

Zagreb, 9 October 2023

24th 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 2023

At its 21st session held on 9 October 2023, 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 (hereinafter: Croatia) for the First Semester of 2023 adopted by the Government of the Republic of Croatia on 27 September 2023.

Despite unfavourable global trends, Croatia's economic activity achieved strong growth in the first semester of 2023. Such growth, due to favourable labour market trends and significant price increase also facilitated an increase in revenue collected from taxes. At the same time, fiscal expenditure also increased but at a slower pace than income, finally resulting in a surplus of both the state budget and the general government budget. The Commission highlights the current expansionary pro-cyclical position of fiscal policy in 2023 and calls for caution in the future period due to the potential effects of the overflowing of the negative trends from the rest of the European Union into national economy. Therefore, the Commission considers it extremely important to carefully plan current and future fiscal measures. The Commission also believes it is necessary to assess the effects of discretionary measures implemented by the executive branch in a more quality and proactive manner and avoid under- or overestimating certain categories of budgetary income and expenditure. In addition, due to a number of uncertainties, fiscal discipline and sustainability and the structure of public finances must be constantly borne in mind, focusing on the most efficient measures for preserving and improving the economic potential necessary for long-term fiscal sustainability.

In a situation characterized by geopolitical instability and uncertainty, increased inflation and tightened financing conditions at the global level, Croatian economy achieved relatively strong growth in the first semester of 2023. Moreover, Croatian economy proved to be strong and resilient, mostly as a result of strong personal consumption, favourable labour market trends (increased employment levels), foreign demand for services (tourism), inflows from EU funds and national fiscal incentives. Consequently, the real GDP in the first half of 2023 increased by 2.7 % compared to the same period of 2022. However, such trends in the Croatian economy differ from the trends recorded among Croatia's main trade partners where the economy is visibly

slowing down, as already reflected in decreased foreign demand for Croatian products and the slowing down of industrial production during the third quarter of 2023. At the same time, supply problems during the COVID19 pandemic and the abrupt energy and food price increase after the beginning of the war in Ukraine brought on strong price growth which had a positive impact on the growth of nominal GDP.

The Commission assesses that Croatian economy is in a positive stage of the economic cycle stimulated by strong domestic demand and significant assistance from the European Union. Such outcomes have a positive effect on the increase in income of the general government and need to be used for consolidating public finances (decrease structural and nominal deficit, level of debt and government debt-to-GDP ratio), while the available funds, especially from European sources, need to be directed at investments which will stimulate economic growth.

The package(s) of measures for protecting households and companies from increasing prices in 2023

Building on the 2022 fiscal measures introduced to mitigate the consequences of increasing prices, in March 2023, the Government adopted the fourth package of measures (applying from 1 April 2023) in the amount of EUR 1.7 billion for the purpose of mitigating increasing energy prices and inflation hedging, and provided special grants and incentives. In September 2023, the Government adopted the new, fifth package of measures (applying from 1 October 2023), worth EUR 464 million, for the purpose of maintaining low energy prices and inflation hedging, through assistance, grants and incentives for the most vulnerable citizens. Although these fiscal measures partially depreciate the inflationary pressure and are consistent with budgetary possibilities, their fiscal effects on the state budget have not been defined clearly. Moreover, administrative price limitation can result in unwanted market disruptions and must only be used as a last-resort measure and for a limited time only. In addition, to minimize the costs of the implementation of targeted assistance and maximize its results, fiscal support measures need to be directed as much as possible at the most vulnerable groups.

Table 1 The measures for protecting households and companies from increasing prices in 2022 and 2023

PACKAGES OF MEASURES	PURPOSE	AMOUNT IN €
1st package of measures for mitigating the price increase due to increasing energy prices, February 2022	<ul style="list-style-type: none"> - Tax relief in the VAT system - Gas subsidies - Social benefits and pension fees - Limitation of the electricity fee increase - Subsidies to farmers and fishermen 	663 mil.
2nd package of measures	- Limitation of the price of electricity and heating (HEP)	

