POVJERENSTVO ZA FISKALNU POLITIKU

Zagreb, November 14, 2023

26th 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 2024 and the Projections for 2025 and 2026

At its 23rd session held on 14 November 2023, the Fiscal Policy Commission (hereinafter: the Commission), examined the Draft State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2024 and the Projections for 2025 and 2026 (hereinafter: the Draft) which was adopted by the Government of the Republic of Croatia (hereinafter: the Croatian Government) on 9 November 2023 at its 262nd session.

According to the Draft State Budget for 2024 which is based on the Draft Budgetary Plan for 2024, expectations and forecasts for 2024 suggest similar macroeconomic trends as in 2023, while continued growth of budget expenditure will result in a significant increase of the budgetary deficit in 2024. The Commission holds that if the foreseen favourable macroeconomic trends are achieved, medium-term fiscal sustainability will not deteriorate significantly; instead, further decrease of the relative share of public debt is foreseen. Although fiscal indicators will deteriorate in 2024 (provided expansionary fiscal policy in favourable conditions), a positive trend of the planned continued decrease of public debt-to-GDP ratio in the next period is underlined. Therefore, the Commission invites the Croatian Government to limit the adoption of fiscal measures with a permanent effect on expenditure and insist on those structural reforms and investments necessary to increase the potential growth rate. Since the macroeconomic perspective can change very quickly and bring about a deceleration of economic activity, the Commission underlines the need for responsible management of Croatian public finances in the upcoming medium-term period.

Macroeconomic projections

On 13 October 2023, the Commission confirmed the macroeconomic projections which served as the basis for composing the Draft Budgetary Plan for 2024 which lays down the macroeconomic and fiscal framework for 2024. Croatian economy turned out to be resilient in 2023 due to a high share of services (recession limited to the industrial sector, demand for services increased) and a stronger investment cycle powered by EU funds. Achievement of economic growth, despite high inflation, is a consequence of strong real growth of domestic demand and favourable labour market trends. In the next period, characterised by a similar macroeconomic framework as in 2023 and relatively positive economic trends, GDP is expected to grow at a lower rate compared to the growth in the period 2015-2019, and real GDP is expected to grow by 2.8% in 2024, by 2.7% in 2025 and by 2.5% in 2026. In 2024, inflation should slow down, first and foremost as a consequence of reduced inflationary pressures due to the prices of food and beverages and the basic inflation, while GDP deflator trends will also decelerate significantly in 2024.

While economic forecasts are positive although macroeconomic projections are still exposed to increased uncertainty and negative risks, fiscal forecasts are less optimistic because, a higher budgetary deficit is expected in 2024 than in 2023, partly because of the necessary adjustment of salary growth to inflationary pressures as well as the consequential harmonisation of pension fees and the need to protect vulnerable social groups. Therefore, in these circumstances it is important to preserve an appropriate level of investments and the implementation of structural reforms for the purpose of strengthening potential growth and resilience of the Croatian economy. The main external macroeconomic risks that could jeopardize growth in 2024 are the sharper deceleration of growth in the EU, preservation of a higher inflation rate, restrictive financing conditions, the war in Ukraine and geopolitical challenges of the conflict in the Middle East. Key domestic risks include the possible deceleration of economic activities in the most important trade partners (especially Germany) which would significantly affect a decrease in foreign demand.

Table 1 shows that the Government's macroeconomic projections do not deviate significantly from the other projections. The last available projection of the European Commission from May does not reflect the latest trends.

Table 1 Comparison of macroeconomic projections by the Croatian Government, IMF, Croatian National Bank and the EC

in %

	Croatian Government				IMF			CNB			EC	
	(November)				(October)			(September)			(May)	
	2022	2023	2024	2025	2023	2024	2025	2023	2024	2025	2023	2024
Real GDP growth	6.3	2.8	2.8	2.7	2.7	2.6	2.7	2.9	2.6	2.6	1.6	2.3
Consumer price index (CPI)	10.8	8.0	3.1	2.4	8.6	4.2	2.5	8.8*	4.7*	2.4*	6.9*	2.2*
Unemployment rate	7.0	6.1	5.7	5.3	6.3	5.9	-	6.3	6.0	5.6	6.6	6.1

Source: Croatian Government, IMF, CNB, EC
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Evaluation of the Draft State Budget for 2024 and the projections for 2025 and 2026

