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Assessment of the 2018 Convergence Programme for

Croatia

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

On 26 April 2018, Croatia submitted its 2018 Convergence Programme (hereafter called Convergence Programme), covering the period 2018-2021, as approved by the government.

Croatia is subject to the preventive arm of the 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 78.0% of GDP in 2017, exceeding the 60% of GDP reference value, Croatia is also subject to the debt reduction benchmark.

This document complements the Country Report published on 7 March 2018 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 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Convergence Programme. In particular, it provides an overview on the medium term budgetary plans, an assessment of the measures underpinning the Convergence 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 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

Real GDP growth slowed to 2.8% in 2017 on account of unexpectedly low growth in the last quarter. Growth remained broad-based in spite of a slowdown in private investment due to the Agrokor crisis[1] and a strong decline in public investment. Exports continued to perform well, but together with strong household consumption they pushed up imports, thus further worsening the net contribution of external demand to growth.

The macroeconomic scenario underpinning the Convergence Programme projects GDP growth to remain at 2.8% in 2018 and weaken towards 2.5% in 2020-2021. While the pace of growh of household consumption and exports is projected to progressively slow down, growth of investmtent is expected to accelerate in 2018, before slowing down in the outer years. In 2018, net external demand is projected to detract from growth slightly more than in 2017 as the slowdown in exports is expected to be more marked than for imports, while the opposite is true in the subsequent years. Positive labour market developments are projected to continue as employment increases and the unemployment rate goes down to 10% in 2018 and 7% in 2021.

[1] Agrokor group is the country's largest private employer, in financial distress since early 2017 and currently undergoing restructuring.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.8	2.8	2.8	2.8	2.7	2.7	2.5	2.5
Private consumption (% change)	3.6	3.6	3.1	2.9	2.9	2.8	2.6	2.5
Gross fixed capital formation (% change)	3.4	3.4	6.2	6.7	6.0	6.3	5.6	5.2
Exports of goods and services (% change)	6.1	6.1	4.8	5.3	4.6	5.2	4.9	4.7
Imports of goods and services (% change)	8.1	8.1	6.6	7.4	6.0	6.8	6.0	5.7
Contributions to real GDP growth:								
- Final domestic demand	3.1	3.1	3.6	3.5	3.3	3.3	3.0	2.9
- Change in inventories	0.4	0.4	-0.1	0.1	0.0	0.1	0.0	0.1
- Net exports	-0.8	-0.8	-0.8	-0.9	-0.6	-0.8	-0.6	-0.5
Output gap[1]	0.9	0.7	2.3	2.3	3.1	3.1	3.8	4.7
Employment (% change)	2.2	2.2	1.7	1.8	1.5	1.6	1.4	1.3
Unemployment rate (%)	11.1	11.2	9.6	10.0	8.5	9.1	8.2	7.3
Labour productivity (% change)	0.6	0.6	1.1	1.0	1.1	1.1	1.1	1.1
HICP inflation (%)	1.3	1.1	1.4	1.4	1.5	1.4	1.5	1.6
GDP deflator (% change)	1.2	1.2	2.1	1.6	1.9	1.6	1.5	1.5
Comp. of employees (per head, % change)	-1.1	-1.1	1.1	2.6	1.4	2.5	2.4	2.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	n.a.	4.3	n.a.	4.1	n.a.	3.1	2.3	1.5

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 2018 spring forecast (COM); Convergence Programme (CP).

Real GDP growth in 2017 was noticeably weaker than expected by the previous Convergence Programme (2.8% compared to 3.2%), mostly on account of lower than projected investment and government consumption. By contrast, employment grew more strongly while compensation of employees and inflation were lower than expected. The projected growth rate in 2018 remains the same as in the previous programme, but with substantial revisions in demand composition. Most notably, the contribution to growth of household and government consumption has been revised upwards throughout the programme period.

The Commission 2018 spring forecast has the same real GDP growth outlook as the Convergence Programme, but with weaker growth of investment being offset by more dynamic government and household consumption as well as a smaller detraction from growth from external demand. Employment growth projections are very similar in the two projections, but the spring forecast projects a slightly stronger reduction in the unemployment rate in 2018 and 2019, due to lower anticipated labour force growth. Importantly, the Commission forecast projects a higher GDP deflator than the Convergence Programme in 2018 and, to a lesser extent, 2019. As a result, nominal GDP growth is 0.6 pps and 0.2 pps, respectively, higher in the Commission forecast.

