



REPUBLIC OF CROATIA  
FISCAL POLICY COMMISSION

Pula, Zagreb, 16 May 2022

**17th Position Paper of the Fiscal Policy Commission on the Draft Amendments to the State Budget of the Republic of Croatia and the Financial Plans of Extra-Budgetary Users for 2022 and the Projections for 2023 and 2024**

At its 12th session held on 16 May 2022, 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 2022 and the projections for 2023 and 2024.

*The Commission considers the proposed macroeconomic and budgetary plans to be appropriate for the current situation, and highlights the need that EU funds be utilized as much as possible to finance investments and reforms for the purpose of stimulating productivity growth, and reiterates the importance of implementing reforms to restrain the growth of expenditure for healthcare, pensions and compensations for employees. It also points to the increasing risks of inflation growth and economic consequences of the war in Ukraine that demand an active response of economic and fiscal policy holders.*

**The evaluation of macroeconomic projections for 2022**

In addition to the existing duties laid down in the Fiscal Responsibility Act (OG 111/18), mainly aimed at monitoring the following of fiscal rules, in early 2022, the Commission also took on the task of evaluating macroeconomic and budgetary projections pursuant to Article 21(2) of the new Budget Act (OG 144/2021) which incorporates the provision that, for Euro area member states, budgetary projections should be based on independent macroeconomic projections prepared or endorsed by an independent fiscal authority

which, in the Republic of Croatia, is the Fiscal Policy Commission. By the decision of the Council of the European Union on the introduction of the Euro as the official currency in the Republic of Croatia, Article 21(3) will also come into force and, accordingly, the macroeconomic projections underlying the convergence programme and the draft budgetary plan, will have to be endorsed by the Commission.

The year 2021 has seen a quick and record-breaking growth rate of the Croatian GDP, impelling Croatia to exceed the level of economic activity achieved in 2019, the year before the pandemic, and step into 2022 with optimism. However, the year 2022 is not without certain negative macroeconomic risks. The risks are primarily based on the escalation and consequences of the war in Ukraine, further disruption of supply chains and instabilities on financial markets caused by the tightening of the monetary policy due to increasing inflation. In response to this, the Government of the Republic of Croatia, in its Convergence Programme for 2023 - 2025, revised its macroeconomic projections underlying the Draft Amendments to the State Budget for 2022. Hence, the initially projected GDP growth rate for 2022 was lowered from 4.4 % to 3 %, and the inflation rate was raised from 2.6 % to 7.8 %. It is expected that the main factor contributing to GDP growth will be an increased export of goods and services and gross investments in fixed capital.

In evaluating macroeconomic projections, the Commission retained the approach of comparing the Government's macroeconomic projections with the projections of other institutions.

Table 1 Macroeconomic projections for 2022 according to various institutions

Institution	Croatian National Bank	International Monetary Fund	World Bank	Croatian Government	European Commission
GDP	3.2	2.7	3.8	3.0	3.4
Inflation	5.4	5.9	6.1	7.8	6.1

The Commission came to the conclusion that the macroeconomic projections for 2022, underlying the Draft Amendments to the State Budget, are appropriate as they do not deviate from the projections of other institutions. In this regard, the Government expects

a substantial increase in prices, which means that the nominal values of the tax base for calculating budgetary income will increase as well. Considering the significant negative macroeconomic risks and the current practice of conservative planning of the growth of real activity and budgetary income, the Commission considers this approach appropriate and highlights the necessity to maintain it in preparing the budget for 2023 and its updates in case negative risks are achieved.

### **Evaluation of Draft Amendments to the State Budget for 2022**

To a certain extent, Draft Amendments to the State Budget for 2022 acknowledges new macroeconomic circumstances. The planned increase in state budget expenditures for 2022 also provides for an amelioration of the economic consequences of the war in Ukraine, the costs of receiving and hosting Ukrainian refugees as well as securing gas supplies and procuring buffer stock. State budget expenditures also include increased expenditure for higher bases for accounting salaries in state and public services by 4 % as of 1 May 2022, ensuring funds for measures to mitigate energy prices, including subsidies for gas prices, compensation for vulnerable energy buyers and a four-billion-kuna increase in healthcare expenditure, the largest part of which relates to hospitals' and pharmacies' debts and liabilities toward suppliers.

