

Zagreb, 5 June 2023

23rd 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 2022 and on the Stability Programme

At its 19th session held on 5 June 2023, the Fiscal Policy Commission (hereinafter: the Commission) discussed the Draft Annual Report on the Realization of the State Budget of the Republic of Croatia for 2022 adopted by the Government of the Republic of Croatia (hereinafter: the Government) at its 220th session held on 25 May 2023, and the Stability Programme for the period of 2024-2026 adopted by the Government at its 212th session held on 27 April 2023.

The Commission holds that fiscal policy in 2022 was responsible and adequate as it provided for strong fiscal incentives in response to the energy crisis, without endangering mid-term fiscal sustainability, and responsibly using strong economic recovery for strong fiscal consolidation. However, the Commission underlines that, in the upcoming period, the Government should continue to pursue a prudent fiscal policy and comply with the fiscal rules by controlling expenditure growth, while undertaking key reforms in the public sector.

The last three years, from the outbreak of the COVID-19 pandemic to the war in Ukraine, have been characterized by great shocks which had an intense impact on both the global and Croatian economy, resulting in strong public policy responses. To enable an adequate fiscal policy response, the European Union (hereinafter: the EU) temporarily postponed the application of fiscal rules and, to mitigate the socioeconomic impact of the pandemic, building on the budget resources and the next multiannual financial framework, launched a new financial instrument, Next Generation EU.

Croatian economy made a quick recovery from the downturn caused by the pandemic, mostly owing to foreign demand for Croatian services (and products) and a strong influx of EU's assistance. Croatian economy was not heavily disrupted by the increase in import prices after the outbreak of the pandemic and the beginning of the war in Ukraine. Unlike the period preceding the previous global financial crisis in 2008, the conservative fiscal policy pursued by Croatia prior to the outbreak of the pandemic created sufficient fiscal space which made it possible to conduct a countercyclical fiscal policy throughout the last three years. In that regard, Croatia's EU membership and the influx of resources from EU funds had positively impacted economic activity and

resilience, while (global) inflation in the first stage had a positive effect on public finances (public revenue increased and real expenditure slightly decreased). In these conditions, Croatia, despite the fiscal measures it had implemented to counter the effects of negative shocks, quickly corrected its fiscal imbalances and achieved a significant decrease of public debt. Such prudent fiscal policy contributed to the introduction of the euro as the official currency in 2023.

In the upcoming period, it is expected that economic activities will normalize completely and that inflationary pressures will ebb, thus minimizing the effect on public revenue and causing negative shocks to disappear, ultimately allowing for the reapplication of fiscal rules in 2024. The Commission highlights that public finances must be structured so as to continue stimulating growth, and that the Republic of Croatia must use its current favourable period to implement key reforms and enable investments into inclusive growth and resilience, all for the purpose of creating fiscal buffers allowing it to act in a future crisis.

Evaluation of the Execution of the State Budget for 2022

Croatian economy, despite the negative consequences of the war in Ukraine, strong growth of energy prices, food and import products, and the tightening of financing terms on the international market, continued its strong growth in 2022 (annual GDP growth of 6.3 %). A strong incentive to growth still comes from tourism and EU funds, while external factors and limitations in domestic offer, especially in the services sector, have contributed to a strong inflation growth (based on the consumer prices index throughout 2022, the average inflation level was 10.8 %, mostly due to the increase in food and energy prices). In these conditions, nominal GDP in 2022 increased by 14.9 %.

Continued strong growth of economic activity and the increase of prices had a positive effect on Croatian public finances. Due to strong GDP growth, the effect of strong inflation and the government's measures (three packages of fiscal support measures to mitigate the consequences of increasing energy prices), fiscal policy in 2022 was largely marked by a strong growth of revenue from taxes. Countercyclical fiscal policy played a significant role again in 2022 in terms of alleviating the damages caused by the energy crisis and ensuring conditions for continued growth.

The effects of these trends on the realization of the state budget indicate an adequate fiscal policy in 2022 because, despite the significant increase of public finances, the growth of budget expenditure was much slower than GDP growth (see more in Table 1). Since the achieved results were better than planned, in May and October 2022, two amendments to the state budget for 2022 were adopted.

