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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

At its 6th meeting held on 2 November 2020, the Fiscal Policy Commission (hereafter referred to as: the Commission) discussed the Guidelines for the Preparation of the State Budget of the Republic of Croatia for the year 2021 and the Projections for 2022 and 2023 and the Draft Budget of the Republic of Croatia for the year 2021 and Projections for 2022 and 2023, submitted to the Speaker of the Croatian Parliament by the Government of the Republic of Croatia on 29 October 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: FRA) was activated in order to enable the provision of fiscal incentives.[1] 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

[1] For more information on the temporary postponement of the application of fiscal rules see the Commission's 9th Position Paper from 2 November 2020.

well. [2] 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 FRA, 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 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 FRA. 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 FRA. 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

[2] Available at https://ec.europa.eu/info/sites/info/files/economy-finance/hr.pdf.

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 the 2021 Draft 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 FRA, 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 HRK 118.4bn, which is a decrease of HRK 3.6bn in 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 2021 is 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.