



REPUBLIC OF CROATIA

**CONVERGENCE PROGRAMME
OF THE REPUBLIC OF CROATIA
FOR THE PERIOD 2016-2019**

April 2016

Foreword

At its session on April 28 2016, the Government of the Republic of Croatia adopted the Convergence Programme of the Republic of Croatia for 2016. This is the third Convergence Programme drafted by the Republic of Croatia as an EU Member State. This document is the result of a process in which all EU Member States are obliged to report and harmonize their economic policies with the jointly defined objectives and provisions of the EU. This harmonization and reporting is conducted as part of the annual cycle of the European semester, where each Member State submits its strategic documents to the European Commission by the end of April. This is followed by an economic dialogue, drafting recommendations for individual Member States and their practical implementation. The Convergence Programme is also a document aimed at reporting on the efforts undertaken by the Republic of Croatia for the purpose of fulfilling the recommendations of the Council of the European Union within the framework of the Excessive Deficit Procedure. The document was drafted by the Ministry of Finance.

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1. FRAMEWORK AND OBJECTIVES OF THE ECONOMIC POLICY

Economic policy framework of the Republic of Croatia was characterized by a gradual recovery of economic activity after a six-year recession period. In the medium-term, we expect a real GDP growth of 2.0% and 2.1% in 2016 and 2017 respectively, which will increase even faster to 2.3% in 2018 and 2.5% in 2019. The most significant contribution to economic growth throughout the projection period will continue to come from domestic demand with the most positive impact coming from household consumption. The gradual acceleration of gross fixed capital formation will also have a significant positive impact on economic activity, although its contribution will still be lower if compared to the pre-recession period when the intense cycle of construction activity greatly impacted the strong dynamics of the total investment volume. Government spending will make a negligible contribution to economic growth as a result of general government deleveraging. The contribution of net foreign demand will be slightly positive in the period 2016-2018, although it will gradually decrease with the acceleration of economic activity and record a slightly negative value in 2019.

Despite the expected recovery, the economy of the Republic of Croatia is characterized by strong challenges, particularly related to the economic imbalances which require the implementation of decisive measures. In this sense, the economic programme of the Republic of Croatia for the forthcoming mid-term period will be based on continuous strong efforts with the aim of fiscal consolidation and stimulating economic growth.

Appropriate fiscal consolidation contributes to the reduction of public debt, but also raises the trajectory of potential gross domestic product because it reduces the cost of long-term debt and interest, makes space for private sector investments, strengthens the fiscal policy's credibility and improves the perception of state risk, consequently improving the credit rating and increasing the availability and lowering the cost of capital. In addition, a strong medium-term fiscal consolidation represents one of the obligations the Republic of Croatia has undertaken within the framework of the Excessive Deficit Procedure in order to implement the Recommendations of the Council of Ministers of the EU which state that the Republic of Croatia must reduce its budget deficit below 3% of the GDP and steer the general government debt to a sustainable path by the end of 2016. The efforts regarding these objectives have intensified in the last year, and the Financial Report of the Republic of Croatia from March of this year indicates a strong positive step forward in terms of reducing budget deficit to 3.2% of the GDP in 2015, which exceeds the Recommendations of the Council of Ministers of the EU.

The upcoming mid-term period will see the continuation of decisive fiscal efforts that will, according to the plans, result in reduced budget deficit to 2.6% of the GDP in 2016 and a reduced share of public debt in gross domestic product in the same period and the subsequent fulfilment of the Recommendations issued by the EU Council in the framework of the Excessive Deficit Procedure.

Medium-term efforts on the revenue side of the budget will be focused on a comprehensive analysis of the tax system and creating a corresponding legislative proposal in order to establish a stable, sustainable, simple and competitive tax system, strengthening the efficiency of the tax inspection

procedure and further enhancing the work of the Tax Administration. The application of the cash transaction fiscalization system will continue. Furthermore, the exchange of data on income and receipts of citizens with other institutions has also been strengthened. With the aim of improving tax system efficiency, the risk analysis system was improved and the institute of tax settlements with the aim of shortening the process of tax inspections and faster collection of newly established obligations was also introduced. With the introduction of tax treaties, taxpayers will find it easier to settle tax obligations, and the newly developed eOvrhe platform will facilitate a more efficient tax debt management. We continue making efforts to eliminate or reduce non-tax payments.

On the expenditure side, attention is focused on reducing the budget deficit by implementing measures that do not adversely affect growth, while maintaining the social protection of citizens and an increasing orientation towards the use of EU funds. The Budget for 2016 provides for structural savings in most expenditure categories. Investments in water, transport and energy infrastructures will be among the priorities of public spending. In the conditions of high unemployment, especially among the youth, attention is directed to the implementation of active labour market measures. Structural efforts within the pension and health systems, justice, social welfare and education will also be carried out.

All these objectives and expected trajectories of fiscal aggregates are defined and dependent on the implementation of key structural reforms in the coming period. They are primarily focused on public finances conditional also on the stability of the health and pension system, social protection, labour market, public administration, improving the investment climate and reducing the burden on businesses, as well as increasing the absorption of EU funds, which would ensure long-term fiscal sustainability and create foundations for a stronger economic growth and employment. In connection with the activation of state property, the Government of the Republic of Croatia has focused on intensifying the process of privatization of companies in state ownership, except for those of strategic importance.

The planned deficit of the consolidated general government will amount to 2.6% of the GDP in 2016, 2.0% of the GDP in 2017, 1.6% of the GDP in 2018, and 1.0% of the GDP in 2019 based on the implementation of structural reform measures, and in line with macroeconomic projections for the period between 2016 and 2019.

These fiscal efforts will result in a reduction of the structural deficit and achievement of the medium-term budgetary objective, which ensures compliance of public debt trends with the provisions of the Stability and Growth Pact and EC recommendations.

The aforementioned positive trends regarding the significant deficit reduction, taking into account the aforementioned privatization incomes and a change of deposits, will lead to a reduction of the public debt in the GDP in 2016 to 85.9%, after several years of strong growth. The rest of the observed medium term period is also expected to show its gradual reduction to 80% of the GDP in 2019.

2. MACROECONOMIC TRENDS

The macroeconomic framework described hereafter was drafted in February of this year, when drawing up the Budget for 2016, with the revenue and expenditure side of the consolidated general government budget in line with these projections. The external assumptions for macroeconomic projections are for the most part taken from the latest projections of the European Commission from February - "Winter 2016". The subsequently published macroeconomic data for 2015 are included in this macroeconomic framework without altering the projected rates of change of variables by the end of the projection period.

2.1. Gross Domestic Product

The six-year negative economic activity trend ended in 2015 and a real growth of gross domestic product (GDP) of 1.6% was recorded¹. It can be ascertained that the economic activity recovery recorded in 2015 was sustainable in the sense that it did not generate additional imbalances, neither external nor internal, taking into account the state of the business cycle of the domestic economy. Moreover, it had an extremely favourable effect on the labour market. The positive contribution to GDP growth in 2015 primarily came from domestic demand, mainly driven by household consumption, but also from net foreign demand. Data on the rate of change in the seasonally adjusted GDP series show a continuous acceleration of growth in the first three quarters of 2015, while a slight decline in economic activity was recorded in the last quarter. However, we must mention that all the individual components of the final demand recorded a very strong growth in the last quarter of 2015, as it was expected when preparing this macroeconomic framework (except changes in inventories which were expected to show somewhat stronger dynamics), which initially predicted a slightly stronger annual GDP growth in 2015, as it was published in the Guidelines for the Preparation of the Croatian State Budget for 2016. Moreover, the growth of exports of goods and services in the last quarter of 2015 slightly exceeded expectations. The decline in seasonally adjusted GDP in the last quarter is thus exclusively the result of a very high implicit elasticity of the imports of goods and services that has exceeded all expectations and a somewhat less positive dynamics of changes in inventories than was anticipated.

