EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 23 May 2017

Assessment of the 2017 convergence programme for

Croatia

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION 3
2. MACROECONOMIC DEVELOPMENTS 3
3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS 5
3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017 5
3.2. MEDIUM-TERM STRATEGY AND TARGETS 6
3.3. MEASURES UNDERPINNING THE PROGRAMME 8
3.4. DEBT DEVELOPMENTS 9
3.5. RISK ASSESSMENT 11
4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT 12
   4.1. Compliance with the EDP recommendation (in EDP years) 12
   4.2. Compliance with the debt criterion 12
5. LONG-TERM SUSTAINABILITY 15
6. FISCAL FRAMEWORK 17
7. SUMMARY 17
8. ANNEXES 19

1. INTRODUCTION

On 27 April 2017, Croatia submitted its 2017 convergence programme, covering the period 2017-2020. The government approved the programme on the same day.[1]

Croatia is currently subject to the corrective arm of the Stability and Growth Pact (SGP). The Council opened the Excessive Deficit Procedure (EDP) for Croatia on 28 January 2014. Croatia was recommended to correct the excessive deficit by 2016, by bringing its general government deficit below the 3%-of-GDP Treaty reference value in a durable manner and – since the EDP was opened on the basis of the deficit as well as the debt criterion – by ensuring that the general government debt ratio approaches the 60%-of-GDP Treaty reference value at a satisfactory pace. The year following the correction of the excessive deficit, Croatia would become subject to the preventive arm of the SGP and should achieve and maintain a position at its medium-term budgetary objective (MTO). As the debt ratio in 2016 was reported at 84.2% of GDP, exceeding the 60%-of-GDP Treaty reference value, Croatia would also become subject to the debt reduction benchmark.

This document complements the Country Report published on 22 February 2017 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 2017 spring forecast. The following section presents the recent and planned budgetary developments, according to the convergence programme. In particular, it includes 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 the 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 sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

In 2016, real GDP growth turned out at a solid 2.9%, being broad-based across demand components and sectors. Private consumption continued to expand, supported by employment growth, the reduction in the personal income tax enacted at the end of 2015 and falling consumer prices. Investment also rebounded, on the back of a strong recovery in public investment. Exports of goods and services grew strongly, likely signalling further integration of the Croatian economy in the EU. Strong demand, however, ushered in buoyant import growth, and the net contribution of external demand to growth turned slightly negative.

The macroeconomic scenario in the convergence programme projects Croatia to remain on a path of robust growth throughout the programme's horizon, with real GDP growth peaking at 3.2% in 2017 and progressively decelerating thereafter, reaching 2.5% in 2020. The programme expects internal demand to remain the driver of growth, with consumption growing in line with real GDP and investment soaring above 6% in 2017 and 2018 and moderating thereafter. Export growth is forecast to remain strong, especially in the goods component. Yet imports are expected to keep growing faster than exports on account of the surge in investment. As a result, net external demand is projected to keep detracting from growth, though with declining intensity over the programme's horizon. Job creation is

[1] The convergence programme was submitted in Croatian language only.

expected to broadly follow the strong economic activity, but with a lag, peaking in 2018 and slowing down in 2019 and 2020.

The output gap as recalculated by the Commission based on the information in the programme, following the commonly agreed methodology, is set to turn positive in 2017 and expand at a fast pace thereafter.

Table 1: Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019	2020
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.9	2.9	2.9	3.2	2.6	2.8	2.6	2.5
Private consumption (% change)	3.3	3.3	3.2	3.5	2.8	2.8	2.5	2.4
Gross fixed capital formation (% change)	4.6	4.6	5.2	6.3	5.7	6.9	5.8	5.1
Exports of goods and services (% change)	6.7	6.7	5.2	5.7	4.6	5.0	4.8	4.8
Imports of goods and services (% change)	7.3	7.3	6.6	7.3	5.7	6.0	5.5	5.4
Contributions to real GDP growth:								
- Final domestic demand	3.2	3.2	3.3	3.5	3.1	3.2	2.8	2.7
- Change in inventories	-0.1	-0.1	0.0	0.1	0.0	0.0	0.0	0.1
- Net exports	-0.1	-0.1	-0.5	-0.5	-0.5	-0.3	-0.2	-0.2
Output gap[1]	-1.3	-1.5	1.0	0.8	2.5	2.0	2.9	3.7
Employment (% change)	0.7	0.6	1.9	1.3	1.5	1.5	1.5	1.3
Unemployment rate (%)	13.3	13.1	11.6	11.5	9.7	10.0	9.1	8.8
Labour productivity (% change)	2.2	2.3	0.9	1.8	1.1	1.2	1.1	1.2
HICP inflation (%)[2]	-0.6	-1.1	1.6	1.5	1.5	1.4	1.4	1.5
GDP deflator (% change)	-0.1	-0.1	1.4	1.4	1.6	1.4	1.3	1.3
Comp. of employees (per head, % change)	1.2	-0.5	2.5	2.9	2.5	2.9	2.4	2.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.7	3.6	4.2	3.5	2.5	3.4	3.1	2.8

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.

[2]Inflation is measured as consumer price index (CPI) in the Convergence programme.

Source:

Commission 2017 spring forecast (COM); Convergence programme (CP).

