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ON THE DRAFT ANNUAL REPORT ON THE EXECUTION OF THE STATE BUDGET OF THE REPUBLIC OF CROATIA FOR 2023

Zagreb, June 2024

At its 25th session held on 17 June 2024, the Fiscal Policy Commission (hereinafter: the Commission) discussed the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2023 adopted by the Government of the Republic of Croatia (hereinafter: the Government) at its 1st session held on 20 May 2024.

The Commission assessed that the Government of the Republic of Croatia (hereinafter: the Croatian Government) used the favourable macroeconomic trends in 2023 for fiscal expansion, and that state budget and consolidated general government expenditure (nominal and real) increased significantly. Nevertheless, the general government balance remained well below 3 % of GDP defined by the Stability and Growth Pact, whereas, due to the inflation and growth of GDP, the public debt-to-GDP ratio continued to decrease. The Commission concluded that in 2023 the long-term sustainability of public finance did not deteriorate but indicated the need to restore the countercyclical character of fiscal policy and reapply the fiscal rules.

The last four years were marked by numerous extraordinary events at the international level such as the COVID pandemic, the war in Ukraine and the conflict in the Middle East, leading to a strong decrease of GDP in 2020, and, in 2022 and 2023, a strong increase of global prices, especially of goods and energy, meaning that the normal functioning of global and national economies was interrupted. Because such challenges demanded strong responses of economic and fiscal policy holders, the European Union (hereinafter: the EU), as early as in 2020, postponed the application of the defined fiscal rules which first and foremost limit and direct the extent of budgetary deficit and public debt.

At the level of EU Member States, this resulted in the economic recovery from 2020 onwards being largely stimulated by fiscal measures, particularly direct transfers to citizens and the economy, bringing about a significant growth of the amount of budgetary deficit. In 2022 and 2023, the measures were directed at alleviating the negative impact of high inflation, where the amount of deficit, largely due to much better trends in the economies of the Member States, was much lower than in 2020, but still significantly higher than in the period before 2020.

In the period since 2020, Croatia was one of the Member States with the most dynamic economic recovery, mostly due to a significant increase in the export of services, that is, tourism, abundant use of EU funds and growth in goods export as well as increased personal consumption. In addition to favourable trends in net salaries, employment levels, credit activity and remittances from abroad, personal consumption was also supported by five packages of aid measures issued by the Government to citizens and aimed at alleviating the consequences of the strong price increase.

Before the pandemic broke out, Croatia consolidated its public finance and implemented a conservative fiscal policy, thus creating fiscal space for conducting a countercyclical policy during the crisis. Owing to a significant influx of EU funds and an increase in total demand, Croatia, despite the introduced fiscal measures aimed at combating the consequences of negative shocks, quickly corrected its fiscal imbalance, achieved significantly lower levels of general government deficit compared to the EU Member States average and, shortly after 2020, achieved a significant decrease of public debt. Such prudent fiscal policy contributed to Croatia becoming eligible for the introduction of the euro as the official currency in 2023.

Fiscal policy in 2023 took place in the circumstances where GDP increased by 3.1 % (second highest growth in the EU), inflation slowed down but was still high (8.1 %, somewhat higher than at EU level), labour market trends were positive and the provision of fiscal support measures continued (for the purpose of protecting households and economies from the impact of high prices). This is why tax revenue and social contributions increased significantly in 2023 both in relation to 2022 and in relation to the original plan for 2023, which the Government of the Republic of Croatia largely used to decrease the planned state budget deficit and to significantly increase the compensations to citizens and households and current fees within the general budget. Such acting resulted in the fiscal policy being one of the sources of expansion of domestic demand and growth.

The evaluation of fiscal policies and rules is based on the European System of National and Regional Accounts (hereinafter: ESA 2010) which, for Croatia, is prepared by the National Bureau of Statistics. The achieved fiscal indicators for 2023, according to the ESA methodology, show a strong growth of expenditure of the consolidated general government, with this growth being somewhat stronger than in case of income and much higher than in the previous period. Both income and expenditure grew much faster than the nominal GDP which was high (11.8 %), meaning their share in GDP increased significantly. Consequently, in 2023, a general government deficit of -0.7 % of GDP was achieved. Nevertheless, due to the growth of GDP, a positive trend of continued decrease of the public debt-to-GDP share was retained. On the other hand, structural balance, which depicts the fiscal position in relation to cyclical economy trends, deteriorated in 2023, amounting to -1.8 % of GDP in 2023 according to EC's calculation.