Table 1 Trends in 2021 and 2022 state budget revenue and expenditure

in HRK billion	2021.	2022.				
	Realization	Budget	1st amendments	2nd amendments	Realization	Annual growth
Revenue	154.1	164.5	171.1	171.8	171.7	11.5%
Operating revenue	153.4	163.7	170.3	170.4	170.3	11.0%
Tax revenue	83.7	87.9	91.1	95.5	97.9	17.0%
Profit tax	7.9	8.4	9.3	11.3	11.7	47.8%
VAT	57.1	60.8	62.6	64.7	66.2	16.0%
Excise duties	16.3	16.4	16.8	16.7	17.0	4.0%
Contributions	25.2	26.0	28.0	28.0	28.7	13.5%
Grants	22.0	32.4	33.5	28.2	23.9	8.4%
Revenue from assets	3.1	2.4	2.8	2.2	2.5	-19.4%
Revenue from duties	6.2	4.5	4.5	4.6	4.8	-23.0%
Expenditure	169.0	173.8	184.7	184.7	175.1	3.6%
Operating expenditure	161.6	160.9	170.7	173.7	167.0	3.3%
Expenditure for employed persons	24.2	25.0	25.3	25.6	25.5	5.1%
Material expenditure	18.0	16.6	18.7	21.1	21.8	21.3%
Financial expenditure	7.8	7.9	7.7	7.9	7.7	-0.9%
Subsidies	12.0	8.1	9.3	9.5	9.7	-19.6%
Grants	39.9	39.5	43.1	42.3	41.7	4.7%
Compensations to citizens and households	52.7	54.6	56.5	56.9	56.7	7.6%
Other expenditure	7.0	9.2	10.1	10.4	9.4	32.7%
Expenditure for the procurement of non-financial assets	7.4	13.4	14.0	11.0	8.1	8.5%
Total deficit/surplus	-15.0	-9.3	-13.7	-12.9	-3.3	

Source: Croatian National Bank, Ministry of Finance.

The total state budget revenue in 2022 was HRK 171.7 billion, which is an increase by 11.5 % compared to 2021. The realization of the state budget revenue in 2022 was impacted by macroeconomic trends in economy, the fiscal effects of tax changes implemented during 2021 and the changes which came into force in 2022 (changes in excise duty regulations and the value added tax system). On the other hand, total expenditure in the state budget of the Republic of Croatia for 2022 was planned in the amount of HRK 184.7 billion, while in the end, the total state budget expenditure in 2022 was realized in the amount of HRK 175.1 billion (94,8 % of the expenditure planned for 2022). Total state budget expenditure in 2022 was HRK 6.0 billion or 3.6 % higher than in 2021 due to the implementation of the measures by the Government of the Republic of Croatia for the protection of citizens and the economy from increasing prices, increasing expenditure for the payment of pension fees and benefits, expenditure for employed persons and due to an increase of expenditure financed from EU funds.

Realization of total revenue at the general government level (ESA2010) in 2022 amounts to HRK 229.5 billion (45.2 % of GDP), where revenue from value added tax increased by 16.2 %, from excise duties by 1.4 % and revenue from social contributions by 12,8 % as a result of the growth of salaries and employment due to increased economic activity. Revenue from EU funds in 2022 notably increased by 26.7 % at the annual level. From the aspect of the general government sector revenue, government actions, due to the decrease of VAT and excise duties on energy, had a negative effect on revenue from taxes, whereas the amount of collected revenue from personal income tax and corporate income tax was positively affected by additional corporate income tax.

Total general government expenditure (following the ESA2010 methodology) was HRK 227.6 billion (44.8 % of GDP). Its nominal increase compared to 2021 was mostly due to the compensations to employed persons, expenditure for intermediate consumption, product subsidies, social benefits and capital transfers. However, expenditure for gross investments in fixed capital which attained 3.8 % of GDP, also showed an interannual decrease of 6.8 %.

In 2022, after a deficit was realized in the general government budget of 2.5 % of GDP in 2021, due to revenue growth and simultaneous expenditure control at every level of the general government sector, a general government surplus was achieved in the amount of HRK 1.9 billion (0.4 % of GDP). Viewed by subsector, the central government recorded a deficit of 0.3 % of GDP, while the local government and social security funds actually achieved a surplus of 0.6 % of GDP, i.e. 0.1 % of GDP. Moreover, the decreasing trend of the share of debt in GDP continued and the level of the general government debt was HRK 347.2 billion, that is, the share of general government debt in GDP amounted to 68.4 %, which is a decrease of 10 percentage points compared to its share at the end of 2021. Although public debt still exceeds the criterion of 60 %, the achieved debt rate meets the criteria for its decrease.