The output gap, as recalculated by Commission based on the information in the programme following the commonly agreed methodology, is estimated to have turned positive (at 0.7%)

in 2017 and to continue widening, reaching 4.7% in 2021[2], as real GDP growth is projected to outpace potential growth throughout the programme period.

The failure to reach a settlement among Agrokor creditors remains a notable downside risk to the forecast, even though some of the negative effects on growth (via investment and consumption) are deemed to have already materialised in 2017. Other risks to the Programme projections relate to the possible underperformance of the strong projected growth of investment, which relies on a significant improvement in absorption capacity of EU funds.

Overall, the GDP growth assumption in the Convergence Programme's macroeconomic scenario appears plausible in the short term and favourable thereafter.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2017 and 2018

The general government headline balance turned positive in 2017, reaching +0.8% of GDP, up from −0.9% of GDP in 2016 and more than two percentage points above the deficit (−1.3% of GDP) planned in the 2017 Convergence Programme. The surplus was driven by strong growth in tax revenue and expenditure restraint. Through cuts in public investment and declining interest payments, the expenditure level has decreased also in nominal terms. All other main spending items grew at a slower pace than nominal GDP, with the exception of the wage bill which increased at a slightly higher rate as a result of the agreed gradual increase in wages in the public sector.

The difference between the 2017 outcome and the target in the 2017 Convergence Programme mostly owes to the containment of expenditure, which was planned to grow by 4%, but declined instead by 0.3%. In addition, tax revenue grew stronger than expected, despite the weaker-than-anticipated real GDP growth (2.8% compared to 3.2% in the 2017 Convergence Programme). At the same time, total revenue grew slightly below projections due to substantially lower-than-projected current and capital transfers received, namely EU funds.

For 2018, the Convergence Programme targets a headline balance of −0.5% of GDP, only slightly above the target in the 2017 Convergence Programme (-0.8 % of GDP), despite the much more favourable starting position. On the revenue side, the Convergence Programme projections takes into account tax cuts implemented in 2108. Expenditure is projected to grow strongly, which is neither substantiated with measures nor is it supported by the latest known budgetary developments. At least in the case of investment, it does not appear to be consistent with the underlying macroeconomic scenario either, as also acknowledged in the Convergence Programme, as it would imply an unexplained volatility in private investment. In addition to investment, the most notable expenditure categories projected to increase significantly are capital transfers and subsidies.

[2] Taken at face value, the Convergence Programme projections point to the output gap turning positive only in this year, followed by a much slower widening (1.9% in 2021). Such a difference reflects the programme's substantially more optimistic projections of potential growth compared to those recalculated by the Commission.

3.2. Medium-term strategy and targets

Following the projected significant deterioration of the headline balance in 2018, the Convergence Programme plans a slight improvement, to −0.4% of GDP, in 2019, followed by a balanced budget in 2020 and a retur to a surplus in 2021.

At −1.75% of GDP, Croatia's MTO remains unchanged from the 2016 Convergence Programme and reflects the objectives of the Pact. In 2017, the structural balance recalculated by the Commission based on the information in the programme is estimated to have reached a small surplus, thus significantly overachieving the MTO. The return to a headline deficit in 2018 projected in the Programme would imply a sharp reversal of the fiscal stance, with the recalculated structural balance dropping by 2% of GDP in that year and declining slightly further in 2019, down to the level of the MTO[3]. The structural balance would return slightly above the MTO in 2021.