It is expected that growth will continue in 2024 and 2025, with a weakening of inflationary pressures, and thus also their impact on public revenue, and that the effect of negative shocks on expenditure will disappear. Considering the fact that the new fiscal rules were adopted and in force since 2024, the Fiscal Policy Commission underlines that public finance should continue to have a stimulative effect on economic growth, but that it should also be aimed at reducing the structural deficit within the general target limits of not more than 1.5 % of GDP according to the newly adopted rules. Such fiscal policy in "good times" should make it possible to create reserves for its stronger countercyclical effect in the future crisis periods, which are inevitable.

Evaluation of the execution of the state budget for 2023

Data on the realized state budget income and expenditure according to the national methodology (Table 2, enclosed) show that total income in 2023 was 20.1 % or EUR 4.6 billion higher than in 2022, which is a consequence of further growth of economic activity as well as continued strong price growth (Table 1, enclosed). Among operating income which achieved a growth of 20.8 % (or EUR 4.7 billion) compared to 2022, the most prominent was the increase of VAT revenue (by EUR 2.5 billion or almost 20 %), revenue from aid or, more specifically, revenue from various programs and EU funds (growth by slightly more than EUR 800 million or 28.4 %) and the revenue from social security contributions (growth by EUR 582 million or 15.3 %).

Total expenditure, under a major influence of inflation, also increased by EUR 4.9 billion, with the most prominent growth of EUR 1.3 billion being recorded with compensations to citizens and households based on insurance and other compensations. Within this item, expenditure for pensions and other pension benefits increased by EUR 994 million or 16.0 %. Moreover, aids within the general budget also increased (by EUR 602 million), the same as expenditure for employed persons (by EUR 519 million), subsidies to companies in and outside the public sector and farmers and trades (by EUR 484 million) and expenditure for acquisition of non-financial assets, mostly construction and business facilities (growth by EUR 446 million). A part of the expenditure for non-financial assets related to earthquake remediation, the costs of which for 2023 were estimated at EUR 1.8 billion.

Such income and expenditure trends resulted in a state budget deficit, according to the national methodology, of EUR -729 million (increase by EUR 288 million compared to 2022).

Favourable macroeconomic trends in 2023 resulted in two amendments to the state budget in June and October 2023 (Table 2, enclosed). Compared to the original budget plan, when the Ministry of Finance estimated GDP growth at 0.7 %, inflation at 5.7 % and personal consumption growth at a low amount of 0.4 % for 2023, income increased by 10.1 % (or EUR 2.5 billion) and total expenditure by 5.4 % (or EUR 1.4 billion), resulting in the state budget being EUR 1.1 billion lower than the original plan for 2023.

Compared to the original plan, on the income side, the biggest "surprise" was tax revenue which was 16.7 % (or EUR 2.2 billion) higher, whereas the worst performer was planned revenue from aid (mostly EU funds) which was 18.2 % (EUR 906 million) lower. The growth of total income resulted in a significant increase of expenditure, especially compensations to citizens and households which increased by 9.4 % (or EUR 756 million).

Based on all of the above, the Commission concluded that the execution of the state budget in 2023 significantly depended on the realized macroeconomic trends and certain extraordinary factors, which primarily refers to the continued implementation of the aid measures for citizens which were introduced due to the exceptional increase of prices in 2022, increased dynamic of remediation of earthquake-affected areas as well as the pre-election year which is typically marked by certain budget relaxations.

The described state budget trends in 2023 also influenced the trends of income, expenditure and the consolidated general government balance. At the same time, income increased significantly (17.4 %) and general government expenditure even more (19.4 %), leading to a slight deterioration of fiscal indicators. More specifically, with a state budget deficit according to the national methodology of -1.0 % of GDP, its extrabudgetary users finished 2023 with a surplus of 0.5 % of GDP, as did the units of local and regional self-government and their extrabudgetary users. This resulted in a consolidated general government budget surplus which, according to the national methodology, amounted to 0.04 % of GDP.

According to the ESA 2010 methodology, the consolidated general government budget deficit in 2023 was -0.7 % of GDP (or EUR -528.3 million) which, compared to 2022, which ended with a surplus of 0.1 % of GDP, represents a significant deterioration.