The state budget for 2022, adopted by the Croatian Parliament on 8 December 2021, forecast income in the amount of HRK 164.5 billion, expenditure in the amount of HRK 173.8 billion, and a budget deficit of HRK 9.3 billion (or 2.6 % of GDP). These amendments to the state budget for 2022 forecast state budget income in the amount of HRK 171 billion (increase of HRK 6.6 billion or 4 % compared to the original plan) and expenditure in the amount of HRK 184.7 billion (increase of HRK 10.9 billion or 6.3 % compared to the original plan).

State budget income foreseen in the Amendments to the State Budget of the Republic of Croatia for 2022 is based on expected economic activity trends, taking into consideration the fiscal effects of tax changes in the value added tax system (VAT; decrease of VAT on certain products) and excise tax regulations (partial decrease of excise tax on certain energy sources) implemented to mitigate the inflation-induced pressure on citizens and the economy, as well as of withdrawing the contracted EU funds from the EU budget, Next

Generation EU and the Solidarity Fund. Increase of budget income from EU funds only is HRK 1 billion. In terms of tax income, an increase is forecast to be HRK 3.2 billion, mostly on account of increased revenue from VAT due to the expected trends of the nominal value of personal consumption and tourist activity, and partly due to increased income from assets and contributions.

The amending budget for 2022 foresees the greatest increase of expenditure financed from general income and revenue for healthcare recovery (HRK 3.5 billion), pensions (HRK 1.8 billion), expenditure related to the consequences of the war in Ukraine (HRK 1 billion) and expenditure for employees (HRK 550 million). Within the expenditures financed from EU and other sources, the increase is a result of ensuring funds for measures to mitigate increasing energy prices in the amount of HRK 898 million and expenditure related to the projects of remediation of damages caused by the earthquake in the amount of HRK 185 million.

The Commission reiterates the potential risks related to the achievement of such plans, and these include uncontrolled growth of expenditure for healthcare (primarily hospitals' and pharmacies' debts and liabilities toward suppliers). The fact that the healthcare sector generates a new monthly debt of between 400 and 500 million kunas is especially alarming. Moreover, the coronavirus pandemic is not over yet and a potential new wave of one of the coronavirus strains also carries the risk of additionally increasing healthcare costs. The Draft Amendments to the State Budget for 2022 indicate the intention to moderately consolidate public finances, and the Commission proposes to the Croatian Government to carry out an evaluation of the past and present activities in the healthcare sector so as to determine their actual fiscal effects on economy development. The Commission considers it necessary to assess the future risks of budget expenditure, especially bearing in mind the increasing debt of the healthcare system as well as the public sector salary system and significant potential liabilities related to the operation of local public companies.

According to the ESA 2010 methodology, the total result of the amendments to the state budget for 2022 planned in this manner will result in a general government deficit of HRK 13.4 billion (i.e. 2.8 % of GDP), which is 0.3 percentage points more than initially planned,

but still within the limits of the Maastricht criteria, while the share of public debt in GDP should be 76.2 % of GDP, 3.6 percentage points less than in 2021.

Although fiscal rules have been temporarily postponed, the Commission reminds the Croatian Government of the necessity to draft a Report on the application of fiscal rules, together with draft budgetary documents presenting the trends of structural balance, expenditure and public debt, so as to be able to examine the level of countercyclical effect of fiscal policy. All the supporting analyses are presented in the Convergence Programme, underlining the new evaluation of the so-called fiscal impulse. Therefore, preparing the prescribed Report should not be particularly challenging.

According to the Commission's analyses and assessment, the production gap will stay at the level of app. 1 % of GDP in 2022. In that regard, the discontinuance of COVID-19 measures will be of greater effect than the new one-off measures aimed at mitigating the effect of increasing prices and the economic consequences of the war in Ukraine. In such circumstances, the assessed structural deficit will slightly increase. However, because the decrease in the share of public debt in GDP is expected to continue, as will the temporary postponement of the application of fiscal rules, the Commission considers this temporary aggravation of the structural deficit to present no threat to public finances in the mid-term.

The Commission holds the proposed budgetary plans appropriate for the current situation of continued negative macroeconomic shocks which require constant monitoring of the economic position of the Croatian economy and a timely correction of fiscal policy. In doing so, the Commission points out that the main generator of unplanned increase in expenditure is the expenditure for healthcare, pensions and compensations for employees, and invites the Croatian Government to implement the necessary reforms in those sectors so as to ensure long-term sustainability of Croatian public finances.