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Assessment of the 2016 Convergence Programme for Croatia

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Croatia's 2016 Convergence Programme (hereafter called Convergence Programme), which was submitted to the Commission and the Council on 28 April and covers the period 2016-2019. It was adopted by the government on the same day, following which it was presented to the national parliament.

Croatia is currently subject to the corrective arm of the Stability and Growth Pact (SGP). The Council opened the Excessive Deficit Procedure (EDP) based on both deficit and debt on 28 January 2014. Croatia was recommended to correct the excessive deficit situation by 2016, including by ensuring compliance with the debt reduction benchmark in the final year of the correction period. The year following the abrogation of the excessive deficit procedure, Croatia will be subject to the preventive arm of the SGP and should ensure sufficient progress towards its medium-term budgetary objective (MTO).

This document complements the Country Report published on 26 February 2016 with the information included in the programme.

The note is structured as follows. Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2016 spring forecast. The subsequent section presents the recent and planned budgetary developments, according to the Convergence Programme. In particular, it includes an overview of the medium-term budgetary plans, an assessment of the measures underpinning the programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview of long-term sustainability risks and Section 6 discusses recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

In 2015, Croatia came out of a six-year-long recession, with real GDP expanding by 1.6%. External demand continued to contribute positively to economic growth, on the back of a strong tourist season and further gains in EU market shares. Internal demand, however, registered the largest contribution, with household consumption growing by 1.2% and investment by 0.6%, despite the sharp contraction of public investment, by over 20% according to the 2015 fiscal data notified to Eurostat.

The macroeconomic scenario underpinning the Convergence Programme foresees an acceleration of GDP growth up to 2019. Specifically, in 2016 and 2017, real GDP growth is set to attain 2.0% and 2.1% respectively, and to further expand by 2.3% and 2.5% in 2018 and 2019. Over the programme horizon, domestic demand is set to be the main driver of the recovery. Private consumption is projected to accelerate and investment is expected to rebound as fiscal consolidation needs progressively abate and absorption of EU funds progresses. Net exports are projected to continue to contribute positively to economic growth, especially in 2016 and 2017, before mildly detracting from it in 2019.

The labour market is expected to continue its recovery, with employment expanding by 1% in 2016 and progressively accelerating to about 1.5% in the outer years. After the prolonged wage restraint of previous years, compensation of employees is set to grow in real terms. HICP inflation is expected to increase to 1.7% by 2019, broadly in line with unit labour costs.

The output gap as recalculated by the Commission, following the commonly agreed methodology, is now expected to close in 2018, as real GDP is set to grow significantly above its potential growth throughout the programme horizon, whereas according to the Commission 2016 spring forecast, the output gap is projected to be nearly closed already by 2017 (-0.3% of GDP).

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	1.6	1.6	1.8	2.0	2.1	2.1	2.3	2.5
Private consumption (% change)	1.2	1.2	1.7	1.8	2.0	1.8	2.0	2.5
Gross fixed capital formation (% change)	1.6	1.6	2.6	2.5	3.4	3.2	3.5	4.5
Exports of goods and services (% change)	9.2	9.2	5.7	5.2	4.2	5.5	5.6	5.4
Imports of goods and services (% change)	8.6	8.6	5.8	4.7	4.7	5.3	5.9	6.3
Contributions to real GDP growth:								
- Final domestic demand	1.2	1.2	1.7	1.6	2.2	1.8	2.1	2.7
- Change in inventories	0.0	0.0	0.0	0.1	0.0	0.1	0.1	-0.1
- Net exports	0.5	0.5	0.1	0.3	-0.1	0.3	0.1	-0.2
Output gap[1]	-2.9	-3.1	-1.7	-2.0	-0.3	-0.9	0.1	1.2
Employment (% change)	1.7	1.7	1.0	1.1	1.4	1.4	1.6	1.5
Unemployment rate (%)	16.3	16.3	15.5	15.5	14.7	14.5	13.5	12.8
Labour productivity (% change)	0.0	0.0	0.7	0.9	0.7	0.7	0.7	0.9
HICP inflation (%)	-0.3	-0.5	-0.6	0.1	0.7	1.4	1.6	1.7
GDP deflator (% change)	0.1	0.1	0.3	1.0	1.0	1.2	1.5	1.7
Comp. of employees (per head, % change)	-0.5	-0.5	1.1	1.5	1.6	1.9	2.1	2.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	5.5	5.6	5.0	4.9	4.7	5.2	5.3	4.9

Note:

[1]In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2016 spring forecast (COM); Convergence Programme (CP).

In light of the Commission 2016 spring forecast, the real GDP growth assumptions presented in the programme appear plausible in the first two years of the programme. The growth assumptions for 2018 and especially 2019 appear somewhat favourable, in light of the low potential growth (0.6% in 2017 on the back of subdued growth in total factor productivity). The composition of growth, on the other hand, appears broadly plausible, as it factors in a progressive narrowing of the contribution of external demand and a rebound in investment. HICP inflation is significantly higher in 2016 and 2017 (by 0.7 pp.) than projected in the Commission 2016 spring forecast, while the GDP deflator is 0.7 pp. higher than projected by the Commission in 2016 and 0.2 pp. in 2017. The projected price developments in the programme do not seem to take into account the effects of the administered decrease in gas prices in effect from 1 April 2016. Labour market dynamics also appear plausible in terms of employment expansion – at least for 2016 and 2017. Employment growth in the outer years is consistent with the path of expansion of GDP. The projection of nominal compensation per employee, on the other hand, appears on the high side – though consistent with the rather sanguine expectations on price developments.

Overall, the macroeconomic scenario underpinning the budgetary projections is plausible in real terms until 2017, but nominal GDP growth is higher than projected in the Commission forecast, and considerably so for 2016. Risks surrounding the macroeconomic scenario are skewed to the downside, and are related to the still high debt burden in both the public and private sectors and uncertainty regarding the progress in the structural reform agenda. In the outer years the programme scenario appears somewhat favourable, in light of the low projection of potential growth.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2015

The general government deficit decreased to 3.2% of GDP in 2015, down from 5.5% of GDP in 2014 and significantly below the 5.0% of GDP target set in the Convergence Programme of last year.

