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PRESS RELEASES

Should any budget surplus be immediately squandered? A commentary on the EU and Croatia fiscal stance assessment

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The European Commission has released its Union fiscal stance assessment. On the basis of member states' stability and convergence programmes and its spring 2017 economic forecast, the Commission takes a look at budgetary developments in 2016 and fiscal plans for the 2017 – 2020 period at the level of individual member states, the euro area and the Union as a whole.[1] Of all EU member states, Croatia saw the sharpest decrease in budget deficit in 2016; however, the country continues to face significant public finance sustainability risks, particularly high overall public debt sustainability risk. It is a good thing, then, that the government is planning a budget deficit reduction, even a surplus, over the long-term. But in order to achieve these goals, the government should launch the necessary reforms and avoid indulging interest groups and ignorant, populist demagogues.

Children should perhaps not be blamed too harshly if they squander their allowance as soon as they get it, especially if their peers are trying to talk them into it. They lack the necessary knowledge and experience when it comes to money – and have their parents to cover their expenses. Adults, however, especially those in charge of leading the country, should not behave like that, not even if people are trying to talk them into it. There isn't anyone who will take care of the needs of the country – there are only cruel financial markets – and least of all should this be the way of the leaders of a country with a high debt-to-GDP ratio and inevitable high expenditures in, e.g., the health care system which is in need of reform, the railways, road infrastructure, and local government, as well as numerous – and not-so-inevitable – expenditures which are unlikely to be reduced due to the influence of powerful interest groups. Croatia's moderate fiscal recovery in the short term was mainly the result of economic growth and favourable debt repayment terms, but both can change overnight, while fiscal prospects over the medium and long term are still uncertain, even unfavourable.

Fiscal stance of the Union

In 2016, consolidated general government deficit in member states was lower than expected, averaging 1.7% of GDP, mostly due to the fact that average GDP growth exceeded prospects. Member states plan to significantly step up fiscal consolidation in the future, particularly from 2018 on, with average deficit approaching zero in 2020. Most member states plan to approach their medium-term budgetary objectives.

[1] The analysis includes all member states apart from Greece, which is under a macroeconomic adjustment programme and therefore did not submit a Stability and Convergence Programme.

The comparison of the member states' programmes with the Commission forecast suggests that the projected budgetary figures for 2017 are mostly plausible; when it comes to 2018, however, member states are somewhat more optimistic, which appears to be mainly linked to a different quantification of fiscal measures to be implemented. The assumptions which underlie member states' projections for the last two years of the programmes (2019 and 2020) appear realistic in general, but are nevertheless rather optimistic in the case of some member states.

Average public debt in EU member states peaked in 2014 at 88% of GDP and is projected to decrease steadily to reach, on average, 78% of GDP in 2020, mainly due to primary surpluses supported by favourable debt repayment terms on financial markets. Medium-term projections show that, if the fiscal plans in the member states' programmes were fully implemented, additional fiscal consolidation measures totalling around 0.5 percentage points of GDP would be needed over the next five-year period to bring the debt-to-GDP ratio to 60% by 2031. However, a number of member states must undertake significant fiscal consolidation measures.

Fiscal stance of Croatia

While consolidated general government deficit of all EU member states was reduced on average by 0.6 percentage points of GDP in 2016, Croatia reduced its deficit by commendable 2.6 percentage points of GDP, more than any other EU country, followed by the Netherlands and Portugal, while Romania's deficit even grew by 2.3 percentage points of GDP. Owing to this reduction, Croatia's deficit in 2016 was lower than the EU average (0.8 and 1.7% of GDP, respectively). Outturns were better than planned, but it should be noted that the same was true of most member states, with few exceptions.

When it comes to public debt reduction in 2016, Croatia comes in sixth (after Slovenia, Ireland, the Czech Republic, the Netherlands, and Germany), while its debt amount is basically the same as EU average (84.2 and 84.4% of GDP, respectively).

Further stabilization is projected on EU level, with EU aggregate deficit somewhat decreasing, from 1.7% in 2016 to 1.6% of GDP in 2017. Croatia is one of the few member states knowingly allowing a deterioration in budget balance (an increase in deficit from 0.8% in 2016 to 1.3% of GDP in 2017), though this may be merely a case of careful planning considering uncertainties surrounding, for instance, debts in health care or the *Agrokor* case. However, it is quite apparent that the government is intent on meeting medium-term budgetary objectives by the end of the corresponding period. In the years to come, Croatia plans to reduce its deficit to 0.8% in 2018 and to 0.3% in 2019, finally forecasting a 0.5% surplus in 2020.

In its overview, the Commission compares the projected cumulative general government deficit reduction as percentage of potential GDP for the 2017 – 2020 period and public debt as percentage of GDP in 2016, reaching the conclusion that more indebted member states are more likely to pursue further deficit reduction. In some cases, however, such as in the case of Italy and Portugal, the planned budget adjustment is significantly smaller than what is needed; „moreover, CY, HR, and HU plan a structural deterioration despite high levels of public debt".

