CROATIAN PARLIAMENT

Fiscal Policy Commission

Class: 021-19/19-10/02

Ref. No.: 6524-3-19

Zagreb, 5th November 2019

3rd Position paper of the Fiscal Policy Commission on the Proposal of Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for the year 2019

At its 2nd session held on November 5, 2019, the Fiscal Policy Commission (hereinafter: the Commission) discussed the Proposal of Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2019, submitted by the Government of the Republic of Croatia to the Speaker of the Croatian Parliament, by an act of October 31, 2019.

Discussing the proposed amendments to the State Budget, the Commission, in accordance with its tasks, focused on assessing the application of the fiscal rules of the Fiscal

Responsibility Act (Official Gazette 111/18) and the realism of macroeconomic and budgetary projections.

The Commission estimates that the November 2018 macroeconomic projections underlying the 2019 State Budget are realistic, indicating realistic planning but also the absence of macroeconomic shocks this year. The estimate of the real growth of gross domestic product in 2019 is slightly reduced from the originally planned 2.9% to 2.8%, based on the realization in the first 9 months of this year. GDP structure is also growing according to plan, with government spending, investment and imports growing faster than planned. The latest available European Commission projections from June 2019 suggested slightly slower growth in 2019 (2.6%), but the European Commission is also expected to increase the expected growth in its Autumn Economic Forecast in November, in line with forecasts from other domestic and foreign countries institution.

Despite realistically planned macroeconomic developments, the proposed amendments to the State Budget are needed to correct certain categories of revenues and expenditures. Under the proposed changes, total revenues and expenditures are growing faster than planned, with growth more pronounced in items affecting the budget balance, while the use of European funds is slightly slower than planned. Careful budgeting for budget revenues allows for “positive” surprises and better financial results in conditions of positive economic growth.

Total State Budget revenue increases by 1.6 billion and is expected at the level of HRK 137.7 billion or 34.5% of GDP, which is 0.4% of GDP higher than planned and indicates an increase in the tax burden on the economy. Tax revenues are projected to be HRK 3.1billion or 3.9%

higher than the original plan for 2019 due to better value added tax revenues (by HRK 2.2bn), special taxes excise duties (by HRK 478 million) and income taxes (by HRK 350 million).

Total expenditures of the State Budget are lower than planned, which, together with the lower realization of activities financed from European sources, was also influenced by favourable macroeconomic and financial developments. The largest savings were made in interest expense of almost HRK 800 million due to low interest rates on the international financial market, but also the positive impact of fiscal consolidation so far on the risk premium. Positive macroeconomic developments also contribute to lower expenditures for active employment policies.

On the other hand, there is a noticeable deviation of certain categories of expenditures from the plan for 2019, in particular the growth of expenditures for employees and pensions. These expenditures were increased even though they were based on information that was known when drafting the Budget for 2019 last year, which the Commission warned then. With the rebalancing of staff expenditures increased by HRK 494 million compared to the plan and pensions by as much as HRK 850 million, the Commission underlines the need for better control and planning of these categories of expenditures.

The Commission welcomes the reduction of the planned deficit. According to the Proposal of Amendments to the State Budget for 2019, compared to the original budget plan, the deficit of the State Budget should be reduced from -1.0 to -0.3% of GDP. Extra-budgetary users will see a slight increase in surplus (from 0.3% to 0.4%), while local and regional self-government units will remain at the same planned deficit of 0.1% of GDP. At the general government level, according to the national methodology and rules of budgetary accounting, the budget is balanced, which is significantly better than the previously planned deficit of -0.9% of GDP (or HRK 3.6 billion). Positive financial result of companies included in the government sector (0.4% of GDP) should be added, as well as additional adjustments of -0.5% of GDP (primarily HRK 2 billion of state-issued guarantees for Uljanik shipyard). In other words, according to the ESA methodology, the general government deficit could amount to -0.1% of GDP, which is also a better result than previously planned -0.3% of GDP.

The Commission recalls that such budgetary developments in 2019 are affected by favourable macroeconomic developments, and that the estimated structural deficit is high (-1.1% of GDP). According to the estimate of the Ministry of Finance, the Gross Domestic Product gap for Croatia is positive and amounts to a high 2.1% of GDP, which indicates that the economy has been in a positive phase of the business cycle for a longer time with increasing slowdown risks. Positive cyclical developments contribute to the nominal balance by as much as 1% of GDP, so an estimated structural deficit that shows how much the budget balance would be if the economy were in equilibrium is about -1.1% of GDP.

The Commission estimates that the fiscal rules of the Fiscal Responsibility Act according to the Proposal of Amendments to the State Budget for 2019 will be fulfilled given that the structural balance will remain within the limits foreseen by the medium-term budgetary objective, while continuing the trend of reducing public debt. The Republic of Croatia has accepted the structural balance of -1.75% of GDP as its medium-term budgetary objective for 2019, well above the expected structural deficit of -1.1% of GDP. As the structural deficit rule is realized, the expenditure rule does not apply. Furthermore, the plan also envisages the continuation of a rapid reduction of public debt from 74.8% of GDP in

2018 to 71.3% of GDP in 2019, which will meet the debt rule that determines the dynamics of debt reduction by the level of 60% of GDP.

The Commission points out that the Government of the Republic of Croatia used the fiscal consolidation results of the previous period for fiscal expansion in 2018 and 2019, during which the structural deficit was exacerbated by 1.7% of GDP (1.3% of GDP if excluding the Uljanik Group state-issued guarantees), thereby reducing the fiscal space needed to adapt to possible negative economic shocks in the coming period. At the same time, the Republic of Croatia is implementing the Convergence Program for the period 2020-2022 committed to a more ambitious medium-term budgetary objective of -1.0% of GDP, which is 0.75 percentage points higher than the 2019 budget target. The 2019 structural balance is estimated at -1.1 % Of GDP, which requires adjustment to the new medium-term budgetary objective and increases the risks of meeting the fiscal rule in case of a slowdown in economic activity in 2020. In other words, insisting on an increase in budget spending rather than an increase in available fiscal space increases the risk of failure to comply with the structural deficit rules and reduces the ability of fiscal policy to act in case of slowing economic growth and unforeseen fiscal risks, such as the need to engage additional funds to cover losses in health care systems and new expenditures to assist state-owned companies.