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25th 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 2023

At its 22nd session held on 16 October 2023, 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 2023 and the Projections for 2024-2025 adopted at the 256th session of the Government of the Republic of Croatia on 12 October 2023.

The Draft Amendments to the State Budget for 2023 foresee a significant increase of both state budget income and state budget expenditure. This is primarily a consequence of continuous economic growth and high inflation. Despite the decrease of the public debt-to-GDP ratio, the Government of the Republic of Croatia used favourable macroeconomic trends for fiscal expansion, and the share of state budget expenditure in GDP increased strongly. In the light of all of the foregoing and considering a number of negative risks and potentially unforeseen circumstances, the Commission calls for caution in planning future expenditures, all for the purpose of leaving as much room as possible for adjustment in case the economic situation deteriorates.

Despite the high inflation, the contractionary monetary policy and lower foreign demand levels, strong (real and nominal) economic growth was achieved again in the first nine months of 2023. Such trends are primarily a result of personal consumption, export of services and significant EU assistance. Accordingly, the expected real growth rate in 2023 was increased from 2.2 to 2.8%, which is consistent with the projections and evaluations of other national and international institutions. The price increase is still high, and the consumer price index is expected to be 8 % at the annual level. Such macroeconomic trends and the positive stage of the economic cycle the Croatian economy is undergoing have a favourable influence on Croatian public finances in terms of increased income (growing faster than nominal GDP); however, the strong influence of inflation also resulted in a decreased public debt burden (measured by share in GDP).

Evaluation of the Draft Amendments to the State Budget for 2023

The proposed Amendments to the State Budget for 2023 are the second amendments in 2023. In these proposed Amendments for 2023, the state budget income is increased due to strong economic activity and achievements that were better than planned. Income was heavily influenced by both domestic demand and price growth. While inflation positively influenced income growth and the budget balance in the previous and partially this year, it is now obviously increasingly impacting the growth of a number of expenditure categories, some of which have been increased significantly in these amendments, such as the fiscal effects of the fifth package of Government's measures and the increase in pensions (indexation) and salaries for persons employed in government and public services. The Amendments to the State Budget increased the expenditure also for many other programs such as continued earthquake remediation, assistance given to farmers and pig breeders due to the African swine fever, government-funded primary school meals, demographic measures related to maternity leaves and investments into energy diversification.

The original State Budget Plan for 2023, adopted by the Croatian Parliament on 22 November 2022, foresaw 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 First Amendments to the State Budget of the Republic of Croatia for 2023 adopted in May 2022, 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).

By these 2nd Amendments to the State Budget for 2023, total income is planned in the amount of EUR 27.7 billion (additional increase compared to the 1st Amendments to the State Budget from May 2023 by EUR 1.1 billion). Such an increase in total income is primarily a result of the increase in the total indirect taxes collected, exceptional corporate income tax and inflation.

Revenue from taxes was planned in the amount of EUR 15.5 billion (increase by EUR 1.2 billion compared to the 1st Amendments from May 2023), where the greatest increase occurred with revenue from corporate tax and added value tax. Revenue from special taxes and excise duties compared to the 1st Amendments from May 2023 was also increased by EUR 195.7 million. In addition, revenue from contributions was also increased by EUR 17.9 million and now amounts to EUR 4.3 billion, which is a result of the expected growth of salaries and employment levels in 2023. On the other hand, according to the dynamics of EU funds use, revenue from assistance is decreased by EUR 353.2 million (7.1 %) compared to the plan.

At the same time, by these 2nd Amendments, the total state budget expenditure was additionally increased compared to the 1st Amendments to the State Budget from May 2023 by EUR 1,2 billion (from EUR 28.1 to 29.3 billion). Expenditure funded from general income and receipts, contributions and dedicated receipts was increased by EUR 1.4 billion, while expenditure funded from the EU and other sources was decreased by EUR 159.1 million, primarily as a result of decreased expenditure funded from EU sources and provision of additional financing for healthcare institutions funded from income based on the contractual relationship with the Croatian Health Insurance Fund.

Within the framework of the total state budget expenditure, operating expenditure is EUR 27.4 billion (compared to the 1st Amendments to the State Budget from May 2023, an increase by EUR 1.4 billion), while the expenditure for the procurement of non-financial assets is EUR 1.9 billion (EUR 150 million decrease). Total expenditure for employed persons was planned in November 2022 in the amount of EUR 3.7 billion and increased by these 2nd Amendments by EUR 161.6 million (i.e. to EUR 3.9 billion). Increase of expenditure for employed persons is primarily a consequence of the Government's decisions intended to improve the material position of civil and public servants (i.e. comprehensive solution for small salaries of civil servants and state employees as well as civil service officials and employees and mitigation of the consequences of increased costs of living for officials and employees with the lowest income levels).

Compared to the 1st Amendments to the State Budget from May 2023, the increase in material expenditure was EUR 111.4 million, almost all of which (EUR 104.9 million) relates to expenditure funded from the EU and other sources due to the provision of additional funding for healthcare institutions from income based on the contractual relationship with the Croatian Health Insurance Fund. The increase in expenditure funded from general income and receipts, contributions and dedicated receipts was primarily a result of additional funds for remedying the damages caused by the earthquake, additional funds for expenditures for persons employed in primary and secondary education due to the disbursement of the contractual provisional salary bonuses, additional funds for excise duty in the price of fuel for Hrvatske ceste d.o.o. and HŽ Infrastruktura d.o.o., Croatia's contribution to the European Union budget, stimulation of railway passenger traffic and regulation of railway traffic, free primary school meals and grants for county road administrations. For the purpose of adjustment with the dynamics of project implementation, the total state budget expenditure for the procurement of non-financial assets compared to the 1st Amendments to the State Budget from May 2023 were decreased by EUR 150.5 million and now amount to EUR 1.9 billion.