The Commission 2017 spring forecast presents a more conservative macroeconomic outlook compared to the convergence programme. In particular, the Commission expects this and next year's real GDP growth to be negatively affected by the financial difficulties faced by the food and retail conglomerate Agrokor[2] – Croatia's largest private company – on account of downsized investment and lower consumption in households directly and indirectly linked to

[2] Agrokor is in a deep financial crisis under a large debt burden accumulated during its expansion over the past decade. In early March, the firm was downgraded by credit rating agencies. In April, the Croatian parliament adopted a law on receivership in "systemically important companies", which allowed for the company's operations to resume, while providing for all ownership rights and existing liabilities (debentures, interest and principal loan obligations) to be frozen during the restructuring period.

the group. The programme projections do not factor in the impact of Agrokor's difficulties and ongoing restructuring.

Despite the lower growth forecast, the Commission 2017 spring forecast expects slightly higher employment growth than the convergence programme in 2017, which would bring the unemployment rate to below 10% in 2018. In the meantime – following several years of slack on the labour market and wage restraint – compensation of employees is set to increase well above inflation, though at a slightly lower rate than projected in the convergence programme.

The range of risks surrounding these projections is wide and tilted to the downside. On the one hand, export performance both on goods and services could continue to surprise on the positive side as Croatian firms continue to benefit from enhanced access to the EU market and tourism continues to benefit from geopolitical tensions in competing destinations on the southern and eastern shores of the Mediterranean. On the other hand, the forthcoming restructuring of Agrokor could have stronger-than-expected spill-over effects, also through weakening economic sentiment. In addition, re-emerged political instability also represents a risk, as uncertainty could hold back private investment and EU funds absorption.

Also in the outer years, the Commission 2017 spring forecast points to more moderate real GDP growth compared to the convergence programme, against the background of low potential output growth. Yet, it is possible that EU accession and the increasing absorption of EU funds could keep pushing GDP growth above the potential output growth in the medium term.

Overall, the macroeconomic assumptions underpinning the convergence programme appear favourable over the programme's horizon.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017

In 2016, the general government headline deficit decreased markedly, to 0.8 % of GDP, from 3.4% of GDP in 2015. This outcome is substantially better than the headline deficit of 2.6% of GDP planned in the 2016 convergence programme, mainly owing to buoyant revenue growth. Higher-than-projected real GDP growth (at 2.9% vs, 2% in the 2016 convergence programme) underpins much of the revenue surprise. In addition, revenue elasticities turned out considerably above standard elasticities, which can be partly explained by an increase in payments of tax debt accumulated in previous years. Overall, revenue grew by 8.2% in 2016, compared to the 4% initially planned in the 2016 convergence programme. Expenditure also contributed to the deficit outcome, as overall it grew by 2.3% in nominal terms, compared to the planned 2.7%. However, lower-than-planned expenditure growth was primarily due to interest expenditure turning out almost 0.3% of GDP below the projections of the 2016 convergence programme, thanks to improved financing conditions for Croatia. Primary expenditure grew by 3.0% compared to the 2.7% initially planned, despite lower expenditure on gross fixed capital formation and social transfers.

For 2017, the government plans to achieve a headline deficit of 1.3% of GDP, from the 0.8% of GDP recorded in 2016. This substantially improved deficit projection compared to the 2% of GDP planned in the 2016 convergence programme reflects the better starting position from 2016 and a sizeable upward revision of real GDP growth (from 2.1% in the 2016 convergence programme to 3.2% in the current programme). After incorporating the expected negative

budgetary impact of the tax reform adopted in December 2016[3] (see section 3.3), estimated at −0.5% of GDP in 2017 and −0.2% of GDP in 2018, the programme projects revenue to grow by 4% in 2017. Meanwhile, expenditure is planned to expand more strongly than anticipated in the 2016 convergence programme, by 5.2%, and slightly faster than nominal GDP growth. This reflects among others a significant increase in compensation of employees related to the renegotiation of the collective agreement in the public sector, which took place in December 2016. It should be noted that the convergence programme expects both revenue and expenditure to grow also as a result of improved absorption of EU funds.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

Croatia's MTO was set at -1.75% of GDP in the 2016 convergence programme and reflects the objectives of the SGP. The convergence programme aims at "*achieving the medium term budgetary objective of -1.75% of GDP, (...) in order to ensure compliance with the provisions of the SGP.*" After over-achieving its MTO by a wide margin in 2016, the structural balance (recalculated by the Commission based on the information in the programme) is set to decline by 1.5% of GDP in 2017, thus returning to the MTO with no margin. The structural balance would remain broadly unchanged in 2018, before gradually improving again to −1.3% of GDP in 2020. To this end, after 2017, when the effect of the tax reform will be most pronounced, the convergence programme envisages a gradual improvement of the headline balance in each year, thereby reaching a surplus of 0.5% of GDP in 2020.

