

**POSITION PAPER OF THE FISCAL POLICY COMMITTEE ON THE APPLICATION OF FISCAL RULES ESTABLISHED BY THE FISCAL RESPONSIBILITY ACT FOR 2012**

SUMMARY

**The Fiscal Policy Committee assesses that the fiscal rule for 2012 is fulfilled.** According to the Fiscal Responsibility Act, the fiscal rule applied for 2012 sets that total expenditures of the general government budget, reduced by the expenditures linked to the financing of projects from EU aid programmes and funds, and expressed as a share of GDP, have to be decreased by at least 1 percentage point in relation to the previous year. The data from the Annual Report on the Application of Fiscal Rules for 2012 indicate the decline of the total expenditures share in the officially published GDP, from 44.33 percent in 2011 to 42.25 percent in 2012. The fiscal rule for 2012 was fulfilled by the decline of the share by 2.08 percentage points. The data on total expenditures have been presented according to the ESA95 statistical methodology which is used for monitoring the application of a fiscal rule.

**The assessment of the application of fiscal rules established by the Fiscal Responsibility Act for 2012 faced significant methodological difficulties.** These difficulties are: (a) insufficiently precise definition of fiscal rules in the Act and (b) lack of final data according to the ESA95 methodology. Due to the use of temporary data, several changes in the results and methodological framework occurred during the period of monitoring the fiscal rules application, and the data used for the current assessment have still not been officially confirmed by the Eurostat. However, it all indicates that the remaining uncertainties regarding the legal interpretation of fiscal rules or the expected methodological changes can not have a major influence on the assessment of the application of fiscal rules for 2012; therefore, the Committee adopted the previously mentioned assessment.

**The assessment of the fulfilment of the fiscal rule largely depends on the applied methodology.** The analysis of fiscal data according to the cash flow principle and in line with the budget accounting instead of ESA95 methodology would lead to different conclusions. The key difference between the ESA95 methodology and budget accounting in this case refers

to the treatment of guarantee called. Pursuant to the ESA95 rules, in the third consecutive year of guarantee called, the total outstanding debt of entities involved is registered as government expenditure and government debt, and not only the amount of disbursed instalment of the debt by guarantee called. Due to this rule, the total expenditures in 2011 were increased by HRK 6.6 billion. As a result, the level of expenditures in 2012 remained significantly lower than in 2011, which led to the fulfilment of the fiscal rule. The fiscal rule was fulfilled mostly as a consequence of methodological rules, and only partially as a consequence of the activities carried out by policy makers.

**Notwithstanding the execution of total planned expenditures carried out in line with the plan, the budget planning in 2012 indicated weaknesses reflected in the budget revision during the year and in a series of redistributions among specific items of Ministries.** The preparation of the budget requires a more serious approach than the one taken by some Ministries; therefore, it is necessary to prevent some Ministries from underestimating necessary expenditures for acquired rights (gross salaries, pensions, subsidies,...) and in that way endangering the budget execution at the end of the year. The implementation of the structural reform regarding the central salary calculation is a measure that should partly make such practice impossible.

**The Fiscal Policy Committee acknowledges difficult economic circumstances under which the budget consolidation was taking place in 2012, and it welcomes a significant effort made while doing so.** In 2012, regardless of the calculation methodology, total expenditures of the general government were nominally reduced, while there was a significant nominal decline registered at the budget deficit as well as a significant decline of its share in GDP. In spite of that, public debt reached, by the end of the year, the level of 53.7 percent of GDP and it continues to grow, which reinforces the need to undertake the activities for keeping it at the level below 60 percent of GDP. Stopping the public debt growth should remain one of the main goals of the fiscal rules application.

**The Fiscal Policy Committee points to the need of a urgent clarification of fiscal rules defined in the Fiscal Responsibility Act, and it is also advisable to adjust these rules to fiscal goals set within the framework of the fiscal policies coordination mechanisms in the EU.** In addition, the Committee points to the necessity of officially determining and publishing fiscal statistic data according to the ESA95 methodology, as soon as possible, with clearly defined methodological steps following which the fulfilment of fiscal rules may be

monitored in the future. According to the announcements from the Ministry of Finance, the preparation of a new legal definition of fiscal rules is underway; this definition would take into consideration a cyclical position of the economy and would be aligned, in a better way, with the fiscal rules from the fiscal coordination process at the EU level. The redefinition of the role of the Fiscal Policy Committee has also been announced, whereby the independency thereof as well as the capacity thereof for monitoring the fiscal rules application should be reinforced. The Committee welcomes these initiatives believing that they lead to the improvement of transparency and accountability in governing fiscal policy.