[3] Taken at face value, the Convergence Programme projects a deterioration of the structural balance from 0.9% of GDP in 2017 to -0.8% of GDP in 2018, around which level it stabilizes until 2021, when it is set to improve to -0.4% of GDP.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018		2019		2020	2021	Change: 2017-2021
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**46.0**	**45.8**	**46.0**	**45.4**	**45.2**	**45.1**	**44.6**	**-1.4**
of which:								
- Taxes on production and imports	19.7	19.7	19.8	19.6	19.1	19.1	19.0	-0.7
- Current taxes on income, wealth, etc.	6.3	6.4	6.2	6.3	6.2	6.1	6.1	-0.3
- Social contributions	11.9	12.0	12.0	11.9	12.0	12.0	11.9	0.0
- Other (residual)	8.1	7.8	8.1	7.6	8.0	7.9	7.6	-0.5
Expenditure	**45.3**	**45.1**	**46.5**	**44.6**	**45.6**	**45.1**	**44.1**	**-1.2**
of which:								
- Primary expenditure	42.6	42.6	44.0	42.2	43.5	43.6	42.7	0.1
of which:								
Compensation of employees	11.4	11.4	11.5	11.3	11.4	11.3	11.1	-0.3
Intermediate consumption	7.9	7.8	7.9	7.6	7.9	7.9	7.8	-0.1
Social payments	15.7	15.7	15.6	15.5	15.5	15.3	15.1	-0.7
Subsidies	1.7	1.7	2.0	1.7	1.8	1.7	1.6	-0.1
Gross fixed capital formation	2.7	2.7	3.5	2.8	3.5	3.7	3.6	0.9
Other (residual)	3.1	3.3	3.4	3.3	3.3	3.6	3.6	0.5
- Interest expenditure	2.7	2.5	2.5	2.4	2.1	1.5	1.4	-1.3
General government balance (GGB)	**0.8**	**0.7**	**-0.5**	**0.8**	**-0.4**	**0.0**	**0.5**	**-0.3**
Primary balance	**3.4**	**3.3**	**2.0**	**3.2**	**1.7**	**1.5**	**1.9**	**-1.6**
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	**0.8**	**0.7**	**-0.5**	**0.8**	**-0.4**	**0.0**	**0.5**	**-0.3**
Output gap[1]	0.9	2.3	2.3	3.1	3.1	3.8	4.7	3.8
Cyclically-adjusted balance[1]	0.3	-0.3	-1.6	-0.6	-1.8	-1.8	-1.7	-2.0
Structural balance[2]	**0.4**	**-0.3**	**-1.6**	**-0.6**	**-1.8**	**-1.8**	**-1.7**	**-2.1**
Structural primary balance[2]	3.1	2.2	0.9	1.7	0.3	-0.3	-0.3	-3.4

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.

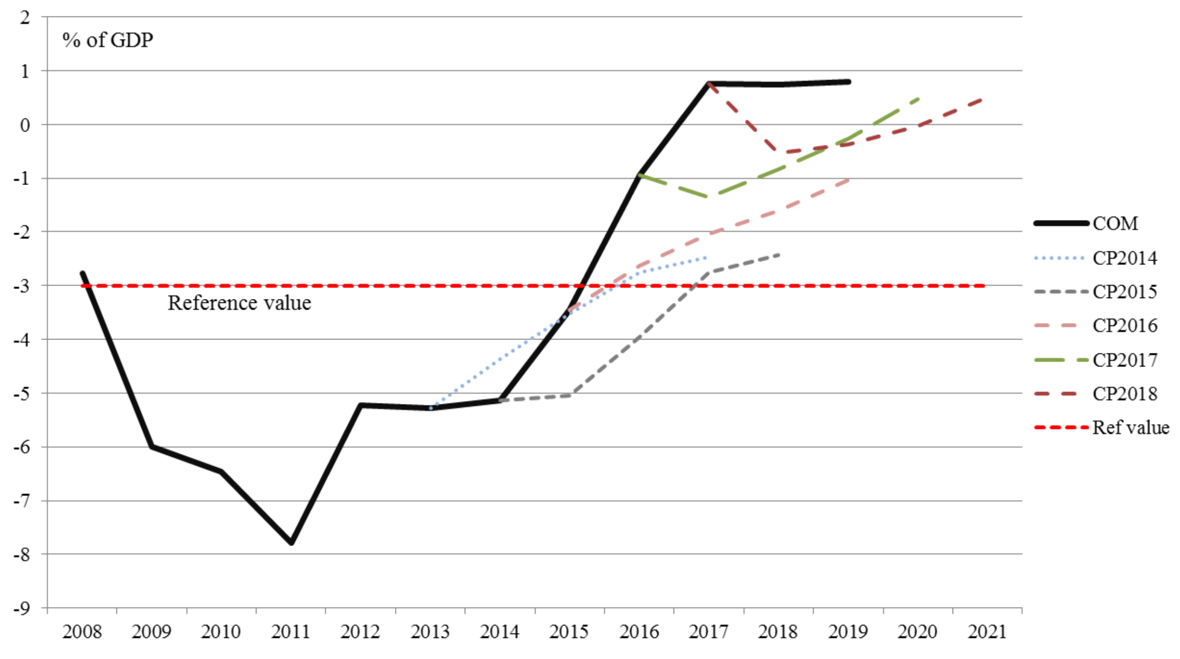
Source:

Convergence Programme (CP); Commission 2018 spring forecasts (COM); Commission calculations.

