FISCAL POLICY COMMISION

28th POSITION PAPER

OF THE FISCAL POLICY COMMISION ON THE DRAFT SEMI-ANNUAL REPORT ON THE EXECUTION OF THE STATE BUDGET OF THE REPUBLIC OF CROATIA FOR THE FIRST SEMESTER OF THE 2024

The Fiscal Policy Commission (hereinafter: the Commission), at its 1st session held on October 2, 2024, discussed the Proposal for the Semi-Annual Report on the Execution of the State Budget of the Republic of Croatia for the first half of 2024, which was adopted by the Government of the Republic of Croatia (hereinafter: the Government) at its 26th session held on September 20, 2024.

The Commission assesses that the direction of fiscal policy implementation in the first six months of 2024 continues in line with the previous year and is consistent with the adopted budget plan for 2024. In the context of relatively high GDP growth, the Commission views this as a continuation of a pro-cyclical fiscal policy. The Proposal for the Semi-Annual Report on the Execution of the State Budget for 2024 anticipates an increase in revenues (operational income) but also an increase in state budget expenditures, particularly in terms of higher spending on wages and benefits to citizens and households. The Commission highlights that although current macroeconomic trends are positive and favorable, increased fiscal pressures call for heightened caution in managing public finances, as the expenditure trajectory poses a challenge to fiscal sustainability. Furthermore, the Commission points out a marked deterioration in the structural balance of the general government, which exceeds the newly defined upper limit in accordance with the new fiscal rules. Therefore, the Commission urges the utilization of the positive macroeconomic momentum to consolidate public finances, enhance fiscal resilience, and strengthen fiscal discipline.

The Commission assesses that the direction of fiscal policy in the first six months of 2024 aligned with that of the previous year and adhered to the budget plan for the current year. Namely, in the previous year, the Government opted to continue implementing measures to protect the households and businesses from the cumulative impact of high inflation in order to protect the standard of living for a significant part of the croatian citizents. This can largely be attributed to the Government's social sensitivity, but the upcoming parliamentary elections, held in

April 2024, were also a significant factor. With considerable support for the most vulnerable social groups and one-time payments to pensioners, the Government increased pensions and wages in the public sector. Both of these policies have continued into this year, making spending on wages and transfers to citizens and households the primary drivers of expenditure growth in both the full-year budget plan and the semi-annual execution for the first half of the year.

The Commission believes that this direction of fiscal policy has significantly contributed to improving the standard of living and to the dynamic growth of the economy—specifically, GDP, which was among the highest in the EU. However, it has had a negative impact on the state budget balance, the general government balance, and the structural balance of the general government—indicators commonly used to assess fiscal policies of EU member states. The exception was gross public debt, which, thanks to the high nominal growth of GDP, maintained a downward trend, and according to the budget plan, this reduction is expected to continue throughout 2024.

At the beginning of 2024, the suspension of fiscal rules introduced during the COVID-19 pandemic was lifted. Many member states took advantage of this suspension to introduce fiscal measures aimed at supporting the households and the economy, leading to a deterioration in key fiscal indicators. Given these circumstances, along with the emergence of unexpected crises (following COVID-19, a crisis driven by high inflation arose), the EU agreed on and adopted new fiscal rules in April 2024, which are more oriented toward long-term goals and a longer-term perspective on economic growth.

However, the Commission emphasizes that the new rules also have clearly defined targets, with differentiated treatment for member states depending on whether they meet the basic rules defined by the Stability and Growth Pact (general government deficit below 3% of GDP and gross public debt below 60%). Therefore, it is in the interest of all member states, including the Republic of Croatia (hereinafter: HR), to meet these basic conditions while also defining the process for adjusting to the new fiscal rules, which primarily focus on the trajectory of net expenditures and the required level of structural balance.

Based on the data from the previous year, the budget plan for 2024, and the execution for the first six months of 2024, the Commission concludes that, despite the favorable current macroeconomic trends, increased fiscal pressures necessitate caution in the management of public finances. The trajectory of expenditures in the upcoming period will present a challenge in balancing social and economic needs with fiscal sustainability. Therefore, the Commission calls for stronger public finance consolidation and the strengthening of fiscal discipline and resilience to future shocks.

