



REPUBLIC OF CROATIA



FISCAL
POLICY
COMMISSION

2022 ANNUAL REPORT OF THE FISCAL POLICY COMMISSION

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Chairperson's statement

Dear Sir/Madam,

it is my pleasure to present to you the 3rd (third) Annual Report of the Fiscal Policy Commission which describes the Commission's work and activities in 2022 and provides comments on and an overview of macroeconomic and fiscal policy trends throughout last year, underlining the importance of the challenges and priorities for the short- and mid-term period of Croatia's fiscal policy in these challenging times.

Pursuant the Fiscal Responsibility Act (Official Gazette 111/18, hereinafter: FRO), the Fiscal Policy Commission (hereinafter: the Commission) is obligated to report annually to the Croatian Parliament on its work in the previous year, not later than by 1 July of the current year. The Commission's work is based on the Fiscal responsibility Act, the Budget Act (Official Gazette 144/21) and the Commission's Annual Plan and Work Programme. The Commission's main tasks are related to analysing and assessing the risk of application of fiscal rules, providing an unbiased and comprehensive evaluation, a confirmation of macroeconomic and budgetary projections, continuous monitoring of the fulfilment of the recommendations of the Council of the European Union for the purpose of resolving the situation of an excessive budgetary deficit and public debt and producing an opinion to the Government of the Republic of Croatia (hereinafter: Croatian Government) on the temporary postponement of the application of fiscal rules in case of extraordinary circumstances.

In 2022, independent fiscal institutions in the European Union (hereinafter: the EU), including the Croatian Fiscal Policy Commission, operated in complex and specific circumstances. Temporary postponement of the application of fiscal rules, in force since 2020, has significantly minimized the room for manoeuvre through the assessment of the appropriateness of fiscal policies. In these circumstances, we continued to follow European Commission's general recommendations in terms of choosing fiscal policy measures which must be targeted and temporary, to ensure a quick adjustment to fiscal rules when the extraordinary circumstances disappear and when fiscal rules are reactivated and in force, which is expected next year. On the other hand, in 2022, the Commission was tasked with new activities on top of the existing ones, more specifically, confirming macroeconomic projections and evaluating

budgetary projections, which additionally increases its scope of work. In the conditions of increased uncertainty and limited resources, based on how realistic the projections were and by comparing them with those of other relevant foreign and national institutions and by examining the errors in last years' predictions, the Commission analysed and evaluated the projections, as documented in the Commission's position papers published in 2022.

Looking back, after 2020 and 2021, that is, two pandemic years marked by materialized and significant negative macroeconomic risks, 2022 started with optimistic expectations. In fact, the consequences of the COVID-19 epidemic started diminishing and global supply conditions were expected to normalize, with moderate inflationary pressure. The economic base was supposed to stimulate economic growth because of the large share of household saving, favourable financing conditions and the implementation of the EU recovery and resilience facility and the improvement of labour market conditions. However, as Russia began its invasion on Ukraine in the second half of February 2022, this optimism disappeared quickly and new challenges appeared, such as: increase in energy costs and prices of agricultural products and the pressure to increase prices due to lack of material, equipment and workers. In addition, due to increasing inflation expectations, central banks also started tightening the financing conditions. The unfavourable geopolitical situation due to the war in Ukraine caused many disturbances and problems in the European economy, first and foremost as a consequence of its dependence on energy, gas primarily. These disturbances have significantly increased inflationary pressures and decreased households' and companies' purchase power. In response to this turn of events, the European Commission enabled the member states the same level of flexibility as during the COVID-19 pandemic, primarily in terms of using an expansionary fiscal policy and supporting their economies using various fiscal measures.

Such international trends had an influence on the small and open Croatian economy and its economic prospects. Despite numerous challenges, in 2022, Croatian economy achieved economic growth higher than planned (6.3 % compared to the planned 4.4 %), and such strong (nominal and real) growth (double the economic growth at the EU level (3.5 %)) had a favourable effect on Croatian public finances in terms of increasing profit and decreasing burden of public debt (share in GDP). Due to strong GDP growth

and the effect of strong inflation (in 2022, Croatia recorded a very high inflation rate - 10.8 %) and the measures to mitigate the consequences of increasing energy prices, in 2022, fiscal policy was largely marked by a strong growth of revenue from taxes. In that regard, to protect Croatian economy from the effects of increasing international energy prices and support economic recovery, the Croatian Government introduced strong fiscal support measures. The general government balance according to the ESA 2010 methodology was positive, resulting in a general government surplus of EUR 261.9 million or 0.4 % of GDP. At the same time, the public debt-to GDP ratio compared to 2021 decreased by ten percentage point (to 68.4 % of GDP) and it is expected to continue decreasing in 2023. If such positive macroeconomic trends continue (the Croatian economy is currently undergoing a positive output gap), further fiscal consolidation and public debt reduction measures must be kept despite any challenges Croatian economy might be facing in the future. In the last three years, countercyclical fiscal policy played an important role in minimizing the damages caused by the coronavirus pandemic and the consequences of the Russian-Ukrainian war and in creating preconditions for economic recovery. In the upcoming period, conservative income planning should continue, expenditure control should be improved and implementation of necessary structural reforms ensured. This especially relates to improving, that is, reorganizing the entire public administration, increasing efficiency and transparency of public companies and reforms in the area of health and education to ensure economy is well prepared to tackle long-term challenges related to climate change and digital transition. In that sense, priority should be given to public investments, and the use of EU funds to finance investments and reforms for stimulating productivity growth should be maximized. The structure of public finances must remain stimulative for sustainable growth and resilience of Croatian economy, all for the purpose of creating fiscal reserves for action in case of a future crisis.

In addition, in 2024, fiscal rules will again be in force. Being an EU Member State and subject to the Fiscal Responsibility Act, the Republic Croatia is obligated to abide by these rules. The expected deactivation of the general escape clause after 2024 means that public finances should trend in the direction of deficit consolidation toward the mid-term budgetary objective of 0.5 %. In that sense, it is paramount to try to limit the aggravation of structural deficit and nominally increase nationally funded net primary expenditure. Additionally, structural deficit must be improved to ensure fiscal rules are

respected. Therefore, fiscal policy needs to include a countercyclical element, which is why the preventive part of the Stability and Growth Pact, transposed in the Fiscal Responsibility Act, requires stronger adjustment (in favourable fiscal times).

Since 2022 was the year the Fiscal Policy Commission started working as an independent and autonomous body, at the beginning of 2022, activities were commenced targeted at the establishment of the Commission Office so that the Commission could fulfil its tasks defined under the Fiscal Responsibility Act and the Budget Act. I would like to especially highlight here the challenges the Commission faced during 2022 while the establishment of the Commission Office was just starting. After its the entry into the Registry of Business Entities, the Commission started working on the amendments to the existing Rules of Procedure, preparing the documentation related to the search for adequate business premises, designing our own website¹, ensuring sufficient financial means for achieving the objectives and entrusted tasks, as well as ensuring conditions related to the internal organization of the Commission Office in terms of workplaces and job descriptions and the number of officials and employees. In the period between April and November 2022, Croatia was expecting the passing of the Government Decree on the amendments to the Decree on job titles and the coefficients of the complexity of work in government service laying down special titles of workplaces and coefficients of the complexity of work in the Commission; however, it was only done in late November 2022 when the concerned Decree was published in the Official Gazette (no. 139/22). Only after this Decree was passed was it possible to pass the Rules on the internal organization of the Commission Office which is the precondition for starting the recruitment process. Furthermore, since the Commission Office requires business premises for its operation, the Commission referred to the Ministry of Physical Planning, Construction and State Assets which allocated the Commission business premises in late August 2022. However, the allocated premises, due to the earthquake, are inhabitable and do not meet the basic minimum prescribed standards and require thorough renovation, equipment and furnishing.

However, despite all these challenges encountered on the road to independence and functional setting up of the Commission Office, in 2022, the Commission kept up to

¹ www.pfp.hr

date and retained a high level of professionalism and quality in performing its tasks, and I am certain the situation with the premises has not affected the Commission's results and work quality.

The Commission regularly published its position papers and provided reliable information and evaluations of the sustainability of public finances and the state of fiscal policy on which it reported to the Croatian Parliament and the general public in a timely manner. All the position papers, confirmations of macroeconomic projections and other information on activities were published on the Commission's website.

Finally, I would like to thank the members of the Croatian Parliament, the members of the Fiscal Policy Commission and their parent institutions and all the Commission's associates on stimulative cooperation, their assistance and support in our work.

Chairperson

Prof. Sandra Krtalić, PhD

A handwritten signature in blue ink, appearing to be 'S. Krtalić', written over a large, stylized letter 'S'.

1 The fiscal policy position and the evaluation of the state of public finances in 2022

Last year, 2022, was marked by exceptionally high inflation, steep increase of energy prices and a decrease of real salaries and the consumers' and companies' trust. Despite these circumstances, in 2022, Croatian economy surpassed the expectations and recorded a strong (real and nominal) growth despite the shocks caused by the war in Ukraine, energy shocks and the resulting record-high inflation rates. In 2022, economic growth had a positive impact on Croatian public finances in terms of increased public revenue and decreased burden of public debt (measured by the share in GDP). In 2022, a 13.3 % increase of the total general government revenue was achieved. This is a result of a strong increase in indirect taxes (due to increased prices, the increase in personal consumption and tourist activity) and partially the increase in direct taxes (personal income tax and corporate income tax) and the decrease in unemployment and increase in employment. On the other hand, general government budget expenditure increased by 6.6 % in 2022, primarily due to the increase in expenditure for social fees and expenditure for compensations to employed persons. At the same time, due to the slower implementation of EU-funded projects in 2022, investment activity visibly abated.

To mitigate the negative economic consequences for the citizens' and companies' standard due to increasing energy prices and in general in the fight against inflation, the Government of the Republic of Croatia adopted three temporary packages / aid measures that served as fiscal stimuli for the overall aggregate demand. The first package of measures was adopted in February 2022 (in force since 1 April 2022), and the second, autumn package at the beginning of September 2022 (in force since 1 October 2022), while the third package was adopted on 22 December 2022. All the three packages were appropriate to the current circumstances and within the limits of state interventionism. Since the introduction of extraordinary measures always affects the change of position and state of public finances, the Commission analysed them in its position papers and provided its opinion thereon in the evaluation of the delivered budgetary documents. Although it assessed them as appropriate, the Commission also pointed out that the assessment of the effects of implemented fiscal interventions was insufficiently transparent, that is, that the fiscal effects of defined packages of

measures were not completely clear nor specific both in the short- and mid-term. All the more so as the indicated costs of the adopted measures will not be observed only through the state budget, making it extremely difficult to assess their (permanent) effect. By doing so, the Commission wanted to raise awareness of economic policy makers and of the general public on the risks for the mid- and long-term sustainability of public finances.

In a situation when the General Escape Clause is still in force, the Commission repeatedly highlighted the need to continuously monitor and examine the fiscal position of Croatian economy to enable adjustment and continuity of implementation of responsible fiscal policy to maintain the long-term sustainability of Croatian public finances. If a prudent and balanced budget policy is implemented in the mid-term, there will be plenty of room for a timely and appropriate fiscal policy response in recession circumstances. Furthermore, strong economic growth, which is also higher than potential growth, in combination with increased inflation and favourable budgetary achievements resulted in a decrease of the burden of public debt and lower state indebtedness. More specifically, in 2022, a consolidated general government surplus was achieved of 0.4 % of GDP, whereas the consolidated general government debt was 68.4 % of GDP. In 2022, compared to 2021, the level of public debt decreased in relative terms (by ten percentage points, but still nominally high), which makes Croatian economy vulnerable and threatens the long-term sustainability of public finances. Positive economic trends were used for a strong adjustment of public finances, so the structural balance in 2022 amounted to -0.9 % of GDP, which is below the mid-term budgetary objective set at -1.0 %. The existing fiscal rules, despite their imperfection and temporary postponements, significantly contributed to improved fiscal discipline and increased long-term sustainability of public finances in EU member states, including Croatia. Being a small and open economy, Croatia must respect the fiscal rules, although these are currently under suspension and revision. The European Commission is working intensely on their reform, and the discussions led so far show that it is precisely the analysis of the sustainability of public debt that should play the central role in determining the direction of fiscal adjustment and consolidation in the future.

Even though fiscal policy in 2022 enabled fiscal stimuli in response to the crisis, this did not endanger mid-term fiscal sustainability which the Commission assessed as adequate. Furthermore, due to a high level of uncertainty, fiscal policy also ensured credibility, flexibility and transparency and maintained the sustainability of public debt, all the while ensuring the necessary interventionist fiscal measures to mitigate the impact of the increasing prices on households and companies. Although in 2022 Croatian public finances turned out to be “healthier and better” than the forecasts and predictions, we must remain cautious due to the uncertainty the future brings (increasing interest rates, high inflation rate) due to which the prospects for economic growth in the Republic of Croatia in the upcoming period are much lower than in the last two years. Although in 2022 the Government of the Republic of Croatia led a responsible fiscal policy in terms of deficit and public debt trends, in the upcoming period, it will have to pay much more attention to the existing fiscal risks which are a threat to the stability and long-term sustainability of public finances. These risks are reflected in very unfavourable demographic trends (population ageing and decreasing number of working-age citizens) which exert additional pressure on the sustainability of the pension system, in outstanding liabilities and the overall financial sustainability of the healthcare system and all necessary structural reform interventions which have been deferred for years. Moreover, the Government will have to pay special attention to the stabilization function of public finances with a special accent on the cyclical nature of fiscal activities, that is, on “correcting” cyclical oscillations in the long term as well as to the further decrease of public debt.

In the upcoming period, the Commission will continue contributing as much as possible to a successful fulfilment of its tasks and giving independent and professionally based opinions on the compliance of fiscal policy with both the existing and future fiscal rules. Pursuant to its legal powers, the Commission wants to contribute to creating the conditions for ensuring mid- and long-term sustainability of public finances, including economic development and permanent improvement of Croatia’s welfare.

2 About the Fiscal Policy Commission

In the period between 2011 and 2021, the Fiscal Policy Commission worked and operated in a few stages, and the Commission itself underwent several significant changes in its organization and work. Although the Council Directive EU 2011/85, which lays down that the Commission is a permanent, independent and autonomous professional body endowed with a stronger supervisor role over the implementation of the FRA, was transposed into the Fiscal Responsibility Act, the Commission acted no less than eight years as another Croatian Parliament's body and it only became an independent and professional, independent body in late 2021, after the election of the Commission's first chairperson and the effecting of its registration as a business entity at the Croatian Bureau of Statistics. The process of registration of this body also marked the first modest steps in the operative establishment of the Commission Office (as the Commission's specialist service).

The Fiscal Policy Commission belongs to the group of independent fiscal institutions whose basic task is to supervise public finances to ensure their long-term sustainability and improvement.

The Commission is composed of the chairperson and six members appointed for a five-year term by the Croatian Parliament. The chairperson is elected through a public call, and the six members are elected from among prominent scientists and professionals at the proposal of the State Audit Office, Institute of Economics in Zagreb, Institute of Public Finance, the Croatian National Bank and faculties of economics and law of the universities in Zagreb, Split, Osijek and Rijeka.