Compared to the 2017 Convergence Programme, the budgetary targets for the outer years of the Programme are somewhat less ambitious in spite of the much better than expected starting position: while last year's programme projected a deficit of 0.3% of GDP in 2019 to turn to a surplus of 0.5% of GDP in 2020, the new Convergence Programme plots a balanced budget in 2020 and a surplus of 0.5% only in 2021. Accordingly, the recalculated structural balance is set to remain lower than projected in the 2017 Convergence Programme over the programme period.

The programme states that the medium term revenue projections take into account the effects of planned tax cuts, but does not specify concrete measures in that respect. The tax revenue projections suggest that the tax cuts are planned in 2019 and particularly in taxes on production and imports. As regards expenditure, according to the programme intermediate consumption and compensation of employees will be affected by the 2020 Croatian presidency of the Council of the EU as well as several measures concerning social benefits and the planned purchases of fighter jets. The lack of specificied measures impedes the assessment of the revenue and expenditure projections in the Programme.

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



Source: Commission 2018 Spring Forecast, 2018 Convergence Programme

3.3. Measures underpinning the programme

In 2018, on the revenue side the programme incorporates the additional impact of measures enacted in the 2016 tax reform which entered into force with a delay (increase of the VAT registration threshold and introduction of input tax deductions on vehicle purchases and associated expenditures) and the lowering of the special tax on motor vehicles. Together, the impact of these measures is estimated at -0.14% of GDP, in line with the Commission's estimate. The programme also takes into account the measure to lower the tax base for calculation of the employer social contribution for minimum wage workers by 50%. The impact on the revenue side is projected at -0.1% of GDP. On the expenditure side, the programme considers the full annual impact of the wage increase agreed in 2017 in the public sector, but does not quantify it (the Commission's estimate is 0.34% of GDP). Similarly, the full year effect of several laws expanding social benefits (Act on war veterans' rights, Act on maternity and parent benefits) is included, but not quantified.

In the medium term, as already mentioned above, the programme very broadly mentions planned tax cuts which will impact government revenue, but does not provide details or quantification of the measures. On the expenditure side, the programme incorporates the effects of increased spending due to the 2020 Croatian presidency of the Council of the EU as well as several measures concerning social benefits (increase of the income ceiling for child benefit eligibility, increase in disability benefits and continuation of subsidies on mortgage loans) and the planned purchases of fighter jets. None of these measures are quantified.

Main budgetary measures

Revenue	Expenditure
2018	
• 2016 tax reform - VAT changes (-0.14% of GDP) • Decrease in social contributions (-0.1% of GDP)	• Public sector wage increase (n/a)
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.	

3.4. Debt developments

After the fall recorded in 2016, the debt ratio continued to decline strongly in 2017, reaching 78% of GDP. The decrease was driven primarily by the high primary surplus, but also by the snowball effect starting to detract from the debt ratio for the first time after eight years, as interest expenditure was curbed and the growth effect, although slowing, was aided by a pickup in inflation. At the same time, the stock-flow adjustment added to the debt ratio. The Convergence Programme does not state the drivers of this adjustment other than the negative effect of a mild appreciation of the kuna. According to notified data, the debt-increasing effect of the stock-flow adjustment mostly owes to the acquisition of financial assets but also adjustments (most notably a decrease in other accounts payable) and statistical discrepancies[4].

The Convergence Programme projects the public debt ratio to continue declining by around 3 pps each year. The debt-decreasing impact of the primary surplus is set to weaken. Similarly, as real GDP growth and inflation slow down, the denominator (growth) effect is set to subside. These developments are projected to be offset by lower interest spending and, most notably, the stock-flow adjustment turning negative. Namely, the Convergence Programme projects privatisation proceeds at around 0.3% of GDP in both 2018 and 2019 and at 0.2% of GDP in 2020 (lower than plans in previous convergence programmes and other strategic documents).

