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19th 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 2022

At its 15th session held on 24 October 2022, 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 2022 adopted by the Government of the Republic of Croatia on 19th October 2022 at its 159th session.

The Draft Amendments to the State Budget for 2022 foresee a decrease in the deficit of the general government budget and of public debt measured according to the share in the GDP in 2022. Fiscal policy in 2022 was largely marked by the unexpectedly high increase in tax revenue due to the strong real and nominal GDP growth and the effect of inflation, as well as due to the measures for alleviating the consequences of increasing energy prices. The Commission agrees with these Draft Amendments and highlights the need to continuously monitor the position of the Republic of Croatia in order to facilitate the adjustment of fiscal policy in uncertain and volatile circumstances and ensure continuity and responsibility which guarantee long-term sustainability of Croatian public finances. The Commission underlines that it is necessary to constantly bear in mind the consolidation of public finances, and that most of the available funds, especially those from European sources, must be planned more realistically and used more efficiently and directed as much as possible into activities which will preserve and support economic growth. As many times before, it also highlights the need for improved expenditure planning and control, and calls for structural reforms. Due to the possibility of realization of a number of (global) negative risks in the upcoming period, it is extremely important to manage Croatian public finances wisely.

The strong (real and nominal) economic growth, achieved in 2021, continued in the first nine months of 2022, with a positive effect on Croatian public finances in terms of increased income and decreased public debt burden (according to its share in GDP). Such economic growth was a result of strong real growth of domestic and foreign demand stimulated by accumulated savings from the last two pandemic years, improved export structure and favourable labour market trends. Therefore, the expected real growth rate in 2022 increased from 3.0 to 5.7 %, which is consistent with the evaluations of other institutions. The price increase due to the consequences of the pandemic and the war in

Ukraine, is also high, and the CPI is expected to increase by 10.4 % at the annual level. Nominal GDP is also expected to increase by as much as 13.2 %.

Evaluation of the Draft Amendments to the State Budget for 2022

The proposed amendments which, for the second time in 2022, amend the State Budget, can be considered as technical amendments because they reflect the trends which have already been achieved and measures which have already been adopted, without any major or significant effects on further policies. In examining the budget documents related to the Draft Amendments to the State Budget, the Commission focused on the evaluation of the credibility and realism of macroeconomic and budgetary analyses of the state of public finances and the effect of budgetary plans on mid-term and long-term sustainability of public finances.

Since the achieved results exceeded the expected ones, the state budget income was increased under the Draft Amendments to the State Budget for 2022. Income was affected by a strong growth of domestic and foreign demand in conditions of higher prices and the effects of the changes in the value added tax (VAT) system and excise duty regulations, for the purpose of alleviating inflationary pressures. On the expenditure side, the amendments are related to the measures which have been undertaken for the purpose of suppressing inflationary pressures as well as to decrease in expenditure related to EU-funded projects, financing from the EU Solidarity Fund and the Next Generation EU instrument, including the expenditure related to earthquake remediation.

The State Budget for 2022, adopted by the Croatian Parliament on 8 December 2021, forecast 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. By the first Amendments to the State Budget for 2022 adopted in May 2022, the state budget income increased by HRK 6.6 billion to HRK 171 billion, and expenditure increased by 10.9 billion to HRK 184.7 billion. In these second Amendments to the State Budget for 2022, total income was planned in the amount of HRK 171.8 billion (of which operating income was HRK 170.4 billion, and income from sale of non-financial assets was HRK 1.4 billion), and increased by HRK 758.2 million. This increase of the total income is a result of improved collection of tax revenue due to favourable cyclical trends in the economy and GDP and personal consumption growth, good tourist season results but also of a high, growing inflation.

Tax revenue was planned in the amount of HRK 95.5 million which is HRK 4.4 billion more than in the first two amendments of the State Budget from May 2022. The greatest increase was achieved from VAT revenue increase (HRK 2.1 billion) and corporation income tax revenue increase (HRK 2 billion). On the other hand, revenue from special taxes and excise duties decreased by HRK 28.1 million in relation to the first Amendments to the State Budget of the Republic of Croatia for 2022 and amounts to HRK 16.7 billion

which is a consequence of the trends in the consumption of certain products subject to excise duty. With the second Amendments to the State Budget of the Republic of Croatia for 2022, the revenue from taxes on games of chance and other taxes on games increased by HRK 24.1 million in relation to the first Amendments from May 2022, and so did the revenue from the fees for organizing games of chance (increase by HRK 199 million to HRK 1.3 billion). Revenue from taxes on international trade and transactions was increased under these Amendments by HRK 118 million.