The members of the Commission in the period between 2019 and 2025 were:

- Prof. Sandra Krtalić, PhD, Commission Chairperson
- PhD Maroje Lang, representative of the Croatian National Bank, Deputy Chairperson

- Vesna Kasum, MSc, representative of the State Audit Office
- PhD Maruška Vizek, representative of the Institute of Economics, Zagreb
- PhD Vjekoslav Bratić, representative of the Institute of Public Finance
- Associate Prof. Domagoj Karačić, PhD, Faculty of Economics, University of Osijek, from among the representatives of faculties of economics, and
- Associate Prof. Zoran Šinković, PhD, Faculty of Law, University of Split, from among the representatives of faculties of law.

The mission of the Commission, as an independent fiscal body, is to act with the aim of ensuring mid- and long-term sustainability of public finances, that is, fiscal policy of the Republic of Croatia in its entirety. The Commission's vision is directed at being recognised as an independent, specialist and highly professional institution whose primary function is to act in the public interest and whose unbiased, efficient and transparent monitoring encourages long-term fiscal sustainability and thus contributes to Croatia's prosperity.

The basic purpose of the Commission's operation is to review and assess fiscal rules defined pursuant to EU rules, assess how realistic the Government's forecasts and assessments of potential growth are and provide opinions on the compliance of fiscal and budgetary projections with long-term objectives of Croatia's public finances. The Commission is obligated to point to the consequences of the decisions of all government levels (first and foremost the Government of the Republic of Croatia) on mid- and long-term sustainability of public finances and public debt and their impact on future generations.

Article 22 of the FRA lays down the Commission's powers, tasks and duties which, in general terms relate to:

- examining and assessing the risks of applying the fiscal rules in mid-term budgetary documents and the annual report on the execution of the budget,
- examining and comparing macroeconomic and budgetary projections indicated in mid-term budgetary documents with the most recent available projections of the European Commission (hereinafter: EC),

- monitoring the fulfilment of the recommendations of the Council of the European Union for the purpose of resolving the situation of an excessive budgetary deficit and public debt,
- identifying the occurrence of a disaster, that is, the existence of major economic disruptions which significantly impact the balance of the general budget, due to which the application of the fiscal rule is temporarily postponed under the condition that fiscal sustainability in the mid-term is not jeopardized, and
- producing an opinion to the Government of the Republic of Croatia on the temporary postponement of the application of fiscal rules in case of extraordinary circumstances.

Furthermore, the introduction of the euro as the official currency in the Republic of Croatia implies stricter rules regarding the monitoring and coordination of economic policy of euro area member states. Within this framework, the Commission was tasked with confirming macroeconomic projections. Therefore, under the new Budget Act (Official Gazette 144/21), the budget process was adjusted to the requirements of the euro area membership which requires enhanced coordination of economic policies. Therefore, the Government is obligated to prepare a draft budgetary plan for the purpose of consultations with the European Commission, provided that the macroeconomic projections are independent, that is, confirmed by the Commission. The Commission has an important role in that process because it must evaluate whether the prepared macroeconomic projections are a good basis for preparing budgetary plans, and whether they reflect macroeconomic projections and other planned and adopted measures, which was not obligatory under the former FRA. Paragraphs 2 and 3 of Article 21 of the Budget Act lay down the Commission's new tasks as follows:

- it carries out an unbiased and comprehensive evaluation of macroeconomic and budgetary projections and
- confirms macroeconomic projections on which it bases the stability programme (Article 22 of the Budget Act) and the draft budgetary plan (Article 27 of the Budget Act).

2.1 Overview of Fiscal Policy Commission's activities in 2022 in establishing the necessary (pre)conditions for its operation

After the first chairwoman of the Commission was elected, 2022 was the first calendar year the Commission operated throughout as an independent and autonomous body. Accordingly, in early 2022, targeted activities were commenced to establish the Commission Office. Commission's special objectives are a result precisely of the strengthening of the Commission's role in implementing the fulfilment of fiscal rules and the strengthening of its infrastructural, administrative and analytical capacities. After the entry into the Registry of Business Entities in late 2021, the Commission started working on the amendments to the existing Rules of Procedure, preparing the documentation related to the search for adequate business premises for the needs of the Commission Office's work, designing our website, ensuring sufficient financial means for achieving its objectives and entrusted tasks, as well as ensuring conditions related to the internal organization of the Commission Office in terms of workplaces and job descriptions and defining the number of officials and employees. Until a fully integrated and functional Commission Office is established, its administrative and technical tasks, pursuant to the FRA, are handled by the Croatian Parliament's Service for General Affairs.

While it operated within the Croatian Parliament, the Commission used the Parliament's premises. As the Commission became independent, the search started for adequate business premises for the Commission's accommodation and work and the establishment of a functional Commission Office. For the purpose of allocation of business premises, the Commission referred to the Ministry of Spatial Planning, Construction and State Assets. Premises were allocated to the Commission in late August 2022. However, due to the earthquake, the business premises need to be thoroughly renovated, equipped, furnished and adapted - as soon as possible - after which the necessary equipment will be purchased (furniture, communication and computer equipment, inventory).

To strengthen the Commission's administrative capacities, the plan was to recruit a certain number of professional and specialist personnel in the Commission Office. The Office will, among other, perform complex works of economic analyses and forecasts

requiring specialist knowledge. Considering the total planned number of workers, the idea is for the Commission Office to be structured horizontally and predominantly employ consultants, that is, analysts with specialist knowledge and skills in macroeconomics, econometrics, (public) finances and quantitative analyses. We can expect that it will be challenging to find on the market a sufficient number of skilled candidates for these workplaces which means the personnel will have to be additionally trained. Furthermore, the entry into the euro area implies an increased volume of the Commission's tasks in the area of macroeconomic planning which significantly increases the complexity of works performed in the Commission Office. Therefore, in early 2022, the Croatian Government was asked to supplement the Decree on job titles and the coefficients of the complexity of work in government service laying down special job titles and coefficients of the complexity of work in the Commission. The Croatian Government's Decree on the amendments to the Decree on job titles and the coefficients of the complexity of work in government service was published in late November 2022 (Official Gazette 139/22) and it laid down special job titles and coefficients of the complexity of work for the Commission. Furthermore, the composing of the Rules on the internal organization of the Commission Office, for which preliminary consent was requested from the Ministry of Finance and the Ministry of Justice and Administration, was necessary to pass the Civil Service Recruitment Plan in the Office of the Fiscal Policy Commission for 2023.

Considering the Commission's main tasks, it will be necessary to introduce IT support which includes all the activities related to automated creation of certain analytical reports used for analysing and publishing data for the purpose of fiscal transparency. In that regard, funds were planned for procuring computer equipment, statistical and mathematical apps and other software solutions the Commission needs for its work.

3. Fiscal Policy Commission's Position Papers

During 2022, pursuant to Article 22 of the FRA and Article 21 of the Budget Act, the Commission directed its activities toward evaluating and confirming macroeconomic projections and examining and comparing macroeconomic and budgetary projections from mid-term budgetary documents with the last available projections of the European Commission and other international institutions. The Commission evaluated all the budgetary documents from the perspective of ensuring fiscal liability, that is, examining and assessing the risks of applying fiscal rules in mid-term budgetary documents and the annual report on the execution of the budget. To ensure mid- and long-term sustainability of Croatian public finances, in 2022, the Commission again published its position papers in which it continuously and firmly highlighted the need:

- to further consolidate public finances;
- for improved expenditure planning and control, that is, better prediction of certain budget items, such as the expenditure for employed persons, pension fees and healthcare, which are often initially planned at unrealistically low levels, in order to increase them in the subsequent amendments to the budget;
- implement and continue structural reforms (in public administration, healthcare, pension, educational and social welfare system) that would significantly minimize the generation of additional losses in certain sectors often necessitating the amending of the State Budget;
- to attract investments enabling stronger growth in the future, where most of the available funds, especially those from EU sources, must be directed toward all those activities that would preserve and maintain economic activity, help the most vulnerable households and contribute to long-term sustainability of public finances;
- for temporary, targeted and efficient fiscal policy measures aimed at alleviating the consequences of inflationary pressures;
- to constantly and meticulously monitor economic and budgetary achievements as well as the timely reaction of economic and fiscal policy in case of any serious deviations in uncertain and changed circumstances for the purpose of ensuring continuity of fiscal policy, that is, long-term sustainability of Croatian public finances.

The Commission regularly met with key domestic and international stakeholders. To discuss and exchange ideas on macroeconomic and fiscal assessments and the applied methodology of predicting and assessing risks, regular communication was maintained, and professional meetings held also with the representatives of the Ministry of Finance. In addition, in composing its analyses and position papers, the Commission also used different reports and forecasts of other institutions (Croatian National Bank (hereinafter: CNB), Croatian Bureau of Statistics (hereinafter: CBS), Organization for Economic Cooperation and Development (hereinafter: OECD), the International Monetary Fund (hereinafter: IMF) and the World Bank). During 2022, the Commission also intensified its international activities within the framework of the EU Independent Fiscal Institutions Network and the EU Independent Fiscal Institutions.

The Commission's position papers, as in the previous years, were also sent to the members of the Croatian Parliament's Finance and Central Budget Committee before their discussion on budgetary documents. Moreover, pursuant to its new task laid down in Article 21 of the Budget Act, the Commission provided the Croatian Government with the confirmation of the macroeconomic projections underlying the Draft Budgetary Plan for 2023.

3.1 The schedule of sessions and the position papers of the Fiscal Policy Commission in 2022

In 2022, the Commission held two (2) expert meetings and six (6) sessions at which is adopted six (6) position papers and the Confirmation of Macroeconomic Projections. Position papers were published in Croatian and English on the Commission's website. The agendas of the Commission's sessions are listed below.

The 11th (electronic) session of the Fiscal Policy Commission held on 11 March 2022

- Passing the Decision on the adoption of the Rules of Procedure of the Fiscal Policy Commission
- Passing the Decision on the adoption of the Report on the work of the Fiscal Policy Commission in 2021
- Adopting the Annual Work Plan for 2022

The 12th (electronic) session of the Fiscal Policy Commission held on 16 May 2022

- 16th Position Paper of the Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2021
- 17th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2022 and the Projections for 2023 and 2024

13th (electronic) session of the Fiscal Policy Commission held on 5 October 2022

- 18th Position Paper of the Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022

14th (electronic) session of the Fiscal Policy Commission held on 11 October 2022

- The Confirmation of macroeconomic projections of the Ministry of Finance for 2023

15th (electronic) session of the Fiscal Policy Commission held on 24 October 2022

- 19th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024
- 20th Position Paper of the Fiscal Policy Commission on the Draft Budgetary Plan

16th (electronic) session of the Fiscal Policy Commission held on 21 November 2022

- 21st Position Paper of the Fiscal Policy Commission on the Draft State Budget of the Republic of Croatia for 2023 and the Projections for 2024 and 2025.

Table 1 Fiscal Policy Commission's annual publications timetable

Month	Week 1	Week 3	Week 4	
February			<i>National Bureau of Statistics: The first assessment of the three-month gross domestic product (GDP) for the fourth quarter of 2021</i>	
March			<i>National Bureau of Statistics: Report on excessive deficit and general government debt procedure, April 2022 (ESA 2010)</i>	Annual Report on the work of the Fiscal Policy Commission in 2021
April		<i>National Bureau of Statistics: Report on excessive deficit and general government debt procedure</i>	<i>Croatian Government: Convergence programme of the Republic of Croatia for the 2023-2025 period</i>	
May		<i>EC: European Economic Forecast Spring 2022</i>	<i>Croatian Government: Execution of the State Budget of the Republic of Croatia for 2021</i> <i>Croatian Government: Draft Amendments to the State Budget for 2022</i>	Position Paper on the Execution of the State Budget of the Republic of Croatia for 2021 Position Paper on the Draft Amendments to the State Budget of the Republic of Croatia for 2022
September	<i>Croatian Government: The execution of the Draft State Budget of the Republic of Croatia in the first half of 2022</i>		<i>Croatian Government: Draft Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022</i>	The Position Paper on the Draft Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022
October	<i>MF: delivery of macroeconomic projections</i>	<i>National Bureau of Statistics: Report on excessive deficit and general government debt procedure, October 2022</i>		Confirmation of macroeconomic projections The Position Paper on the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users
November	<i>EC: Autumn 2022 Economic Forecast</i>		<i>Croatian Government: Draft State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024</i>	The Position Paper on the Draft Budgetary Plan of the Republic of Croatia for 2023 The Position Paper on the Draft State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2023 and the Projections for 2024 and 2025

Note: This chart shows the timeline of the Commission's **regular** publications during the calendar year. The Commission can also publish analyses and assessments outside of this schedule.

Source: Fiscal Policy Commission

4 The timeline of Commission's activities with highlights

This part presents a short overview of the Commission's position papers and conclusions from its sessions and meetings. The activities are listed chronologically and linked to the adopted position papers on budgetary documents discussed by the Commission in 2022. Consolidated texts of the position papers can be found enclosed with this Report.

16th Position Paper of the Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2021

At its 12th regular session held on 16 May 2022, the Commission discussed the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2021 and published its conclusions in the 16th Position Paper (enclosed hereto). The summary of the position paper was as follows:

Strong recovery of economic activity that was unexpectedly achieved in 2021 also deeply affected Croatian public finances. In the last two years (2020 -2021), the countercyclical fiscal policy played an essential role in mitigating the damages caused by the pandemic and creating the preconditions for economic recovery. The Commission holds that fiscal policy in 2021 was appropriate, because it enabled strong fiscal stimuli in response to the COVID-19 crisis, and also responsible, because it did not endanger mid-term fiscal sustainability. However, the Commission reiterates the need to implement decisive reforms in the healthcare and pension sector as well as in the domain of employee compensation as these areas in fact represent the heaviest burden on the state budget.

17th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2022 and the Projections for 2023 and 2024

At the same session held on 16 May 2022, the Commission also examined the Draft Amendments to the State Budget of the Republic of Croatia and the Financial Plans of

Extra-Budgetary Users for 2022 and the Projections for 2023 and 2024. The summary of the position paper was as follows:

The Commission came to the conclusion that the macroeconomic projections for 2022, underlying the Draft Amendments to the State Budget, are appropriate as they do not deviate from the projections of other institutions. To a certain extent, the Draft Amendments to the State Budget for 2022 acknowledge the existence of new macroeconomic circumstances. The Commission holds that the proposed macroeconomic and budgetary plans are appropriate to the current situation and highlights the need for EU funds to be used as much as possible to finance investments and reforms for the purpose of stimulating productivity growth and reiterates the importance of implementing reforms to restrain the growth of expenditure for healthcare, pension fees and compensations for employed persons. It also points to the increasing risks of inflation growth and economic consequences of the war in Ukraine that demand an active response of economic and fiscal policy holders.