Continued positive trends and a gradual moderate speeding up of economic activity are expected in the medium-term. In 2016 and 2017, a real growth of GDP of 2.0% and 2.1% respectively is expected, which will then further accelerate to 2.3% in 2018 and 2.5% in 2019.² The most significant

¹ Data on the gross domestic product for 2014 and 2015 are preliminary.

² Compared to the latest projections of the European Commission for Croatia ("Winter 2016", published in February), the GDP growth projection for 2016 is only slightly lower (0.1 percentage points), reflecting lower projected contribution of domestic demand with the same contribution of net external demand. The growth rate of GDP in 2017 within this framework is identical to that of the EC projections for Croatia.

contribution to economic growth throughout the projection period will continue to come from domestic demand with the most positive impact coming from household consumption. The gradual acceleration of gross fixed capital formation will also have a significant positive impact on economic activity, although its contribution will still be lower compared to the pre-recession period, when the intense cycle of construction activity greatly impacted the strong dynamics of the total investment volume. Government spending will make a negligible contribution to the economic growth as a result of general government deleveraging. The contribution of net external demand will be slightly positive in the period 2016-2018, although it will gradually decrease with the acceleration of economic activity and record a slightly negative value in 2019. It should be noted that in the pre-crisis period, in the years with the economic growth dynamic similar to that described in this macroeconomic framework, net exports had a significant negative contribution to economic growth. On the other hand, according to the currently expected pattern of economic growth, net exports have a slightly positive or neutral contribution which would assume more significant negative value only with higher GDP growth rates. The above also shows that domestic demand, in particular investments, contributed more significantly to economic activity in the corresponding pre-crisis years than it is now anticipated.

Table 2.1 Projection of gross domestic product

	2015	2016 forecast	2017 forecast	2018 forecast	2019 forecast
GDP - real growth (%)	1.6	2.0	2.1	2.3	2.5
Household consumption	1.2	1.8	1.8	2.0	2.5
Government consumption	0.6	0.3	0.8	1.4	2.0
Gross fixed capital formation	1.6	2.5	3.2	3.5	4.5
Exports of goods and services	9.2	5.2	5.5	5.6	5.4
Exports of goods	12.1	7.1	6.8	6.7	6.8
Exports of services	6.4	3.2	4.1	4.5	4.1
Imports of goods and services	8.6	4.7	5.3	5.9	6.3
Imports of goods	8.8	4.9	5.4	5.9	6.3
Imports of services	7.4	4.1	5.0	5.9	6.1
Contributions to real GDP growth (percentage points)	1.6	2.0	2.1	2.3	2.5
Household consumption	0.7	1.1	1.1	1.2	1.5
Government consumption	0.1	0.0	0.2	0.3	0.4
Gross fixed capital formation	0.3	0.5	0.6	0.7	0.9
Changes in inventories	0.0	0.1	0.1	0.1	-0.1
Exports of goods and services	4.2	2.5	2.8	2.9	2.9
Imports of goods and services	-3.8	-2.2	-2.5	-2.9	-3.2

Source: Croatian Bureau of Statistics, Ministry of Finance

Household consumption, a component which amounts to almost 60% of the GDP, will be the main driver of the growth of domestic demand in the medium-term. Its recovery, after three consecutive years of decline, has begun already in 2015 when consumption increased by 1.2% in real terms. This is the result of significantly accelerated real growth of household disposable income³, largely due to employment growth and income tax changes implemented at the end of 2014, which led to an

³ It has been estimated that the household disposable income nominally increased by 1.6% in 2015, of which tax changes increased the disposable income by HRK 1.0 billion (this amount includes the positive effect of changes in the taxation of income from the end of 2014 and the negative effect of introducing interest on savings taxation at the beginning of 2015), or 2.1% in real terms.

increase of net wage bill⁴, as well as favourable price developments. Despite a significant improvement of the consumer confidence indices to a pre-crisis 2007 level, 2015 saw a continued deleveraging of the household sector (excluding the impact of the conversion of loans in Swiss francs, household loans declined by approximately 0.8% in 2015), reflecting its high indebtedness and uncertainty about future economic activity dynamics as well as developments in the financial markets, especially given the long recession. In 2016, the real growth of household consumption will amount to 1.8%, still slightly lower than the growth of disposable income which will maintain the dynamics from 2015 (real growth of 2.1%) even though the positive effect of income tax changes will fade, and despite the inflation sign reversal.⁵ This will primarily be the result of a positive contribution of its largest category, compensation of employees (with 75.0% share in the disposable income of households), which will increase due to the continuation of favourable trends in the labour market. The significant positive impact on consumption in 2016 is projected to come from the conversion of loans in Swiss francs. The total effect of the conversion and the write-off of loans for households is estimated at approx. 2.2% of the GDP, which is related to a reduction in principal amount and net overpayment of loan instalments. Due to reductions in future loan instalments based on decreased total debt of households, but also on net overpayment in the previous period, additional funds will be consequently released to the households sector⁶. Deleveraging of the household sector will continue in 2016 with the projected decline in total household loans, from which the effect of the conversion of loans in Swiss francs has been excluded, of similar intensity as in 2015. Positive trends in household consumption will continue with a similar intensity in the coming years, while only at the end of the projection period we expect to see a slightly higher growth rate which would stop the decline in the share of household consumption in the GDP expressed in constant prices. Therefore, we expect to see a real growth of household consumption of 1.8% in 2017, 2.0% in 2018 and 2.5% in 2019. The real growth of household disposable income will noticeably slow down to 1.4% in 2017, primarily as a result of strengthening of inflation, only to show gradual acceleration to 1.5% in 2018 and 1.6% in 2019. In this period, the real growth of household consumption will exceed the growth of disposable income causing the household sector saving rate to fall rapidly from its multi-year maximum (12.9% in 2016) to long-term equilibrium values which will continue to be significantly higher than pre-crisis levels (12.5% in 2017, 12.0% in 2018 and 11.2% in 2019). The deleveraging process of the household sector, present for five consecutive years, should cease during 2017 with a projected slight growth in household loans in conditions of the expected recovery of loan demand, retaining favourable levels of kuna liquidity of the banking system and potential further slight reduction in active interest rates of commercial banks. The

⁴ We estimate that the real growth of household disposable income in 2015 could have been even higher as the Eurostat data on compensation of employees and GFS fiscal statistics data on collected employers' contributions, taking into account the increase in the number of employees by 1.8% (all the stated data are still considered preliminary), implies a decline in the average gross wage per employee of 0.8%, while the administrative data of the Croatian Bureau of Statistics (CBS) indicates an average gross wage growth of 1.3%.

⁵ We should mention here that the projections of the European Commission for Croatia published in February predicted an identical growth rate of household consumption in 2016.

⁶ The maximum amount potentially available for household sector consumption which is released due to the conversion is estimated at 0.4% of the GDP in 2016 and 0.1% of the GDP in 2017, and this amount will gradually fade in subsequent years, due to loan repayments. However, this estimate does not include the impact of different interest rates due to the conversion.

recovery of consumer confidence will intensify in the coming years characterized by a more favourable and stable economic developments with a further recovery of the labour market and maintaining a relatively low and stable inflation.