Table 1 presents the Original Plan and two amendments to the state budget for 2023 (May and October 2023) expressed as shares in the projected/expected GDP. The 2023 revenue-to-GDP ratio laid down in the 2nd Amendments to the State Budget from October 2023, compared to the realization in 2022, was increased by 2.3 percentage points (from 33.8 to 36.1 percentage points), that is, by 1.4 percentage points between the two amendments to the state budget in 2023 (from 34.7 to 36.1

percentage points). On the other hand, the 2023 expenditure-to-GDP ratio laid down in the 2nd Amendments to the State Budget from October 2023 compared to the realization in 2022 was increased by almost 4 percentage points (from 34.5 to 38.2 percentage points), that is, by 1.6 percentage points between the two amendments to the state budget in 2023 (from 36.6 to 38.2 percentage points). The Commission warns about a significant growth of the government debt-to-GDP ratio which is returning to the levels recorded during previous recessions, due to which public finances are susceptible to increased risks in case economic activity slows down significantly. At the same time, the impact of inflation on the budget was first felt on the income side, and only later on the expenditure side, so there is a significant risk that, due to the adjustment to the price increase, the increase in expenditure in the upcoming period will exceed the increase in income, resulting in increasing budgetary deficit. In that sense, the Commission invites the Government to limit, when proposing the state budget, the growth of the public expenditure-to-GDP ratio as an important determinant of fiscal sustainability.

Table 1 Original plan and amendments to the State Budget for 2023 *(in % of projected/expected GDP), national methodology*

	2022	2023		
	Realization of the state budget for 2022	***Original budget plan for 2023 (November 2022)***	***1st amendments (May 2023)***	***2nd amendments (October 2023)***
Revenue	33.8	33.4	34.7	36.1
Expenditure	34.5	35.9	36.6	38.2
Total deficit/surplus	-0.7	-2.4	-1.9	-2.1
General budget, national methodology, share in GDP	*0.2*	*-2.3*	*-1.3*	*-1.8*
Consolidated general government (ESA 2010), share in GDP	0.4	-2.2	-0.7	-0.3

Source: Croatian Government.

In accordance with the total income and expenditure of the state budget planned in the 2nd Amendments from October 2023, it is expected that, according to the national methodology, state budget will record a deficit in the amount of EUR 1.6 billion (2.1 % of GDP), which is an increase of EUR 159 million compared to the original plan from November 2022. At the same time, extrabudgetary users and local and regional self-government units have achieved a surplus of 0.2 % of GDP and, according to the national methodology, a general state budget deficit is foreseen in the amount of EUR 1.4 billion (1.8 % of GDP). This means that the general government budget according to the national methodology is decreased in 2023 by as much as 2 percentage points of GDP.

Compared to 2022, when a general government budget surplus was achieved in the amount of 0.4 % of GDP, fiscal trends in 2023 will result in a general budget deficit of 0.3 % of GDP (or 235 million euros according to the ESA 2010 methodology). Although a deficit of 0.7 % of GDP was initially planned, this improvement is largely affected by the achieved economic growth and inflation. The planned structural deficit in 2023 increased and is estimated at app. 1.5 % of GDP which is slightly above the midterm budgetary goal of 1 % of GDP. Since fiscal rules are to be reactivated next year (2024), the Government needs to recommend a decrease of the structural deficit by 0.5 percentage points of GDP.

Despite the (mildly) expansionary fiscal policy, the strong growth of nominal GDP continues to favour the decrease of the public debt-to-GDP ratio which increased strongly in 2020. Thus, in 2023, the public debt-to-GDP ratio is expected to decrease by 7.5 percentage points (from 68.2 % of GDP to 60.7 % of GDP at the end of 2023). These trends mean Croatia is coming close to the upper public debt limit according to the EU rule of 60 % of GDP. In that sense, the Commission recognizes the Government's results in decreasing the debt as an important indicator of fiscal sustainability, because the fiscal result exceeded the previously planned one, indicating enhanced fiscal capacity for responding to future economic challenges.

Croatian public finances are undergoing an expansive stage where the structural (and nominal) deficit is increasing. At the same time, owing to strong economic growth and high inflation, a strong decrease of the public debt-to-GDP ratio was achieved, improving the state of public finances. However, despite the significant decrease of the public debt-to-GDP ratio, the size of general government measured by the general government debt-to-GDP ratio, has been increasing significantly, and the Commission warns that the growth of expenditure must be kept under control. Furthermore, the Commission reiterates the need to implement structural reforms bearing in mind the real limitations of the Croatian economy and its structural weakness, as well as to maximize the use of EU assistance for development activities. Although Croatia is still undergoing the favourable stage of the economic cycle, the situation can overturn very quickly, meaning that, should economic activity slow down significantly, public finances would be exposed to higher risks.

PRESIDENT OF THE COMMISSION

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