18th Position Paper of the Fiscal Policy Commission on the Draft Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022

At its 13th session held on 5 October 2022, the Commission examined the Draft Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022. The summary of the position paper was as follows:

In 2021, the Croatian economy saw unexpected growth which continued throughout the first half of 2022 despite intense global shocks and pressures in terms of global disruptions and blockages in the supply chains, increasing energy prices and very high and growing inflation. Strong (real and nominal) economic growth had a favourable effect on Croatian public finances through the growth of income and decrease of the public debt burden (share in GDP). The Commission warns that in the upcoming period when the risk of deceleration of economic activity and of a recession will rise abruptly, the Croatian economy might be faced with numerous limitations such as a low potential growth level, pronounced price pressures on the

economy and on the citizens' standard of living as well as the tightening of monetary policy. Faced with these challenges, fiscal policy should be as targeted and as selective as possible so as to prevent additionally increasing mid-term inflationary pressures, bearing in mind at the same time the sustainability of public debt because, in a situation of a tightening monetary policy, loans taken on by the general government might become much more expensive and thus become a serious problem. The Commission emphasizes the need to continuously monitor Croatia's fiscal position to allow fiscal policy to adjust in uncertain and changed circumstances and ensure the continuity of a responsible fiscal policy for the purpose of long-term sustainability of Croatian public finances.

Confirmation of macroeconomic projections for 2023

At its 14th session held virtually on 11 October 2023, the Fiscal Policy Commission examined the macroeconomic projections of the Government of the Republic of Croatia and, after the discussion, unanimously confirmed the macroeconomic projections prepared by the Ministry of Finance for 2023.

Considering the uncertain nature of macroeconomic forecasts, the Commission assessed the credibility of the macroeconomic scenario based on how realistic it was and by comparing it with the projections of other competent institutions. The Fiscal Policy Commission also considered the errors made in last years' forecasts in order to establish any institutional, that is, systematic bias. In doing so, the Fiscal Policy Commission found that the macroeconomic projections of the Ministry of Finance were lower than the currently available projections of other relevant institutions, indicating a more cautious and conservative approach in creating the settings of the projections for the next period. The Commission established that the projections were within the acceptable range.

19th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024

At its 15th session held on 24 October 2022, the Commission discussed (the second) Draft Amendments to the State Budget and the Projections for 2023 and 2024. The summary of the position paper was as follows:

The Draft Amendments to the State Budget for 2022 foresee a decrease in the deficit of the general government budget and of public debt measured by the share in the GDP in 2022. Fiscal policy in 2022 was largely marked by an unexpectedly high increase in tax revenue due to the strong real and nominal GDP growth and the effect of inflation, as well as due to the measures for alleviating the consequences of increasing energy prices. The Commission agrees with these Draft Amendments and highlights the need to continuously monitor the position of the Republic of Croatia in order to facilitate the adjustment of fiscal policy in uncertain and volatile circumstances and ensure continuity and responsibility which guarantee long-term sustainability of Croatian public finances. The Commission underlines that it is necessary to constantly bear in mind the consolidation of public finances, and that most of the available funds, especially those from European sources, must be planned more realistically and used more efficiently and directed as much as possible at the activities which preserve and support economic growth. As many times before, it also highlights the need for improved expenditure planning and control, and calls for structural reforms. Due to the possibility of realization of a number of (global) negative risks in the upcoming period, it is extremely important to manage Croatian public finances wisely.

20th Position Paper of the Fiscal Policy Commission on the Draft Budgetary Plan

At the same session, the Commission examined the Draft First Budgetary Plan. The summary of the position paper was as follows:

The Fiscal Policy Commission evaluated the first Draft Budgetary Plan of the Republic of Croatia for 2023. Considering the current global circumstances and 2023

being characterized by pronounced economic uncertainty and high geopolitical risks, it is appropriate to continue the former practice of conservative budget planning. After a strong recovery and growth in 2021 and the first half of 2022, the prospects for 2023 are less favourable. This creates an uncertain framework for economic and fiscal policy and could necessitate its quick adaptability. In such circumstances, the main task of fiscal policy will be to minimize the effect of external shocks on the Croatian economy and help the most vulnerable groups which will be most affected by those shocks. Because of the economic slowdown, cyclical general budget income will grow at a slower pace, while the growth of the general budget expenditure will depend on intensified investment spending related to EU funds, which represents the main lever of countercyclical action. Therefore, the Commission highlights the need to prepare, as realistically as possible, as many quality and sustainable investment projects as possible. The Commission repeats its warning about certain challenges in the existing capacities and the key stakeholders' readiness to undertake the necessary structural reforms within the framework of the overall public sector (especially in healthcare and public administration, but also in the other sectors).

21st Position Paper of the Fiscal Policy Commission on the Draft State Budget of the Republic of Croatia for 2023 and the Projections for 2024 and 2025

At its 16th session held on 21 November 2022, the Commission discussed both the Draft State Budget for 2023 and the Projections for 2024 and 2025. In addition to evaluating the Draft State Budget, the Commission adopted an opinion in which it upheld the proposal to continue the postponement of the application of fiscal rules in 2023 as well. The summary of the position paper was as follows:

The Draft State Budget for 2023 is the first budget prepared in accordance with the euro area membership obligations. The budget, indicated in euros, was preceded by the Draft Budgetary Plan for 2023 whose purpose was to coordinate the economic policies of the euro area member states. In its 20th position of 24 October 2022, the Commission confirmed the macroeconomic projections for 2023 and supported the fiscal policy course planned for the next year. The evaluation by the European

Commission (hereinafter: EC) is also expected. The Commission highlights that the strong growth of Croatian economy in 2022 was used to consolidate public finance, and commends the plan to continue the decrease of the high share of state debt in GDP in the next period. The Fiscal Policy Commission supports the Draft State Budget for 2023 and calls on the Government to limit as much as possible the adoption of fiscal measures with a permanent effect on expenditure and to insist on structural reforms necessary to increase the potential growth rate. The Commission also highlights that it is necessary to carefully and continuously analyse the sustainability of public finance and bear in mind the fiscal rules, even though these are currently under suspension and revision. European Commission intense efforts invested in the revision of the fiscal rules should result in new fiscal rules applying from 2024.

In addition to the sessions, on 10 May and 6 July 2022, the Commission held two expert meetings related to the subject of institutional and functional organization of the Fiscal Policy Commission - creating the website, preparing the risk strategy, preparing the annual work plan for 2023 and other tasks related to the Commission's operation.

5 Commission's publicity

The Commission's publicity is mainly achieved in the manner laid down in Article 23 (4) of the FRA which stipulates that the Commission shall inform the public on the positions adopted during the performance of its tasks referred to in Article 22 of the FRA by posting on the Commission's website.

Pursuant to the transitional provisions, until the second half of 2022, and until it set up its own, independent website, the Commission used the one within the Croatian Parliament's web page at <https://www.sabor.hr/hr/radna-tijela/povjerenstvo-za-fiskalnu-politiku-10-saziv-hrvatskoga-sabora>.

In early November 2022, the Commission set up its own website at <https://pfp.hr> where it publishes its position papers and other analyses and the results of its operation as well as other documents defined by legal regulations.

To enhance its visibility and inform the public on its work, the Commission informed the public of its position papers through publications issued by the Croatian News Agency (HINA) which were also often published by other media. Pursuant to the provisions of the Media Act (Official Gazette 59/04, 84/11, 81/13, 114/22), the Commission participated directly in giving answers to the questions posed by public media.

To increase the Commission's visibility during 2022, the members of the Commission also participated in work presentations, round tables and various public events:

1. Presentation of the work of the International Monetary Fund (IMF) "Reforming the EU Fiscal Framework: Strengthening the Fiscal Rules and Institutions" organized by the Croatian National Bank;
2. Presentation of work by Frane Banić and Vladimir Arčabić: "Characteristics of fiscal policy in Croatia: Does it depend on the stage of the business cycle?" organized by the Croatian National Bank and the Institute of Public Finance;
3. Presentation of work by Ozana Nadoveza, Lovorka Grgurić and Nina Pavić: "The challenge of the pandemic: how to dissociate supply shock and demand"

shock in the conditions of the COVID-19 disease” organized by the Croatian National Bank and the Institute of Public Finance;

4. Presentation of the book by Sanja Bach: “Fiscal committees in the European Union: transparency and responsibility in managing public finances” organized by the Institute of Public Finance and the Croatian National Bank. The presentation of the book also gave rise to the discussion on the work of the Croatian Fiscal Policy Commission attended by the Commission’s Chairwoman, Sandra Krtalić, and her deputy, Maroje Lang. They also participated in the Interliber book fair on 11 November 2022 where Sanja Bach’s book was presented.

6. International cooperation

In 2022, the Commission regularly attended meetings and conferences of the EU Network of Independent Fiscal Institutions (EUNIFI) and the EU Independent Fiscal Institutions (IFI), in which it is also a member, and held two meetings with the representatives of the European Commission, three meetings with the representatives of the Organization for Economic Cooperation and Development and one meeting with the representatives of the International Monetary Fund. At international conferences or meetings, the Commission was represented by its chairperson and deputy.

- The topics discussed at the online meeting of the EU Network of Independent Fiscal Institutions held on 27 and 28 January 2022 were related to the new website of the Network of Independent Fiscal Institutions (<https://www.euifis.eu/>), the draft of the new European Fiscal Monitor, and, for the output gap, the workgroup presented its paper which, using examples of several member states, compared various calculation methods with the codes being available to all independent EU fiscal bodies.
- The topics discussed at the 17th meeting of the EU Network of Independent Fiscal Institutions, the first live one after COVID, held on 20 September 2022 in Brussels, were the IFI's role in the mid-term budgetary framework, the change of fiscal rules and the SGP reform.
- The topic discussed at the meeting of the EU Network of Independent Fiscal Institutions (EUIFI) held on 21 September 2022 in Brussels was the reform of the economic management system.
- At EUNIFI's online meeting held on 16 November 2022, the members of the Network discussed the European Commission's communication on the reform of fiscal rules and other current significant issues relevant to IFI's work.
- The topic discussed at the 4th online conference of the European Fiscal Board (EFB) titled "Public finances and climate change in the post-pandemic period", held on 25 February 2022, was the role of fiscal policy in the EU green economy transition and IFI's role in the climate transition, fiscal costs of the green transition and its impact on public debt of EU member states.

- At the online conference “Economic management in the EU: new rules for new times?” held on 10 May 2022 in the organization of the French High Council of Public Finance, the attendees discussed the functioning and the (in)efficiency of the existing European budgetary rules, the draft fiscal rules reform and the effect on the stakeholders.
- At the online conference organized by ECFIN titled “National Fiscal Framework: Fit for the Future?” held on 13 December 2022, the proposals of the European Commission on the new role of fiscal committees and the further development and strengthening of fiscal committees were discussed.

7. Financial Statement

As indicated above, after its registration at the Croatian Bureau of Statistics, the Commission became an independent and autonomous body and, with the registration process, it started working on the setting up of a functional Commission Office. This required budgetary resources which were provided under the existing defined Commission budget for 2022 as well as the projections for the 2023-2025 period without realistically examining all of the real needs and were insufficient for the Commission's operation. Therefore, the first Draft Amendments to the State Budget of the Republic of Croatia were used as an opportunity for the Commission to correct the originally planned amount of funds. In this manner, budgetary resources for 2022 were ensured and spent (only partially) to:

- 1) pay salaries and contributions for mandatory health insurance for the Commission's chairwoman starting from March 2022;
- 2) cover the costs of the chairwoman's business-related trips from Pula to Zagreb;
- 3) pay the fees to the Commission's external members;
- 4) cover the travel costs of a Commission's member;
- 5) cover the costs of setting up the Commission's website, its annual hosting and maintenance;
- 6) prepare a part of the project documentation for furnishing the Commission's premises based on the remediation study (because the premises were damaged by the earthquake);
- 7) cover the costs of purchasing computer equipment;
- 8) cover the costs of the translation of the Commission's position papers;
- 9) cover the costs of purchasing a seal;
- 10) cover the costs of purchasing a mailbox;
- 11) cover telecommunication services costs (mobile phone) and postage costs;
- 12) cover utility fees and water regulation fee costs;
- 13) cover the costs of sending electronic invoices (eRačun) and FINA's certificates and
- 14) cover the costs of CEPS international membership.

Table 2 Fiscal Policy Commission's financial plan for 2022

in HRK

Code	Name	Initial plan for 2022	Plan for 2022 after the 1st amendments	Plan for 2022 after the 2nd amendments
11	FISCAL POLICY COMMISSION	1,680,850	2,789,000	2,389,000
A926001	ADMINISTRATION AND MANAGEMENT	1,614,850	2,599,000	2,199,000
31	Expenditure for employed persons	1,139,800	1,249,800	484,800
32	Material expenditure	404,600	1,102,950	1,517,950
34	Financial expenditure	450	1,250	1,250
37	Compensations to citizens and households based on insurance and other compensations		50,000	
42	Expenditure for the procurement of produced fixed assets	70,000	195,000	195,000
K926002	INFORMATIZATION	66,000	190,000	190,000
41	Expenditure for the procurement of non-produced fixed assets	6,000	70,000	70,000
42	Expenditure for the procurement of produced fixed assets	60,000	120,000	120,000

Source: State budget of the Republic of Croatia for 2022; Service for General Affairs of the Croatian Parliament and the Croatian Government

Enclosures: Position Papers of the Fiscal Policy Commission for 2022

16th Position Paper of the Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2021

At its 12th (online) session held on 16 May 2022, the Fiscal Policy Commission (hereinafter: Commission) discussed the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2021 adopted by the Government of the Republic of Croatia (hereinafter: Government) at its 118th session held on 12 May 2022.

The Commission holds that fiscal policy in 2021 was appropriate, because it enabled strong fiscal changes in response to the COVID-19 crisis, and responsible, because it did not endanger mid-term fiscal sustainability. However, the Commission reiterates the need to implement decisive reforms in the healthcare and pension sector as well as in the domain of employee compensation as these areas are in fact the largest load on the state budget.

After a deep recession caused by the COVID-19 pandemic, in 2020, Croatian (but also global) economy underwent a strong recovery in 2021. A normalization of the overall situation also resulted in a significant recovery of economic activity, especially tourism in the summer months, bringing economic activity in the last quarter of 2021 back to pre-pandemic levels. Thus, after economic activity decreased in 2020 by as much as 8.1 %, in 2021, the economic growth rate increased to 10.2 %. A positive GDP trend was primarily a result of growing domestic demand and net foreign demand. However, after the recovery of economic activity in the second half of 2022, an increase in prices ensued due to insufficient supply caused by the pandemic (issues with supply chains and decreased supplies) which, considering a strong recovery in demand, additionally increased nominal GDP and the tax base.

Over the last two years (2020 - 2021), countercyclical fiscal policy played an essential role in mitigating the damage caused by the pandemic and creating the preconditions for economic recovery. Fiscal rules are in fact meant to facilitate a countercyclical effect of fiscal policy in times of crisis. Therefore, at the beginning of 2020, the application of fiscal rules was temporarily postponed at the level of the European Union (EU), and thus also in the Republic of Croatia (Croatia). On 2 November 2020, in its 10th Position Paper on the Draft State Budget for 2021, the Commission issued a positive opinion on the continued postponement of the application of fiscal rules in the EU and Croatia in 2021.

