, whereas the Decision on the Establishment of the Fiscal Policy Commission, that was adopted by the Croatian Parliament at its session on 18 December 201, defines, among other things, the task of the Commission to consider and assess the compliance with the fiscal rule as defined in the Fiscal Responsibility Act in the draft semi-annual and annual report on the execution of the state budget and financial plans of extra-budgetary users of the state budget.

Due to long-term fiscal imbalances characterized by high budget deficit and growing public debt, the EU Council adopted in 2014 a Decision on the existence of excessive deficit and Recommendations of the EU Council with a view to bringing an end to the situation of an excessive government deficit, by which the excessive deficit procedure for Croatia was formally initiated. According to the Council recommendations, Croatia should correct the excessive deficit situation by 2016 by reducing the general government deficit to 4.6% of GDP in 2014, 3.5% of GDP in 2015 and 2.7% in 2016. To achieve the above-mentioned targets, Croatia was supposed to adopt consolidation measures of 2.3% of GDP in 2014 and

[1] ***Fiscal Policy Commission of the Croatian Parliament, phone: 4569-427, fax: 6303-025, e-mail: financ@sabor.hr***

1% of GDP in 2015 and 2016. However, the general government deficit, despite the measures implemented, increased to 5.7% of GDP in 2014 due to a lower economic growth than expected and due to debts of public companies assumed by the state. The Government failed to reduce the general government deficit in 2014, yet adopted consolidation measures to an extent that was agreed upon with the European Commission, leading to the conclusion that Croatia has undertaken effective action to reduce the excessive deficit. The implementation of consolidation measures was mainly directed at the revenue side of the budget, primarily through the increase in the health insurance contribution rate, changes in the pension insurance scheme based on accelerated retirement plan, increased taxation on earnings from games of chance, introduction of a telecommunication services fee and increase in excise duties on energy products. However, strong structural measures on the expenditure side failed to materialise, despite of a certain reduction in subsidies, intermediate consumption, social benefits and investment expenditures. Structural measures aimed at increasing the efficiency of the public administration and reducing structural expenditures did not materialise either. Thus, in 2014 significant actions were taken to reduce the deficit, which however have not resulted in a deficit decrease yet. Among other things, concern remains around the methodology of adopting structural measures which are not the result of a well-conceived strategy in a mid-term budget period, but instead are based on *ad hoc* (discretionary) measures. The nature of fiscal consolidation suggests that a review of such an approach is required, because in the past, when deficits were reduced by increasing indirect taxes and reducing transfers and wages, consolidation results were significantly better. The Commission therefore calls upon the Government to step up efforts to achieve a permanent reduction of the government deficit in line with the EU Council recommendations and to undertake additional measures aimed at bringing an end to the excessive deficit situation within the set deadline.

It is noteworthy that the important measure from the Council recommendations relating to the adoption of amendments to the Fiscal Responsibility Act also failed to materialise. The Commission emphasises that with the amendments of the Budget Act in February 2015 (*Narodne novine* No. 15/15) Croatia lost all legal control of the public debt, which increased to exceed 85% of GDP at the end of 2014 and is expected to exceed 90% of GDP at the end of 2015. Fast growth of the public debt at high levels indicates the presence of fiscal weaknesses and poses a great threat to the sustainability of public finances. Ten years ago the public debt was at the level of 35% of GDP, which was at the level of comparable countries, whereas today it is far above the level of comparable countries. High public debt level can become an insurmountable burden for public finances in the case of deterioration of the liquidity situation in the global financial market. A high debt level is always accompanied by a high level of expenditures for interests, which in circumstances of a relatively low economic growth may result in an automatic increase in public debt, even in conditions off balanced primary deficit/surplus (so-called *snowball effect*).

The budget expenditures are under constant pressure of overdue liabilities payments, especially in the healthcare sector. Every year one part of the budget funds is used to pay arrears from previous years. The Government is trying to solve this problem by separating the Croatian Health Insurance Fund from the state treasury. The Commission holds this to be a risky undertaking and proposes that the possible return of the Croatian Health Insurance Fund to the state treasury system be considered in early 2016 in the case of new overdue liabilities.

According to the Fiscal Responsibility Act, a provisional fiscal rule applies in 2014 because Croatia is under the excessive deficit procedure and because neither the medium-term budgetary target has been set nor has the adjustment plan been adopted. According to the provisional fiscal rule, year-over-year growth rate of the general budget expenditure should not exceed the growth rates of the projected or estimated GDP in current prices, whereby exemptions for certain categories of expenditures are allowed. Thus, in the assessment of the fiscal rule the total expenditure of the general government does not include interest expenditures, expenditures for EU programmes and changes in expenditure due to changes in the institutional coverage of the general budget. The Government of the Republic of Croatia stated in the Draft Annual Report on the Application of the Fiscal Rule for 2014 that these adjusted expenditures were reduced by 0.3% of GDP, while the nominal GDP in 2014 dropped by 0.4%. Therefore, the Government concluded in the Draft Report that "the fiscal rule for 2014 was not met", which is explained by "the negative economic developments and deflationary pressures." The Fiscal Policy Commission has discussed the scope of the total expenditures of the general government relevant to the calculation of the fiscal rule and is of the opinion that the total expenditures should not be adjusted (reduced) by the amount of reimbursement of EU aid because domestic sources of funding are actually being replaced by the sources from the EU.