The Commission forecast projects the debt ratio to decline faster than in the programme in 2018 and 2019, due to the more positive primary surplus and, to a smaller extent, the stronger pick-up in th GDP deflator in 2018. However, the Commission's forecast does not take into account the authorities' plans with regard to privatisation proceeds, as they are insufficiently specifed.

[4] Eurostat (2018), Stock-flow adjustment (SFA) for the Member States, the euro area and the EU28 for the period 2014-2017, as reported in the April 2018 EDP notification (http://ec.europa.eu/eurostat/documents/4187653/8821237/STOCK-FLOW-2018-APR.pdf/29af3c6b-2acf-4d9e-9811-13ed4aed8033)

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**79.7**	**78.0**	**73.7**	**75.1**	**69.7**	**72.1**	**69.1**	**65.9**
Change in the ratio	3.4	-2.7	-4.3	-2.9	-4.0	-3.0	-3.0	-3.2
Contributions[2] *:*								
1. Primary balance	**0.7**	**-3.4**	**-3.3**	**-2.0**	**-3.2**	**-1.7**	**-1.5**	**-1.9**
2. "Snow-ball" effect	**2.5**	**-0.4**	**-1.1**	**-0.7**	**-0.9**	**-1.0**	**-1.3**	**-1.2**
Of which:								
Interest expenditure	3.3	2.7	2.5	2.5	2.4	2.1	1.5	1.4
Growth effect	-0.5	-2.2	-2.1	-2.1	-1.9	-2.0	-1.7	-1.6
Inflation effect	-0.3	-0.9	-1.6	-1.2	-1.3	-1.2	-1.1	-1.0
3. Stock-flow adjustment	**0.2**	**1.2**	**0.1**	**-0.2**	**0.1**	**-0.2**	**-0.2**	**0.0**
Of which:								
Cash/accruals diff.								
Acc. financial assets				-0.3		-0.3	-0.2	0.0
Privatisation				-0.3		-0.3	-0.2	0.0
Val. effect & residual								

Notes:

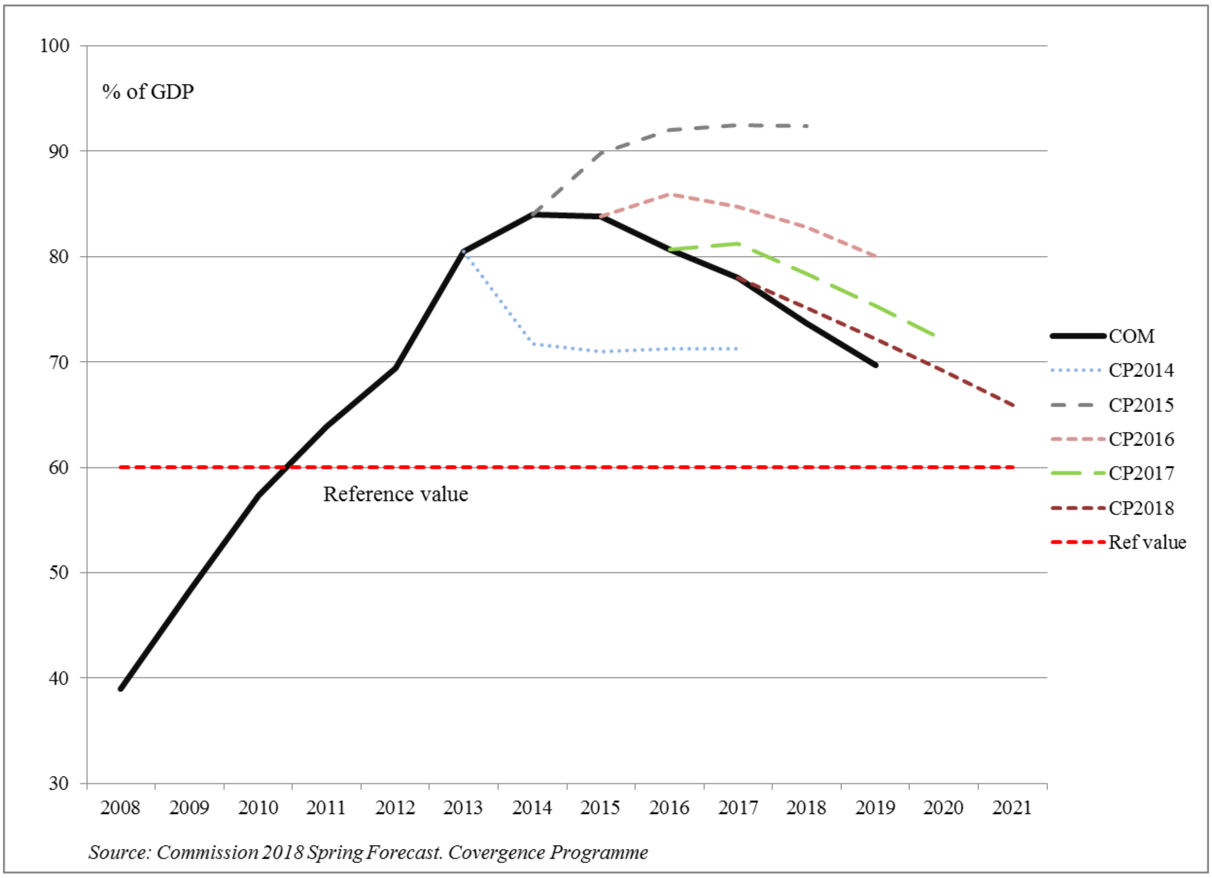
[1] End of period.