Government spending recorded a slight real growth of 0.6% in 2015⁷, primarily due to an increase in intermediate consumption, while, on the other hand, the largest item of government spending - compensation of employees - recorded a slight real decrease since an identical decline in employment was realized on the general government level. In accordance with further deleveraging needs of the consolidated general government, a significant contribution of government spending to economic growth is not expected in the medium-term. We expect to see a real growth in government spending of 0.3% in 2016, 0.8% in 2017, 1.4% in 2018 and 2.0% in 2019.⁸

Gross fixed capital formation recorded a real growth of 1.6% in 2015, primarily driven by strong real growth of investments of companies in majority state ownership (outside the general government sector) amounting to 14.5%, while private sector investments achieved a slight growth of 0.8%, and general government investments have shown a slight decline of 0.5% (according to preliminary results for 2015).⁹ Gross fixed capital formation is expected to grow by 2.5% in 2016¹⁰. General government investments will show a strong real growth fueled by capital inflows from EU funds while, on the other hand, investments from companies in majority state ownership are expected to increase only slightly after two years of extremely high growth rates. We expect the growth of private sector investments to slightly accelerate compared to 2015. Their subdued dynamics in 2016 will be affected by the still present limitations regarding the investment activities of the business sector such as continued deleveraging of companies, weak liquidity within the sector, lack of resources and the high cost of financing, uncertainty about the continued growth of foreign and domestic demand and the volume of international trade. A considerable uncertainty should also be pointed out regarding the recovery of the construction sector, despite the stabilization of trends during 2015, in conditions with a still present gap between supply and demand (although the real

⁷ According to preliminary CBS data, the nominal decrease of government spending amounted to 2.1% in 2015 while a growth of 0.9% was predicted for this macroeconomic framework, with the main reason for this divergence being a surprisingly strong growth in the category "market output, output for own end-use and payments for non-market output" of nearly 10%, according to CBS data. These data were not taken into consideration in these projections as they would have direct implications when calculating the GDP.

⁸ The largest deviation in projections of real growth of GDP components on the expenditure side for 2016 between this projection framework and the projections of the European Commission for Croatia, which caused this macroeconomic framework to have a projected lower growth of 0.1 percentage points, is the growth of government spending which the European Commission predicted at 1.1% (contribution to GDP growth of 0.2 percentage points), while we predicted a neutral contribution to economic growth.

⁹ According to preliminary CBS data, the nominal decrease of gross fixed capital formation of consolidated general government exceeds 20%, that is, amounts to almost HRK 3 billion in 2015. However, taken into account that these results are not obtained by using standard calculation method (INV-P forms) and that preliminary Ministry of Finance data still point to stagnation or minor nominal decrease, CBS data are not used in this projections since we expect their upward correction.

¹⁰ Which is only slightly lower than the EC projections (2.6%).

estate price indices showed some positive developments during 2015). Growth of gross fixed capital formation will exceed the overall economic activity growth in the medium-term, nevertheless, a growing share of investments in the GDP expressed in constant prices will remain below the pre-crisis levels at the end of the observed period. The reason for such forecast should be sought in the pre-crisis structure of foreign capital inflows and investment activity pattern which, in an unsustainable manner, primarily relied on the construction activity. A significant incentive to the investment activity dynamics is expected from raising the utilization rates of structural and investment EU funds containing considerable investment potential, especially given the current level of overall capitalization of the domestic economy. Therefore, we expect to see a real growth of gross fixed capital formation of 3.2% in 2017, 3.5% in 2018 and 4.5% in 2019. The growth of private sector investments will gradually outpace the broader public sector investments towards the end of the projection period in terms of strengthening business optimism and improving the investment climate, with persistent structural reforms that will facilitate business operations for entrepreneurs. Additionally, we expect to see a stable increase of foreign direct investments in the medium term stimulated by a reduction of negative risks and uncertainties regarding future economic developments, positive structural economic changes and a consequent improvement of the country credit rating. We should also note that the credit lines provided by HBOR (Croatian Bank for Reconstruction and Development) and the creation of a fund aimed at small and medium-sized entrepreneurs play an important role in ensuring sufficient funding under favourable terms to the business sector, especially SMEs.

Table 2.2 Gross fixed capital formation by sectors (real growth, in %)

	2015	2016 forecast	2017 forecast	2018 forecast	2019 forecast
Total gross fixed capital formation	1.6	2.5	3.2	3.5	4.5
Broader public sector*	3.6	4.8	5.3	3.3	2.3
General government	-0.5	6.7	4.8	2.7	1.7
Public enterprises	14.5	0.6	6.6	4.7	3.5
Private sector	0.8	1.6	2.3	3.5	5.3

Note: Deflated by total gross fixed capital formation deflator.

* Consolidated.

Source: Croatian Bureau of Statistics, Ministry of Finance

The largest positive contribution to GDP growth in 2015 came from exports of goods and services, which increased in real terms by 9.2%. Exports of goods had a significantly greater contribution to the overall exports growth than the exports of services, despite the record-breaking tourist season partly influenced by temporary factors such as political instability in some competitive tourist destinations, as well as very favourable weather conditions. Extremely positive achievements regarding the exports of goods from the middle of 2013 followed by a strong growth of Croatian export market share, especially in 2015, were to a large extent the result of one-off positive impact of structural changes associated with joining the common market of the European Union pertaining to a better integration of domestic exporters and improving non-price competitiveness of domestic exports due to the positive effect of the declaration of country of origin (EU). The significant positive impact on the growth of goods exports can also be attributed to the effect of re-exports which is difficult to measure but can be observed indirectly, through a very pronounced simultaneous increase of imports and exports, which is evident when observing the total trend of exports and

imports, especially by specific activities. Despite an estimated acceleration of growth in foreign demand for domestic goods and services, the real growth of exports of goods and services will be lower in the coming years when compared to the preceding two years. We expect to see a real growth in the exports of goods and services of 5.2% in 2016.¹¹ Strong one-time slowdown of total exports refers both to the exports of goods and of services. A slower growth in the exports of goods primarily reflects the expected sudden and strong weakening of re-exports dynamics, while the main reason for the reduced growth of the exports of services is due to an unfavourable base effect. Nevertheless, 2016 should again be characterized by a successful tourist season, which is confirmed by booking and promotional activities at tourism fairs, and the expected unfavourable results of competitive tourist countries will again have a positive impact. The growth of exports of goods and services will continue to accelerate to 5.5% in 2017, 5.6% in 2018, and will slightly slow down to 5.4% in 2019. At the same time, the continuation of positive changes in the share of domestic export sector on export markets is expected, but they will be considerably less when compared to the period 2013-2015, and will decelerate closer to 2019. Thus, the exports of goods and services will to a much greater extent reflect the movement of foreign demand for domestic goods and services during the remainder of the projection period. Higher growth rates are expected for the exports of goods than the exports of services during the forecast period. The projected acceleration of the exports of services in the period between 2017 and 2018 is primarily related to the tourism sector where we expect to see an increase in capacity and tourist offers in the short term with a stable and relatively low inflation of tourist prices. Due to the ending of re-exports dynamics correction, as well as the disappearance of positive temporary factors related to EU accession, we expect a further mild slowdown in exports of goods in 2017 and 2018 despite slightly accelerating foreign demand, and the growth of exports of goods could stabilize at an even lower level compared to 2016.¹² We should also mention that in the period between 2016 and 2018, but to a lesser degree than in previous years, the positive effect on exports will also come from the movement of real effective exchange rate of kuna whose impact will weaken towards the end of the projection horizon. This strengthening of price competitiveness of exports refers to more favourable price movements in foreign markets, particularly in energy, taking into account the structure of the domestic export sector, projected weak dynamics of unit labour costs, as well as the expected exchange rate movements of kuna against the euro and the dollar. The expected mild slowdown of overall exports in 2019 is due to the weakened dynamics of the exports of services and a slight acceleration of the exports of goods.