The strong recovery of economic activity that was unexpectedly achieved in 2021 also deeply affected Croatian public finances. This primarily relates to the achievement of total income which, at the level of the general government (ESA2010), in 2021, through strong nominal and real growth, increased by 11.8 %, mostly due to an increase in indirect taxes

(by 17.5 %, with VAT only increasing by 20.9 %), while contributions increased by 10.7 % and non-tax income by 13.6 %. On the other side, direct taxes decreased by 5.6 % due to a decrease in personal income tax and profit tax and a decline in financial operations in 2020.

Furthermore, in June and October 2021, amendments to the state budget for 2021 were adopted and the total initially planned income in the amount of HRK 147.3 billion was increased through the amending budget by a total of HRK 6.8 billion eventually totalling at HRK 154.1 billion compared to the original plan for 2021 (4.6 % more than planned). On the other hand, total state budget expenditure for 2021 was initially planned in the amount of HRK 157.9 billion, and was finally executed in the amount of HRK 169.0 billion in 2021 (HRK 11.1 billion or 7 % more than the plan). In this respect, general government expenditure (pursuant to the ESA2010 methodology) increased by a total of HRK 5.8 billion (2.8 %), mostly due to the phasing out of the measures to mitigate the effects of the COVID-19 pandemic and the financing costs due to lower interest rates and restructuring of government debt. Thus, for example, COVID-19 measures decreased from HRK 14.2 to 9.5 billion, and financial expenditure decreased by HRK 0.8 billion. If the effect of COVID-19 measures is excluded from the calculation, general state expenditures in 2021 increased by 5.4 %, that is, 6.1 % if financial expenditure is also excluded. The greatest increase occurred in material expenditures (11.6 %), expenditure for employees (6.7 %) and pensions (4.5 %).

Such favourable conditions facilitated strong fiscal consolidation and a decrease of general government deficit (ESA2010) from HRK 27.7 to 12.4 billion.² This decrease of general government deficit is even more significant if compared to the level of GDP which saw a strong recovery in 2021. General government debt, as measured by the share in GDP, decreased from 7.3 % of GDP during the crisis year of 2020 to 2.9 % (or HRK 12.4 billion) in 2021 mostly due to a strong decrease of the state budget deficit. Looking at the subsectors, the central government achieved a deficit of 3 % of GDP, the local government achieved a deficit of 0.3 % of GDP, and social security funds achieved a surplus of 0.4 % of GDP. This is a significant decrease and an achievement that puts Croatia below the reference level of general government deficit of 3 %, i.e. the budgetary deficit ceiling which triggers the excessive deficit procedure.

Despite these positive indicators, general government deficit in 2021 actually continued its strong nominal increase trend (HRK 343.6 billion at the end of 2021). However, due to strong economic recovery, the share of debt in GDP, after a strong increase in the previous year, decreased from 87.3 % of GDP in 2020 to 79.8 % of GDP in 2021. The high level of public debt exceeds the reference value of 60 % of GDP and greatly limits the possibilities of intense use of fiscal policy for anti-crisis action. **Therefore, the Commission supports**

² Report on excessive deficit and general government debt procedure, Republic of Croatia, April 2022 (ESA 2010).

the stronger fiscal consolidation achieved in circumstances of unexpectedly strong growth and reiterates the importance of using the period of economic growth for stronger fiscal consolidation and creating the necessary fiscal space for countercyclical policy in a crisis situation.

The Commission also underlines that the Government, in adopting the Annual Report on the Execution of the State Budget, again failed to draft the ancillary Report on the achievement of fiscal rules. Temporary postponement of the application of fiscal rules refers only to the allowed exceeding of the minimum fiscal consolidation level prescribed, in numbers, in preventive and corrective procedures of the Stability and Growth Pact ³, and does not eliminate the need for drafting the prescribed report. Unlike the preceding year, 2020, when, due to the high level of uncertainty, the Government did not publish its evaluation of potential GDP required for the calculation of the structural balance, these calculations are incorporated in the Convergence Programme of the Republic of Croatia for the period of 2023 - 2025.

According to the Commission's assessment, the great shock of the pandemic resulted in major oscillations in the GDP gap. After the economy grew above its potential level in 2019, in 2020 it slowed down considerably due to the pandemic, and recovered completely in 2021. All of this caused large fluctuations of the production gap and, consequently, of the cyclical budget components. Extraordinary COVID-19 measures, as well as the measures aimed at remediating the damages caused by the earthquake, additionally hinder the evaluation of the structural balance. The Commission's assessment which is based on the Convergence Programme indicates that the structural balance in the pandemic year of 2020 and in 2021 revolved around the level of the mid-term budgetary target.

The Commission concludes that the fluctuations of the budget deficit and public debt in the last two years were, first and foremost, a consequence of the pandemic, which is best reflected in the heavy decline in budget income in 2020 as well as its recovery in 2021. The implementation of exceptional COVID-19 measures (HRK 14.2 billion in 2020 and HRK 9.5 billion in 2021) was necessary to protect citizens' health and maintain the potential of the economy; the overall fiscal policy was appropriate and responsible because the strong fiscal response to the crisis did not endanger mid-term fiscal sustainability.

Nevertheless, the Commission points to the significant increase in public debt during the pandemic which neutralized the effect of the fiscal consolidation in the previous period. Therefore, in the upcoming period, the growth of long-term expenditures should be strictly controlled, especially expenditure for healthcare, pensions and employee

³ A decrease of structural deficit according to the mid-term fiscal target which amounts to -1 % of GDP for the Republic of Croatia.

compensations. Reforms in those sectors are necessary to ensure long-term sustainability of Croatian public finance.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD

17th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2022 and the Projections for 2023 and 2024

At its 12th session held on 16 May 2022, the Fiscal Policy Commission (hereinafter: Commission) discussed the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for 2022 and the projections for 2023 and 2024.

The Commission considers the proposed macroeconomic and budgetary plans to be appropriate for the current situation, and highlights the need that EU funds be utilized as much as possible to finance investments and reforms for the purpose of stimulating productivity growth, and reiterates the importance of implementing reforms to restrain the growth of expenditure for healthcare, pensions and compensations for employees. It also points to the increasing risks of inflation growth and economic consequences of the war in Ukraine that demand an active response of economic and fiscal policy holders.

The evaluation of macroeconomic projections for 2022

In addition to the existing duties laid down in the Fiscal Responsibility Act (OG 111/18), mainly aimed at monitoring the following of fiscal rules, in early 2022, the Commission also took on the task of evaluating macroeconomic and budgetary projections pursuant to Article 21(2) of the new Budget Act (OG 144/2021) which incorporates the provision that, for Euro area member states, budgetary projections should be based on independent macroeconomic projections prepared or endorsed by an independent fiscal authority which, in the Republic of Croatia, is the Fiscal Policy Commission. By the decision of the Council of the European Union on the introduction of the Euro as the official currency in the Republic of Croatia, Article 21(3) will also come into force and, accordingly, the macroeconomic projections underlying the convergence programme and the draft budgetary plan, will have to be endorsed by the Commission.

The year 2021 has seen a quick and record-breaking growth rate of the Croatian GDP, impelling Croatia to exceed the level of economic activity achieved in 2019, the year before the pandemic, and step into 2022 with optimism. However, the year 2022 is not without certain negative macroeconomic risks. The risks are primarily based on the escalation and consequences of the war in Ukraine, further disruption of supply chains and instabilities on financial markets caused by the tightening of the monetary policy due to increasing inflation. In response to this, the Government of the Republic of Croatia, in its Convergence Programme for 2023 - 2025, revised its macroeconomic projections underlying the Draft Amendments to the State Budget for 2022. Hence, the initially projected GDP growth rate for 2022 was lowered from 4.4 % to 3 %, and the inflation rate was raised from 2.6 % to 7.8 %. It is expected that the main factor contributing to GDP

growth will be an increased export of goods and services and gross investments in fixed capital.

In evaluating macroeconomic projections, the Commission retained the approach of comparing the Government's macroeconomic projections with the projections of other institutions.

Table 1 Macroeconomic projections for 2022 according to various institutions

<i>Institution</i>	<i>Croatian National Bank</i>	<i>International Monetary Fund</i>	<i>World Bank</i>	<i>Croatian Government</i>	<i>European Commission</i>
GDP	3.2	2.7	3.8	3.0	3.4
Inflation	5.4	5.9	6.1	7.8	6.1

The Commission came to the conclusion that the macroeconomic projections for 2022, underlying the Draft Amendments to the State Budget, are appropriate as they do not deviate from the projections of other institutions. In this regard, the Government expects a substantial increase in prices, which means that the nominal values of the tax base for calculating budgetary income will increase as well. Considering the significant negative macroeconomic risks and the current practice of conservative planning of the growth of real activity and budgetary income, the Commission considers this approach appropriate and highlights the necessity to maintain it in preparing the budget for 2023 and its updates in case negative risks are achieved.

Evaluation of Draft Amendments to the State Budget for 2022

To a certain extent, Draft Amendments to the State Budget for 2022 acknowledges new macroeconomic circumstances. The planned increase in state budget expenditures for 2022 also provides for an amelioration of the economic consequences of the war in Ukraine, the costs of receiving and hosting Ukrainian refugees as well as securing gas supplies and procuring buffer stock. State budget expenditures also include increased expenditure for higher bases for accounting salaries in state and public services by 4 % as of 1 May 2022, ensuring funds for measures to mitigate energy prices, including subsidies for gas prices, compensation for vulnerable energy buyers and a four-billion-kuna increase in healthcare expenditure, the largest part of which relates to hospitals' and pharmacies' debts and liabilities toward suppliers.

The state budget for 2022, adopted by the Croatian Parliament on 8 December 2021, forecast income in the amount of HRK 164.5 billion, expenditure in the amount of HRK 173.8 billion, and a budget deficit of HRK 9.3 billion (or 2.6 % of GDP). These amendments to the state budget for 2022 forecast state budget income in the amount of HRK 171 billion (increase of HRK 6.6 billion or 4 % compared to the original plan) and expenditure in the

amount of HRK 184.7 billion (increase of HRK 10.9 billion or 6.3 % compared to the original plan).

State budget income foreseen in the Amendments to the State Budget of the Republic of Croatia for 2022 is based on expected economic activity trends, taking into consideration the fiscal effects of tax changes in the value added tax system (VAT; decrease of VAT on certain products) and excise tax regulations (partial decrease of excise tax on certain energy sources) implemented to mitigate the inflation-induced pressure on citizens and the economy, as well as of withdrawing the contracted EU funds from the EU budget, Next Generation EU and the Solidarity Fund. Increase of budget income from EU funds only is HRK 1 billion. In terms of tax income, an increase is forecast to be HRK 3.2 billion, mostly on account of increased revenue from VAT due to the expected trends of the nominal value of personal consumption and tourist activity, and partly due to increased income from assets and contributions.

The amending budget for 2022 foresees the greatest increase of expenditure financed from general income and revenue for healthcare recovery (HRK 3.5 billion), pensions (HRK 1.8 billion), expenditure related to the consequences of the war in Ukraine (HRK 1 billion) and expenditure for employees (HRK 550 million). Within the expenditures financed from EU and other sources, the increase is a result of ensuring funds for measures to mitigate increasing energy prices in the amount of HRK 898 million and expenditure related to the projects of remediation of damages caused by the earthquake in the amount of HRK 185 million.

The Commission reiterates the potential risks related to the achievement of such plans, and these include uncontrolled growth of expenditure for healthcare (primarily hospitals' and pharmacies' debts and liabilities toward suppliers). The fact that the healthcare sector generates a new monthly debt of between 400 and 500 million kunas is especially alarming. Moreover, the coronavirus pandemic is not over yet and a potential new wave of one of the coronavirus strains also carries the risk of additionally increasing healthcare costs. The Draft Amendments to the State Budget for 2022 indicate the intention to moderately consolidate public finances, and the Commission proposes to the Croatian Government to carry out an evaluation of the past and present activities in the healthcare sector so as to determine their actual fiscal effects on economy development. The Commission considers it necessary to assess the future risks of budget expenditure, especially bearing in mind the increasing debt of the healthcare system as well as the public sector salary system and significant potential liabilities related to the operation of local public companies.

According to the ESA 2010 methodology, the total result of the amendments to the state budget for 2022 planned in this manner will result in a general government deficit of HRK 13.4 billion (i.e. 2.8 % of GDP), which is 0.3 percentage points more than initially planned, but still within the limits of the Maastricht criteria, while the share of public debt in GDP should be 76.2 % of GDP, 3.6 percentage points less than in 2021.

Although fiscal rules have been temporarily postponed, the Commission reminds the Croatian Government of the necessity to draft a Report on the application of fiscal rules, together with draft budgetary documents presenting the trends of structural balance, expenditure and public debt, so as to be able to examine the level of countercyclical effect of fiscal policy. All the supporting analyses are presented in the Convergence Programme, underlining the new evaluation of the so-called fiscal impulse. Therefore, preparing the prescribed Report should not be particularly challenging.

According to the Commission's analyses and assessment, the production gap will stay at the level of app. 1 % of GDP in 2022. In that regard, the discontinuance of COVID-19 measures will be of greater effect than the new one-off measures aimed at mitigating the effect of increasing prices and the economic consequences of the war in Ukraine. In such circumstances, the assessed structural deficit will slightly increase. However, because the decrease in the share of public debt in GDP is expected to continue, as will the temporary postponement of the application of fiscal rules, the Commission considers this temporary aggravation of the structural deficit to present no threat to public finances in the mid-term.

The Commission holds the proposed budgetary plans appropriate for the current situation of continued negative macroeconomic shocks which require constant monitoring of the economic position of the Croatian economy and a timely correction of fiscal policy. In doing so, the Commission points out that the main generator of unplanned increase in expenditure is the expenditure for healthcare, pensions and compensations for employees, and invites the Croatian Government to implement the necessary reforms in those sectors so as to ensure long-term sustainability of Croatian public finances.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD

18th Position Paper of the Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022

At its 13th session held on 5 October 2022, the Fiscal Policy Commission (hereinafter: the Commission) discussed the Draft Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022 adopted by the Government of the Republic of Croatia on 29 September 2022.