[3] The tax reform increased the personal allowance and decreased personal income tax rates. In corporate income tax, the general rate was decreased and a reduced rate was introduced, but the tax base is broadened through the abolition of some tax breaks and exemptions. In VAT, categories of goods and services were reshuffled across the existing rates.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018		2019	2020	Change: 2016-2020
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**47.6**	**47.5**	**47.3**	**47.4**	**47.6**	**47.5**	**47.2**	**-0.3**
of which:								
- Taxes on production and imports	20.3	20.5	19.9	20.4	19.6	19.5	19.4	-0.9
- Current taxes on income, wealth, etc.	6.3	5.8	5.9	5.9	6.0	6.0	6.0	-0.3
- Social contributions	11.9	11.8	11.9	11.8	11.9	11.9	11.9	0.0
- Other (residual)	9.1	9.3	9.6	9.3	10.0	10.1	10.0	0.9
Expenditure	**48.4**	**48.6**	**48.6**	**48.4**	**48.4**	**47.8**	**46.8**	**-1.6**
of which:								
- Primary expenditure	45.1	45.7	45.4	45.6	45.2	44.6	43.7	-1.4
of which:								
Compensation of employees	12.0	12.1	11.8	12.2	11.7	11.5	11.4	-0.6
Intermediate consumption	8.0	7.8	7.9	7.6	7.9	7.7	7.6	-0.4
Social payments	16.3	16.1	15.9	15.8	15.7	15.4	15.1	-1.2
Subsidies	1.6	1.6	1.5	1.4	1.4	1.2	1.1	-0.5
Gross fixed capital formation	3.2	3.3	3.6	3.5	3.9	4.2	4.2	1.0
Other (residual)	4.1	4.8	4.6	5.1	4.6	4.5	4.4	0.3
- Interest expenditure	3.3	3.0	3.2	2.8	3.2	3.1	3.0	-0.2
General government balance (GGB)	**-0.8**	**-1.1**	**-1.3**	**-0.9**	**-0.8**	**-0.3**	**0.5**	**1.3**
Primary balance	**2.4**	**1.9**	**1.9**	**1.8**	**2.3**	**2.9**	**3.5**	**1.1**
One-off and other temporary	0.1	0.1	0.0	0.0	0.0	0.0	0.0	-0.1
GGB excl. one-offs	**-0.9**	**-1.2**	**-1.3**	**-0.9**	**-0.8**	**-0.3**	**0.5**	**1.4**
Output gap[1]	-1.3	1.0	0.8	2.5	2.0	2.9	3.7	5.0
Cyclically-adjusted balance[1]	-0.2	-1.6	-1.7	-2.1	-1.8	-1.6	-1.3	-1.0
Structural balance[2]	**-0.3**	**-1.7**	**-1.7**	**-2.1**	**-1.8**	**-1.6**	**-1.3**	**-0.9**
Structural primary balance[2]	2.9	1.3	1.5	0.7	1.4	1.5	1.8	-1.2

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 2017 spring forecasts (COM); Commission calculations.

Differences in the medium term budgetary strategy compared to the 2016 convergence programme again reflect the better-than-expected starting position in 2016 as well as the improved macroeconomic outlook.

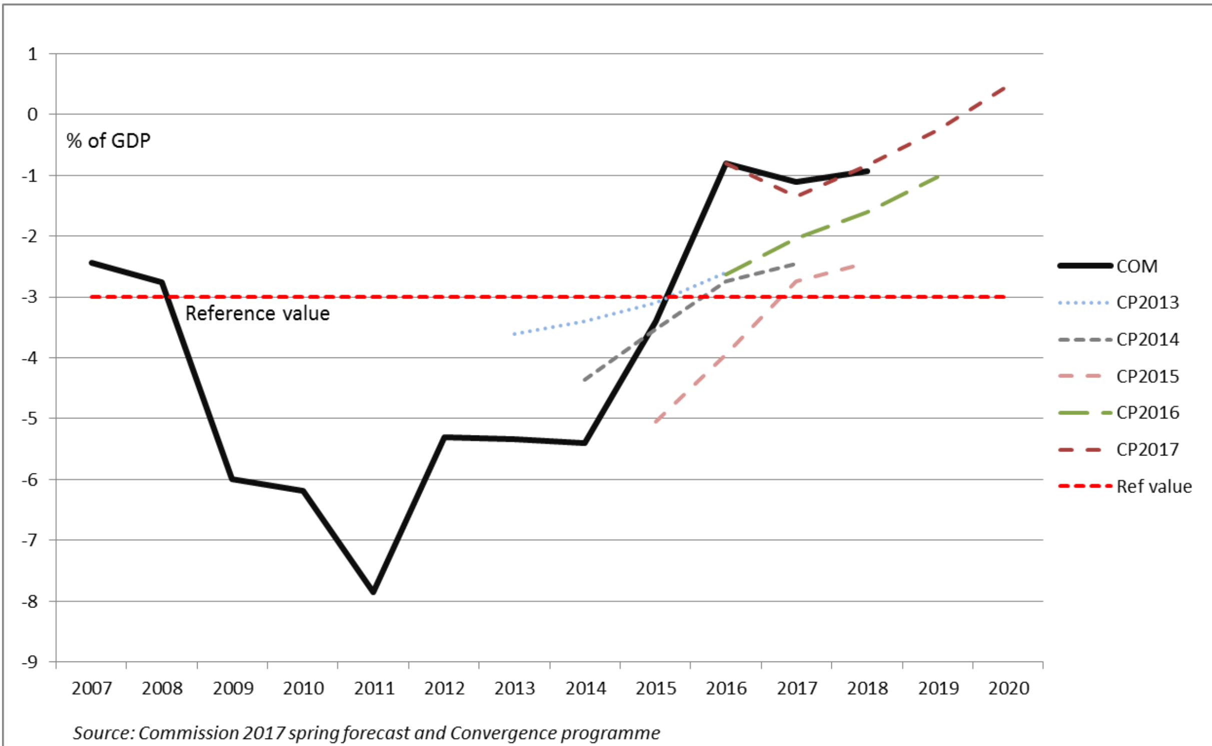
The programme projections confirm that the central government level will be the only major driver of the general government deficit, with the sub-central level having a slightly offsetting effect (with a surplus of 0.1% of GDP throughout the programme's horizon) and the social security funds attaining a balanced position.

