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COMMISSION OPINION

of 22.11.2022

on the Draft Budgetary Plan of Croatia

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(Only the Croatian text is authentic)

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GENERAL CONSIDERATIONS

1. Council Decision (EU) 2022/1211 has established that Croatia fulfils the necessary conditions for the adoption of the euro.[1] Therefore, Croatia will become a Member State of the euro area as of 1 January 2023.

2. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area, to ensure that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact and the European Semester for economic policy coordination.

3. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan by 15 October, presenting the main aspects of the budgetary outlook of the general government and its subsectors for the forthcoming year.

4. Regulation (EU) No 473/2013 will apply to Croatia from 1 January 2023. Croatia has decided on a voluntary basis to submit its Draft Budgetary Plan for 2023 together with the current euro area Member States and requested the Commission's assessment.

5. The Commission welcomes the initiative by Croatia, since its budget for 2023 will be implemented when Croatia is already part of the euro area. The submission and assessment of Croatia's 2023 Draft Budgetary Plan contributes to the coordination of the fiscal policies of euro area Member States in 2023.

6. The general escape clause of the Stability and Growth Pact has been active since March 2020.[2] On 23 May 2022, the Commission indicated, in its Communication on the European Semester[3], that heightened uncertainty and strong downside risks to the economic outlook in the context of war in Europe, unprecedented energy price hikes and continued supply chain disturbances warrant the extension of the general escape clause of the Stability and Growth Pact through 2023 and it considered that the conditions to deactivate it as of 2024 were met. The continued activation of the general escape clause in 2023 will provide the space for national fiscal policy to react promptly when needed, while ensuring a smooth transition from the broad-based support to the economy during the pandemic times towards an increasing focus on

[1] Council Decision (EU) 2022/1211 of 12 July 2022 on the adoption by Croatia of the euro on 1 January 2023 (OJ L 187, 14.7.2022, p. 31).

[2] Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact, COM(2020) 123 final of 20 March 2020.

[3] COM(2022) 600 final.

temporary and targeted measures and fiscal prudence required to ensure medium-term sustainability.[4]

7. The Recovery and Resilience Facility, as established by Regulation (EU) 2021/241, provides financial support for the implementation of reforms and investment, notably to promote the green and digital transitions, thereby strengthening the economies' resilience and potential growth. Part of this support is in the form of non-repayable financial support ("grants"), entailing a fiscal impulse financed by the Union. Together with cohesion policy funds and the Just Transition Mechanism, the RRF is supporting a fair and inclusive recovery in the EU in line with the European Pillar of Social Rights. It also boosts growth and job creation in the medium and long term, and thereby strengthens sustainable public finances. According to the Commission proposal of 18 May 2022[5], the Facility should also aim at increasing the resilience of the Union energy system by reducing dependence on fossil fuels and diversifying energy supplies at Union level ('REPowerEU objectives').

8. On 12 July 2022, in the recommendations delivering Council opinions on the 2022 Stability and Convergence Programmes[6], the Council recalled that the overall fiscal stance is currently best measured as the change in primary expenditure (net of discretionary revenue measures and excluding temporary emergency measures related to the COVID-19 crisis), including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other Union funds, relative to medium-term potential growth.[7] Going beyond the overall fiscal stance, in order to assess whether national fiscal policy is prudent and its composition is conducive to a sustainable recovery consistent with the green and digital transitions, attention is also paid to the evolution of nationally financed[8] primary current expenditure (net of discretionary revenue measures and excluding temporary emergency measures related to the COVID-19 crisis) and investment.

9. The shocks unleashed by the Russian invasion of Ukraine are impacting the EU economy both directly and indirectly, setting it on a path of lower growth and higher inflation. Intensifying and broadening inflationary pressures have been prompting faster normalisation of monetary policy in the euro area. Public spending on measures containing the social and economic impact of high energy costs, on security and defence and on humanitarian assistance to the displaced persons from Ukraine is weighing on public finances. The specific nature of the macroeconomic shock imparted by Russia's invasion of Ukraine, as well as its long-term implications for the EU's energy security needs, call for a careful design of fiscal policy in 2023. A broad-based fiscal impulse to the economy in 2023 does not appear warranted. The focus should instead be on protecting the vulnerable, allowing automatic stabilisers

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[4] On 17 June 2022, the Council agreed its recommendations on the 2022 National Reform Programmes and the opinions on the 2022 Stability and Convergence Programmes, which takes into account the continuation of the Stability and Growth Pact's general escape clause into 2023. (See: https://www.consilium.europa.eu/en/meetings/ecofin/2022/06/17/)

[5] COM(2022) 231 final.

