

5 October 2022

18th Position Paper of the Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for the First Semester of 2022

At its 13th session held on 5 October 2022, 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 for the First Semester of 2022 adopted by the Government of the Republic of Croatia on 29 September 2022.

*In 2021, the Croatian economy saw unexpected growth which continued throughout the first half of 2022 despite intense global shocks and pressures in terms of global disruptions and blockages in the supply chains, increasing energy prices and very high and growing inflation. Strong (real and nominal) economic growth had a favourable effect on Croatian public finances through the growth of income and decrease of the public debt burden (share in GDP). The Commission warns that in the upcoming period when the risk of deceleration of economic activity and of a recession will rise abruptly, the Croatian economy might be faced with numerous limitations such as a low potential growth level, **pronounced price pressures on the economy and on the citizens' standard of living as well as** monetary policy tightening. Faced with these challenges, fiscal policy should be as targeted and as selective as possible so as to prevent additionally increasing mid-term inflationary pressures, bearing in mind at the same time the sustainability of public debt because, in a situation of a contractionary monetary policy, loans taken on by the general government might become much more expensive and thus become a serious problem. The Commission emphasizes the need to continuously monitor Croatia's fiscal position so as to allow fiscal policy to adjust in uncertain and changed circumstances and ensure the continuity of a responsible fiscal policy for the purpose of long-term sustainability of Croatian public finances.*

After two pandemic years, Croatia entered 2022 with optimistic expectations; however, the previous semester was marked with materialized, significant negative macroeconomic risks which began in 2021. Similarly to the rest of the European Union (EU), Croatia is facing a high level of uncertainty, primarily due to the war in Ukraine, increasing energy prices, the consequences of the crisis caused by the COVID-19 pandemic and an excessively high inflation rate. The war in Ukraine is contributing to increased costs of energy and agricultural products, and the pressure on price growth is

additionally aggravated by material, equipment and labour shortages. In addition, central banks are also tightening their financing conditions because the inflation is expected to increase. After the Croatian economy improved in the first half of 2022, the global economy trends in terms of unstable energy prices and price pressures which are spreading and picking up pace across various industries indicate that, in the next quarters, the economy will weaken and slow down, while the prospects for economic growth will weaken, indicating a stagnation of economic activities in the second half of 2022 and the first quarter of 2023. The unfavourable geopolitical situation caused by the war in Ukraine is also contributing to a further weakening of the companies' and consumers' trust, while for some time yet the inflation will probably remain high, much higher than the targeted level. This means that the scenario of further decrease of the companies and households' purchasing power is very probable, resulting in a heavy burden on private spending and decreased production/growth in the upcoming quarters as well.

Therefore, the Commission reiterates that attention must be paid to the consolidation of public finances, where most of the available funds, especially those from EU sources, must be directed toward those activities that would preserve and maintain economic activity, help the most vulnerable households and contribute to long-term sustainability of public finances.

The packages of measures for mitigating the price increase and protecting households and companies from increasing energy prices in 2022

As part of the fiscal measures undertaken in 2022 for mitigating the consequences of negative economic disruptions due to increasing energy prices on the citizens' and companies' standard, in February 2022, the Government adopted the first package of measures which came into force on 1 April 2022 and, in early September 2022, the second one which came into force on 1 October 2022.

The packages of measures adopted by the Government in February and September 2022 are presented in Table 1. The Commission finds them appropriate to the current circumstances and within the limits of justified state interventionism. However, although these interventions are appropriate, the Commission holds that the fiscal effects these packages of measures have on the state budget are not entirely clear nor specific, both in the short- and mid-term, because the indicated costs of the adopted measures will not be examined through the state budget only, making it difficult to assess their (permanent) effect. Therefore, the Commission finds it extremely important to monitor how these measures will reflect on the state budget in the next years to prevent them from bringing about certain challenges on the income side of the budget, primarily within the framework of the tax system and/or to prevent their effect from spilling over into the future generations.

