Fiscal Policy Commission
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11th Position Paper of the Croatian Parliament Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for the year 2020

At its 7th meeting held on 7 June 2021, the Fiscal Policy Commission (hereafter referred to as: the Commission) discussed the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for the year 2020, submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia (hereafter referred to as: the Government) on 20 May 2021.

In the year 2020, the pandemic had a significantly negative impact on both the revenue side (significant revenue reduction) and the expenditure side of the budget (strong increase in expenditures related to the fight against the pandemic). However, given the extraordinary situation of the pandemic, which necessitated exceptional fiscal efforts both globally and in the Croatian economy, the Commission considers that the fiscal developments in 2020 and the state budget deficit could not have been avoided. In addition, despite the temporary postponement of the implementation of fiscal rules in 2020, the Commission is of the opinion that the Government should prepare and publish a Report on the Implementation of Fiscal Rules and analyse the development of the structural deficit, which has not been done.

Since the beginning of 2020, the world and the Croatian economy have been facing the trying circumstances of the COVID-19 outbreak. Strong support from public finances has been required to mitigate the negative consequences of the pandemic and stimulate aggregate demand. As a result, in March 2020, the Council of the European Union activated the general escape clause of the Stability and Growth Pact in order to provide fiscal stimulus to the Member States. The Croatian Fiscal Responsibility Act (hereinafter: ZFO) provides for a temporary postponement of the application of fiscal rules in case of extraordinary circumstances, provided that in accordance with EU rules this does not jeopardize fiscal sustainability in the medium term. In accordance with the recommendation of the Fiscal Policy Commission of 30 March 2020, on 2 April 2020 the Government adopted a Decision on the temporary suspension of the application of fiscal rules (official gazette *Narodne novine* no. 41/2020) referred to in Articles 6, 7 and 8 of the ZFO, temporarily suspending the application of numerical fiscal rules. The benchmarks – the budget deficit limit of 3% of gross domestic product and the public debt of 60% and/or on a declining trajectory – are still in force. If the European Commission (hereinafter: EC) considers that there is a risk that these criteria are not met, it is obliged to regularly assess and report thereon to the Council of the European Union. On 20 May 2020, the EC prepared a Report in accordance with Article 126(3) of the Treaty on the Functioning of the European Union[1], in which it identified a probable excess of the deficit criterion in 2020 and concluded that it was exceptional and temporary, which is why no corrective procedures were initiated. Moreover, the Council of the European Union, in its Specific Recommendations of 20 July 2020[2] recommended that the Republic of Croatia "take all necessary measures, in line with the general escape clause of the Stability and Growth Pact, to effectively address the COVID-19 pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment."

The aim of fiscal rules is to provide sufficient space to run counter-cyclical fiscal policy in order to facilitate measures aimed at providing assistance to people and the economy in times of economic crisis. The trends and fiscal consolidation achieved in the Republic of Croatia over the last few years, membership in the European Union, and preparations for joining the euro area have provided additional fiscal space and helped the Croatian economy during the first months of the pandemic. However, Croatia's fiscal policy is limited by a high level of public debt and a low rate of potential growth. In such circumstances, **it is necessary to consistently follow the provisions related to the postponement of the application of fiscal rules, while ensuring that the fiscal measures taken are short-term, effective and aimed at combating the consequences of the epidemic.**

The COVID-19 outbreak has hit the Croatian economy and public finances hard: compared to 2019, in 2020 general government revenues were nominally reduced by 6.5%. The largest decline in revenues was recorded in tax revenues, mostly due to the decline in revenues from value added tax (13.4%). There was also a smaller decline in labour market-related revenues – income taxes and contributions – but this decline was not as significant due to fiscal measures introduced by the Government. Thus, the decline in income tax revenues amounted to 6.0%, and from contributions to 4.8%. At the same time, general government expenditures increased by as much as 8.6% as a result of planned and undertaken activities that increased public spending, and special measures related to combating the effects of the pandemic.

[1] Report by the European Commission under Article 126(3) of the Treaty on the Functioning of the European Union (COM(2020) 547), available at https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-547-hr_en.pdf.

[2] Council recommendation of 20 July 2020 on the 2020 National Reform Programme of Croatia and delivering a Council opinion on the 2020 Convergence Programme of Croatia (2020/C 282/11), available at https://eur-lex.europa.eu/legal-content/HR/TXT/PDF/?uri=CELEX:32020H0826(11)&from=EN.

State budget revenues in 2020 amounted to 131.6 billion HRK, which is by 8.3 billion HRK (6.0%). lower compared to 2019. Tax revenues were significantly reduced, by 9.5 billion HRK (11.6%), mostly due to the decline in value added tax revenues as a result of the drop in personal consumption. In contrast, aid revenues, which mostly relate to funds from the European Union, were by 3.4 billion HRK or 22.9%. higher than the year before.

