Fiscal Policy Commission
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12th Position Paper of the Fiscal Policy Commission on the Convergence Programme 2022-2024 and the Proposal of Amendments to 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 (hereinafter: Commission) discussed the Convergence Programme of the Republic of Croatia for 2022-2024, that was adopted by the Government of the Republic of Croatia (hereinafter: Government) on 29 April 2021, and the Proposal of Amendments to the State Budget of the Republic of Croatia and extra-budgetary users' financial plans for the year 2020, submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia by an act of 2 June 2021.

The Commission supports the continuation of short-term and targeted measures necessary to mitigate the effects of the pandemic, stressing the need to avoid the adoption of measures with a lasting negative impact on public finances. Macroeconomic projections point to a rapid recovery, but the Commission emphasizes that without strong reforms aimed at increasing potential growth, Croatia could very quickly face limited economic growth. Therefore, the expected recovery and lifting of crisis measures need to be used for stronger consolidation of public finances as early as 2022.

For the second year in a row, the world and Croatian economies are threatened by the COVID-19 pandemic, which necessitates increased funding for health interventions and other measures to mitigate the economic and social consequences of the pandemic, including supporting recovery and increasing economic resilience.

The provisions of the Fiscal Responsibility Act (hereinafter: ZFO) and the Stability and Growth Pact (hereinafter: SGP) provide for situations in which it is possible to derogate from numerical rules in order to adequately respond to adverse events beyond the control of Member States, but provided that the medium- and long-term sustainability of public finances is protected. Accordingly, at its session held on 2 April 2020, at the invitation of the Commission, the Government adopted a Decision on the temporary postponement of the application of fiscal rules, by which, in accordance with Article 10 of the ZFO and EU rules (hereinafter: EU), the implementation of the numerical fiscal rules referred to in Articles 6, 7, 8 and 9 is postponed. At the same time, the Council of the EU, on the recommendation of the European Commission (hereinafter: EC), activated the general escape clause. The general

clause at EU level allows Member States a budget deficit that does not have to follow the amounts projected towards the medium-term budgetary objective but may temporarily exceed the set levels.
Other procedures from the SCG are still active, including the quantitative criteria for budget deficit and public debt. Already in May 2020, in its Report under Article 126(3) for the Republic of Croatia[1], the EC warned that the deficit criterion will be exceeded, but upon consultation with the Council of the EU it concluded that due to the high level of uncertainty and the necessary support to the economy it would not activate any corrective procedures. The EC took the same position in June 2021, establishing that the deficit and public debt criterion had been exceeded.[2] In the country-specific recommendations addressed to the Member States of July 2020, the Council of the EU[3] recommended that necessary fiscal support to address the impacts of the pandemics should be ensured, first of all in the form of targeted and temporary measures, and stressed the need to return to the path of sustainability of public finances and the path of sustainable growth. The same messages for 2021 were conveyed by the Executive Vice President of the EC and the Commissioner for the Economy in their letter[4] in September.

In March 2021, the EC issued guidelines[5] for the development of stability and convergence programmes according to which fiscal support for recovery is still needed. Fiscal support measures should be timely, temporary and targeted, and once health risks have diminished, the fiscal measures should gradually pivot to more targeted measures that promote a resilient and sustainable recovery. Given the lack of fiscal capacity, it is necessary to rely more heavily on funds from the Recovery and Resilience Facility. This position was reiterated by the EC in the European Semester Spring Package from June 2021[6], and it confirmed that the general escape clause is expected to be deactivated as of 2023.