[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 2018 spring forecast (COM); Convergence Programme (CP), Comission calculations.

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



3.5. Risk assessment

In 2018, risks to the achievement of the planned budgetary targets in the Convergence Programme are mostly positive. The projected high growth in several expenditure categories does not appear plausible, as it is not underpinned by measures nor recent developments and in the case of investment it does not appear to be fully consistent with the underlying macroeconomic scenario. Slightly below the Commission forecast, the projected growth of tax revenues appears prudent, but plausible and in this sense a minor source of positive risks. The indirect fiscal effects arising from the still possible fallout of the crisis in Agrokor constitute downside risks to the budgetry targets.

The assessment of risks to the achievement of the planned budgetary targets in the outer years of the programme is hindered by lack of underpinning measures. Most notably, the planned tax cuts and the purchase of fighter jets are neither quantified nor detailed.

Besides risks related to the unfolding of the Agrokor crisis, the Convergence Programme highlights already visible supply-side constraints which may increasingly detract from growth in the medium term. These could pose a risk to maintaining realively high growth rates, above the estimated low potential growth, and bring into question the achievement of government targets in the outer years.

Considering direct fiscal risks, the Convergence Programme underscores risks related to pension and healthcare systems, in particular related to demographic trends and the continued generation of payment arrears in health care. However, given the recent trend of growing employment and social contributions as well as the government's recent payment which decreased the stock of arrears in the healthcare system, these risks seem more pertinent in the medium and long term. Risks outlined by the programme which seem more pertinent in the short term relate to potential liabilities arising from issued guarantees, particularly in cases of companies which are currently under restructuring.

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

Box 1. Council Recommendations addressed to Croatia

On 11 July 2017, the Council 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 remain at its medium-term budgetary objective in 2018.

4.1. Compliance with the debt criterion

The pace at which the debt ratio is projected to decrease in the programme would be compliant with the debt benchmark in 2018 and 2019. Also according to the Commission 2018 spring forecast, Croatia would be compliant in both years with the debt reduction benchmark.

Table 5. Compliance with the debt criterion

	2017	2018		2019	
		CP	COM	CP	COM
Gross debt ratio	**78**	**75.1**	**73.7**	**72.1**	**69.7**
Gap to the debt benchmark [1,2]	-5.9	-4.4	-5.1	-4.9	-5.9

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.

Source :

Commission 2018 spring forecast (COM); Convergence Programme (CP), Comission calculations.

4.2. Compliance with the MTO

On 11 July 2017, the Council recommended to Croatia to remain at its medium-term budgetary objective (set at a structural balance of −1.75% of GDP) in 2018. The recalculated structural balance from the programme points to a strong deterioration of the structural balance from +0.4% of GDP in 2017 to -1.6% of GDP in 2018. While this is much lower than the Commission's 2018 spring forecast projection of −0.3% of GDP, it is still slightly above the MTO.

According to the Convergence Programme projections, the recalculated structural balance would dip further, but remain within the tolerance margin from the MTO in 2019. The Commission's 2018 spring forecast instead projects the structural balance to overachieve the MTO also in 2019, at −0.6% of GDP.