Measured in structural primary terms, the fiscal stance would be highly expansionary in 2017, mainly due to the tax reform and through increased government expenditure, and broadly neutral thereafter. However, after 2018 the programme also seems to project some

expenditure restraint. Expenditure is projected to peak at 48.6% of GDP in 2017, as gross fixed capital formation soars, and then gradually decline to 46.8% of GDP in 2020. The projected decline is largely driven by decelerating growth (in nominal terms) in gross fixed capital formation, but as from 2019 also growth in social spending, compensation of employees, and intermediate consumption would slow down, while subsidies are expected to decline.

Revenue in proportion to GDP is projected to grow slightly only in 2018, despite the additional impact of the tax reform on VAT revenues in that year. It is set to decline thereafter to 47.2%. The biggest contribution to the reduction should come from taxes on production and imports. The convergence programme does not explain why revenue from indirect taxes would not grow more in line with nominal GDP, especially in light of the projected strength of household consumption, but the phasing out of payments of tax debt accumulated in previous years and conservative planning may play a role.

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



3.3. MEASURES UNDERPINNING THE PROGRAMME

In 2017, the measures on the revenue side listed in the convergence programme relate mostly to the tax reform adopted in late 2016, with most provisions having entered into force on 1 January 2017. The impact of the reform on revenue is negative, and reported at 0.5% of GDP in 2017 and an additional 0.2% in 2018. The programme also mentions, but does not quantify, the positive budgetary impact of the 2016 increase in excises taking effect in 2017. On the expenditure side, the programme expects the 2017 fiscal position to be affected by the wage increase in the public sector stemming from the renegotiated collective agreement and the March 2017 decision to pay out the holiday allowance in 2017. It also reports an increase in defence spending and co-funding of rising expenditure financed by EU funds. Increases in child benefits, paid parental leave and spending for war veterans would increase total social spending. However, none of these measures has been quantified in the programme, which hampers a proper assessment of the budgetary projections in the convergence programme.

The programme also refers to the planned increase in transfers to local government units as compensation for the tax revenue they are set to lose through the tax reform. However, this type of measure – intra-government transfers – should be neutral at the level of the general government.

In 2018, the only other measure considered by the programme – beside the tax reform – is the additional (full-year) impact of the increase in public sector wages from 2017, which is also not quantified in the programme.

3.4. DEBT DEVELOPMENTS

In 2016, both the nominal level of gross general government debt and the debt-to-GDP ratio decreased. This was the first year since the beginning of recording of general government gross debt (EDP definition) in 2002 that nominal debt decreased, from 86.7% to 84.2% of GDP, driven by the large decrease in the headline deficit and GDP growth. Furthermore, a stock-flow adjustment in the order of 1% of GDP played an important role. Namely, the convergence programme emphasises currency appreciation (since a large share of general government debt is denominated in foreign currency), the use of central government deposits and privatisation proceeds. Notified data point to changes in *currency and deposits* (-1.4% of GDP) and *depreciation of foreign currency debt* (-0.6% of GDP) as the main contributors, partly offset by *other accounts receivable* (+0.9% of GDP) and *loans* (+0.6% of GDP).[4] The reduction in the debt ratio from 2017 onwards is projected to rely mainly on the primary surplus, but also on the nominal growth-interest rate differential (the so-called snowball effect) turning positive. In addition, the programme projections include privatisation proceeds of 0.4% of GDP annually, which however remain unspecified. Overall, the convergence programme projects the debt ratio to decline by 3% of GDP on average per year over the programme's horizon, with the debt ratio reaching 72.1% of GDP in 2020. This path is set in accordance with the strategic goal of the government – defined in the public debt management strategy adopted by the government on 26 January 2017 – to reduce the debt ratio by 10 pps by the end of 2020.

The Commission 2017 spring forecast projects a somewhat higher debt ratio than the convergence programme in 2017 and 2018, which can be explained by the difference in projected GDP growth and the fact that the Commission does not take into account the government's unspecified privatisation plans.

[4] Eurostat (2017), Stock-flow adjustment (SFA) for the Member States, the euro area and the EU28 for the period 2013-2016, as reported in the April 2017 EDP notification.

Table 3: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**78.3**	**84.2**	**81.9**	**81.2**	**79.4**	**78.4**	**75.4**	**72.1**
Change in the ratio	5.7	-2.5	-2.4	-3.0	-2.5	-2.8	-3.0	-3.3
Contributions[2] :								
1. Primary balance	**2.1**	**-2.4**	**-1.9**	**-1.9**	**-1.8**	**-2.3**	**-2.9**	**-3.5**
2. "Snow-ball" effect	**3.1**	**0.9**	**-0.4**	**-0.5**	**-0.6**	**-0.1**	**0.2**	**0.3**
Of which:								
Interest expenditure	3.4	3.3	3.0	3.2	2.8	3.2	3.1	3.0
Growth effect	0.3	-2.5	-2.3	-2.5	-2.1	-2.1	-1.9	-1.8
Inflation effect	-0.5	0.1	-1.1	-1.2	-1.3	-1.1	-1.0	-1.0
3. Stock-flow adjustment	**0.5**	**-1.0**	**0.0**	**-0.6**	**0.0**	**-0.4**	**-0.4**	**0.0**
Of which:								
Cash/accruals diff.								
Acc. financial assets				0.6		0.4	0.4	0.0
Privatisation				0.4		0.4	0.4	0.0
Val. effect & residual				0.2				

Notes:

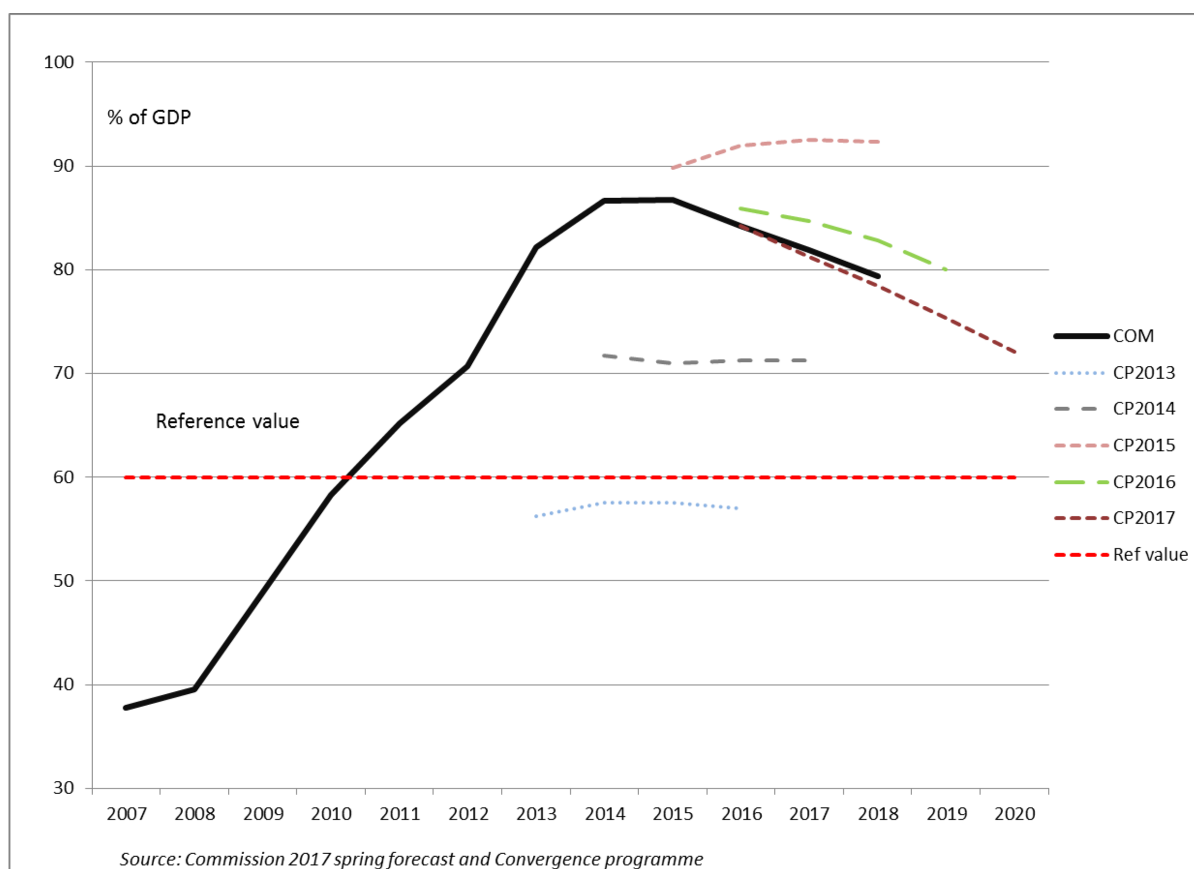
[1] End of period.

[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 2017 spring forecast (COM); convergence programme (CP), Comission calculations.

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



3.5. RISK ASSESSMENT

For 2017, the Commission 2017 spring forecast projects a slightly lower general government deficit than the convergence programme, thus pointing to positive risks to the programme projection. Differences between the two projections mainly stem from taxes on production and imports, where the convergence programme estimates appear conservative. On the expenditure side, the projected 48.6% of GDP overall ratio in both projections is underpinned by lower expected nominal GDP growth in the Commission forecast, pointing to higher expected growth of expenditure in nominal terms in the programme. This is especially the case for gross fixed capital formation, where the programme expects higher absorption of EU funds, and interest expenditure, where the programme appears cautious in taking account of the improving financing conditions for Croatia.

Downside risks to the budgetary targets in the programme mainly stem from the impact of Agrokor's financial difficulties, both on the underpinning macroeconomic scenario – through domestic demand – and directly on the budget – including through lower corporate income tax liabilities from Agrokor, its suppliers and creditors. Unlike the 2017 Commission spring forecast, the convergence programme projections do not incorporate any such impact.

