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13th Position paper of the Fiscal Policy Commission on the Draft Semi-Annual Report on the execution of the State Budget of the Republic of Croatia for the first semester of 2021 and the Guidelines for the preparation of the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024

At its 8th session held on 21 September 2021, 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 2021, adopted by the Government of the Republic of Croatia on 9 September 2021 and the Guidelines for the preparation of the State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024, which were adopted by the Government on 29 July 2021.

Achieved developments in 2021 point to a faster recovery than previously projected, which was contributed by the fiscal measures taken to mitigate the consequences of the pandemic. The Commission also calls on the Government to adjust its growth projections to the latest developments when drafting the budget for 2022, but also to avoid adopting measures with a lasting negative effect on public finances. The Commission warns that in the face of expected continued growth, the Croatian economy could soon face constraints stemming from a low rate of potential growth that needs to be increased through reforms and investment. Therefore, as early as 2022, the expected recovery and repeal of crisis measures need to be used for stronger consolidation of public finances, and to ensure full implementation of fiscal rules from 2023.

For the second year in a row, the world and Croatian economy is threatened by the COVID-19 pandemic, which necessitated strong funding for health interventions and other measures to mitigate its economic and social consequences, including supporting recovery and increasing economic resilience. To enable this, the provisions of the Fiscal Responsibility Act (hereinafter: FRA) and the Stability and Growth Pact (SGP) have been applied, which allow a temporary deviation from the numerical rules, but with the condition of protecting the medium and long-term sustainability of public finances.

The economic policy measures taken at the national and global level, in the context of growing resistance to coronavirus, primarily through vaccination of the population and improvement of treatment methods, contribute to the gradual normalization of life and accelerated economic recovery. Economic activity is projected to reach pre-pandemic levels as early as 2022, which is why it is necessary to ensure the normalization of fiscal policy and the long-term sustainability of public finances. Due to the high level of public debt and low rates of potential growth of the Croatian economy, it is necessary to start a stronger consolidation of public finances as early as 2022, whereby available funds, especially those from the Recovery and Resilience Facility (hereinafter: RRF), should contribute to economic potential growth and long-term sustainability of public finances. The fiscal rules of the preventive part of the Stability and Growth Pact are designed to ensure that counter-cyclical fiscal policies are pursued in "normal" circumstances. The transition to a "normal" mode of operation in the context of the achieved recovery requires Croatia to abolish fiscal incentives, which could jeopardize the expected growth in the event of a worsening of the epidemic situation. In terms of gradual adjustment and avoiding a sharp tightening of fiscal policy, the European Commission's communication on the continuation of fiscal support and postponement of the numerical fiscal adjustment requirements in 2022[1] should be considered, as well as the announced discussion on their reform. However, despite the temporary postponement of the full application of numerical fiscal rules, the Commission recalls the need to continuously monitor and review the fiscal position and calls on the Government to present an analysis of fiscal rules when presenting budget documents and ensure their compliance in 2023 when fiscal rules will be active again.

Execution of the state budget of the Republic of Croatia for the first semester of 2021

The economic activity of the Republic of Croatia is rapidly recovering and is expected to soon reach pre-pandemic levels. Such developments favour the recovery and growth of budget revenues, which contributes to the reduction of the budget deficit. At the same time, budget expenditures continue to rise, which can be largely related to measures aimed at combating the consequences of the pandemic. In such circumstances, the Commission recalls the need to use the recovery for fiscal consolidation by controlling expenditure growth and redirecting it to areas that will contribute as much as possible to potential growth.

[1] Available at https://ec.europa.eu/info/system/files/com-2021-500_en.pdf.

According to the State Budget of the Republic of Croatia for 2021 (Amendments to the State Budget of the Republic of Croatia for 2021 from June 2021), total revenues are planned in the amount of HRK 150.2 billion, and in the first half of 2021 they amounted to HRK 74, 1 billion, which is 49.3% of the annual plan. Compared to the same period in 2020, total revenues increased by HRK 13.7 billion or 22.8%.

