

24 October 2022

20th Position Paper of the Fiscal Policy Commission on the Draft Budgetary Plan of the Republic of Croatia for 2023

At its 15th session held on 24 October 2022, the Fiscal Policy Commission (hereinafter: the Commission) examined the Draft Budgetary Plan of the Republic of Croatia for 2023 (hereinafter: the Draft) which was adopted by the Government of the Republic of Croatia (hereinafter: the Government) at its 159th session held on 19 October 2022.

The Fiscal Policy Commission evaluated the first Draft Budgetary Plan of the Republic of Croatia for 2023. Considering the current global circumstances and 2023 being characterized by a pronounced economic uncertainty and high geopolitical risks, it is appropriate to continue the former practice of conservative budget planning. After a strong recovery and growth in 2021 and the first half of 2022, the prospects for 2023 are less favourable. This creates an uncertain framework for economic and fiscal policy and could necessitate its adaptability. In such circumstances, the main task of fiscal policy will be to mitigate the effect of external shocks on the Croatian economy and help the most vulnerable groups which will be most affected by those shocks. Because of the economic slowdown, cyclical general budget income will grow at a slower pace, while the growth of the general budget expenditure will depend on intensified investment spending related to EU-funds, which represents the main lever of countercyclical action. Therefore, the Commission highlights the need to prepare, as realistically as possible, as many quality and sustainable investment projects as possible. The Commission repeats its warning about certain challenges in the existing capacities and the key stakeholders' readiness to undertake the necessary structural reforms within the framework of the overall public sector (especially in healthcare and public administration, but also in the other sectors).

Croatia's entry into the euro area is taking place in times of great political and economic uncertainty caused by the consequences of the pandemic and intensifying geopolitical tensions (the war in Ukraine and growing hostilities between USA and China). A consequence of these shocks was a surge in import prices, primarily energy prices due to the difficulties in the supply chains and the disruptions in energy import due to the war in Ukraine, which have spilt over into the general price increase. In an exchange situation,

such negative shocks are impoverishing the energy-dependent European Union (EU) and Croatia, while citizens and companies have to adjust their spending and investments to the decline in real income. Moreover, in response to the growing inflation, central banks are tightening their monetary policies and financing conditions. In these circumstances, it is probable that overall economic activity will slow down abruptly, and fiscal policy should have a countercyclical effect in this regard to prevent the risk of a recession¹. Croatia's euro area membership, which implies a common monetary policy and other control and support mechanisms, should also have an alleviating effect on the negative consequences of these shocks. Bearing all these challenges in mind, it is extremely important to pursue a transparent and responsible economic and fiscal policy in 2022 and 2023, and accelerate the reforms funded from the EU programs (Resilience and Growth Program) for the purpose of improving the low potential growth rate which is a result of an unfavourable demographic structure and low additional value of the Croatian industry.

Confirming the macroeconomic projections

The new Budget Act (hereinafter: the Budget Act; Official Gazette 144/21) aligned the budget process with the requirements of the euro area membership in the form of an enhanced coordination of economic policies. The Government of the Republic of Croatia is obligated to prepare a draft budgetary plan for the purpose of consultations with the European Commission, with the macroeconomic projections being confirmed by the Commission. Therefore, according to the provisions of the new Budget Act, the Commission is obligated to evaluate whether the drafted macroeconomic projections are a good foundation for preparing the budgetary plans, which was not necessary under the former Fiscal Responsibility Act (FRA).

As the budgetary plans are based on macroeconomic projections, it is particularly important for the macroeconomic projections to be accurate and unbiased. The high level of macroeconomic uncertainty in the last few years has made the process of drafting the macroeconomic projections much more demanding. In such conditions, quality macroeconomic projections must contain an internal consistency between the variables and may not deviate significantly from the projections of other institutions. In this regard, it is sensible to base the budgetary plans on a lower level of presumed macroeconomic growth, in the part determining the expected income, but also to keep certain reservations on the side of a possible growth of state expenditure costs.

To confirm the macroeconomic projections, the Commission had somewhat improved the former methodology of macroeconomic projections evaluation which, pursuant to Article

¹ The goal of such prudent fiscal activity is to prevent the onset of the scenario from the global financial crisis when the foreign shocks related to an unsustainable level of domestic demand as well as the need for a strict fiscal consolidation in a crisis situation (countercyclical) brought on a long-lasting recession in Croatia.