Table 6: Compliance with the requirements under the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-1.75	-1.75		-1.75	
Structural balance[2] (COM)	0.4	-0.3		-0.6	
Structural balance based on freezing (COM)	-0.9	-0.3		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	Compliance				
Required adjustment corrected[5]					
Change in structural balance[6]					
One-year deviation from the required adjustment [7]					
Two-year average deviation from the required adjustment [7]					
Expenditure benchmark pillar					
Applicable reference rate[8]					
One-year deviation adjusted for one-offs[9]					
Two-year deviation adjusted for one-offs[9]					
PER MEMORIAM: One-year deviation [10]					
PER MEMORIAM: Two-year average deviation [10]					

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 points (p.p.) 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, page 38.).

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

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2017) is carried out on the basis of Commission 2018 spring forecast.

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

[8] 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.

[9] 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.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law 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 2018 spring forecast (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

Croatia does not appear to face fiscal sustainability risks in the short run.[5]

Based on the Commission 2018 spring forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 78% of GDP in 2017, is expected to decrease steadily to 60.4% in 2028, though remaining slightly above the 60% of GDP Treaty threshold. This reflects medium risks for the country from debt sustainability analysis in the medium term, as also confirmed by sensitivity analysis. The full implementation of the Convergence Programme would keep the debt on a decreasing path until 2021, after which it is projected to increase again, reaching 72.1% by 2028, well above the 60% of GDP reference value.

Based on the Commission forecast, the medium-term fiscal sustainability risk indicator S1[6] indicates low risks in the medium term. The full implementation of the Convergence Programme would increase the sustainability risk indicator S1, leading to a higher medium-term risk. Overall, risks to fiscal sustainability over the medium term are medium. Fully implementing the fiscal plans in the Convergence Programme would increase those risks.

In the long term, Croatia appears to face low fiscal sustainability risks, considering a projected decline in ageing costs (contributing -2.2 percentage points of GDP) and a favourable initial budgetary position. Full implementation of the programme would raise the S2 indicator, but the long-term fical sustainability risk would remain low.[7]

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[5] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 5 for a definition of the indicator.

[6] See the note to Table 5 for a definition of the indicator.

[7] The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

Table 4: Sustainability indicators

Time horizon			Commission Scenario		Stability / 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]			-0.4	LOW risk	1.7	MEDIUM risk
of which						
	Initial Budgetary Position		-1.1		1.3	
	Debt Requirement		0.7		0.5	
	Cost of Ageing		0.0		-0.1	
	of which					
		Pensions	-0.1		-0.2	
		Health-care	0.1		0.1	
		Long-term care	0.1		0.0	
		Other	-0.1		-0.1	
Long Term			**LOW risk**		**LOW risk**	
S2 indicator [4]			-2.6		-0.9	
of which						
	Initial Budgetary Position		-0.4		1.5	
	Cost of Ageing		-2.2		-2.4	
	of which					
		Pensions	-2.5		-2.8	
		Health-care	0.5		0.4	
		Long-term care	0.2		0.2	
		Other	-0.4		-0.3	

Source: Commission services; 2018 stability/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 2018 forecast covering until 2019 included. 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 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 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 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 2015 and Debt Sustainability Monitor 2017.

6. FISCAL FRAMEWORK

In part linked to the repeated delays with the planed wide-ranging amendments to the Fiscal Responsibility Act and Budget Act, a transition period applies for Croatian fiscal rules. During this period, a provisional expenditure rule requires that in any given year the growth rate of general budget expenditure does not exceed the projected growth rate of nominal GDP, allowing exemptions for certain categories of expenditure. Specifically, the total general government budget expenditures for estimating fiscal rules do not include interest expenditures, expenditures for EU co-financed programmes (fully matched by revenues from the EU budget) as well as changes in expenditure due to changes in the institutional scope of the general budget.

Based on the budgetary outcomes in 2017, it can be established that this rule was met, as the growth rate of total expenditures (even without the permissible corrections) was -0.3% against the increase in nominal GDP of 4%. The regular report of the Fiscal Policy Commission on the application of the fiscal rules for the year 2017 was not available at the time of the cut-off date of the present analysis (in previous years, it was published in June).