As also mentioned in section 2, the forthcoming restructuring of Agrokor could lead to stronger-than-expected spill-over effects, over and above what is already included in the Commission 2017 spring forecast.

In the period beyond the Commission forecast's horizon, the programme projects a decline in the expenditure-to-GDP ratio (by more than 1% of GDP in cumulative terms over 2019-

2020). In particular, the deceleration in social spending (against the background of adverse demographic trends) and intermediate consumption could be difficult to achieve.

Additional important sources of risk which are also acknowledged in the convergence programme are the continued generation of arrears in healthcare, as well as the substantial amount of issued guarantees and their growing trend in 2016, as highlighted by data on general government guarantees.[5]

Additional risks to the debt projections stem from a possible lower-than-planned net contribution from the unspecified privatisations. Furthermore, the currency structure of Croatia's public debt makes it vulnerable to currency exchange risks.

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

Box 1: Council recommendations addressed to CROATIA

- The latest Council recommendations under Article 126(7) of the Treaty*: "On 28 January 2014, the Council recommended Croatia under Article 126(7) of the Treaty to correct its excessive deficit by 2016. To this end, Croatia should put an end to the present excessive deficit situation by 2016, reach a headline general government deficit targets of 4.6% of GDP in 2014, 3.5% of GDP in 2015, and 2.7% of GDP in 2016".*
- The SGP-related part of 2016 Country-specific Recommendations: *"On 12 July 2016, the Council addressed recommendations to Croatia in the context of the European Semester. In particular, in the area of public finances the Council recommended that Croatia ensures a durable correction of the excessive deficit by 2016 and an annual fiscal adjustment of at least 0.6% of GDP in 2017."*

4.1. Compliance with the EDP recommendation (in EDP years)

Croatia brought its headline deficit down to 0.8% of GDP in 2016, i.e. the deadline to correct its excessive deficit, well below the recommended headline deficit target of 2.7% of GDP. The Commission 2017 spring forecast projects a deficit of 1.1% of GDP in 2017 and 0.9% of GDP in 2018. Thus, the deficit is set to remain below the Treaty reference value of 3% of GDP over the forecast horizon. At 84.2% of GDP in 2016, the Commission 2017 spring forecast projects the gross government debt to decrease to 79.4% of GDP in 2018, backed by the primary surplus and strong nominal GDP growth. On this basis, the 2016 debt ratio fulfils the forward-looking element of the debt benchmark.

4.2. Compliance with the debt criterion

The pace of the reduction of the debt ratio projected by the programme would be compliant with the debt benchmark in 2017 and 2018. Also according to the Commission 2017 spring forecast, Croatia would be compliant in both years with the debt reduction benchmark.

---

[5] Croatian National Bank, available at: http://www.hnb.hr/documents/20182/80efd9b4-1b2d-4191-b490-bc4c4cfb81ca

Table 4: Compliance with the debt criterion

	2016	2017		2018		2019
		CP	COM	CP	COM	CP
Gross debt ratio	**84**	**81.2**	**81.9**	**78.4**	**79.4**	**75.4**
Gap to the debt benchmark [1]		-3.8	-1.5	-4.4	-2.5	

Notes:

[1] 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 2017 spring forecast (COM); Convergence programme (CP), Comission calculations.

4.3. Compliance with the MTO

Assuming the correction of the excessive deficit in 2016, Croatia is subject to the preventive arm of the SGP as from 2017.

On 12 July 2016, the Council recommended Croatia to achieve a fiscal adjustment of at least 0.6% of GDP towards the MTO (set at a structural balance of −1.75% of GDP) in 2017. However, outturn data showing a sizeable improvement in the headline balance for 2016 indicate that the structural balance was at −0.3% of GDP in 2016, i.e. over-performing the MTO. In 2017, the (recalculated) structural balance from the programme is projected to deteriorate by 1.5% of GDP. The 2017 Commission spring forecast projects a somewhat milder deterioration, of 1.3% of GDP from a slightly higher structural deficit as a starting position. Both forecasts estimate a return back to the MTO in 2017.

In 2018, the recalculated structural balance on the basis of the convergence programme is projected to remain broadly unchanged at the MTO. Meanwhile, the Commission 2017 spring forecast projects a deterioration by 0.5% pps, to -2.1% of GDP. This corresponds to a deviation from the MTO of 0.4% of GDP, measured by the change in the structural balance. Also the expenditure benchmark points to a 0.4% of GDP deviation in 2018. Therefore, an overall assessment points to a risk of some deviation from the MTO in that year.