Since the declaration of the epidemic in March 2020, the Fiscal Policy Commission has been supporting the Government's activities in addressing the consequences of the epidemic. It reminds that even in the conditions of postponing the application of fiscal rules, there are still restrictions in conducting fiscal policy. The Commission therefore recommends the following:

- targeted and short-term measures should be adopted, which do not jeopardize the sustainability of public finances;

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[1] Available at: https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-547-hr_en.pdf
[2] Communication on the economic policy coordination in 2021. COM(2021)500. Available at: https://eur-lex.europa.eu/legal-content/HR/TXT/?uri=CELEX%3A52021DC0500&qid=1623048563205
[3] Country-specific recommendations for Croatia (ST 8184/20 - COM(2020) 511) available at: https://data.consilium.europa.eu/doc/document/ST-8430-2020-INIT/hr/pdf
[4] Available at: https://ec.europa.eu/info/sites/default/files/economy-finance/hr.pdf
[5] Communication from the Commission to the Council: One year since the outbreak of COVID-19: fiscal policy response (COM(2021)105). Available at: https://eur-lex.europa.eu/legal-content/HR/TXT/HTML/?uri=CELEX:52021DC0105&from=EN
[6] Read more about the Spring Package at: https://ec.europa.eu/commission/presscorner/detail/hr/IP_20_901.

- high public debt in conditions of low potential growth significantly limits the possibility of using fiscal policy, so it is necessary to use as much as possible the funds from the Recovery and Resilience Facility (hereinafter: RRF);
- measures aimed at increasing the potential growth of the Croatian economy, such as public investment and reforms, contribute the most to fiscal sustainability;
- the decision to temporarily postpone the application of fiscal rules should be constantly reviewed and revoked once the crisis is over.

In addition, when delivering its position on the Draft Budget for 2021, the Commission concluded that, according to the projections at the time, the requirements for postponing the application of fiscal rules in 2021 were met. However, although the EC concluded on the basis of its Spring Forecast that the application of the general escape clause could be maintained in 2022, the Commission will issue its opinion and recommendation to the Government in autumn 2021 on possible repeal of the Decision on temporary postponement of fiscal rules in 2022.

Macroeconomic projections

The Commission assesses macroeconomic and budgetary projections based on an assessment of their credibility, i.e. realism, and their comparison with the latest available EC projections. As the Convergence Programme and the Proposal of Amendments to the State Budget for 2021 are based on a single and identical macroeconomic and fiscal projection, the Commission assessed them jointly in this position paper.

Macroeconomic projections are based on better-than-expected expectations, with a simultaneously accelerating economic recovery. Despite such trends, the Croatian economy will not return to pre-pandemic levels until next year, 2022, which also influences the conclusion that fiscal support needs to continue. With the expected normalization of the health situation, a large contribution to growth is expected from RRF funds, on the basis of which an additional contribution to growth of 0.3% in 2021, 1.4% in 2022, 1.4% in 2023 and 0.9% in 2024 is predicted. With such assumptions, the Government predicts that GDP will grow by 5.2% in real terms in 2021, 6.6% in 2022, 4.1% in 2023 and 3.4% in 2024. However, in the conditions of low potential growth, this will also mean a very fast closing of the production gap, which will lead to a number of restrictions on the continuation of such high growth.

Furthermore, the ZFO requires that macroeconomic projections must be aligned with EC projections. However, the growth projections expected by the EC are somewhat lower and amount to 5.0% in 2021 and 6.1% in 2022, while they also expect significantly slower rise in deflators. In other words, the Government expects higher real growth than the EC projections by 0.2% in 2021 and 0.5% in 2022, while the deviation of nominal growth is even larger and amounts to 0.6% in 2021. and 1.2% in 2022.

With all this in mind, the Commission considers that, despite the fact that the Government's macroeconomic projections deviate to some extent from the EC projections, they can be achieved in the event of continued current trends and stronger use of RRF funds. The Commission therefore proposes to the Government that when drafting the budget for 2022, it should revise its adjustments in accordance with the achievements during the summer of 2021 and the findings regarding the planned dynamics of RRF withdrawals, and maintain a conservative approach to budget revenue planning.

Convergence Programme

The convergence programme is based on the assumption of a rapid recovery and absorption of RRF funds and contains assumptions on amendments to the budget for 2021, with no major changes to existing policies in the coming period.

The Commission, which in previous position papers called on the Government to temporarily postpone the implementation of tax changes in 2021, especially regarding tax reductions, welcomes the plan to correct the budget deficit during the growth period primarily through slower growth of current spending, while a possible reduction in the tax burden should be pursued only once recovery and consolidation of public finances are achieved.