Table 1 The Government's measures for mitigating the price increase and protecting households and companies from increasing energy prices in 2022

The 1st package of measures for mitigating the price increase due to increasing energy prices, February 2022		The 2nd package of measures for protecting households and companies from the price increase, September 2022	
Total relief	in HRK billion	Total relief	in HRK billion
- tax relief through VAT	2.1	- limitation of the price of electricity and heating	5.9
- gas subsidies	1.2	- tax relief and lower excise duty on fuel	2.8
- social benefits and pension fees	0.8	- allowances and subsidies for socially disadvantaged groups, unemployed persons, retired persons, students, farmers	2.5
- limitations of the electricity fee increase	0.46	- energy efficiency renovation of houses and residential buildings	0.988
- subsidies to farmers and fishermen	0.25	<i>* Additional measures for companies:</i>	
		- energy transition grants to companies	1.9
		- loans for working capital plus subsidized interest for companies in difficulties	3.8
		- guarantees provided by the Croatian Reconstruction and Development Bank for loans to exporters in difficulties	3.1
Total value of the measures: HRK 4.81 billion		Total value of the measures: HRK 21 billion	
Total value of the measures adopted: HRK 25.81 billion or 6.3 % of GDP			

Source: Croatian Government

The Commission holds that it was indeed possible and quite necessary, both in relation to citizens and to companies, to create a better balance and fine-tune certain measures for the targeted support to yield even better results and decrease the costs for their implementation covered from the budget. The prices are the fundamental market mechanism, so controlling and limiting them (which first and foremost concerns food products) is not the most efficient measure, because such measures can lead to a decreased offer, lower quality, shortages, development of the black market and so on. Transfers toward the neediest is a more efficient and fair measure than price control. The Commission also highlights that the proposed measure by which VAT rates were decreased is not the best nor the most efficient instrument for the resolution of social challenges and issues, so it is no surprise that the measure of lowering the VAT rates for a wide range of products has not yielded the desired effect.

In the context of growing uncertainty and negative risks for economic prospects due to the war in Ukraine, the increasing energy prices and continued disruptions in supply chains, in May 2022, the European Commission suggested to prolong the general escape clause under the Stability and Growth pact by the end of 2023.

However, although the numerical fiscal rules still have not started to apply in 2022, the Commission emphasizes the need to continuously monitor and examine the fiscal position of Croatian economy so as to allow for the adjustment of fiscal policy and ensure the continuity of a responsible fiscal policy for the purpose of long-term sustainability of Croatian public finances. After a strong fiscal “relaxation” due to the crisis caused by the coronavirus pandemic, in the future period, a certain tightening of the fiscal policy is foreseen, and the Commission again calls on the Government to control, especially in these times of exceptionally high inflation, the increase of expenditure and not to direct the increase in budget income only toward increasing public spending, but instead to take care also of the sustainability of public debt.

The execution of the Draft State Budget of the Republic of Croatia in the first half of 2022

Strong economic growth achieved in 2021, and growth which exceeded the projections in the first half of 2022, favoured a positive and accelerated economic activity in Croatia. Favourable cyclical trends in the economy in the first half of 2022, as a combination of increased GDP and personal spending, good tourist season results as well as a high and growing inflation, have had a positive impact on a strong increase in state budget income.

The state budget for 2022, adopted by the Croatian Parliament on 8 December 2021, forecast total income in the amount of HRK 164.5 billion, expenditure in the amount of HRK 173.8 billion, and a budget deficit of HRK 9.3 billion (i.e. 2.6% of GDP). By the Amendments to the State Budget of the Republic of Croatia for 2022 adopted in May 2022 budget income increased by HRK 6.6 billion (i.e. 4 % compared to the original plan), expenditure increased by HRK 10.9 billion (i.e. 6.3% compared to the original plan), and general government budget deficit, according to the ESA methodology, increased by HRK 1.4 billion, i.e. to HRK 13.4 billion or 2.8 % of GDP. Thus the total income planned under the Amendments to the State Budget of the Republic of Croatia for 2022 was HRK 171.05 billion, and the income achieved in the first half of 2022 was HRK 79.3 billion (i.e. 46.35 % of the annual plan). In relation to the same period in 2021, the total semi-annual state budget income increased by HRK 5.2 billion, i.e. 7 %.

