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6th 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 2020 and the Convergence Programme for 2020 and 2021

At its 4th session held (remotely, by electronic means) on 11 May 2020, the Fiscal Policy Commission (hereinafter: the Commission) discussed the Draft Amendments to the State Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for 2020 and the Convergence Programmes for 2020 and 2021, which were submitted in the form of an act to the Speaker of the Croatian Parliament by the Croatian Government on 7 May 2020.

The Fiscal Policy Commission considers the proposed budgetary plans appropriate to the current situation of deep recession and limited fiscal space, provided that the measures foreseen remain short-term and focused on mitigating the impacts of the pandemic. The Commission draws the attention to significant negative macroeconomic risks that require continuous monitoring of the economic position and timely correction of the fiscal policy with a view to ensuring medium- and long-term sustainability of public finances.

Global economy, including the Croatian economy, found itself in extraordinary circumstances that have caused numerous negative consequences due to the COVID-19 pandemic. Due to these extraordinary circumstances, the Government, in accordance with the recommendation of the Commission of 30 March 2020, at its session held on 2 April 2020 adopted a Decision on the temporary postponement of the implementation of the fiscal rules, according to which the numerical fiscal rules referred to in Articles 6, 7, 8 and 9, in line with Article 10 of the Fiscal Responsibility Law and the rules of the European Union, are temporarily suspended.

The main objective of the Fiscal Responsibility Law is to ensure and maintain fiscal responsibility, transparency and medium- and long-term sustainability of public finances. This objective is achieved by establishing, implementing and strengthening fiscal rules on the basis of which the Government determines and implements its fiscal policy. The provisions of the Fiscal Responsibility Law, taken over from the legal acts of the European Union, in the case of a negative event beyond the control of the Member States or a deep economic crisis at EU level provide for the possibility of derogating from numerical rules, all in order to ensure the medium-and long-term sustainability of public finances by protecting the economic potential. Therefore, under conditions of temporary postponement of the implementation of fiscal rules, it is necessary to analyse the situation and the medium and long-term sustainability of public finances.

When considering the budget documents, 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, without considering the numerical fiscal rules.

1. Macroeconomic projections

By analysing the budget documents, the Commission found that:

- the Convergence Programme and the Draft Amendments to the State Budget for 2020 are based on a single macroeconomic projection;
- macroeconomic and budgetary projections are relatively optimistic and do not include the potential effects of negative risks, which are potentially large, and
- macroeconomic and budgetary projections from the Convergence Programme do not deviate significantly from the latest projection of the European Commission of 6 May 2020. As far as the Croatian economy is concerned, the EC predicts a GDP decline of 9.1% in 2020 and GDP growth of 7.5% in 2021, while the 2020 Convergence Programme predicts a decline of 9.4% and growth of 6.4% in 2021. Both of these projections are based on common and aligned assumptions about the short duration of the epidemic.

According to the 2020 Convergence Programme, the GDP decline is largely due to the domestic demand (-5.3 percentage points) and net exports (-3.3 percentage points). It is assumed that the first wave of the epidemic is also the largest, so the largest decline in GDP is expected in the second quarter of 2020, with the transfer of some negative effects to the third quarter of 2020 due to the weak tourist season. However, the risks of achievement of these macroeconomic projections from the Convergence Programme are significant and markedly negative, and are related, first of all, to the uncertainty of the intensity and duration of the epidemic and possible, financially significant, measures necessary to combat it. The economic risks of achievement of these projections are primarily related to the possibility of a significantly larger initial decline in GDP than projected, a stronger decline in the potential of the Croatian economy, insufficiently fast recovery and the transfer of new negative shocks from abroad.

