



REPUBLIC OF CROATIA



Zagreb, May 22, 2023

22nd Position Paper the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for the 2023 and Projections for the Years 2024 and 2025

At its 18th session held on May 22, 2023, the Fiscal Policy Commission (hereinafter: the Commission) examined the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for 2023 and Projections for the Years 2024 and 2025 adopted by the Government of the Republic of Croatia (hereinafter: the Government) on May 19, 2023 at its 218th session.

The Commission considers the Draft Amendments to the State Budget for 2023 appropriate, given the current conditions. The amendments are based on new macroeconomic projections approved by the Commission on April 22, 2023. The Commission emphasizes the need for cautious and conservative fiscal policy, with particular attention to controlling expenditure growth and further reducing public debt.

Macroeconomic projections for 2023

The Draft Amendments to the State Budget for 2023 is based on macroeconomic projections from the Stability Programme, which were approved by the Commission on April 22, 2023, in accordance with the provisions of the Budget Act (Official Gazette 144/2021). Although the macroeconomic projections of the Government of the Republic of Croatia and other institutions at the end of 2022 indicated a temporary slowdown of the Croatian economy, such negative expectations did not materialize. Favourable trends in the Croatian economy continued during the last quarter of 2022 and the first quarter of 2023. Despite external shocks and high inflation, the Croatian economy recorded strong growth in 2022 (6.3% compared to the planned 5.7% in October 2022). Based on these achievements, the Government of the

Republic of Croatia updated its growth projection for 2023 from the previous 0.7% to 2.2%, with all components of GDP growing, especially exports of goods and services. In 2023, a slowdown in inflation to 6.6% is expected due to the reduction in energy prices and primary raw materials. Furthermore, economic growth in 2023 will be accompanied by an increase in employment and a decrease in unemployment. When assessing the macroeconomic projections from the Stability Programme, the Commission concluded that they are more optimistic than the projections of other relevant institutions (European Commission, EBRD, World Bank, and IMF), but these deviations are a result of a time shift in the making of projections. This is confirmed by the latest projection of the European Commission in May 2023, where the expected growth rate for 2023 was increased from 1.2% to 1.6% with positive risks, which is still lower than the projection of the Government of the Republic of Croatia. Nevertheless, the Commission considers that the macroeconomic projections are within an acceptable range and provide a good basis for fiscal projections.

Assessment of the Draft Amendments to the State Budget for 2023

The State Budget for 2023, adopted by the Croatian Parliament on November 29, 2022, projected revenues of EUR 24.9 billion (or 45.2% of GDP) and expenditures of EUR 26.7 billion (or 45.8% of GDP), with a planned budget deficit of EUR 1.8 billion (or 2.3% of GDP).

The Draft Amendments to the State Budget for 2023 includes changes to the macroeconomic conditions and represents a technical correction in light of the measures adopted by the Government after the adoption of the budget for 2023. These amendments increase total revenues by EUR 1.7 billion (or 7%), from EUR 24.9 billion to EUR 26.6 billion compared to the original plan from 2022. In the new plan for 2023, the increase in total budget revenues primarily comes from an increase in tax revenues by EUR 999 million and from property income by EUR 312.7 million. Value-added tax revenues are higher by EUR 537.1 million, and corporate income tax revenues are higher by EUR 428.7 million, as a result of improved business performance of companies and banks in 2022, as well as revenue from a additional corporate income tax (temporary windfall tax). Social contributions are higher by EUR 297.4 million, and property income is higher by EUR 312.7 million, due to higher expected dividend payments and profits of state-owned companies, as well as a one-time fee for the use of radio frequency spectrum. According to the new plan for 2023, aid receivable revenues amount to nearly EUR 5 billion and relate to revenues from projects financed by European funds, the EU Solidarity Fund, and the EU's new generation instrument, namely the Recovery and Resilience Mechanism.