In the structure of tax revenues in the first half of 2021, HRK 37.5 billion was collected compared to the plan that foresaw HRK 32 billion, which is an increase of 16.9% (46.9% of the annual plan). The most significant growth in tax revenues was recorded in value added tax, profit tax and special taxes and excise duties. Revenues from value added tax in the first half of 2021 amount to HRK 24.6 billion (increase of 19.5% or 45.9% of the annual plan), from income tax of HRK 4.9 billion (increase of 19, 1% or 58.9% of the annual plan), from special taxes and excise duties HRK 7 billion (increase of 8.5% or 44.5% of the annual plan), while revenues from contributions amount to HRK 12.1 billion (increase from 15.9% or 48.4% of the annual plan). The increase in tax and contribution revenues is the result of increased economic activity and increased employment. Furthermore, revenues from aid in the first half of 2021 amount to HRK 12.4 billion (an increase of 19.4%), and relate to projects that are mostly financed from the European Union budget.

Total state budget expenditures in 2021 are planned in the amount of HRK 167.4 billion, and in the first half of 2021 they were made in the amount of HRK 84 billion (50.2% of the annual plan), which compared to the same period in 2020 represents an increase of HRK 6.9 billion or 8.9%.

Operating expenses amounted to HRK 81.9 billion (51.5% of the annual plan) and increased by HRK 7 billion year on year. The most significant increase in expenditures was recorded in the area of health care, where HRK 1.6 billion was allocated for settling part of debts to suppliers and HRK 2.7 billion for transfers to the Croatian Health Insurance Institute. An increase in expenditures was also recorded for employees in the public sector and allocations for pensions, which increased by HRK 1.9 billion year on year.

Despite the fact that part of the due liabilities of the health care system has been settled, these liabilities continue to grow uncontrollably. Also, in some positions, especially expenditures for salaries and pensions, there will not be enough funds and it will be necessary to provide additional funds for their financing.

The difference between the total revenues and expenditures of the state budget in the first half of 2021 amounts to HRK 9.8 billion (2.5% of GDP, or 57.7% of the annual plan). Compared to the same period in 2020, when it amounted to HRK 16.7 billion, the deficit is lower by HRK 6.9 billion. At the general government level, the total deficit amounts to HRK 9 billion (2.3% of GDP or 48% of the annual plan). Given the positive economic trends, the deficit at the level of the entire 2021 could be lower than the planned HRK 18.8 billion (or 4.7% of GDP). Thus, the general government deficit according to the ESA methodology could be slightly lower than the planned 3.8% of GDP in 2021.

Guidelines for the preparation of the state budget for 2022 and projections for 2023 and 2024

The State Budget Guidelines is a document that expands the general budget plan at the general government level presented in the Convergence Program of 29 April 2021 to the national methodology used for state and budgeting of other general government units.

In its 12th Position paper since June 2021, the Commission has assessed the Convergence Program and concluded several things. First, the Commission called on the Government, when drafting the 2022 budget, to revise its corrections in line with the achievements during the summer of 2021 and the expected dynamics of RRF withdrawals, and to maintain a conservative approach to budget revenue planning. Secondly, the Commission reminded 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 and compliance with numerical fiscal rules from 2023. Third, the Commission warned that when drafting the budget for 2022, it is necessary to come up with a more ambitious consolidation plan given the expected recovery, and limit the growth of current expenditures well below the expected high real growth rates.

Macroeconomic projections

The macroeconomic projections from the 2022 Guidelines were drawn up in March 2021 and did not assume such a strong and rapid recovery of the economy, which in the first half of 2021 grew by 7.5% compared to the same period in 2020, and strong growth continued in third trimester. On the other hand, the projections in the Guidelines are very optimistic about the amount and impact of the use of RRF funds in the next financial period. With such assumptions, the Guidelines predict that GDP will grow in real terms by 5.2% in 2021, 6.6% in 2022, 4.1% in 2023 and 3.4% in 2024.

The FRA requires that macroeconomic projections must be aligned with the European Commission's projections. In July 2021, the European Commission published a new projection[2] in which, based on the data available at the time, it increased the expected growth of the Croatian economy to 5.4% in 2021 and 5.9% in 2022, while expecting significantly slower price growth.

Such projections and trends in the second and third quarters of 2021 indicate that the projections from the Guidelines as well as the European Commission's summer projections are underestimated and need to be updated when drafting the following budget documents (amendments and budget proposals). On the other hand, the Government is optimistic about the projections for the next period, especially if an accelerated recovery is achieved in 2021. In such circumstances, the output gap closes as early as 2022 and Croatia will once again face the constraints of a low rate of potential growth, the increase of which requires the implementation of reforms and additional investment in sources of growth.