A strong growth in the imports of goods and services amounting to 8.6% was recorded in 2015, strongly related to the growth of exports, primarily as a result of the aforementioned high re-exports growth. Considering the one-time strong slowdown of exports growth and disappearance of positive re-exports dynamics, it is expected that the real growth of imports of goods and services will decelerate to 4.7% in 2016, despite a slight acceleration of domestic demand. Although a fairly strong slowdown in final demand growth by 1.0 percentage point is expected in 2016, this projection of imports of goods and services leads to a very high reduction of implicit elasticity of total imports in

¹¹ This expectation is slightly more optimistic than projections of the EC (5.0%), predicting a slightly stronger increase in the exports of goods and a slightly weaker increase in the exports of services.

¹² A similar path of the exports of goods in the years following the EU accession was recorded to a certain extent in countries that joined the EU in the fifth round of expansion, but the start of the financial crisis undermined the dynamics of the exports of goods in said countries in subsequent years, and thus made it difficult to compare their multi-year adjustment of export with the Republic of Croatia.

relation to the final demand as a result of a significant impact assessment of partial elasticity of imports with respect to the exports component.¹³ Towards the end of the projection period and in line with the strengthening demand, imports will again accelerate to the projected real growth of 5.3% in 2017, 5.9% in 2018 and 6.3% in 2019. Throughout the entire projection period, the growth of imports of services will fall behind the growth of imports of goods with the exception of 2018, when it will catch up. The path of imports of goods and services shown in this macroeconomic framework implies that the elasticity of imports with respect to final demand in the coming period will gradually grow with the acceleration of the final demand, but will remain at lower levels than in recent years when, as previously described, it was strongly influenced by temporary effects and, on the other hand, will be again somewhat more pronounced compared to the levels from the pre-crisis period. Although the partial elasticity of imports in relation to the exports component in the crisis years has experienced an extremely strong, but largely only temporary increase, the elasticity of imports in relation to other components of the final demand showed a mild upward correction in the recession period, but of a permanent character, in connection with structural changes in the economy, including the loss of certain production capacities and appropriate substitution with imported products. Accordingly, the acceleration of the economic activity will cause the growth of imports of goods and services to overcome the growth of exports, which will be especially pronounced in 2019. However, since the exports of goods and services showed a significant absolute increase in the last few years, the contribution of net exports to economic growth will be slightly positive in the period between 2016 and 2018, although it will decrease with the acceleration of recovery, while in the last year of the projection period, the net foreign demand will have a slightly negative contribution to economic growth.

Last year's Convergence Programme projected a growth in economic activity of 0.4% in 2015, which underestimated the acceleration of economic activity after six consecutive years of recession. The largest deviations between last year's projections and realisations were noticed with regard to foreign trade; the growth of exports and imports of goods and services was underestimated, while the projected total contribution of net exports to GDP growth was realised. This divergence between the projected growth of exports and imports and the realised results was, for the most part, caused by underestimating the effect of re-exports which was expected to have a much smaller overall impact in 2014, followed by a significant impact reduction in 2015. Significant deviations also occurred with regard to gross fixed capital formation which was projected to have a slight decline versus its real growth, primarily due to private sector investments having opposite trends than anticipated, but also due to underestimating the investment growth of the broader public sector. In addition, the real growth of household consumption was somewhat stronger than expected, primarily due to considerably more favourable trends in the labour market. Government spending recorded a slight increase instead of the projected decrease, primarily due to the absence of the expected reduction in intermediary consumption.

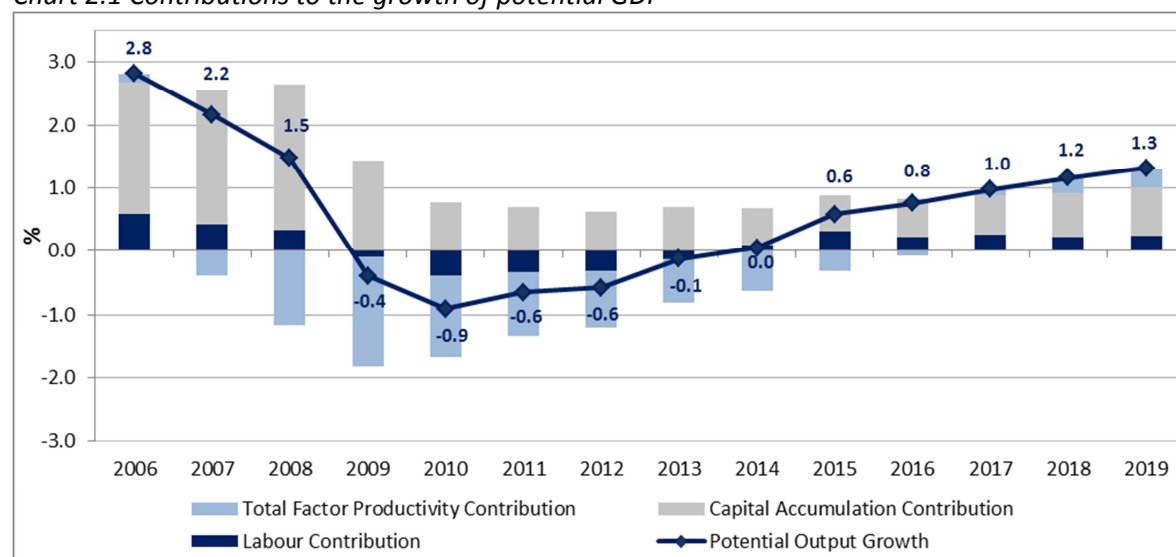
¹³ We should point out that this projection is more reserved than the EC projection for Croatia (slightly lower growth of imports of goods and services of 4.6% in 2016), which assumes a slightly lower elasticity of total imports with regard to final demand and faster expected growth of the final demand itself (by 0.1 percentage points), and especially domestic demand (by 0.2 percentage points). At the same time, the projections for 2016 predict a higher growth rate of imports of goods (0.6 percentage points) and a lower growth rate of imports of services (2.0 percentage points).

2.2. Cyclical trends

The growth of potential gross domestic product¹⁴ has slowed significantly in the six-year period of recession. The growth of potential gross domestic product amounted to an average of more than 3.0% in the pre-crisis period, while dropping to 0.6% in 2015, and could again exceed 1.0% only in 2018. The pronounced contribution to the growth of potential gross domestic product which came from capital accumulation before the crisis due to strong investment activity has been significantly reduced at the beginning of the crisis. There was also a significant decrease of the positive contribution of total factor productivity which recorded negative values in the period between 2007 and 2015. Negative contributions to the growth of potential GDP in the crisis period were also attributed to the labour factor, primarily as a consequence of the labour force decline, and to a lesser extent due to the increasing unemployment rate trend.

In the medium term, we expect to see an acceleration of potential GDP growth. Potential GDP is expected to grow by 0.8% in 2016. It is expected that the biggest contribution will come from capital accumulation as a result of re-intensification of capital investments, and to a lesser extent from potential labour which will be impacted by increased labour force participation¹⁵, while the contribution of total factor productivity is expected to remain slightly negative. We expect to see a growth of potential GDP of 1.0% in 2017, 1.2% in 2018 and 1.3% in 2019. Capital accumulation will contribute the most to the growth of potential GDP during the entire period, and to a lesser extent, labour and total factor productivity, which could again begin to increase after 2016.