22 (2) of the FRA (Official Gazette 111/2018), was based on the comparison with the latest available projections of the European Commission (EC). However, the Commission is still not drafting its own macroeconomic projections but is instead comparing the projections of the Government of the Republic of Croatia with the macroeconomic projections of a larger number of institutions and additionally considering the presumptions and the consistency of the macroeconomic projections of the Croatian Government. To be able to make its own projections and conduct more thorough analyses, the Commission should have a functional and professionally staffed office set up, which the Commission has been actively working on some time now, despite many difficulties and challenges.

In the initial stages, the Commission and the Ministry of Finance (MF) regulated the process of confirming the macroeconomic projections according to the Timetable which defined the exchange of information and consultations on macroeconomic and budgetary projections before their adoption this year. Thus, in late September 2022, the Commission received preliminary macroeconomic projections, and, on 6 October 2022, the final macroeconomic projections from the Draft Budgetary Plan. On 7 October 2022, it held a meeting with the representatives of the MF. Based on the conducted analysis, on 13 October, in a letter addressed to the Ministry of Finance, the Commission confirmed the macroeconomic projections from the Draft Budgetary Plan.

The macroeconomic projections from the Draft Budgetary Plan for 2023 have been amended in relation to the projections from the Convergence Program from April 2022 to accommodate the achieved trends and materialize the negative risks in the global economy (Annex 1). An increase in economic activities during the first three quarters of 2022 exceeded prior expectations by far (the expected real growth rate for 2022 increased from 3.0 to 5.7 %). On the other hand, many negative risks have also been achieved, resulting in a rapid downturn of economic activity in both the EU and Croatia. Bearing all this in mind, the projections for 2023 foresee a halting of the growth of economic activity in late 2022 and early 2023 when GDP is expected to grow by 0.7 % (2023 Convergence Program assumed growth would additionally accelerate to 4.4 %). Unlike 2022, when the main contributors of growth were personal consumption and export which grew at two-digit rates, in 2023, growth should mainly be driven by state spending and EU-funded investments, while personal consumption, private investments and export will have a minor or negative contribution to growth.

The presented macroeconomic projections for 2023 are consistent both internally and with the projections of the other institutions, albeit with somewhat more cautious expectations for 2023. The Commission compared the macroeconomic projections from the Draft Budgetary Plan for 2023 with the projections of other institutions and established that there are no significant deviations. The Government's projections are somewhat more conservative, mostly due to their later date which allowed them to include the realization of a number of negative risks as well (Annex 2).

Taking into consideration the uncertainty which is characteristic for macroeconomic projections, the Commission assessed the credibility of the macroeconomic scenario based on how realistic it was and by comparing it with the projections of other relevant institutions. MF's projections are lower than the currently available projections of other relevant institutions, indicating their more cautious approach in determining the settings of the projections for the next period. The Commission holds that this kind of approach is justified because fiscal planning can be adjusted in very uncertain and volatile circumstances of the upcoming period when the risk of deceleration of economic activity and of a recession will rise abruptly, causing the Croatian economy to possibly face numerous limitations.

Although there are risk factors which pose a threat to economic growth, the Fiscal Policy Commission, at its 14th session held on 11 October 2022, confirmed the macroeconomic projections drafted by the MF for 2023 and concluded that these are within an acceptable range based on the currently available information.

Evaluation of the Draft Budgetary Plan

Due to the introduction of the euro as the official currency, the Republic of Croatia (Croatia) assumed a new obligation of participating in the procedures of monitoring and coordinating the economic policy of the euro area member states, including consultations and the preparation of the Draft Budgetary Plan for the following budget year. The new Budget Act (Official Gazette 144/21) adjusted the budget planning process to the requirements of the euro area membership and, in accordance with the Budget Act, the Government is obligated to prepare the Draft Budgetary Plan for the purpose of consultations with the EC which analyses whether the member states' budgetary plans take into consideration in an appropriate manner the recommendations of the Council of the EU issued under the European Semester and whether they transpose them into specific budgetary policies and an appropriate macroeconomic framework. The draft budgetary plan is a summary overview which defines the macroeconomic and fiscal frameworks of a particular euro area member state in the following budget year, and it serves as the basis for further preparation of the proposed budget for the following year.