Furthermore, in 2023, the public debt-to-GDP ratio was decreased to 63.0 % of GDP (Image 2, enclosed). In fact, under the influence of strong nominal GDP growth of 11.8 % indicated above, the public debt-to-GDP ratio decreased, compared to 2022, by 4.8 percentage points, that is, by 4.9 percentage points compared to the original plan for 2023 when it was foreseen to decrease to 67.9 % of GDP.

Based on these trends, the budget deficit and public debt criteria defined by the provisions of the Stability and Growth Pact were met, that is, a general government deficit lower than 3 % of GDP was realized, while the share of public debt continued decreasing toward the limit of 60 % of GDP.

In 2023, the postponement of the application of fiscal rules was still in force based on the “general escape clause” allowing the deviation from the rules defined under the Stability and Growth Pact. The adoption of the said clause enabled the Member States to temporarily derogate from the previously defined fiscal goals (fiscal rules), provided the medium-term fiscal sustainability was not endangered. Therefore, despite the suspension, fiscal sustainability indicators are monitored and analysed, indicating a slight deterioration in 2023.

The structural balance of the consolidated general government represents a general government surplus or deficit which excludes cyclical economic effects and the effects of one-off and temporary measures on income and expenditure. According to EC’s calculations, the structural balance increased from 1.2 % in 2022 to 1.8 % of GDP in 2023 (Image 3, enclosed). Based on these data, the Commission reiterates that the Government, due to a temporary postponement of the application of fiscal rules, failed to use this indicator to consider the character of fiscal policy in relation to economy trends, and that it did not present it in the annex to the annual report on the execution of the state budget – the report on the application of fiscal rules.

In other words, fiscal policy in 2023 used favourable economic trends to increase public consumption. Since it is difficult to reduce public consumption, a continuation of such fiscal policy will very probably result in a significant budgetary deficit in the future, especially in the years of slugged growth or GDP decrease, indicating the need for additional adjustment.

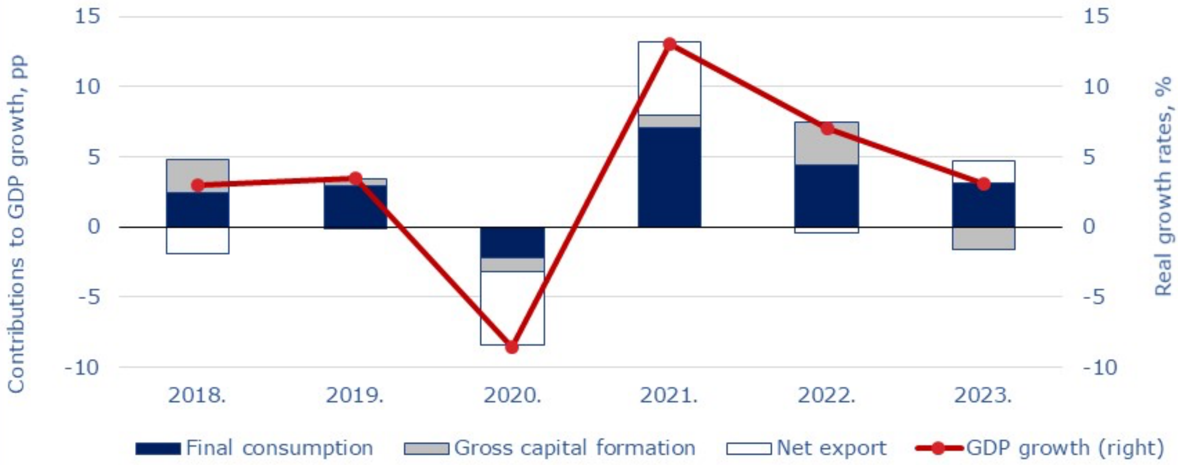
Tables and images

Table 1. Real GDP rates in the EU and the Republic of Croatia, real growth rates of GDP components and inflation in the period from 2018. to 2023.