On the other hand, total expenditures increase by EUR 1.4 billion (or 5.3%), from EUR 26.7 billion to EUR 28.1 billion. Total operating expenses increase by EUR 1.3 billion and amount to EUR 26.1 billion, while total personnel expenditure increase by EUR 27.5 million compared to the current plan for 2023, resulting

from the allocation of funds for the growth of complexity coefficients in public service salary calculations in the healthcare sector. Total material expenditure increase by EUR 56.9 million. Out of the total increase in expenditure, expenditure financed from general revenues and receipts, contributions, and designated receipts increase by EUR 1.2 billion, while expenditure financed from the EU and other sources increase by EUR 185.3 million, primarily due to better utilization of the European Union's Solidarity Fund and the provision of additional funds for healthcare institutions financed from revenues based on a contractual relationship with the Croatian Health Insurance Fund.

The most significant increases in expenditure relate to the provision of additional funds for pension indexing, additional funds for the 4th package of Government measures to protect households and the economy from price increases, due to the rising costs of social services, as well as personal assistance services, which are legislatively regulated for the first time. The new plan for 2023 also allocates funds for the payment resulting from the arbitration case initiated by MOL in 2022. Additionally, funds are provided to cover the costs of continuing the reconstruction of buildings damaged by the earthquake in the affected areas.

According to the new plan, the general government budget will have a deficit of EUR 1 billion (or 1.4% of GDP) according to the national methodology. The state budget will have a deficit of 2% of GDP, while local and regional self-government units will have a surplus of 0.4% of GDP, and extra-budgetary users will have a surplus of 0.2% of GDP. Adjusting the national methodology of the budget plan to the European statistical methodology ESA 2010, the overall result of these changes to the state budget for 2023 will result in a general government deficit of EUR 510 million (or 0.7% of GDP), and a reduction in the share of public debt in GDP by 5.8 percentage points compared to 2022, reaching 62.6% of GDP.

The Commission considers the Draft Amendments to the State Budget for 2023 appropriate in the current state and circumstances. Furthermore, the Commission highlights that the Croatian economy is in a positive phase of the economic cycle, driven by the demand for Croatian products and services as well as significant EU assistance. Economic growth has a positive impact on Croatian public finances in terms of increased public revenues and a reduction in the burden of public debt (measured as a share of GDP). In addition to growth, public revenues have been strongly influenced by inflation, the introduction of an additional extraordinary corporate income tax, and increased utilization of EU funds, which is reflected in the increase in the share of revenues in GDP in 2023. On the other hand, an increase in expenditures is expected in 2023 and in the coming years. In such circumstances, the improvement in the state budget in 2022 is of a temporary nature, as indicated by the fiscal projections from the Stability Programme. The Commission emphasizes the need to avoid a situation similar to earlier periods (late 1990s and immediately before the global financial crisis) when a temporary increase

in revenues led to a permanent increase in expenditures and long-term problems in public finances, which had to be addressed during periods of low activity, further deepening the negative economic trends at that time. Furthermore, a significant part of the fiscal space has already been utilized through the previous fiscal support measures. Therefore, it is necessary to rebuild and secure the fiscal space that existed before the pandemic, in order to ensure the long-term sustainability of Croatian public finances in light of future challenges, potential shocks, negative demographic trends, climate change, and digital transition.

Moreover, the temporary suspension of the application of fiscal rules in 2023 and the announcements of a new form of monitoring fiscal sustainability create uncertainty regarding the limitations on public expenditure and deficits. In such circumstances, the Commission calls on the Government to adhere to the Fiscal Responsibility Act when planning fiscal policy measures, which includes a preventive part (medium-term budgetary target adjustment plan) and recommendations from the European Commission regarding expenditure growth. In this regard, it is necessary to limit a significant deterioration of the structural deficit in 2023 and 2024.

In light of the above, the Commission will soon provide an assessment of the Stability Programme, which will include recommendations for the preparation of future budget proposals in order to ensure the sustainability of public finances.

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