The Commission's assessment is that, on the one hand, reference values of less than 3% have been achieved for fiscal deficit criteria and of less than 60% in GDP for public debt, that is, the decrease is at the required level. On the other hand, the preventive part of the Stability and Growth Pact requires the consideration of public finances from the perspective of the business cycle which has a strong impact on the trend of structural deficit. In addition, the Government of the Republic of Croatia, in submitting the Annual State Budget Realization Report for 2022, again failed to draft the ancillary report on the achievement of fiscal rules, even though the [Stability Programme](#) and the [Spring European Economic Forecast](#) include the necessary figures for this calculation.

The Commission underlines that Croatian economy, after a quick recovery, is enjoying favourable conditions of a positive production gap which has a positive effect on public finances. After a correction for positive cyclical trends, the structural balance in 2022 was in deficit, amounting to -0.9 % of GDP, which is below the mid-term budgetary

goal of -1.0 % in 2022. In addition, according to the calculations made by the European Commission, structural deficit decreased from -2.9% in 2021 to -1.0% in 2022 indicating strong fiscal consolidation in the previous year. According to these results, the Commission concludes that the Government used the positive economic trends in 2022 and achieved a strong adjustment of public finances.

Evaluation of the Stability Programme for Croatia 2024-2026

Having entered the euro area, the Republic of Croatia accepted a stronger coordination of economic policies and stricter fiscal rules. The Stability Programme replaced the former Convergence Programme, and the macroeconomic projections in mid-term budgetary documents must now be confirmed by an independent fiscal body (the Commission).

Evaluation of macroeconomic projections

The macroeconomic projections from the Stability Programme were confirmed by the Commission on 22 April 2023 pursuant to the provisions of the Budget Act (Official Gazette 144/2021).

After high levels of economic growth in 2021 and 2022, economic activity is expected to grow at a more moderate and lower pace in the period from 2024 to 2026. The Government of the Republic of Croatia expects a growth of 2.2% in 2023, 2.6% in 2024, 2.5% in 2025 and 2.2% in 2026, which exceeds the European Commission's projections. Additionally, it is expected that unemployment rates and the number of unemployed persons will remain at historically low levels throughout the period 2024-2026, largely due to labour shortages. All of this is reflected in stronger requirements and pressures for salary growth, which can have an effect on retaining price pressures.

Table 2 Projections of economic growth and inflation rates from 2023 and 2026

Institution	Date	Real GDP (%)				Price index (%)	
		2023	2024	2025	2026	2023	2024
EBRD	February	1.5	2.3				
CNB	March	1.5	2.8	2.6		7.0	3.8
World Bank	March	1.3	2.8	3.0			
IMF	April	1.7	2.3			7.4	6.3
Consensus Forecast	May	1.6	2.6			7.1	3.1
European Commission	May	1.6	2.3			6.9	1.6
Projections average		1.5	2.6	2.8		7.2	5.1
Stability Programme	April	2.2	2.6	2.5	2.2	6.6	2.8
Budget 2023-2025	<i>November</i>	<i>0.7</i>	<i>2.7</i>	<i>2.6</i>		<i>5.7</i>	<i>2.5</i>

The Commission has assessed the projections presented in the Stability Programme as mostly realistic; however, it underlines the need for remaining cautious due to a certain dose of uncertainty and potential risks in the global environment. The Commission proposes to the Government to revise, in preparing the draft budget for 2024, its corrections in accordance with the achievements in summer 2023 and insight gained in the projected dynamics of EU funds uptake, and to keep pursuing a conservative and cautious approach in planning budget income.

Evaluation of the draft fiscal policy

Preliminary fiscal figures from the Stability Programme for 2023 and 2024 indicate a stronger fiscal expansion, whereas a stronger contraction is planned after 2024. The Draft Stability Programme in 2023 foresees a relatively low budget deficit of -0.7% of GDP, which should additionally decrease by 2026 (in 2024, a deficit of -1.5% of GDP is expected, -0.8% in 2025, and -0.6% of GDP in 2026). In the same period, a further decrease is planned of the share of public debt in GDP from 62.6% of GDP in 2023 to 55.6% of GDP in 2026.