The main driver of the sizeable improvement was a notified 22% drop in public investment, shared broadly equally between the central and local government levels. While lower-than-expected investment explains most of the 1.0% of GDP difference between the expenditure target set in the 2015 Convergence Programme and the outturn, differences were recorded also in subsidies and capital transfers paid (0.2% and 0.3% of GDP below their respective targets), while current transfers paid turned out 0.6% of GDP above the target. The sizeable differences between planned and actual expenditure outcomes may indicate weaknesses in budgeting at the general government level, both at the planning and execution stages, as they do not appear to be the result of higher nominal growth nor of explicit fiscal policy measures implemented after the adoption of last year's programme.

General government revenue was 0.8% of GDP higher than last year's target, largely on account of higher-than-expected yields of indirect and direct (excluding social security contributions) taxation (0.6% and 0.4% of GDP above the respective targets), while property income was 0.2% of GDP lower than planned. The yields of both indirect and direct taxation exceeded the anticipated growth based on the relevant tax elasticities and the estimated impact of fiscal policy measures.

On the back of these developments, the structural balance is estimated to have improved by nearly 2% of GDP to about -1¾% of GDP in 2015.

3.2. Medium-term strategy and targets

The main aim of the Croatian fiscal policy in the medium term, as defined by the Convergence Programme, is to correct the excessive deficit by 2016 and to maintain a structural deficit around the MTO of 1.75% of GDP throughout the programme period. Most of the planned headline deficit reduction stems from the expenditure side of the budget.

For 2016, the authorities target a general government deficit of 2.6% of GDP, down from 3.2% of GDP in 2014 and just below the recommended target of 2.7% of GDP. The share of total revenue in GDP is projected to increase by 0.4% of GDP, while the expenditure ratio is expected to remain broadly stable in 2016. The authorities aim to achieve this target on the basis of revenue-increasing measures totalling 0.4% of GDP, and expenditure-decreasing measures of 0.7% of GDP (see table below). The fiscal consolidation efforts projected in the programme originate from the central government level, which is planned to reduce its deficit

from 3.2% of GDP in 2015 to 2.6% in 2016. In addition, the social security funds are expected to go from a deficit of 0.2% of GDP in 2015 to a balanced budget position in 2016. These efforts are partly offset by local authorities, which according to plans will go from a small surplus in 2015 (0.2% of GDP) to a deficit (0.1% of GDP) in 2016.

In the 2015 Convergence Programme, the authorities were aiming at a deficit of 3.9% of GDP in 2016, 1.3% of GDP higher than the current target (Figure 1). The base effect of a better-than-expected outcome of 2015 is partly offset by the change in the implicit projected growth rate of expenditure, which is 1% of GDP higher than in the previous year Convergence Programme.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		2018	2019	Change: 2015-2019
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**43.7**	**44.1**	**44.1**	**44.4**	**43.7**	**43.7**	**43.1**	**-0.6**
of which:								
- Taxes on production and imports	19.5	19.5	19.4	19.5	19.2	19.0	18.8	-0.8
- Current taxes on income, wealth, etc.	5.9	5.8	5.7	6.1	5.7	5.6	5.6	-0.4
- Social contributions	11.9	11.9	11.8	12.0	11.6	11.4	11.2	-0.7
- Other (residual)	6.3	6.7	7.2	6.8	7.2	7.7	7.6	1.3
Expenditure	**46.9**	**46.8**	**46.8**	**46.6**	**45.7**	**45.3**	**44.2**	**-2.7**
of which:								
- Primary expenditure	43.3	43.2	43.2	43.1	42.3	41.9	40.8	-2.5
of which:								
Compensation of employees	11.4	11.4	11.2	11.3	11.0	10.8	10.5	-0.9
Intermediate consumption	8.1	8.0	7.8	8.0	7.6	7.6	7.4	-0.6
Social payments	16.4	16.3	16.2	16.1	16.0	15.7	15.5	-0.9
Subsidies	1.7	1.7	1.6	1.7	1.5	1.3	1.2	-0.5
Gross fixed capital formation	2.8	3.1	3.4	3.3	3.8	3.8	3.8	0.9
Other (residual)	3.0	2.7	3.0	2.7	2.4	2.7	2.3	-0.6
- Interest expenditure	3.6	3.6	3.5	3.6	3.5	3.4	3.3	-0.2
General government balance (GGB)	**-3.2**	**-2.7**	**-2.6**	**-2.3**	**-2.0**	**-1.6**	**-1.0**	**2.2**
Primary balance	**0.4**	**0.9**	**0.9**	**1.3**	**1.4**	**1.8**	**2.3**	**1.9**
One-off and other temporary	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
GGB excl. one-offs	**-3.1**	**-2.7**	**-2.6**	**-2.3**	**-2.0**	**-1.6**	**-1.0**	**2.1**
Output gap[1]	-2.9	-1.7	-2.0	-0.3	-0.9	0.1	1.2	4.1
Cyclically-adjusted balance[1]	-1.8	-1.9	-1.7	-2.1	-1.6	-1.7	-1.6	0.3
Structural balance[2]	**-1.7**	**-1.9**	**-1.7**	**-2.1**	**-1.6**	**-1.7**	**-1.6**	**0.2**
Structural primary balance[2]	1.8	1.7	1.8	1.4	1.9	1.7	1.8	-0.1