## **1. INTRODUCTION**

**The Fiscal Policy Committee prepared the assessment of the application of the fiscal rules established by the Fiscal Responsibility Act for 2012 on the basis of the information contained in the reports of the Government of the Republic of Croatia forwarded to the Croatian Parliament for the discussion and adoption in May 2013.** These reports are the Annual Report on the Execution of the State Budget of the Republic of Croatia for 2012 and the Annual Report on the Application of Fiscal Rules for 2012.

**Other data from official and publically available sources were also used, above all the documents of the Ministry of Finance and official statistic data.** Furthermore, the Committee asked and received from the Ministry of Finance the table with main expenditure items explaining the differences between total expenditures of the general government budget according to the budget accounting rules and total expenditures according to the ESA95 statistic standards. Data from this supplementary table are also used in the assessment of the application of fiscal rules.

## **2. FISCAL RULES**

**Fiscal rules are established by the Fiscal Responsibility Act (Box 1).** The Act specifies two rules. The first rule defined in Article 5, paragraph 1 of the Act may be considered as a temporary rule, and the second rule from Article 5, paragraph 2 as a permanent rule. The permanent rule refers to the maintenance of cyclically-adjusted primary fiscal balance of the general government budget at nil level or positive. The temporary rule refers to the reduction of total expenditures by 1 percentage point of the share in GDP until a point when the primary fiscal balance will be equal to nil or positive. Since, according to the calculations made by the Ministry of Finance, the cyclically-adjusted primary fiscal balance of the general government was negative in Croatia in 2011, the temporary fiscal rule is relevant for 2012.

**Fiscal rule for 2012 requires that total expenditures of general government, expressed as a share in the gross domestic product (GDP) are to be decreased by at least 1 percentage point.** While doing so, the increase in the expenditures directly connected with financing of the projects co-financed from pre-accession aid programmes and European funds in the process of joining the EU, is excluded from the established fiscal rule.

**According to the agreement between the Fiscal Policy Committee and the Ministry of Finance at the 1<sup>st</sup> session of the Committee which took place on July 6, 2011, it was decided that the fiscal rule shall be officially monitored according to the ESA95 methodology, the harmonised European methodology for the compilation of national accounts.** By accepting this methodology, better harmonization of monitoring fiscal stance in the European Union was meant to be provided. Budget documents in Croatia are not directly comparable with the ESA95 methodology because they have been prepared according to the special chart of accounts and by following different rules of calculating revenues and expenditures. Therefore, it is not possible to assess the fiscal rule application on the basis of official budget documents. On the other hand, fiscal data according to the ESA95 methodology are still, to a great extent, temporary and are not officially published, except several basic indicators in certain documents of the Ministry of Finance, for example in the Pre-Accession Economic Programme 2012-2014 or in the Economic and Fiscal Policy Guidelines for the period 2013-2015. Unfortunately, all these data are still temporary and the revision thereof is possible. According to the information from the Ministry of Finance, final data according to ESA95 methodology, fully aligned to Eurostat and to the needs of EDP, will not be available until October 2013. The Croatian Bureau of Statistics will be officially publishing these data. In the current assessment of the fiscal rule, the Fiscal Policy Committee relied on fiscal data according to ESA95 methodology prepared by the Ministry of Finance.

**Box 1 – Fiscal rules in the Fiscal Responsibility Act (OG 139/10)**

**FISCAL RULES**

**Article 5**

(1) Total expenditures of the general government expressed as a share in the estimated Gross Domestic Product shall annually be reduced by no less than 1 percentage point.

(2) The reduction referred to in paragraph 1 of this Article shall be conducted until a point when the primary fiscal balance of the general government shall be equal to nil or positive in nominal terms.

(3) From the point when the primary fiscal balance of the general government shall be equal to nil or positive in nominal terms onwards the objective shall be the reaching of the cyclically-adjusted primary fiscal balance of the general government at nil level or positive during the cycle to achieve public debt to Gross Domestic Product share stabilisation and reduction.

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## **FISCAL RULES APPLICATION**

### **Article 8**

(1) The deficit and net borrowing levels for a three-year period shall be determined in the Economic and Fiscal Policy Guidelines, in keeping with the fiscal rules set forth in Article 5 of this Act.

(2) Should there be an in-year creation of new commitments for the general government or changes in the economic trends resulting in an increase in expenditures or a decrease in revenues which may result in a failure to meet the fiscal rules referred to in Article 5 of this Act, the Government must propose amendments to the state budget and the financial plans of the extra-budgetary users of the state budget.

(3) Increases in the general government expenditures directly related to natural disasters, epidemics and environmental incidents shall be excluded from the set fiscal rules referred to in Article 5 of this Act.

(4) Increases in the general government expenditures directly related to financing projects under co-financing from the pre-accession aid programmes and the European funds in the process of Republic of Croatia's accession to the European Union and during the three first years of membership shall be excluded from the set fiscal rules referred to in Article 5 of this Act.