In the first half of 2022, HRK 44.7 billion of tax revenue was collected (i.e. 49.03 % of the annual plan). Compared to the same period of 2021, these have increased by HRK 7.2 billion, i.e. 19.20 %. The most significant increase in tax revenue pertains to indirect taxes - added value tax (VAT) and excise duty, which is largely a consequence of increasing personal spending and a strong growth in consumer prices. Higher prices mean greater

income from VAT and excise duty (such trends are consistent with the expectations of the central bank that personal spending in 2022 will rise despite the decrease of the real salary due to the inflation and uncertainty brought on by the war in Ukraine). Revenue from sales tax (on goods and services) in the first half of 2022 amounts to HRK 37.6 billion (i.e. 46.19 % of the annual plan), which is an increase of 17 %. At the same time, VAT revenue was almost HRK 29 billion, i.e. 77 % of the revenue from sales tax in the first half of 2022, and it is HRK 4.3 billion (18 %) higher than in the same period of 2021. Income from special sales taxes (excise duties) brought HRK 7.6 billion (i.e. 45.46 % of the annual plan and an increase from the previous year of 8.4 %), which is a result of increased trading intensity and consumption of certain products subject to excise duty. The biggest increase was achieved with excise duty on energy and electricity which amounted to HRK 3.7 billion in the first six months of 2022 and which grew by 3.1 % in relation to the previous year even though excise duties on gasoline and diesel fuels were decreased for the purpose of mitigating the inflationary effects on the economy and the citizens. This increase indicates that trade has picked up, because the paid excise duties on energy depend only on the sold volumes of derivatives, and the increase of prices has no direct effect on them.

Economic recovery has also reflected on the increase of tax revenue from income and from social contributions. In the first half of 2022, revenue from income tax amounted to HRK 6.8 billion (i.e. 73.31 % of the annual plan) and shows a significant increase in relation to the previous year (38 %). This is a consequence of a high increase in the companies' income during 2021 since the revenue from income tax in the current year is based on the company's performance in the previous year. Revenue from social contributions in the first half of 2022 amounted to HRK 13.8 billion (i.e. 49.30 % of the annual plan), which is an increase of HRK 1.7 billion (14 %) mostly due to salary and employment growth, that is, favourable labour market trends. Further, in the first half of 2022, revenue from contributions for employment was paid in the amount of HRK 5.8 million, and these is related to the payment of debts based on contributions for employment (this contribution was revoked on 1 January 2019), while revenue from assets amounts to HRK 902 million (i.e. 31.9 % of the annual plan). Revenue from assets was 25.4 % lower than in the same period last year because the dynamics of payment of revenue based on dividends and income of companies in the public sector have changed in relation to the same period of 2021.

On the other hand, decreased revenue has been recorded in the other current and capital revenue mostly in relation to projects which are mostly financed from the EU budget. This decline is due to a decreased transfer from EU funds. In the first half of 2022, these were HRK 11.2 billion (i.e. 33.55 % of the annual plan), which is a decrease of HRK 1.2 billion, i.e. 9.5 %.

Total state budget expenditure was planned in the amount of HRK 184.7 billion for 2022: HRK 170.7 billion for operating expenditure and HRK 14.0 billion for expenditure for the

procurement of non-financial assets. Total expenditure in the first half of 2022 amounted to HRK 82.8 billion (i.e. 44.81 % of the annual plan), and compared to the first half of 2021, these decreased by HRK 1.2 billion, i.e. 1.4 %. The decrease of the total state budget expenditure was influenced by the decrease in the expenditure for subsidies, that is, a decreased disbursement of subsidies to companies for the preservation of jobs due to the unfavourable epidemiological situation. In addition to expenditure for subsidies, which decreased by HRK 3.2 billion in the first half of 2022, the allocations for financial expenditure in the amount of HRK 526.6 million also decreased, primarily due to a decrease in the execution of expenditure for interest and other financial expenditure.