for protecting households and economies from increasing prices, September 2022	<ul style="list-style-type: none"> - Tax relief and lower excise duty on fuel - Allowances and subsidies for socially disadvantaged groups, unemployed persons, retired persons, students, farmers - Energy efficiency renovation of houses and residential buildings - Additional measures for companies: <ul style="list-style-type: none"> a) energy transition grants to companies b) loans for working capital plus subsidized interest for companies in difficulties c) guarantees provided by the Croatian Reconstruction and Development Bank for loans to exporters in difficulties 	2.8 billion
3rd package of measures for mitigating the consequences of increasing costs of living, December 2022	<ul style="list-style-type: none"> - One-off cash benefits to pension beneficiaries - One-off cash benefits to social welfare beneficiaries - One-off cash benefits to child allowance beneficiaries - One-off cash assistance to persons in temporary accommodation for victims of earthquakes 	95 mil.
4th package of measures for protecting households and economies from increasing prices, March 2023	<ul style="list-style-type: none"> - Mitigating increasing energy prices - Inflation hedge - Special grants and incentives 	1.7 billion
5th package of measures for protecting households and economies from increasing prices, September 2023	<ul style="list-style-type: none"> - Mitigating increasing energy prices - Inflation hedge - Special grants and incentives - Decreasing energy consumption 	464 mil.
Total		5.7 billion
<i>Assistance related to the COVID-19 pandemic, 2020</i>		1.6 billion
Overall total		6.8 billion

Source: Croatian Government

The execution of the Draft State Budget of the Republic of Croatia in the first half of 2023

Economic growth achieved in the first half of 2023, that is, strong domestic demand (a combination of real income recovery and an increase in personal consumption,

employment levels and revenue from tourism), in the conditions of a relatively high inflation, together with European Union funds had a positive impact on state budget income.

The original State Budget Plan for 2023, adopted by the Croatian Parliament on 22 November 2022, anticipated that the amount of total income at EUR 24.9 billion, expenditure at EUR 26.7 billion and the budget deficit at EUR 1.8 billion or 2.3 % of GDP. By the Amendments to the State Budget of the Republic of Croatia for 2023 adopted in May 2023, the state budget income was increased by EUR 1.7 billion (7 % compared to the original plan), expenditure was increased by EUR 1.4 billion (5.3 % compared to the original plan), while the general government budget deficit, according to the ESA methodology, was estimated at EUR 510 million (0.7 % of GDP). In the first semester of 2023, the total state budget income was achieved in the amount of EUR 13.7 billion (51.4 % of the annual plan) which is an increase of almost 30 % compared to the same period of 2022.

In the first half of 2023, EUR 13.6 billion of operating income was collected (51.5% of the original plan). Compared to the same period of 2022, these have increased by EUR 3.2 billion (31%). The greatest increase was achieved with direct taxes, where the greatest increase was recorded with income from corporate tax due to the taxation of “extra” profit. In the first semester of 2023, income from corporate tax amounted to EUR 1.5 billion (76 % of the annual plan) and, compared to 2022, increased by 71 %, which is a consequence of increasing companies profit in 2022 and the payment of one-off additional corporate tax. In addition, higher prices also resulted in greater revenue collected from VAT and excise duties. Increased revenue collected from sales taxes (goods and services) is also a result of increasing personal and tourist consumption. This income amounted to EUR 5.8 billion (47 % of the original plan) in the first half of 2023, which is an increase of 15 % compared to 2022. At the same time, revenue from VAT amounted to EUR 4.6 billion (47.2 % of the original plan), that is, it constitutes 79 % of the revenue from sales tax in the first half of 2023 and increased by EUR 709 million (18 %) compared to the same period of 2022.

Revenue collected from special sales taxes (excise duty) resulted in an income of EUR 1 billion (47.1 % of the original plan) which is a 2.8 % increase compared to the previous year and a result of increased trade and spending and increased prices of certain products subject to excise duty. The biggest contributor was excise duty on energy and electricity which generated revenue of EUR 491.8 million in the first six months of 2023 (0.6 % decrease compared to the original plan, as a consequence of the Government’s measures), while compared to the same period of 2022, growth was achieved due to excise duty on private cars and other motor vehicles, vessels and planes (37 %), excise duty on tobacco products (3.9 %) and special tax on coffee (1 %).

Economic growth also had a positive effect on revenue from contributions which increased by EUR 235 million (12.8 %) in the first half of 2023, primarily owing to the increase in salaries and employment levels.