[6] Council Recommendation of 12 July 2022 on the National Reform Programme of Croatia and delivering a Council opinion on the 2022 Convergence Programme of Croatia, OJ C 334, 1.9.2022, p. 88.

[7] The estimates on the fiscal stance and its components in this Opinion are Commission estimates based on the assumptions underlying the Commission 2022 autumn forecast. The Commission's estimates of medium-term potential growth do not include the full positive impact of reforms that are part of the Recovery and Resilience Plan and that can boost potential growth.

[8] Not financed by grants under the Recovery and Resilience Facility or other Union funds.

to operate and providing temporary and targeted measures to mitigate the impact of the energy crisis and to provide humanitarian assistance to people fleeing from Russia's invasion of Ukraine, while maintaining the agility to adjust, if needed. Fiscal policy should combine higher investment with controlling the growth in nationally financed primary current expenditure. Full and timely implementation of the Recovery and Resilience Plans is key to achieving higher levels of investment. Fiscal policies should aim at preserving debt sustainability as well as raising the growth potential in a sustainable manner, thus also facilitating the task of monetary policy to ensure the timely return of inflation to the ECB's 2% medium-term target. Fiscal plans for 2023 should be anchored by prudent medium-term adjustment paths reflecting fiscal sustainability challenges associated with high debt-to GDP levels that have increased further due to the pandemic as well as reforms and investment challenges associated with the twin transition, energy security and social and economic resilience.

10. Russia's war of aggression against Ukraine has resulted in substantial additional increases in and volatility of the prices of energy. The price shock in imported energy implies a substantial terms of trade loss to Member States' economies. In parallel, the exceptionally high temperatures in summer 2022 pushed up demand for electricity, while, at the same time, energy production from certain technologies has been significantly below historical levels due to technical and weather-dependant circumstances. All Member States have been negatively affected by the current energy crisis, albeit to a different extent, calling for a rapid and coordinated response.

11. Given that budgetary resources are limited and need to be used in the most efficient way, in order to manage a durable and equitable adjustment across society, the quality and design of the policy response is highly important. Therefore, also in line with the Council Regulation on an emergency intervention to address high energy prices adopted on 6 October 2022, measures should focus on providing temporary support, targeted to households and firms most vulnerable to energy price increases, while maintaining the right incentives to reduce energy demand and increase energy efficiency, in line with the European Green Deal.[9] Policies should also help reducing the energy consumption and develop the energy autonomy of the Union.

CONSIDERATIONS CONCERNING CROATIA

12. On 20 October 2022, Croatia submitted the Draft Budgetary Plan for 2023. On that basis, the Commission has adopted the following opinion.

13. On 12 July 2022, the Council recommended that Croatia[10] take action to ensure in 2023 that the growth of nationally financed primary current expenditure is in line with an overall neutral policy stance[11], taking into account continued temporary and targeted support to households and firms most vulnerable to energy price hikes and to people fleeing Ukraine. Croatia should stand ready to adjust current spending to

[9] Communication from the Commission, the European Green Deal, COM(2019) 640 final.

[10] Council Recommendation of 12 July 2022 on the National Reform Programme of Croatia and delivering a Council opinion on the 2022 Convergence Programme of Croatia, OJ C 334, 1.9.2022, p. 88.

[11] Based on the Commission 2022 autumn forecast, the medium-term (10-year average) potential output growth of Croatia, that is used to measure the fiscal stance, is estimated at 8.4% in nominal terms. The Commission's estimates of medium-term potential growth do not include the full positive impact of reforms that are part of the Recovery and Resilience Plan and that can boost potential growth.

the evolving situation. Croatia was also recommended to expand public investment for the green and digital transitions, and for energy security taking into account the REPowerEU initiative, including by making use of the Recovery and Resilience Facility and other Union funds. For the period beyond 2023, Croatia should pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions.