Given that the risks of macroeconomic projections are predominantly negative because they show the best case scenario of the epidemiological crisis, **the Commission deems the macroeconomic projections from the Convergence Programme to be insufficiently**

conservative. Considering the degree of uncertainty and negative risks of projections, the main projection scenario should include the effects of some of the negative risks. There are two reasons why a more conservative approach to macroeconomic projections would be more appropriate. The first refers to the fact that the projection of budget revenues is related to macroeconomic projections, which means that in the case of materialisation of only part of the negative risks, the budget deficit and public debt could be higher than projected. Furthermore, regardless of the temporary postponement in the implementation of numerical fiscal rules, the government must take account of medium- and long-term fiscal sustainability, thus in macroeconomic projections that do not include at least some negative risks the possibility of permanent increases in deficit and public debt that would jeopardize fiscal sustainability is not taken into account.

Therefore, the Commission considers the macroeconomic and budgetary projections from the Convergence Programme from the perspective of the Fiscal Responsibility Law to be appropriate due to the similarities with the European Commission's projections, but draws the attention to the negative risks that indicate the need for continuous monitoring of macroeconomic developments and timely adjustment of the fiscal policy in the case of materialisation of such risks.

2. Impact of budgetary plans on medium- and long-term fiscal sustainability

This year's Convergence Programme, made in an abbreviated scope as instructed by the European Commission, contains macroeconomic and fiscal projections for 2020 and 2021, with a focus on measures to mitigate the effects of the epidemic, while the standard assessment of the structural balance, fiscal rules and long-term sustainability of public finances is left out. Due to the temporary postponement of implementation of the fiscal rules, both budget documents (Convergence Programme and Draft Amendments to the State Budget for 2020), are not accompanied by Reports on the Implementation of Fiscal Rules provided for in Article 30 of the Fiscal Responsibility Law. **However, the Commission points out that these reports are used for the analysis of medium-term fiscal sustainability and calls on the Ministry of Finance to prepare such an analysis when drafting future budgetary plans, regardless of the possible postponement of implementation of the fiscal rules.**

In 2020, the planned general government balance according to the ESA methodology, after three years of nominal surplus, will deteriorate significantly and will have a deficit of -6.8% of GDP (-2.4% in 2021). Given the intensity of the recession, such developments are relatively favourable, and, along with optimistic assumptions and projections, they also result from the statistical treatment of deferred payment of taxes and contributions, which, regardless of deferred payment, are accounted for as income in the year of commitment, which means that the actual inflow of funds will be significantly lower.

Under such conditions, government debt will increase sharply from 73.2% in 2019 to 86.7% of GDP in 2020. In addition to the statistical treatment of deferred payments, this is also the consequence of increased pre-financing of expenditures from EU funds and reduction in government deposits as compared with the situation at the end of 2019. The projected recovery and decline in the budget deficit in 2021 will lead to a reduction in the public debt-to-GDP ratio to 83.2%, indicating a short-term disruption and a gradual return to the path envisaged by the fiscal rules.

As this year's Convergence Programme does not contain a calculation of the cyclical position of the economy and structural balance, the Commission's assessment is based on the calculations from the projection of the European Commission.

Public finances are assessed by the structural balance that is based on an estimate of the potential GDP, which is particularly difficult to estimate in times of crisis. An additional difficulty is the fact that current macroeconomic shocks affect the change in the assessment of past trends. Due to the large economic downturn in 2020 and the gradual recovery in 2021, the assessed potential of the Croatian economy has been watered down. Thus, according to the projections of the European Commission, in 2020 the Croatian economy will perform far below its potential with an estimated negative output gap of a high 6.1%. In such conditions, due to reduced income and increased expenditures for the unemployed, the cyclical component of the fiscal balance is extremely negative and amounts to 2.7% of the potential GDP. If this calculation is linked to the plans from the Convergence Programme, the corresponding cyclically-adjusted fiscal balance in 2020 is estimated at 4.1% of GDP.