Chart 2.1 Contributions to the growth of potential GDP



Source: Croatian Bureau of Statistics, Eurostat, Ministry of Finance

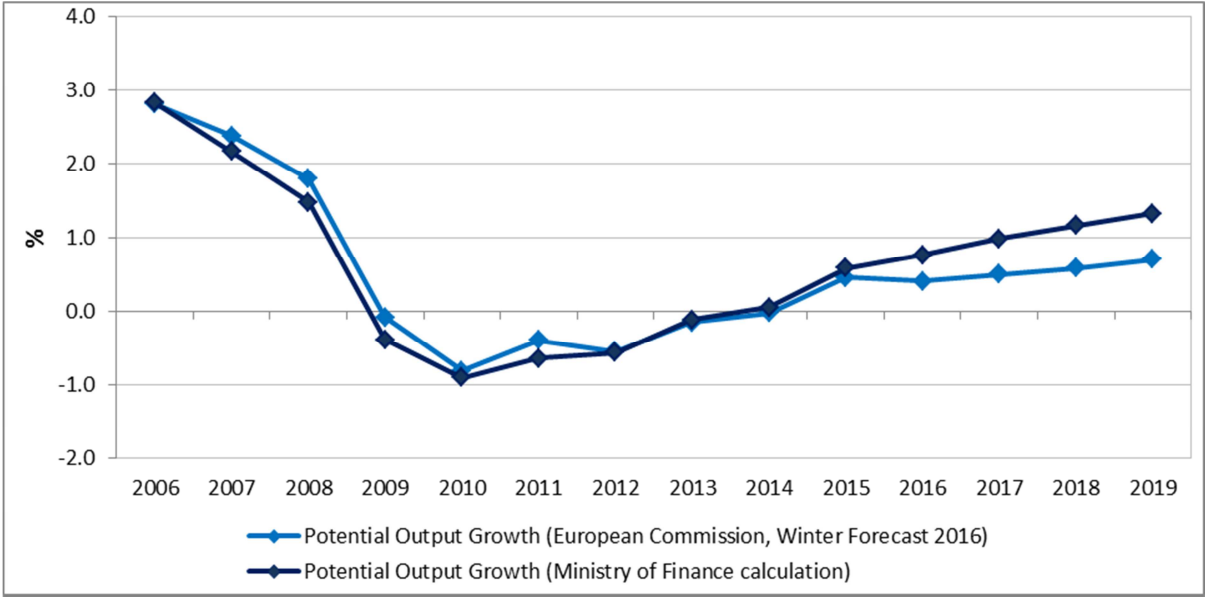
¹⁴ Calculation made by the Ministry of Finance using the production function methodology of the European Commission.

¹⁵ Although the working-age population (aged 15-74) is expected to decline in 2016, as is the trend since 2006, the growth of labour force results from an increase in the participation rate, which should continue to grow in the rest of the projection period although at a slower pace.

It is expected that the negative output gap, which has been present since 2009 and reached its peak in 2014, will be significantly reduced during 2016 and 2017 due to a significantly higher GDP growth than the potential growth. Gap should be closed in 2018, according to projections, when we will see a slightly positive output gap which will then increase to 1.4% in 2019.

The potential growth calculated by the Ministry of Finance approximately coincides with the calculations of the EC¹⁶ up until 2015, but in the period from 2016 onwards, it is slightly higher than the forecast made by the EC. More specifically, according to calculations made by the Ministry of Finance, the potential growth will accelerate after 2016 and reach 1.3% in 2019, which is 0.6 percentage points¹⁷ higher than the potential growth in 2019 as forecasted by the European Commission.

Chart 2.2 Comparison of the potential output growth between the European Commission and the Ministry of Finance



Source: Croatian Bureau of Statistics, Eurostat, European Commission, Ministry of Finance

2.3. Prices

During 2015, a stagnation of the GDP deflator was recorded for the second consecutive year, while household consumption deflator negative trend was of similar intensity as in the previous year,

¹⁶ Winter Economic Forecast, February 2016

¹⁷ This difference primarily stems from a higher contribution by the employment trend as calculated by the Ministry of Finance which, unlike the Winter Economic Forecast of the EC, did not use a series of an average annual number of working hours per employee. The European Commission uses a series of working hours in its calculations which are available starting from 2008 (values in earlier years are assumed equal to the 2008 values), and we consider these series quite short for forecasting in the mid-term using ARIMA models, which should be used according to the methodology.

government consumption deflator recorded a slight growth and implicit deflators of trade in goods and services recorded decrease, where a faster decline was experienced by the imports of goods and services deflator than the exports deflator. The only significant difference compared to 2014 is in the movement of the investment deflator that, following a reduction in 2014, slightly increased in 2015. Inflation measured by the consumer price index stood at -0.5% in 2015.¹⁸ The most important deflationary trend factor during 2015 were energy prices, which decreased by 4.9% compared to 2014. A decline in energy prices was primarily caused by a significant reduction in crude oil prices on the world market, as well as the administrative reduction in gas prices for households in April 2015 while, from the opposite direction, energy prices were affected by the increase in excise duties on fuel, also in April. If we exclude energy prices from the total consumer price index, 2015 saw a growth of 0.6% of the remaining index components.

We expect a slow recovery of GDP deflator growth to 1.0% in 2016. As for its components, we expect a stagnation of the household consumption implicit deflator, i.e., a slight increase of 0.1%, whose projected growth rate is identical to that of the consumer price index. Raw material prices on the world market will continue to be the main inflation factor during 2016, and are expected to further decline, primarily due to a considerable decrease in oil prices¹⁹. On the other hand, the strengthening of household consumption and growth of unit labour costs should contribute to the growth of the consumer price index. Therefore, in 2016, we expect a slight acceleration of growth of consumer price index excluding food and energy to 0.8%, stagnation of food prices, while the prices of energy could decrease by 2.7%, and will continue to generate a significant negative contribution to consumer price inflation.

As for the imports of goods and services deflator, its decline will slow down in 2016 as compared to 2015 and will amount to 0.7% due to a slower decrease of the imports of goods deflator, largely as a result of the movement of energy import prices and growth of imports of services deflator. The deflator of export of goods will decline mildly, however, the growth of the deflator of export of services, partly due to continued strong tourism demand, will ultimately lead to a slight increase of the total export deflator of 0.6%. Compared to 2015 and previous years, the decline of the exports of goods deflator will slow down considerably, reflecting the gradual disappearance of extremely negative pressures from the domestic labour market and exchange rate movements, as well as reduction of imported deflationary pressures. The investment deflator growth will slightly accelerate compared to the previous year (to 1.0%) while the government spending deflator will remain approximately on the same level (0.5%), primarily as a result of only slightly stronger growth in unit compensation of employees on the general government level.²⁰

¹⁸ Inflation was slightly higher and amounted to -0.3% when measured by the Harmonized Index of Consumer Prices (HICP).

¹⁹ According to the projections of the International Monetary Fund (*World Economic Outlook Update*, January 2016), oil prices expressed in US dollars should decrease by 17.6% in 2016, while the prices of food and drinks are expected to decrease by 6.6%.

²⁰ In its projections for Croatia published in February, the European Commission projected only a slightly stronger growth of the GDP deflator of 1.2% in 2016 primarily as the result of a slightly stronger growth of household consumption deflator (by 0.3 percentage points) and government consumption deflator (by 0.7 percentage points), while the change in the terms of trade of goods and services is expected to remain approximately on the same level.

