Fiscal Policy Commission
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4th Position Paper of the Fiscal Policy Commission on the Draft Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for the year 2020 with Draft Projections for the period 2021-2022

At its 2nd meeting held on 5 November 2019, the Fiscal Policy Commission (hereafter referred to as: Commission) discussed the Draft Budget of the Republic of Croatia and Financial Plans of Extra-Budgetary Users for the year 2020 with Draft Projections for the period 2021-2022 (hereinafter referred to as: Draft Budget), submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia on 31 October 2019.

In its debate on the Draft Budget, the Commission focuses on the application of the fiscal rules in line with the Fiscal Responsibility Act (Official Journal *Narodne novine* 111/18), as well as on checking how realistic the macroeconomic and budgetary projections are.

The Commission estimates that the macroeconomic projections in the Draft Budget can serve as a credible basis for budget planning and for projecting budget revenue growth. The Draft Budget for 2020 and the projections for 2021 and 2022 were made based on the assumption that economy would grow by 2.5% in 2020 and by 2.4% in 2021 and again in 2022, which is in line with the projections of other relevant domestic and foreign institutions. The projection for the year 2020 is identical to the one the European Commission issued in June 2019. The macroeconomic projections indicate that domestic demand, especially personal consumption and gross fixed capital formation, will continue to be a major generator of Croatian economy's growth. The contribution of net exports to growth is expected to be negative, which entails risks to the sustainability of economic growth, especially if no serious structural reforms are implemented.

For the most part, the revenues and expenditures of the State Budget are realistically projected, though several categories may not prove to be sufficiently realistic. Tax revenues have been cautiously projected, especially when it comes to VAT revenue. The government has given up the proposal to cut the general VAT rate, but the VAT rate for the hospitality industry is projected to drop to 13% with a fiscal impact of HRK 900m. Other planned revenues are also growing in line with the expected base salary growth, whereby the effects of the 4th cycle of tax reforms resulting from a further decline in income taxation of 1.2 billion HRK are not directly shown in the Draft Budget as they are revenues of local and regional self-government units. Revenues from pension contributions are projected rather optimistically (4.9% growth compared to the proposed changes to the 2019 State Budget) based on projected employment and wage growth. The projected growth of revenues from EU funds is also very optimistic, but as these funds do not affect the budget deficit, the risks of over-optimistic planning of this item will not affect the projected budget deficit.

Although expenditures planned for the 2019 wage bill had proven insufficient and had to be increased by reviewing the budget, it is again evident that their growth has been relatively modestly planned for the next period. Considering the correction of the classification of expenditures for employees in the education system, it is planned to increase the expenditures for the wage bill by around HRK 1.2 billion, which, with the increase of the base for calculating salaries by 6.12% in 2020, includes the full year effect of the increase in salaries in 2019, increase in past work expenses and funds for new employees. The proposed budget excludes any other adjustments to expenditures for wage bill in the years to come, except for the already adopted base increase and the automatic increase based on past work and the growth in the number of new employees. In addition, the growth of pension expenditures seems to be slightly underestimated, especially given their increase in the 2019 budget review and the rise in the average gross wage used in the automatic formula for adjusting pensions.

The Commission draws attention to the need to limit the growth of expenditures financed from the general government revenue, which continue to grow faster than the nominal GDP in 2020. In relation to the amendments to the 2019 State Budget, in 2020 the expenditures financed from the general government revenue are planned to increase by 5.1%, which further increases the burden of financing public spending and defers fiscal consolidation.

In the current circumstances, the Commission considers the planned budget deficit of -0.5% of GDP in 2020 to be too high. Specifically, except for the negative balance of the state budget for 2020 (and a slight deficit at the level of the local government), positive balances of extra-budgetary users and of companies in the general government sector, as well as methodological adjustments are all expected at the level of the consolidated general government in 2020 (but also in 2021 and 2022), which ultimately leads to a gradual improvement of the general government fiscal balance according to the ESA methodology from a projected -0.1% in 2019 (amendments to the 2019 State Budget) to 0.2% in 2020, 0.4% in 2021 and 0.8% in 2022. Such a draft budget assumes a gradual tightening of fiscal policy positions in a period when risks of economic slowdown increase, with a potentially negative effect on the fiscal balance, which could again require pro-cyclical reductions in public spending in the face of weaker economic activity.

The Commission estimates that the Draft Budget and the Financial Plans of Extra-Budgetary Users for the year 2020 are in compliance with the fiscal rule of structural deficit under the Fiscal Responsibility Act, but there are significantly increased risks for the rule to be met. Namely, in order to see this fiscal rule through, it is necessary to observe the structural budget balance, which contains the correction with respect to the state of the economic cycle (Table 1). Over the entire budget horizon, the Croatian economy is in a positive phase of the business cycle, which is reflected in the high positive GDP gap. Thus, applying the prescribed methodology, the estimated structural balance, corrected with respect to the business cycle, should be improved from -1.1% in 2019 to -0.8% in 2020, with a further reduction of -0.6% in 2021 and -0.1% in 2022. The structural deficit planned in this way is set within the framework of the new medium-term budgetary objective, which in the period 2020-2022 stands at -1.0% (until now it stood at -1.75% of GDP). Therefore, the Commission emphasizes that in order to comply with the fiscal rule of structural deficit in the forthcoming period, it will be necessary to adhere to the proposed plan of switching to the restrictive fiscal policy instead of an expansive one, which has been implemented for the past two years.

In the case of compliance with the structural balance rule, the **expenditure rule does not apply**.

Compliance with the structural balance rule in the context of economic growth and a positive business cycle ensures the continuation of the trend of accelerated reduction of public debt. The debt rule is thus met. According to the plan, public debt should decrease from 71.3% of GDP in 2019 to 68% of GDP in 2020, and further to 65.0% in 2021 and 61.6% in 2022, and a nominal reduction in public debt is also expected.

Table 1 Trends in the structural balance of the consolidated general government, 2019-2022

	2018	Projection 2019	Projection 2020	Projection 2021	Projection 2022
Total deficit/surplus, ESA 2010., in % GDP	0.3	-0.1	0.2	0.4	0.8
GDP gap	1.4	2.1	2.2	2.2	2.1
Structural balance, in % GDP	-0.4	-1.1	-0.8	-0.6	-0.1
Change in the structural balance	-1.0	-0.7	0.3	0.2	0.5

Source: Ministry of Finance, Croatian Bureau of Statistics.