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9 th Position paper of the Fiscal Policy Commission on the application of the fiscal rule for the year 2015

At its 15th meeting held on 11 November 2016, the Fiscal Policy Commission reconsidered the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2015 and Draft Annual Report on the Application of the Fiscal Rules for 2015 submitted by the Croatian Government to the Speaker of the Croatian Parliament by the Act on 3 November 2016.

The *Fiscal Responsibility Act* (official gazette Narodne novine No. 139/10 and 19/14) sets the fiscal rules, whereas the Decision on the Establishment of the Fiscal Policy Commission, adopted by the Croatian Parliament at its session of 18 December 2013, defines, among other things, the task of the Commission to consider and assess the compliance with the fiscal rules 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. Fiscal Policy Commission has not changed its position with respect to the 8th Position paper of 3 June 2016 therefore we mostly repeat it.

According to the Report on the Excessive Budget Deficit and General Government Debt in the Republic of Croatia (Croatian Bureau of Statistics, 21 October 2016) drawn up in line with ESA 2010 methodology, the deficit of the general government budget was reduced from -5,4% GDP in 2014 to -3,3% GDP in 2015. The increase in budget revenues in 2015 due to increased revenues from indirect taxes (excise duties and VAT) and a significant reduction in expenditures for public investment (gross fixed capital formation decreased from 12 billion kuna in 2014 to only 9.4 billion kuna in 2015) had the greatest impact on reducing the general government deficit in 2015. Revenues generated on the basis of a one-time transfer from second into the first pension pillar also had a significant impact on the budget and the trend of the general government deficit in 2015, but that particular transaction was excluded from the revenue for calculating the deficit, and on that account the deficit increased by 1,264 million kuna.

Due to the reduction of the general government deficit in 2015 for the first time a primary surplus of general government (general government deficit plus interest) was recorded in the amount of HRK 1,218 million (0.36% of GDP). The primary surplus of the general 2 government shows that in 2015 the country did not have to incur debts so as to cover the entire interest payment.

It is also important to point out that the general government deficit increased by 950 million in called guarantees by companies *HŽ Cargo* and *HŽ putnički prijevoz* as in the event of the third call of the guarantee, the entire amount of the guarantee is included in the budget deficit and in the public debt of the general government. In 2015, the statistical coverage of the general government was further expanded to include HAKOM and *Bina Istra*.

Despite the positive trends in public finances in 2015, fiscal imbalance is still present as a result of the high budget deficit. In fact, the reduction of the general government deficit is largely due to automatic stabilizers and favourable macroeconomic indicators in the service sector attributable to foreign demand. Reducing the budget deficit by decreasing public investment is not sustainable in the long run and the public sector will need investments which will increase the budget deficit if structural reforms are not implemented and if the space for increased investment is not created.

According to the Council Decision adopted in 2014 on the existence of excessive deficit and in line with the Recommendations of the Council of the EU, Croatia has to remedy 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. According to the results of the general government deficit in 2015, the target for 2015 is met because the deficit amounts to 3.3% of GDP. The government forecasts a deficit of 2.6% of GDP in 2016, which should be enough to meet the recommendations of the Council.

According to the *Fiscal Responsibility Act*, a provisional fiscal rule is applied in 2015, under which the 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 2015 that these adjusted expenditures were reduced by 3.6% of GDP, while the nominal GDP in 2015 increased by 1.8%. Therefore, the Government concluded in the Draft Report that the fiscal rule for 2015 was met.

The Fiscal Policy Commission has reached the same conclusion in its own assessment, although there are certain doubts regarding the calculation relevant for the compliance with the fiscal rule. The Commission considered the scope of the total expenditure of the general government relevant to the calculation of the fiscal rule and is of the opinion that the total expenditure should not be reduced (adjusted) by the amount of reimbursement of EU aid for direct payments in agriculture since this is a replacement of domestic with EU funds. On the basis of this calculation, total expenditure relevant to the calculation of the fiscal rule decreased by 2.1%, while nominal GDP increased by 1.8%, and therefore the Commission concludes that the provisional fiscal rule for 2015 is fulfilled.

Fiscal Policy Commission further considers that the Draft Annual Report on the Application of the Fiscal Rules for 2015 misinterpreted the GDP growth indicator relevant from the calculation of the fiscal rules. It states that the application of the fiscal rule is calculated on the basis of "expected developments in the gross domestic product during the drawing up of the budget", and later in the reasoned application of the fiscal rule it states GDP growth "that was used during the most recent amendments to the state budget for 2015". Since *Fiscal Responsibility Act* states the use of "year-over-year growth rates of the projected or estimated GDP in current prices", the Commission considers that the annual report on the application of fiscal policies should use the indicator that estimates GDP for the previous year according to the Reports of the Croatian Bureau of Statistics. Although the conclusion of respecting the application of the fiscal rules for 2015 does not change, no matter which indicator of the gross domestic product is used, it is important to accurately determine the parameters relevant to the assessment of compliance with the rules, which is one of the tasks of the expected changes in the legislative framework for the strengthening of fiscal responsibility.

Croatia should start the process of enacting amendments to the *Fiscal Responsibility Act* as soon as possible in order to strengthen the independence of the Fiscal Policy Commission and to redefine the numerical fiscal rules, which was one of the recommendations of the Council, and that is the obligation of this year's recommendations to the EU Council. The Commission reiterates that due to the amendments to the *Budget Act* of February 2015 (official gazette Narodne novine No. 15/2015), Croatia remained lost all legal control over the public debt. The aforementioned amendments abolished the provisions regulating the permissible level of public debt, which at the end of 2015 reached 86.7% of GDP. The slower growth of public debt is positive, but its high level still poses a big threat to the sustainability of Croatian public finances. Ten years ago, the public debt was at a level of only 38% of GDP, i.e. at the level of comparable countries, while today with a share of 87.5 percent it is well above the average in comparable countries. In this way, high levels of debt can become an insurmountable burden for public finances in the event of deterioration of liquidity in the global financial market.

The Commission proposes to the Government of the Republic of Croatia that besides fulfilling the national fiscal rule and cutting spending in 2015 additional efforts should be made to further reduce the structural deficit of the general budget. In its proposal to the EU Council and in its recommendations on the National Reforms Programme for Croatia in May 2016, the European Commission states that the medium-term budgetary objective for the structural 4 general government deficit is 1.75% of GDP, and according to the European Commission's autumn forecasts, the structural deficit in 2015 amounts to 2.2% of GDP while projections for 2016 indicate an expected growth of the structural deficit to 1.8%. The Commission considers that the *Fiscal Responsibility Act* or an appropriate constitutional law should incorporate the obligation not to exceed an appropriate level of the structural general government deficit. Many European countries have embedded in their laws a 1% maximum ceiling for the structural budget deficit, while countries signatory to the fiscal compact have even stricter rules on maximum structural deficit of 0.5%.