REPUBLIC OF CROATIA
FISCAL POLICY COMMISSION

Pula, Zagreb, 16 May 2022

16th Position Paper of the Fiscal Policy Commission on the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2021

At its 12th (online) session held on 16 May 2022, the Fiscal Policy Commission (hereinafter: Commission) discussed the Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2021 adopted by the Government of the Republic of Croatia (hereinafter: Government) at its 118th session held on 12 May 2022.

The Commission holds that fiscal policy in 2021 was appropriate, because it enabled strong fiscal changes in response to the COVID-19 crisis, and responsible, because it did not endanger mid-term fiscal sustainability. However, the Commission reiterates the need to implement decisive reforms in the healthcare and pension sector as well as in the domain of employee compensation as these areas are in fact the largest load on the state budget.

After a deep recession caused by the COVID-19 pandemic, in 2020, Croatian (but also global) economy underwent a strong recovery in 2021. A normalization of the overall situation also resulted in a significant recovery of economic activity, especially tourism in the summer months, bringing economic activity in the last quarter of 2021 back to pre-pandemic levels . Thus, after economic activity decreased in 2020 by as much as 8.1 %, in 2021, the economic growth rate increased to 10.2 %. A positive GDP trend was primarily a result of growing domestic demand and net foreign demand. However, after the recovery of economic activity in the second half of 2022, an increase in prices ensued due to insufficient supply caused by the pandemic (issues with supply chains and decreased supplies) which, considering a strong recovery in demand, additionally increased nominal GDP and the tax base.

Over the last two years (2020 - 2021), countercyclical fiscal policy played an essential role in mitigating the damage caused by the pandemic and creating the preconditions for economic recovery. Fiscal rules are in fact meant to facilitate a countercyclical effect of fiscal policy in times of crisis. Therefore, at the beginning of 2020, the application of fiscal rules was temporarily postponed at the level of the European Union (EU), and thus also in the Republic of Croatia (Croatia). On 2 November 2020, in its 10th Position Paper on the Draft State Budget for 2021, the Commission issued a positive opinion on the continued postponement of the application of fiscal rules in the EU and Croatia in 2021.

The strong recovery of economic activity that was unexpectedly achieved in 2021 also deeply affected Croatian public finances. This primarily relates to the achievement of total income which, at the level of the general government (ESA2010), in 2021, through strong nominal and real growth, increased by 11.8 %, mostly due to an increase in indirect taxes (by 17.5 %, with VAT only increasing by 20.9 %), while contributions increased by 10.7 % and non-tax income by 13.6 %. On the other side, direct taxes decreased by 5.6 % due to a decrease in personal income tax and profit tax and a decline in financial operations in 2020.

Furthermore, in June and October 2021, amendments to the state budget for 2021 were adopted and the total initially planned income in the amount of HRK 147.3 billion was increased through the amending budget by a total of HRK 6.8 billion eventually totalling at HRK 154.1 billion compared to the original plan for 2021 (4.6 % more than planned). On the other hand, total state budget expenditure for 2021 was initially planned in the amount of HRK 157.9 billion, and was finally executed in the amount of HRK 169.0 billion in 2021 (HRK 11.1 billion or 7 % more than the plan). In this respect, general government expenditure (pursuant to the ESA2010 methodology) increased by a total of HRK 5.8 billion (2.8 %), mostly due to the phasing out of the measures to mitigate the effects of the COVID-19 pandemic and the financing costs due to lower interest rates and restructuring of government debt. Thus, for example, COVID-19 measures decreased from HRK 14.2 to 9.5 billion, and financial expenditure decreased by HRK 0.8 billion. If the effect of COVID-19 measures is excluded from the calculation, general state expenditures in 2021 increased by 5.4 %, that is, 6.1 % if financial expenditure is also excluded. The greatest increase occurred in material expenditures (11.6 %), expenditure for employees (6.7 %) and pensions (4.5 %).

