*(Croatian national emblem)*

**CROATIAN PARLIAMENT**

**[1]Fiscal Policy Commission**

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**Zagreb, 5 June 2014**

**Re: Position paper of the Fiscal Policy Commission on the application of the fiscal rule as stipulated by the Fiscal Responsibility Act with due reference to the Draft Annual Report on the execution of the State Budget of the Republic of Croatia for 2013**

At its second meeting held on 12 May and 5 June 2014, in line with the provision of item IV subparagraph 3 of the Decision on the Establishment of the Fiscal Policy Commission, the Fiscal Policy Commission assumed the following position:

The Fiscal Responsibility Act (official gazette "*Narodne novine*" No. 139/10) sets forth fiscal rules that the Government is obliged to observe when implementing fiscal policy. Under this act (prior to its amendments in January 2014 (*"Narodne novine"* No. 19/2014)), the fiscal rules were subdivided into two categories: provisional and permanent rules. Since in 2013 the requirements for the application of the permanent rule were not met, including the zero or positive cyclically adjusted primary balance (primary balance representing the difference between revenues and expenditures less interest expenditures), the provisional fiscal rule has been applied. According to this rule, the total expenditures of the general budget expressed by the share in the estimated gross domestic product shall decline by at least one percentage point. The scope of the general budget and the methods for the calculation of expenditures, for the purpose of these rules, is based on the ESA 95 methodology of the European Union. The increase in expenditures of the general budget directly related to the funding of projects which are co-financed from the pre-accession programmes and European funds in the process of Croatia's accession to the European Union shall be exempted from the total expenditures also in the first three year of membership.

In the Annual Report on the application of the fiscal rule the Ministry of Finance stated that the general government budget expenditures relevant for the calculation of the fiscal rule in 2013 according to the ESA 95 methodology amounted to 150.6 billion Kuna, which is 45.9% share in the realised GDP in 2013. According to ESA 95, the general government budget expenditures in 2012 were 150 billion Kuna, i.e. 45.7% share in the realised GDP in 2012. Thus, instead of declining by one percentage point of share in GDP, the expenditures

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increased by 0.2 percentage points in 2013. The aberration from the fiscal rule is 1.2 percentage point of share in GDP or 4.04 billion Kuna (Table 1).
The Fiscal Policy Commission concludes that the **fiscal rule for 2013 has not been met.**

The Fiscal Policy Commission understands that the failure to meet the rule is partly associated with the unfavourable circumstances which are not directly influenced by the fiscal policy, in particular by: a) more subdued economic growth in 2013 than expected, b) increase in interest expenditures due to the assumption of debt of the shipyards and other restructures companies, and c) payment of matured outstanding liabilities in health, but at the same time indicating that these circumstances do not exclude the liability of the application of the fiscal rule in terms of the Fiscal Responsibility Act. In Article 8 paragraph 2 of the then applied Act it is stated that "if in the course of the year the expenditures increase, i.e. the revenues decline due to the occurrence of new liabilities for the general budget or changes in economic trends, which could result in a failure to meet the fiscal rules set forth in Articles 5 of this Act, the Government must propose amendments to the state budget and financial plans of extra-budgetary users of the state budget". The Commission has no knowledge of any actions taken by the Government in the face of the evident risk of failing to meet the fiscal rules, thus it has come to the conclusion that no actions have been taken.

*Table 1. Calculation of adherence to the fiscal rule*

| | 2012 | 2013 |
|---|---|---|
| (1) General government expenditures acc. to ESA 95 (bn. Kuna) | 150,006.9 | 150,627.2 |
| (2) Realised nominal GDP (bn. Kuna) | 328,561.6 | 328,251.5 |
| (3) Share of expenditure in GDP (1)/(2) | 45.7% | 45.9% |
| (4) Change of expenditure share in GDP (percentage points) | | 0.2 |
| (5) Aberration from fiscal rule → 1 pp + (4) | | 1.2 |
| (6) Aberration from fiscal rule (in mil Kuna) | | 4,004.4 |

In 2013 the Fiscal Policy Board, the authority preceding the Fiscal Policy Commission, warned about the too optimistic projections of economic growth and about the existence of a very high risk that the fiscal rule under the Fiscal Responsibility Act (*"Narodne novine"* No. 139/10) would not be met and that it was necessary to undertake additional measures in order to meet the fiscal rule. According to ESA 95 the general government deficit in 2013 amounted to 16.2 billion Kuna or 4.9% of the GDP, while the public debt reached 220.2 billion Kuna or 67.1% of share in the GDP. The Fiscal Policy Commission expresses its great concern about exceeding the public debt limit of 60% share in the GDP and deficit limit of 3% of the GDP, which is set out as the middle-term objective in the Fiscal Responsibility Act as amended in January 2014: “The middle-term budgetary objective referred to in paragraph 1 of this Article is defined as the structural balance ensuring that the general budget deficit does not exceed 3 % of the gross domestic product, i.e. that the public debt does not exceed 60% of the gross domestic product.” (Article 5, paragraph 2). Exceeding these limits in 2013 will significantly influence the setting up of and adherence to the fiscal rules for 2014 and for the years to come.

The Fiscal Policy Commission also pointed at exceeding of the government debt limit defined by the Budget Act, i.e. by the Act on the State Budget Execution for 2013. Article 74 of the Budget Act states that the “ratio of the outstanding government debt at the end of the year in relation to the projection of the gross domestic product can be above the previous year’s ration, with such ration not exceeding 60% of the gross domestic product, while Article 29 of the Act on the State Budget Execution for 2013 sets forth that “In 2013 the total government debt may not exceed 60% of the total gross domestic product in 2013”. According to official data, the government debt (debt of the state budget and extra-budgetary users of the central budget) amounted to 215.2 bn. Kuna at the end of 2013, which is 64.0% of the realised GDP or 65.6% of the GDP used when drafting and adopting the Amendments to the State Budget in December 2013. The Commission also suggested that the government debt limit is being exceeded in 2014 as well, since in the Act on the State Budget Execution for 2014, Article 30 it is stated that “In 2014 the total government debt will amount to 62% of the total gross domestic product in 2014”.

Based on the conclusion that the fiscal rules have not been met, the Fiscal Policy Commission proposes that significant additional efforts should be taken in order bring the ley fiscal indicators within the limits defined by the applicable regulations. It is necessary (by appropriate legal amendments) to regulate the procedures and mechanisms in clearly defined time limits in order to bring the key fiscal indicators within the legal limits. In addition, the Commission proposes that the previous, preventive procedures and mechanisms should be regulated as well in the case there is a need to take corrective measures in situations when the fiscal indicators are still within the limits stipulated by the fiscal rules, but have reached a critical point near the limits and/or there is a significant risk that these limits might be exceeded.

The Commission recommends a decisive implementation of fiscal consolidation and structural measures that will boost the competitiveness of the Croatian economy and enable the decrease of fiscal imbalances and gradual decline of the public debt in GDP. It is necessary to create a fiscal environment that will stimulate investment and provide space for co-financing projects which are not funded from EU funds. It is also necessary to strengthen the process of budgetary planning, especially in the long run, and expenditure control, particularly regarding the implementation of budgetary limitations as stipulated by the fiscal rules.