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

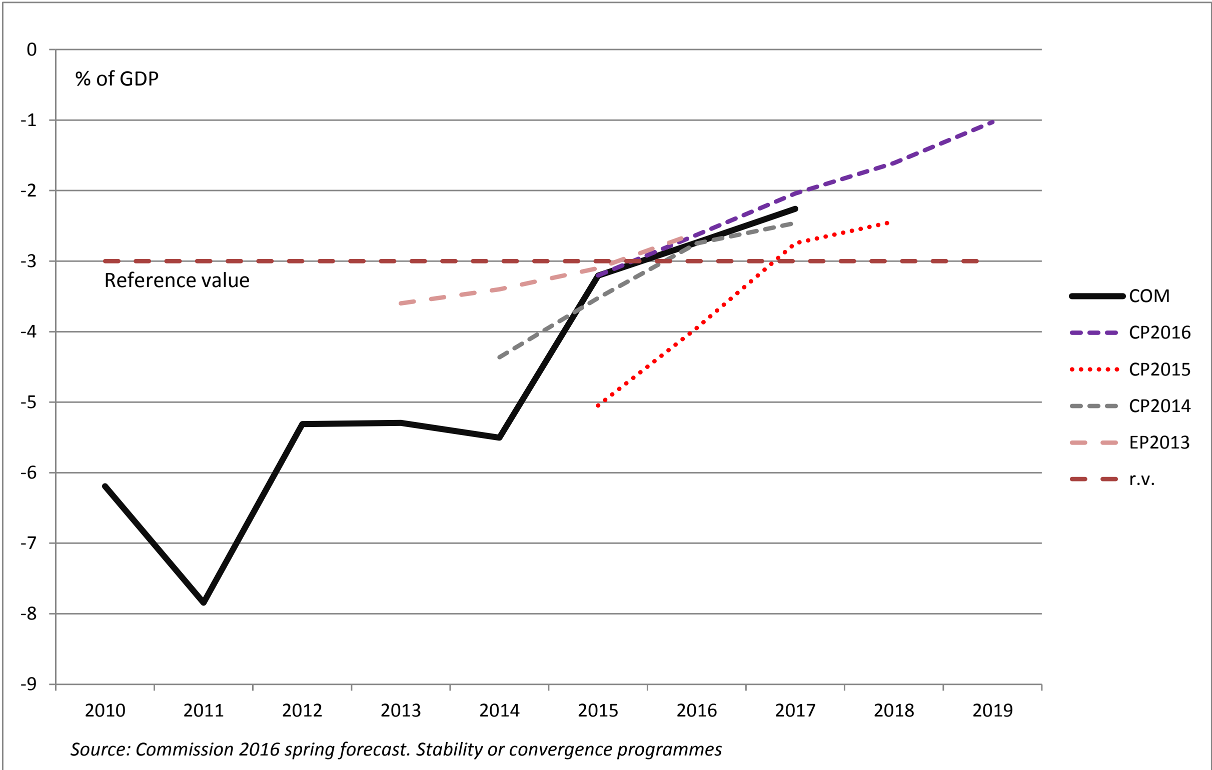
Source :

Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.

In the Commission 2016 spring forecast, the general government deficit in 2016 is projected at 2.7% of GDP, an improvement of 0.5% of GDP compared to the 2015 outturn. The difference between the Convergence Programme target for 2016 and the Commission 2016 spring forecast is minimal, reflecting broadly similar revenue and expenditure projections. However, in light of the higher inflation expectations in the programme macroeconomic scenario, a broadly similar projected expenditure ratio for 2016 implies a higher amount of expenditure in nominal terms.

On the basis of the information in the programme, the structural balance[1], as recalculated by the Commission according to the commonly agreed methodology, is expected to remain broadly stable over the programme horizon. By contrast, according to the Commission 2016 spring forecast, the structural balance is expected to worsen by 0.2% of GDP in both 2016 and 2017 (a difference which can be entirely explained by different assumptions about the potential output drivers translating into a different estimated output gap for 2016).

Figure 1: Government balance projections in successive programmes (% of GDP)



In the medium term, the reduction of the headline general government deficit in the programme appears evenly distributed over the 2015-2019 period. Similar to the expected developments in 2016, the deficit reduction throughout the programme period is expected to occur mainly at central government level. The broadly stable (recalculated) structural balance suggests a broadly neutral fiscal stance throughout the observed period.

The programme deficit targets are significantly lower than the targets in the 2015 Convergence Programme, mostly on account of the lower starting position in 2015 as well as

[1] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

the significantly improved macroeconomic outlook (in the programme, real GDP growth rates in the period 2016-2018 are on average 0.9 pp. higher than in the previous year's programme).

3.3. Measures underpinning the programme

Similarly to the 2015 Convergence Programme, the programme envisages several small expenditure cuts in 2016 across many different categories and also levels of government (including extra-budgetary users). These cuts are often not underpinned by specified fiscal policies and/or require further implementation measures by budgetary users. In addition, some of the items presented in the programme as budgetary measures cannot be considered as policy actions. The notable example is a drop in unemployment benefits driven by improved labour market conditions. Furthermore, the government plans revenue from the withdrawal of profits from state-owned enterprises (SOEs), although this does not appear to imply a change in the policy orientation with regards to profits of SOEs. On the revenue side, revenue from corporate income taxation in 2016 is expected to be positively affected by a less favourable tax treatment of reinvested earnings. In addition, according to the National Reform Programme, in 2016 and 2017 the government plans to divest real assets – apartments, offices – in the amount of around 1% of GDP per year to support the fiscal consolidation strategy. The Convergence Programme does not report on this plan, other than with a general reference to a planned improvement of the management of state assets. However, according to information from the Ministry of Finance, the programme projections for 2016 and 2017 incorporate the proceeds from disposals of fixed assets as negative gross fixed capital formation, although not in the full planned amount.

For 2017 and the later years, no additional measures have been specified. The programme only foresees the continuous impact of previously introduced measures on the expenditure side. Thus, similarly to last year's Convergence Programme, the fiscal strategy requires measures that still need to be specified, in particular on the expenditure side. The programme states that the achievement of the fiscal targets will depend on the implementation of key structural reforms described in the Croatian 2016 National Reform Programme, which are expected to mainly affect expenditure.