*In 2021, the Croatian economy saw unexpected growth which continued throughout the first half of 2022 despite intense global shocks and pressures in terms of global disruptions and blockages in the supply chains, increasing energy prices and very high and growing inflation. Strong (real and nominal) economic growth had a favourable effect on Croatian public finances through the growth of income and decrease of the public debt burden (share in GDP). The Commission warns that in the upcoming period when the risk of deceleration of economic activity and of a recession will rise abruptly, the Croatian economy might be faced with numerous limitations such as a low potential growth level, **pronounced price pressures on the economy and on the citizens' standard of living as well as** monetary policy tightening. Faced with these challenges, fiscal policy should be as targeted and as selective as possible so as to prevent additionally increasing mid-term inflationary pressures, bearing in mind at the same time the sustainability of public debt because, in a situation of a contractionary monetary policy, loans taken on by the general government might become much more expensive and thus become a serious problem. The Commission emphasizes the need to continuously monitor Croatia's fiscal position so as to allow fiscal policy to adjust in uncertain and changed circumstances and ensure the continuity of a responsible fiscal policy for the purpose of long-term sustainability of Croatian public finances.*

After two pandemic years, Croatia entered 2022 with optimistic expectations; however, the previous semester was marked with materialized, significant negative macroeconomic risks which began in 2021. Similarly to the rest of the European Union (EU), Croatia is facing a high level of uncertainty, primarily due to the war in Ukraine, increasing energy prices, the consequences of the crisis caused by the COVID-19 pandemic and an excessively high inflation rate. The war in Ukraine is contributing to increased costs of energy and agricultural products, and the pressure on price growth is additionally aggravated by material, equipment and labour shortages. In addition, central banks are also tightening their financing conditions because the inflation is expected to increase. After the Croatian economy improved in the first half of 2022, the global economy trends in terms of unstable energy prices and price pressures which are spreading and picking up pace across various industries indicate that, in the next quarters, the economy will weaken and slow down, while the prospects for economic growth will weaken, indicating a stagnation of economic activities in the second half of 2022 and the

first quarter of 2023. The unfavourable geopolitical situation caused by the war in Ukraine is also contributing to a further weakening of the companies' and consumers' trust, while for some time yet the inflation will probably remain high, much higher than the targeted level. This means that the scenario of further decrease of the companies and households' purchasing power is very probable, resulting in a heavy burden on private spending and decreased production/growth in the upcoming quarters as well.

Therefore, the Commission reiterates that attention must be paid to the consolidation of public finances, where most of the available funds, especially those from EU sources, must be directed toward those activities that would preserve and maintain economic activity, help the most vulnerable households and contribute to long-term sustainability of public finances.

The packages of measures for mitigating the price increase and protecting households and companies from increasing energy prices in 2022

As part of the fiscal measures undertaken in 2022 for mitigating the consequences of negative economic disruptions due to increasing energy prices on the citizens' and companies' standard, in February 2022, the Government adopted the first package of measures which came into force on 1 April 2022 and, in early September 2022, the second one which came into force on 1 October 2022.

The packages of measures adopted by the Government in February and September 2022 are presented in Table 1. The Commission finds them appropriate to the current circumstances and within the limits of justified state interventionism. However, although these interventions are appropriate, the Commission holds that the fiscal effects these packages of measures have on the state budget are not entirely clear nor specific, both in the short- and mid-term, because the indicated costs of the adopted measures will not be examined through the state budget only, making it difficult to assess their (permanent) effect. Therefore, the Commission finds it extremely important to monitor how these measures will reflect on the state budget in the next years to prevent them from bringing about certain challenges on the income side of the budget, primarily within the framework of the tax system and/or to prevent their effect from spilling over into the future generations.

The Commission holds that it was indeed possible and quite necessary, both in relation to citizens and to companies, to create a better balance and fine-tune certain measures for the targeted support to yield even better results and decrease the costs for their implementation covered from the budget. The prices are the fundamental market mechanism, so controlling and limiting them (which first and foremost concerns food products) is not the most efficient measure, because such measures can lead to a decreased offer, lower quality, shortages, development of the black market and so on. Transfers toward the neediest is a more efficient and fair measure than price control. The Commission also highlights that the proposed measure by which VAT rates were decreased is not the best nor the most efficient instrument

for the resolution of social challenges and issues, so it is no surprise that the measure of lowering the VAT rates for a wide range of products has not yielded the desired effect.

Table 1 The Government's measures for mitigating the price increase and protecting households and companies from increasing energy prices in 2022

The 1st package of measures for mitigating the price increase due to increasing energy prices, February 2022		The 2nd package of measures for protecting households and companies from the price increase, September 2022	
Total relief	in HRK billion	Total relief	in HRK billion
- tax relief through VAT	2.1	- limitation of the price of electricity and heating	5.9
- gas subsidies	1.2	- tax relief and lower excise duty on fuel	2.8
- social benefits and pension fees	0.8	- allowances and subsidies for socially disadvantaged groups, unemployed persons, retired persons, students, farmers	2.5
- limitations of the electricity fee increase	0.46	- energy efficiency renovation of houses and residential buildings	0.988
- subsidies to farmers and fishermen	0.25	<i>* Additional measures for companies:</i>	
		- energy transition grants to companies	1.9
		- loans for working capital plus subsidized interest for companies in difficulties	3.8
		- guarantees provided by the Croatian Reconstruction and Development Bank for loans to exporters in difficulties	3.1
Total value of the measures: HRK 4.81 billion		Total value of the measures: HRK 21 billion	
Total value of the measures adopted: HRK 25.81 billion or 6.3 % of GDP			

Source: Croatian Government

In the context of growing uncertainty and negative risks for economic prospects due to the war in Ukraine, the increasing energy prices and continued disruptions in supply chains, in May 2022, the European Commission suggested to prolong the general escape clause under the Stability and Growth pact by the end of 2023.

However, although the numerical fiscal rules still have not started to apply in 2022, the Commission emphasizes the need to continuously monitor and examine the fiscal position of Croatian economy so as to allow for the adjustment of fiscal policy and ensure the continuity of a responsible fiscal policy for the purpose of long-term sustainability of Croatian public finances. After a strong fiscal “relaxation” due to the crisis caused by the coronavirus pandemic, in the future period, a certain tightening of the fiscal policy is foreseen, and the Commission again calls on the Government to control, especially in these times of exceptionally high inflation, the increase of expenditure and not to direct the increase in budget income only toward increasing public spending, but instead to take care also of the sustainability of public debt.

The execution of the Draft State Budget of the Republic of Croatia in the first half of 2022

Strong economic growth achieved in 2021, and growth which exceeded the projections in the first half of 2022, favoured a positive and accelerated economic activity in Croatia. Favourable cyclical trends in the economy in the first half of 2022, as a combination of increased GDP and personal spending, good tourist season results as well as a high and growing inflation, have had a positive impact on a strong increase in state budget income.

The state budget for 2022, adopted by the Croatian Parliament on 8 December 2021, forecast total income in the amount of HRK 164.5 billion, expenditure in the amount of HRK 173.8 billion, and a budget deficit of HRK 9.3 billion (i.e. 2.6% of GDP). By the Amendments to the State Budget of the Republic of Croatia for 2022 adopted in May 2022 budget income increased by HRK 6.6 billion (i.e. 4 % compared to the original plan), expenditure increased by HRK 10.9 billion (i.e. 6.3% compared to the original plan), and general government budget deficit, according to the ESA methodology, increased by HRK 1.4 billion, i.e. to HRK 13.4 billion or 2.8 % of GDP. Thus the total income planned under the Amendments to the State Budget of the Republic of Croatia for 2022 was HRK 171.05 billion, and the income achieved in the first half of 2022 was HRK 79.3 billion (i.e. 46.35 % of the annual plan). In relation to the same period in 2021, the total semi-annual state budget income increased by HRK 5.2 billion, i.e. 7 %.

In the first half of 2022, HRK 44.7 billion of tax revenue was collected (i.e. 49.03 % of the annual plan). Compared to the same period of 2021, these have increased by HRK 7.2 billion, i.e. 19.20 %. The most significant increase in tax revenue pertains to indirect taxes - added value tax (VAT) and excise duty, which is largely a consequence of increasing personal spending and a strong growth in consumer prices. Higher prices mean greater income from VAT and excise duty (such trends are consistent with the expectations of the central bank that personal spending in 2022 will rise despite the decrease of the real salary due to the inflation and uncertainty brought on by the war in Ukraine). Revenue from sales tax (on goods and services) in the first half of 2022 amounts to HRK 37.6 billion

(i.e. 46.19 % of the annual plan), which is an increase of 17 %. At the same time, VAT revenue was almost HRK 29 billion, i.e. 77 % of the revenue from sales tax in the first half of 2022, and it is HRK 4.3 billion (18 %) higher than in the same period of 2021. Income from special sales taxes (excise duties) brought HRK 7.6 billion (i.e. 45.46 % of the annual plan and an increase from the previous year of 8.4 %), which is a result of increased trading intensity and consumption of certain products subject to excise duty. The biggest increase was achieved with excise duty on energy and electricity which amounted to HRK 3.7 billion in the first six months of 2022 and which grew by 3.1 % in relation to the previous year even though excise duties on gasoline and diesel fuels were decreased for the purpose of mitigating the inflationary effects on the economy and the citizens. This increase indicates that trade has picked up, because the paid excise duties on energy depend only on the sold volumes of derivatives, and the increase of prices has no direct effect on them.

Economic recovery has also reflected on the increase of tax revenue from income and from social contributions. In the first half of 2022, revenue from income tax amounted to HRK 6.8 billion (i.e. 73.31 % of the annual plan) and shows a significant increase in relation to the previous year (38 %). This is a consequence of a high increase in the companies' income during 2021 since the revenue from income tax in the current year is based on the company's performance in the previous year. Revenue from social contributions in the first half of 2022 amounted to HRK 13.8 billion (i.e. 49.30 % of the annual plan), which is an increase of HRK 1.7 billion (14 %) mostly due to salary and employment growth, that is, favourable labour market trends. Further, in the first half of 2022, revenue from contributions for employment was paid in the amount of HRK 5.8 million, and these is related to the payment of debts based on contributions for employment (this contribution was revoked on 1 January 2019), while revenue from assets amounts to HRK 902 million (i.e. 31.9 % of the annual plan). Revenue from assets was 25.4 % lower than in the same period last year because the dynamics of payment of revenue based on dividends and income of companies in the public sector have changed in relation to the same period of 2021.

On the other hand, decreased revenue has been recorded in the other current and capital revenue mostly in relation to projects which are mostly financed from the EU budget. This decline is due to a decreased transfer from EU funds. In the first half of 2022, these were HRK 11.2 billion (i.e. 33.55 % of the annual plan), which is a decrease of HRK 1.2 billion, i.e. 9.5 %.

Total state budget expenditure was planned in the amount of HRK 184.7 billion for 2022: HRK 170.7 billion for operating expenditure and HRK 14.0 billion for expenditure for the procurement of non-financial assets. Total expenditure in the first half of 2022 amounted to HRK 82.8 billion (i.e. 44.81 % of the annual plan), and compared to the first half of 2021, these decreased by HRK 1.2 billion, i.e. 1.4 %. The decrease of the total state budget expenditure was influenced by the decrease in the expenditure for subsidies, that is, a

decreased disbursement of subsidies to companies for the preservation of jobs due to the unfavourable epidemiological situation. In addition to expenditure for subsidies, which decreased by HRK 3.2 billion in the first half of 2022, the allocations for financial expenditure in the amount of HRK 526.6 million also decreased, primarily due to a decrease in the execution of expenditure for interest and other financial expenditure.

Operating expenditure in the first half of 2022 was executed in the amount of HRK 79.6 billion (i.e. 46.63 % of the annual plan) and decreased in relation to last year by HRK 2.3 billion, i.e. 2.8 %, while the expenditure for the procurement of non-financial assets was executed in the amount of HRK 3.2 billion (i.e. 22.6 % of the annual plan). In the operating expenditure structure, the largest share (34.1 %) pertains to compensations to citizens and households based on insurance and other compensations, followed by assistance granted abroad and within the general budget (24.0 %) and expenditure for employed persons (15.5 %). According to the functional classification, social welfare has the biggest share in the state budget expenditure (35.2 %). The most significant expenditure in the first half of 2022 was executed within the pension fees and benefits program in the amount of HRK 22.6 billion, while a total of HRK 17.1 billion was allocated for expenditure for employed persons. A total of HRK 20.4 billion was allocated for the healthcare system in 2022, and in the first half of 2022, HRK 9.6 billion was executed for the healthcare system, of which HRK 1.9 billion was additionally allocated for paying the difference in the increase of the salary for overtime work to healthcare and health insurance workers and for settling a part of the debts of hospitals founded by the Republic of Croatia or local/regional self-government units and of the Croatian Pension Insurance Institute toward pharmacies. The expenditure side of the state budget was also affected by costs related to the remediation of the consequences of the disastrous earthquakes that occurred in 2020 in Croatia (the earthquake on the territory of the City of Zagreb, Krapina-Zagorje County and Zagreb County in March 2020, and the earthquake on the territory of Sisak-Moslavina County, Zagreb County and Karlovac County in December 2020) for which a total of HRK 684.5 million was spent in the first half of 2022.

Material expenditure was executed in the amount of HRK 8.2 billion (i.e. 45.3 % of the annual plan) in the first half of 2022, and these increased by HRK 85.3 million, i.e. 1.0 % compared to the same period last year. Expenditure for intermediate consumption, social benefits and compensations to employed persons has also slightly increased at the annual level. The greatest increase of expenditure in the first half of 2022 in relation to the same period of 2021, occurred in the expenditure for the procurement of non-financial assets in the amount of HRK 1.1 billion, primarily for the purpose of paying the obligations under the contracts for the procurement of the multi-purpose fighter plane. Expenditure for the disbursement of pension fees and benefits also increased by HRK 822.0 million, primarily due to the adjustment of the pension fees and the transferred cumulative effect of the change in the number and structure of pension users. The increase in the expenditure in the first half of 2022 in relation to the same period of 2021 was also affected by a higher

level of execution of the total expenditure for employed persons by HRK 521.5 million, which is a result of the application of collective agreements and other regulations governing the salaries for persons employed in government and public services.

The difference between the total state budget income and expenditure in the first half of 2022 is HRK 3.5 billion, i.e. 0.7 % of GDP. In relation to the first half of 2021 when it was HRK 9.8 billion, deficit has decreased by HRK 6.3 billion, i.e. 64 %.

In the first quarter of 2022, the consolidated general government deficit according to the national methodology amounts to HRK 153 million, i.e. 0.03 % of GDP, that is, HRK 1.3 billion according to the ESA 2010 methodology, which is an improvement of HRK 2.7 billion at the annual level. A decrease in the budget deficit reflects an increase in income (4.3 %) and, at the same time, a decrease in expenditure (1.5 %). At the same time, extra-budgetary users achieved a surplus of HRK 1.2 billion, i.e. 0.3 % of GDP, and local and regional self-government units and county road administrations a surplus of HRK 2.2 billion, i.e. 0.5 % of GDP.

When it comes to general government debt trends, it amounted to HRK 343.7 billion at the end of June 2022, being HRK 65.2 million lower than in late 2021, while the relative share of public debt in GDP decreased significantly from 79.8 % at the end of 2021 to 74.2 % in the first half of 2022, indicating a positive effect of intensified economic activity thus far.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD

19th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2022

At its 15th session held on 24 October 2022, the Fiscal Policy Commission (hereinafter: the Commission) examined the Draft Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2022 adopted by the Government of the Republic of Croatia on 19th October 2022 at its 159th session.