INDICATOR / YEAR	2018.	2019.	2020.	2021.	2022.	2023.
GDP EU, real growth rates %	2,1	1,8	-5,6	6,0	3,5	0,4
GDP HR, real growth rates, %	3,0	3,4	-8,5	13,0	7,0	3,1
Households	3,4	4,1	-5,2	10,6	6,7	3,0
General government	2,2	2,8	3,5	3,1	2,7	6,6
Gross fixed capital formation	3,9	9,0	-5,0	6,6	0,1	4,2
Exports of goods and services	3,6	6,8	-23,2	32,7	27,0	-2,9
Imports of goods and services	7,4	6,7	-12,3	17,3	26,5	-5,3
Consumer prices growth, % (inflation)	1,5	0,8	0,1	2,6	10,8	8,0

Source: CBS, Eurostat

Figure 1. Real GDP growth rates and GDP components contribution in the Republic of Croatia for the period from 2018. to 2023.



Source: CBS

Table 2. Selected indicators of revenue and expenditure of the state budget and adopted rebalances in the period from 2020. to 2023. (according to the national methodology), EUR billion

INDICATOR / YEAR	2020.	2021.	2022.	2023.			2023.	Growth '23./'22., %
				Original plan	New plan I	New plan II		
Total revenues	**17,5**	**20,4**	**22,8**	**24,9**	**26,6**	**27,7**	**27,4**	**20,1**
Operating revenue	17,4	20,4	22,6	24,8	26,5	27,6	27,3	20,8
Tax revenues	9,7	11,1	13,0	13,3	14,3	15,5	15,5	19,3
Corporate profits tax	1,2	1,1	1,6	1,6	2,0	2,4	2,4	51,4
Value-added taxes	6,3	7,6	8,8	9,1	9,7	10,3	10,3	16,9
Excise duties	1,9	2,2	2,3	2,2	2,2	2,4	2,4	6,7
Social contributions	3,0	3,4	3,8	4,0	4,3	4,3	4,4	15,3
Grants	2,4	2,9	3,2	5,0	5,0	4,6	4,1	28,4
Property income	0,4	0,4	0,3	0,3	0,6	0,7	0,7	121,3
Administrative fees	0,5	0,8	0,6	0,6	0,6	0,7	0,7	15,8
Sale of non-financial assets	0,1	0,1	0,2	0,1	0,1	0,1	0,1	-63,1
Total expenses	**20,4**	**22,4**	**23,2**	**26,7**	**28,1**	**29,3**	**28,1**	**20,9**
Operating expenses	19,7	21,4	22,2	24,7	26,1	27,4	26,6	19,9
Expenses for employees	3,0	3,2	3,4	3,8	3,8	3,9	3,9	15,4
Material costs	1,9	2,4	2,6	2,7	2,7	2,9	2,8	10,5
Financial expenses	1,1	1,0	1,0	1,0	1,0	1,0	1,0	0,6
Subsidies	1,9	1,6	1,1	1,5	1,7	1,9	1,6	42,4
Grants	4,1	5,3	5,4	6,2	6,5	6,8	6,6	23,7
Compensations to citizens and households	6,8	7,0	7,5	8,0	8,5	9,0	8,8	17,2
Other expenses	0,9	0,9	1,2	1,6	1,8	1,9	1,8	46,3
Acquisition of non-financial assets	0,6	1,0	1,1	1,9	2,0	1,9	1,5	41,6
Total budget deficit/surplus	**-2,9**	**-2,0**	**-0,4**	**-1,8**	**-1,5**	**-1,6**	**-0,7**	**-**