Main budgetary measures

Revenue	**Expenditure**
2015	
• Increase of the rate of healthcare contributions from 13% to 15% (+0.25% of GDP) – a residual effect of the measure introduced in 2014; • Changes in the lottery and gambling taxes (+0.05% of GDP) – a residual effect of the measure introduced in 2014; • Increased social security contributions due to the shift of part of the future pension contributions to first pillar (+0.04% of GDP) – a residual effect of	• Savings on central government compensation of employees (-0.05%); • Lower intermediate consumption due to savings on externally-provided services (-0.08% of GDP); • Reduction of subsidies for agriculture, active labour market policies and Croatian Bank for Reconstruction and Development (-0.03% of GDP); • Social benefits savings on housing loan subsidies and preferential pensions above 5000 HRK, and

the measure introduced in 2014; • Personal income tax rebate[2] (-0.37% of GDP); • Tax on savings interest (+0.07% of GDP); • Higher fuel and tobacco excises (+0.16% of GDP).	consolidation of social benefits (-0.05% of GDP); • Savings of extrabudgetary users, in particular Croatian Waters, Croatian Health Insurance Fund, Croatian Highways, Croatian Railway Infrastructure (-0.5% of GDP); • Reduction of transfers, mainly guarantee funds (-0.13% of GDP); • Reduction of investment expenditure of the central and local government units (-0.5% of GDP).
2016	
• SOEs dividend and profit withdrawal (+0.2% of GDP); • Higher fuel and tobacco excises (+0.06% of GDP) – a residual effect of the measure introduced in 2014 • New treatment of reinvested earnings in the corporate income tax system (+0.15% of GDP).	• Lower intermediate consumption due to implementation of "standard material costs guidelines" (-0.05% of GDP); • Further reduction of subsidies of some activities and substitution with EU funds (-0.16% of GDP); • Reduction of social benefits through their further integration and decreasing unemployment (-0.13% of GDP) • Savings in other transfers through expiry of certain programmes and substitution with EU funds (-0.21% of GDP); • Reduction of investment expenditure in defence, health, education, science (-0.07% of GDP).
2017	
• No measures specified in the Convergence Programme	• No measures specified in the Convergence Programme
2018	
• No measures specified in the Convergence Programme	• No measures specified in the Convergence Programme
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

[2] As from January 2015, the personal allowance was increased from HRK 2200 to 2600 per month and the lower limit for the highest marginal tax rate of 40% was increased from HRK 8800 to HRK 13200.

3.4. Debt developments

The general government gross debt reached 86.7% of GDP in 2015. Compared with 2014, the debt ratio increased marginally, by 0.1% of GDP, as the contribution of the general government deficit was nearly fully offset by a debt-reducing decrease in government deposits.

The programme projects that, after peaking in 2015, the debt ratio will gradually decrease to 80% of GDP by 2019 (Figure 2). The reduction in the debt ratio over the programme horizon is driven by a strengthening primary surplus, a declining debt-increasing snow-ball effect and sustained debt-reducing stock flow adjustments. The latter are expected to include about 0.4-0.5% of GDP privatisation receipts annually in 2016-2019 due to sales of financial assets, and an additional 0.3% of GDP in 2016 due to a further draw-down of government deposits.

The Commission 2016 spring forecast expects the debt ratio to peak in 2016 (at 87.6% of GDP) and to edge down by 0.3% of GDP in 2017. The main difference between the projection underpinning the programme and the Commission forecast is that the latter incorporates a neutral impact of stock-flow adjustments, largely because the announced sales of state financial assets have not yet been specified in the programme and therefore cannot be taken into account.

The debt ratio was substantially affected by the reclassification of several highly-indebted SOEs inside the general government sector in 2014 and 2015, which was triggered by the changeover to the European System of National and Regional Accounts (ESA2010). In 2016, government debt was revised further upwards by around 1.4% of GDP due to the recording of the assets related to a concession contract for the construction of motorways on the government balance sheet. Even after controlling for the impact of these revisions, which imply an upward shift in the data series for the debt, the 2015 debt ratio still appears to have been significantly overestimated in the 2015 Convergence Programme, largely on account of the better-than-expected deficit outturn and the greater-than-planned drawdown of government deposits.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**72.6**	**86.7**	**87.6**	**85.9**	**87.3**	**84.7**	**82.8**	**80.0**
Change in the ratio	7.5	0.1	1.0	-0.7	-0.3	-1.2	-1.9	-2.8
Contributions [2] *:*								
1. Primary balance	**2.8**	**-0.4**	**-0.9**	**-0.9**	**-1.3**	**-1.4**	**-1.8**	**-2.3**
2. "Snow-ball" effect	**3.3**	**2.1**	**1.8**	**1.0**	**1.0**	**0.7**	**0.4**	**0.1**
Of which:								
Interest expenditure	3.2	3.6	3.6	3.5	3.6	3.5	3.4	3.3
Growth effect	0.7	-1.4	-1.5	-1.7	-1.7	-1.8	-1.8	-1.9
Inflation effect	-0.6	-0.1	-0.3	-0.9	-0.8	-1.0	-1.2	-1.3
3. Stock-flow adjustment	**1.4**	**-1.6**	**0.0**	**-0.8**	**0.0**	**-0.4**	**-0.4**	**-0.5**
Of which:								
Cash/accruals diff.								
Acc. financial assets				0.8		0.4	0.4	0.5
Privatisation				0.5		0.4	0.4	0.5
Val. effect & residual				0.3				

Notes:

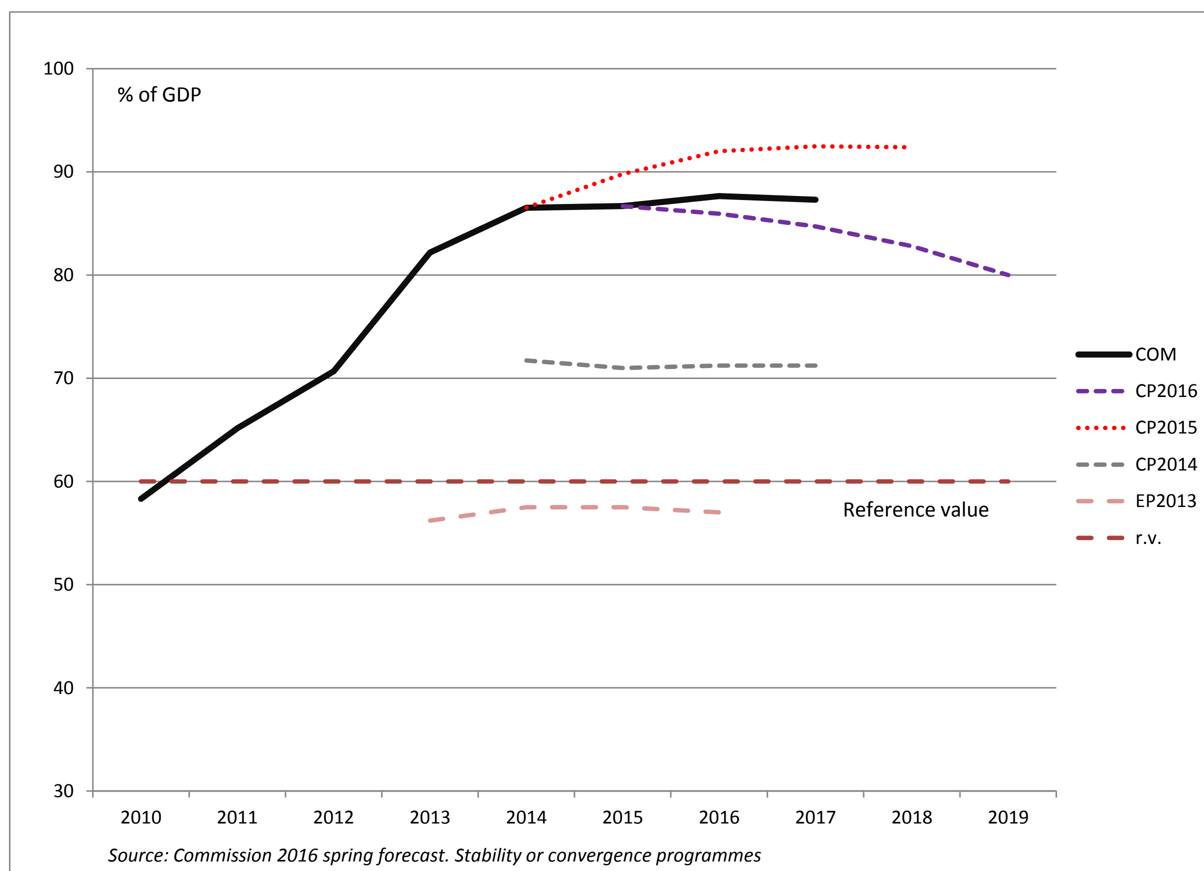
[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2016 spring forecast (COM); Convergence Programme (CP), Comission calculations.

Figure 2: Government debt projections in successive programmes (% of GDP)



Source: Commission 2016 spring forecast. Stability or convergence programmes

3.5. Risk assessment

Risks to the deficit projection for 2016 in the Convergence Programme are related to the high inflation expectations in the underpinning macroeconomic scenario relative to the Commission 2016 spring forecast. If prices grow below the projections in the programme, additional expenditure restraint will be necessary in order to reach the expenditure targets foreseen in the programme.

Furthermore, both the Commission and the Convergence Programme deficit projection for 2016 and 2017 are subject to considerable risks. In 2016, these are in particular related to the ongoing renegotiation of collective wage agreements in the public sector. In 2009 government and trade unions in the public sector agreed to postpone a previously arranged 6% increase of the wage base until GDP growth accelerates to an average 2% over two consecutive quarters, which happened in the second half of 2015. Additional risks stem from continued uncertainty about the impact of the CHF loan conversion legislation and a stronger rebound of investment activity in public corporations classified in the general government sector, following the sharp adjustment in 2015. In 2017, expenditure could increase more than planned in view of the 2017 local elections. Further risks relate to the continued generation of arrears in the health sector, as well as potential adverse developments of interest expenditure if market rates go up from current historically low levels.

There are some specific implementation risks to the fiscal measures reported in the programme (see Section 3.2). In 2016, on the revenue side, there is a risk that developments in SOE profits and dividends will not enable their envisaged increased withdrawal by the government. Similar plans in the past have underperformed – e.g. in last year's Convergence

Programme the authorities planned the withdrawal of SOE profits in the amount of HRK 600 mn in 2015; according to this year's programme, there was no withdrawal in 2015 –, while their impact is likely to be temporary.

For 2017 and the outer years of the programme, risks are related to the fact that no measures to achieve the targets have been specified yet. This is, however, partly compensated for by the relatively conservative revenue projections in the programme; total revenue growth rates are mostly well below the nominal GDP growth.

Contingent liabilities are still present, most notably in the form of numerous guarantees issued to SOEs outside the general government sector, in particular in the transportation sector. The likelihood of these risks materialising also depends on the success of the further restructuring operations of indebted SOEs.

Regarding the debt-to-GDP ratio, the projections in the programme are based on a relatively optimistic nominal GDP forecast and strongly rely on an ambitious privatisation agenda (yielding 0.4-0.5% of GDP per year). While the expected privatisation receipts in 2016 carry considerable implementation risks, also because the tenders for the sale of the assets are expected to be initiated only in November 2016, the plans for the following years are not specified. Moreover, the track record shows that privatisation receipts tend to be overestimated. The 2015 Convergence Programme targeted 0.6% of GDP privatisation receipts in 2015 but, according to the notified data for 2015, the turnout was negligible. Additional risks relate to possible further reclassifications of some operations and/or entities in the general government sector, as was the case with the April 2016 notification.

Beyond the risks related to the development of the deficit mentioned above, another source of concern is the currency structure of the Croatian public debt, which exposes its repayment to foreign exchange risk (almost 80% of the public debt is denominated in the foreign currency). Sensitivity analysis reported in the Convergence Programme shows that a 15% depreciation of the HRK against the euro would lead to a 10 pps. higher public debt-to-GDP ratio. Nevertheless, ample liquidity in the financial sector and the current low interest rate environment implies no major refinancing risks in the short term. Accordingly, the indicator S0 indicates limited risks of fiscal stress in the short term (see Table 5).[3] Still, a difficult financial situation in specific SOEs classified in the general government sector, in particular in the highway maintenance and operation sector, may pose refinancing risks.

[3] This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Fiscal Sustainability Report 2015 (page 67).

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

The 3.2% of GDP general government deficit in 2015 is below the headline target of 3.5% of GDP. The structural balance is estimated to have improved by 1.8% of GDP, which is substantially above the recommended improvement of 0.9% of GDP in 2015. The structural improvement exceeds the target implied by the Council recommendation also in cumulative terms over 2014-2015 (1.6% of GDP compared with the target of 1.4% of GDP).

Box 1. Council recommendations addressed to Croatia

- On 28 January 2014, the Council recommended Croatia under Article 126(7) of the Treaty to correct its excessive deficit situation by 2016. To this end, Croatia was required to reach a headline general government deficit target of 4.6 % of GDP in 2014, 3.5 % of GDP in 2015 and 2.7% of GDP in 2016, which was consistent with an annual improvement in the structural balance of 0.5 % of GDP in 2014, 0.9 % of GDP in 2015 and 0.7% of GDP in 2016, and use any windfall gains for deficit reduction. The Council set the deadline of 30 April 2014 for Croatia to take effective action and, in accordance with Article 3(4a) of Regulation (EC) No 1467/97, to report in detail on the consolidation strategy that it envisaged in order to achieve the targets; thereafter the Croatian authorities was required to report on progress made in the implementation of these recommendations at least every six months until the excessive deficit has been fully corrected. Furthermore, the Council invited the Croatian authorities to: (i) carry out a thorough expenditure review with the objective of rationalising wage, social security and subsidy outlays and to provide sufficient fiscal space for the implementation of growth-enhancing expenditure, including co-financing of projects funded by the Union; (ii) further improve tax compliance and increase the efficiency of its tax administration, and (iii) improve the institutional framework of public finances, including by enhancing multi-annual budgetary programming, by strengthening the role and independence of the Fiscal Policy Committee, and by ensuring compliance with fiscal rules.
- On 14 July 2015, the Council also addressed recommendations to Croatia in the context of the European Semester. In particular, in the area of public finances the Council recommended to Croatia to ensure a durable correction of the excessive deficit by 2016 by taking the necessary measures in 2015 and reinforcing the budgetary strategy for 2016.

Based on the Commission 2016 spring forecast, Croatia is on track to bring its deficit to below 3% of GDP in 2016, as recommended by the Council. For 2016, the Convergence Programme projects that the headline deficit will decrease to 2.6% of GDP, 0.1% of GDP below both the headline target recommended under the EDP for this year and the deficit projected in the Commission 2016 spring forecast. According to the programme, the (recalculated) structural balance is expected to remain unchanged in 2016. By contrast, the Commission forecast points to a deterioration of 0.2% of GDP, leading to a gap of 0.9% of GDP *vis-à-vis* the required structural effort of 0.7% of GDP. The cumulative unadjusted change in the structural balance over the 2014-2016 (a period covered by the EDP recommendation) is, according to the Commission 2016 spring forecast, 1.4% of GDP, against the recommended 2.1% of GDP.

Accounting for revisions in the potential output growth estimate and unexpected revenue windfalls/shortfalls since the time of the EDP recommendation, the adjusted change in the structural balance in 2016 amounts to 0.6% of GDP, only slightly below the recommended effort of 0.7% of GDP. The difference between the unadjusted and adjusted change in the structural balance is largely due to a less favourable assessment of windfall revenues compared to what was assumed at the time when the recommendation was issued. In addition, potential output growth is now estimated to be lower. Based on the bottom-up assessment,

Croatia is expected to deliver a fiscal effort of 0.9% of GDP in 2016, below the 1.0% of GDP of structural measures that are considered necessary to achieve the required fiscal effort in the EDP recommendation.

Due to the sizeable over-achievement in 2014, the fiscal effort achieved in cumulative terms over 2014-2016 meets the targets both according to the adjusted change in the structural balance (2.4% of GDP compared to 2.1% of GDP implied by the Council recommendation) and based on the bottom-up method (5.0% of GDP compared to the 4.3% of GDP of structural measures considered necessary to achieve the required fiscal effort).

For 2017 and beyond, the Convergence Programme projects that the headline deficit will remain below the 3% of GDP reference value and the (recalculated) structural balance at the MTO of -1.75% of GDP. By contrast, based on the Commission 2016 spring forecast, the structural balance is expected to worsen by 0.2% of GDP in 2017, reaching -2.1% of GDP.

With a debt ratio above 60% of GDP, Croatia is required to ensure that the debt-to-GDP ratio is reduced at a sufficient pace. Taken at face value and based on the somewhat favourable assumptions on nominal GDP growth (see Section 2) and the sizeable debt-reducing stock-flow adjustment (see Section 3.4), the Convergence Programme projects compliance with the forward-looking element of the debt benchmark in both 2016 and 2017.[4] On the basis of the Commission 2016 spring forecast, the gross debt ratio is expected to remain 3.2% of GDP and 2.8% of GDP above the forward-looking element of the debt benchmark in 2016 and 2017, respectively.

Overall, based on the findings of the Commission 2016 spring forecast, Croatia is expected to meet the recommended deficit target for 2016 and to deliver the required fiscal effort over the period 2014-2016.

Given that Croatia's general government gross debt-to-GDP ratio is projected at above the reference value of 60% in the Treaty, the EDP should only be abrogated if the Commission forecast indicates that the debt ratio fulfils the forward-looking element of the debt benchmark. However, the debt benchmark is expected not to be complied with in 2016 and 2017. Based on the Commission 2016 spring forecast, a structural adjustment beyond the MTO chosen by the Croatian authorities would be needed to ensure compliance with the debt reduction benchmark. In particular, in view of the high debt and given current cyclical conditions in Croatia (the output gap almost closing in 2017 and GDP growth well above potential), a fiscal adjustment above the 0.5% of GDP benchmark would seem appropriate, also with a view to facilitating compliance with the debt reduction benchmark.

[4] The assessment of the debt benchmark based on the Convergence Programme is limited by the programme horizon to years 2016 and 2017.

