Fiscal Policy Commission
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8th Position Paper of the Fiscal Policy Commission of the Croatian Parliament on the Draft Annual Report on the execution of the State Budget of the Republic of Croatia for 2019 and Draft Annual Report on the application of fiscal rules for 2019

At its 5th meeting held on 22 September 2020, the Fiscal Policy Commission (hereinafter: the Commission) deliberated on the Draft Annual Report on the execution of the State Budget of the Republic of Croatia for 2019 and Draft Annual Report on the application of fiscal rules for 2019, which were submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia.

The Commission concluded that, despite a slight deterioration in the structural balance, fiscal rules for 2019 have been met.

1. **Assessment of compliance with fiscal rules for 2019**

   To assess the application of fiscal rules in 2019, the following were used: a) *Report on the excessive budget deficit procedure and the level of general government debt in the Republic of Croatia* from April 2020 (ESA 2010) published by the Central Bureau of Statistics (CBS) on 22 April 2020 and[1] b) *Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2019*[2] and c) *Draft Annual Report on the Application of Fiscal Rules for 2019* **adopted by the Government of the Republic of Croatia at its 230th session held on 14 May 2020.** In its assessment, the Commission also used other documents such as the Convergence Program[3] of the Republic of Croatia and the projections and analyses of the European Commission.

[1] Available at: https://www.dzs.hr/Hrv_Eng/publication/2020/12-01-02_01_2020.htm
[2] Both documents available at:
https://vlada.gov.hr/UserDocsImages/2016/Sjednice/2020/Svibanj/230%20sjednica%20VRH/230%20-%2025.pdf
[3] Available at:
https://vlada.gov.hr/UserDocsImages/2016/Sjednice/2020/Travanj/227%20sjednica%20VRH/Novi%20direktorij/227%20-%202%20Program%20konvergencije%20Republike%20Hrvatske%20za%202020.%20i%202021.%20godinu.pdf.

Fiscal Responsibility Law (Official Gazette, No. 111/2018) defines fiscal rules and determines that the Commission's task is to consider and assess the application of fiscal rules in medium-term budget documents and the annual budget execution report. Three fiscal rules have been defined (Articles 6-8), which have been taken over from the Stability and Growth Pact. The first rule, *the structural balance rule,* is met when the structural balance stated in the annual report on the application of fiscal rules for the previous year is equal to or greater than the medium-term budgetary objective, i.e. when it is achieved according to the adjustment plan defined in accordance with EU legislation. The second rule, *the expenditure rule*, limits the growth of general budget expenditure adjusted for the effects of tax changes, which must not exceed the reference potential GDP growth rate. The expenditure rule does not apply if the structural balance rule is met. The third fiscal rule, *the debt rule*, limits the level of public debt to 60% of GDP, i.e. determines the dynamics of its reduction to the reference value.

Structural balance rule. The calculation of the general government balance is based on the common European methodology (ESA 2010). According to the *Report on the Excessive Budget Deficit and the Level of General Government Debt in the Republic of Croatia* from April 2020, the general government budget in 2019 for the third year in a row had a surplus of HRK 1.6 billion or 0.4% of GDP in 2019. This execution is significantly better than the planned deficit of -0.1% of GDP. Observed by sectors, the surplus was recorded by the central government (HRK 2.1bn) and social funds (HRK 0.9bn), while at the local government level the deficit increased to HRK 1.4bn. The general budget surplus is the result of continued favourable economic trends and the consolidation of public finances from previous years.

To calculate the structural balance rule, it is necessary to assess the impact of cyclical economic trends on the budget, for which a common methodology[4] has been established at the level of the European Union. However, in the conditions of a deep economic crisis caused by a pandemic, the problems of calculating the cyclical position are further emphasized because they imply a number of assumptions related to current and future trends. Precisely to avoid this problem in the *Draft Annual Report on the Application of Fiscal Rules for 2019*, the Government of the Republic of Croatia assessed the cyclical effect using assumptions and

[4] More on common methodology: European Commission. "Vade Mecum on the Stability & Growth Pact, 2019 Edition", European Economy Institutional paper 101, April 2019). Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip101_en.pdf.

estimates from the time before the pandemic and assessed that the positive production gap in 2019 was high 2, 1% of GDP, which positively contributed to the budget result of 0.9% of GDP, bringing the structural balance to -0.6% of GDP. The inclusion of the current impact of the crisis with optimistic assumptions about its duration as incorporated by the European Commission in its last *Spring 2020 Economic Forecast* published in May indicates an even larger positive output gap in 2019 in the amount of as much as 3.7% of GDP, i.e. favourable cyclical impact on the budget in the amount of 1.6% of GDP, so the corresponding structural balance in 2019 was -1.2% of GDP.

Despite the wide range of estimates of the structural balance (-0.6% to -1.2% of GDP), which could subsequently increase in the conditions of further deepening of the recession, the achieved positive nominal balance enabled the achievement of the medium-term budgetary objective which for 2019 was set at a relatively low level of -1.75% of GDP.

Therefore, the Commission concludes that the fiscal rule of the structural balance in 2019 has been met.

Expenditure rule. Given that the medium-term budgetary objective has been achieved, the part of the rule relating to expenditure growth does not apply. However, the Commission warns that expenditures, increased by the effect of revenue cuts due to tax changes, have been growing faster than potential economic growth for two years in a row. In this way, the savings from previous years have been spent and the space for a stronger influence and effect of fiscal policy in the conditions of the crisis has been reduced.

Public debt rule. The Commission also considered the public debt rule, according to which public debt must not exceed 60% of GDP. If the public debt exceeds the reference amount, it should be reduced at an average rate of one twentieth per year. The share of public debt in GDP in Croatia has been continuously declining since 2014 (from 84.7% in 2014 to 73.2% in 2019). The reduction of the share of public debt in GDP in 2019 compared to 2018 from 1.5 percentage points (i.e. from 74.7% to 73.2%) was greater than the minimum required reduction, **thus achieving the public debt rule**. There is a noticeable slowdown in the reduction of the share of public debt in GDP compared to previous years.