The Draft Amendments to the State Budget for 2022 foresee a decrease in the deficit of the general government budget and of public debt measured according to the share in the GDP in 2022. Fiscal policy in 2022 was largely marked by the unexpectedly high increase in tax revenue due to the strong real and nominal GDP growth and the effect of inflation, as well as due to the measures for alleviating the consequences of increasing energy prices. The Commission agrees with these Draft Amendments and highlights the need to continuously monitor the position of the Republic of Croatia in order to facilitate the adjustment of fiscal policy in uncertain and volatile circumstances and ensure continuity and responsibility which guarantee long-term sustainability of Croatian public finances. The Commission underlines that it is necessary to constantly bear in mind the consolidation of public finances, and that most of the available funds, especially those from European sources, must be planned more realistically and used more efficiently and directed as much as possible into activities which will preserve and support economic growth. As many times before, it also highlights the need for improved expenditure planning and control, and calls for structural reforms. Due to the possibility of realization of a number of (global) negative risks in the upcoming period, it is extremely important to manage Croatian public finances wisely.

The strong (real and nominal) economic growth, achieved in 2021, continued in the first nine months of 2022, with a positive effect on Croatian public finances in terms of increased income and decreased public debt burden (according to its share in GDP). Such economic growth was a result of strong real growth of domestic and foreign demand stimulated by accumulated savings from the last two pandemic years, improved export structure and favourable labour market trends. Therefore, the expected real growth rate in 2022 increased from 3.0 to 5.7 %, which is consistent with the evaluations of other institutions. The price increase due to the consequences of the pandemic and the war in Ukraine, is also high, and the CPI is expected to increase by 10.4 % at the annual level. Nominal GDP is also expected to increase by as much as 13.2 %.

Evaluation of the Draft Amendments to the State Budget for 2022

The proposed amendments which, for the second time in 2022, amend the State Budget, can be considered as technical amendments because they reflect the trends which have already been achieved and measures which have already been adopted, without any

major or significant effects on further policies. In examining the budget documents related to the Draft Amendments to the State Budget, the Commission focused on the evaluation of the credibility and realism of macroeconomic and budgetary analyses of the state of public finances and the effect of budgetary plans on mid-term and long-term sustainability of public finances.

Since the achieved results exceeded the expected ones, the state budget income was increased under the Draft Amendments to the State Budget for 2022. Income was affected by a strong growth of domestic and foreign demand in conditions of higher prices and the effects of the changes in the value added tax (VAT) system and excise duty regulations, for the purpose of alleviating inflationary pressures. On the expenditure side, the amendments are related to the measures which have been undertaken for the purpose of suppressing inflationary pressures as well as to decrease in expenditure related to EU-funded projects, financing from the EU Solidarity Fund and the Next Generation EU instrument, including the expenditure related to earthquake remediation.

The State Budget for 2022, adopted by the Croatian Parliament on 8 December 2021, forecast income in the amount of HRK 164.5 billion, expenditure in the amount of HRK 173.8 billion, and a budget deficit of HRK 9.3 billion. By the first Amendments to the State Budget for 2022 adopted in May 2022, the state budget income increased by HRK 6.6 billion to HRK 171 billion, and expenditure increased by 10.9 billion to HRK 184.7 billion. In these second Amendments to the State Budget for 2022, total income was planned in the amount of HRK 171.8 billion (of which operating income was HRK 170.4 billion, and income from sale of non-financial assets was HRK 1.4 billion), and increased by HRK 758.2 million. This increase of the total income is a result of improved collection of tax revenue due to favourable cyclical trends in the economy and GDP and personal consumption growth, good tourist season results but also of a high, growing inflation.

Tax revenue was planned in the amount of HRK 95.5 billion which is HRK 4.4 billion more than in the first two amendments of the State Budget from May 2022. The greatest increase was achieved from VAT revenue increase (HRK 2.1 billion) and corporation income tax revenue increase (HRK 2 billion). On the other hand, revenue from special taxes and excise duties decreased by HRK 28.1 billion in relation to the first Amendments to the State Budget of the Republic of Croatia for 2022 and amounts to HRK 16.7 billion which is a consequence of the trends in the consumption of certain products subject to excise duty. With the second Amendments to the State Budget of the Republic of Croatia for 2022, the revenue from taxes on games of chance and other taxes on games increased by HRK 24.1 million in relation to the first Amendments from May 2022, and so did the revenue from the fees for organizing games of chance (increase by HRK 199 million to HRK 1.3 billion). Revenue from taxes on international trade and transactions was increased under these Amendments by HRK 118 million.

Revenue from contributions increased by HRK 7.1 million to HRK 28 billion. These income categories are under the influence of revenue from contributions for employment

achieved from debts based on payments of such contributions, since it was revoked by the tax reform which came into force in January 2019.

On the other hand, according to the new plan for 2022, grant revenue (related to EU-funded projects, funds from the EU Solidarity Fund and the Next Generation EU instrument) was decreased from HRK 28.2 billion to HRK 22.9 billion (decrease of HRK 5.3 billion), which means these revenue categories decreased by almost 20 %. In its prior position papers, the Commission has already drawn attention to the fundamental threat in withdrawing funds from EU sources, that is, to the low level of efficiency in contracting and planning those funds.

In addition, revenue from pension also decreased in relation to the first Amendments to the State Budget of the Republic of Croatia for 2022 to HRK 2.2 billion (by HRK 662 million).

With the second Amendments, the total state budget expenditure remained at the same level in relation to the first Amendments from May 2022 and amount to HRK 184.7 billion. The share of operating expenditure in this amount is HRK 173.7 billion (an increase of 3 billion kunas), and of the expenditure for the procurement of non-financial assets is HRK 11 billion (a decrease of HRK 3 billion). Expenditure financed from general income and receipts, contributions and dedicated receipts was increased by HRK 3.6 billion, while expenditure financed from EU and other sources was decreased by the same amount. These second Amendments to the State Budget for 2022 primarily served to ensure funds for implementing the autumn package of measures of the Government of the Republic of Croatia for the protection of households and the economy from increasing prices as well as the funds for pension adjustment, for the implementation of which HRK 2.4 billion were ensured (the Commission assessed that these Amendments were appropriate to the current circumstances, except that it emphasized that the fiscal effects of the defined package of measures on the state budget in the short- and mid-term were not clear nor specific enough and that this might bring about certain challenges on the income side of the budget and/or that their effect might spill over onto the next generations).

In the operating expenditure category, material expenses increased by as much as HRK 2.5 billion to provide funds for the compensation of damages under the ruling in the INA-MOL arbitration proceedings (HRK 1.4 billion) and for the expenses of healthcare institutions financed from income based on the contractual relationship with the Croatian Pension Insurance Institute (HZZO, HRK 1 billion). Moreover, the most significant expenditure increase is related to the expenses for the employed (including salaries for the persons employed in primary and secondary schools, HRK 583 million), excise duty in the price of fuel for Hrvatske ceste d.o.o. and HŽ Infrastruktura d.o.o. (HRK 355 million) and for increased transfer to HZZO (HRK 300 million).

On the other hand, the expenditure related to the earthquake remediation projects (HRK 650 million) and the participation funds related to the implementation of the projects

from operative programs (HRK 390 million). Total expenditure for the procurement of non-financial assets were also decreased, by HRK 3 billion, of which expenditure financed from general income and receipts, contributions and dedicated receipts was decreased by HRK 331,6 million, and expenditure financed from the EU and other sources by HRK 2.6 billion.

Table 1 Changes in the State Budget for 2022 (in % of projected GDP), national methodology

	2021	2022		
	<i>Realization</i>	<i>Budget</i>	<i>1st Amendments</i>	<i>2nd Amendments</i>
		<i>10/2021</i>	<i>5/2022</i>	<i>10/2022</i>
Income	35.8	35.6	36.3	35.2
<i>Operating income</i>	35.6	35.5	36.1	35.0
<i>Tax revenue</i>	19.4	19.0	19.3	19.6
<i>Profit tax</i>	1.8	1.8	2.0	2.3
<i>VAT</i>	13.3	13.2	13.3	13.3
<i>Excise duty</i>	3.8	3.5	3.6	3.4
<i>Contributions</i>	5.9	5.6	5.9	5.7
<i>Grants</i>	5.1	7.0	7.1	5.8
<i>Income from assets</i>	0.7	0.5	0.6	0.4
Expenditure	39.3	37.6	39.2	37.9
<i>Operating expenditure</i>	37.5	34.9	36.2	35.6
<i>Expenditure for employed persons</i>	5.6	5.4	5.4	5.2
<i>Material expenditure</i>	4.2	3.6	4.0	4.3
<i>Financial expenditure</i>	1.8	1.7	1.6	1.6
<i>Subsidies</i>	2.8	1.7	2.0	1.9
<i>Assistance granted abroad and within the general budget</i>	9.3	8.6	9.2	8.7
<i>Compensations to citizens and households based on insurance and other compensations</i>	12.2	11.8	12.0	11.7
<i>Other expenditures</i>	1.6	2.0	2.1	2.1
<i>Expenditure for the procurement of non-financial assets</i>	1.7	2.9	3.0	2.3
Total deficit/surplus	-3.5	-2.0	-2.9	-2.7
Consolidated general government (ESA)	-2.6	-2.6	-2.8	-1.5

The development of the State Budget for 2022, expressed as the share in expected GDP, is given in Table 1. At the level of the whole year, the share of income in GDP decreases by 0.6 percentage points primarily as a consequence of decreased income from the relevant budget and from HZZO. At the same time, tax revenue is increasing, mostly due to the increase in income tax, except for a pronounced decline in revenue from excise duty due to the interventions in the excise duty system, while VAT remained at the same level. Grant revenue (EU funds) was increased in relation to the previous year, despite the proposed decrease. On the expenditure side, there is an expressed additional decrease, as measured by the share in GDP, primarily due to the decrease in operating expenditure which is a consequence of a much lower uptake of financial COVID measures.

In accordance with the income and expenditure of the state budget planned in these second Amendments, based on the national methodology, the State Budget is expected to record a deficit of HRK 12.9 billion. This is 751 million kunas (or 2.7 % of GDP) less than what was planned in May 2022 and, in relation to the earlier plan, it represents an improvement of 0.2 percentage points. The general government deficit, according to the ESA methodology, will amount to HRK 7.1 billion or 1.5 % of GDP. Based on the trends of the fiscal general government budget balance, the share of public debt in GDP in 2022 is expected to decrease by 8.5 percentage points in relation to 2021, amounting to 71.3 % of GDP.

After the negative consequences of the coronavirus pandemic in 2020 resulted in a high budget deficit (7.3 % of GDP) and increased public debt (87.0 % of GDP), these indicators have significantly improved in 2021 and the first eight months of 2022. The state budget balance deficit in the amount of HRK 15 million or 3.4 % of GDP had a significant impact on the level of deficit in 2021 because of the measures undertaken on the expenditure side of the budget for the purpose of preserving jobs with employers whose economic activity had been disrupted in the circumstances of the COVID-19 pandemic and for the purpose of financing the costs for the preservation of the citizens' health which continued in 2021. The general government budget deficit decreased significantly in 2021, amounting to HRK 11.3 billion or 2.6 % of GDP, and its decrease continued in 2022 when it should amount to 1.5 % of GDP (which is below the threshold of 3 % of GDP according to the Maastricht criteria). This improvement is impacted by the achieved economic growth which is higher than the potential growth. Therefore, the structural deficit will amount to 2.0 % of GDP in 2022, meaning it will exceed the mid-term budget objective of 1 % of GDP, although it is much lower than in 2021 when it was 2.8 % of GDP, and that it is consistent with the temporarily postponed correction requirement of at least 0.5 percentage points of GDP. At the same time, strong growth has a positive effect on alleviating the burden of public debt which will decrease from 78.4 % of GDP in 2021 to 71.3 % of GDP in 2022, i.e. it will return to the pre-crisis level.

The Commission finds the Amendments to the State Budget for 2022 appropriate to the current economic situation, especially considering the existing negative macroeconomic

shocks which call for continuous monitoring of the economic position of the Croatian economy as well as timely and flexible fiscal policy action. Although the Republic of Croatia remained on a stimulative fiscal policy course in 2022 and restrained the growth of current expenditure financed by the state, the Commission highlights and reiterates that it is necessary to undertake reforms (e.g. in public administration, in health, pension and education systems as well as in the social welfare system) in order to minimize additional losses in certain sectors which in fact necessitate the amendments to the State Budget. Moreover, the Commission has continuously emphasized the need for a better prediction of certain budget items, such as the expenditure for employed persons, pension and healthcare, which are often initially planned at unrealistically low levels, and then increased under subsequent amendments. Finally, the Commission highlights again that the available funds from the European sources must be planned more seriously and more realistically and also used and directed toward those activities which will preserve and maintain economic activity, because these funds are the key to stronger fiscal expansion and sustainability, with great reform potential and a strong contribution to potential GDP growth.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD

20th Position Paper of the Fiscal Policy Commission on the Draft Budgetary Plan of the Republic of Croatia for 2023

At its 15th session held on 24 October 2022, the Fiscal Policy Commission (hereinafter: the Commission) examined the Draft Budgetary Plan of the Republic of Croatia for 2023 (hereinafter: the Draft) which was adopted by the Government of the Republic of Croatia (hereinafter: the Government) at its 159th session held on 19 October 2022.

The Fiscal Policy Commission evaluated the first Draft Budgetary Plan of the Republic of Croatia for 2023. Considering the current global circumstances and 2023 being characterized by a pronounced economic uncertainty and high geopolitical risks, it is appropriate to continue the former practice of conservative budget planning. After a strong recovery and growth in 2021 and the first half of 2022, the prospects for 2023 are less favourable. This creates an uncertain framework for economic and fiscal policy and could necessitate its adaptability. In such circumstances, the main task of fiscal policy will be to mitigate the effect of external shocks on the Croatian economy and help the most vulnerable groups which will be most affected by those shocks. Because of the economic slowdown, cyclical general budget income will grow at a slower pace, while the growth of the general budget expenditure will depend on intensified investment spending related to EU-funds, which represents the main lever of countercyclical action. Therefore, the Commission highlights the need to prepare, as realistically as possible, as many quality and sustainable investment projects as possible. The Commission repeats its warning about certain challenges in the existing capacities and the key stakeholders' readiness to undertake the necessary structural reforms within the framework of the overall public sector (especially in healthcare and public administration, but also in the other sectors).

Croatia's entry into the euro area is taking place in times of great political and economic uncertainty caused by the consequences of the pandemic and intensifying geopolitical tensions (the war in Ukraine and growing hostilities between USA and China). A consequence of these shocks was a surge in import prices, primarily energy prices due to the difficulties in the supply chains and the disruptions in energy import due to the war in Ukraine, which have spilt over into the general price increase. In an exchange situation, such negative shocks are impoverishing the energy-dependent European Union (EU) and Croatia, while citizens and companies have to adjust their spending and investments to the decline in real income. Moreover, in response to the growing inflation, central banks are tightening their monetary policies and financing conditions. In these circumstances, it is probable that overall economic activity will slow down abruptly, and fiscal policy should have a countercyclical effect in this regard to prevent the risk of a recession⁴. Croatia's euro area membership, which implies a common monetary policy and other

⁴ *The goal of such prudent fiscal activity is to prevent the onset of the scenario from the global financial crisis when the foreign shocks related to an unsustainable level of domestic demand as well as the need for a strict fiscal consolidation in a crisis situation (countercyclical) brought on a long-lasting recession in Croatia.*

control and support mechanisms, should also have an alleviating effect on the negative consequences of these shocks. Bearing all these challenges in mind, it is extremely important to pursue a transparent and responsible economic and fiscal policy in 2022 and 2023, and accelerate the reforms funded from the EU programs (Resilience and Growth Program) for the purpose of improving the low potential growth rate which is a result of an unfavourable demographic structure and low additional value of the Croatian industry.