Revenue from contributions increased by HRK 7.1 million to HRK 28 billion. These income categories are under the influence of revenue from contributions for employment achieved from debts based on payments of such contributions, since it was revoked by the tax reform which came into force in January 2019.

On the other hand, according to the new plan for 2022, grant revenue (related to EU-funded projects, funds from the EU Solidarity Fund and the Next Generation EU instrument) was decreased from HRK 28.2 billion to HRK 22.9 billion (decrease of HRK 5.3 million), which means these revenue categories decreased by almost 20 %. In its prior position papers, the Commission has already drawn attention to the fundamental threat in withdrawing funds from EU sources, that is, to the low level of efficiency in contracting and planning those funds.

In addition, revenue from pension also decreased in relation to the first Amendments to the State Budget of the Republic of Croatia for 2022 to HRK 2.2 billion (by HRK 662 million).

With the second Amendments, the total state budget expenditure remained at the same level in relation to the first Amendments from May 2022 and amount to HRK 184.7 billion. The share of operating expenditure in this amount is HRK 173.7 billion (an increase of 3 billion kunas), and of the expenditure for the procurement of non-financial assets is HRK 11 billion (a decrease of HRK 3 billion). Expenditure financed from general income and receipts, contributions and dedicated receipts was increased by HRK 3.6 billion, while expenditure financed from EU and other sources was decreased by the same amount. These second Amendments to the State Budget for 2022 primarily served to ensure funds for implementing the autumn package of measures of the Government of the Republic of Croatia for the protection of households and the economy from increasing prices as well as the funds for pension adjustment, for the implementation of which HRK 2.4 billion were ensured (the Commission assessed that these Amendments were appropriate to the current circumstances, except that it emphasized that the fiscal effects of the defined package of measures on the state budget in the short- and mid-term were not clear nor specific enough and that this might bring about certain challenges on the income side of the budget and/or that their effect might spill over onto the next generations).

In the operating expenditure category, material expenses increased by as much as HRK 2.5 billion to provide funds for the compensation of damages under the ruling in the INA-

MOL arbitration proceedings (HRK 1.4 billion) and for the expenses of healthcare institutions financed from income based on the contractual relationship with the Croatian Pension Insurance Institute (HZZO, HRK 1 billion). Moreover, the most significant expenditure increase is related to the expenses for the employed (including salaries for the persons employed in primary and secondary schools, HRK 583 million), excise duty in the price of fuel for Hrvatske ceste d.o.o. and HŽ Infrastruktura d.o.o. (HRK 355 million) and for increased transfer to HZZO (HRK 300 million).

On the other hand, the expenditure related to the earthquake remediation projects (HRK 650 million) and the participation funds related to the implementation of the projects from operative programs (HRK 390 million). Total expenditure for the procurement of non-financial assets were also decreased, by HRK 3 billion, of which expenditure financed from general income and receipts, contributions and dedicated receipts was decreased by HRK 331,6 million, and expenditure financed from the EU and other sources by HRK 2.6 billion.

Table 1 Changes in the State Budget for 2022 (in % of projected GDP), national methodology

	2021	2022		
	<i>Realization</i>	<i>Budget</i>	<i>1st Amendments</i>	<i>2nd Amendments</i>
		<i>10/2021</i>	<i>5/2022</i>	<i>10/2022</i>
Income	35.8	35.6	36.3	35.2
<i>Operating income</i>	35.6	35.5	36.1	35.0
<i>Tax revenue</i>	19.4	19.0	19.3	19.6
<i>Profit tax</i>	1.8	1.8	2.0	2.3
<i>VAT</i>	13.3	13.2	13.3	13.3
<i>Excise duty</i>	3.8	3.5	3.6	3.4
<i>Contributions</i>	5.9	5.6	5.9	5.7
<i>Grants</i>	5.1	7.0	7.1	5.8
<i>Income from assets</i>	0.7	0.5	0.6	0.4
Expenditure	39.3	37.6	39.2	37.9
<i>Operating expenditure</i>	37.5	34.9	36.2	35.6
<i>Expenditure for employed persons</i>	5.6	5.4	5.4	5.2
<i>Material expenditure</i>	4.2	3.6	4.0	4.3
<i>Financial expenditure</i>	1.8	1.7	1.6	1.6
<i>Subsidies</i>	2.8	1.7	2.0	1.9
<i>Assistance granted abroad and within the general budget</i>	9.3	8.6	9.2	8.7
<i>Compensations to citizens and households based on insurance and other compensations</i>	12.2	11.8	12.0	11.7
<i>Other expenditures</i>	1.6	2.0	2.1	2.1
<i>Expenditure for the procurement of non-financial assets</i>	1.7	2.9	3.0	2.3

