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EUROPEAN COMMISSION
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B-1049 Brussels, Belgium
Mr Maarten Verwey
Director General Economic and Financial Affairs

Dear Mr Verwey,

Thank you for your letter dated 27 October, regarding Croatia's Draft Budgetary Plan for 2024 and the opportunity to clarify the drivers of net primary expenditure planned for the next year. In this respect, I would like to emphasize several points.

As outlined in our 2024 Draft Budgetary Plan, the outlook for the next year is characterised by the continuation of relatively positive economic trends, nevertheless, accompanied by high level of uncertainty and predominantly negative risks, which represents a challenge for economic and fiscal policy creators. The planned response of the fiscal policy in the framework of still considerable inflation pressures is focused on the protection of households and firms. Fiscal policy strives to be flexible, standing ready to react promptly in rapidly changing circumstances. It has to take into consideration: the necessity for protection and inclusion of the vulnerable households, demographic and geopolitical trends as well as try to ensure at the same time the appropriate living standard for all the people in Croatia. In such circumstances, it is important to preserve nationally financed public investment, especially in green and digital transition as well as energy security and to carry on with the effective absorption of RRF grants and other EU funds. The continuation of reconstruction works in the areas affected by the earthquake (Zagreb and Banovina region) also builds into the previously mentioned investment and reform efforts by the Government.

In such a challenging environment, Croatia is expected to record the worsening of its fiscal position (an increase in the fiscal deficit and a nominal increase in nationally financed net primary expenditure). It partly results from the necessity to align pensions with the growth of wages and consumer price index, the need to align wages with the rise in the cost of living, and the obligation to protect the most vulnerable members of the society. Consequently, it is also of the utmost importance to maintain investment level and reform implementation to increase potential growth and resilience of Croatian economy.

More specifically, there are several factors at play here and they will be described concisely in the following paragraphs. **Social payments** (without social transfers in kind) make the most important expenditure category of the general government, amounting to 12.7% of GDP. They are mostly determined by the pensions (in the amount of 9.9% of GDP, which represents the increase by 0.7 percentage points compared to 2023). This is the result of pension indexation based on the legislation defining general and special pensions, the accumulated effect of changes in the number and structure of pensioners as well as pension indexation from 2023[1]. The projection also includes the fiscal effect of the new model for family (survivors') pensions, which enables pensioners to use a part of the family pension with the simultaneous use of their own age/early/invalidity pension. Finally, this expenditure category incorporates the effect of the Amendments to the Pension Supplement Act. It enables pensioners, eligible for the pensions from both pension "pillars" and entitled to the basic pension from the pillar I, to get a 27% pension supplement instead of the previous 20.25% one. The calculations also take into consideration the increase in the minimum pension by 3% in real terms. All these efforts are undertaken in the framework of National Recovery and Resilience Plan in order to increase the pension adequacy in Croatia, especially in the context of inflationary pressures and demographic challenges. Maternity allowances will amount to 0.6% of GDP, while child allowances and unemployment benefits will amount respectively to 0.2% of GDP. Social security benefits are projected at the level of 0.9% of GDP (increasing by 0.4 percentage points compared to 2023) and include the payment of social benefits stipulated by the Social Welfare Act from 2022. In this context, it is also important to mention Personal Assistance Act, which came into force on 1 July 2023 and improved the services of personal assistance for disabled persons in their daily lives. Lastly, this expenditure category also includes the fiscal effect of the Inclusivity Supplement Act, which should come into force on 1 January 2024 and will introduce the inclusivity supplement, pooling together personal disability allowance, assistance and care allowance, child allowance and financial allowance for unemployed persons with disability. These efforts are also an integral part of the National Recovery and Resilience Plan with the aim of improving coverage, adequacy and targeting of social benefits.

The second largest expenditure category refers to **compensations of employees** and amounts to 12.1% of GDP. Their increase by 0.7 percentage points compared to 2023 results from a series of factors: increase in the wage base established by the collective agreements for public and state employees, annual effect of wage supplements and wage coefficients increased during 2023, years-of-service bonus of 0.5%, and the envisaged dynamics of public and civil service employment. The agreed wage coefficients will be incorporated in the new Wages Act and the accompanying bylaws, which should come into force next year as a part of the comprehensive wage reform for civil and public servants as one of the key milestones in National Recovery and Resilience Plan.

If we look at the trajectory of social payments and compensation of employees, the key factor resulting in their increase is the necessity to align the income of households, especially the most vulnerable ones, with the rising cost of living. For example, according to a paper published by the European Commission titled "Inflation in the euro area" from October 2023, food inflation accelerated to unprecedented levels in 2022 and 2023. It is crucial for consumers as food is an important item of households' consumption basket, most notably for low-income households, which were also pressed by energy inflation. In this respect, the hardest hit countries are the

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[1] Pension indexation is implemented twice a year (1 January and 1 July) based on the increase in average gross wage and consumer price index in the last 6 months compared to the previous 6 months. Subsequently, the indexation rate is calculated as the weighted average of the above mentioned 2 rates (with the respective weights of 0.7 and 0.3, where the bigger weight is given to the faster growing factor and the smaller weight to the other one). It is the so-called Swiss formula.