## **REPORTING**

### **Article 9**

(1) The application of the rules referred to in Article 5 of this Act shall be reported on semi-annually and annually along with the semi-annual and annual state budget execution report within the deadlines envisaged in the Budget Act to be published in the Official Gazette (*Narodne novine*) and on the website of the Ministry of Finance.

(2) In the Decree referred to in Article 7, paragraph 9 of this Act the Government shall prescribe the form and contents of the reports on the application of fiscal rules referred to in Article 5 of this Act.

**The Government of the Republic of Croatia prepared the Annual Report on the Application of Fiscal Rules for 2012 in line with the Decree on the Fiscal Responsibility Statement and the Fiscal Rules Application Report Production and Submission (OG 78/11). This Decree prescribes the contents of the Report and indicators on the basis of which the application of fiscal rules will be assessed.**

**The Fiscal Policy Committee notices that the Decree, in the part "total general government expenditure expressed as a share in the estimated gross domestic product", specifies that relevant indicator of gross domestic product is the indicator used in**

**preparation of the amendments to the State Budget for 2012.** In this case, "estimated GDP" is a Government estimation of GDP, which was used when preparing the State Budget and its Amendments. The Committee believes that the expression "estimated gross domestic product" stated in the Fiscal Responsibility Act, Article 1 paragraph 1, should be interpreted as a data on gross domestic product for 2012 which was published by the Croatian Bureau of Statistics in its Statement no. 12.1.1/4 of March 20, 2013, under the name "Quarterly gross domestic product estimate, first quarter of 2013" The uncertainty regarding the use of an appropriate indicator of GDP has been mitigated by the fact that the Government prepared, in the Annual Report, data in both versions, one with GDP used when preparing the Amendments to the Budget and the other one with GDP published by the Croatian Bureau of Statistics.

**The Fiscal Policy Committee noticed a lack of precision when legally defining fiscal rules in some other segments as well.** This refers to, for example, the way of excluding expenditures linked with the use of EU funds, or estimating a moment and the method of initiating the amendments to the State Budget (Article 8, paragraph 2) due to possible non-fulfilment of the fiscal rule. The Committee suggests that the fiscal rules are more precisely defined in the draft of the new Fiscal Responsibility Act.

### **3. MACROECONOMIC FRAMEWORK**

**Macroeconomic situation in Croatia was unfavourable in 2012.** The data published by the Croatian Bureau of Statistics show a decline in real GDP by 2.0 percent. In the previous year, the stagnation of economic activity was registered at the annual level. However, negative trends in the economy were already present in the last quarter of 2011 when year-on-year decrease in activity by 0.3 percent was registered, and such negative trends were transferred and continued in 2012. The largest contribution to the decrease in total activity in 2012 was given by personal consumption and investments which fell by 3 and 4.6 percent, respectively. Recession trends were reflected in the reduction of import by 2.1 percent, while the export faced difficulties registering only a slight increase of 0.4 percent. Government consumption, particularly the expenses for the supply of goods and services for the needs of the state, was effectively reduced by 0.8 percent.<sup>1</sup> Negative trends from 2012 were also extended to the

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<sup>1</sup> The indicator of government consumption from the statistics of national accounts should not be mistaken for government expenditure from the government finance statistics because it is about different spending concepts;

beginning of 2013, as seasonally adjusted values of the GDP level, along with the year-on-year growth rates, point to (Figure 1).

*Table 1. Main Macroeconomic Indicators*

	2011	2012	2011		2012			2013	
			Q4	Q1	Q2	Q3	Q4	Q1	
<i>Percentage change over the same period of the previous year</i>									
Real GDP	0.0	-2.0	-0.3	-1.1	-2.5	-1.9	-2.3	-1.5	
-Personal consumption	0.2	-3.0	0.1	-0.9	-3.2	-3.5	-4.2	-	
-Government spending	-0.6	-0.8	-1.1	-1.1	0.3	-0.4	-2.0	-	
-Fixed capital formation	-6.4	-4.6	-5.2	-3.9	-5.1	-4.4	-4.9	-	
-Export of goods and services	2.0	0.4	-3.9	3.9	-4.1	0.1	3.2	-	
-Import of goods and services	1.3	-2.1	-3.3	0.1	-4.0	-2.8	-1.6	-	
GDP deflator	2.0	2.0	1.9	1.2	2.0	2.1	2.8	-	
Consumer prices (avg)	2.3	3.4	2.4	1.5	3.4	4.1	4.6	4.6	
<i>Memo</i>									
Nominal GDP (HRK billion)	330.2	330.2	82.7	75.4	82.2	89.6	83.0	-	
Unemployment rate (Labour Force Survey, 15-64 years)	13.9	16.3	14.3	16.8	14.9	15.0	18.5	-	