Since euro area member states were obligated to prepare and deliver to the EC their 2023 Draft Budgetary Plan by 15 October 2022, Croatia prepared its first Draft Budgetary Plan for 2023 pursuant to the Guidelines on the format and the content of draft budgetary plans, economic partnership programmes and debt issuance reports, and the consultations with the EC. In doing so, it abided by the provisions of the Budget Act, the Stability and Growth Pact, the latest recommendations of the Council of the EU for the Republic of Croatia, the activities foreseen under the National Recovery and Resilience Plan (NRRP), the National Reform Program (NRP) and the package of measures of the

Government of the Republic of Croatia for the protection of citizens and the economy from increasing prices and activities related to receiving and caring for displaced persons from Ukraine.

To enable realistic planning, in this process, the Fiscal Policy Commission, as an independent fiscal body in Croatia, must confirm the macroeconomic projections underlying the draft budgetary plan (Article 21 (3) of the Budget Act). Moreover, macroeconomic and budgetary projections are subject to an unbiased and comprehensive evaluation by an independent body competent for the evaluation of fiscal policy, the results of which are considered in preparing future macroeconomic and budgetary projections (Article 21 (2) of the Budget Act). In its first evaluation of the Draft Budgetary Plan, the Commission assessed that, considering the current global situation, 2023 is characterized by extreme uncertainty and high geopolitical risks, hence it is appropriate to continue the former practice of conservative budget planning. Just as the countries, Croatia is facing numerous challenges and limitations caused by the war in Ukraine, increasing energy prices, the consequences of the crisis due to the COVID-19 pandemic (imbalance between high demand and insufficient offer) and an excessively high inflation rate. After the growth of Croatian economy in 2021 and the first half of 2022, the global trends (unstable energy prices and price pressures spreading and intensifying across industries) demonstrate that the economy will weaken and decelerate in the next quarters.

The prospects for Croatia's economic growth in 2023 have worsened and indicate a stagnation, which creates a very uncertain and volatile framework for implementing economic and fiscal policies. This all calls for flexibility and adjustability of the Croatian fiscal policy which needs to be able to act fast and ensure efficient measures for limiting the consequences of inflation and preventing further inflationary pressures, so as not to endanger the mid-term sustainability of public debt. Fiscal policy measures will have to be efficient in the next period and on, without permanently harming the state of public finances. They also need to be temporary, selective and targeted in order to focus only on supporting the most vulnerable groups and the most affected parts of the economy.

Croatian fiscal policy in 2021 and 2022 was largely characterized by the adoption of measures for limiting the consequences of the epidemic as well as soaring energy prices. At the same time, numerous and relatively comprehensive discretionary measures were adopted with a long-term effect on the state of public finances. The share of the general government budget income, measured by the share in GDP, decreased slightly (from 46.8 % in 2021 to 46.2 % in 2023). After a significant increase of the general government budget income in the last two years, these are expected to grow slightly in 2023. General budget income is determined by the projected economic activity, taking into consideration also the fiscal effects of revenue measures (0.2 % of GDP in 2023) adopted by the Government in April and October 2022 as part of the package for the protection of households and the economy from increasing prices. The funds provided as grants from

EU institutions and bodies (funds from the Multi-Annual Financial Framework - MFF 2021 – 2027, the Recovery and Resilience Facility and the EU Solidarity Fund) also have a significant effect on general budget income.

General budget income will increase less primarily due to the lower level of tax revenue growth. The most significant taxes are those on production and import projected in the amount of 18.8 % of GDP. In the tax structure, value added tax (VAT) stands out: for 2023 it is projected at the level of 13.3 % of GDP due to the growth of personal consumption, tourism services, intermediate consumption, investments and social transfers in kind. These projections include the effect of expansion of products and services which are taxed at lower VAT rates (13 %, 5 % and 0 %) and which apply since April and October 2022 for the supply of natural gas and heating from heating stations, that is, for the supply and installation of solar panels. Along with the lower foreseen growth of personal consumption, decreased revenue from excise duty is expected due to lower excise duty on fuel and lower retail prices.