In the coming years, in line with developments in domestic economic activity and international price developments, GDP deflator growth will gradually accelerate to 1.2% in 2017, 1.5% in 2018 and 1.7% in 2019. Primarily influenced by the recovery of raw material prices on the world market²¹, the expected inflation acceleration in the EU²² and the continued growth of domestic demand the rate of inflation is expected to accelerate to 1.4% in 2017, 1.6% in 2018 and 1.7% in 2019. At the same time, inflationary pressures on the side of domestic supply will be muted as a result of projected dynamics of unit labour costs. Consumer price inflation, due to structural reasons, will generally not exceed the rate of inflation in the EU markets. Imports of goods and services deflator, under the influence of foreign price developments, will gradually accelerate its growth towards the end of the projection period. Deflator of export of goods and services will also show somewhat lower growth rates which will accelerate towards 2019, whereby the deflator of export of goods during the entire observed period will have lower growth rates than the deflator of export of services as a slower dynamic of domestic cost pressures, and at the same time stronger foreign demand for domestic services and raising the quality of said services is expected. Thus, anticipated trends in the labour market will enable the strengthening of domestic sector competitiveness regarding the trade of goods which will be reflected in the retention of negative changes in the terms of trade in goods by the end of the period, although with a declining dynamic. Acceleration toward 2019 will be recorded by deflators of remaining domestic demand components, whereby the government spending deflator will show lower growth rates during the entire observed period than the deflator of household consumption and investment consumption deflator, as a result of a relatively weak expected growth dynamics of the average gross wage per employee on the general government level.

Table 2.3 Price developments

	2015	2016 forecast	2017 forecast	2018 forecast	2019 forecast
GDP deflator, change (%)	0.1	1.0	1.2	1.5	1.7
Consumer price index, change (%)	-0.5	0.1	1.4	1.6	1.7

Source: Croatian Bureau of Statistics, Ministry of Finance

Last year's Convergence Programme projected a growth of GDP deflator only negligibly higher than realized, primarily due to the expected stagnation in consumer prices, while a slight decline was realized. Rates of inflation lower than projected are primarily due to significantly stronger decline in primary commodity prices on the world market.

²¹ According to projections of the International Monetary Fund (*World Economic Outlook Update*, January 2016), oil prices in 2017 (in US dollars) should increase year-on-year by 14.9%, while a continued growth with a slower dynamic of 8.9% and 6.8% is expected in 2018 and 2019 respectively.

²² According to the forecasts of the European Commission, inflation in the EU measured by the Harmonized Index of Consumer Prices (HICP) should accelerate from 0.5% in 2016 to 1.6% in 2017.

2.4. Labour market

As mentioned earlier, economic growth in 2015 had an extremely favourable effect on the labour market²³. According to preliminary data, harmonized with the definition of national accounts, 2015 saw a growth of employment of 1.7%²⁴. This employment trend was mainly driven by growth in employment in trade and tourism²⁵, which could be associated with stronger seasonal employment. Survey unemployment rate decreased from 17.3% in 2014 to 16.3% in 2015. Positive trends will continue in the coming period, although at a slower pace, with a projected employment growth of 1.1% in 2016, 1.4% in 2017, 1.6% in 2018 and 1.5% in 2019. Employment growth in the private sector will exhibit a much stronger dynamic in the observed period. Throughout the projection period, we predict a further reduction of the survey unemployment rate, from 15.5% in 2016 to 14.5% in 2017, 13.5% in 2018 and to 12.8% in 2019. This projection incorporates the assumption that, in spite of unfavourable demographic trends, the economic recovery will have some positive impacts on the participation rate, which is supported by the fact of unfavourable structural characteristics of the Croatian labour market, especially a high share of long-term unemployed persons and the long average duration of unemployment.

Table 2.4 Labour market developments

	2015		2016	2017	2018	2019
	level, in 000	change (%)	forecast change (%)	forecast change (%)	forecast change (%)	forecast change (%)
Labour force	1,898	0.3	0.1	0.2	0.4	0.7
Number of employed	1,589	1.5	1.1	1.4	1.6	1.5
Number of unemployed	309	-5.6	-4.5	-6.3	-6.4	-5.1
Unemployment rate, level (%)		16.3	15.5	14.5	13.5	12.8

Note: According to ILO methodology.

Source: Croatian Bureau of Statistics, Ministry of Finance

After the stagnation in 2015, the average labour productivity will show a slight increase throughout the projection period since the projected growth of the GDP will be faster than the employment growth in each year of the projection period, whereby the labour productivity will reach its minimum growth in 2018 (increase of 0.7%). After three consecutive years of pronounced reduction, unit labour cost slowed its decline in 2015 and reduced only slightly. In the coming years, somewhat stronger and accelerated growth of compensation of employees per head than the growth of labour productivity will lead to a more dynamic unit labour cost. However, with the accelerating inflation, the real change in compensation of employees per head will be weaker than the growth of labour productivity in the period between 2017 and 2019.

²³ Although the methodology changed at the start of 2014 and the employment series was interrupted, this should not impact the employment trends in 2015.

²⁴ According to the Labour Force Survey, the employment growth was 1.5%.

²⁵ According to Labour Force Survey data.

2.5. External sector

In 2015, for the third consecutive year, a surplus on current account of the balance of payments was registered, in the amount of 5.2% of the GDP, which is the highest value recorded. The largest contribution to the improvement of the current account balance in 2015 came from the reduction of the negative balance of primary income, primarily as a consequence of the reported loss of the banking sector in predominantly foreign ownership due to the conversion of loans in Swiss francs²⁶. The improved balance of payments was also contributed by the services and secondary income account, while the goods account affected the current account balance negatively.

We expect a stabilization of surplus in the current account of the balance of payments in the following period, which will be reduced from its record high value of 2015 to the level of about 4% of the GDP. The most significant influence on the current account balance is expected from the account of goods and services, with the positive balance of services continuously exceeding the negative balance of goods. Following a temporary correction in 2015, the negative balance of the primary income account will return to higher levels, mainly due to the income growth of foreign-owned companies, while the intensive use of EU funds will lead to an increase in the positive balance of the secondary income account.

The capital transactions account will exhibit a continuous increase of the positive balance during the entire projection period due to an intensified use of capital transfers from the EU. As a result of the trends described above, it is expected that the surplus in the current and capital accounts, which reached 5.6% of the GDP in 2015, will remain around 5% of the GDP in the coming period.

The previous Programme predicted a positive balance of current and capital accounts in the amount of 1.9% of the GDP (1.4% of the GDP if we only observe the current account) in 2015. A much more favourable achievement is primarily due to the unforeseen conversion of loans in Swiss francs.

2.6. Monetary developments

The Central Bank continued to maintain stability of the domestic currency in 2015. The average exchange rate of kuna against the euro was 7.61 HRK/EUR in 2015 and a slight appreciation of 0.3% was recorded when compared with 2014. In the coming period, we still expect to maintain the HRK/EUR exchange rate at stable levels.

The liquidity of the monetary system was exceptionally high during 2015, and similar trends are expected in the coming period. In late 2015, the Central Bank abolished the obligation to allocate the foreign currency component of reserve requirements in order to facilitate the flexible management of foreign currency liquidity by the banks. In addition, structural repo operations were implemented

²⁶ According to preliminary unaudited data for credit institutions, the banking sector recorded a loss of HRK 4.7 billion or 1.4% of the GDP at the end of 2015.

in early 2016 with a view of ensuring long-term kuna liquidity of banks so that they could finance the economy and the households in the domestic currency more intensively and under more favourable conditions. Furthermore, the Central Bank continued to use regular reverse repo operations and foreign exchange interventions.

Despite the above-mentioned high liquidity of the monetary system, 2015 saw a continued decline in lending to the private sector for the fourth year in a row. Credit demand of the private sector is limited by long-term adverse economic developments, high level of indebtedness (private sector debt amounted to approx. 120% of the GDP in September 2015, of which approximately 80% related to corporate debt), as well as uncertainty with regard to future developments. In addition, larger companies have turned to more favourable financing on international markets. On the other hand, loan supply is limited by the continuously reduced appetite for banking sector risk and a high share of non-performing loans, especially with regard to companies. As previously mentioned, a revival of bank lending activities is not expected in 2016. Due to the above limitations, the household sector will experience a slight decrease in placements and the deleveraging trend of companies will continue. Growth in total loans is expected to start in 2017.