Such favourable conditions facilitated strong fiscal consolidation and a decrease of general government deficit (ESA2010) from HRK 27.7 to 12.4 billion.[1] This decrease of general government deficit is even more significant if compared to the level of GDP which saw a strong recovery in 2021. General government debt, as measured by the share in GDP, decreased from 7.3 % of GDP during the crisis year of 2020 to 2.9 % (or HRK 12.4 billion) in 2021 mostly due to a strong decrease of the state budget deficit. Looking at the subsectors, the central government achieved a deficit of 3 % of GDP, the local government achieved a deficit of 0.3 % of GDP, and social security funds achieved a surplus of 0.4 % of GDP. This is a significant decrease and an achievement that puts Croatia below the reference level of general government deficit of 3 %, i.e. the budgetary deficit ceiling which triggers the excessive deficit procedure.

[1] Report on excessive deficit and general government debt procedure, Republic of Croatia, April 2022 (ESA 2010).

Despite these positive indicators, general government deficit in 2021 actually continued its strong nominal increase trend (HRK 343.6 billion at the end of 2021). However, due to strong economic recovery, the share of debt in GDP, after a strong increase in the previous year, decreased from 87.3 % of GDP in 2020 to 79.8 % of GDP in 2021. The high level of public debt exceeds the reference value of 60 % of GDP and greatly limits the possibilities of intense use of fiscal policy for anti-crisis action. **Therefore, the Commission supports the stronger fiscal consolidation achieved in circumstances of unexpectedly strong growth and reiterates the importance of using the period of economic growth for stronger fiscal consolidation and creating the necessary fiscal space for countercyclical policy in a crisis situation.**

The Commission also underlines that the Government, in adopting the Annual Report on the Execution of the State Budget, again failed to draft the ancillary Report on the achievement of fiscal rules. Temporary postponement of the application of fiscal rules refers only to the allowed exceeding of the minimum fiscal consolidation level prescribed, in numbers, in preventive and corrective procedures of the Stability and Growth Pact [2], and does not eliminate the need for drafting the prescribed report. Unlike the preceding year, 2020, when, due to the high level of uncertainty, the Government did not publish its evaluation of potential GDP required for the calculation of the structural balance, these calculations are incorporated in the Convergence Programme of the Republic of Croatia for the period of 2023 - 2025.

According to the Commission's assessment, the great shock of the pandemic resulted in major oscillations in the GDP gap. After the economy grew above its potential level in 2019, in 2020 it slowed down considerably due to the pandemic, and recovered completely in 2021. All of this caused large fluctuations of the production gap and, consequently, of the cyclical budget components. Extraordinary COVID-19 measures, as well as the measures aimed at remediating the damages caused by the earthquake, additionally hinder the evaluation of the structural balance. The Commission's assessment which is based on the Convergence Programme indicates that the structural balance in the pandemic year of 2020 and in 2021 revolved around the level of the mid-term budgetary target.

The Commission concludes that the fluctuations of the budget deficit and public debt in the last two years were, first and foremost, a consequence of the pandemic, which is best reflected in the heavy decline in budget income in 2020 as well as its recovery in 2021. The implementation of exceptional COVID-19 measures (HRK 14.2 billion in 2020 and HRK 9.5 billion in 2021) was necessary to protect citizens' health and maintain the potential of the economy; the overall fiscal policy was appropriate and responsible because the strong fiscal response to the crisis did not endanger mid-term fiscal sustainability.

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[2] A decrease of structural deficit according to the mid-term fiscal target which amounts to -1 % of GDP for the Republic of Croatia.

Nevertheless, the Commission points to the significant increase in public debt during the pandemic which neutralized the effect of the fiscal consolidation in the previous period. Therefore, in the upcoming period, the growth of long-term expenditures should be strictly controlled, especially expenditure for healthcare, pensions and employee compensations. Reforms in those sectors are necessary to ensure long-term sustainability of Croatian public finance.