14. According to the Commission 2022 autumn forecast, Croatia's economy is expected to grow by 6.0% in 2022 and 1.0% in 2023, while inflation is forecast at 10.1% in 2022 and 6.5% in 2023. According to the Draft Budgetary Plan, Croatia's economy is expected to grow by 5.7% in 2022 and 0.7% in 2023, while inflation is projected at 10.4% in 2022 and 5.7% in 2023. In both sets of projections, government consumption and investment are expected to be the main growth drivers in 2023, while the contribution to growth of net exports is similarly negative in both projections. The inflation profile is slightly less frontloaded in the Commission forecast. The difference between the inflation scenarios mainly stems from import growth and the import deflator, both significantly higher in the Commission forecast.

Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan are plausible in both 2022 and 2023.

Croatia complies with the requirement of Regulation (EU) No 473/2013 since the draft budget is based on independently endorsed macroeconomic forecasts.

15. The Draft Budgetary Plan assumes that expenditure amounting to 0.5% of GDP in 2022 and 1.2% in 2023 will be financed by non-repayable financial support (grants) from the Recovery and Resilience Facility. Expenditures financed by Recovery and Resilience Facility grants will enable high-quality investment and productivity-enhancing reforms without a direct impact on the general government deficit and debt of Croatia. The Commission 2022 autumn forecast includes a similar amount of expenditures financed by Recovery and Resilience Facility grants.

16. In its 2023 Draft Budgetary Plan, Croatia's general government deficit is planned to increase from 1.5% of GDP in 2022 to 2.3% of GDP in 2023, mainly due to the budgetary cost of measures to help households and companies cope with the economic and social impact of rising prices of energy products and food. The general government debt ratio is planned to decrease from 71.3% of GDP in 2022 to 69.0% of GDP in 2023. These projections are in line with the Commission 2022 autumn forecast. Nevertheless, it is worth noting that, unlike the Draft Budgetary Plan, the Commission forecast takes into account an upward revision in the nominal GDP for 2021, amounting to 1.8 percentage points, due ot its later cut-off date. This difference affects the deficit- and debt-to-GDP ratios in the forecast years through the base effect.

The outlook for public finances continues to be subject to the high uncertainty that surrounds the macroeconomic projections, including macroeconomic risks related to the Russian invasion of Ukraine, energy price hikes and continued supply chain disturbances.

17. For 2022, new discretionary measures envisaged in the Draft Budgetary Plan (besides the energy measures detailed below) include a temporary increase in expenditure due to the ruling of the Court for Settlement of Investment Disputes (ICSID), according to which Croatia would have to pay EUR 0.24 billion (approximately 0.4% of GDP) to the Hungarian company MOL. In turn, for 2023, there are two new discretionary measures that are not temporary in nature: on the

revenue side, an increase of the personal income tax exemption for dependent people amounting to EUR 33 million per year (0.05% of GDP); on the expenditure side, an *ad-hoc* increase in the minimum pension, on top of the regular adjustment, amounting to approximately EUR 27 million per year (0.04% of GDP). The difference compared with the Draft Budgetary Plan is that the Commission estimates that the dividend exemption for HEP (national energy company) will be extended to take place also in 2023, and that a temporary expenditure will be required for a capital injection to HEP amounting to up to 0.5% of GDP in 2023, since the company is financing the difference between the market price and the capped prices for electricity and gas.

The government deficit is impacted by the measures adopted to counter the economic and social impact of the exceptional increases in energy prices, which aggravated over the course of the summer.[12] The budgetary cost of these measures is projected in the Commission 2022 autumn forecast to amount to 0.8% of GDP in 2022 and 1.1% of GDP in 2023. They consist of measures reducing government revenue, namely the decrease of the VAT rate (for natural gas, heat, pellet, wood chippings and firewood from 25% to 13%) and excise duties on fuel, as well as a dividend exemption for HEP. Measures increasing expenditure, such as additional social benefits for unemployed and vulnerable energy buyers, a lump-sum energy supplement for pensioners, subsidies for companies and households, and capital increases for HEP. Most measures have been announced as temporary, expiring after the first quarter of 2023. Most measures do not appear targeted to vulnerable households or firms[13], and most of them do not fully preserve the price signal to reduce energy demand and increase energy efficiency.[14] As a result, the amount of temporary and targeted support to households and firms most vulnerable to energy price hikes, that can be taken into account in the assessment of compliance with the fiscal country-specific recommendation for 2023, is estimated in the Commission 2022 autumn forecast at 0.3% of GDP in 2022 and 0.1% of GDP in 2023.