In the Draft State Budget for 2024 public income is 3% higher and public expenditure is 11% lower than in 2023. The income side of the state budget in the period between 2024 and 2026 is determined by the projected economic activity trends, the fiscal effect of the measures of the Croatian Government for protecting households and economies from increasing prices, tax changes and the changes in the contributions in the pension insurance system. Total state budget income is planned in the amount of EUR 28.5 billion in 2024, EUR and 30.1 billion in 2025 and EUR 30.6 billion in 2026. Tax revenue in 2024 is projected at the amount of EUR 16.1 billion (increase by 4.2%

compared to 2023). These are expected to continue growing by 5% (to EUR 16.9 billion) in 2025, that is, 4% in 2026 (to EUR 17.6 billion). Revenue from the EU, amounting to EUR 3.6 billion in 2024, EUR 3.9 billion in 2025 and EUR 3.3 billion in 2026 also has a significant effect on the budget. The projections of the revenue from contributions are based on the growth trend of nominal gross salaries and employment as well as the effect of the Amendments to the Contributions Act. Therefore, in 2024, the planned revenue from contributions amount to EUR 4.6 billion (a growth by 5.4%), EUR 4.9 billion in 2025 and EUR 5.1 billion in 2026.

Total state budget expenditure for 2024 is planned in the amount of EUR 32.6 billion, and these are EUR 3.3 billion (11.2%) higher than the plan for 2023, while these are planned at the level of EUR 33.3 billion for 2025 and EUR 32.9 billion for 2026. While operating expenses will grow by 14.5% in 2024, the expenditure for the procurement of non-financial assets will grow by 43%. due to increased provisioning of expenditure financed from the EU due to the implementation of EU projects. Increased expenditure is mostly a result of increased expenditure for employed persons (EUR 1.5 billion, where expenditure for employed persons (financed from other sources) is increased compared to the current plan for 2023 primarily due to the inclusion of general hospitals and their income and expenditure in the state budget), for pension fees due to pension indexation (EUR 1.1 billion), social expenditure, continued earthquake remediation , investments into energy renovation and railway infrastructure modernisation, public debt service and the allocations for the Croatian Health Insurance Fund. In that regard, social benefits are the most important expenditure category of the general government, amounting to 12.7% of GDP and are largely determined by the expenditure for pension fees (9.9% of GDP), while the second biggest expenditure category refers to compensation of employees (12.1% of GDP).

On the other hand, allocations for the implementation of projects financed European structural and investment funds are decreased as a consequence of the closing of the 2014-2020 programming period and the period of using the funds from the EU Solidarity Fund, payment of damages and costs of the arbitration procedure based on the verdict in the INA-MOL case and tackling disruption on the domestic energy market since this Government measure is planned to be implemented by the end of March 2024 following the recommendations of the European Commission.

In the expenditure structure, the most important group are compensations to citizens and households (including funds for pension fees) with a 32% share in 2024, and these are expected to continue growing (by 17% in 2024, 2.5% in 2025 and 3.4% in 2026). After the 17% increase in 2023, the expenditure for the employed should increase by 32% in 2024, mostly as a result of the agreed salary increase in the public sector. Material expenditure could increase in 2024 compared to the current plan for 2023 by EUR 374.2 million or 13%, mostly due to the inclusion of income and expenditure of 22 general (county) hospitals and healthcare institutions in the state budget. Financial expenditure (interest for issued securities, interest for loans received and other financial expenditure) are projected in accordance with the situation on the financial markets, i.e. the costs of debt service and with the growth in the projected period 2024-2026.

Accordingly, Croatia’s fiscal position is expected to slightly worsen in 2024 compared to 2023. According to the national methodology, the 2024 state budget will bring a deficit of as much as EUR 4.1 billion (5% of GDP) which is planned to decrease to

3.7% in 2025, that is to 2.5% of GDP in 2026. At the same time, extrabudgetary users will record a surplus (0.1% of GDP in 2024 and 2025 and 0.04% of GDP in 2026), and so will local and regional self-government units (0.3% of GDP in 2024, 0.2% of GDP in 2025 and 0.1% of GDP in 2026).

According to the ESA 2010 methodology, at the general government level, it is expected that the fiscal position will worsen significantly and the deficit will increase from the planned EUR 235 million (0.3% of GDP) to EUR 1.5 billion (1.9% of GDP) in 2024, while the general government budget deficit in 2025 is projected at the level of 1.6 % of GDP, that is, 1.5 % of GDP in 2026. Despite the worsening budget position, in the conditions of strong nominal GDP growth in the 2024-2026 period, the public debt-to-GDP ratio is expected to decrease (from 60.7% of GDP in 2023 to 58% of GDP in 2024, 56.6% of GDP in 2025 and 55.5% of GDP in 2026), meeting the criteria of a budget deficit, that is, debt pursuant to the provisions of the Stability and Growth Pact (*general government budget deficit must not exceed 3 % of GDP, and public debt may not exceed 60 % of GDP*).