Based on the information provided in the Convergence Programme and in budget documents, the past forecast fiscal performance in Croatia appears to comply with the requirements of the applicable provisional numerical rule. The authorities confirmed their plan to adopt a major fiscal framework reform package during the course of 2018. The Fiscal Policy Commission has not endorsed or assessed the medium-term macroeconomic scenario underpinning the Convergence Programme.

7. SUMMARY

In 2017, Croatia achieved a headline surplus of 0.8% of GDP. The Commission 2018 spring forecast projects a significantly more positive profile for the development of public finances with the general government balance expected to remain in surplus throughout the forecast period. The structural balance is projected to deteriorate in both 2018 and 2019 but it should stay within the tolerance margin from the MTO. The debt ratio would decline in line with the forward-looking element of the debt reduction benchmark. Overall, Croatia is expected to remain fully compliant with the provisions of the preventive arm of the SGP.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	4.4	1.8	-0.9	2.3	3.2	2.8	2.8	2.7
Output gap [1]	-0.6	3.1	-3.2	-2.4	-0.7	0.9	2.3	3.1
HICP (annual % change)	3.2	3.4	1.8	-0.3	-0.6	1.3	1.4	1.5
Domestic demand (annual % change) [2]	5.2	1.9	-2.0	2.1	3.4	3.6	3.7	3.4
Unemployment rate (% of labour force) [3]	15.0	10.5	15.2	16.1	13.4	11.1	9.6	8.5
Gross fixed capital formation (% of GDP)	22.8	26.4	20.0	19.6	19.9	19.9	20.3	20.7
Gross national saving (% of GDP)	21.0	22.3	19.8	n.a	n.a	n.a	n.a	n.a
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.9**	**-3.7**	**-6.0**	**-3.4**	**-0.9**	**0.8**	**0.7**	**0.8**
Gross debt	**37.4**	**40.8**	**71.0**	**83.8**	**80.6**	**78.0**	**73.7**	**69.7**
Net financial assets	**1.3**	**-8.4**	**-33.3**	**-45.4**	**-44.0**	**n.a**	**n.a**	**n.a**
Total revenue	44.7	42.8	41.7	44.9	46.3	46.0	45.8	45.4
Total expenditure	48.6	46.5	47.7	48.4	47.2	45.3	45.1	44.6
of which: Interest	1.8	2.0	3.0	3.5	3.1	2.7	2.5	2.4
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.3**	**-3.7**	**1.0**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; non-financial corporations	**-82.4**	**-110.1**	**-128.6**	**-121.7**	**-119.1**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-2.9**	**-8.6**	**3.3**	**5.6**	**2.5**	**n.a**	**n.a**	**n.a**
Gross capital formation	17.3	18.9	13.5	n.a	n.a	n.a	n.a	n.a
Gross operating surplus	17.2	20.7	18.6	n.a	n.a	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**3.1**	**0.8**	**4.8**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets	**47.9**	**48.7**	**66.1**	**81.6**	**86.3**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	43.7	43.2	43.7	n.a	n.a	n.a	n.a	n.a
Net property income	1.0	1.0	1.5	n.a	n.a	n.a	n.a	n.a
Current transfers received	19.6	17.5	18.5	n.a	n.a	n.a	n.a	n.a
Gross saving	6.5	4.9	8.1	n.a	n.a	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.7**	**-6.4**	**-0.3**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets	**36.1**	**78.4**	**92.5**	**79.9**	**74.3**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-5.6	-6.4	0.4	2.4	2.8	2.2	1.9	1.7
Net primary income from the rest of the world	-2.1	-2.7	-2.8	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	46.5	44.2	43.3	43.7	43.7	43.7	n.a	n.a
Non tradable sector	37.1	41.0	42.1	40.8	40.2	39.9	n.a	n.a
of which: Building and construction sector	5.2	6.9	5.0	4.5	4.5	4.4	n.a	n.a
Real effective exchange rate (index, 2000=100)	87.8	97.5	93.0	83.6	81.1	80.3	80.2	79.1
Terms of trade goods and services (index, 2000=100)	90.5	97.1	99.9	100.5	101.9	102.2	103.3	104.1
Market performance of exports (index, 2000=100)	109.6	108.5	100.7	107.5	108.9	109.0	107.7	107.0

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 2018 spring forecast