Table 5: Compliance with the requirements under the preventive arm

(% of GDP)	2017		2018	
Initial position[1]				
Medium-term objective (MTO)	-1.75		-1.75	
Structural balance[2] (COM)	-1.7		-2.1	
Structural balance based on freezing (COM)	-1.7		-	
Position vis-a -vis the MTO[3]	At or above the MTO		At or above the MTO	
(% of GDP)	**2017**		**2018**	
	CP	**COM**	**CP**	**COM**
Structural balance pillar				
Required adjustment[4]	0.0		0.0	
Required adjustment corrected[5]	-1.4		-0.1	
Change in structural balance[6]	-1.5	-1.3	0.0	-0.5
One-year deviation from the required adjustment [7]	-0.1	0.1	0.0	-0.4
Two-year average deviation from the required adjustment [7]	n.a.	n.a.	0.0	-0.1
Expenditure benchmark pillar				
Applicable reference rate[8]	3.6		2.4	
One-year deviation adjusted for one-offs[9]	n.a.[11]	-0.6	n.a.[11]	-0.4
Two-year deviation adjusted for one-offs[9]	n.a.[11]	n.a.	n.a.[11]	-0.5
PER MEMORIAM: One-year deviation [10]	0.9	-0.6	0.2	-0.5
PER MEMORIAM: Two-year average deviation [10]	n.a.	n.a.	0.5	-0.5
Conclusion				
Conclusion over one year	Compliance	Compliance	Compliance	Overall assessment

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.

[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

[11] Could not be calculated due to lack of reliable data.

Source :

Convergence programme (CP); Commission 2017 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

Croatia does not appear to face fiscal sustainability risks in the short run according to the S0 indicator, which captures short-term risks of fiscal stress stemming from the fiscal, as well as the macro-financial and competitiveness sides of the economy.

After peaking at 86.7% of GDP in 2015, the general government debt decreased to 84.2% in 2016. Based on the Commission 2017 spring forecast and a no-fiscal policy change scenario beyond the forecast, the general government debt is expected to continue decreasing until 2019, but to start increasing again thereafter, reaching 82.4% in 2027, thus remaining above the 60% of GDP Treaty threshold. This highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the convergence programme would nonetheless put debt on a steadily decreasing path, although remaining above the 60% of GDP reference value in 2027.

The medium-term fiscal sustainability risk indicator S1 is at 1.9% of GDP, primarily related to the high level of government debt, indicating medium risks in the medium term. The full implementation of the convergence programme would put the sustainability risk indicator S1 at 0.2% of GDP, reducing the sustainability risk, which would however remain in the medium risk category. Overall, risks to fiscal sustainability over the medium-term are, therefore, high. Fully implementing the fiscal plans in the convergence programme would decrease those risks.

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 -1.5%of GDP. In the long-term, Croatia therefore appears to face low fiscal sustainability risks, primarily related to the projected decline in ageing costs, contributing with -2.3 pps. Full implementation of the programme would put the S2 indicator at -2.8% of GDP, leading to a similarly low sustainability risk in the long term. Notwithstanding the falling costs of ageing related to the pensions, the pension system poses risks concerning future pension adequacy.

Table 6: Sustainability indicators

Time horizon				No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term				**LOW risk**			
	S0 indicator [1]			0.2			
		Fiscal subindex		0.1	LOW risk		
		Financial & competitiveness subindex		0.2	LOW risk		
Medium Term				**HIGH risk**			
	DSA [2]			HIGH risk			
	S1 indicator [3]			1.9	MEDIUM risk	0.2	MEDIUM risk
	of which						
		Initial Budgetary Position		0.8		-0.5	
		Debt Requirement		1.4		1.0	
		Cost of Ageing		-0.3		-0.2	
		of which					
			Pensions	-0.4		-0.3	
			Health-care	0.2		0.2	
			Long-term care	0.0		0.0	
			Other	-0.1		-0.1	
Long Term				**LOW risk**		**LOW risk**	
	S2 indicator [4]			-1.5		-2.8	
	of which						
		Initial Budgetary Position		0.8		-0.4	
		Cost of Ageing		-2.3		-2.3	
		of which					
			Pensions	-2.6		-2.7	
			Health-care	0.6		0.6	
			Long-term care	0.0		0.0	
			Other	-0.3		-0.3	

Source: Commission services; 2017 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 2017 forecast covering until 2018 included. 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 2015 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 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change scenario and from last available year for the convergence programme 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 2016.

6. FISCAL FRAMEWORK

In the absence of the expected amendments to the Fiscal Responsibility Act and Budget Act, challenges in the Croatian fiscal framework remain. They primarily relate to the clarity of the numerical fiscal rules, the independence of the fiscal monitoring body (the Fiscal Policy Commission, FPC) 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. According to the former, the structural budget balance has to be 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%. The FRA currently in force does not specify how the target for the structural balance would be set.

The accompanying expenditure rule constrains growth of general budget expenditure to the reference potential GDP growth rate increased for the expected price growth and any 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 does not exceed the projected growth rate of nominal GDP. The FRA does not specify exactly the nature of this 'adjustment plan'. The application of this rule remains therefore unclear.

The deficit rule was introduced in 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 any preventive measures or escape clauses (namely in case of an unexpected economic downturn), seriously questions its relevance and effectiveness.

Both the 2017 National Reform Programme and Convergence Programme reiterate the government commitment to address the identified shortcomings in Croatia's fiscal framework. Firstly, through 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 reviews of the efficiency 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 with 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. SUMMARY

In 2016, the deadline for correcting the excessive deficit, Croatia achieved a headline deficit of 0.8% of GDP, substantially lower than the headline deficit target of 2.7% of GDP under the EDP. The Commission 2017 spring forecast projects the general government deficit to remain below the 3%-of-GDP Treaty reference value throughout the forecast period, while the debt ratio would decline in line with the forward-looking element of the debt reduction benchmark.