Operating expenditure in the first half of 2022 was executed in the amount of HRK 79.6 billion (i.e. 46.63 % of the annual plan) and decreased in relation to last year by HRK 2.3 billion, i.e. 2.8 %, while the expenditure for the procurement of non-financial assets was executed in the amount of HRK 3.2 billion (i.e. 22.6 % of the annual plan). In the operating expenditure structure, the largest share (34.1 %) pertains to compensations to citizens and households based on insurance and other compensations, followed by assistance granted abroad and within the general budget (24.0 %) and expenditure for employed persons (15.5 %). According to the functional classification, social welfare has the biggest share in the state budget expenditure (35.2 %). The most significant expenditure in the first half of 2022 was executed within the pension fees and benefits program in the amount of HRK 22.6 billion, while a total of HRK 17.1 billion was allocated for expenditure for employed persons. A total of HRK 20.4 billion was allocated for the healthcare system in 2022, and in the first half of 2022, HRK 9.6 billion was executed for the healthcare system, of which HRK 1.9 billion was additionally allocated for paying the difference in the increase of the salary for overtime work to healthcare and health insurance workers and for settling a part of the debts of hospitals founded by the Republic of Croatia or local/regional self-government units and of the Croatian Pension Insurance Institute toward pharmacies. The expenditure side of the state budget was also affected by costs related to the remediation of the consequences of the disastrous earthquakes that occurred in 2020 in Croatia (the earthquake on the territory of the City of Zagreb, Krapina-Zagorje County and Zagreb County in March 2020, and the earthquake on the territory of Sisak-Moslavina County, Zagreb County and Karlovac County in December 2020) for which a total of HRK 684.5 million was spent in the first half of 2022.

Material expenditure was executed in the amount of HRK 8.2 billion (i.e. 45.3 % of the annual plan) in the first half of 2022, and these increased by HRK 85.3 million, i.e. 1.0 % compared to the same period last year. Expenditure for intermediate consumption, social benefits and compensations to employed persons has also slightly increased at the annual level. The greatest increase of expenditure in the first half of 2022 in relation to the same period of 2021, occurred in the expenditure for the procurement of non-financial assets in the amount of HRK 1.1 billion, primarily for the purpose of paying the obligations under the contracts for the procurement of the multi-purpose fighter plane. Expenditure for the disbursement of pension fees and benefits also increased by HRK 822.0 million, primarily

due to the adjustment of the pension fees and the transferred cumulative effect of the change in the number and structure of pension users. The increase in the expenditure in the first half of 2022 in relation to the same period of 2021 was also affected by a higher level of execution of the total expenditure for employed persons by HRK 521.5 million, which is a result of the application of collective agreements and other regulations governing the salaries for persons employed in government and public services.

The difference between the total state budget income and expenditure in the first half of 2022 is HRK 3.5 billion, i.e. 0.7 % of GDP. In relation to the first half of 2021 when it was HRK 9.8 billion, deficit has decreased by HRK 6.3 billion, i.e. 64 %.

In the first quarter of 2022, the consolidated general government deficit according to the national methodology amounts to HRK 153 million, i.e. 0.03 % of GDP, that is, HRK 1.3 billion according to the ESA 2010 methodology, which is an improvement of HRK 2.7 billion at the annual level. A decrease in the budget deficit reflects an increase in income (4.3 %) and, at the same time, a decrease in expenditure (1.5 %). At the same time, extra-budgetary users achieved a surplus of HRK 1.2 billion, i.e. 0.3 % of GDP, and local and regional self-government units and county road administrations a surplus of HRK 2.2 billion, i.e. 0.5 % of GDP.

When it comes to general government debt trends, it amounted to HRK 343.7 billion at the end of June 2022, being HRK 65.2 million lower than in late 2021, while the relative share of public debt in GDP decreased significantly from 79.8 % at the end of 2021 to 74.2 % in the first half of 2022, indicating a positive effect of intensified economic activity thus far.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD.