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Assessment of the 2019 Convergence Programme for

Croatia

(Note prepared by DG ECFIN staff)

CONTENTS

EXECUTIVE SUMMARY

Croatia is subject to the preventive arm of the SGP. With a debt ratio above the 60% reference value, Croatia needs to ensure sufficient compliance with the debt reduction benchmark.

Real growth in Croatia is set to slightly moderate in 2019-2020, but remain above potential growth. The Convergence Programme projects GDP growth slightly below the Commission's forecast, gradually slowing down towards the end of the programme period. Employment is expected to continue growing, bringing the unemployment rate to 5.8% in 2021 and 2022. Overall, the Convergence Programme's macroeconomic scenario appears broadly plausible throughout the programme period.

At +0.2% of GDP in 2018, the general government balance remained in surplus for the second consecutive year. After a decline to -0.3% of GDP in 2019, the Convergence Programme projects the headline balance to gradually improve, reaching a surplus of 0.8% of GDP in 2022. Croatia has been meeting its MTO with a margin in recent years and is projected to remain compliant throughout the programme period, including as of 2020 when its newly adopted MTO of -1% of GDP enters into force. Nevertheless, in 2019 the programme projects a deterioration of both the headline and structural balance, followed by a recovery from 2020 onwards.

With the adoption of the new Fiscal Responsibility Act in December 2018, the fiscal framework improved, but the adoption of a new Budget Act is still delayed.

1. INTRODUCTION

On 18 April 2019, the Croatian government adopted and submitted its 2019 Convergence Programme (hereafter called Convergence Programme), covering the period 2019-2022.

Croatia is subject to the preventive arm of the Stability and Growth Pact (SGP) and should preserve a sound fiscal position which ensures compliance with the medium-term budgetary objective (MTO). As the debt ratio was 74.6% of GDP in 2018, exceeding the 60% of GDP reference value, Croatia is also subject to the debt reduction benchmark.

This document complements the Country Report published on 27 February 2019 and updates it with the information included in the Convergence Programme.

Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2019 spring forecast. The subsequent section presents the recent and planned budgetary developments according to the Convergence Programme. In particular, it provides an overview of the medium term budgetary plans, an assessment of the measures underpinning the Convergence Programme and a risk analysis of the budgetary plans based on the Commission's forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Due to a particularly weak fourth quarter, annual real GDP growth in 2018 slowed to 2.6%. Growth was driven by strong domestic demand, in particular private consumption, although investment accelerated towards the end of the year. Exports underperformed compared to

2017, while strong household consumption drove imports growth. The contribution of net exports to growth thus further deteriorated.

The macroeconomic scenario underpinning the Convergence Programme projects GDP growth to gradually slow, first to 2.5% in 2019 and to 2.3% in 2021-2022. Both private consumption and total investment are projected to accelerate in 2019, before moderating towards the end of the programme period. Net external demand should continue detracting from growth throughout the forecast horizon, although improving. Employment is expected to continue growing at a slower pace until 2022, bringing the unemployment rate to 5.8% in 2021 and 2022.

Table 1: Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021	2022
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**	**CP**
Real GDP (% change)	2.6	2.6	2.6	2.5	2.5	2.4	2.3	2.3
Private consumption (% change)	3.5	3.5	3.3	3.7	3.2	3.3	2.9	2.7
Gross fixed capital formation (% change)	4.1	4.1	6.0	6.4	5.4	5.3	4.3	4.7
Exports of goods and services (% change)	2.8	2.8	3.2	2.7	3.3	3.2	3.3	3.4
Imports of goods and services (% change)	5.5	5.5	5.3	5.3	5.0	5.2	5.0	5.0
Contributions to real GDP growth:								
- Final domestic demand	3.4	3.4	3.6	3.9	3.3	3.4	3.0	3.0
- Change in inventories	0.5	0.5	0.0	-0.1	0.0	0.0	0.1	0.1
- Net exports	-1.2	-1.2	-1.0	-1.2	-0.8	-1.0	-0.9	-0.9
Output gap[1]	1.2	1.4	2.1	1.8	2.4	1.8	1.7	1.9
Employment (% change)	2.4	1.8	1.6	1.6	1.3	1.5	1.3	1.2
Unemployment rate (%)	8.5	8.4	7.8	7.0	6.9	6.0	5.8	5.8
Labour productivity (% change)	0.2	0.8	1.0	1.0	1.1	1.0	1.0	1.1
HICP inflation (%)	1.6	1.5	1.0	0.8	1.2	1.4	1.5	1.6
GDP deflator (% change)	1.7	1.7	1.5	1.4	1.6	1.8	1.8	1.9
Comp. of employees (per head, % change)	1.9	2.2	3.6	2.9	3.4	3.1	3.0	3.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	n.a.	4.3	n.a.	4.2	n.a.	3.7	2.7	2.3

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 2019 spring forecast (COM); Convergence Programme (CP).

Real GDP growth in 2018 came out slightly weaker than expected by the previous Convergence Programme (2.6% compared to 2.8%), mostly on account of lower than projected investment and exports. By contrast, private consumption surprised positively despite employment and wages growing in line with projections. The projected growth rate in 2019 is 0.2 percentage points lower than in the previous programme, despite a significant upward revision of the growth rate of private consumption throughout the forecast period. Imports and especially exports were revised significantly downwards, which in sum noticeably worsened the net export contribution to growth.

The Commission 2019 spring forecast has a slightly more positive real GDP growth outlook than the Convergence Programme. The Commission's weaker private consumption and investment growth projections are offset by a less negative expected contribution of net exports. There are no major differences between the two employment growth projections, but the Commission spring forecast projects a higher unemployment rate in 2019 and 2020, due to a higher projected increase in the activity rate. Finally, the GDP deflator forecasts differ slightly in both years, with the Commission's forecast being slightly higher in 2019 and lower in 2020.

The output gap, as recalculated by Commission based on the information in the programme following the commonly agreed methodology, was estimated at 1.4% of potential GDP in 2018. It is projected to widen to 1.8% in 2019 before stabilising around that level until the end of the programme period.

A possible stronger slowdown in external demand remains a notable downside risk to the forecast, as shown by the observed slowdown in GDP growth at the end of 2018. Labour shortages, already visible in some sectors, also pose a risk to the forecast scenario in the medium term as they could exert pressure on wages beyond productivity growth and weigh the growth of supply.

Overall, macroeconomic scenario underpinning the Convergence Programme appears broadly plausible throughout the programme period.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2018 and 2019

At +0.2% of GDP in 2018, the general government balance deteriorated from +0.8% of GDP in 2017, but remained in surplus for the second consecutive year, exceeding by a wide margin the deficit (-0.5% of GDP) planned in the 2018 Convergence Programme.

The difference between the 2018 outturn and the target in the 2018 Convergence Programme is largely due to the underestimation of tax revenue in the projections (+4.2% vis-à-vis +7.1% outturn) and, to a lesser extent, to an overestimation of expenditure growth (+7.3% vis-à-vis a +7% outturn). While most key components of current expenditure grew more strongly than projected, spending on subsidies and interest was lower than planned. Public investment also picked up strongly and capital transfers were higher than planned amid the materialisation of contingent liabilities in the amount of 0.7% of GDP.

In 2019, the Convergence Programme projects the headline balance to deteriorate further to -0.3% of GDP. Two main revenue categories (taxes on production and imports and contributions) will be negatively affected by cuts, which entered into force in January this year: a shift of several items (mainly foodstuffs) from the standard to the reduced VAT rate and a net reduction of the contributions rate by 0.7 percentage points. On the expenditure side, the authorities project strong growth of compensation of employees and intermediate consumption (driven by a wage increase for public and civil servants and the costs of Croatia's upcoming presidency of the Council of the European Union), as well as subsidies and continued strong growth in public investment. The growth of expenditure beyond what would be expected under the no-policy change scenario is only partly explained by measures, which are however not quantified in the programme.

In 2018, the structural balance according to the Convergence Programme (recalculated by the Commission based on the information in the programme) deteriorated to 0.3% of GDP, from 0.6% of GDP in 2017. The 0.7% of GDP capital transfers related to the materialisation of contingent liabilities in 2018 is treated as a one-off measure (but according to the Commission methodology,[1] this measure does not qualify as a 'one-off'). However, given its temporary effect, the magnitude of the structural deterioration in 2018 is not considered as mirroring an equally strong pro-cyclical turn of fiscal policy. In 2019, the (recalculated) structural balance is projected to deteriorate further to -0.8% of GDP.

3.2. Medium-term strategy and targets

The medium term strategy of the programme is to maintain a structural balance exceeding the medium term objective throughout the programme period.

In the Convergence Programme, Croatia adopts a new MTO of -1% of GDP (applicable as of 2020), which is more stringent than required by the Pact. The authorities' motivation behind this decision is to be in line with the more stringent MTO requirements which apply to ERM II members, in line with Croatia's intention to join ERM II.

After a decline to -0.3% of GDP in 2019, the Convergence Programme projects the headline balance to gradually improve, recording surpluses of 0.2% of GDP in 2020, 0.4% of GDP in 2021 and 0.8% of GDP in 2022. In structural terms, the balance recalculated by the Commission based on the information in the programme is expected to improve as of 2020, reaching -0.1% of GDP in 2022.

[1] For a detailed description of classification principles for one-off measures used by the Commission, see European Commission (2015), Report on public finances in EMU, Chapter II.3. One-off measure classification principles used in fiscal surveillance, pp. 52-65.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2018	2019		2020		2021	2022	Change: 2018-2022
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**46.6**	**46.8**	**47.0**	**46.7**	**46.9**	**46.4**	**46.2**	**-0.4**
of which:								
- Taxes on production and imports	20.1	19.9	19.8	19.6	19.5	19.4	19.4	-0.7
- Current taxes on income, wealth, etc.	6.4	6.4	6.5	6.4	6.5	6.4	6.4	0.0
- Social contributions	12.0	11.9	11.9	11.9	12.0	12.0	12.0	0.0
- Other (residual)	8.1	8.6	8.8	8.8	9.0	8.4	8.4	0.3
Expenditure	**46.4**	**46.7**	**47.3**	**46.1**	**46.7**	**46.0**	**45.4**	**-1.0**
of which:								
- Primary expenditure	44.1	44.5	45.0	44.3	44.7	44.1	43.7	-0.4
of which:								
Compensation of employees	11.7	11.7	11.7	11.7	11.7	11.6	11.6	-0.1
Intermediate consumption	8.2	8.4	8.4	8.4	8.5	8.5	8.5	0.3
Social payments	15.6	15.6	15.6	15.6	15.4	15.2	15.1	-0.5
Subsidies	1.5	1.5	1.7	1.4	1.8	1.8	1.7	0.2
Gross fixed capital formation	3.5	3.8	4.0	4.0	4.2	4.0	4.0	0.5
Other (residual)	3.7	3.5	3.5	3.1	3.1	3.0	2.9	-0.8
- Interest expenditure	2.3	2.1	2.3	1.8	2.0	1.9	1.7	-0.6
General government balance (GGB)	**0.2**	**0.1**	**-0.3**	**0.5**	**0.2**	**0.4**	**0.8**	**0.6**
Primary balance	**2.5**	**2.3**	**2.0**	**2.3**	**2.2**	**2.3**	**2.5**	**-0.1**
One-off and other temporary	0.0	0.0	-0.3	0.0	-0.1	0.0	0.0	0.7
GGB excl. one-offs	**0.2**	**0.1**	**0.0**	**0.5**	**0.3**	**0.4**	**0.8**	**-0.1**
Output gap[1]	1.2	2.1	1.8	2.4	1.8	1.7	1.9	0.5
Cyclically-adjusted balance[1]	-0.3	-0.8	-1.1	-0.5	-0.6	-0.4	-0.1	0.3
Structural balance[2]	**-0.3**	**-0.8**	**-0.8**	**-0.5**	**-0.5**	**-0.4**	**-0.1**	**0.3**
Structural primary balance[2]	2.0	1.3	1.5	1.3	1.5	1.5	1.6	-0.3

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.

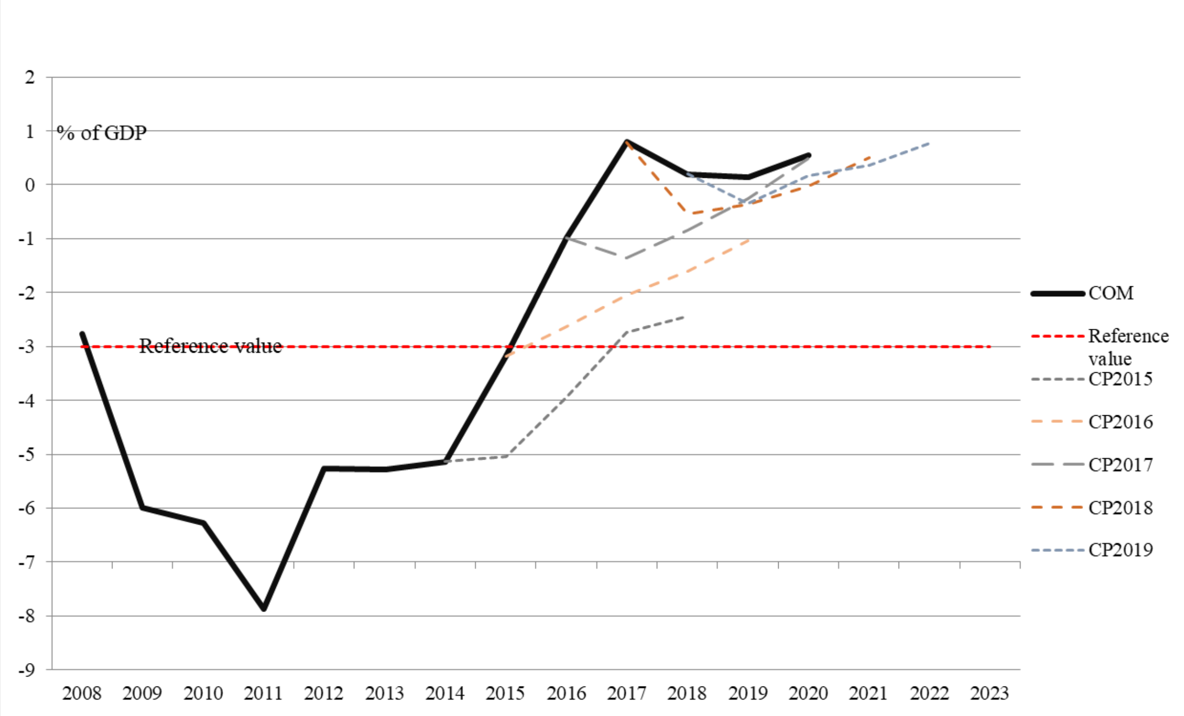
Source :

Convergence Programme (CP); Commission 2019 spring forecasts (COM); Commission calculations.

For the years 2019-2020, the targets are only marginally more ambitious than the ones in the 2018 Convergence Programme, in spite of the significantly better starting position in 2018. For 2021, the targeted surplus is even lower than that projected by the 2018 Convergence Programme.

The projections for 2020 take into account the effects of the additional legislated tax cuts in 2020, the impact of which however does not fully explain the projected deceleration of tax revenue growth. In 2020 and beyond, expenditure growth is set to moderate.

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



Source: Commission 2019 spring forecast; Convergence Programme (CP)

3.3. Measures underpinning the programme

The main measures included in the programme relate to the tax cuts entering into force in 2019 and 2020. In 2019, the biggest impact (-0.4% of GDP) comes from the shift of several products (mainly foodstuffs) from the standard (25%) to the reduced VAT rate (13%) and a shift of all medicines to the reduced rate of 5%. Further changes in excise duties roughly cancel each other out. Social contributions are also substantially affected (-0.2% of GDP) by the net reduction of the effective contribution rate as the increase of health insurance contribution rate (from 15% to 16.5%) is more than offset by the abolition of the employers' contributions for unemployment insurance (1.7%) and protection of health at work (0.5%). Finally, the increase in the income threshold for the top tax bracket (from HRK 17 500 per month to HRK 30 000 per month) has a decreasing effect on personal income tax revenues by 0.1% of GDP. In 2020, the reduction of the standard VAT rate from 25% to 24% is expected to cost 0.4% of GDP in foregone revenue.

On the expenditure side, the Convergence Programme envisages two temporary measures with an effect of 0.3% of GDP in 2019 and 0.1% of GDP in 2020. These relate to the expected materialisation of a further HRK 1 billion (0.25% of GDP) in 2019 in called guarantees in the Uljanik shipyard and HRK 0.6 billion of costs of Croatia's presidency of the Council of the European Union, spread across 2019 (0.15% of GDP) and 2020 (0.1% of GDP). These measures are treated as one-offs in the programme, but according to the Commission methodology,[2] neither qualifies as a 'one-off'.

[2] For a detailed description of classification principles for one-off measures used by the Commission, see European Commission (2015), Report on public finances in EMU, Chapter II.3. One-off measure classification principles used in fiscal surveillance, pp. 52-65.

The impact of most quantified measures reported in the Convergence Programme is in line with the Commission's assessment, with the exception of the capital transfers related to the guarantee calls, where the Commission expects a stronger impact in 2019 (0.5% of GDP).

Several other measures are listed in the programme, but their budgetary impact is not quantified. In 2019, these include an increase in the basic salaries of public and civil servants (by 3% in January and another 2% in September), indexation of pensions and the implementation of the Law on Croatian Homeland war veterans. In 2020, in addition to incremental impact of the aforementioned measures, unquantified measures include the increase in the subsidies for renewable energy production. The Commission 2019 spring forecast includes all these measures except the latter.

The purchase of military fighter jets that was envisaged in the 2018 Convergence Programme is no longer included in the expenditure projections, which is in line with the government's decision to repeal the purchase of the jets in January 2019.

Main budgetary measures included in the programme

<table>
<tr><th>Revenue</th><th>Expenditure</th></tr>
<tr><td colspan="2">2018</td></tr>
<tr><td>• Reduction of the special tax on motor vehicles (not quantified)
• Abolition of sales tax on used motor vehicles (not quantified)
• Increase in excises on tobacco products pursuant to Council directive 2011/64/EU (not quantified)
• Increase of the revenue threshold for entry into the VAT system (not quantified)
• Reintroduction of a deduction of input tax on vehicles (not quantified)</td><td>• Full-year effect of the increase in the base salary for public and civil servants in 2017 (not quantified)
• Adjustment of pensions (not quantified)
• Implementation of the Law on Croatian Homeland war veteran (not quantified)
• One-off liabilities stemming from guarantee calls in the Uljanik Group (+0.7% of GDP)</td></tr>
<tr><td colspan="2">2019</td></tr>
<tr><td>• Shift of several products from the standard (25%) to the reduced VAT rate (13%) and a shift of all medicines to the reduced rate of 5% (-0.4% of GDP)
• Net reduction of the effective social contribution rate (-0.2% of GDP)
• Increase in excise duties on tobacco (+0.1% of GDP)
• Introduction of excise tax return on diesel fuel for certain commercial vehicles (-0.1% of GDP)
• Increase in the income threshold of the top bracket (-0.1% of GDP)</td><td>• One-off liabilities stemming from guarantee calls in the Uljanik Group easure (+0.3% of GDP)
• Costs of EU presidency (+0.1% of GDP)
• Increase in the basic salaries of public and civil servants (not quantified)
• Adjustment of pensions (not quantified)
• Implementation of the Law on Croatian Homeland war veterans (not quantified)</td></tr>
<tr><td colspan="2">2020</td></tr>
<tr><td>• Reduction of the standard VAT rate from 25% to 24% (-0.4% of GDP)</td><td>• Costs of EU presidency (+0.1% of GDP)
• Increase in the subsidies for renewable energy production (not quantified)</td></tr>
<tr><td colspan="2">Note: The table refers to the main measures included in the 2019 Convergence Programme that have an incremental budgetary impact over the programme period. 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.</td></tr>
</table>

3.4. Debt developments

The decrease of the debt ratio continued at a strong pace in 2018, driven by the high primary surplus, but also assisted by the snowball effect as the effects of real GDP growth and inflation outweighed that of interest spending. At the same time, the stock-flow adjustment added to the debt as the portion of the Uljanik shipyard's debt for which guarantees existed but were not called in 2018 has been classified under the general government[3].

The Convergence Programme projects the public debt ratio to continue decreasing by around 3% of GDP per year. The primary balance is projected to remain the key driver of debt reduction, supported by a broadly stable contribution from the snowball effect. A sizable debt-decreasing stock-flow adjustment is envisaged only in 2019. This is in line with the Commission’s projection of adjustment for additional guarantee calls on debt which is already classified under the general government.

The Commission forecast projects a somewhat faster decrease of the debt ratio. The difference stems largely from the different projections of the primary balance and primarily concerns 2019.

[3] Total guaranteed debt of Uljanik amounts to HRK 4.4 billion (1.2% of 2018 GDP). Out of this, guarantees in the amount of HRK 2.55 billion (0.7% of GDP) were called in 2018. These were recorded as capital transfers and affected the headline balance. The remaining HRK 1.9 billion (0.5% of GDP) was statistically added to the general government debt through stock-flow adjustment.

Table 3: Debt developments

(% of GDP)	Average 2013-2017	2018	2019		2020		2021	2022
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**81.3**	**74.6**	**70.9**	**71.6**	**67.6**	**68.5**	**65.4**	**62.0**
Change in the ratio	1.7	-3.2	-3.6	-3.0	-3.4	-3.1	-3.1	-3.4
Contributions[2] *:*								
1. Primary balance	**-0.4**	**-2.5**	**-2.3**	**-2.0**	**-2.3**	**-2.2**	**-2.3**	**-2.5**
2. "Snow-ball" effect	**1.6**	**-0.9**	**-0.8**	**-0.5**	**-1.0**	**-0.9**	**-0.8**	**-0.9**
Of which:								
Interest expenditure	3.2	2.3	2.1	2.3	1.8	2.0	1.9	1.7
Growth effect	-1.3	-2.0	-1.9	-1.8	-1.7	-1.7	-1.5	-1.4
Inflation effect	-0.3	-1.3	-1.1	-1.0	-1.1	-1.2	-1.2	-1.2
3. Stock-flow adjustment	**0.5**	**0.3**	**-0.5**	**-0.5**	**0.0**	**0.0**	**0.0**	**0.0**
Of which:								
Cash/accruals diff.								
Acc. financial assets				-0.5		0.0	0.0	0.0
Privatisation								
Val. effect & residual				-0.5				

Notes:

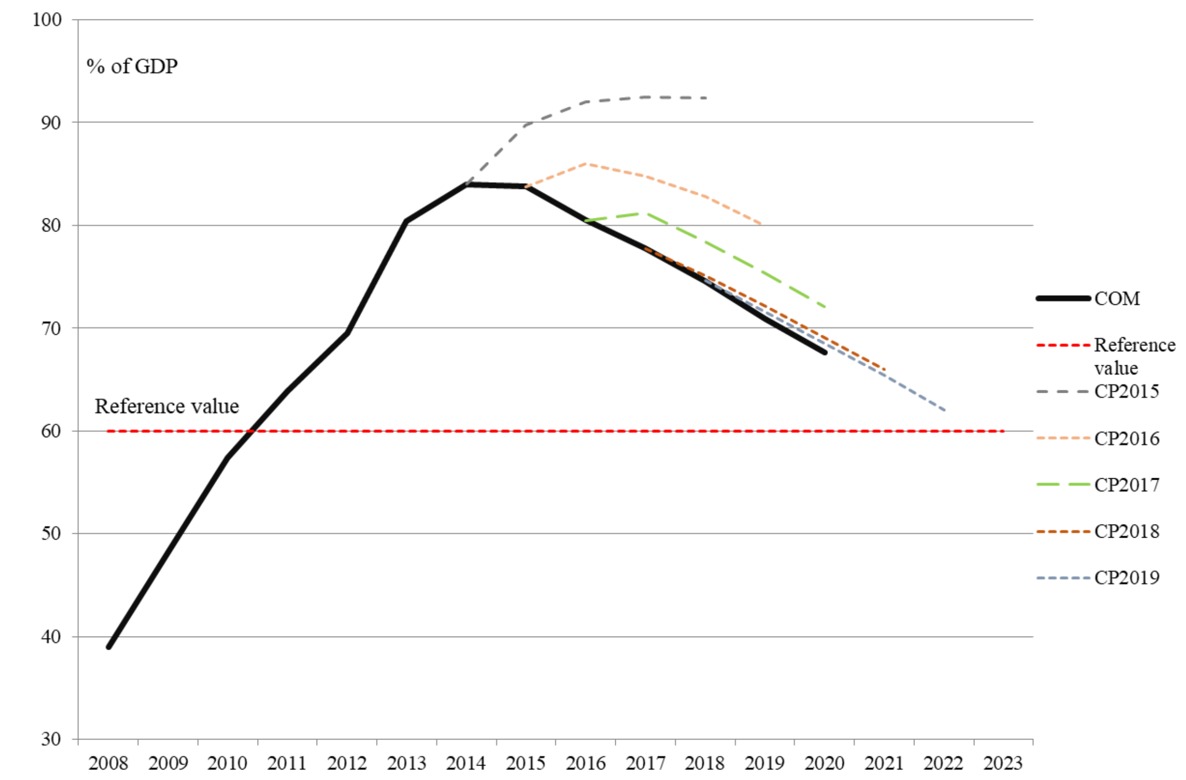
[1] End of period.

[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 2019 spring forecast (COM); Convergence Programme (CP), Commission calculations.

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



Source: Commission 2019 spring forecast; Convergence Programme (CP)

3.5. Risk assessment

Risks to the achievement of the budgetary targets set in the Convergence Programme are positive in 2019 and, to a lesser extent, in 2020. Namely, tax revenue growth projections seem to be mildly conservative. While in most expenditure categories the targets are more realistic, the growth in subsidies and interest spending is not fully explained by measures or other developments. This risk assessment is based on the Commission 2019 spring forecast projecting a higher general government balance in 2019 and 2020, at +0.1% of GDP and +0.5% of GDP, respectively, 0.4 and 0.3 percentage points higher than the Convergence Programme in the two respective years.

Downside risks to the budgetary targets set over the full time horizon of the Convergence Programme are related to the macroeconomic environment, in particular external demand from Croatia's main trading partners. Risks related to contingent liabilities are reducing as the stock of centrally guaranteed debt shrinks, but remain at the local level.

The Convergence Programme also highlights interest rate and exchange rate risks, as well as demographic challenges connected to emigration and aging which are particularly relevant in the long run. It also underscores the stock of arrears in the health sector and the need to address it through efficiency-enhancing measures in the system.

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

4.1. Compliance with the debt criterion

The pace at which the debt ratio is projected to decrease in both the programme and the Commission 2019 spring forecast is compliant with the debt benchmark in 2019 and 2020 by a comfortable margin.

Table 5. Compliance with the debt criterion

	2018	2019		2020	
		CP	COM	CP	COM
Gross debt ratio	**74.6**	**71.6**	**70.9**	**68.5**	**67.6**
Gap to the debt benchmark [1,2]	-5.3	-4.9	-4.9	-5.6	-5.3
Structural adjustment [3]	-1.0	-1.1	-0.5	0.3	0.3
To be compared to:					
Required adjustment [4]					

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining annual structural adjustment over the transition period which ensures that - if followed – Member State will comply with the debt reduction benchmark at the end of the transition

Source :
Commission 2019 spring forecast (COM); Convergence Programme (CP), Commission calculations.

4.2. Compliance with the MTO

Same as the Commission’s forecast, the recalculated structural balance from the programme points to a deterioration from -0.3% of GDP in 2018 to -0.8% in 2019. However, this is still above Croatia’s 2019 MTO of -1.75% of GDP.

In 2020, the more stringent MTO of -1.0% of GDP will enter into force. Based on both the Commission’s spring forecast and the recalculated structural balance based on the Convergence Programme, in 2020 the structural balance is projected to improve to -0.5% of GDP, ensuring a comfortable margin towards the MTO.

Table 6: Compliance with the requirements under the preventive arm

(% of GDP)	2018	2019		2020	
Background budgetary indicators[1]					
Medium-term budgetary objective (MTO)	-1.8	-1.8		-1.0	
Structural balance[2] (COM)	-0.3	-0.8		-0.5	
Setting the required adjustment to the MTO					
Structural balance based on freezing (COM)	-0.3	-0.8		-	
Position vis-à-vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	-2.4	-1.4		-0.2	
Corresponding expenditure benchmark[6]	7.5	6.4		3.5	
Compliance with the required adjustment to the MTO					
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Change in structural balance[7]	Compliance				
One-year deviation from the required adjustment[8]					
Two-year average deviation from the required adjustment[8]					
Expenditure benchmark pillar					
Net public expenditure annual growth corrected for one-offs[9]					
One-year deviation adjusted for one-offs[10]					
Two-year deviation adjusted for one-offs[10]					
Finding of the overall assessment					

Legend

'*Compliance*' - the recommended structural adjustment or a higher adjustment is being observed.

'*Some deviation*' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.

'*Significant deviation*' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).

Irrelevant for the Significant Deviation Procedure' - a SDP would not be opened only based on the two-year deviation if the MTO has reached (at the time of the freezing or on the base of the last storage) in one of the two years.

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage point is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, 2018 edition, p.38.). In case of a SDP, the requirement corresponds to the Council recommendation when available; otherwise it refers to the Commission recommendation to the Council.

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[7] Change in the structural balance compared to year t-1. Expost assessment (for 20XX-1) is carried out on the basis of Commission 20XX spring forecast.

[8] The difference of the change in the structural balance and the corrected required adjustment.

[9] Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :
Convergence Programme (CP); Commission 2019 spring forecast (COM); Commission calculations.

5. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

Croatia does not appear to face fiscal sustainability risks in the short run.[4]

Based on Commission 2019 spring forecasts and a no-policy-change scenario beyond the forecast horizon, government debt, projected at 70.9% of GDP in 2019, is expected to decrease steadily to 58.8% in 2029, thus falling below the 60% of GDP Treaty threshold. Sensitivity analysis point to somewhat higher risks, though, considering the impact possible adverse shocks would have on the initial debt stock.[5] The full implementation of the Convergence Programme would put the debt ratio on a slightly more strongly decreasing path by 2029.

The medium-term fiscal sustainability risk indicator S1[6] based on both scenarios points to low risks in the medium term. However, considering that debt sustainability analysis points to medium risks, the overall medium-term fiscal sustainability risks are assessed as medium for Croatia.

The long-term fiscal sustainability risk indicator S2 is at -2.4 % of GDP, implying low risks, primarily because of the projected decline in pension expenditure.[7]. Full implementation of the programme would decrease the S2 indicator further to -2.8 percentage points of GDP, leading to a lower long-term risk.[8] As the debt sustainability analysis discussed above points to medium risks, the overall long-term fiscal sustainability risks are assessed as medium for Croatia.

[4] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 7 for a definition of the indicator.

[5] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

[6] See the note to Table 7 for a definition of the indicator.

[7] The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report. The impact of the recent pension reforms is thus not yet reflected in these indicators. However, based on a preliminary assessment, the reform does not involve severe risks to Croatia’s long-term fiscal sustainability. Namely, the 2018 Ageing report’s baseline scenario projected a steady decrease in public pension expenditure by as much as 3.8 % of GDP in 2070 compared to 2016. Although the supplement granted to multi-pillar perspective pensioners will increase public pension spending compared to that baseline, the long-term downward trend appears confirmed.

[8] The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report.

Table 7: Debt sustainability analysis and sustainability indicators

Time horizon			Commission Scenario		Convergence Programme Scenario	
Short-term			**LOW risk**			
S0 indicator [1]			0.2			
Fiscal subindex			0.2	LOW risk		
Financial & competitiveness subindex			0.3	LOW risk		
Medium-term			**MEDIUM risk**			
DSA [2]			MEDIUM risk			
S1 indicator [3]			-0.5	LOW risk	-1.3	LOW risk
of which	Initial Budgetary Position		-0.9		-1.2	
	Debt Requirement		0.5		0.2	
	Cost of Ageing		-0.1		-0.3	
	of which	Pensions	-0.2		-0.3	
		Health care	0.1		0.1	
		Long-term care	0.1		0.0	
		Other	-0.1		-0.1	
Long-term			**MEDIUM risk**			
DSA [2]			MEDIUM risk			
S2 indicator [4]			-2.4	LOW risk	-2.8	LOW risk
of which	Initial Budgetary Position		-0.1		-0.3	
	Cost of Ageing		-2.3		-2.5	
	of which	Pensions	-2.6		-2.8	
		Health care	0.4		0.4	
		Long-term care	0.2		0.2	
		Other	-0.4		-0.3	

Source: Commission services; 2019 Convergence Programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2019 forecast until 2020. The 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 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[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*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2018.

6. FISCAL FRAMEWORK

After a long delay, the new Fiscal Responsibility Act was finally adopted in December 2018. It is expected to improve the fiscal framework by strengthening the status and mandate of the Fiscal Policy Commission and replacing the previous fiscal rules with new ones[9] that are more in line with the provisions of the Stability and Growth Programme. Awaiting the appointment of a new chairperson, which is facing challenges[10], the Fiscal Policy Commission continues to function according to old legal provisions.

The Convergence Programme bases the assessment of the application of fiscal rules in 2018 on the fiscal rules from the new Fiscal Responsibility Act. The assessment concludes on compliance with both the debt rule and the structural balance rule (the examination of compliance with regard to the expenditure rule was not required as the structural balance was above MTO). This numerical assessment is confirmed by the Commission analysis.

If Croatia's fiscal performance in 2018 were assessed against the fiscal rules as laid out in the Fiscal Responsibility Act that was in force in 2018, it is estimated that Croatia would not be compliant, because the former rules did not take account of the structural position of the country relative to the MTO when considering expenditure growth.

Going forward, the planned and forecast fiscal performance in Croatia (both with respect to the structural balance and debt dynamics) would comply with the applicable national numerical fiscal rules.

The adoption of the new Budget Act is still delayed. Once adopted, the new act is expected to improve budgetary planning and the collection of fiscal data and to review the criteria for the issuance of government guarantees

7. SUMMARY

In 2018, Croatia recorded a second consecutive surplus of the general government balance in spite of a sizable activation of contingent liabilities. The Commission's 2019 spring forecast projects the surplus to narrow in 2019 as revenue is affected by tax cuts, and increase again in 2020. The Convergence Programme projects instead the general government balance to turn into a small deficit in 2019 and back into surplus in 2020 and grow thereafter. In structural terms, a deterioration witnessed in 2018 is projected to continue in 2019, and recover thereafter. All the while, the structural balance is expected to exceed the MTO throughout the period. The debt ratio is set to continue declining strongly, in line with the debt reduction benchmark. Overall, Croatia is expected to remain fully compliant with the provisions of the preventive arm of the SGP.

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[9] The new Fiscal Responsibility Act sets out three rules: the structural balance rule, the expenditure rule and the debt rule, essentially mimicking the SGP framework. The structural balance rule is deemed complied with when the structural balance equals or exceeds the MTO or enables adjustment towards the MTO in line with the adopted plan. The expenditure rule, applicable only when the structural balance is below the MTO, states that expenditure shall not exceed the reference potential GDP growth rate. The debt rule states that the debt to GDP ratio shall either not exceed 60% of GDP or shall converge towards that level at a defined rate.

[10] The first public call for candidates for the role of chairing the Commission was unsuccessful.

8. ANNEXES

Table I. Macroeconomic indicators

	2001-2005	2006-2010	2011-2015	2016	2017	2018	2019	2020
Core indicators								
GDP growth rate	4.5	0.7	-0.2	3.5	2.9	2.6	2.6	2.5
Output gap [1]	0.1	2.8	-3.8	-1.2	0.5	1.2	2.1	2.4
HICP (annual % change)	2.9	3.0	1.6	-0.6	1.3	1.6	1.0	1.2
Domestic demand (annual % change) [2]	5.9	0.2	-0.7	3.8	3.6	3.9	3.7	3.3
Unemployment rate (% of labour force) [3]	14.4	10.2	16.0	13.4	11.0	8.5	7.8	6.9
Gross fixed capital formation (% of GDP)	23.9	25.6	19.7	20.0	20.1	20.1	20.7	21.3
Gross national saving (% of GDP)	21.8	21.8	19.7	n.a	n.a	n.a	n.a	n.a
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.9**	**-4.2**	**-5.3**	**-1.0**	**0.8**	**0.2**	**0.1**	**0.5**
Gross debt	**38.5**	**44.1**	**76.3**	**80.5**	**77.8**	**74.6**	**70.9**	**67.6**
Net financial assets	**-0.1**	**-12.0**	**-38.6**	**-45.4**	**-42.7**	**n.a**	**n.a**	**n.a**
Total revenue	44.5	42.5	42.7	46.3	46.1	46.6	46.8	46.7
Total expenditure	48.4	46.7	48.1	47.3	45.3	46.4	46.7	46.1
of which: Interest	1.8	2.1	3.2	3.1	2.7	2.3	2.1	1.8
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.0**	**-3.0**	**1.5**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; non-financial corporations	**-85.3**	**-116.6**	**-125.6**	**-116.6**	**-110.6**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-3.2**	**-8.2**	**4.5**	**2.5**	**1.5**	**n.a**	**n.a**	**n.a**
Gross capital formation	17.6	18.1	12.9	n.a	n.a	n.a	n.a	n.a
Gross operating surplus	17.8	20.3	18.8	n.a	n.a	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**2.7**	**1.4**	**4.9**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets	**47.2**	**51.7**	**70.4**	**85.7**	**85.7**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	43.5	43.3	43.7	n.a	n.a	n.a	n.a	n.a
Net property income	1.1	1.0	1.7	n.a	n.a	n.a	n.a	n.a
Current transfers received	19.2	17.5	18.8	n.a	n.a	n.a	n.a	n.a
Gross saving	6.2	5.4	8.1	n.a	n.a	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.5**	**-5.6**	**0.0**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets	**41.4**	**85.1**	**89.3**	**73.8**	**66.0**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-6.2	-5.2	1.0	2.8	2.2	1.4	0.5	-0.1
Net primary income from the rest of the world	-2.2	-2.8	-2.7	n.a	n.a	n.a	n.a	n.a
Net capital transactions	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Tradable sector	45.8	42.9	42.5	42.9	42.8	42.4	n.a	n.a
Non tradable sector	37.3	41.6	41.5	40.1	39.7	39.7	n.a	n.a
of which: Building and construction sector	5.6	6.7	4.7	4.4	4.3	4.4	n.a	n.a
Real effective exchange rate (index, 2000=100)	89.5	98.8	89.7	82.0	81.1	82.1	81.9	82.0
Terms of trade goods and services (index, 2000=100)	91.9	98.1	100.0	101.9	102.1	102.9	103.2	103.6
Market performance of exports (index, 2000=100)	113.1	105.7	102.1	108.4	108.7	107.6	107.3	106.5

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2010 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 2019 spring forecast

Mandatory variables not included in the Stability Programme

The Stability Programme does not include several mandatory variables for the basic assumptions including cyclical unemployment benefit expenditure, long-term estimates for total revenue and expenditure, public guarantees estimate for 2019, EU GDP growth, and short-term and long-term interest rate. Not included mandatory variables do not impede the Commission's ability to assess the Stability Programme on the basis of the Programme's assumptions.