Risks to the realization of member states' programmes

Risks to the realization of member states' programmes for 2017 and 2018 are assessed by comparing Stability and Convergence Programmes and Commission forecasts. However, since the 2019 – 2020 period is not covered by Commission forecasts, no such comparison for that period is possible.

Budgetary deficit targets made by member states and the Commission for 2017 are aligned (EU average being 1.6% of GDP). However, for 2018, member states' programmes are more optimistic than the Commission's at 1.1 and 1.4% of GDP, respectively. Croatia forecasts a higher deficit than the Commission for 2017 (1.3 and 1.1% of GDP, respectively), while the situation is reverse for 2018, with Croatian deficit forecast being lower than that of the Commission (0.8 and 0.9% of GDP, respectively).

Regarding public debt in 2017, member states and the Commission forecast an EU average reaching 83.4% of GDP, and 82 and 82.2% of GDP, respectively, for 2018. Croatia forecasts public debt to reach a

somewhat lower amount than what the Commission forecasts – 81.2 and 81.9% of GDP, respectively, for 2017 and 78.4 and 79.4% of GDP, respectively, for 2018.

When it comes to 2018 and 2019, the Commission is concerned whether member states' projections are plausible, if they are based on overly optimistic assumptions, if policy changes are taken into consideration, and if their achievement requires too many discretionary measures. Therefore, the risk to the realisation of fiscal targets is evaluated on the basis of fiscal targets as declared by member states assuming an unchanged policy scenario.

According to the Commission, the baseline assumptions on which member states' budgetary objectives are based appear prudent in general. However, the projections may be too optimistic in the case of some member states that might encounter revenue shortfalls in an unchanged fiscal policy scenario, without increasing revenues significantly. Most envisaged fiscal adjustments rely on planned savings in expenditure as a share of GDP, and experience tells us that such savings can be difficult to achieve. While interest expenditure is not expected to fall after 2018, some member states, including Croatia, still count on significant savings from lower interest rates.

Public finance sustainability

Moreover, the Commission analyses the short-, medium- and longer-term sustainability of member states' public finance, taking into account various macroeconomic scenarios and the ageing effect which are incorporated in the Commission's special report on the issue named The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060), including a detailed analysis of the case of Croatia. The key issue is the amount and nature of fiscal consolidation necessary for average public debt to fall to 60% of GDP by 2031. Given relatively significant economic growth and favourable debt repayment terms, no member state, Croatia included, currently faces short-term fiscal challenges. However, the situation changes significantly if we look at the bigger picture.

Over the medium term, 11 member states face high overall risk, 5 face medium overall risk, and 11 face low overall risk, with Croatia being one of the member states facing high overall risk. Over the long term, only one member state (Slovenia) faces high overall risk, 14 face medium overall risk, and 12 face low overall risk, with Croatia being in the latter group. When analysing public debt sustainability risk, 11 member states face high overall risk, 4 face medium overall risk, while 12 face low overall risk, Croatia being one of the member states facing high overall risk. In short, Croatia faces significant public finance sustainability risks. The fact that it faces high overall risk when it comes to public debt sustainability should be borne in mind.

It is, however, nice to see that Croatia is, for a change, best at something according to European Commission analyses – this year, this was budget deficit reduction. Moreover, it is nice to see that, according to Economic and Fiscal Policy Guidelines, the government plans a budget surplus in 2020. The government should therefore be supported in its fiscal efforts, but one should not ignore the pertaining risks, their types and their significance, also mentioned by the Commission. We should bear in mind at all times that Croatia is a country with a high debt-to-GDP ratio and high general government expenditures[2], the reduction of which poses a significant challenge, not least due to resistance from interest groups. However, the government should be supported in all its efforts leading to a reduction in expenditure, deficit and debt. Admittedly, the tax burden in Croatia is very high, meaning that general government revenue is high as well. However, tax revenue cannot be reduced unless expenditure is reduced first. The Laffer curve (according to which the lowering of tax rates can lead to the collection of more tax revenue) is an attractive theoretical concept, but, as in case of all theoretical concepts, its practical effect is questionable and contingent on many factors. As expenditures are reduced, revenue can be reduced as well, but the focus will have to remain on the reduction of overall tax burden rather than the selective lowering of certain tax rates. Though many like to think they know everything about football and economics, including taxes, all professional choices, fiscal ones included, should be left to experts.

[2] For the sake of comparison, general government expenditures in Croatia amount to almost 49% of GDP, while in e.g. Romania they amount to 35%, in Bulgaria and Lithuania to 36%, in Slovakia to 39%, and in the Czech Republic to 40%.