Table 4: Compliance with the requirements of the corrective arm

(% of GDP)	2015	2016		2017	
	COM	CP	COM	CP	COM
Headline balance					
Headline budget balance	-3.2	-2.6	-2.7	-2.0	-2.3
EDP requirement on the budget balance	-3.5	-2.7			
Fiscal effort - change in the structural balance					
Change in the structural balance[1]	1.8	0.0	-0.2	0.1	-0.2
Cumulative change[2]	1.6	1.5	1.4		
Required change from the EDP recommendation	0.9	0.7			
Cumulative required change from the EDP recommendation	1.4	2.1			
Fiscal effort - adjusted change in the structural balance					
Adjusted change in the structural balance[3]	1.5	-	0.6	-	
of which: *correction due to change in potential GDP estimation (α)*	0.0	-	0.3	-	-
correction due to revenue windfalls/shortfalls (β)	0.3	-	-0.5	-	
Cumulative adjusted change [2]	1.8	-	2.4	-	
Required change from the EDP recommendation	0.9	0.7			
Cumulative required change from the EDP recommendation	1.4	2.1			
Fiscal effort - calculated on the basis of measures (bottom-up approach)					
Fiscal effort (bottom-up)[4]	1.7	-	0.9	-	
Cumulative fiscal effort (bottom-up)[2]	4.1	-	5.0	-	
Requirement from the EDP recommendation	1.0	1.0			
Cumulative requirement from the EDP recommendation	3.3	4.3			

Notes

[1]Structural balance = cyclically-adjusted government balance excluding one-off measures. Structural balance based on programme is recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology. Change compared to *t-1* .

[2] Cumulated since the latest EDP recommendation.

3 Change in the structural balance corrected for (-) unanticipated revenue windfalls/shortfalls and (+) changes in potential growth compared to the scenario underpinning the EDP recommendations.

[4]The estimated budgetary impact of the additional fiscal effort delivered on the basis of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and the current forecast.

Source :

Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

Based on Commission forecasts and a no-policy-change scenario beyond the forecast years, the general government gross debt is expected to decrease from 87.6% of GDP in 2016 to 83.7% in 2026, thus remaining above the 60% of GDP Treaty reference value. The debt sustainability analysis, which assesses the response of the baseline scenario to different shocks, indicates high risks for the country in the medium term. However, the medium-term fiscal sustainability gap, measured as the risk indicator S1, shows that the upfront adjustment needed to bring the debt ratio to 60% of GDP in 2030 is 1.9 % of GDP, which indicates medium risks in the medium term. The value of the indicator is primarily affected by the high level of government debt. The full implementation of the Convergence Programme would decrease the size of the sustainability gap to 1.4% of GDP, still consistent with the assessment of medium risks. Overall, risks to fiscal sustainability over the medium-term are, therefore, medium to high.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at -2.3 % of GDP. In the long-term, Croatia therefore appears to face low fiscal sustainability risks, primarily due to the projected decrease in age-related spending (contributing with -2.5% of GDP, driven largely by the projected decrease in pension expenditures). The full implementation of the programme would put the S2 indicator at -2.6% of GDP, leading to a similar assessment.

Table 5: Sustainability indicators

Time horizon				No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term				**LOW risk**			
	S0 indicator [1]			0.2			
	Fiscal subindex (2015)			0.1	LOW risk		
	Financial & competitiveness subindex (2015)			0.2	LOW risk		
Medium Term				**HIGH risk**			
	DSA [2]			HIGH risk			
	S1 indicator [3]			1.9	MEDIUM risk	1.4	MEDIUM risk
	of which						
		IBP		0.4		-0.1	
		Debt Requirement		1.9		1.6	
		CoA		-0.4		-0.2	
Long Term				**LOW risk**		**LOW risk**	
	S2 indicator [4]			-2.3		-2.6	
	of which						
		IBP		0.2		-0.3	
		CoA		-2.5		-2.3	
		of which					
			Pensions	-2.7		-2.6	
			HC	0.6		0.6	
			LTC	0.0		0.0	
			Other	-0.4		-0.3	

Source: Commission services; 2016 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

[1] The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections. See Fiscal Sustainability Report 2015.

[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

[4] The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

6. FISCAL FRAMEWORK

Despite some recent upgrades, challenges in the Croatian fiscal framework remain. They primarily relate to the independence of the fiscal monitoring body (the Fiscal Policy Commission, FPC), the numerical fiscal rules, and budgetary planning at general government level including the multiannual expenditure framework.

In terms of numerical fiscal rules, the Croatian fiscal framework includes a structural budget balance rule coupled with an expenditure rule, as defined in the Fiscal Responsibility Act (FRA), and a deficit rule, defined in the Budget Act. The structural budget balance has to be set at a level ensuring that the general government deficit-to-GDP ratio is not higher than 3% and the debt-to-GDP ratio is not higher than 60%. For the latter, the FRA does not specify how the target for the structural balance would be set in the period necessary to bring the debt down from its current level of 86.7% of GDP in 2016 to the 60% of GDP reference value.

The accompanying expenditure rule constrains the general budget expenditure which cannot exceed the referential potential GDP growth rate increased for the expected price growth and revenue increases mandated by law. This rule becomes operational after the government defines an 'adjustment plan'. Until then, a transition period applies during which the FRA requires that the growth rate of general budget expenditure must not exceed the projected growth rate of the nominal GDP. The FRA does not specify exactly what is the nature of this 'adjustment plan' and whether the 2016 Convergence Programme, which is the first one clearly defining the numerical level of the MTO, constitutes such adjustment plan. It is therefore unclear which rule applies.

The deficit rule was introduced into the Budget Act in 2015, stipulating that the national parliament or a local representative body cannot endorse a budget for the following year with a higher planned deficit (according to the national methodology) than that projected for that same year with the previous (multi-year) budget. The rigidity of this rule, which is not accompanied by preventive measures or escape clauses (especially in case of an unexpected economic downturn), seriously questions its effectiveness. The FPC did not issue an assessment of the Convergence Programme and its relation to domestic fiscal rules.

On 17 September 2015, following the government adoption of revised 2015 budget, the FPC issued a position paper on the proposed budget amendments. The FPC considered that at that time the transition period foreseen in the FRA was still in force. According to the FPC's estimate, the general government expenditure in 2014, after correction for interest and EU programmes expenditure, amounted to 43.9 % of GDP, while an equal or slightly lower expenditure-to-GDP ratio is expected for 2015. Therefore, the FPC was of the opinion that the transitional fiscal rule will probably be fulfilled in 2015. The FPC has not issued position papers since then.

