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9th Position Paper of the Fiscal Policy Commission on the Proposed Amendments of the State Budget of the Republic of Croatia and extra-budgetary users' financial plans for 2020

At its 6th (electronic) meeting held on 2 November 2020, the Fiscal Policy Commission (hereinafter: the Commission) deliberated on the Proposed Amendments of the State Budget of the Republic of Croatia and extra-budgetary users' financial plans for 2020, which the Government of the Republic of Croatia submitted to the Speaker of the Croatian Parliament by the act of 29 October 2020.

The Commission supports the Proposed Amendments to the State Budget despite the increase in the general government budget deficit and public debt in 2020, as they are the result of countercyclical fiscal policies aimed at combating the epidemic and its economic consequences.

The world and Croatian economies have found themselves under extraordinary circumstances of the COVID-19 pandemic, which requires strong support from public finances in order to mitigate its negative consequences and stimulate aggregate demand. In that sense, the Council of the European Union (hereinafter: the Council) applied a general clause derogating from the budgetary rules set out in the Stability and Growth Pact in March 2020 to enable fiscal stimulus to be provided in the Member States. The Croatian Fiscal Responsibility Act provides for a temporary postponement of the application of fiscal rules in the event of extraordinary circumstances, provided that this does not jeopardize fiscal sustainability in the medium term, in accordance with European Union rules. In accordance with the recommendation of the Fiscal Policy Commission of 30 March 2020, on 2 April 2020 the Government of the Republic of Croatia adopted a *Decision on the temporary postponement of the application of fiscal rules* (Official Gazette 41/2020) from Articles 6, 7 and 8 of the Fiscal Responsibility Act (hereinafter: FRA), which temporarily suspended the application of numerical fiscal rules. Delays in applying the rules must be temporary, fiscal policy measures must be linked to a negative event, and long-term fiscal sustainability must not be jeopardized. In doing so, the benchmarks - the allowed budget deficit of 3% of gross domestic product and the public debt of 60% and / or the reduction trajectory - are still in force, and the European Commission (hereinafter: EC) is obliged to regularly assess and report to the Council if it assesses that there is a risk that these criteria will not be met. On 20 May 2020, the EC issued the *Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union*[1], in which it identified a probable exceeding of the deficit criteria in 2020 and concluded that it was exceptional and temporary, which is why it did not initiate corrective measures. Moreover, in its *Country-specific recommendations* adopted by the Council on 20 July 2020[2], the Council recommended that the Republic of Croatia "take all necessary measures, in line with the general escape clause of the Stability and Growth Pact, to effectively address the COVID-19 pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment. "

The aim of the fiscal rules is to provide space for conducting counter-cyclical fiscal policy in order to enable activities that provide assistance to the population and the economy during the economic crisis. Achieved trends and fiscal consolidation in Croatia over the last few years, membership in the European Union, and preparations for joining the euro area have provided additional fiscal space and provided assistance to the Croatian economy during the first months of the epidemic. However, Croatia's fiscal policy is limited by a high level of public debt and a low rate of potential growth. In such circumstances, it is necessary to consistently follow the provisions related to delaying the application of fiscal rules and the fiscal measures taken must be short-term, effective and aimed at combating the effects of the epidemic. Epidemic-related fiscal measures can be divided into three groups. The first group of measures refers to financing interventions in the health care system to combat the epidemic, the second to the necessary financial support to citizens and companies affected by the epidemic, to maintain the potential of the Croatian economy and their quick and easy activation after normalization, and the third to increase public spending and investment to stimulate domestic activity after the epidemic subsides, which are necessary to reactivate economic activity and ensure the long-term sustainability of public finances.

[1] REPORT FROM THE COMMISSION Croatia Report (COM(2020) 547), at https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-547-hr_en.pdf.

[2] COUNCIL RECOMMENDATION of 20 July 2020 on the 2020 National Reform Programme of Croatia and delivering a Council opinion on the 2020 Convergence Programme of Croatia, (2020/C 282/11), at https://eur-lex.europa.eu/legal-content/HR/TXT/PDF/?uri=CELEX:32020H0826(11)&from=EN.

When considering budget documents related to other amendments to the State Budget this year, the Commission primarily focused on assessing the credibility and realism of macroeconomic and budgetary projections, their comparison with the latest EC projections in accordance with Article 22 paragraph 2 of the FRA, and the analysis of the state of public finances and the impact of budget plans on the medium and long-term sustainability of public finances from the perspective of Article 10 paragraph 3 of the FRA. In particular, when considering the adopted measures, the Commission also observed their targeting, short duration and temporary nature. The Commission did not consider the numerical fiscal rules from the preventive section, which were temporarily postponed.

Macroeconomic and budgetary projections

Macroeconomic developments in the current extraordinary circumstances are determined by the epidemiological situation, so the uncertainties regarding the further development of the epidemic also affect the high degree of macroeconomic uncertainties. Macroeconomic projections from the first Amendments to the State Budget adopted in May 2020 predicted that the majority of negative macroeconomic effects were realized in the second quarter of 2020, after which a gradual normalization of the situation was predicted. The Commission assessed the planned economic decline of 9.4% in 2020 as optimistic, but also concluded that it does not deviate significantly from the EC projections.

However, the temporary alleviation of the epidemic during the summer months allowed for some normalization as well as the realization of personal consumption and the tourist season which were better than previously planned. Based on these achievements, the macroeconomic and budgetary projections from the Proposed Amendments to the State Budget for 2020 were adjusted. They do not envisage a significant deterioration of the epidemiological situation and the introduction of new restrictions that would negatively affect economic trends in the short term. For example, macroeconomic projections from other Amendments to the State Budget for 2020 predict an economic decline of 8.0%, primarily due to a decline in exports of goods and services of 24.1%, personal consumption of 6.3% and investment of 6.1%. The projections show the obvious importance of government spending in the context of the crisis, which is growing at a rate of 2.4% in 2020.