The share of total general government expenditure is decreasing from 49.4 % of GDP in 2021 to 48.6 % in 2023. However, compensations to employees in 2023 are increasing by 7.1 % annually, mostly due to the increase of the basis for salary calculation based on collective agreements for civil and public servants, the corrections for past service of 0.5 % and the expected trends regarding the number of employed civil and public servants (presumed growth of 0.8 %). Increased expenditure for pension fees in 2023 is also projected, in the amount of HRK 5 billion, which includes the effect of pension indexation of 6 %, the effects of the amendments to the Pension Insurance Act and the transferred cumulated effect of the change in the number and structure of pension users. Automatic adjustment of certain types of expenditure to the inflation (pensions and salaries, partially social benefits) results in their permanent (relative) increase. The expenditures for intermediate consumption, which are expected to be at the level of 8.4 % of GDP in 2023, include higher amounts that healthcare institutions put aside for the settlement of debts toward drug suppliers as well as for medical consumables and embedding medical materials. The Commission highlights that, in times of high inflation as we are experiencing now, it is particularly important to control the increase in expenditure (especially increasing salaries for civil and public servants, pension increase). The Commission also reiterates that, in planning the expenditure, non-controlled costs were continuously expressed and that significant losses of the healthcare system were underestimated. The healthcare system needs to be additionally financed from the state budget which calls for fundamental reforms and major changes within the framework of the healthcare system.

According to the draft budgetary plan, further decrease of the general government deficit is planned. Having incorporated the effects of the measures for alleviating the costs of life in 2023, deficit should reach 2.3 % of GDP (0.8 percentage points more than in 2022), satisfying the criteria for the budget deficit pursuant to the provisions of the

Stability and Growth Pact. The nominal increase of deficit in 2023 will partly be a result of discretionary measures, that is, the effects of comprehensive measures for alleviating the inflation, further growth of investments and increase in other consumption. It is expected that the share of public debt in GDP will continue to decrease and amount to 69.0 % of GDP at the end of 2023, mostly as a result of the inflation. This represents a satisfactory dynamic of public debt adjustment according to the provisions of the Stability and Growth Pact. The importance of economic growth is reflected precisely in the trend of the share of public debt in GDP. Therefore, caution must be applied in the context of economic stagnation and deceleration, and significant efforts must be invested to ensure fiscal sustainability precisely because a relatively higher level of debt could endanger the stability of fiscal policy in case of new shocks.

The Commission concludes that, because of the deceleration of economy, the growth of cyclical general budget income will slow down, while the growth of the general budget expenditure will depend on intensified EU-funded investment spending. In 2023, just as in 2022, the expansiveness of fiscal policy is related to investment interventions and use of EU funds, but the issue of real and complete usability and realization of those funds remains open. Since fiscal sustainability arises from (the growth of) economic potential which serves as the basis for planning public spending, the Commission highlights the need to prepare as many quality and sustainable investment projects as possible to be able to withdraw the funds for strengthening the economy.

Considering the expected uncertainties, the main task of fiscal policy in 2023 will be to mitigate the effect of external shocks on the Croatian economy and help the most vulnerable groups which will be most affected by those shocks. The Commission has also noticed certain challenges in the existing capacities and the readiness of key stakeholders to undertake the necessary structural reforms within the framework of the overall public sector (especially in healthcare and public administration, but also in the other sectors). Moreover, attention should also be paid to those projects which will bring about the maximum possible added value for the economy and contribute to the growth of potential GDP, which will in turn facilitate increases fiscal sustainability of the national economy.

As a reform is expected of economic governance in the EU as well as reforms of fiscal rules at the EU level, and bearing in mind the economic and political circumstances at the level of the EU based on the [EC Communication \(2022a\)](#), the General Escape Clause will remain in force in 2023, the same as the Decision on the temporary postponement of the application of national fiscal rules. The Government of the Republic of Croatia brought this decision back in 2020 due to a number of extraordinary circumstances, all in accordance with the recommendations of the Fiscal Policy Commission and based on the provisions of the Budget Act, in order to leave national fiscal policies enough space for manoeuvre.

PRESIDENT OF THE COMMISSION

Prof. Sandra Krtalić, PhD.