Baltics, Slovakia and Croatia where the cumulative food inflation reached around 32%-42% in the past two and a half years. Furthermore, there was a noticeable co-movement between the size of the food price shock in the last 2 years and the importance of food in the overall consumption basket. Consequently, the cost of living especially for the low-income households strongly eroded their real income and made it more difficult for them to make ends meet. That is why the Croatian government pressed with the above mentioned measures regarding increase in the social payments as well as the compensation of employees, especially those in the civil and public service (219 000 out of 250 000) with the lowest wage coefficients (from 0.63 to 1.87) who got temporary[2] wage supplements. In this context, it is also worth mentioning that continued inflationary pressures spurred the Government to adopt the 4th and the 5th package of anti-inflationary measures during 2023, which are planned to be phased out at the end of March of 2024, in line with the Country Specific Recommendations from June 2023.

The next important expenditure category in this context is **gross fixed capital formation**. It is projected in the amount of 4.5% of GDP and determined by the expected investment dynamics of the central and local (regional) government. These investments are to be financed in a significant amount from EU ESI funds and RRF loans. This category entails investment in education, transport and utility infrastructure. It also includes the delivery of 6 new trains to Croatian Railways Passenger Transport as well as the delivery of fighter jets and weapons to the Ministry of Defence in order to strengthen geo-political position of Croatia. Considerable resources will continue to be invested in the reconstruction of public infrastructure in the areas hit by the earthquake (Zagreb and Banovina region) exclusively from national resources and new RRF loans. The renovation of public buildings to improve energy efficiency is planned to be financed largely from the REPowerEU chapter of National Recovery and Resilience Fund, more specifically from new RRF loans.

Other expenditure category mainly includes current and capital transfers and is projected in the amount of 4.2 % of GDP. It mostly refers to the Croatian contribution into the EU budget and the projects financed from EU funds, particularly in the water-management and utility sector. This category also takes into consideration subsidies for the price of gas for households until the end of March 2024 and the continuation of the project that will enable women who are relatively less employable on the labour market to work as caretakers for the elderly (the over-contracted EU project in the amount of 0.1% of GDP). Capital transfers mostly refer to capital transfers to public companies and other legal entities; renovation of residential houses to improve energy efficiency and the reconstruction of residential buildings hit by the earthquake, financed through the national sources. This category also includes resources invested with the aim of increasing the capacity of the LNG terminal and improving the gas infrastructure, financed through RRF loans (as a part of the REPowerEU chapter) in order to strengthen the security of energy supply for Croatia as well as Central and Southeast Europe.

When we observe the trajectory of gross fixed capital formation as well as capital transfers projected in 2024, it is important to mention that 0.3% of GDP of these expenditures refers to the national financing of the over-contracted EU projects i.e. the projects contracted above the amounts allocated from the EU funds. Over-contracting is a regular practice in EU member states and represents a contingency approach in order to achieve the maximum absorption of the allocated EU funds in a country, in line with the Country Specific Recommendations adopted by the Council in June 2023. These projects get to be included in the EU financed envelope in case of financial corrections, absorption below the allocated EU funds or decisions not to implement a project within the EU approved project pipeline. The over-contracted

[2] As explained above, the agreed wage coefficients will be incorporated in the new Wages Act and the accompanying bylaws.

projects are mostly part of the environment protection and water-management sector and have to be implemented in order to fulfil Croatia's obligations stemming from the *EU acquis*. Overall, the projections of both gross fixed capital formation and capital transfers in 2024 Draft Budgetary Plan reflects the effort of the Croatian Government to preserve nationally financed public investment and ensure the effective absorption of RRF grants with special emphasis on REPowerEU chapter and other EU Structural and Investment Funds, in line with the Country Specific Recommendations from June 2023.

All the above-mentioned factors will result in the temporary worsening of Croatia's fiscal balance in 2024 compared to 2023 (-0.3% of GDP in 2023 and -1.9% of GDP in 2024). In spite of that, it is important to notice that, at the same time, the ratio of public debt to GDP continues its downward trajectory. Consequently, it will record the level of 60.7% in 2023 and go down further to 58% in 2024.

The Croatian Government is fully committed to keeping the public finances on a sustainable path. Consequently, we will continue to pursue a medium-term fiscal strategy of gradual and sustainable consolidation, combined with investments and reforms conducive to higher sustainable growth, to achieve a prudent medium-term fiscal position. Accordingly, fiscal deficit in 2025 will amount to 1.6% of GDP, while the ratio of public debt to GDP will continue to fall at the level of 56.6%. Therefore, the general government deficit is planned to remain well below 3% of GDP and the general government debt-to-GDP ratio to further drop and remain below 60% over the medium-term horizon.

I would like to emphasize that Croatia remains committed to the Stability and Growth Pact. As always, we are fully available to engage in a constructive dialogue at the technical level in order to provide all the information you may deem useful.

Yours sincerely,

STIPE ŽUPAN
State Secretary

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