Such optimistic macroeconomic projections differ from the last available EC macroeconomic projections from the beginning of May 2020, which predicted an economic decline of 9.1% in 2020. Although the difference between the latest EC projections and the current projections related to the Amendments to the State Budget is significant, it should be emphasized that this difference may be justified by the high variability of the epidemiological situation, and thus economic activity from May 2020 until today. The EC has yet to publish its new projections, which it normally prepares in October, and which could have built-in effects of deteriorating macroeconomic conditions caused by the unexpectedly rapid deterioration of the epidemiological situation in the Republic of Croatia and the European Union.

Based on the above, the Commission considers that the macroeconomic projections from the September amendments to the State Budget are slightly optimistic and deviate from the latest available EC projections. However, given the fact that most budget revenues have already been generated, and there is still a short time until the end of the budget year, the Commission considers the fiscal revenue projection appropriate, but also emphasizes that the negative risks associated with the realization of those projections, due to aggravated epidemiological situation both in Croatia and its major trading partners, can equally be found on the revenue and expenditure side, especially in the case of increased needs to combat the effects of the epidemic in the last two months of 2020.

Evaluation of proposed amendments to the State Budget for 2020

Other Amendments to the State Budget for 2020 significantly increased the revenues and expenditures of the State Budget. Namely, with the Amendments to the State Budget from May 2020, budget revenues were significantly reduced due to the expected consequences of the epidemic. Despite such expectations, revenues were significantly better than expected during the first nine months of 2020, and are now expected to increase by 6.7% or 9.2 billion HRK in relation to the current plan (from the first Amendments to the State Budget from May 2020). First of all, this refers to operating revenues, which increase by 9.1 billion HRK. Revenues from VAT (increase by 6.9% or 3bn HRK), profit tax (2.5bn HRK) and contributions (1.5bn HRK) stand out in particular. Despite this, the expected revenues are significantly lower than the revenues generated in 2019.

Total budget expenditures increase by 8.6 billion HRK compared to those planned in May, which raises a number of issues related to planning the budgetary items. Significant increases relate to the rehabilitation of the health sector, pensions and rights from the social welfare system, additional funds for employees, subsidies to safeguard jobs in businesses affected by the epidemic, and the cost of financing and payments to the European Union budget.

Amendments to the State Budget envisage additional funds to meet the liabilities of hospitals in the amount of 1.3 billion HRK and an increase in transfers to the Croatian Health Insurance Institute in the amount of 200 million HRK. Given that the due liabilities of the health sector are significantly higher than the planned additional funds, and that these liabilities increase every month, these additional funds did not solve the problem of total outstanding liabilities of the health sector and it still represents a significant fiscal risk. The Commission has continuously warned of major fiscal risks related to the health sector, but believes that the financial problems of the system in this period should not jeopardize the functioning of the health system during the epidemic, so the necessary reforms should be undertaken after the normalization of the situation.

The Commission shall in particular monitor the extraordinary and temporary costs associated with the epidemic. In addition to the large drop in budget revenues which represents 8.8 billion HRK less than in 2019 (taxes and contributions are lower by as much as 12.2bn HRK), the amount of expenditures allocated in the fight against the epidemic is significant. 8.1 billion HRK is planned for safeguard job measures in 2020 (of which 2.6 billion HRK from EU sources). Other expenditures for COVID measures (procurement of goods in stock, support in sports, agriculture, culture, tourism, etc.) by the end of September 2020 amounted to 1.2 billion HRK (335 million HRK from sources that affect the budget result). Thus, the effect of the extraordinary circumstances related to the epidemic explains about 3/4 of the planned state budget deficit in the total amount of 24.8 billion HRK (554 million HRK less than the current plan).

In order to perceive the general financial result, it is necessary to include other sectors in the scope of the general government and to make the necessary adjustments. In addition to the central government budget deficit, there is a significant deterioration in the deficit of local and regional self-government units (deterioration of 1.8bn HRK), the planned surplus of extra budgetary users and other legal entities within the general government decreased by 149 million HRK, while health liabilities increased by an additional 1.1 billion HRK. Other adjustments included in the deficit calculation according to the ESA methodology amount to -1.2 billion HRK and are aimed at providing liquidity for state-owned companies particularly affected by the crisis (650 million HRK) and new guarantees for shipbuilding (514 million HRK).

In other words, the planned general government deficit in 2020 has increased from 6.7% of GDP to 8.0% of GDP or 29.5 billion HRK. The economic downturn and increased financing needs have led to a large increase in public debt, which this year increased from 72.8% of GDP to as much as 87.3% of GDP.

Such outcomes and results are a consequence of an appropriate countercyclical fiscal policy used by the Government of the Republic of Croatia to mitigate the effects of the COVID-19 epidemic. In a situation where a temporary suspension of the application of numerical fiscal rules is in force, the increase in general government deficit and public debt does not pose a risk of significant deviation from fiscal rules in the spirit of FRA because both declining revenues and increasing state budget expenditures are largely caused by negative events (epidemics) due to which the fiscal rules were also suspended. However, it should be emphasized that the increase in the general government deficit and public debt has further exploited the already narrowed and limited fiscal space and created new liabilities. In conditions of low potential growth rate, these repayments can be a big expense, so it is necessary to make maximum efforts to prepare reforms and investments that will enable stronger growth in the future, where it is extremely important to make good use of available EU funds.