1. Dynamics of Macroeconomic and Fiscal Projections

Observing the period from the preparation of the 2024 budget to the execution of the first half of the year, macroeconomic expectations for the Republic of Croatia have improved (Table 2). In the European Commission's (hereinafter: EC) Spring 2024 forecast, compared to the Autumn 2023 forecast, which were current during the budget preparation for 2024, expectations for real GDP growth increased by 0.8 percentage points. This upward revision is primarily due to higher expected growth in private consumption (+1.5 pp) and public consumption (+0.7 pp), alongside higher inflation (+1.1 pp) and an increase in employment (+0.9 pp). These developments are expected to have a favorable impact on the realization of tax revenues, which are based on consumption, employment, and gross fixed investments.

In the most recent available (Autumn) macroeconomic forecast of the Croatian National Bank (hereinafter: CNB) for 2024, higher real GDP growth is projected compared to the EC's Spring 2024 forecast (+0.3 pp), mainly driven by stronger private consumption and gross fixed capital formation, as well as slightly higher inflation (Table 2a).

Simultaneously, between the two aforementioned EC forecasts for 2024, expectations for EU27 growth were revised downward, with real GDP growth reduced by 0.3 percentage points, primarily due to lower anticipated gross fixed investment growth (-1.2 pp). This change in expectations indicates a minimal risk to the achievement of the revenue targets set out in the 2024 HR budget.

Observing the period from the preparation of the 2024 budget to the execution of the first half of the year, fiscal expectations for the Republic of Croatia have slightly worsened (Table 3). Despite higher expected GDP growth for HR, the EC's Spring 2024 forecast, compared to the Autumn 2023 forecast, indicate a larger general government deficit (net lending (+) / net borrowing (-)) by 0.8 percentage points, an increase in interest expenditures by 0.5 percentage points, and higher gross public debt by 0.7 percentage points for 2024. These changes in forecasts, along with a 1.2 pp increase in the output gap as a share of potential GDP, have led to a 1.3 percentage point increase in the projected structural deficit as a share of potential GDP.

This shift in expectations suggests a greater expansion of expenditures in 2024 than initially planned, which could raise fiscal risks in the medium term. Nevertheless, according to EC forecast, both the general government deficit and public gross debt are expected to remain within the Maastricht criteria by the end of 2024.

In the announced budget revision for 2024, the necessary additional funds will be determined for the expenditure categories that the Government decided to increase in the first half of 2024. As highlighted in the Semi-Annual Budget Execution Report, these expenditures will not be fully covered through reallocations from other budget categories. These expenditures include:

- Expenditures for employees, including those employed in primary and secondary schools,
- Expenditures for the payment of inclusive allowances, as well as for extended maternity and parental leave, and equipment for newborns.

The dynamics of aggregate fiscal projections at the EU27 level for 2024 are slightly unfavorable when observing the shares of specific fiscal indicators in GDP (Table 3). This suggests that in the upcoming period, greater oversight of expenditures can be expected, particularly if economic growth remains at or below the projected levels. The tightening of fiscal oversight would likely aim to ensure compliance with fiscal rules and the stabilization of key fiscal indicators, given the challenges posed by slower growth and potential expenditure overruns.

2. Assessment of State Budget Execution for the First Half of 2024

Macroeconomic trends in the first six months of 2024 were positive. Preliminary GDP performance for the first half of 2024 (Table 4) aligns with the latest available projections from the EC. A real GDP growth rate of 3.6% was achieved in this period, primarily driven by growth in private consumption and gross fixed capital formation.

The economic growth recorded in the first half of 2024, alongside higher-than-planned inflation, increased employment, and funds from the European Union (hereinafter: EU), had a moderately positive impact on state budget revenues. These favorable developments in the macroeconomic environment supported stronger revenue collection from taxes and other sources tied to consumption, employment, and gross fixed investments.