In evaluating the structural deficit, the Commission used the European Commission's Spring Forecast according to which structural deficit increases from -1.3% in 2023 to -1.9% in 2024 (i.e. by -0.6 percentage points). The expected deactivation of the general escape clause after 2024 and the reapplication of fiscal rules means that public finances should move in the direction of deficit consolidation toward the mid-term budgetary objective of 0.5%.

It is expected that the structural balance in the period 2024-2026 will range between 1.6% to -1.2% of GDP (deteriorating by -2.3% in 2024), and that it will stay above the mid-term budgetary objective of -0.5% of GDP in all the years. In that regard, it is paramount to follow the recommendations of the Commission, the European Commission and the Council of the EU and strive to limit the deterioration of structural deficit in 2023 as well as the nominal increase of nationally funded net primary expenditure. Bearing in mind fiscal sustainability, the European Commission holds that an increase of structural balance of at least 0.3% of GDP would be appropriate for 2024, where the growth of government-funded net primary expenditure should not exceed 5.1%.

Although, according to the Stability Programme, the budgetary deficit will remain at a level significantly below the fiscal criterion, the proposed trends are not consistent with the fiscal rules from the Fiscal Responsibility Act (Official Gazette 111/18). Fiscal rules foresee the realization of a cyclically harmonized fiscal balance which must not exceed the level of the mid-term fiscal objective. According to the European Commission's calculation, in the period 2023-2025, a mid-term budgetary balance is set at the level of -1.0%. However, with its entry into the euro area, and being a country with a deficit of more than 60%, Croatia became subject to the provisions of the Treaty on Stability, Coordination and Governance which provides for a mid-term objective of -0.5%.

In May 2023, the Commission supported the proposal of the amendments to the state budget, although it contains a structural balance deteriorated by 0.7 percentage points to 1.6% in 2023 according to the government's calculation, that is, by 0.3 percentage points according to EC's calculation. This position arises from the fact that fiscal rules are still not applied in 2023, and that in 2022, a significant fiscal consolidation was carried out which exceeds the required multiannual effort. Moreover, the amendments to the budget provided for a significant improvement of the nominal deficit, as well as a quicker decrease of debt than previously foreseen. In that regard, the Commission believes that the recommendation of the Council of the EU on the neutral fiscal stance for 2023 has been mostly complied with, despite the deterioration of structural deficit.

The Commission recalls that, in 2024, fiscal rules will again apply. Being an EU Member State and subject to the Fiscal Responsibility Act, Croatia is obligated to abide by these rules. In that sense, the proposed increase of the nominal general government budget deficit, although below the reference deficit criterion, is not adequate due to the deterioration of structural deficit. Despite differing calculations of structural deficit deterioration in 2024 (cca. 0.6-0.7 percentage points), complying with fiscal rules can only be ensured by improving structural deficit by 0.3 to 0.5 percentage points. 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 a stronger adjustment in good fiscal times.

In addition, the Commission calls on the Government to use the Stability Programme for mid-term planning, incorporating therein all of its planned policies with a fiscal effect. This primarily concerns the fiscal effects of the new cycle of tax changes the Government is planning to introduce by 2024. The Commission also highlights that, due to the proposed decrease of the pension insurance basis, a significant correction of general government net tax expenditures must also be foreseen in planning the budget.

The Commission finally recalls that the fiscal policy of the Government of the Republic of Croatia in the last ten years or so was responsible and focused on achieving fiscal sustainability. Owing to such fiscal policy during the pandemic, it was possible to act in a timely manner to counter the crisis and significantly improve financing terms, which eventually proved to be decisive for ensuring the introduction of the euro. However, considering the spent fiscal reserves for the government's interventions in 2021 and 2022, the Commission underlines that, in pursuing economic policy, it is crucial to manage public finances responsibly.

Therefore, the Commission invites the Government to plan for the upcoming period a prudent fiscal policy that will be even more supportive of the planned reforms and investments, and, taking into consideration further uncertainties related to demography, digitalization and climate change, to bear in mind the long-term sustainability of Croatia's public finances.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD