REPUBLIC OF CROATIA
Commission on Fiscal Policy

2020 COMMISSION ON FISCAL POLICY ACTIVITY REPORT

Zagreb, June 2021

1. About the Commission on Fiscal Policy

The Fiscal Policy Commission is an independent and autonomous body that performs tasks within its scope and competence, as defined by the Fiscal Responsibility Act („Official Gazette“, number 111/18) which transposed EU Directive 2011/85 on requirements for national budget frames.

Public finances are crucial for the execution of the roles of the state defined by the Constitution, so their medium- and long-term sustainability is necessary for social and economic well-being. Sustainability of public finances is achieved by establishing, applying and strengthening fiscal rules and rules for ensuring fiscal responsibility on the basis of which the Government of the Republic of Croatia determines and implements fiscal policy. Fiscal rules are defined in accordance with the rules of the European Union.

According to the Fiscal Responsibility Act, the duties of the Fiscal Policy Commission are:

– consideration and risk assessment of the application of fiscal rules set out in Articles 6, 7 and 8 of this Act, in medium-term budget documents and in the annual report on budget implementation

– consideration and comparison of macroeconomic and budgetary projections from medium-term budget documents with the latest available projections of the European Commission

– monitoring the compliance with the recommendations of the Council of the European Union in order to address the excessive budget deficit and public debt

– providing an opinion to the Government on the temporary postponement of the application of fiscal rules referred to in Articles 6, 7 and 8 of this Act, in case of extraordinary circumstances referred to in Article 10 of this Act.

The Commission is made up of seven members who are appointed for a term of five years. The Chair of the Commission is appointed on the basis of a public call while six members are appointed from among prominent scientists and professional staff and at the suggestion of the State Audit Office, Institute of Economics, Zagreb, Institute of Public Finance, Croatian National Bank, and faculties of economics and law of the Universities of Zagreb, Split, Osijek and Rijeka.

In 2019, the Finance and Central Budget Committee issued a public call for the Chair of the Commission twice, at which no candidate was elected. In 2020, due to the epidemiological situation, the public call was not conducted at all. Pursuant to Article 40, paragraph 3 of the Fiscal Responsibility Act (Official Gazette 118/18) until the election of the Chairperson of the Commission, in accordance with the provisions of Title VI of this Act, the duty of the Chairperson shall continue to be performed by the Chair of the Finance and Central Budget Committee of the Croatian Parliament who is the Chairperson of the Fiscal Policy Committee in accordance with the Decision on the Establishment of the Fiscal Policy Commission (Official Gazette 156/13). During the time when the Chair of the Commission was not elected on the basis of a public call, the Commission continued to act according to the transitional provisions under the chairmanship of the Chair of the Finance and Central Budget Committee of the Croatian Parliament, Grozdana Perić. In such conditions, the new Rules of Procedure could not be adopted nor the Office of the Commission under Article 40 of the Fiscal Responsibility Act could be established, but the Commission continued to operate according to the old Rules of Procedure and the Act, within the framework of the Croatian Parliament.

Members of the Commission on Fiscal Policy were appointed on 12 July 2019

- Vesna Kasum, M. Sc., representative of the State Audit Office
- Maruška Vizek, Ph. D., representative of the Institute of Economics, Zagreb
- Vjekoslav Bratić, Ph. D., representative of the Institute of Public Finance
- Maroje Lang, PhD, representative of the Croatian National Bank
- Assoc. Prof. Domagoj Karačić, Ph. D., from among representatives of faculties of economics and businesses
- Zoran Šinković Ph. D., from among representatives of faculties of law.

At the session on September 24, 2019, in accordance with Article 17 (5) of the Fiscal Responsibility Act, the members of the Commission elected Maroje Lang, PhD as a Deputy Chair.

The Fiscal Policy Commission had its first constitutive session on 24 September 2019.

2. Fiscal policy and assessment of public finances in 2020

While 2019 was marked by the continuation of positive economic trends and indicators from previous years (the general government budget surplus of HRK 1.6 billion or 0.4% of GDP for the third year in a row, the structural balance was -0.6 % to -1.2% of GDP and the medium-term budgetary target of -1.75% of GDP was met, the share of public debt in GDP in the Republic of Croatia was reduced to 73.2%), however, in 2020 they marked quite opposite movements.

Namely, after several years of favourable economic growth during which the state of public finances improved, a pandemic of COVID-19 disease broke out in 2020, which led to a large economic downturn in the Republic of Croatia due to closure measures and restrictions on the spread of CoV -SARS-2.

On 2 April 2020, at the proposal of the Commission, the Government of the Republic of Croatia adopted a Decision on the temporary postponement of the application of fiscal rules. However, despite the temporary postponement of fiscal rules for 2020, the Fiscal Policy Commission has consistently strongly emphasized the need, inter alia, to ensure the medium- and long-term sustainability of public finances:

- careful monitoring of economic and budgetary achievements and timely reaction of economic policy in case of major deviations;

- streamlining and changing the originally planned activities in the state budget and other financial plans for 2020 in order to make the best use of the limited fiscal potential to finance the necessary measures to combat the consequences of the epidemic;

- the timeliness, targeting and effectiveness of the envisaged fiscal policy measures to mitigate the consequences of the pandemic, but also due to the high public debt and low growth rate. Therefore, the Commission called on the executive to postpone the application of those measures that do not meet the criteria related to the temporary postponement of the application of fiscal rules (e.g. continued reduction of income and income tax rates) and

- implementation of radical reforms and investments that will enable stronger growth in the future, where the most important thing is to use EU funds as well as possible and as soon as possible and direct them to sustainable projects that will contribute to future economic growth.

3. Sessions and Position Papers of the Fiscal Policy Commission held in 2020

In the year 2020, the Commission continued to work in accordance with the transitional provisions and assigned tasks from Art. 22 of the Fiscal Responsibility Act and, despite the negative epidemiological situation, held sessions electronically.

In 2020, the Commission held 4 sessions at which it adopted 6 position papers that were published on the Commission's website.

3rd session of the Fiscal Policy Commission held on 30 March 2020

- *5th Position Paper* on the economic and fiscal consequences of the COVID-19 epidemic and on the implementation of fiscal rules during the crisis period
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4th session of the Fiscal Policy Commission held on 11 May 2020

- *6th Position Paper* o 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

5th session of the Fiscal Policy Commission held on 22 September 2020

- *7th Position Paper* on the Draft Semi-Annual Report on the execution of the State Budget of the Republic of Croatia for the first semester of 2020,
- *8th Position Paper* on the Draft Annual Report on the execution of the State Budget of the Republic of Croatia for2019and Draft Annual Report on the application of fiscal rules for 2019

6th session of the Fiscal Policy Commission held on 2 November 2020

- *9th Position Paper* on the Proposed Amendments to the State Budget of the Republic of Croatia and extra-budgetary users’ financial plans for 2020,
- *10th Position Paper* on the Draft Budget of the Republic of Croatia for the year 2021 and Projections for 2022 and 2023

Below you can find the Commission's positions.

5th Position Paper of the Fiscal Policy Commission on the economic and fiscal consequences of the COVID-19 epidemic and on the implementation of fiscal rules during the crisis period

of 30 March 2020

The COVID-19 disease pandemic caused by the SARS-CoV-2 virus and measures to curb its spread are a major shock to the global and the Croatian economy and the state of public finances. A major slowdown in economic activity will lead to a sharp decline in public revenues. At the same time, the implementation of necessary health interventions, the rescue and support of a troubled economy during and after the epidemic will also affect the increase in public spending. All this will lead to a significant increase in the budget deficit and public debt.

The Commission recalls that the Fiscal Responsibility Act and the rules of the European Union's Stability and Growth Pact recognize the possibility of similar disruptions and allow an appropriate fiscal policy response to mitigate the negative effects of the crisis. Thus, the Fiscal Responsibility Act Article 10 (3) provides for the possibility to temporarily postpone the implementation of fiscal rules in the event of extraordinary circumstances, in accordance with EU rules, provided that this does not endanger fiscal sustainability in the medium term. The rules of the Stability and Growth Pact allow for a temporary increase in the budget deficit in two cases, provided that this does not endanger fiscal sustainability in the medium term. The first case refers to the occurrence of events outside the control of the state, in which it is allowed to finance additional activities directly related to that event. The second case, now activated for the first time, concerns the state of deep economic crisis at European Union level and provides for a stronger and more coordinated fiscal response across the European Union.

The Commission holds that by the adoption of the Decision on declaring the COVID-19 epidemic caused by the SARS-CoV-2 virus of 11 March 2020 the existence of extraordinary circumstances under Article 10 of the Fiscal Responsibility Act has been recognised and calls on the Government of the Republic of Croatia to adopt a Decision on the temporary postponement of the implementation of fiscal rules.

Temporarily postponing the implementation of fiscal rules will allow the Croatian Government to take measures to eliminate the health, social, economic and any other consequences of this epidemic, which will almost certainly adversely affect public finances in the short term. Notwithstanding the temporary delay in the implementation of fiscal rules, **the Commission emphasizes that in such a complex situation it is still necessary to take account of the long-term sustainability of public finances.**

The fiscal policy measures related to the epidemic can be divided into three groups. The first concerns the financing of healthcare interventions to combat the epidemic. The second group of measures refers to the necessary financial support for employees and business entities who are particularly affected by the epidemic in order to retain the potential of the Croatian economic sector and to activate them as soon as possible after normalization. The third group of measures is intended to increase public spending and investment in order to stimulate domestic activity during the slowdown of the epidemic. Such measures may, in the short term, additionally burden the state budget, but they are necessary to reactivate economic activity and ensure the long-term sustainability of public finances.

The Commission also points out that the Government, when adopting measures during extraordinary circumstances, may deviate from the target level of the budget deficit and reducing public debt, but these measures must at the same time be of short term and targeted in order to address the social and economic consequences of the epidemic as soon as possible.

In this regard, the Commission calls on the Government of the Republic of Croatia, local government units and other public sector bodies to consider changing the planned activities in the State Budget and other financial plans for 2020 as soon as possible in order to make best use of the limited fiscal potential for funding the necessary measures to combat the effects of the epidemic.

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

of 22 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 2020adopted 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 Act and the rules of the European Union, are temporarily suspended.

The main objective of the Fiscal Responsibility Act (ZFO) 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 ZFO, 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 ZFO 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 ZFO, 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 2020and 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 ZFO 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 ZFO. **The Commission points out that an analysis of medium-term fiscal sustainability was left out and calls on the Ministry of Finance to prepare the planned Reports regardless of the postponement of the application of fiscal rules and the European Commission's instructions on the necessary content of the Convergence Programme.**

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 ZFO.**

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.

7th Position Paper of the Fiscal Policy Commission of the Croatian Parliament on the Draft Semi-Annual Report on the execution of the State Budget of the Republic of Croatia for the first semester of 2020 of 22 September 2020

The Commission supports the fiscal policy measures aimed at reducing the impact of the pandemic, but also warns that due to the high level of public debt and low rates of potential economic growth, it is necessary to use as much as possible those measures that will most efficiently mitigate the effects of the pandemic on the population and economy and contribute to increasing the medium-and long-term potential of the Croatian economy.

n the spring of 2020, due to extraordinary circumstances caused by the COVID-19 epidemic, the application of numerical fiscal rules in the Republic of Croatia and the European Union was temporarily suspended[1]. Thus, in order to protect the population and economic potential and to ensure the medium and long-term sustainability of public finances, a temporary postponement of the fulfilment of numerical rules is allowed. In such circumstances, the task of the Commission is to monitor the implementation and execution of macroeconomic and budgetary projections and to analyse the current situation and medium-and long-term sustainability of public finances.

The macroeconomic projections for 2020, which are the basis of the amended budget, are being realized, but with a slightly different dynamic. On the one hand, the economic downturn in the second quarter will be partially offset by slightly better economic results than expected in the third quarter of 2020. However, contrary to budget projections, the risks of prolonging the pandemic in the second half of 2020 with a tendency to accelerate are materialising. Thus, the normalization of the system and a stronger economic recovery will be postponed for the next period. In such conditions, the planned economic decline of 9.4% (on which the estimate of budget revenues is based) could still be realized, but the increased risks for the planned recovery in 2021 are worrying.

According to the data on the execution of the state budget in the first half of 2020, notwithstanding the measures taken, such as temporary write-off of taxes and subsidies, the

[1] See the Decision on Temporary Suspension of Numerical Rules (official gazette of the Republic of Croatia *Narodne novine* 41/2020) and the 5thPosition Paper of the Fiscal Policy Commission on economic and fiscal consequences of the COVID-19 epidemic and on the implementation of fiscal rules during the crisis period, available at: https://www.sabor.hr/sites/default/files/uploads/inline-files/5_stajali%C5%A1te_Povjerenstva_za_fiskalnu_politiku_0.pdf

budget revenues are well realized, primarily due to good results from the first part of the tourist season, which could lead to the realisation of planned budget revenues at the level of the whole of 2020. On the other hand, the Government's fiscal measures on the expenditure side caused slightly higher expenditure growth in the first half of 2020. However, with the assumption used for the preparation of the Amendments to the State Budges in May 2020[2], most of these fiscal measures should be phased out in the second half of 2020, which would reduce the pressure on expenditures. However, no one knows at this time how long the pandemic will last, and the longer it lasts, the duration of existing measures on the expenditure side could be prolonged or even new measures could be required. Despite such uncertainty and circumstances, the projected state budget deficit could still be realised.

On the other hand, strong pre-financing has also affected the large increase in public debt in the first half of the year. The results of economic growth and fiscal consolidation from the previous period, favourable external circumstances and large purchases of government bonds by the Croatian National Bank contributed to favourable financing conditions and confirmation of the investment rating of the Republic of Croatia, without the borrowing affecting the risk premium. However, the high level of public debt limits the scope for fiscal policy to operate in times of crisis, which is why in the future the emphasis will have to be on fiscal instruments and the necessary reforms within the public sector.

In these circumstances, more attention needs to be paid to the quality of public finances and their structure, concentrating on measures that will help combat the negative consequences of the pandemic as effectively as possible, and preserving and increasing the economic potential necessary for long-term fiscal sustainability. All this should be kept in mind when adopting new fiscal measures for this year and next 2021, but also when programming investments and reforms in the National Recovery Plan.

[2] Available at: https://www.sabor.hr/hr/prijedlog-izmjena-i-dopuna-drzavnog-proracuna-republike-hrvatske-za-2020-godinu-i-projekcija-za

8th Position Paper of the Fiscal Policy Commission of the Croatian Parliament on the Draft Annual Report on the execution of the State Budget of the Republic of Croatia for2019and Draft Annual Report on the application of fiscal rules for 2019 of 22 September 2020

The Commission concluded that, despite a slight deterioration in the structural balance, fiscal rules for 2019 have been met.

1. Assessment of compliance with fiscal rules for 2019

To assess the application of fiscal rules in 2019, the following were used: a) *Report on the excessive budget deficit procedure and the level of general government debt in the Republic of Croatia* from April 2020 (ESA 2010) published by the Central Bureau of Statistics (CBS) on 22 April 2020[3] and b) *Draft Annual Report on the Execution of the State Budget of the Republic of Croatia for 2019*[4] and c) *Draft Annual Report on the Application of Fiscal Rules for 2019* adopted by the Government of the Republic of Croatia at its 230th session held on 14 May 2020.In its assessment, the Commission also used other documents such as the Convergence Programme[5] of the Republic of Croatia and the projections and analyses of the European Commission..

The Fiscal Responsibility Act (Official Gazette, No.111/2018) defines fiscal rules and determines that the Commission's task is to consider and assess the application of fiscal rules in medium-term budget documents and the annual budget execution report. Three fiscal rules have been defined (Articles 6-8), which have been taken over from the Stability and Growth Pact. The first rule, *the structural balance rule*, is met when the structural balance stated in the annual report on the application of fiscal rules for the previous year is equal to or greater than the medium-term budgetary objective, i.e. when it is achieved according to the adjustment plan defined in accordance with EU legislation. The second rule, *the expenditure rule*, limits the growth of general budget expenditure adjusted for the effects of tax changes, which must not exceed the reference potential GDP growth rate. The expenditure rule does not apply if the structural balance rule is met. The third fiscal rule, *the debt rule*, limits the

[3] Available at: https://www.dzs.hr/Hrv_Eng/publication/2020/12-01-02_01_2020.htm
[4] Both documents available at:
https://vlada.gov.hr/UserDocsImages/2016/Sjednice/2020/Svibanj/230%20sjednica%20VRH/230%20-%2025.pdf
[5] Available at:
https://vlada.gov.hr/UserDocsImages/2016/Sjednice/2020/Travanj/227%20sjednica%20VRH/Novi%20direktorij/227%20-%202%20Program%20konvergencije%20Republike%20Hrvatske%20za%202020.%20i%202021.%20godinu.pdf.

level of public debt to 60% of GDP, i.e. determines the dynamics of its reduction to the reference value.

Structural balance rule. The calculation of the general government balance is based on the common European methodology (ESA 2010). According to the *Report on the Excessive Budget Deficit and the Level of General Government Debt in the Republic of Croatia* from April 2020, the general government budget in 2019 for the third year in a row had a surplus of HRK 1.6 billion or 0.4% of GDP in 2019.This execution is significantly better than the planned deficit of -0.1% of GDP. Observed by sectors, the surplus was recorded by the central government (HRK 2.1bn) and social funds (HRK 0.9bn), while at the local government level the deficit increased to HRK 1.4bn. The general budget surplus is the result of continued favourable economic trends and the consolidation of public finances from previous years.

To calculate the structural balance rule, it is necessary to assess the impact of cyclical economic trends on the budget, for which a common methodology[6] has been established at the level of the European Union. However, in the conditions of a deep economic crisis caused by a pandemic, the problems of calculating the cyclical position are further emphasized because they imply a number of assumptions related to current and future trends. Precisely to avoid this problem in the *Draft Annual Report on the Application of Fiscal Rules for 2019*, the Government of the Republic of Croatia assessed the cyclical effect using assumptions and estimates from the time before the pandemic and assessed that the positive production gap in 2019 was high 2, 1% of GDP, which positively contributed to the budget result of 0.9% of GDP, bringing the structural balance to -0.6% of GDP. The inclusion of the current impact of the crisis with optimistic assumptions about its duration as incorporated by the European Commission in its last *Spring 2020 Economic Forecast* published in May indicates an even larger positive output gap in 2019 in the amount of as much as 3.7% of GDP, i.e. favourable cyclical impact on the budget in the amount of 1.6% of GDP, so the corresponding structural balance in 2019 was -1.2% of GDP.

Despite the wide range of estimates of the structural balance (-0.6% to -1.2% of GDP), which could subsequently increase in the conditions of further deepening of the recession, the

[6] More on common methodology: European Commission. "Vade Mecum on the Stability & Growth Pact, 2019 Edition", European Economy Institutional paper 101, April 2019. Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip101_en.pdf.

achieved positive nominal balance enabled the achievement of the medium-term budgetary objective which for 2019 was set at a relatively low level of -1.75% of GDP.

Therefore, the Commission concludes that the fiscal rule of the structural balance in 2019 has been met.

Expenditure rule. Given that the medium-term budgetary objective has been achieved, the part of the rule relating to expenditure growth does not apply. However, the Commission warns that expenditures, increased by the effect of revenue cuts due to tax changes, have been growing faster than potential economic growth for two years in a row. In this way, the savings from previous years have been spent and the space for a stronger influence and effect of fiscal policy in the conditions of the crisis has been reduced.

Public debt rule. The Commission also considered the public debt rule, according to which public debt must not exceed 60% of GDP. If the public debt exceeds the reference amount, it should be reduced at an average rate of one twentieth per year. The share of public debt in GDP in Croatia has been continuously declining since 2014 (from 84.7% in 2014 to 73.2% in 2019). The reduction of the share of public debt in GDP in 2019 compared to 2018 from 1.5 percentage points (i.e. from 74.7% to 73.2%) was greater than the minimum required reduction, **thus achieving the public debt rule**. There is a noticeable slowdown in the reduction of the share of public debt in GDP compared to previous years.

9th Position Paper of the Fiscal Policy Commission on the Proposed Amendments to the State Budget of the Republic of Croatia and extra-budgetary users' financial plans for 2020 of 2 November 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: ZFO), 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*[7], 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

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

did not initiate corrective measures. Moreover, in its *Country-specific recommendations*[8] adopted by the Council on 20 July 20202, 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.

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 Article22 paragraph 2 of the ZFO, 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 ZFO. In particular, when

[8] 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), available at https://eur-lex.europa.eu/legal-content/HR/TXT/PDF/?uri=CELEX:32020H0826(11)&from=EN.

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 as12.2bn HRK), the amount of expenditures allocated in the fight against the epidemics significant. 8.1 billion HRK is planned for safeguard job measures in 2020 (of which2.6 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 by149 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 ZFO 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 itis extremely important to make good use of available EU funds.

10th Position Paper of the Fiscal Policy Commission on the Draft Budget of the Republic of Croatia for the year 2021 and Projections for 2022 and 2023 of 2 November 2020

The Commission supports the Government's efforts to consolidate public finances as soon as possible, but also points out that due to the COVID-19 epidemic, extraordinary circumstances will continue in 2021. Due to high public debt and low potential growth rates, fiscal policy measures must be targeted, temporary and effective and the Commission calls on the Government of the Republic of Croatia to postpone the application of those measures that do not meet these criteria. The EU funds represent a key instrument and opportunity for stronger fiscal expansion and it is necessary to make every effort to start absorbing them as soon as possible and to direct them to economically viable projects that will contribute to future economic growth.

Strong public finance support is needed to mitigate the negative consequences of the COVID-19 pandemic and to stimulate aggregate demand. Due to these extraordinary circumstances, in 2020 the possibility of temporary derogation from the application of fiscal rules defined by the Stability and Growth Pact and the Fiscal Responsibility Act (hereinafter: ZFO) was activated in order to enable the provision of fiscal incentives.[9] However, postponing the application of the rules must be temporary, fiscal policy measures must be linked to the negative event, and long-term fiscal sustainability must not be jeopardized.

Since the pandemic is expected to continue, the European Commission (hereinafter: the EC) sent a letter to Member States on 19 September 2020 with instructions for the implementation of fiscal policy in 2021, in which it confirmed that the general escape clause will remain in force in 2021 as well.[10] In the context of the activation of the general clause in 2021, Member States should continue to provide targeted and temporary fiscal support, and regularly analyse its results and effectiveness, while being mindful of the preservation of medium-term fiscal sustainability.

In accordance with its task defined in Article 22 of the ZFO, the Commission considered the continuation of the temporary postponement of the application of the fiscal rules from Articles 6, 7 and 8 in case of extraordinary circumstances under Article 10. The Commission

[9] For more information on the temporary postponement of the application of fiscal rules see the Commission's 9th Position Paper from 2 November 2020.
[10] Available at https://ec.europa.eu/info/sites/info/files/economy-finance/hr.pdf.

considers that there are still significant macroeconomic risks and uncertainties associated with the epidemic that could negatively affect the achievement of planned revenues and cause additional needs for fiscal measures to mitigate the effects of the epidemic. The Commission considers that such circumstances dictate to maintain the temporary postponement of the application of numerical fiscal rules in 2021. It is therefore necessary to consistently follow the provisions related to the postponement of the application of fiscal rules, while the fiscal measures taken must be short-term, effective and aimed at combating the effects of the epidemic.

When considering the Draft State Budget for 2021 and Projections for 2022, the Commission primarily focused on assessing how credible and realistic the macroeconomic and budgetary projections are, comparing them with the latest EC projections in accordance with Article 22 paragraph 2 of the ZFO. Also, the Commission analysed the state of public finances and the impact of budgetary plans on the medium and long-term sustainability of public finances from the perspective of Article 10 paragraph 3 of the ZFO. In particular, when considering the adopted measures, the Commission also observed their structure and, in accordance with its analytical capacities, tried to assess their pointedness, short duration and temporary nature. The emphasis of the analysis is based on 2021, the year in which it is expected that the temporary postponement of the application of fiscal rules will continue, but also that the situation will gradually normalize and the epidemic will end. In such circumstances, fiscal rules should be reactivated in 2022. However, the Commission did not analyse the cyclical position and structural deficit as these indicators are difficult to assess given the high degree of uncertainty.

Macroeconomic and budgetary projections

The macroeconomic projections presented in the Guidelines for the Preparation of the State Budget of the Republic of Croatia for 2021 and the Projections for 2022 and 2023 and incorporated in the Draft State Budget for 2021 were prepared in September 2020 after it became obvious that the revenues during the summer months were higher than expected. The projections were based on the assumption that in 2021 the epidemic would continue weakening and that economic activity would gradually return to normal. GDP decreased by 8% in 2020, as expected, but a gradual recovery of 5% is expected in 2021, of 3.4% in 2022 and of 3.1 % in 2023. As in previous years, this growth will be primarily based on the contribution of domestic demand, mainly personal consumption and investment, while government consumption will grow weaker than the overall economy.

As per annual dynamics, the proposed 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 with a strong recovery of 7.5% in 2021. Although the difference between the latest EC projections and the current projections from the2021Draft State Budget is significant, it can be justified by the great variability of the epidemiological situation, and consequently of the economic activity from May 2020 to this day. The EC has yet to publish its new projections (usually prepared in October and published in early November), which could include the effects of deteriorating macroeconomic conditions caused by the unexpectedly rapid deterioration of the epidemiological situation in recent weeks. Nevertheless, if we look at the projected level of economic activity in 2021, the budgetary projections do not deviate from those of the EC.

Given the assumptions and the unknowns about the epidemic, the Commission considers such projections to be optimistic. The latest trends suggest that even if revenue generation improved during the summer months of 2020, the poor epidemiological situation could continue until the vaccine is found and widely used, which will also affect economic trends in the first half of 2021. However, given that the projections for 2021 do not deviate significantly in levels from the last available EC projection, the Commission considers them acceptable from the perspective of the ZFO, but also calls on the Government of the Republic of Croatia to closely monitor the economic and budget outturn and to provide economic policy timely responses in the case of major deviations.

Assessment of the 2021 Draft State Budget and the Projections 2022 and 2023

Trends in state budget revenues in the period 2021-2023 are based on the expected recovery of economic activity, taking into account the effects of the announced tax changes in 2021 and the planned absorption of EU funds. Accordingly, total revenues are planned in the amount of HRK 147.3bn in 2021, HRK 152.7bn in 2022 and HRK 152.9bn in 2023.While the growth of taxes and contributions is largely influenced by the projected macroeconomic trends, total revenues in 2021 and 2022 are significantly influenced by the projected increase in aid revenues, which will decrease in 2023.

Total planned expenditures in 2021 financed from all sources amount to HRK 157.9bn and are higher by HRK 2bn (1.3%) than those envisaged in the Draft Supplementary and Amending Budget for 2020 from October (hereinafter: the revised budget). Expenditures financed from sources that affect the result of the general government budget in 2021 are planned in the amount of HRK118.4bn, which is a decrease of HRK 3.6bnin relation to the revised budget. This reduction is primarily due to the discontinuation of epidemic-related measures and their future financing mainly from European Union funds. If the impact of these measures is excluded from expenditures, total expenditures financed from sources that affect the result of the state budget increase by HRK 1.7bn (1.5%).

Compared to 2020, the largest increase in expenditures financed from sources that affect the result of the state budget in 2021is planned for compensatory measures to local and regional self-government units (hereinafter: LRSGU) due to the reduction of income tax rates, increase in staff costs, contribution to the European Union budget, guarantee reserve and post-earthquake reconstruction. The overall result will lead to a large reduction in the state budget deficit, which in 2021 is estimated at HRK 10.7bn or 2.7% of GDP, with a tendency to further decrease in the coming years.

The 2021 Draft State Budget and the Projections for 2022 and 2023 reflect the intention of the Government of the Republic of Croatia to consolidate public finances as soon as possible and to respect the 3% deficit benchmark, which is in force despite the temporary postponement of fiscal rules. Thus, according to the ESA methodology, the general government deficit of 2.9% of GDP is projected for 2021, which will gradually decrease to 2.1% in 2022 and to 1.6% in 2023. Such developments in the general government budget are largely influenced by the projected deficit within the central government budget and the LRSGU budget. In other words, in order to review the overall fiscal policy, it is necessary to look at the broader effects of fiscal policy rather than merely assessing the state budget.

The Commission supports the efforts of the Government of the Republic of Croatia to consolidate public finances as soon as possible, but also reminds that the extraordinary circumstances brought about by the COVID-19 pandemic will continue in 2021. The Commission also points out that due to the high public debt and the low rate of potential growth, the fiscal policy measures must be targeted, temporary and efficient, and calls on the

Government of the Republic of Croatia to postpone the implementation of those measures that do not meet these criteria.