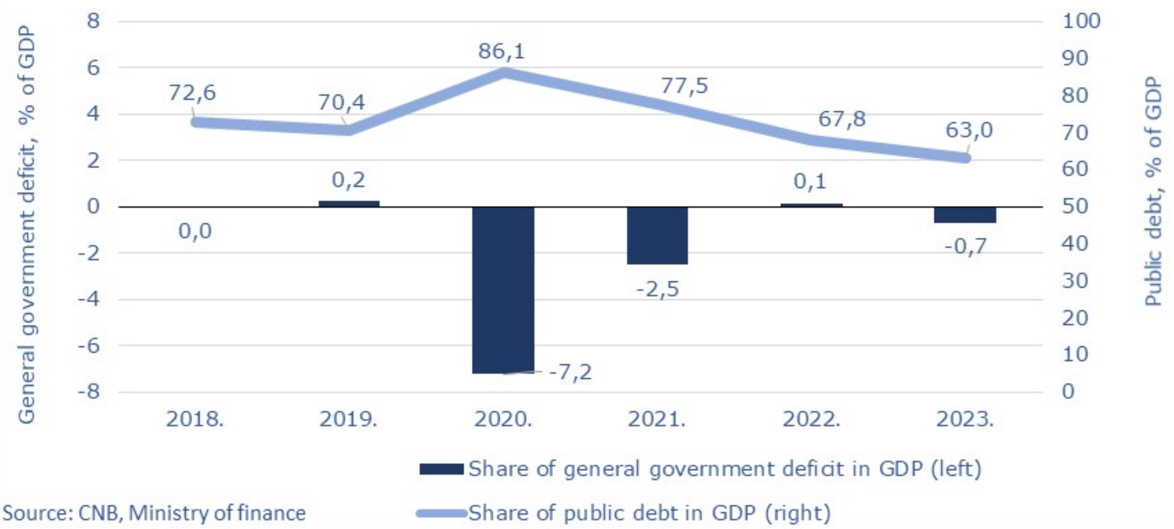
Source: Ministry of finance

Table 3. Selected economic and fiscal policy indicators from 2020. to 2023.

INDICATOR / YEAR	2020.	2021.	2022.	2023.			2023.
				Plan	N.p. I	N. p. II	
Real GDP growth and estimates at the time of budget adoption, %	-8,5	13,0	7,0	0,7	2,2	2,8	3,1
Growth of consumer prices and estimates at the time of budget adoption, %	0,1	2,6	10,8	5,7	6,6	8,0	8,0
General government total deficit/surplus, % of GDP, national methodology	-	-3,6	0,2	-2,3	-1,4	-1,8	0,0
Total general government revenue, ESA 2010, % of GDP	46,0	45,2	44,5	-	-	-	46,7
Total general government expenditure, ESA 2010, % of GDP	53,3	47,7	44,4	-	-	-	47,4
Total general government deficit/surplus ESA 2010, % of GDP	**-7,2**	**-2,5**	**0,1**	**-2,2**	**-0,7**	**-0,3**	**-0,7**
Public debt, % of GDP	**86,1**	**77,5**	**67,8***	**67,9**	**62,6**	**60,7**	**63,0**

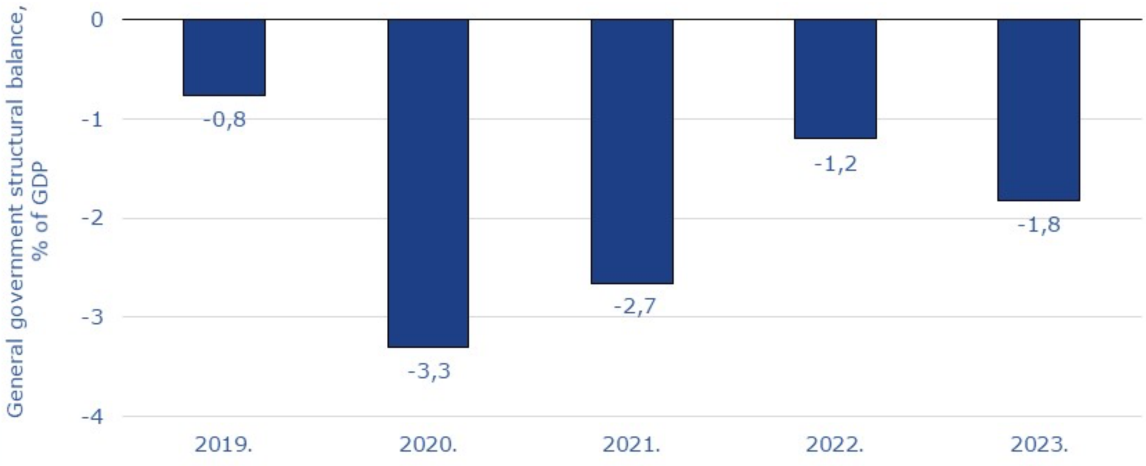
Izvor: CNB, MF; *in the period of adoption of the budget plan for 2023, the estimate for 2022 amounted to 70.2% of GDP

Figure 2. General government deficit (ESA 2010) and public debt share in GDP for the period 2018. - 2023. in the Republic of Croatia



Source: CNB, Ministry of finance

Figure 3. General government structural balance share in GDP for the period 2019.-2023.



Source: EK (Spring projections May 2024)