Position and evaluation of fiscal policy

The activation of the general escape clause in 2020 according to the Stability and Growth Pact allowed the EU Member States for the first time to offer fiscal incentives to economies in order to mitigate strong negative effects due to the COVID-19 pandemic. Thus, in April 2020, based on the Fiscal Responsibility Act, the Fiscal Policy Commission issued its recommendation to temporarily postpone the application of fiscal rules, and the Government adopted the Decision on the temporary postponement of the application of fiscal rules. In March 2023, in the Fiscal Policy Guidelines for 2024, the European Commission reminded the EU countries about the planned deactivation of the general escape clause at the end of 2023 because, according to EC's assessments, the period of the major economic crisis has ended for the EU economy which has achieved levels of economic activity from the pre-pandemic period. In doing so, it announced a political agreement on the new economic management system by the end of the year, which is also incorporated in Council's specific recommendations from June 2023.

As the Commission's main task is to analyse and assess fiscal risks pursuant to the Fiscal Responsibility Act, the Commission highlights that in the medium-term budget horizon Croatian economy is undergoing a positive business cycle stage reflected in the positive GDP gap and that, despite the increase of the budget deficit in 2024, it is below the level of 3% of GDP with a decreasing relative share of public debt. Therefore, the Commission highlights that, in the upcoming period, the Government must follow economic achievements and continuously analyse the sustainability of public finances because, if this projected growth is not achieved, it is possible that the general government budget deficit will increase in 2024. The projected increase of the budget deficit to 1.9% of GDP in 2024 also increases the structural balance to 2.3% of GDP (provided a positive economic growth scenario at the rate of 2.8%), but it is projected to decrease in 2025 and 2026 and return to the medium-term fiscal objective level. The cyclically adjusted balance shows a stronger decrease, especially in 2025 and 2026 when new fiscal rules are expected to apply.

The Commission highlights that the public debt-to-GDP ratio, with a temporary increase in the pandemic year of 2020, is continuously decreasing. The Government made good use of the favourable high inflation period and achieved a strong decrease of this share of public debt which is expected to fall below the fiscal criterion of 60% of GDP laid down in the Treaty on the Functioning of the EU as early as in 2024. Bearing all this in mind, the Commission concludes that the debt rule will be met throughout the 2024-2026 period. However, despite the significant decrease of the public debt-to-GDP ratio, its nominal amount remains high and thus represents a source of vulnerability for the Croatian economy and long-term sustainability of public finances. The size of the general government measured by the share in GDP is high, so the Commission warns that public expenditure must be restrained, all the more so as the projected economic perspective can change quickly and that if economic activity slows down significantly public finances will be exposed to greater risks.

The Commission holds that if the foreseen favourable macroeconomic trends are achieved, medium-term fiscal sustainability will not deteriorate significantly; instead, further decrease of the share of public debt is foreseen. Furthermore, the Commission highlights that fiscal policy is very hard to manage while inflation is high because, in the first stage, it has a positive effect on the budget due to the increase of income and slower growth of expenditure, while in the second stage, expenditure grows more intensely than income. Because these trends are reflected in the budget proposal for 2024, the Commission urges the Government to control the sustainability of public finances, especially the increase of expenditure, so that it would not suffocate the economy and result in a sudden aggravation of fiscal indicators in case economic growth slows down. It is especially important to abide by EC's fiscal guidelines and the Council's recommendations related to the increase of net expenditure.[1]

As many times before, the Commission warns about the existence of serious, long-term fiscal risks which relate to adverse demographic trends due to population ageing and the decrease of working-age citizens which creates pressure on the sustainability of the pension system as well as the balance of outstanding liabilities in the healthcare system, which finally reflects on the issue of long-term sustainability of Croatia's public finances.

In conclusion, the Commission calls on the Government to maximize its efforts regarding fiscal measures that have an effect on the increase of expenditure and to insist on those structural reforms and investments which will have the biggest effect on the increase of the potential growth rate. In 2021 and 2022, Croatian economy achieved relatively high economic growth rates, while the key instrument that allowed Croatia to maintain the level of economic activity were EU funds. Therefore, in the next budget period, quality development and reform projects and EU funds are necessary in order to improve, modernise and digitalise Croatian economy and thus bring about both future economic growth and increase of Croatia's fiscal sustainability. The Commission highlights the real risk that, if Croatian economy fails to increase its productivity and the competitiveness of the private and public sector in the medium-

[1] EC's recommended net expenditure growth rate of 5.1% in 2024 reflects the potential growth rate from expenditure rules. In the budget proposal (former Draft Budgetary Plan), the Government based the budget on net expenditure growth of 10.3%, that is 2 percentage points of GDP more than the maximum amount.

term, diminished inflow of EU funds could result in a serious macroeconomic imbalance and a stagnation of Croatian economy. Therefore, the main objective of economic and fiscal policy must be constant striving for sustainable growth because only such growth can support (increased) public debt and long-term sustainability of public finances.

PRESIDENT OF THE COMMISSION

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