



Fiscal Policy Commission

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14. Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for 2021

At its 9th session held on 2 November 2021, the Fiscal Policy Commission (hereinafter: Commission) discussed the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for 2021, which were submitted in the form of an act to the Speaker of the Croatian Parliament by the Croatian Government on 28 October 2021.

The proposed amendments to the 2021 State Budget foresee an increase in the general government budget deficit and public debt in 2021 as a result of countercyclical fiscal policy aimed at combating the epidemic and its economic consequences. The Commission agrees with this Draft Amendment, but, as many times before, emphasizes the need for better planning and control of expenditure, especially in the healthcare system.

For the second year in a row, the global economy, including the Croatian, is threatened by the COVID-19 pandemic, which requires strong funding for healthcare interventions and other measures to mitigate its economic and social effects, including supporting the recovery and increasing the resilience of the economy. Accordingly, the provisions of the Fiscal Responsibility Law and the Stability and Growth Pact have been applied, which allow a temporary deviation from the prescribed numerical rules, but only on the condition of protecting the medium and long-term sustainability of public finances.

With the proposed Amendments, the State Budget is amended for the second time in 2021; they include primarily already realized trends and activities on the revenue and expenditure side and can be considered a technical amending budget without major impact on further policies.

When considering the budget documents relating to the Draft Amendments to the State Budget, the Commission primarily focused on assessing the credibility and realism of macroeconomic and budgetary projections, their comparison with the latest projections of the European Commission (EC) in accordance with Art. 22 paragraph 2 of the Fiscal Responsibility Law and the analysis of the situation in public finances and the impact of budgetary plans on the medium- and long-term sustainability of public finances from the perspective of Art. 10 paragraph 3 of the Fiscal Responsibility Law. In particular, when considering the adopted measures, the

Commission observed their targeting, short duration and temporary nature, and did not consider the temporarily postponed numerical fiscal rules from the preventive part.

Macroeconomic projections

The economic policy measures taken, combined with vaccine development and greater consumer optimism, have contributed to the rapid recovery of economic activity nationally and globally. The trends realised, especially during the summer months of 2021, indicate that the Croatian economy will already reach pre-pandemic levels in 2021.

In the Draft Amendments to the State Budget for 2021, the Government of the Republic of Croatia has increased expectations about economic growth, and predicts that in 2021 the growth of real gross domestic product will amount to 9% (compared to 5% from the initial Draft Budget for 2021 and 5,2% from the Convergence Programme, whose macroeconomic projections are incorporated in the first Amendments to the 2021 State Budget from June 2021). This is mainly due to the growth in private and government spending and the recovery of exports of services (tourism).

The Commission assesses macroeconomic and budgetary projections based on their realism, and by comparison with EC forecasts. However, the latest available EC forecasts were published in July and do not include the recovery in the second and third quarters of 2021, and predict GDP growth in 2021 of only 5.4%. However, the EC should increase its expectations in the upcoming Autumn Forecast, so that the deviation of these two projections is expected to decrease by as much as 3.6 percentage points. However, the Commission emphasizes the fact that the Government's projections are higher than the projections of other relevant institutions and points to the need for a more conservative approach when making projections for the next period, especially since part of the growth previously projected for 2022 has been achieved in 2021, whereas growth in the next medium-term period is generally limited by a low potential growth rate.

Assessment of the Draft Amendments to the State Budget for 2021

The proposed Amendments to the State Budget for 2021 involve an additional increase in the revenue and expenditure of the State Budget. Given the specific circumstances, during the assessment it needs to be identified to what extent these amendments are targeted, temporary and transient. It should also be emphasized that the proposed amendments are of a technical nature as they largely reflect the activities already carried out. On the revenue side, the amendments relate primarily to better-than-expected performance. On the expenditure side, the amendments relate to measures taken to combat the effects of the pandemic, but also to some items that do not meet the target and temporality requirements. The Commission continuously emphasizes the need to better anticipate certain items such as staff and pension expenditure, and in particular health expenditures, which are often initially planned at unrealistically low levels, in order to be increase with subsequent amendments.

Total budget revenues should amount to HRK 153.6 billion (of which operating revenues amounting to HRK 152.9 billion, and revenues from the sale of non-financial assets HRK 769 million) and are increase by HRK 3.3 billion, which primarily results from generating better tax revenue stream, which increased by HRK 2.4 billion compared to the amendments from June. Higher budget revenues are primarily the result of a better tourist season and stronger economic activity.

Total state budget expenditures shall increase by HRK 6 billion (from HRK 167.3 to HRK 173.3 billion). Expenditures financed from general revenues and receipts, contributions and assigned receipts shall increase by HRK 7.1bn, while expenditures financed from the EU and other sources shall decrease by HRK 1.1bn. The increase refers to additional funds for debt settlement and the functioning of the healthcare system (HRK 1.5 billion) and support for preserving jobs in activities affected by the COVID-19 epidemic (HRK 608 million). However, expenditures not related to the consequences of the pandemic, such as expenditures for employees (HRK 929 million) and pensions (HRK 672 million), as well as the contribution to the EU budget (HRK 495 million), have also increased. In addition, an advance is planned for the procurement of fighter jets of HRK 2.4 billion, which will be reported in 2023 according to the ESA methodology.

In accordance with the planned revenues and expenditures, the State Budget is expected to post a deficit of HRK 19.7 billion or 4.7% of GDP, which is a significant deterioration compared to what was previously planned (e.g. 2.7% of GDP from October 2020 and 4.2% of GDP from June 2021.) The general government deficit, according to the ESA 2010 methodology, will amount to HRK 18.9 billion or 4.5% of GDP (which also provides for a significant increase compared to the original plan from October 2020, which amounted to 2.9%, and the first amendments from June 2021, which envisaged a deficit of 3.8%). Based on the development of the fiscal balance of the general government budget, the share of public debt in GDP in 2021 is expected to decrease by 4.2 percentage points compared to 2020 and will amount to 83.1% of GDP.

Although the projected deficit exceeds the reference value of 3 % of GDP, the Commission considers that increased government spending was necessary in the previous period to mitigate the negative effect of the pandemic. However, the Commission considers that part of the increased government spending did not involve expenditures directly related to combating the pandemic and addressing related economic damage, nor was it of a temporary nature, but referred to a permanent increase in general budget spending in the form of increased expenditures for employees and pensions in the amount of HRK 1.7 billion only in this Draft Amendment to the State Budget, which will spill over to the next year with likely pressures for further increases due to stronger inflation. Therefore, in view of the achieved economic recovery, a stronger fiscal consolidation is required, which should take into account measures to ensure funds that are aimed at investments and reforms needed to increase the potential growth rate, which would be financed as much as possible under EU support programmes, and as little as possible from own sources of funding. In the conditions of accelerated population aging, the concept of intergenerational solidarity is also compromised, a concept under which

the costs of current consumption are passed on to future generations, so it would be desirable to take certain reform measures without compromising the basic principles of the already implemented pension reform. Primarily, this refers to the reform of the healthcare system in such a way that it does not generate additional losses that are continuously, year after year, object of the amending budget.