The favorable dynamics of tax revenue collection align with the increased macroeconomic expectations for 2024. The original 2024 state budget plan, adopted by the Croatian Parliament on November 30th 2023, according to used national methodology in the preparation of the Buget plan, projected total revenues of 28.5 billion euros, total expenditures of 32.6 billion euros, and a budget deficit of 4.1 billion euros or 5.0% of GDP (Table 5). Total state budget revenues in the first half of 2024 amounted to 14.0 billion euros (or 49.2% of the annual plan), representing an increase of 2.6% compared to the same period in 2023. Based on current macroeconomic trends, economic activity dynamics, and the collection dynamics of various tax categories, it is expected that these revenues may outperform the planned figures for 2024.

Significant year-on-year revenue growth in the first half of 2024 compared to the first half of 2023 was achieved in the following areas: VAT (+433 million EUR, or +9.5%), contributions (+287 million EUR, or +13.9%), and excise duties (+199 million EUR, or +19.1%). The increase in VAT revenue is the result of higher private and tourist consumption as well as a still relatively higher inflation rate (measured with HICP) compared to forecasts. The year-on-year increase in excise duties was driven by enhanced economic activity, changes in excise duties on motor fuels in November

2023, and higher personal consumption (excise duties on tobacco, coffee, alcoholic and non-alcoholic beverages). The growth in contribution revenues was due to increased employment and wage levels. Significant growth was also achieved in corporate tax (+97 million EUR, or +6.3%), reflecting stronger corporate performance in 2023 compared to 2022. Slower project implementation and prolonged public procurement processes resulted in substantially lower revenue from grants in the first half of 2024 compared to the same period of the previous year (-1.227 million EUR, or -47%).

The dynamics of state budget expenditure execution in the first six months of 2024 are consistent with the adopted budget plan. Total state budget expenditures for 2024 were originally planned at 32.6 billion euros, of which 30.6 billion euros were allocated for operating expenses, and 2 billion euros for the acquisition of non-financial assets. In the first half of 2024, total state budget expenditures amounted to 15.1 billion euros (46.4% of the annual plan), representing an increase of 2 billion euros or 15.3% compared to the first half of 2023.

The increase in total state budget expenditures was influenced by higher spending on wages, which amounted to 2.7 billion euros (51.6% of the original plan), representing an increase of 864 million euros or 47.4% compared to the same period in 2023. When the expenditures for employees in primary and secondary schools, which are recorded under the budget line for "Grants Abroad and within the General Budget," are added to this amount, the total expenditures on wages in the first half of 2024 reach 3.6 billion euros, marking a year-on-year increase of 1.1 billion euros.

Significant year-on-year expenditure increases in the first half of 2024 were also recorded for transfers to citizens and households (+753 million euros, or +18.0%) and subsidies (+310 million euros, or +44.8%).

The increase in these categories compared to the first half of 2023 was influenced by the following factors:

- The September 2023 package of measures, which included payments to the unemployed, social welfare beneficiaries, and pensioners, as well as changes to the base for the inclusive allowance introduced in January 2024.

- Reforms to the wage system in state and public services introduced in February 2024, aimed at harmonizing wages for similar occupations, standardizing job positions, simplifying or eliminating the system of wage supplements, and increasing existing wages.
- Costs of the Energy System Development and Hydrocarbon Management program, which provided funds to ensure sufficient gas supply in the PSP Okoli storage facility (payments made to HEP for storage and financing costs).

Table 1. Measures to Protect Households and Businesses from Rising Prices in the Period 2022–2024, in Million Euros

No.	Date	MEASURES	AMOUNT	TOTAL YEAR	% in total expenses*	% of GDP
1.	02/22	Mitigation of price increases due to rising energy costs	663	3,558	11,73%	5,20%
2.	09/22	Protection of Households and the Businesses from price increases	2,800			
3.	12/22	Mitigation of the Impact of rising living costs	95			
4.	03/23	Protection of Households and the Businesses from price increases	1,700	2,164	5,97%	2,83%
5.	09/23	Protection of Households and the Businesses from price increases	464			
6.	03/24	Protection of Households and the Businesses from price increases	503	751	/	/
7.	09/24	Protection of Households and the Businesses from price increases	248			
TOTAL measure			**6,473**			
COVID-19 Pandemic-Related Aid, 2020.			1,600			
TOTAL aids			**8,073**			