Total deficit/surplus	-3.5	-2.0	-2.9	-2.7
Consolidated general government (ESA)	-2.6	-2.6	-2.8	-1.5

The development of the State Budget for 2022, expressed as the share in expected GDP, is given in Table 1. At the level of the whole year, the share of income in GDP decreases by 0.6 percentage points primarily as a consequence of decreased income from the relevant budget and from HZZO. At the same time, tax revenue is increasing, mostly due to the increase in income tax, except for a pronounced decline in revenue from excise duty due to the interventions in the excise duty system, while VAT remained at the same level. Grant revenue (EU funds) was increased in relation to the previous year, despite the proposed decrease. On the expenditure side, there is an expressed additional decrease, as measured by the share in GDP, primarily due to the decrease in operating expenditure which is a consequence of a much lower uptake of financial COVID measures.

In accordance with the income and expenditure of the state budget planned in these second Amendments, based on the national methodology, the State Budget is expected to record a deficit of HRK 12.9 billion. This is 751 million kunas (or 2.7 % of GDP) less than what was planned in May 2022 and, in relation to the earlier plan, it represents an improvement of 0.2 percentage points. The general government deficit, according to the ESA methodology, will amount to HRK 7.1 billion or 1.5 % of GDP. Based on the trends of the fiscal general government budget balance, the share of public debt in GDP in 2022 is expected to decrease by 8.5 percentage points in relation to 2021, amounting to 71.3 % of GDP.

After the negative consequences of the coronavirus pandemic in 2020 resulted in a high budget deficit (7.3 % of GDP) and increased public debt (87.0 % of GDP), these indicators have significantly improved in 2021 and the first eight months of 2022. The state budget balance deficit in the amount of HRK 15 million or 3.4 % of GDP had a significant impact on the level of deficit in 2021 because of the measures undertaken on the expenditure side of the budget for the purpose of preserving jobs with employers whose economic activity had been disrupted in the circumstances of the COVID-19 pandemic and for the purpose of financing the costs for the preservation of the citizens' health which continued in 2021. The general government budget deficit decreased significantly in 2021, amounting to HRK 11.3 billion or 2.6 % of GDP, and its decrease continued in 2022 when it should amount to 1.5 % of GDP (which is below the threshold of 3 % of GDP according to the Maastricht criteria). This improvement is impacted by the achieved economic growth which is higher than the potential growth. Therefore, the structural deficit will amount to 2.0 % of GDP in 2022, meaning it will exceed the mid-term budget objective of 1 % of GDP, although it is much lower than in 2021 when it was 2.8 % of GDP, and that it is consistent with the temporarily postponed correction requirement of at least 0.5 percentage points of GDP. At the same time, strong growth has a positive effect on

alleviating the burden of public debt which will decrease from 78.4 % of GDP in 2021 to 71.3 % of GDP in 2022, i.e. it will return to the pre-crisis level.

The Commission finds the Amendments to the State Budget for 2022 appropriate to the current economic situation, especially considering the existing negative macroeconomic shocks which call for continuous monitoring of the economic position of the Croatian economy as well as timely and flexible fiscal policy action. Although the Republic of Croatia remained on a stimulative fiscal policy course in 2022 and restrained the growth of current expenditure financed by the state, the Commission highlights and reiterates that it is necessary to undertake reforms (e.g. in public administration, in health, pension and education systems as well as in the social welfare system) in order to minimize additional losses in certain sectors which in fact necessitate the amendments to the State Budget. Moreover, the Commission has continuously emphasized the need for a better prediction of certain budget items, such as the expenditure for employed persons, pension and healthcare, which are often initially planned at unrealistically low levels, and then increased under subsequent amendments. Finally, the Commission highlights again that the available funds from the European sources must be planned more seriously and more realistically and also used and directed toward those activities which will preserve and maintain economic activity, because these funds are the key to stronger fiscal expansion and sustainability, with great reform potential and a strong contribution to potential GDP growth.

PRESIDENT OF THE COMMISSION

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