Despite the losses associated with the conversion of loans in Swiss francs and the high share of non-performing loans, the domestic financial sector proved to be resilient and stable. The capitalization of the banking sector is high (capital adequacy ratio is around 21%), and a reduction of non-performing loans is certain (share of non-performing loans in total loans fell below 17% by the end of 2015). Foreign assets value of the banking sector exceeded the value of foreign liabilities for the first time after 14 years, while foreign reserves of the Croatian National Bank are continually at high levels.

2.7. Risks to the macroeconomic projections

The described macroeconomic scenario is exposed to mildly prevailing negative risks, especially with regard to the international environment. As a result of the strong and growing integration within the EU, all risks that threaten the expected developments in Europe also affect the domestic economy. As such, considering the dynamics of the exports of goods, a fundamental negative risk stems from a weaker foreign demand from relevant export markets, but also the stronger disappearance of positive effects, i.e., stronger negative effects of re-exports in the short term. Growth in the exports of services could also be jeopardized by the lower foreign demand for tourist services, as well as strengthening of unfavourable geopolitical factors. Risks to the household consumption forecast in the medium term are considered to be balanced, with the predicted path closely linked to trends in the labour market. As for the risks related to gross fixed capital formation, it is estimated that positive risks prevail in this regard, especially in the short term. These positive short term risks are primarily related to possible stronger dynamics of investments by companies in majority state ownership and investments in the construction activity, while the adverse risks associated with the expected growth of aggregate investments are largely related to potentially lower utilization of capital EU funds, stronger fiscal consolidation related to investment spending of the general government, but also with less positive effects of efforts for encouraging private investments.

Government spending risks imply different dynamics of fiscal consolidation than expected and are considered to be balanced. As for the projection of imports of goods and services, except for a stronger growth in domestic demand and changes in inventories and exports of goods and services than projected, due to the aforementioned factors, the main cause that could lead to a stronger growth in imports of goods and services is the overestimated one-time correction of imports elasticity versus the aggregate demand in 2016, with regard to previously described analysis of the impact of re-export category on the trade of goods. We should also mention that the value of such imports elasticity which is significantly higher than the value implicitly assumed in these projections would mean considerably higher levels of imports dependence of the domestic economy in the long run, compared to pre-crisis levels, which would represent a serious obstacle to a stronger dynamic of future economic growth. The main risks that could cause a different realization of the forecasted inflation rates are related to the price trends of oil and other raw materials as well as the trend of kuna exchange rate, especially against the US dollar, but also developments in the labour market. Also, different realizations of the projected rate of inflation could cause possible changes in administratively regulated prices.

Since the described macroeconomic framework has been drafted two months before the development of this document, available high-frequency indicators and new data related to the domestic economy and the international environment show that some negative, but also some positive risks, in part already materialized. We will present a brief analysis of potential changes and their consequences for 2016. The most significant changes are related to price trends, while significant deflationary pressures in the domestic economy continued at the start of 2016. The consumer price index decreased in the first three months of 2016 by 1.3% year on year, mainly influenced by energy prices and, to a lesser extent, food prices. As a result of the inclusion of administrative reduction in gas prices in April of this year²⁷, price trends of raw materials in the world market, as well as the consumer price index to date, we expect a lower inflation rate compared to the previously projected 0.1% in 2016. The updated projected inflation for 2016 would amount to -1.0%, primarily as a result of a significant reduction in energy prices, and to a lesser extent, the reduction in food prices. Mild negative projection risks still prevail. It is expected that the price index, excluding food and energy, will continue to grow, albeit at a slower pace than in 2015. With regard to the developments of the implicit GDP deflator, updated projections would include, in addition to the described changes to the household consumption deflator (in accordance with the changes of the consumer price index), slightly lower growth estimates for all other of its components including the imports of goods and services deflator, which would result in a correction of the growth in GDP deflator to 0.1%.

According to the available high-frequency indicators for 2016, we still expect to see a moderate growth in economic activity in the first quarter (identical to previous expectations) and a slightly increased year-on-year growth rates compared to the last quarter of 2015. By observing the real growth of components on the expenditure side of the GDP in 2016, identical projections of growth with balanced risks would be retained with regard to household consumption, government spending and change of inventories. We also expect that, with regard to the household consumption

²⁷ The price reduction of gas for households is estimated at around 20%, which implies a negative contribution to the annual change of the consumer price index of 0.4 percentage points.

projection, the described lower inflation would still represent a favourable impact on the dynamics of household consumption through its positive effects on disposable income. We should also mention that the retail trade turnover recorded expectedly good results in early 2016. On the other hand, a slight deterioration of all consumer confidence indices was recorded in early 2016 (however, they are influenced by factors such as the political cycle as well). As for the projection of gross fixed capital formation, according to the data collected from the time the original macroeconomic scenario was drafted, some positive risks have materialized. First of all, this includes a newly updated investment plan for companies in majority state ownership, which indicates a real investment growth identical to that in 2015 (14.5% versus 0.6%, which was assumed in the original scenario), in the event that its achievement has been conservatively predicted²⁸. In addition, the real growth of general government investments was slightly accelerated to 7.1% and private investments to 1.8%. The final correction is largely related to the surprisingly favourable results in the construction activity, as far as the volume of construction works (especially buildings which, however, showed growth already in 2015), as well as leading indicators are concerned. In addition, we should mention that if the preliminary CBS estimate on the decline in general government investments would be proven as correct to an extent, it would implicitly raise the dynamics of private investments in 2015, which would have repercussions on additional upward correction of their dynamics in 2016. In conclusion, if we look at these updated projections of individual components (1.8% increase in private investments and 9.3% growth in broader public sector investments - consolidated), we could conclude that the real growth of total investments in 2016 amounts to 3.8%. Then, according to the published high-frequency indicators on the export of goods, and according to the downward correction of the economic activity in the international environment, and even more pronounced downward correction of world trade, the current projection of the export of goods and services could amount to 4.8%, whereby the entire correction would relate to the exports of goods. Considering the previously published indicators on the imports of goods as well as the aforementioned changes (which would result in a mild acceleration of the final demand by 0.2 percentage points), the projected growth of imports of goods and services could be adjusted to about 5.5%, while assuming a certain upward correction of imports elasticity in relation to demand, and the growth of goods and the growth of services both showed positive changes. All these changes to individual components from the expenditure side of the GDP calculation would lead to a slightly lower rate of real GDP growth, but also cause a 1.1 percentage point lower nominal GDP growth (in the original scenario, GDP growth in current prices amounted to 3.0%), with almost the entire amount related to the correction of GDP deflator growth. It should be noted that the potential loss of a part of the GDP in current prices, although it would necessarily lead to a somewhat different structure of the revenue side of the general government budget (described price trends would primarily lead to a lower realization of the collected VAT), would not threaten the total amount of tax revenue and contributions since they have already been planned conservatively, as indicated by the achievements in tax revenue and contributions categories in the first quarter of 2016.

²⁸ We assumed the realization of investments at the level of 82% of the initial plan, and if we were to assume the realization of the overall plan, real investment growth would amount to nearly 40%.