Source: Government of the Republic of Croatia, CSB, EUROSTAT; *ESA 2010 methodology; term "mitigation" refers to one-off measures, while the term "protection" refers to temporary measures by the Government of the Republic of Croatia

The general government deficit realized in the first half of the year is in line with the initial plan. In the first half of 2024, the general government, according to the national methodology, recorded a deficit of 0.7 billion euros (or 0.8% of GDP). The difference between total revenues and expenditures of the state budget in the first half of 2024 was negative (-1.1 billion euros or -1.3% of GDP), while a surplus of 566 million euros (0.7% of GDP) was recorded in the first half of 2023. Furthermore, extra-budgetary users of the state budget achieved a surplus of 71 million euros (0.1% of GDP), while local and regional self-government units, as well as county road administrations, recorded a surplus of 0.3% of GDP.

The structural balance of the general government shows a significant deterioration in the fiscal outlook, as the European Commission projects it to reach -3.6% of GDP in 2024. Therefore, the Commission highlights the substantial risk of this level of structural deficit, which will exceed the newly defined upper limit of 1.5% of GDP according to the new fiscal rules.

The public gross debt-to-GDP ratio continued to decline in the first six months of 2024. Total public gross debt amounted to 49.2 billion euros at the end of June 2024, which is 1.2 billion euros (or 2.5%) higher compared to June 2023. However, the public debt-to-GDP ratio is decreasing due to the growth of nominal GDP. As of the end of June 2024, the general government debt-to-GDP ratio, according to the Commision estimates, stood at approximately 61.5%, based on semi-annual GDP performance. By the end of the year, this ratio is expected to decrease further, driven by the projected significant GDP growth in the second half of the year, according to current deficit projections.

3. Annex

Table 2. EC's macroeconomic forecast for the EU27 and Croatia for 2024 (y-o-y change)

CATEGORY / FORECAST	Autumn forecast 2023 for EU27	Spring forecast 2024 for EU27	Change in pp EU27	Autumn forecast 2023 for CRO	Spring forecast 2024 for CRO	Change in pp CRO
GDP (real)	1,3	1,0	-0,3	2,5	3,3	0,8
Private consumption	1,3	1,3	0,0	2,8	4,3	1,5
Public consumption	1,2	1,6	0,4	2,4	3,1	0,7
Gross fixed capital formation	1,5	0,3	-1,2	3,4	3,1	-0,3
Exports (goods and services)	2,2	1,4	-0,8	3,2	2,6	-0,6
Import (goods and services)	2,3	1,3	-1,0	2,2	3,4	1,2
Potential GDP	1,5	1,4	-0,1	3,5	3,6	0,1
Output gap*	-0,3	-0,5	-0,2	1,0	2,2	1,2
GDP deflator	3,2	3,2	0,0	3,6	5,5	1,9
Inflation (HIPC)	3,5	2,7	-0,8	2,4	3,5	1,1
Employment rate	0,4	0,6	0,2	1,1	2,0	0,9

Source : EC Spring forecast, May 2024, Autumn forecast, November 2023; *share in potential GDP (%)

Table 2A. MoF forecast for 2024 used in the Draft Budgetary Plan 2024 and the latest published macroeconomic projections of the CNB for 2024.

CATEGORY / FORECAST	Draft budgetary plan 2024 MoF	Autumn forecast CNB 2024
GPD (real)	2,8	3,6
Private consumption	3,2	6,1
Public consumption	2,5	3,0
Gross fixed capital formation	3,2	10,5
Exports (goods and services)	2,2	0,1
Import (goods and services)	2,7	4,8
GDP deflator	4,4	-
Inflation (HIPC)	-	3,9
Employment rate	1,8	3,0

Souce : MoF, CNB

Table 3. Outcomes for selected fiscal categories according to the EC's Spring (May 2024) and Autumn (November 2023) forecasts for Croatia and the EU27 for 2024 (% of GDP, ESA 2010 methodology)