The Commission also warns of rising inflation due to rising raw material and producer prices on the international market, which could be further influenced by domestic factors, especially on the labour supply side due to emigration and unfavourable demographic situation. Also, although more efficient withdrawal and spending of RRF funds is desirable due to the greater multiplier effects of spending these funds on GDP and increasing economic potential, their increased use could create additional pressure in sectors such as logistics or construction that are already facing significant supply-side constraints.

[1] Available at https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/summer-2021-economic-forecast_en.

Budget projections

Given the necessary adjustments to macroeconomic projections, developments and thus part of the budget lines, the Commission welcomes the continuation of the current practice of conservative planning of budget revenues, which is reflected in a significant reduction in the share of revenues in GDP and decreases from 37.7% of GDP in 2021 to 33.9% in 2024. At the same time, as in previous views, it calls on the Government to evaluate and assess the risks of past and current activities and revenues and expenditures, in particular with regard to tax changes, in order to gain insight into their real fiscal effects.

The proposed projections from the Convergence Program indicate that the planned increase in budget expenditures is less than the potential growth. This approach, which is also contained in the fiscal rules, ensures that fiscal consolidation occurs automatically during the recovery period. Total general government expenditures are declining from 55.4% of GDP, as they were in 2020, to 50.5% in 2024, which is a good direction. However, planned expenditures are still significantly higher than in the pre-pandemic period (47.1% of GDP in 2019). In such circumstances, the Commission considers that additional modalities for limiting expenditure growth need to be sought, and it is important that this consolidation does not jeopardize the reforms and investments necessary to ensure faster growth.

The Commission draws attention to certain difficulties that have been present in recent years in planning expenditures. The health care system continuously records significant losses that need to be covered from the state budget, which was particularly pronounced during the pandemic. In addition, there is a continuous problem of insufficient planning (sub-planning) of necessary expenditures for salaries and pensions, which are regularly adjusted to the rebalances. Finally, the realized price growth could further complicate the planned expenditures and create additional pressure for their growth, especially those related to investments. Although most investments are planned to be financed by EU funds, rising prices and slower dynamics of their implementation could put additional pressure on public spending.

The planned budget indicates that during the planned period there will be a significant reduction in the general government deficit from the expected 3.8% in 2021 to 1.5% in 2024. However, such developments largely stem from the expected recovery and are cyclical in nature. In conditions of a low level of potential growth, the projected growth will lead to a sharp opening of the positive output gap as early as 2022.

The Commission recalls that in the event of expected economic growth in 2023, all conditions for reactivation of numerical fiscal rules will be met, which will require an annual correction of the structural deficit of 0.5 percentage points per year to reach the minimum medium-term budgetary target of -1% of GDP. Although the Commission believes that a sharp fiscal consolidation could jeopardize the recovery, the year 2022 is an opportunity for a significant easing of fiscal support, while in the context of strong growth in the coming years, the ambition should be a stronger fiscal consolidation in accordance with fiscal rules. The Commission warns that the current proposal for the 2022 Guidelines does not meet these requirements and that the consolidation of public finances over the next three years should be more significant in order to meet these conditions.

The Commission recalls that a key factor in fiscal sustainability stems from the growth of economic potential that serves as a basis for financing public spending. The Commission strongly calls for the fastest possible consolidation at all levels and the preparation of as many quality and sustainable projects as possible to withdraw funds to strengthen the economic recovery and resilience, but sees the challenges in existing capacities and the will to implement much-needed structural reforms within the entire public sector, especially in health, public administration and education, but also in other sectors. The government must insist at all levels and make every effort to, on the one hand, clearly and unequivocally embark on much-needed reforms and increase the efficiency of public spending and, on the other hand, attract as much EU funding as possible. The focus must be on projects that will bring the greatest added value to the economy and contribute to the growth of potential GDP, which will certainly have an impact on increasing the fiscal sustainability of the domestic economy.

The importance of economic growth for fiscal sustainability is best reflected in the evolution of the public debt-to-GDP ratio. During these two pandemic years, this ratio rose sharply both to secure the necessary fiscal support during the recession and to fall in the baseline. In the conditions of the expected economic boom, it is expected to decrease from 88.7% in 2020 to 86.6% in 2021, 82.5% in 2022, 79.5% in 2023 and 76.8% in 2024. . The expected reduction of this ratio in the three-year budget period is almost 10 percentage points or over 3 percentage points per year, which will achieve the fiscal rule of debt. However, the debt ratio will continue to be significantly higher than before the pandemic, and continued efforts will be needed to ensure fiscal sustainability.