The Commission's assessment of expenditures is shown in Table 1. On the basis of this calculation, total expenditures relevant to the calculation of the fiscal rule increased by 0.2%, while nominal GDP declined by 0.4%, and therefore the Commission concludes that the Croatian Government did not fulfil the fiscal rule in 2014.

The Commission reminds that the fiscal rule was not fulfilled in 2013 either, so the rule was not respected for a second consecutive year. The Commission understands that the adverse economic conditions could cause increased difficulties in applying the fiscal rules, but recalls that the failure to meet the fiscal rules leads to an erosion of confidence in fiscal policy. If the Government of the Republic of Croatia and the Croatian Parliament consider that the fiscal rules under the Fiscal Responsibility Act are not set up in a way that provides an adequate framework for responsible fiscal behaviour, then appropriate rules should be adopted and strictly respected. There have been a number of proposals in this sense. These efforts need to be intensified and a satisfactory fiscal framework should promptly be set up to fit in the

European context (Stability and Growth Pact and the accompanying regulations) and to meet the domestic need for fiscal responsibility.

It should be noted that in 2014 there were visible fiscal efforts that resulted in slowing down the growth of the general budget expenditures, though these were not sufficient to reduce the general government deficit. Payments made by the Government under state guarantees to cover the public enterprises' debts account for a large part of the deficit increase. This suggests that the Government should be more careful while appointing managing boards, so that they are more professional and committed to increasing the efficiency of financial management in public companies. It should also be mentioned that detailed data on deficit/surplus in various segments of the general government sector according to ESA methodology are not available, making it unclear which deficits were created in which parts of the system. The Commission urges the Croatian Bureau of Statistics to publish more detailed information instead of providing rather sketchy data as is the case in the current publication for Eurostat. The Government has clearly recognized the problem of the extra-budgetary users and public companies, and the Commission welcomes the Government's focus on the consolidation of that part of the public system, but the changes must not be cosmetic and should involve more than just mergers and smaller savings for directors' salaries or the costs of renting office space. The consolidation must immediately bring an end to creating further deficit and debt in this part of the public sector. The in-depth review of expenditures conducted in late 2014 and early 2015 is another positive step in the direction of taking control over public finances. The Commission considers that the findings of the in-depth analysis should have been implemented with more determination.

Table 1: The calculation of the fiscal rule for 2014, in thousand HRK and in %

General Government Expenditure according to ESA2010 (1)	2013	2014
	157.584.250	157.913.848
Excluded expenditures:		
- interest expenditures (2)	**11.501.843**	**11.475.874**
- expenditures for implementing EU programmes (3)	**1.100.650**	**1.188.238**
- change of expenditures due to institutional changes (4)	**not available**	
= (1) - (2) - (3) - (4)	**144.981.758**	**145.249.737**
Changes of expenditures for the calculation of the fiscal rule		**0,2 %**
Nominal GDP	**330.135.465**	**328.926.761**
Changes of GDP for the calculation of the fiscal rule		**-0,4 %**

Source: Croatian Bureau of Statistics, Ministry of Finance (for excluded expenditures), own calculation

The Fiscal Policy Commission notes that the Government has made significant changes on the expenditure and revenue side of the budget in 2015, while a budget revision has not taken place. Therefore, the Commission suggests that the Government should as soon as possible propose to the Croatian Parliament amendments to the State Budget for 2015, in line with Article 43 of the Budget Act. We find this proposal necessary in order to encourage the responsible ministry to end the practice of continuous violations of regulations in the area of fiscal responsibility, of which the Commission has recurrently and repeatedly warned. The other aim of this proposal is to prevent the situation in which the Government's Decisions would negate the Budget, reduce the transparency of the budget and undermine the democratic nature of the entire budget process – adoption **and** execution of the budget – by acting in violation of legal provisions (provisions of the Budget Act on budgetary principles (Articles 4 to 12) and on amendments to the budget (Article 7, 39, 43, etc.)).

The Commission considers that there is an extremely high risk that Croatia will not exit the situation of excessive deficit by 2016. Such a risk has also been confirmed in the Convergence Programme in which the Government estimates that the reduction of the budget deficit below 3% will take place only in 2017. However, the criterion of public debt is also important for overcoming the situation of excessive deficit. Given the growing public debt in Croatia, which exceeds 60% of GDP, it is necessary to ensure the reduction of public debt at a satisfactory pace in two years after reducing the budget deficit. The projections of public debt prepared by the Croatian National Bank in the baseline scenario show that, along with plausible macroeconomic assumptions and gradual achievement of equilibrium of the primary budget balance, Croatia cannot expect a reduction of the public debt by 2020, when it would amount to more than 96% of GDP. Such projections indicate that Croatia cannot exit the excessive deficit situation before 2019, not even in the event that by then the budget deficit is reduced to below 3%. The Government must pay much more attention to the state and trends of public debt because otherwise this could become a significant limitation to the economic recovery of the country.