CATEGORY / FORECAST	Autumn forecast 2023 for EU27	Spring forecast 2024 for EU27	Change in pp EU27	Autumn forecast 2023 for CRO	Spring forecast 2024 for CRO	Change in pp CRO
Total government expenditure	48,5	49,2	0,7	46,5	48,3	1,8
Total government revenue	45,7	46,2	0,5	44,7	45,6	0,9
Net lending (+) / net borrowing (-)	-2,8	-3,0	-0,2	-1,8	-2,6	-0,8
Interest expenditure	1,8	1,8	0,0	1,1	1,6	0,5
Primary balance	-1,0	-1,2	-0,2	-0,7	-1,0	-0,3
Cyclically-adjusted net lending (+) / net borrowing (-)*	-2,6	-2,8	-0,2	-2,3	-3,6	-1,3
Structural budget balance*	-2,6	-2,7	-0,1	-2,3	-3,6	-1,3
General government gross debt	82,7	82,9	0,2	58,8	59,5	0,7

Source : EC; *share in potential GDP (%)

Table 4. Trends in real GDP growth rates and its components (Expenditure method) in Croatia from 2019 to 2023, with outcomes for 2024 (January-June)

CATEGORY / YEAR	2019.	2020.	2021.	2022.	2023.	I-VI 2024.
GDP EU27, real growth rates, %	1,8	-5,6	6,0	3,5	0,4	0,7
GDP HR, real growth rates, %	3,4	-8,5	13,0	7,0	3,1	3,6
Private consumption	4,1	-5,2	10,6	6,7	3,0	5,8
Public consumption	2,8	3,5	3,1	2,7	6,6	2,5
Gross fixed capital formation	9,0	-5,0	6,6	0,1	4,2	11,9
Exports (goods and services)	6,8	-23,2	32,7	27,0	-2,9	-1,6
Import (goods and services)	6,7	-12,3	17,3	26,5	-5,3	3,7
Inflation, %	0,8	0,1	2,6	10,8	8,0	3,6

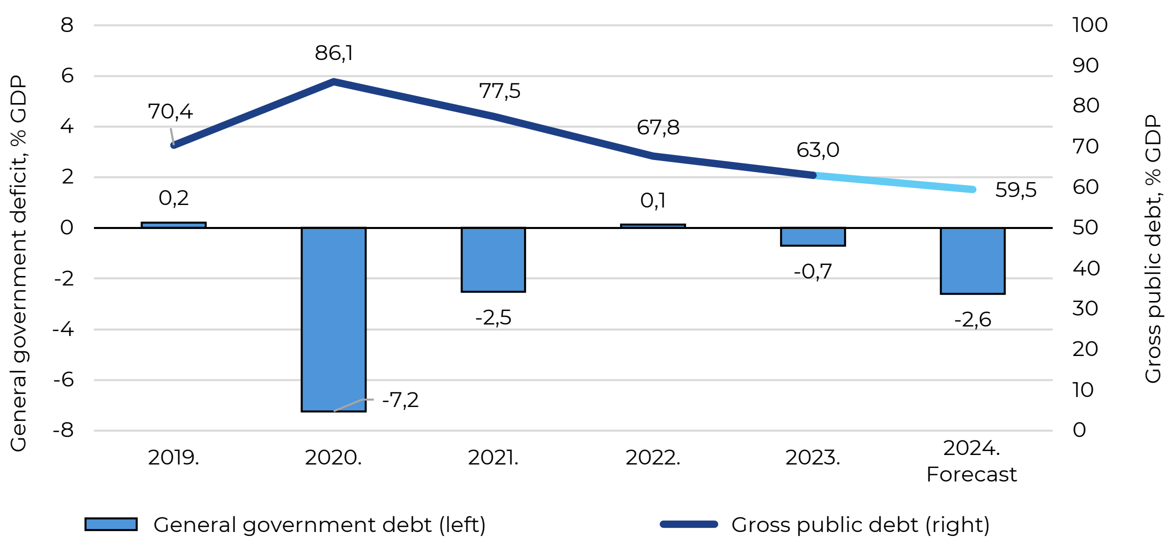
Source: CBS, EUROSTAT

Table 5. Trends and projections of selected State Budget revenue and expenditure categories from 2020 to 2024 (according to national methodology), in billion EUR