State budget expenditures in 2020 amounted to 153.5 billion HRK and are by 13.6 billion HRK or 9.8% higher than in 2019. Subsidies increased significantly compared to 2019 and this due to the implementation of measures to preserve jobs with employers whose businesses were disrupted due to the epidemic. In total, in 2020, the state budget financed expenditures related to the epidemic in the amount of 10.7 billion HRK. In addition to the above, various measures related to the epidemic in the amount of 5.4 billion HRK were financed from the state budget.

Finally, in 2020, state budget expenditures exceeded revenues by 21.9 billion HRK and the deficit is financed by new borrowings. Due to lower revenues and the need to finance higher state budget expenditures due to the epidemic, at the end of 2020 the state budget debt increased by 32.7 billion HRK or 13.3% compared to 2019[3].

Such developments have also led to an increase in the general government deficit[4], which in 2020 amounted to as much as 7.4% of GDP. Of this, the central government budget deficit amounted to 6.4% of GDP, and a significant deterioration was also recorded in the local government sector (deficit of 1.0% of GDP), which, in addition to the negative effects of the pandemic, was also affected by changes in the income tax system.

Although fiscal rules were temporarily postponed in 2020, the Government should have but again failed to **prepare a Report on the Implementation of Fiscal Rules and to analyse the developments of the structural deficit.** Despite the uncertainty that strongly affects the assessment of the potential product, the output gap and thus the structural balance, the provisions of the Stability and Growth Pact do not suspend the application of procedures, but only allow departure from the numerical values of the necessary adjustment of the structural balance towards the medium-term budgetary objective. **Therefore, the Commission considers that the Government, when preparing budget documents, must make and publish such analyses and calculations.**

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[3] Annual Report on the Execution of the State Budget of the Republic of Croatia for the year 2020. Available at https://vlada.gov.hr/UserDocsImages/2016/Sjednice/2021/Svibanj/58%20sjednica%20VRH/58%20-%205.pdf

[4] According to the Central Bureau of Statistics April 2021 Report on the Excessive Budget Deficit Procedure and the General Government Debt Level. Available at https://www.dzs.hr/Hrv_Eng/publication/2021/12-01-02_01_2021.htm.

The calculations cited in the EC Spring Forecast from May 2021[5] show that, according to the standard calculation methodology, in 2020 the output gap in the Republic of Croatia was as high as -5.5%. The cyclical impact of the pandemic on the deficit was -2.4% of GDP, while the structurally adjusted balance was -5.0% of GDP. The large increase in the structural balance of 3.6% of GDP compared to the pre-pandemic levels in 2019 can be fully explained by the impact of fiscal measures to combat the consequences of the pandemic. According to the calculations presented in the Convergence Programme 2022-2024[6], the total amount of fiscal effects of COVID-19 measures in 2020 was 3.8% of GDP. This means that the structural balance, if these measures were to be excluded, would have remained at a level similar to 2019. Although at the time the Commission considered that a faster and stronger reduction of the structural balance and public debt was needed, it is of the opinion that **the fiscal developments in 2020 could not have been different and that the run deficit was necessary to reduce the negative consequences of the pandemic.**

The large economic downturn and budget deficit have led to a large increase of the debt-to-GDP ratio. Thus, the general government debt in 2020 increased by 329.7 billion HRK, which is an annual increase of 36.8 billion HRK. Due to the large nominal decline in GDP, the public debt situation is significantly worse when viewed as a share of GDP. Thus, public debt increased from 72.5% of GDP at the end of 2019 to as much as 88.7% of GDP at the end of 2020.

Budget deficit of 7.4% of GDP and the large increase in public debt to as much as 88.7% of GDP in 2020 significantly exceed the reference values of the Stability and Growth Pact, and both criteria of public finances were exceeded. Therefore, on 2 June 2021, the EC published a Report under Article 126 (3) of the Treaty on the Functioning of the European Union. It found that the excess of the deficit over the reference value was exceptional because it stemmed from exceptional circumstances, but was not close to the 3% of GDP reference value. In addition, based on the projection for 2021 and 2022 in which the expected deficit would again exceed 3%, it concluded that the excess was not temporary. Public debt also exceeded 60% of GDP, and in 2020 it was not reduced as prescribed. Despite the fact that both criteria were exceeded, the EC again decided not to initiate the excessive deficit procedure (the 'corrective arm').

The Commission considers that such a significant deterioration in public finances in the first pandemic year 2020 was necessary to facilitate a countercyclical fiscal policy aimed at mitigating the short- and medium-term consequences of the pandemic, yet stresses the need to closely monitor the situation and

[5] Available at https://ec.europa.eu/info/sites/default/files/economy-finance/ip149_en.pdf.

[6] Available at https://ec.europa.eu/info/sites/default/files/2021-croatia-convergence-programme_hr.pdf

economic developments. It is of the opinion that in the event of a faster-than-expected economic recovery, it is necessary to stay on the path of fiscal consolidation embarked before the crisis. In this regard, it is crucial to follow the recommendations of the Commission, the EC and the European Council on the nature of fiscal measures and to refrain from other expansionary measures that could jeopardize the medium- and long-term sustainability of public finances.