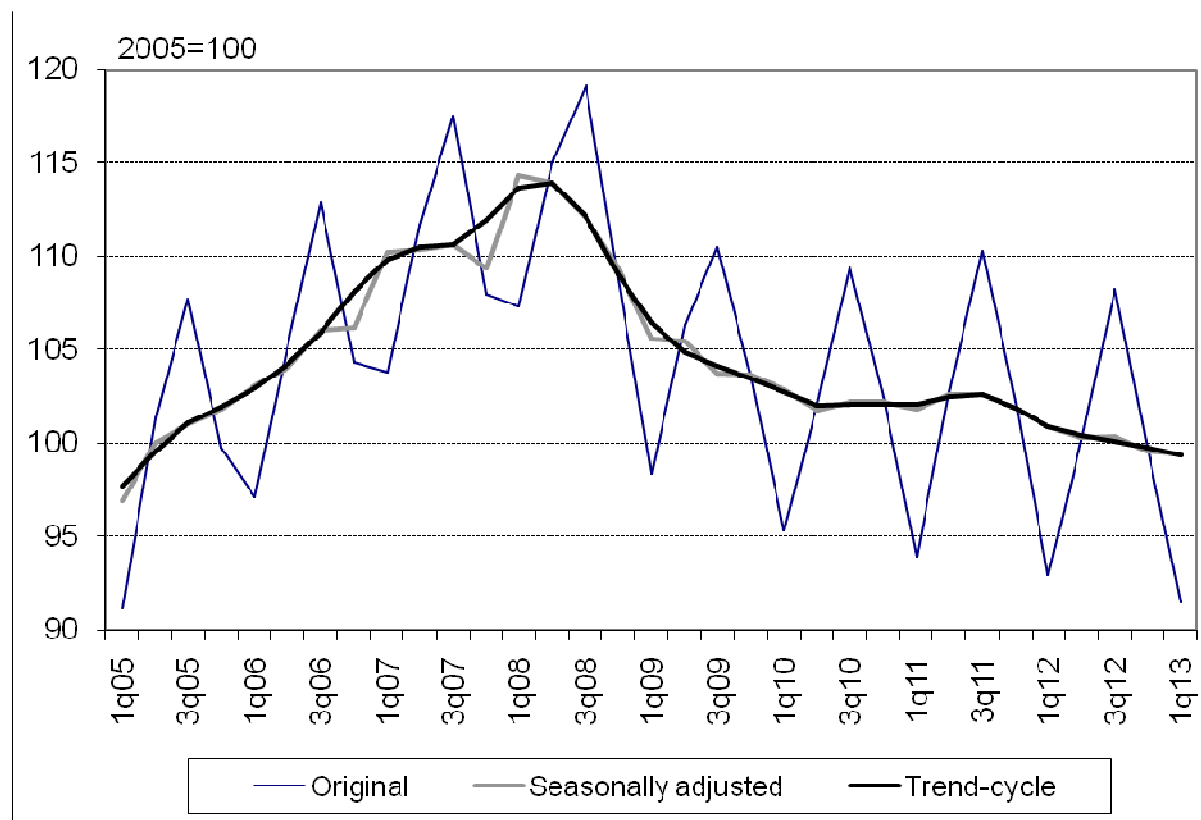
Source: Croatian Bureau of Statistics ([www.dzs.hr](http://www.dzs.hr), accessed 3 July 2013).

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in this context, the government consumption from national accounts, among other things, does not include transfers to the population or subsidies to companies.



Figure 1. Real GDP



Note: Seasonally adjusted by the X11ARIMA method (Statistics Canada).

Source: The Institute of Economics, Zagreb based on the data from the Croatian Bureau of Statistics.

**The intensity of the weakening of the economy in 2012 was not anticipated in time by policy makers, which is clearly shown by macroeconomic projections used during the preparation of key fiscal documents during 2012.** Gradual worsening of the situation during 2012 led to modifications to budget plans. The State Budget and financial plans of extra-budgetary users adopted in February 2012 were amended in November 2012, due to altered economic circumstances. However, macroeconomic projections were already modified in the Economic and Fiscal Policy Guidelines for the period 2013-2015 adopted in July 2012, although the budget plans were not modified. Table 2 shows changes in the economic framework when preparing these key budget documents.

Table 2. Changes in the projections of GDP growth for 2012 in official documents

	Plan/projections 2012		Realization	2012
	State Budget of the Republic of Croatia February 2012	Economic and Fiscal Policy Guidelines July 2012	Amendments to the State Budget of the Republic of Croatia November 2012	Annual Report May 2013
Real GDP growth (%)	0.8	0.0	-1.1	-2.0
Nominal GDP (HRK million)	350,455	340,801	338,136	330,231**
<i>Projections of the real growth of GDP in the moment of the preparation of Government documents (%)</i>				
Consensus Forecast*	-0.5	-1.1	-1.7	-2.0
Institute of Economics, Zagreb	-0.3	-1.3	-1.4	-2.0
Croatian National Bank	-0.2	-1.6	-1.6	-2.0

Notes: \*The average of projections by independent analysts for Croatia prepared by Consensus Economics and published in the publication *Eastern Europe Consensus Forecasts*. \*\*Realized level of GDP is lower than the projected level not only because of forecasts errors but also because of the adjustment of the GDP level by the Croatian Bureau of Statistics at the beginning of 2013, after final annual data on GDP were officially published for 2010. Statistical adjustment has been estimated at about HRK 3.8 billion.

**Although the revision of growth forecasts towards the lower level was present at the non-government analysts as well, the Government projections were in each moment significantly more optimistic than theirs, which turned out to be unjustified considering the realization.** In this context, for example, the Government projected the growth of GDP of 0.8 percent when adopting the Budget in February 2012, while the consensus forecasts indicated the decrease of 0.5 percent, and the forecasts of the Economic Institute, Zagreb talked about the decline of 0.3 percent. Although the discrepancy of the forecasts from the realization was significant in all analyses, it was the largest in the Government forecasts. The forecast of the real growth of GDP in November 2012, when preparing the Amendments to the State Budget, was -1.1 percent, and several months later, the Croatian Bureau of Statistics

published the information on the decrease of GDP of 2.0 percent. The main difference between the Government forecasts and forecasts by other analysts was in projections of fixed capital formation, which were realized in much smaller volume than the Government forecasts. Later, it was shown that the discrepancy regarding the macroeconomic assumptions did not lead to major discrepancies in realization of total revenues and expenditures of the Budget, which was a favourable circumstance that, however, raises questions of budget planning processes.

**In the course of 2012, the Fiscal Policy Committee was pointed to the worsening of the macroeconomic situation in the country and to (too) optimistic projections of the Government as factors increasing the risks of non-fulfilling the fiscal rule.<sup>2</sup>** This was particularly relevant in the situation when there were no reliable indicators of total expenditures according to the ESA95 methodology for 2011, nor the quarterly or semi-annual data for 2012. In these cases, the Committee relied on fiscal data according to the budget accounting, which indicated high risks in the fiscal rule application.

#### **4. BUDGET REVENUES AND EXPENDITURES**

**The Fiscal Policy Committee assesses that the planning of revenues and expenditures of the State Budget in 2012 was carried out with a series of weaknesses in the budget planning.** In spite of total government revenue and expenditure being carried out in line with the plan, weaknesses are reflected in the need for the budget revision during the year and by a series of redistributions among certain items of Ministries. Initial budget plans by Ministries often do not take into account properly the fact that permanent expenditures and acquired rights (gross salaries, interest rates, pensions, subsidies...), which are established by laws and regulations, have to be executed, and that budget expenditures also have to be planned according to legal regulations. For example, the initial plan for 2012 anticipated even 1.1 billion less for salaries of the central state budget users than it was actually spent at the end of the year. Budget planning should be improved and it is suggested to carry out budget supervision of the Ministries that continuously perform such a practice of budget planning.

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<sup>2</sup> See for example, Public Statement after the 8<sup>th</sup> session of the Committee.

**In spite of the optimistic expectations regarding the economic activity at the beginning of 2012, a more cautious approach was used in planning of budget revenues, which provided a more realistic estimation of revenues in the Budget.**<sup>3</sup> Revenues in 2012, compared to the execution in 2011, were increased by HRK 3.1 billion (Table 3) which represents a direct consequence of the revenues growth due to the increased standard value added tax rate from 23% to 25%. The revenues from the income tax were also increased, which may be attributed to the annulment of most tax relieves within the income tax system in 2010, which finally resulted in lower number of tax returns on the basis of the reported tax returns for 2011 that were submitted in 2012. Since the health insurance contribution rate was decreased, the regulation was adopted in parallel according to which the salaries may not be disbursed to employees without paying the contributions, which improved the collection of social security contributions and mitigated the negative effects of the contribution rate reduction.

**The share of revenues of the consolidated general government in GDP reached 38.2% of GDP, which is a consequence of the increase in tax rates and of the improvement of the revenue collection** (Table 4). The Ministry of Finance made a great effort in improving the collection, which may be seen in tax revenues. Putting the tax collection in order is welcomed, but it should not be forgotten that potential further increase in tax burden could significantly influence the competitiveness of the Croatian economy. The redistribution of tax burden from the labour to consumption is also welcome in such an economic situation, but it should not diminish incentives for putting the expenditures under control. First of all this refers to the expenditures that are increased automatically according to certain legal rules (for example, pensions).

**Expenditures of general government are realized somewhat below the planned level, and a moderate fiscal consolidation was carried out.** The compensation of employees are slightly decreased compared to 2011, but were not decreased in line with the initial budget plan for 2012. The expenditures growth was registered regarding pensions and some other social benefits. On the other hand, expenditures for investments (acquisition of non-financial assets) were decreased by almost HRK 900 million. The expenditures for interest payments at

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<sup>3</sup> For the assessment of the revenues and expenditures trends, the Committee used data prepared in line with the budget accounting standards. In the end of this paragraph, there is a short review of methodological adjustments according to ESA95 methodology.

the level of the State Budget were executed for HRK 411 million above the plan, and at the level of the general government budget for HRK 354 million. In order to stimulate the economic growth, it would be better if the expenditures were structured differently and more oriented towards the investments. The Government should continue with the initiated structural reforms that will be reflected on the structure of the budget, and more importantly, will stimulate the economic growth.

*Table 3: Consolidated General Government in 2011 and 2012 (according to budget accounting rules, in HRK million)*

	<b>Execution 2011</b>	<b>Budget 2012</b>	<b>Budget Revision 2012</b>	<b>Execution 2012</b>	<b>Difference</b>
	1	2	3	4	5=4-3
<b>1. Revenues of the consolidated general government</b>	<b>123,035</b>	<b>125,102</b>	<b>126,762</b>	<b>126,138</b>	<b>-624</b>
1.1. VAT	37,718	40,522	40,452	40,652	200
1.2. Income Tax	9,260	9,173	9,938	9,876	-62
1.3. Corporate Income Tax	7,288	7,669	7,669	7,697	29
1.4. Excise duties	11,215	11,493	10,977	11,206	230
1.5. Social benefits	38,605	36,972	37,968	37,846	-122
1.6. Other	18,948	19,273	19,759	18,860	-899
<b>2. Disposals of non-financial assets</b>	<b>833</b>	<b>867</b>	<b>718</b>	<b>600</b>	<b>-118</b>
<b>3. Expenditures of the consolidated general government</b>	<b>132,889</b>	<b>130,992</b>	<b>132,804</b>	<b>132,450</b>	<b>-354</b>
2.1. Compensation of employees	35,610	33,938	35,905	35,382	-524
2.2. Use of goods and services	15,362	15,403	15,287	15,010	-277
2.3. Interest rates	7,576	8,142	8,515	8,869	354
2.4. Subsidies	7,606	6,691	6,890	6,801	-89
2.5. Aids	1,589	2,082	2,009	1,823	-186
2.6. Social benefits	57,136	56,636	56,267	56,881	614
2.7. Other expenditures	8,010	8,100	7,931	7,684	-247
<b>3. Acquisition of non-financial assets</b>	<b>5,857</b>	<b>6,548</b>	<b>6,409</b>	<b>5,513</b>	<b>-895</b>

*Sources: Ministry of Finance and Committee's calculations.*

Table 4: Execution of the consolidated general government budget (in % of GDP)

	Execution 2011	Execution 2012
	1	2
<b>1. Revenues of the consolidate general government</b>	<b>37.3%</b>	<b>38.2%</b>
1.1. VAT	11.4%	12.3%
1.2. Income Tax	2.8%	3.0%
1.3. Corporate Income Tax	2.2%	2.3%
1.4. Excise duties	3.4%	3.4%
1.5. Social benefits	11.7%	11.5%
1.6. Other	5.7%	5.7%
<b>2. Disposalsof non-financial assets</b>	<b>0.3%</b>	<b>0.2%</b>
<b>3. Expenditures of the consolidated general government</b>	<b>40.2%</b>	<b>40.1%</b>
2.1. Compensation of employees	10.8%	10.7%
2.2. Use of goods and services	4.7%	4.5%
2.3. Interest	2.3%	2.7%
2.4. Subsidies	2.3%	2.1%
2.5. Grants	0.5%	0.6%
2.6. Social benefits	17.3%	17.2%
2.7. Other expenditures	2.4%	2.3%
<b>3. Acquisition of non-financial assets</b>	<b>1.8%</b>	<b>1.7%</b>

Source: Committee's calculations based on the Ministry of Finance's data.

**In the period of the decline of the real GDP and of the stagnation of the nominal GDP, total general government expenditures (expenditures plus acquisition of non-financial assets) were decreased by 0.6 percent, which, under these circumstances, is an important step in fiscal consolidation.** Based on the comparison of the data on the execution between 2011 and 2012, expenditures were decreased from 40.2% of GDP to 40.1 % of GDP, and acquisition of non-financial assets from 1.8 to 1.7 percent of GDP. In order to more strongly reduce the expenditures, it is necessary to undertake structural reforms. The project of central salary calculation will surely contribute to putting expenditures for employees in order in terms of the execution as well as of planning the expenditures for public sector employees. There is a great concern regarding the trends of expenditures for interests that reached 2.7% of GDP in 2012, with the increase of 17% compared to 2011, which is partly a consequence of assuming a part of the debt of the state-owned shipyards as public debt and of paying the

interest rate on this basis. The increase in expenditures is expected to continue on the basis of interest rates due to the increasing public debt, which points to the urgent adoption of measures for stopping further increase in the share of public debt in GDP.

**Significant fiscal consolidation was reached by reducing the general government budget deficit.** The data prepared according with the budget accounting rules show that the deficit is decreased from 4.5 percent of GDP in 2011 to 3.4 percent in 2012 (Table 5). This is mostly the result of the increase in total revenues, and to a lesser extent the result of the reduction of total expenditures. The reduction of the deficit is essential for stabilizing the public debt growth, which should be one of the key fiscal goals in Croatia.

*Table 5: General government deficit in 2011 and 2012 (according to the budget accounting rules, in HRK million)*

<i>(in HRK million)</i>	<b>Execution 2011</b>	<b>Budget 2012</b>	<b>Budget Revision 2012</b>	<b>Execution 2012</b>	<b>Difference in executions</b>
	1	2	3	4	5=4-1
1. Revenues of the consolidated general government	123,035	125,102	126,762	126,138	3,103
2. Disposals of non-financial assets	833	867	718	600	-233
Expenditures of the consolidated general government	132,889	130,992	132,804	132,450	-439
3. Acquisition of non-financial assets					
4. Deficit/surplus (5=1+2-3-4)	5,857	6,548	6,409	5,513	-344
- in % of GDP	-14,878	-11,571	-11,732	-11,225	3,653
	-4.5	-3.5	-3.6	-3.4	1.1

*Source: Ministry of Finance and Committee's calculations.*

**In order to monitor fiscal rules, it is necessary to apply ESA95 methodology, due to which, it is necessary to make adjustments of the data prepared according to the budget accounting.** First of all, this refers to the treatment of guarantee called, which, in case they keep repeating for three consecutive years, are attributed to the government expenditures in

the amount of the whole outstanding debt. The other differences refer to the expenses for guarantee reserve, disbursement of debt to pensioners, and some other adjustments. The differences in the classification of the government sector should not be forgotten either, since some institutions (HRT, HŽ infrastructure) are, according to new classification considered as a part of the general government (Table 6 summarizes the key methodological differences). The general government expenditures according to ESA95 methodology strongly increased in 2011, by more than HRK 7.8 billion compared to the data according to the budget accounting rules, while the increase in 2012 was smaller, that is, by HRK 1.8 billion.

*Table 6: Total expenditures according to the budget accounting and ESA95 methodology*

		<b>Execution 2011</b>	<b>Execution 2012</b>
1	<b>Consolidated general government expenditures, of the budget accounting</b>	<b>138,746</b>	<b>137,963</b>
	-of which, expenditures	132,889	132,450
	-of which, acquisition of non-financial assets	5,857	5,513
	<i>Adjustments for ESA95 methodology</i>		
2	Total liabilities – annual change	1,036	538
3	Expenses for guarantee reserve	299	113
4	Disbursement of debt to pensioners	819	718
5	Assuming the outstanding debt under guarantee on the basis of the repeated guarantee calls over three years or more	6,601	0
6	Fund for the compensation of seized asset – reducing the expenditures due to the assumed debt in 2010	85	0
7	Disposals of non-financial assets	833	600
8	Other adjustments	0	1,027
9	<b>Total general government expenditure, ESA 95 methodology (9 =1+2+3+4+5+6+7+8)</b>	<b>146,583</b>	<b>139,759</b>

*Note: Data for the total expenditures according to ESA95 methodology are preliminary and are subject to further changes in line with the agreement with EUROSTAT, and as a part of the consultations for the preparation of EDP Report.*

*Sources: Ministry of Finance's working table prepared for the Fiscal Policy Committee, and Committee's calculations.*



**The fulfilment of the fiscal rule is monitored according to the adjusted total expenditures of the general government.** According to the Fiscal Responsibility Act, the increase in the general budget expenditures directly connected with financing of projects co-financed from the pre-accession aid programmes and European funds in the Croatian process of joining the EU and in the first three years of membership, are excluded from the fiscal rules. The Ministry of Finance made such an adjustment, and the results are shown in Table 7. The increase in the expenditures related the use of EU funds in 2011 amounted to HRK 222 million, and in 2012 they amounted to HRK 226 million. Total expenditures are reduced by these amounts according to ESA95 methodology in order to get general government expenditure for the calculation of the fiscal rule.