CATEGORY / YEAR	2022.	I-VI 2023.	2023.	2024.p	I-VI 2024.	I-VI 2024./ I-VI 2023. %	I-VI 2024./ 2024.p., %
Revenues	**22,8**	**13,7**	**27,4**	**28,5**	**14,0**	**2,6**	**49,2**
Operating revenues	22,6	13,6	27,3	28,4	14,0	2,5	49,2
Tax revenues	13,0	7,3	15,5	16,1	8,1	10,3	50,3
Corporate tax	1,6	1,5	2,4	2,2	1,6	6,3	75,2
VAT	8,8	4,6	10,3	11,0	5,0	9,5	45,4
Duties	2,3	1,0	2,4	2,5	1,2	19,1	49,6
Contributions	3,8	2,1	4,4	4,6	2,4	13,9	51,5
Grants	3,2	2,6	4,1	3,6	1,4	-47,0	38,0
Property income	0,3	0,4	0,7	0,4	0,2	-47,6	54,1
Fee revenues	0,6	0,3	0,7	0,7	0,4	20,9	56,6
Revenues from the sale of non-financial assets	0,2	0,0	0,1	0,1	0,0	72,4	52,7
Expenses	**23,2**	**13,1**	**28,1**	**32,6**	**15,1**	**15,3**	**46,4**
Operating expenditures	22,2	12,4	26,6	30,6	14,6	17,3	47,5
Compensation of employees	3,4	1,8	3,9	5,2	2,7	47,4	51,6
Material expenditures	2,6	1,2	2,8	3,2	1,3	12,4	40,7
Financial expenditures	1,0	0,6	1,0	1,2	0,8	25,0	62,6
Subsidies	1,1	0,7	1,6	1,8	1,0	44,8	55,0
Grants (aids)	5,4	3,1	6,6	6,8	3,1	-1,2	45,1
Transfers to citizens and households	7,5	4,2	8,8	10,8	4,9	18,0	45,8
Other expenditures	1,2	0,8	1,8	1,8	0,8	-5,2	42,8
Expenditures for the acquisition of non-financial assets	1,1	0,7	1,5	2,0	0,6	-20,0	28,3
Net lending (+) / net borrowing (-)	**-0,4**	**0,6**	**-0,7**	**-4,1**	**-1,1**	**-**	**-**

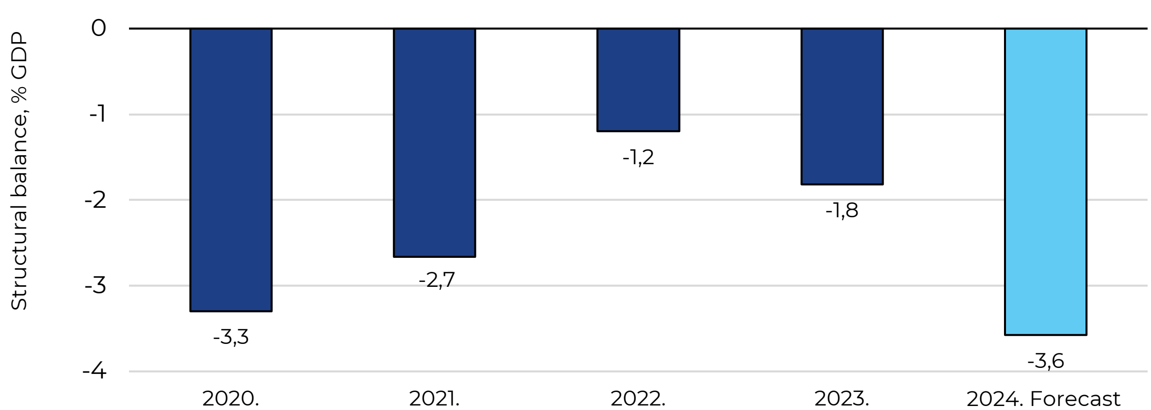
Souce: MoF

Figure 1. Share of general government deficit (ESA 2010) and gross public debt in GDP for the period 2019-2024 (EC's Forecast) in Croatia



Source: CNB, MoF, EC (Spring 2024 forecast)

Figure 2. Share of general government structural balance in GDP for Croatia for the period 2020-2024 (EC's Forecast)



Source: EC (Spring 2024 forecast)