The year following the correction of the excessive deficit, Croatia would become subject to the preventive arm of the SGP. After having over-achieved the MTO in 2016, the (recalculated) structural balance from the programme deteriorates back towards the MTO in 2017 and remains broadly stable in 2018, before slightly improving again. In the programme projections, this corresponds to a headline balance gradually improving from -0.8% of GDP in 2016 to 0.5% of GDP in 2020. The general government debt-to-GDP ratio is planned to continue declining to 72.1% by 2020, after peaking at 86.7% of GDP in 2015.

The revenue and expenditure growth projections in the programme for 2017 appear rather conservative in light of the slightly lower deficit projected in the Commission forecast. At the same time, downside risks to the budgetary targets in the programme stem from the impact of Agrokor's financial difficulties. Unlike the convergence programme, the Commission 2017 spring forecast incorporates the materialisation of some of these risks. However, as uncertainties over the outcome of the ongoing restructuring of Agrokor loom, risks remain, over and above what is already included in the Commission 2017 spring forecast. In addition, in the outer years of the programme, some of the planned expenditure growth restraint may be difficult to achieve. More generally, the absence of any quantification of the budgetary impact of the measures underpinning the budgetary projections of the programme hampers their proper assessment.

Taking into account the balance of risks, the Commission spring forecast projects a deterioration of the structural balance to −2.1% of GDP for 2018. An overall assessment points to a risk of some deviation from the MTO in that year. By contrast, Croatia is forecast to comply with the debt rule in 2017 and 2018.

8. ANNEXES

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	3.4	4.0	-2.5	-0.5	1.6	2.9	2.9	2.6
Output gap [1]	-1.2	3.5	-2.3	-4.4	-3.0	-1.3	1.0	2.5
HICP (annual % change)	3.5	3.4	2.2	0.2	-0.3	-0.6	1.6	1.5
Domestic demand (annual % change) [2]	3.9	4.8	-4.0	-1.9	1.2	3.1	3.5	3.2
Unemployment rate (% of labour force) [3]	15.3	11.4	13.6	17.2	16.1	13.3	11.6	9.7
Gross fixed capital formation (% of GDP)	21.9	26.5	21.2	19.4	19.5	19.7	20.1	20.8
Gross national saving (% of GDP)	19.5	23.0	20.2	19.6	23.8	21.5	22.3	21.3
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.4**	**-3.5**	**-6.1**	**-5.4**	**-3.4**	**-0.8**	**-1.1**	**-0.9**
Gross debt	**36.7**	**39.6**	**65.1**	**86.6**	**86.7**	**84.2**	**81.9**	**79.4**
Net financial assets	**3.7**	**-5.9**	**-30.1**	**-44.5**	**-47.3**	**n.a**	**n.a**	**n.a**
Total revenue	43.3	42.0	41.7	43.1	45.2	47.6	47.5	47.4
Total expenditure	46.8	45.5	47.8	48.5	48.6	48.4	48.6	48.4
of which: Interest	1.8	1.9	2.9	3.5	3.6	3.3	3.0	2.8
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.4**	**-3.5**	**0.7**	**1.0**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; non-financial corporations	**-83.1**	**-105.0**	**-124.6**	**-130.9**	**-121.4**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-1.3**	**-8.5**	**1.6**	**7.6**	**6.7**	**n.a**	**n.a**	**n.a**
Gross capital formation	17.2	19.2	13.7	11.4	n.a	n.a	n.a	n.a
Gross operating surplus	16.3	20.6	18.7	17.4	n.a	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**3.2**	**0.6**	**4.4**	**5.1**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets	**49.5**	**48.5**	**60.5**	**78.0**	**80.8**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	43.9	42.8	43.9	43.6	n.a	n.a	n.a	n.a
Net property income	1.0	1.0	1.4	1.5	n.a	n.a	n.a	n.a
Current transfers received	19.7	17.6	18.5	18.6	n.a	n.a	n.a	n.a
Gross saving	6.4	4.7	7.8	8.1	n.a	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.9**	**-6.3**	**-0.8**	**1.1**	**5.7**	**3.7**	**4.2**	**2.5**
Net financial assets	**31.3**	**70.9**	**92.7**	**89.9**	**81.2**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-5.6	-6.8	-0.7	2.0	2.8	3.2	2.5	1.9
Net primary income from the rest of the world	-2.2	-2.3	-2.6	-2.6	-0.6	-3.4	-2.0	-3.3
Net capital transactions	0.0	0.0	0.0	0.0	0.7	1.1	1.3	1.2
Tradable sector	46.3	44.9	43.1	43.3	43.3	43.3	n.a	n.a
Non tradable sector	37.2	39.9	42.3	41.2	40.7	40.3	n.a	n.a
of which: Building and construction sector	4.8	6.8	5.4	4.4	4.3	4.3	n.a	n.a
Real effective exchange rate (index, 2000=100)	84.8	94.0	96.3	87.1	84.5	83.7	84.7	84.4
Terms of trade goods and services (index, 2000=100)	89.1	96.1	99.7	99.9	100.6	101.9	101.6	101.4
Market performance of exports (index, 2000=100)	104.8	110.7	100.8	105.2	109.8	113.0	113.6	113.4

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 2017 spring forecast