Given the full application of the flexible approach and in order to encourage a stronger fiscal response by the Member States, in its latest projections the European Commission has not made the calculation of structural balance according to the current practice that excludes one-off measures related to adverse events. The Commission, however, considers that this approach helps to assess the state of the fiscal position and its medium-term sustainability, and has used it in its assessment of budgetary plans. One-off measures aimed at combating the consequences of the epidemic under the Convergence Programme amount to over HRK 10 billion, of which HRK 2.5 billion on the side of tax write-offs. To this should be added HRK 100 million of expenditures for financing the impacts of the earthquake, which means that the total amount of one-off measures ranges from 2.2 to 2.8% of GDP, depending on the treatment of tax write-offs in the definition of one-off measures. Thus, the structural deficit in 2020, which results from the budget documents of the Government, is significantly lower and amounts to 1.3 to 1.9% of GDP.

Therefore, the Fiscal Policy Committee holds that the proposed budgetary plans are appropriate to the current state of deep recession also under the conditions of limited fiscal space due to the high level of public debt, under the assumption that the envisaged measures remain short-term and aimed at mitigating the effects of the crisis and preserving the potential of the Croatian economy. In this sense, the proposed budget

documents indicate efforts to ensure medium-term sustainability of public finances in accordance with Art. 10 paragraph 3 of the Fiscal Responsibility Law.

3. Assessment of the Draft Amendments to the State Budget for 2020

The Commission welcomes the fact that the fiscal values from the Draft Amendments to the State Budget for 2020 and from the Convergence Programme for 2020 have been aligned.

The Draft Amendments to the State Budget for 2020 recognize the existence of a major macroeconomic shock and decline in budget revenues along with the simultaneous emergence of new categories of expenditures to finance the fight against the epidemic and support the most affected workers and companies to preserve the economic potential. The decline in budget revenues by HRK 23.2 billion or 16% compared to the previous plan for 2020, is primarily expected in tax revenues. Thus, for example, revenues from taxes on goods and services are projected to fall by HRK 15.2 billion, primarily as a result of the reduction of value added tax and excise duties due to the decline in personal consumption and the weak tourist season, and a decline is also expected in corporate income tax and contributions

The Draft Amendments to the State Budget for 2020 keeps total expenditures at the same level as in the original plan for 2020, but significant reallocations were made in order to provide funds to finance measures and activities to combat the epidemic and its consequences. The planned expenditures were also compared with the amounts after the reallocation of the initially planned funds (savings on intermediate consumption, investments and expenditures for employees to finance increased subsidies for job preservation) adopted by the Government at the session held on 9 April 2020. The Commission points out that, in order to ensure greater transparency, the proposed amendments should be presented in comparison with the original budget for 2020 in the form in which it was adopted by the Croatian Parliament.

The Commission considers this approach to be correct and in line with the Commission's recommendations of 30 March 2020, as it adjusts the fiscal policy response to downturn by maintaining the planned level of public expenditure due to the temporary need to finance mitigation measures while respecting limited fiscal space.

However, the Commission also warns that this approach involves several risks. Firstly, fiscal expenditures aimed at combating the epidemic are focused on the second quarter of 2020 and do not provide for significant amounts for the second half of 2020, in which a gradual recovery is foreseen, yet at levels significantly lower than in previous years. Secondly, no additional activities are envisaged that could spur a faster economic recovery after the peak of the epidemic. Thirdly, the reallocation of funds within the state budget will affect a decline in intermediate consumption, which implies a significant decline in government spending and weaker demand towards the private sector in the period of abatement, when insufficient domestic demand is expected, and the implementation of EU-funded programmes and projects, whereas a significant part of these funds has been redirected for the procurement of medical supplies and equipment and the financing of job preservation measures.

4. Financing risks

The Commission also warns of significant financing risks. It is foreseen that financing needs will be met in both the domestic and international markets, but financing relies primarily on the domestic market, while one bond is planned to be placed on the foreign market using project loans from international financial institutions. However, given that compared to 2019 the financing needs are significantly higher, it is uncertain whether there is sufficient demand and capacity in the domestic financial market. Higher debt increases the risk of rising costs of interest on external borrowing, which can directly affect fiscal sustainability and competitiveness. In addition, the upcoming parliamentary elections also pose an additional fiscal risk that will depend on the speed of forming a new government. For this reason, the Commission welcomes the efforts to make most of the financing before the elections.