The government deficit is also impacted by the costs of offering temporary protection to displaced persons from Ukraine, which in the Commission 2022 autumn forecast are projected at 0.1% of GDP in 2022 and 0.2% in 2023.

18. Based on the Commission 2022 autumn forecast and including the information incorporated in Croatia’s 2023 Draft Budgetary Plan, the general government gross fixed capital formation is expected to amount to 4.4% of GDP in 2022 and 4.9% of GDP in 2023, compared to 4.7% of GDP recorded in 2021. This includes investment for the green and digital transitions and for energy security, such as investment in fostering the green and digital transition of the tourism sector, digitalising the public administration, investment in digital diagnostics and equipment in hospitals and energy renovation of buildings, which are funded by the Recovery and Resilience Facility.

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[12] Deficit developments in 2023 are also affected by the complete phasing-out of COVID-19 emergency temporary measures, which are estimated in the Commission 2022 autumn forecast at 0.4% of GDP in 2022.

[13] Targeted measures amount to 0.3% of GDP in 2022 and 0.1% of GDP in 2023, while untargeted measures amount to 0.5% of GDP in 2022 and 1.0% of GDP in 2023.

[14] Income measures amount to 0.2% of GDP in 2022 and 0.0% of GDP in 2023, while price measures amount to 0.6% of GDP in 2022 and 1.1% of GDP in 2023.

19. In 2023, the fiscal stance is projected in the Commission 2022 autumn forecast to be broadly neutral (-0.1% of GDP[15]). This follows an expansionary fiscal stance in 2022 (-2.6% of GDP).

The growth in nationally financed primary current expenditure (net of new revenue measures) in 2023 is projected to provide a contractionary contribution of 0.4 percentage points of GDP.[16] This includes the decreased impact from the support measures adopted to counter the economic and social impact of the exceptional increases in energy prices by 0.2% of GDP[17], with temporary and targeted support measures to households and firms most vulnerable to energy price hikes accounting for 0.2 % of GDP of this reduction. This also includes higher costs to offer temporary protection to displaced persons from Ukraine (by 0.1 % of GDP).

The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 0.1 percentage points of GDP in 2023 compared to 2022. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.3 percentage points in 2023.[18]

20. The Draft Budgetary Plan does not include budgetary projections beyond 2023.

21. In 2023, based on the Commission's forecast and including the information incorporated in the Draft Budgetary Plan, the overall fiscal policy stance is estimated to be broadly neutral. This includes a contractionary contribution to the overall fiscal stance from nationally financed current expenditure. Overall, given the evolving situation, in particular the expansionary fiscal stance in 2022 and the high inflationary pressures, the growth of nationally financed primary current expenditure is in line with the recommendation of the Council. Croatia plans to finance additional investment through RRF and other EU funds, and it also preserves nationally financed investment. It plans to finance public investment and investment grants for the green and digital transitions, and for energy security.

Overall, the Commission is of the opinion that the Draft Budgetary Plan for Croatia is in line with the fiscal guidance contained in the Council recommendation of 12 July 2022.

While Croatia rapidly deployed energy measures as part of the emergency policy response to the exceptional energy price hikes, a prolongation of existing and/or an enactment of new support measures in response to high energy prices would contribute to higher growth in net nationally financed current expenditure and to an increase in the projected government deficit and debt in 2023. Therefore, it is important that Member States better focus such measures to the most vulnerable households and exposed firms, to preserve incentives to reduce energy demand, and to be withdrawn as energy price pressures diminish.

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15 A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy. The fiscal stance includes the fiscal impulse funded by the Union.

16 This follows an expansionary contribution from this component of 2.2 percentage points in 2022.

17 The budgetary impact of targeted price and income measures is projected to increase by 0.1% of GDP and remain stable respectively, while the budgetary impact of untargeted price and income measures is projected to increase by 0.2% and decrease by 0.2% of GDP respectively.

18 Other nationally financed capital expenditure is projected to provide an expansionary contribution of 0.1 percentage points of GDP.

A comprehensive description of progress made with the implementation of the country-specific recommendations will be made in the 2023 Country Report and assessed in the context of the country-specific recommendations to be proposed by the Commission in spring 2023.

Done at Brussels, 22.11.2022

For the Commission
Paolo GENTILONI
Member of the Commission