Having all this in mind, one of the measures that the Government of the Republic of Croatia should further consider is the planned continuation of tax changes from the beginning of 2021 in the part referring to the reduction of corporate income and income tax rates. For example, the reduction of income tax rates from 36 to 30% and 24 to 20% will in itself result in a significant reduction in general government revenue (LRSGU revenue is expected to drop by around HRK 1.85bn, but at the same time due to these changes it is planned to increase the compensatory measures paid out from the state budget). In addition, the Commission proposes to the Government of the Republic of Croatia to make an evaluation of past and present activities and tax changes in order to determine their real fiscal effects on economic development and the overall tax burden. The Commission welcomes the efforts to further reduce the tax burden, but also considers it necessary to assess the future risks of budget expenditures due to this reduction in fiscal space, especially in view of other risks, such as the growing debt of the national healthcare system, public sector wage system or significant contingent liabilities based on issued state guarantees. The Commission also calls on the Government of the Republic of Croatia to consider postponing other measures that do not meet the prescribed criteria related to the temporary postponement of the application of fiscal rules.

EU funds represent the key instrument and opportunity for stronger fiscal expansion. It is therefore necessary to make every effort to start absorbing them as soon as possible and direct them to economically viable projects that will contribute to future economic growth. In the next seven-year budget period, EU funds of EUR 23.2bn (HRK 173.7bn) are at Croatia's disposal for development, strategic and reform projects. Also, the Republic of Croatia already has HRK 5.1bn from the European Union Solidarity Fund at its disposal for the reconstruction of earthquake-damaged areas that must be withdrawn within 18 months. It is necessary to use these funds to the maximum extent feasible, as quickly and efficiently as possible, through high-quality projects. Both sources of funds make it possible for fiscal policy in 2021 to be countercyclical, without jeopardizing the medium-term sustainability of public finances, and to achieve an ambitious projection of the consolidated general government deficit in 2021. Care should be taken to ensure that contracting and spending should start as early as 2021, in order for them to have a countercyclical effect, that is, to accelerate economic recovery.

However, due to the low level of efficiency in contracting and withdrawing funds, this requirement could be difficult to achieve, regardless of the importance of these funds for stimulating the activities of the Croatian economy in 2021. At the same time, while insisting on the urgent start of spending EU funds, care should be taken to ensure that the Recovery and Resilience Plan, based on which EUR 6 billion in grants will be provided, is targeted at projects with greatest reform potential and contributing to potential GDP growth, which would ultimately contribute to increasing fiscal sustainability. At the same time, directing these funds exclusively to public sector projects could have negative consequences because it can easily lead to a further increase in the size and impact of the public sector on the economy, while crowding out the private sector. Therefore, investment plans designed in this way could worsen the country's already uncompetitive economic structure and negatively affect long-term fiscal sustainability.

4. International cooperation

The Fiscal Policy Committee regularly participates in meetings of the EU Network of Independent Fiscal Institutions (EUNIFI) organized by the European Commission and is a member of the EU Independent Fiscal Institutions. The Commission is represented at international conferences or gatherings on fiscal responsibility by its Deputy Chair or a delegated member (s) of the Commission.

In 2020, two meetings of the EU Network of Independent Fiscal Institutions were held.

The 12th meeting of the EU Network of Independent Financial Institutions was held on 29 January 2020 in Brussels. The first part of the meeting was held together with the alternate members of the European Economic and Financial Committee (EFC) on the preparation and adoption of macroeconomic projections and presented the Annual Report of the European Fiscal Board, the European Court of Auditors' Special Report: EU requirements for national budgetary frameworks, Green Accounting and fiscal publications of the European Commission's Directorate-General for Economic and Financial Affairs: Fiscal Governance Database and Public Finance Report and Debt Sustainability Report 2020.

The 13th meeting of the EU Network of Independent Fiscal Institutions, held virtually on 6 October 2020, was dominated by pandemic-related topics.

In addition, the Commission meets regularly with representatives of the European Commission, the International Monetary Fund and other relevant institutions.

5. Financial Report

The Fiscal Policy Commission did not use the planned budgetary funds, as it was not established.

Fees and travel expenses to members of the Fiscal Policy Commission are still paid from the position 010 of the Croatian Parliament.

All planned budgetary funds for 2020 have been returned to the central budget.