Confirming the macroeconomic projections

The new Budget Act (hereinafter: the Budget Act; Official Gazette 144/21) aligned the budget process with the requirements of the euro area membership in the form of an enhanced coordination of economic policies. The Government of the Republic of Croatia is obligated to prepare a draft budgetary plan for the purpose of consultations with the European Commission, with the macroeconomic projections being confirmed by the Commission. Therefore, according to the provisions of the new Budget Act, the Commission is obligated to evaluate whether the drafted macroeconomic projections are a good foundation for preparing the budgetary plans, which was not necessary under the former Fiscal Responsibility Act (FRA).

As the budgetary plans are based on macroeconomic projections, it is particularly important for the macroeconomic projections to be accurate and unbiased. The high level of macroeconomic uncertainty in the last few years has made the process of drafting the macroeconomic projections much more demanding. In such conditions, quality macroeconomic projections must contain an internal consistency between the variables and may not deviate significantly from the projections of other institutions. In this regard, it is sensible to base the budgetary plans on a lower level of presumed macroeconomic growth, in the part determining the expected income, but also to keep certain reservations on the side of a possible growth of state expenditure costs.

To confirm the macroeconomic projections, the Commission had somewhat improved the former methodology of macroeconomic projections evaluation which, pursuant to Article 22 (2) of the FRA (Official Gazette 111/2018), was based on the comparison with the latest available projections of the European Commission (EC). However, the Commission is still not drafting its own macroeconomic projections but is instead comparing the projections of the Government of the Republic of Croatia with the macroeconomic projections of a larger number of institutions and additionally considering the presumptions and the consistency of the macroeconomic projections of the Croatian Government. To be able to make its own projections and conduct more thorough analyses, the Commission should have a functional and professionally staffed office set up, which the Commission has been actively working on some time now, despite many difficulties and challenges.

In the initial stages, the Commission and the Ministry of Finance (MF) regulated the process of confirming the macroeconomic projections according to the Timetable which defined the exchange of information and consultations on macroeconomic and budgetary projections before their adoption this year. Thus, in late September 2022, the Commission received preliminary macroeconomic projections, and, on 6 October 2022, the final macroeconomic projections from the Draft Budgetary Plan. On 7 October 2022, it held a meeting with the representatives of the MF. Based on the conducted analysis, on 13 October, in a letter addressed to the Ministry of Finance, the Commission confirmed the macroeconomic projections from the Draft Budgetary Plan.

The macroeconomic projections from the Draft Budgetary Plan for 2023 have been amended in relation to the projections from the Convergence Program from April 2022 to accommodate the achieved trends and materialize the negative risks in the global economy (Annex 1). An increase in economic activities during the first three quarters of 2022 exceeded prior expectations by far (the expected real growth rate for 2022 increased from 3.0 to 5.7 %). On the other hand, many negative risks have also been achieved, resulting in a rapid downturn of economic activity in both the EU and Croatia. Bearing all this in mind, the projections for 2023 foresee a halting of the growth of economic activity in late 2022 and early 2023 when GDP is expected to grow by 0.7 % (2023 Convergence Program assumed growth would additionally accelerate to 4.4 %). Unlike 2022, when the main contributors of growth were personal consumption and export which grew at two-digit rates, in 2023, growth should mainly be driven by state spending and EU-funded investments, while personal consumption, private investments and export will have a minor or negative contribution to growth.

The presented macroeconomic projections for 2023 are consistent both internally and with the projections of the other institutions, albeit with somewhat more cautious expectations for 2023. The Commission compared the macroeconomic projections from the Draft Budgetary Plan for 2023 with the projections of other institutions and established that there are no significant deviations. The Government's projections are somewhat more conservative, mostly due to their later date which allowed them to include the realization of a number of negative risks as well (Annex 2).

Taking into consideration the uncertainty which is characteristic for macroeconomic projections, the Commission assessed the credibility of the macroeconomic scenario based on how realistic it was and by comparing it with the projections of other relevant institutions. MF's projections are lower than the currently available projections of other relevant institutions, indicating their more cautious approach in determining the settings of the projections for the next period. The Commission holds that this kind of approach is justified because fiscal planning can be adjusted in very uncertain and volatile circumstances of the upcoming period when the risk of deceleration of economic activity and of a recession will rise abruptly, causing the Croatian economy to possibly face numerous limitations.

Although there are risk factors which pose a threat to economic growth, the Fiscal Policy Commission, at its 14th session held on 11 October 2022, confirmed the macroeconomic projections drafted by the MF for 2023 and concluded that these are within an acceptable range based on the currently available information.

Evaluation of the Draft Budgetary Plan

Due to the introduction of the euro as the official currency, the Republic of Croatia (Croatia) assumed a new obligation of participating in the procedures of monitoring and coordinating the economic policy of the euro area member states, including consultations and the preparation of the Draft Budgetary Plan for the following budget year. The new Budget Act (Official Gazette 144/21) adjusted the budget planning process to the requirements of the euro area membership and, in accordance with the Budget Act, the Government is obligated to prepare the Draft Budgetary Plan for the purpose of consultations with the EC which analyses whether the member states' budgetary plans take into consideration in an appropriate manner the recommendations of the Council of the EU issued under the European Semester and whether they transpose them into specific budgetary policies and an appropriate macroeconomic framework. The draft budgetary plan is a summary overview which defines the macroeconomic and fiscal frameworks of a particular euro area member state in the following budget year, and it serves as the basis for further preparation of the proposed budget for the following year.

Since euro area member states were obligated to prepare and deliver to the EC their 2023 Draft Budgetary Plan by 15 October 2022, Croatia prepared its first Draft Budgetary Plan for 2023 pursuant to the Guidelines on the format and the content of draft budgetary plans, economic partnership programmes and debt issuance reports, and the consultations with the EC. In doing so, it abided by the provisions of the Budget Act, the Stability and Growth Pact, the latest recommendations of the Council of the EU for the Republic of Croatia, the activities foreseen under the National Recovery and Resilience Plan (NRRP), the National Reform Program (NRP) and the package of measures of the Government of the Republic of Croatia for the protection of citizens and the economy from increasing prices and activities related to receiving and caring for displaced persons from Ukraine.

To enable realistic planning, in this process, the Fiscal Policy Commission, as an independent fiscal body in Croatia, must confirm the macroeconomic projections underlying the draft budgetary plan (Article 21 (3) of the Budget Act). Moreover, macroeconomic and budgetary projections are subject to an unbiased and comprehensive evaluation by an independent body competent for the evaluation of fiscal policy, the results of which are considered in preparing future macroeconomic and budgetary projections (Article 21 (2) of the Budget Act). In its first evaluation of the Draft Budgetary

Plan, the Commission assessed that, considering the current global situation, 2023 is characterized by extreme uncertainty and high geopolitical risks, hence it is appropriate to continue the former practice of conservative budget planning. Just as the countries, Croatia is facing numerous challenges and limitations caused by the war in Ukraine, increasing energy prices, the consequences of the crisis due to the COVID-19 pandemic (imbalance between high demand and insufficient offer) and an excessively high inflation rate. After the growth of Croatian economy in 2021 and the first half of 2022, the global trends (unstable energy prices and price pressures spreading and intensifying across industries) demonstrate that the economy will weaken and decelerate in the next quarters.

The prospects for Croatia's economic growth in 2023 have worsened and indicate a stagnation, which creates a very uncertain and volatile framework for implementing economic and fiscal policies. This all calls for flexibility and adjustability of the Croatian fiscal policy which needs to be able to act fast and ensure efficient measures for limiting the consequences of inflation and preventing further inflationary pressures, so as not to endanger the mid-term sustainability of public debt. Fiscal policy measures will have to be efficient in the next period and on, without permanently harming the state of public finances. They also need to be temporary, selective and targeted in order to focus only on supporting the most vulnerable groups and the most affected parts of the economy.

Croatian fiscal policy in 2021 and 2022 was largely characterized by the adoption of measures for limiting the consequences of the epidemic as well as soaring energy prices. At the same time, numerous and relatively comprehensive discretionary measures were adopted with a long-term effect on the state of public finances. The share of the general government budget income, measured by the share in GDP, decreased slightly (from 46.8 % in 2021 to 46.2 % in 2023). After a significant increase of the general government budget income in the last two years, these are expected to grow slightly in 2023. General budget income is determined by the projected economic activity, taking into consideration also the fiscal effects of revenue measures (0.2 % of GDP in 2023) adopted by the Government in April and October 2022 as part of the package for the protection of households and the economy from increasing prices. The funds provided as grants from EU institutions and bodies (funds from the Multi-Annual Financial Framework - MFF 2021 – 2027, the Recovery and Resilience Facility and the EU Solidarity Fund) also have a significant effect on general budget income.

General budget income will increase less primarily due to the lower level of tax revenue growth. The most significant taxes are those on production and import projected in the amount of 18.8 % of GDP. In the tax structure, value added tax (VAT) stands out: for 2023 it is projected at the level of 13.3 % of GDP due to the growth of personal consumption, tourism services, intermediate consumption, investments and social transfers in kind. These projections include the effect of expansion of products and services which are taxed at lower VAT rates (13 %, 5 % and 0 %) and which apply since April and October 2022

for the supply of natural gas and heating from heating stations, that is, for the supply and installation of solar panels. Along with the lower foreseen growth of personal consumption, decreased revenue from excise duty is expected due to lower excise duty on fuel and lower retail prices.

The share of total general government expenditure is decreasing from 49.4 % of GDP in 2021 to 48.6 % in 2023. However, compensations to employees in 2023 are increasing by 7.1 % annually, mostly due to the increase of the basis for salary calculation based on collective agreements for civil and public servants, the corrections for past service of 0.5 % and the expected trends regarding the number of employed civil and public servants (presumed growth of 0.8 %). Increased expenditure for pension fees in 2023 is also projected, in the amount of HRK 5 billion, which includes the effect of pension indexation of 6 %, the effects of the amendments to the Pension Insurance Act and the transferred cumulated effect of the change in the number and structure of pension users. Automatic adjustment of certain types of expenditure to the inflation (pensions and salaries, partially social benefits) results in their permanent (relative) increase. The expenditures for intermediate consumption, which are expected to be at the level of 8.4 % of GDP in 2023, include higher amounts that healthcare institutions put aside for the settlement of debts toward drug suppliers as well as for medical consumables and embedding medical materials. The Commission highlights that, in times of high inflation as we are experiencing now, it is particularly important to control the increase in expenditure (especially increasing salaries for civil and public servants, pension increase). The Commission also reiterates that, in planning the expenditure, non-controlled costs were continuously expressed and that significant losses of the healthcare system were underestimated. The healthcare system needs to be additionally financed from the state budget which calls for fundamental reforms and major changes within the framework of the healthcare system.

According to the draft budgetary plan, further decrease of the general government deficit is planned. Having incorporated the effects of the measures for alleviating the costs of life in 2023, deficit should reach 2.3 % of GDP (0.8 percentage points more than in 2022), satisfying the criteria for the budget deficit pursuant to the provisions of the Stability and Growth Pact. The nominal increase of deficit in 2023 will partly be a result of discretionary measures, that is, the effects of comprehensive measures for alleviating the inflation, further growth of investments and increase in other consumption. It is expected that the share of public debt in GDP will continue to decrease and amount to 69.0 % of GDP at the end of 2023, mostly as a result of the inflation. This represents a satisfactory dynamic of public debt adjustment according to the provisions of the Stability and Growth Pact. The importance of economic growth is reflected precisely in the trend of the share of public debt in GDP. Therefore, caution must be applied in the context of economic stagnation and deceleration, and significant efforts must be invested to ensure fiscal sustainability precisely because a relatively higher level of debt could endanger the stability of fiscal policy in case of new shocks.

The Commission concludes that, because of the deceleration of economy, the growth of cyclical general budget income will slow down, while the growth of the general budget expenditure will depend on intensified EU-funded investment spending. In 2023, just as in 2022, the expansiveness of fiscal policy is related to investment interventions and use of EU funds, but the issue of real and complete usability and realization of those funds remains open. Since fiscal sustainability arises from (the growth of) economic potential which serves as the basis for planning public spending, the Commission highlights the need to prepare as many quality and sustainable investment projects as possible to be able to withdraw the funds for strengthening the economy.

Considering the expected uncertainties, the main task of fiscal policy in 2023 will be to mitigate the effect of external shocks on the Croatian economy and help the most vulnerable groups which will be most affected by those shocks. The Commission has also noticed certain challenges in the existing capacities and the readiness of key stakeholders to undertake the necessary structural reforms within the framework of the overall public sector (especially in healthcare and public administration, but also in the other sectors). Moreover, attention should also be paid to those projects which will bring about the maximum possible added value for the economy and contribute to the growth of potential GDP, which will in turn facilitate increases fiscal sustainability of the national economy.

As a reform is expected of economic governance in the EU as well as reforms of fiscal rules at the EU level, and bearing in mind the economic and political circumstances at the level of the EU based on the EC Communication (2022a), the General Escape Clause will remain in force in 2023, the same as the Decision on the temporary postponement of the application of national fiscal rules. The Government of the Republic of Croatia brought this decision back in 2020 due to a number of extraordinary circumstances, all in accordance with the recommendations of the Fiscal Policy Commission and based on the provisions of the Budget Act, in order to leave national fiscal policies enough space for manoeuvre.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD

21st Position Paper of the Fiscal Policy Commission on the Draft State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2023 and the Projections for 2024 and 2025

The Fiscal Policy Commission (hereinafter: the Commission), at its 16th session held on 21 November 2022, examined the Draft State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2023 and the Projections for 2024 and 2025 (hereinafter: the Draft) which was adopted by the Government of the Republic of Croatia (hereinafter: the Government) at its 166th session held on 14 November 2022.

The Draft State Budget for 2023 is the first budget prepared in accordance with the euro area membership obligations. The budget, indicated in euros, was preceded by the Draft Budgetary Plan for 2023 whose purpose was to coordinate the economic policies of the euro area member states. In its 20th position of 24 October 2022, the Commission confirmed the macroeconomic projections for 2023 and supported the fiscal policy course planned for the next year. The evaluation by the European Commission (hereinafter: EC) is also expected. The Commission highlights that the strong growth of Croatian economy in 2022 was used to consolidate public finance and commends the plan to continue the decrease of the high share of state debt in GDP in the next period. The Fiscal Policy Commission supports the Draft State Budget for 2023 and calls on the Government to limit as much as possible the adoption of fiscal measures with a permanent effect on expenditure and to insist on structural reforms necessary to increase the potential growth rate. The Commission also highlights that it is necessary to carefully and continuously analyse the sustainability of public finance and bear in mind the fiscal rules, even though these are currently under suspension and revision. European Commission intense efforts invested in the revision of the fiscal rules should result in new fiscal rules applying from 2024.

Macroeconomic projections

Pursuant to the Fiscal Responsibility Act and the Budget Act, the Commission examines and evaluates macroeconomic and budgetary projections from mid-term budgetary documents and compares them with EC's latest available projections.

The strong economic growth which continued on from 2021 in the first three quarters of 2022 had a positive effect on Croatian public finance in terms of increase in budget income and decrease of the public debt burden (according to its share in GDP). Such economic growth was a result of strong real growth of domestic and foreign demand stimulated by accumulated savings from the pandemic period (2020 and 2021), improved export structure and favourable labour market trends. However, prices also continued to rise strongly due to the consequences of the pandemic and the war in Ukraine.

A soaring inflation and decreasing reliability of economic operators due to intense geopolitical tension have a negative effect on economic prospects for late 2022 and for

2023, and the GDP growth is expected to slow down from 5.7 % in 2022 to 0.7 % in 2023. Unlike 2022, when growth was mostly driven by personal consumption and export, the main contributor to growth in 2023 should originate from government spending and EU-funded investments. The decrease in real salaries and low demand will reduce personal consumption and export, while the labour market will remain resilient despite slower employment growth and labour shortages. At the same time, the inflation rate is expected to slow down (measured by consumer prices) from 10.4 % in 2022 to 5.7 % in 2023.

By the end of the mid-term period, it is expected that the global economic conditions will stabilize, the expectations of economic operators improve and uncertainty decrease. Moreover, by the end of the observed period, personal consumption growth is expected to recover with a positive contribution of domestic demand to GDP growth. As this would cause economic activity trends to return to the potential growth rate level, a growth of 2.7 % is expected in 2024 and 2.6 % in 2025.

The main external macroeconomic risks are related to global growth and inflation, whereas the most prominent among the domestic risks are the mid-term vulnerability of the real estate market that might have a negative impact on the stability of the Croatian financial system and the efficient absorption of structural EU funds and the funds related to the projects financed under the National Recovery and Resilience Plan (hereinafter: NRRP).

In its 20th Position Paper, the Commission confirmed the macroeconomic projections for 2023 underlying the draft budgetary plan (Article 21 (3) of the Budget Act (Official Gazette 144/21)). These define the macroeconomic and fiscal framework for the preparation of the budget in the next budgetary year. The macroeconomic projections of the Government of the Republic of Croatia for 2023 are lower than the projections of other relevant institutions, indicating the Government applied a more cautious approach in laying down the settings of the projection for the next period. The Commission holds that this kind of approach is justified because fiscal planning can be adjusted in very uncertain and volatile circumstances of the upcoming period when the risk of deceleration of economic activity and a recession will rise abruptly, due to which the Croatian economy might face numerous limitations.

A high level of uncertainty impedes both the preparation and the consideration of mid-term projections. According to the Government's macroeconomic projections, the current negative effects are expected to be short-term, and growth in 2024 and 2025 will return to the level of the evaluated potential growth, which will largely be driven by increased investments. In addition, because a limited number of macroeconomic projections is available from other institutions for 2024 and 2025, a wider comparison is impossible.

A comparison of the macroeconomic projections of the Government of the Republic of Croatia with EC's latest projection of 10 November 2022 (Table 1) indicates that both institutions foresee that economic growth will slow down significantly in 2023 and

recover in 2024. At the same time, the EC foresees a somewhat higher growth than the Government in 2022 and 2023 as well as a slower recovery in 2024. However, looking at cumulative numbers, the Government's projection for 2024 does not deviate significantly from EC's. The Government is more careful about price and deflators growth which shows that it considers the growth of budgetary income more cautiously.

Table 1 Comparison of macroeconomic projections of the Croatian Government and the EC in %

	2021	Croatian Government				European Commission			Difference		
		2022	2023	2024	2025	2022	2023	2024	2022	2023	2024
Real GDP growth	13.1	5.7	0.7	2.7	2.6	6.0	1.0	1.7	-0.3	-0.3	1
Consumer price index (CPI)	2.6	10.4	5.7	2.5	2.3	10.1	6.5	2.3	0.1	-0.8	0.2
Unemployment rate	7.6	6.3	6.3	5.5	5.0	6.3	6.3	5.9	0	0	-0.9

Source: EC, Croatian Government

The Commission has noticed that the projections presented for 2024 and 2025 foresee that the economic activity disruption will be short lasting, which is consistent with the currently expected trends in international and European economy. Strong investment activity financed from EU funds might prevent the recession and accelerate the resumption of the growth curve. Therefore, the Commission reiterates that the macroeconomic projections from the Draft State Budget can serve as a credible basis for drafting the budget for 2023, but it also highlights that, due to the high level of uncertainty related to the expected recovery in 2024 and 2025, the Government must closely monitor the achievement of macroeconomic trends and the absorption of EU funds to be able to adjust its macroeconomic and budgetary projections in due time in case of any deviations.

Evaluation of the Draft State Budget for 2023 and the projections for 2024 and 2025

The Draft State Budget for 2023, stated in euros for the first time, operationalizes at the central government level the fiscal policy course presented in the Draft Budgetary Plan for 2023. The Draft Budgetary Plan was positively evaluated by the Commission, especially in the part relating to the decrease of the share of public debt in GDP and of the share of budget expenses in GDP. The purpose of the Draft State Budget, considering the current uncertainties, is to mitigate the effects of external shocks on the Croatian economy, help the most endangered groups that will be most affected by such shocks, preserve economic growth and make sure the decrease in the budgetary deficit and public debt continues. However, the Government of the Republic of Croatia should indicate the items where it will decrease the expenditure in case the planned income is not achieved.

In the last five years (2018-2020), total state budget income grew by 33 %, where the largest growth was seen in grants revenue (163 %) and revenue from the relevant budget and from the Croatian Pension Insurance Institute (hereinafter: CPII) based on contractual obligations. At the same time, the total state budget expenditure increased by 43 %, where operational expenses increased by 36 % and the expenses for the procurement of non-financial assets by as much as 301 %. These trends are significantly impacted by EU funds which, in the next period, might act as the main driver of growth and investments necessary to achieve the level of economic development of EU Member States.

The income side of the state budget in the period from 2023 to 2025 is determined by the projected trend of economic activity which includes the fiscal effects of income measures adopted by the Croatian Government in April and October 2022 as part of the package for the protection of households and the economy from increasing prices. Total state budget income is planned in the amount EUR 24.9 billion in 2023, EUR 24.8 billion in 2024 and EUR 25.8 billion in 2025. Tax revenue in 2023 is projected in the amount of EUR 13.3 billion (planned growth by 3.4 %). In the upcoming years, it is expected to grow further, so it is projected in the amount of EUR 14 billion in 2024, that is, EUR 14.7 billion in 2025 (5 % growth). Revenue from the EU also has a significant effect on the budget. It has been growing significantly, amounting to EUR 5 billion, while the contributions in 2023 amount to EUR 4 billion (8 % growth), EUR 4.2 billion in 2024 and EUR 4.4 billion in 2025. The increase of tax revenue is planned at a rate lower than the growth rate of nominal GDP, leaving room for additional unburdening next year.

The total state budget expenditure, planned in the amount of EUR 26.7 billion in 2023, is higher by **EUR 2.1 billion** or 8.8 % than in 2022. In 2024, the total state budget expenditure is planned at the level of EUR 25.6 billion, and in 2025 at the level of EUR 25.9 billion. While operating expenses will grow by 7 % in 2023, the expenditure for the procurement of non-financial assets will grow by 30 %. Their growth is a result of increased dissociation of expenditure financed from the EU due to the implementation of EU projects. Increased expenditure is a result of increased expenditure for the employed, for retirement fees and social benefits and welfare, residential loans subsidies, and expenditure for demographic measures, investments in earthquake remediation, into the energy infrastructure and assistance provided to vulnerable citizens. Since the state is repairing the debts of the healthcare sector, as it does every year, the question remains whether the additional investment of EUR 74.8 million will remain the only “extraordinary” cost of the central budget in 2023. The expenditure side of the budget in the next period is focused on protecting the standard of living of Croatian citizens, especially the most vulnerable ones, strengthening the security and defence capabilities of the Republic of Croatia and continued earthquake remediation. In the observed mid-term period, the potential of the Croatian economy will also be strengthened through the

Recovery and Resilience Facility, especially in the water management, energy transition, science, education and health sector.

In considering fiscal sustainability, expenditure presented by funding source must be examined. For example, an increase in expenditure from general receipts and income, contributions and dedicated receipts (sources 1, 2 and 8) must be in tune with the total economy growth, bearing in mind their structure. The growth in other expenditure, especially the items financed from own revenue (source 3) and grants (e.g. EU grants and EU funds, source 5) must be stimulated, especially in the part related to development projects.

Expenditure financed from general income and receipts in 2022 amounted to EUR 18.6 billion, with an annual increase of 6.3 %. It is expected to grow by 5.1 % in 2023, 0 % in 2024 and 1.5 % in 2025. Such plans demonstrate the efforts the Government has invested in halting expenditure growth and encouraging budgetary users to use the available EU funds as much as possible, which affects the unfavourable expenditure structure which is almost entirely dominated by current expenditure, while investments are financed from national funds only at a small extent. There is also the risk of exceeding certain expenditure categories which could affect the fiscal result. In the structure of these expenditures, 40 % pertains to citizens and households based on insurance and other fees, including the funds for retirement fees. These expenditures are expected to grow by 7.4 % in 2022, 7.3 % in 2023, 4.2 % in 2024 and 3.8 % in 2025. After the 5.4 % increase in 2022, the expenditure for the employed is expected to increase by as much as 11.6 % in 2023, mostly as a consequence of the agreed salary increase in the public sector. In the upcoming years, these expenditures are logically expected to stagnate bearing in mind the former practice of incorporating only the agreed salary increase into the budgetary plans, making budgetary projections less realistic, which the Commission has repeatedly warned about. Material expenditure, after an increase of as much as 29.1 % in 2022, should decrease significantly in 2023 (-12.0 %). Significant savings are also expected in financial expenditure which should decline continuously in the observed period, mostly because the payment of the costs of interest for the arbitration proceedings based on the ruling in the INA-MOL case is no longer provided for. Savings in the previous period have been achieved through improved management of the state debt and the prolongation of the maturity structure in the low interest period and improved investment rating, which should amortize the risk of the expected interest rate increase.

In accordance with the stated plan, according to the national methodology, the 2023 state budget will result in a deficit of EUR 1.8 billion (i.e. -2.6 % of GDP), and it is planned to decrease to 1.1 % in 2024, that is to 0.2 % of GDP in 2025. At the same time, extrabudgetary users will record a surplus of 0.3 % of GDP in 2023, 0.1 % of GDP in 2024 and 0.2 % of GDP in 2025. A deficit will also be seen in local and regional self-government units: 0.1 % of GDP in 2023 and 0.2 % of GDP in 2024 and 2025.

When these numbers are supplemented with the adjustment of the national accounting plan methodology to the ESA 2010 methodology and the projections of deficit/surplus achieved by companies and other legal persons included in the general government sector, a deficit of 2.3 % of GDP is expected at the general government level in 2023. In 2024, the deficit is projected at the level of 1.7 % of GDP, while the general government budget deficit expected in 2025 is 1.2 % of GDP. This will satisfy the budget deficit criteria in accordance with the provisions of the Stability and Growth Pact (general government budget deficit may not exceed 3 % of GDP).

Fiscal policy position: evaluation of the fiscal situation

Fiscal rules are the main facility for the achievement of the objective of the Fiscal Responsibility Act, which is to ensure long-term fiscal sustainability. The most important preventive lever is the mid-term budget objective which relates to the amount of the structural budget balance ensuring that the trend of general government budget deficit and public debt is aligned with the reference values of public debt and total deficit. If a prudent and balanced budget policy is implemented in the mid-term, there will be plenty of room (up to 3 % of GDP in total) for fiscal policy to react in recession circumstances.

The structural balance demonstrates the real character and the course of fiscal policy, as well as its space for manoeuvre in fulfilling EU's fiscal rules. It indicates whether the budget is balanced in the mid-term, throughout the entire operating cycle, and whether there is any room for counter-cyclical fiscal policy actions.

Table 2 Consolidated general government structural balance trends from 2021 to 2025, % of GDP, ESA 2010

	2021	2022	Plan 2023	Plan 2024	Plan 2025
Total surplus/deficit	-2.6	-1.4	-2.3	-1.7	-1.2
Potential GDP	3.1	3.4	2.8	2.8	2.5
GDP gap (% of potential GDP)	1.4	3.5	1.3	1.2	1.3
Cyclical component of the budget	0.6	1.6	0.6	0.6	0.6
Cyclically adjusted balance	-3.2	-3.1	-2.9	-2.3	-1.8
Single-term and provisional measures		-0.8	-0.8	0	0
Structural balance	-3.2	-2.3	-2.2	-2.3	-1.8

Source: Ministry of Finance

During the entire budget horizon, the Croatian economy is still undergoing a slightly positive phase of the operating cycle reflected in the positive GDP gap. Therefore, if the above-described methodology is applied, the estimated structural balance corrected by the condition of the operating cycle according to the budget proposal should remain at the level of app. 2.3 % due to the effect of single-term measures in 2022, 2023 and 2024, while it is expected to decline in 2025. The cyclically adjusted balance demonstrates a stronger decline, especially in 2024 and 2025 when new fiscal rules are expected to apply after being temporarily deferred in the period from 2020 to 2023.⁵

In conclusion, the Commission supports the Draft State Budget for 2023 and invites the Government to limit as much as possible the adoption of fiscal measures which have a permanent effect on expenditure and to insist on structural reforms necessary for increasing the potential growth rate which would be financed from available EU funds to the maximum extent.

The Commission underlines that it is necessary to bear in mind the mid-term sustainability of public finance, while the fiscal consumption measures must be targeted, temporary and short-term. However, as many times before, the Commission highlights and warns about the existence of significant fiscal risks. The key fiscal risks relate to very unfavourable demographic trends related to an ageing population and a decreasing number of working-age citizens, which exerts pressure on the sustainability of the pension system as well as the balance of outstanding liabilities and the overall financial sustainability of the healthcare system. It must also be mentioned that although the level of public debt is relatively decreasing, it is still high, and represents a source of vulnerability for the Croatian economy and long-term sustainability of public finance. It is precisely in these areas where decisive reformatory steps should be taken.

Furthermore, a key instrument for maintaining Croatia's economic activity are EU funds. It is necessary to use quality, economically viable, development, strategic and reform projects financed from EU funds in the next budget period, as well as from the EU Solidarity Fund to influence future economic growth and development and to increase Croatia's fiscal sustainability. EU funds can also facilitate fiscal consolidation. Although the Government had projected the utilization of these funds at the maximum level and the results were much lower, these still significantly contribute to financing and could facilitate the resolution of external recession challenges in the upcoming period.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD

⁵ For more information on the amendment of the fiscal rules see the European Commission Communication setting out orientations for a reformed EU economic governance framework, COM(2022) 583