Annex 1 Macroeconomic projections of the Government of the Republic of Croatia

Table 1 Macroeconomic projections of the Government of the Republic of Croatia

	Realization	Draft Budgetary Plan		Convergence Program	
	2021	2022	2023	2022	2023
Gross domestic product (GDP)					
GDP - nominal growth,%	13.8	13.2	6.9	9.5	8.8
GDP - real growth,%	10.2	5.7	0.7	3.0	4.4
Personal consumption¹	10.0	4.5	0.4	1.4	3.2
Government spending	3.1	2.3	2.1	3.3	1.9
Gross investments	7.6	4.5	1.7	5.8	6.1
Export of goods and services	33.3	17.3	-0.2	6.9	6.0
Goods export	20.0	17.4	0.9	4.8	5.4
Export of services	51.5	17.3	-1.6	9.2	6.7
Export of goods and services	14.7	20.2	0.4	6.1	6.9
Goods import	14.8	21.2	0.3	5.6	6.5
Import of services	13.9	14.3	1.1	9.1	9.5
Contributions to GDP growth, percentage points					
Personal consumption	5.9	2.6	0.2	0.8	1.8
Government spending	0.7	0.5	0.5	0.7	0.4
Gross investments	1.7	1.0	0.4	1.2	1.3
Export of goods and services	14.0	8.9	-0.1	3.3	2.3
Export of goods and services	-7.2	-10.6	-0.2	-3.9	-2.4
Changes in the deflators, %	3.2	7.1	6.1	6.2	4.1
Personal consumption¹	2.7	10.4	5.7	7.8	3.7
Government spending	3.7	6.3	5.6	5.4	4.0
Gross investments in fixed capital	2.4	8.7	4.2	5.3	3.9
Export of goods and services	4.6	9.1	2.4	8.5	3.5
Goods export	6.9	12.8	1.3	11.8	3.3
Export of services	2.1	4.8	3.9	4.9	3.7
Export of goods and services	6.7	14.1	1.4	11.0	3.3
Goods import	7.4	15.6	1.1	12.1	3.3
Services import	2.9	4.6	3.0	4.5	3.5
Consumer price index (%)	2.6	10.4	5.7	7.8	3.7
Labour market					
Survey-based unemployment rate (%)²	7.6	6.3	6.3	6.3	5.6
Number of persons employed (in thousands)³	1,696	1,742	1,751		
Employment growth (change, %)³	1.2	2.7	0.5	2.8	1.5
Average gross salary in legal entities (change, %)⁴	4.2	8.3	5.5	6.3	3.8

Source: Croatian Government.

Annex 2 Comparison of macroeconomic projections prepared by various institutions

The former evaluation approach which included a comparison of the macroeconomic projections of the Government of the Republic of Croatia with the projections of the European Commission has been expanded to include the projections of a larger number of institutions preparing the projections for Croatia. In comparing the projections, the Commission focused on two basic parameters, contained in the projections of all the institutions, which determine the macroeconomic projections - real GDP growth and the consumer price index. A problem with this approach is that the projections are made at different times which, in the circumstances of a high macroeconomic uncertainty, results in bigger corrections. Thus, the “older” projections underestimate the growth of GDP and inflation in 2022 and overestimate the growth in 2023. The more recent projections include the achieved trends as well as the effects of negative trends, particularly the contractionary monetary policy and continued disturbances in energy supply on the EU market. The comparison of the projections shows that the Government is expecting a somewhat stronger growth in 2022 than the other analysed institutions do on the average (5.7 compared to 5.5). However, looking at the more recent projections only (especially those of the Croatian banks), the Government’s projections do not deviate significantly. On the other hand, compared to the other analysed projections, the Government is much more cautious with regard to the expectations for 2023 and the expected price increase. At the same time, a somewhat lower price increase directly impacts a lower growth of nominal GDP and the components which define the tax basis, but it might underestimate the pressure it places on the growth of nominal public spending.

Table 2 Comparison of macroeconomic projections by various institutions

Institution	Date	Real GDP (%)			Consumer price index (%)		
		2022	2023	2022-23	2022	2023	2022-23
European Commission	(July)	3.4	2.9	6.4	8.2	3.6	12.1
EBRD	(September)	6.5	2.0	8.6	-	-	-
Consensus Forecasts	(September)	5.3	2.4	7.8	10.1	5.8	16.5
Erstebank	(September)	5.5	2.1	7.7	10.5	6.5	17.7
Privredna banka Zagreb	(September)	5.9	2.3	8.3	10.5	6.1	17.2
Zagrebačka banka	(September)	5.5	2.7	8.3	10.0	7.0	17.7
Raiffeisen Research	(October)	5.8	1.8	7.7	10.6	6.7	18.0
IMF	(October)	5.9	3.5	9.6	9.8	5.5	15.8
Croatian National Bank	(October)	5.5	1.0	6.5	10.3	6.7	17.7
<i>Projections average</i>		5.5	2.3	7.9	10.0	6.0	16.6

Draft Budgetary Plan	(October)	5.7	0.7	6.4	10.4	5.7	16.7
Convergence Program	<i>(April)</i>	3.0	4.4	7.5	7.8	3.7	11.8

*Note: IMF – International Monetary Fund, EBRD – European Bank for Reconstruction and Development
Source: Indicated institutions*