There is a commitment in 2016 National Reform Programme and Convergence Programme to address shortcomings in the fiscal framework. Firstly, by adopting the new Fiscal Responsibility Act the authorities plan to revise the numerical fiscal rules and strengthen the independence of the Fiscal Policy Commission. Furthermore, through amendments to the Budget Act, the authorities plan to revise the strategic planning, improve the medium-term budgetary framework, and introduce regular efficient review of selected budget programmes. The commitments to align the national numerical fiscal rules to the EU rules and to ensure the functional and political independence of the Fiscal Policy Commission are particularly welcome. Further steps would be needed to reinforce the fiscal framework (including better linking the multiannual expenditure limits and the annual budgets, introducing clear rules for

changing annual expenditure ceilings during the year and improving budget planning and monitoring at the ESA10 general government level).

7. CONCLUSIONS

In 2015, Croatia achieved a headline deficit of 3.2% of GDP, below the target under the excessive deficit procedure, and delivered the required fiscal effort.

Croatia plans to correct its excessive deficit by the 2016 deadline set by the Council and to ensure that the structural balance remains at the MTO, reached already in 2015. The programme envisages that the debt-to-GDP ratio will decrease over 2016-2019, also on the back of announced sales of state assets. The programme is based on a macroeconomic scenario that is plausible on the real side until 2017. However, nominal GDP growth is higher than projected in the Commission forecast.

Although relatively close to the Commission forecast, the deficit projection for 2016 and 2017 in the programme is subject to considerable risks. Moreover, the planned reduction of the debt ratio is based on a somewhat optimistic nominal GDP forecast and strongly relies on an ambitious privatisation agenda which carries considerable implementation risks.

Based on the Commission 2016 spring forecast, Croatia is expected to meet the 2016 deficit target and to deliver the required fiscal effort over the period 2014-2016. However, a structural adjustment beyond the MTO chosen by the Croatian authorities would be needed to ensure compliance with the debt reduction benchmark. In particular, in view of the high debt and given current cyclical conditions in Croatia (the output gap almost closing in 2017 and GDP growth well above potential), a fiscal adjustment above the 0.5% of GDP benchmark would seem appropriate, also with a view to facilitating compliance with the debt reduction benchmark.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	2.7	4.7	-1.9	-1.1	-0.4	1.6	1.8	2.1
Output gap [1]	-1.9	2.9	0.2	-3.7	-4.0	-2.9	-1.7	-0.3
HICP (annual % change)	4.0	2.7	2.9	2.3	0.2	-0.3	-0.6	0.7
Domestic demand (annual % change) [2]	2.2	5.4	-3.1	-1.1	-1.7	1.2	1.7	2.2
Unemployment rate (% of labour force) [3]	15.6	12.5	11.8	17.3	17.3	16.3	15.5	14.7
Gross fixed capital formation (% of GDP)	21.0	26.1	22.9	19.8	19.1	19.1	19.3	19.8
Gross national saving (% of GDP)	18.7	22.7	20.6	20.7	19.3	23.4	22.9	22.9
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.8**	**-3.9**	**-5.6**	**-5.3**	**-5.5**	**-3.2**	**-2.7**	**-2.3**
Gross debt	**36.2**	**39.3**	**56.5**	**82.2**	**86.5**	**86.7**	**87.6**	**87.3**
Net financial assets	**2.6**	**-7.3**	**-26.8**	**-41.6**	**-47.1**	**n.a**	**n.a**	**n.a**
Total revenue	43.8	42.1	41.5	42.5	42.6	43.7	44.1	44.4
Total expenditure	46.6	46.0	47.1	47.8	48.1	46.9	46.8	46.6
of which: Interest	1.8	1.9	2.7	3.5	3.5	3.6	3.6	3.6
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.1**	**-3.6**	**-1.0**	**3.4**	**1.0**	**4.8**	**3.2**	**2.8**
Net financial assets; non-financial corporations	**-81.1**	**-97.1**	**-119.5**	**-124.0**	**-129.6**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-0.1**	**-9.3**	**0.5**	**5.2**	**7.0**	**n.a**	**n.a**	**n.a**
Gross capital formation	16.9	18.5	15.5	11.9	11.4	11.2	12.0	12.4
Gross operating surplus	15.6	19.7	19.4	18.6	17.5	17.1	17.3	17.6
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**3.1**	**1.4**	**3.5**	**3.7**	**5.1**	**5.2**	**4.9**	**4.4**
Net financial assets	**51.0**	**49.1**	**55.4**	**68.9**	**77.4**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	43.8	43.0	43.9	43.4	43.6	43.0	43.0	42.9
Net property income	1.0	1.0	1.3	1.2	1.5	1.9	1.4	1.4
Current transfers received	20.2	18.2	18.2	18.6	18.6	18.3	18.1	17.8
Gross saving	6.4	5.2	7.1	7.1	8.1	8.3	8.0	7.6
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.5**	**-5.9**	**-2.9**	**1.6**	**1.1**	**5.5**	**5.0**	**4.7**
Net financial assets	**27.6**	**64.7**	**90.4**	**91.5**	**92.3**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-5.5	-6.7	-2.4	0.5	2.0	2.7	3.1	3.0
Net primary income from the rest of the world	-1.6	-2.4	-2.9	-1.3	-2.6	-0.7	-3.0	-3.3
Net capital transactions	0.0	0.0	0.0	0.0	0.0	0.4	0.6	0.7
Tradable sector	46.5	45.4	43.2	43.1	43.2	43.3	n.a	n.a
Non tradable sector	37.0	39.1	42.4	41.2	41.1	40.5	n.a	n.a
of which: Building and construction sector	4.8	6.5	6.0	4.5	4.3	4.2	n.a	n.a
Real effective exchange rate (index, 2000=100)	84.1	91.5	98.2	90.2	87.0	84.1	84.6	84.4
Terms of trade goods and services (index, 2000=100)	88.6	94.9	99.5	99.5	100.1	100.8	101.5	101.6
Market performance of exports (index, 2000=100)	100.5	113.0	101.9	101.9	105.5	109.7	111.6	110.7

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2016 spring forecast