*Table 7: Calculation of the change of expenditure share in GDP*

	<b>Execution 2011</b>	<b>Execution 2012</b>
<b>Total general government expenditure, ESA 95 methodology (1)</b>	<b>146,583,167</b>	<b>139,759,428</b>
<b>-of which expenditures for assumed shipyard debts</b>	<b>6,601,033</b>	<b>0</b>
<i>% of GDP</i>	44.40	42.32
<b>Expenditures which are excluded from the fiscal rules according to the Act</b>	<b>981,982</b>	<b>1,207,801</b>
<i>Source 12: Funds for aids</i>	245,990	307,803
<i>Source 51: EU aids</i>	735,991	899,998
Annual change of expenditures that are excluded from the fiscal rules according to the Act (2)	222,350	225,819
<b>General budget expenditures for the calculation of the fiscal rule, ESA 95 (1) – (2)</b>	<b>146,360,817</b>	<b>139,533,608</b>
<i>Share in GDP, %</i>	44.33	42.25
<b><i>Annual reduction of the share of the general budget expenditures in GDP – <u>fiscal rule</u></i></b>		<b>-2.08</b>

*Source: Ministry of Finance's working table prepared for the Fiscal Policy Committee.*

## 5. FISCAL RULES APPLICATION ASSESSMENT

**The Fiscal Policy Committee assesses that the fiscal rule for 2012 is fulfilled.** The data from the Annual Report on the Application of Fiscal Rules for 2012 indicate the decline of the share of total expenditures in the officially published estimation of the GDP<sup>4</sup> from 44.3 percent in 2011 to 42.25 percent in 2012. The decline amounted to 2.08 percentage points, which means that the fiscal rule for 2012 was fulfilled.

**Although it may seem that the fiscal rule relevant for 2012 was fulfilled to a much greater extent than required by the Act, the real effort regarding the budget consolidation on the expenditure side was however much smaller.** Therefore, it should be taken into account that total expenditures in 2011 were increased by HRK 6.6 billion (Table 6) as a part of statistical adjustment by which in case of repeated guarantee called over three years the total outstanding debt under guarantee is assumed as government expenditure. It is a one-off statistical intervention which did not result in cash expenses of an equal amount. If there had not been such adjustment in 2011, total general government expenditures according to ESA95 along with the adjustment for monitoring the fiscal rule (reduction by expenses linked with EU aid programmes and funds) would have amounted to HRK 139.8 billion or 42.33 percent of GDP, while in 2012 these expenditures would have remained at the level of HRK 139.5 billion or 42.25 percent of GDP. In this case, fiscal consolidation on the expenditure side would have been very small. Cyclical position of the Croatian economy was an aggravating circumstance for fulfilling the fiscal rule based on the reduction of total expenditures measured by the share in GDP, as defined in the Fiscal Responsibility Act.

**The Fiscal Policy Committee points to the need for Government to prepare projections of the fiscal rules application according to the appropriate methodology as an integral part of all official budget documents within the framework of the State Budget adoption procedure.** Experience shows that this has not been the case. The State Budget, Economic and Fiscal Policy Guidelines, and the Amendments to the State Budget were adopted in the Parliament without submission of precise and methodologically harmonized projections of the fulfilment of fiscal rules in the current year, and for the following two years.

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<sup>4</sup> Statement of the Croatian Bureau of Statistics number 12.1.1/4 of March 20, 2013

**It is necessary to improve the reporting on the fiscal rule application.** For example, in the Semi-Annual Report on the Application of Fiscal Rules for the first half of 2012, adopted by the Croatian Parliament in October 2012, the projections of the economic growth were very briefly mentioned as well as the projections of total expenditures according to ESA95 methodology in 2012. Presented data on total government expenditures were not adjusted for the expenses linked with EU aid programmes and funds. The risks were almost not mentioned except the possibility of further worsening of the economic activity. The Semi-Annual Report actually only repeated the projections already mentioned in the Guidelines from July 2012 and in that way it did not show any relevant up-to-date information which might have helped in better understanding of the situation with the fiscal rules application in that year.

**The experience with the fiscal rule from 2012 points to the need of redefining the fiscal rule.** Fiscal rule should take into account the cyclical position of the economy and the fulfilment of the commitments within the framework of the European Stability and Growth Pact. In addition, the Fiscal Policy Committee points to the need of as precise as possible definition of fiscal rules in order to mitigate the control of the application thereof. In case the fiscal rules were not modified, the problems in the application found in 2012 would also remain in 2013, whereby there is no doubt that the application of the same criteria would then lead to non-fulfilment of the rules despite significant efforts that are undertaken regarding the consolidation of public finances and advancements in that direction.