



CROATIAN PARLIAMENT

Fiscal Policy Commission

Class: 021/19/14-10/06

Number: 6521-05-1/14-02

Zagreb, 21 November 2014

4th Position paper of the Fiscal Policy Commission on the Draft Budget of the Republic of Croatia for 2015

At its 6th meeting held on 21 November 2014, the Croatian Parliament Fiscal Policy Commission discussed the Draft Budget of the Republic of Croatia for 2015 and projections for 2016 and 2017 and the proposal of financial plans of extra-budgetary users for 2015 and projections for 2016 and 2017, that were submitted to the Croatian Parliament by the Government of the Republic of Croatia on 13 November 2014.

Introductory notes

The Commission's position on the Draft Budget will be primarily focused on the application of the fiscal rule in line with the Fiscal Responsibility Act. In its Decision to Establish the Fiscal Policy Commission, specifically in Article 4 thereof, the Croatian Parliament defined the following task of the Commission: *examining and assessing the application of the fiscal rule established by the Fiscal Responsibility Act in the draft state budget and financial plans of extra-budgetary users of the state budget for the budgetary year, and the projections for the following two years*".

The Commission has concluded that for the year 2015 the provisional fiscal rule set forth in the Fiscal Responsibility Act (official gazette of the Republic of Croatia *Narodne novine*, Nos. 139/10 and 19/14) shall be applied, according to which the inter-annual growth rate of the general budget expenditures must not exceed the inter-annual growth rate of the projected or estimated GDP in current prices. The expenditures of the general budget, however, do not include the interest expense, expenditures related to the implementation of EU programmes without national co-financing and the annual changes in expenditures due to the changes in the institutional coverage of the general budget. According to the basic fiscal rule from Article 4 of the Fiscal Responsibility Act, the "structural balance expressed as a share in the gross domestic product (hereinafter referred to as: GDP) shall be achieved according to the adjustment plan in order to reach the medium-term budgetary target, whereby the increase in the expenditures of the general budget must not exceed the referential potential GDP growth rate, increased by the expected price rise". It is further stated that the aforementioned adjustment plan shall be defined by a decision of the Government of the Republic of Croatia for the purpose of achieving the medium-term budgetary target, as recommended by the Council of the European Union, whereby the inter-annual decrease of the structural balance

must be at least 0.5% of the GDP. However, it is very significant that the Act states that the fiscal rule set forth in Article 4 thereof shall be applied after the Government of the Republic of Croatia has determined an adjustment plan in order to achieve the medium-term budgetary target, as recommended by the Council of the European Union. Given that there is still no defined medium-term budgetary target for Croatia nor has the Government determined an adjustment plan according to such target, the basic rule cannot be applied yet and the provisional fiscal rule shall be deemed as relevant.

In the explanation of the Draft Budget submitted by the Government it is not stated whether the proposed budget for 2015 and the projections for 2016 and 2017 are in line with the Fiscal Responsibility Act, which indicates that no attention is devoted to the importance of this Act and to adhering to the rules stipulated therein. It should be recalled that during its term the Fiscal Policy Commission, in relation to each draft budget or draft amending budget, requested that the documents sent to the Croatian Parliament should next time include the Government's assessment of the fulfilment of the fiscal rule. This is extremely important because the Members of the Croatian Parliament could be better informed about the risks pertaining to the adoption of the proposed budget from the point of view of adherence to the Fiscal Responsibility Act. In the explanatory statement to the Draft Budget for 2015 the fiscal rule is mentioned only in the section referring to the expected change of the rule, specifically in the part stating that *"amendments to the Fiscal Responsibility Act were initiated so as to increase the independence and extend the remit of the Fiscal Policy Commission and to fully adjust the fiscal rule with the provisions of the Stability and Growth Pact, by including provisions on a debt rule in the Fiscal Responsibility Act."* The Commission anticipates that the fiscal rule will be changed soon. Yet, in the event it is not changed the existing rules shall apply and it will be important to assess to which extent the proposed budget is brought in line with the existing rules.

The Fiscal Policy Commission has an extremely difficult task to assess potential compliance with the fiscal rule in 2015 and in the projections for 2016 and 2017, since major methodological changes were introduced in the proposed budget compared to the budgets of the previous years, and given the fact that no official assessments and detailed information exist that would enable a comparison with the previous years. The Commission holds that the Draft Budget for 2015 and extra-budgetary funds are not transparent because not a single document has been released that would provide a detailed explanation of the consequences arising from the changes in methodology and budget coverage.

Another difficulty is the application of the fiscal rule at the level of the general government and according to the ESA methodology. The draft budget and plans of extra-budgetary users are available only at the level of the central government, with a far narrower coverage than that applied according to the ESA standard, and under the cash principle, as opposed to the ESA methodology that applies the accrual-based principle. Further, it is not clear which fiscal rule will be applied in 2016 and 2017. The basic fiscal rule is related to the adjustment plan adopted by the Government, and since it is fairly likely that in 2015 this plan will be adopted for the first time, this rule should be applied in 2016 and 2017. However, given that such plan currently does not exist, it is not possible to assess the compatibility of the projections for 2016 and 2017 with the plan. Thus, in the following we shall focus only on the assessment of the compliance with the fiscal rule in 2015.

In view of the fact that the Fiscal Policy Commission holds that the fiscal rule in 2015 is related to the expenditures growth, the Ministry of Finance shall, prior to the adoption of the budget plan in the Croatian Parliament, release a very detailed analysis of the “expenditures related to the implementation of EU programmes without national co-financing” and the “expenditures due to the changes in the institutional coverage of the general budget”. The expenditures for EU programmes are a very important indicator, and it might prove to be crucial in the assessment of the compliance with the fiscal rule in 2015. With regard to the changes in the coverage, the Ministry of Finance should precisely identify all the increased expenditures which are exclusively the result of methodological changes and which caused the increase in expenditures of the consolidated central government. In view of the fact that the Budget Plan for 2015 differs from the Economic and Fiscal Policy Guidelines for the period 2015-2017, as adopted by the Government of the Republic of Croatia on 7 November 2014, the Ministry of Finance should have included in the Budget Plan for 2015 tables to transparently and clearly explain these differences and briefly explain the methodological changes as presented in the Budget Plan for 2015. Only with this information will it be possible to assess the actual trend of the expenditures that are relevant for the assessment of the fiscal rule in 2015.

Assessment of budgetary developments and compliance with the fiscal rule

The Draft Budget for 2015 and plans for 2016 and 2017 entail a number of risks, the key ones being:

- a) difficult comparisons due to methodological changes and changes in budget coverage;
- b) very high risks and uncertainties on the revenue side by reason of tax changes and the possible failure to achieve macroeconomic projections due to the lack of investments underpinning the macroeconomic projections of the Government;
- c) at the level of major expenditure items (pensions) there is a risk to exceed them due to the failure to adopt regulations ensuring the implementation of the planned amount for 2015;
- d) the Commission has strong reservations regarding the ending of the non-payment in the health sector because reforms to ensure the reduction of expenditures in health care have not been implemented, even though spending on health has been increased by about 2 billion HRK in 2015;
- e) there is a particularly high risk with regard to generating revenue from EU aid;
- f) potentially significant underestimation of expenditures, particularly those related to salaries, interests, and costs related to EU programs.

The Commission believes it will be difficult to achieve significant reduction of the deficit of the consolidated central government in 2015 without strong reform programs and structural measures. It should be possible to compare the deficit of the consolidated central government in 2015 with the planned deficit for 2014, regardless of methodological changes in the draft budget. In 2015, the planned deficit is by 3.9 billion HRK lower than the deficit planned for 2014 (a reduction from 16.3 to 12.4 billion HRK).

From the data presented in the draft budget for 2015 that the Croatian Government submitted to the Croatian Parliament, the Commission can, with a number of assumptions, estimate that there is a risk that the fiscal rule in 2015 will not be met. It is expected that the nominal GDP in 2015 will increase by 1.9%, and that by 0.5% on account of real growth and by 1.4% due to inflation (GDP deflator). Although these forecasts do not differ much from other analysts' forecasts as was the case in previous years, still this forecast also seems optimistic. For example, the Zagreb Institute of Economics expects a real growth of 0.2% and inflation of 1.1%, resulting in a nominal GDP growth of 1.3%. The European Commission in its forecasts expects a real growth of 0.2%, but also the GDP deflator of 0.6%, i.e. a nominal GDP growth of 0.8%. In the context of complying with the fiscal rule for 2015, nominal GDP growth is important because it represents the upper limit of growth of general government expenditures net of interest expense, expenses related to EU aid and expenditures due to the changes in the coverage of the general government. Therefore expenditures should not grow by more than 0.8% (if the European Commission's forecasts are used as the assessment basis) or by 1.9% (if the Government's projections are used as the assessment basis).

After eliminating methodological differences between budget expenditures in 2014 and 2015, there are still risks that the actual growth of expenditures relevant for the fiscal rule will be higher than the specified growth of nominal GDP. The key risks arise from a possible underestimation of interest expense, subsidies and salaries. The expenditures for salaries in the state budget have been reduced, but the Commission deems that there is a high risk that this reduction will not be achieved because there are no specific programs and measures which explain *how* this would be achieved. However, on the other hand, it is possible that the local government, because of its reduced revenue due to the changes in the taxation of income, will largely reduce its expenditures, so that could be one of the factors that could bring about compliance with the rule. However, this channel of expenditure control is also beset with unknowns and all the effects of tax changes on the redistribution of revenue and expenditures between the central and local government remain unclear.