According to the projections from the Convergence Programme, the general government deficits will be at 3.8% in 2021, 2.6% in 2022, 1.9% in 2023 and 1.5% in 2024. The Commission believes that the projected deficit for 2021 is appropriate to the current situation, but that a strong recovery should be taken advantage of to accelerate the consolidation of public finances and reduce public debt in the coming years.

Despite the recommendation and request of the Commission that even in the conditions of temporary postponement of the application of fiscal rules, budget documents should contain an assessment of the structural deficit that would enable a better overview of the state of public finances, the Convergence Programme does not contain such an analysis. Therefore, the Commission used the EC Spring Forecast, according to which the structural deficit increased from 1.4% in 2019 to 5.0% in 2020, or by 3.6 percentage points. In 2021, the deficit is expected to decrease to 3.2% and 3.3% in 2021. The increase in the structural deficit was mostly influenced by the measures introduced to address the pandemic (3.8% in 2020 and 2.2% in 2021). Given the extraordinary circumstances, the Commission considers it acceptable that these measures have the greatest impact on the development of the structural deficit. However, given that in 2022, despite the lifting of these measures, which exceed the projected increase in public investment, there is no noticeable correction of the structural deficit, the Commission warns that when drafting the budget for 2022 it is necessary to come up with a more ambitious consolidation plan, especially considering the additional interest savings. The expected deactivation of the general escape clause as of 2023 means that public finances should go in the direction of consolidating the deficit towards the medium-term budgetary target of 1% at a rate of at least 0.5 percentage points per annum, which the existing Convergence Programme does not show. It is also necessary to limit the growth of current expenditures well below the expected high real growth rates.

Proposal of Amendments to the State Budget 2021

The proposed amendments to the State Budget for 2021 recognize the stabilization of budget revenues in 2021, but also a further increase in expenditures to finance the fight against the epidemic, increased expenditures for healthcare and support of employees and companies most affected by the crisis with the aim to preserve the economic potential.

A slight increase in state budget revenues in 2021 presupposes a recovery in economic activities, given the effects of tax changes for 2021 and the planned absorption of EU funds. Accordingly, the planned total revenues in 2021 amount to HRK150.3 billion. Increase in budget revenues by HRK 3 billion or 2.1% compared to the previous plan for 2021, primarily refers to assistance from EU funds in the amount of HRK 1.4 billion. Tax revenues are projected to increase by HRK 336.7 million, primarily on the basis of income tax revenues and taxes on goods and services, with a slight decrease in value added tax revenues, as a result of uncertainties related to the tourist season and personal consumption in 2021.

Based on the proposed amendments to the State Budget for 2021 (hereinafter: Amending Budget), total expenditures increased by HRK 9.4 billion (6%) compared to the original plan for 2021, which is a consequence of the redistribution within the budget in order to provide funds for the functioning of the healthcare sector, financing further measures and activities in the fight against the epidemic and providing funds for expenditures for employees in the education sector. Accordingly, the total expenditures in 2021 were originally planned in the amount of HRK 157.9 billion, and the Amending Budget envisages their further increase to HRK 167.3 billion. The largest increase in expenditures in 2021 financed from sources that affect the result of the state budget compared to the State Budget for 2021 is planned for rehabilitation and investments in healthcare (HRK 4.2bn), aid for employees and companies affected by the coronavirus (HRK 2.4bn) and employee expenditure (HRK 1.3bn). The proposed amendments to the State Budget for 2021 reflect the intention for moderate consolidation of public finances, and the Commission proposes to the Government of the Republic of Croatia to evaluate previous and current activities in healthcare and economy to determine their real fiscal effects on economic development. The Commission considers it necessary to assess the future risks of budget expenditures, especially in view of the growing debts of the healthcare system, the public sector wage system or significant contingent liabilities based on issued state guarantees.

The total result will lead to a state budget deficit of HRK 17 billion or 4.3% of GDP. According to the ESA 2010 methodology, the general government will have a deficit of HRK 15.3 billion or 3.8% of GDP.