Revenue from assets amounted to EUR 428.1 million, while total revenue from assistance amounted to EUR 2.6 billion, largely related to EU-funded assistance and projects.

On the other hand, total state budget expenditure was originally planned in the amount of EUR 28.1 billion for 2023, EUR 26.1 billion of which was planned for operating expenditure and EUR 2 billion for expenditure for the procurement of non-financial assets.

Total state budget expenditure in the first half of 2023 amounted to EUR 13.1 billion (i.e. 46.7 % of the annual plan), and, compared to the first half of 2022, these increased by EUR 2.1 billion or 19.3%. The increase of total state budget expenditure was a result of intensified implementation of expenditure used for alleviating the damages caused by the earthquake and costs related to the implementation of the measures of the Republic of Croatia for protecting households and economies from increasing prices (EUR 371.9 million). In addition, the implementation of expenditure for disbursement of pension fees and benefits was intensified due to the adjustment of pension fees granted based on the general and special regulations and the transferred cumulative effect of the change in the number and structure of pension beneficiaries as well as the amendments to the Pension Insurance Act. Furthermore, expenditure for employed persons also increased due to the full application of collective agreements and other regulations governing the salaries of persons employed in government and public services. In the first semester of 2023 expenditure financed from European Union funds also increased by EUR 1.1 billion compared to the same period of 2022 as a result of increased recording of expenditure financed from the European Union Solidarity Fund and the Recovery and Resilience Facility.

In the first semester of 2023, operating expenditure was implemented in the amount of EUR 12.4 billion (47.6% of the annual plan), which is an increase of EUR 1.9 billion (17.4 %) compared to the same period of 2022, while expenditure for the procurement of non-financial assets was implemented in the amount of EUR 700.6 million (34.7 % of the original plan, i.e. an increase of EUR 282 million or 67 %). In the operating expenditure structure, the largest share (34 %) pertains to compensations to citizens and households based on insurance and other compensations, assistance granted abroad and within the general budget (25 %) and expenditure for employed persons (14.7 %). Material expenditure was implemented in the amount of EUR 1.2 billion (42.8% of the original plan) in the first half of 2023, increasing by EUR 76 million, (6.9%) compared to the same period of 2022, primarily due to increased expenditure for services. At the same time, expenditure for intermediate consumption, social benefits and compensations to employed persons has also slightly increased.

The analysis of the execution of the state budget in the first semester of 2023 and taking into consideration additional costs of new packages of measures of the Government of the Republic of Croatia for inflation hedging as well as the costs for the remediation of the consequences inflicted by the storm has shown that, by the end of 2023, on the one hand, the state budget will require additional funds in certain

expenditure groups and, on the other hand, due to some savings in certain expenditure categories, it will also probably be possible to make certain rearrangements.

In the first half of 2023, according to the national methodology, the general budget generated a surplus of EUR 1.1 billion (1.5 % of GDP). During that period, the difference between total state budget income and expenditure in the first half of 2023 was positive (surplus of EUR 566 mil. or 0.8 % of GDP) compared to the first semester of 2022 (deficit of EUR 464 mil.). Furthermore, extrabudgetary users achieved a surplus of EUR 306 million (0.4 % of GDP), whereas local and regional self-government units and county road administrations recorded a surplus of EUR 236 million (0.3 % of GDP). At the end of June 2023, total debt amounted to EUR 47.6 billion, which is an increase of EUR 2 billion (4.4 %) compared to June 2022, whereas the general government debt-to-GDP ratio at the end of June amounted to 64 % of GDP, which is a decrease of 4 percentage points compared to June 2022.

Data on the execution of the state budget in the first half of 2023 indicate that state budget income is being achieved at a satisfactory level, meaning that the total planned budgetary income at the level of the entire 2023 could also be achieved in accordance with the projections. At the same time, state budget expenditure increased, primarily as a consequence of high inflation and Government measures. Such circumstances represent significant risks in the sense of increasing expenditure, which, in case of the materialization of negative risks and significant slowing down of economic growth, could undermine the state of Croatian public finances. Therefore, the Commission highlights the importance of continuous monitoring and examining the fiscal position of Croatian economy, as well as of increasing available fiscal room, so that fiscal policy could act promptly and efficiently in case economic growth slows down and unforeseen fiscal risks are realized.

PRESIDENT OF THE COMMISSION

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