POVJERENSTVO ZA FISKALNU POLITIKU

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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

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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 %

		Croatian Government				*European Commission*			*Difference*		
	2021	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.[1]

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.

[1] 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

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