3. GENERAL GOVERNMENT BUDGET AND PUBLIC DEBT

3.1. Fiscal policy

The Economic Programme of the Government of the Republic of Croatia in the forthcoming mid-term period will be based on two key areas: stabilization and reduction of public debt and implementation of appropriate structural reforms in order to strengthen the foundations for growth in the medium term. Stabilization and reduction of public debt will have a triple base: 1) fiscal consolidation based on reducing the deficit and of bringing it to a sustainable level; 2) activation of state property that can directly contribute to the reduction of public debt; 3) stimulating economic recovery. Special attention will be directed to adapting economic policies in order to comply with fiscal consolidation principles that will not undermine the foundations of economic growth.

Fiscal consolidation also represents one of the obligations of the Republic of Croatia under the framework for addressing the excessive budgetary deficit procedure. Acting on the proposal of the European Commission (EC), the EU Council of Ministers in January 2014 issued Recommendations which state that the Republic of Croatia must reduce its budget deficit below 3% of the GDP by the end of 2016 and steer the general government debt to a sustainable path by reducing it under 60% of the GDP two years later. The Republic of Croatia is obliged to regularly report to the EC on the achieved progress in meeting the aforementioned Recommendations. In this regard, the latest Winter Economic Forecast of the EC shows a negative deviation in relation to set objectives. However, the Government of the Republic of Croatia is committed to making all efforts in order to fulfil the binding Recommendations of the EU Council. The Fiscal Notification delivered to Eurostat at the end of March of this year indicates a strong positive step forward in terms of reducing budget deficit to 3.2% of the GDP in 2015, which exceeds the Recommendations of the EU Council which stipulates a reduction to 3.5%, and projections published in the Winter Economic Forecast stating a reduction to 4.2% of the GDP.

In this regard, the measures of the Government of the Republic of Croatia will focus on fiscal consolidation in the upcoming medium term period, both on the revenue and the expenditure side of the budget. To this end, the Government of the Republic of Croatia will make further efforts to adjust the fiscal management framework and its harmonization with the provisions and practices of EU legislation. The Government will proceed with the amendments to the Fiscal Responsibility Act, including the strengthening of numerical fiscal rules, strengthening the independence of the Fiscal Policy Committee and medium-term budget planning and strategic management of public debt, all in dialogue with the EC.

Continuing medium-term consolidation efforts on the revenue side of the budget will be focused on a comprehensive analysis of the tax system and creating a corresponding legislative proposal in order to establish a stable, sustainable, simple and competitive tax system, strengthening the efficiency of the tax inspection procedure and further enhancing the work of the Tax Administration. Among other things, application of the cash transaction fiscalization system will continue, and reorganization of the Tax Administration according to the results of work performance monitoring processes. Furthermore, the exchange of data on income and other receipts of citizens with other institutions

on the basis of Reports on receipt, personal income tax, surtax and contributions for compulsory insurance (JOPPD form) has also been strengthened. In order to improve the efficiency of the Tax Administration, the risk analysis system was improved and the institute of tax settlements with the aim of shortening the process of tax inspections and faster collection of newly established obligations was introduced. With the introduction of tax treaties, taxpayers will find it easier to settle tax obligations, and the newly developed eOvrhe platform will facilitate a more efficient tax debt management. Finally making efforts to eliminate or reduce non-tax payments was continued.

On the expenditure side, attention is focused on reducing the budget deficit by implementing such measures that do not affect growth adversely, while maintaining the social protection of citizens and an increasing orientation towards the use of EU funds. The Budget for 2016 provides for structural savings in most expenditure categories. Investments in water, transport and energy infrastructures will be among the priorities of public spending. In the conditions of high unemployment, especially among the youth, attention is directed to the implementation of active labour market measures. We will continue with the health care, justice, welfare and education system reforms to strengthen their efficiency and sustainability.

All these objectives and expected developments of fiscal policies are defined and depend on the implementation of key structural reforms in the coming period, which are detailed in the National Reform Programme.

3.2. Budget implementation in 2015

During 2015, the Government of the Republic of Croatia continued to implement its fiscal consolidation in line with the Recommendations of the EU Council and within the framework of the EDP procedure. The recommended structural effort amounted to 1% of the GDP, and the Government of the Republic of Croatia planned to undertake a structural effort of 1.5% of the GDP in April 2015, under the framework of the Convergence Programme. However, according to final data for 2015, the planned objective has been exceeded and the implemented structural measures amounted to 1.6% of the GDP. The general government deficit amounted to 3.2% of the GDP, which is significantly lower than the recommended value of 3.5% of the GDP, or the recorded deficit of 5.5% of the GDP in 2014.

Accordingly, total revenue of the general government budget was realized at the level of 43.7% of the GDP. The realization of revenues was significantly better than planned primarily due to favourable economic trends. Revenues from the value-added tax, corporate income tax, special taxes and excise duties recorded higher outturn while the most significant decrease was achieved by revenues from grants, primarily due to weaker dynamics of the withdrawal of EU funds.

With regard to the structural measures on the revenue side of the budget, amendments to the Act on Games of Chance adopted on 1 January 2015 introduced a taxation of all winnings irrespective of their value. Insured persons whose pension rights were regulated by special rules were given the

option to transfer the funds from the second to the first pillar. Amendments to the Personal Income Tax Act adopted on 1 January 2015 introduced a taxation of interest on savings at a rate of 12%. At the same time, personal deduction for specific taxpayer categories has also been increased and tax brackets for the application of the 25% and 40% tax rates were changed. Although the objective of these measures was to unburden business operations and stimulate private consumption, they also reduced the revenue of local and regional self-government units (hereinafter referred to as: local units) on this basis. Therefore, the Government of the Republic of Croatia amended the Act on Financing of Local and Regional Self-Government Units in order to partially compensate for this decrease in revenue. In addition, some local units have introduced or increased the rate of surtax on personal income tax so the negative net effect of changes in the personal income tax system was less than originally expected. The increase in health insurance contributions from 13% to 15% in May 2014 had its annual effect in the first four months of 2015. Excise duty on leaded petrol, unleaded petrol and engine gas oil for fuel increased by HRK 0.20/liter. Also, the excise duty on tobacco and tobacco products were increased in order to implement gradual harmonization with the legal provisions of the EU. All these structural revenue measures have resulted in a fiscal effect of 0.2% of the GDP in 2015.

Total expenditures of the general government budget in 2015 were realized at the level of 46.9% of the GDP, while achieving significant structural cost savings in all categories of expenditures. Although it was necessary to secure funds for the payment of jubilee awards to civil servants on the basis of the Decision of the Government of the Republic of Croatia from June 2015, additional efforts were undertaken in order to achieve savings in the category of compensation of employees. Increased salaries based on years of service in the amount of 4%, 8% and 10% have not been paid. Also, withholding payments of Christmas bonuses and holiday allowances continued, and additional measures to further lower base salaries of government officials for another 8% were implemented. In the category of intermediate consumption, savings were primarily achieved on service expenses, mainly intellectual and personal services and overhead costs and other operating expenditures regarding the business operations of budget users. With regard to subsidies, the biggest savings were achieved in relation to the agricultural sector, active employment policy and the elimination of subsidies to the Croatian Bank for Reconstruction and Development. Some savings were also achieved in the field of science and education, and tourism. Social benefits and social transfers savings include reduced spending on subsidies and state guarantees for housing loans, reduced privileged pensions exceeding HRK 5,000 as well as one-time assistance to families of veterans and consolidation of the social benefits system through guaranteed minimum compensations. Among other current and capital transfers, planned permanent savings in the area of Guarantee Fund for industry and innovation expenditures, incentives for housing savings, housing, Entrepreneurial Impulse project, state aid for innovation in the tourism sector and railways were achieved. Structural savings were also achieved in relation to expenditures for gross capital formation, primarily in the health care system. The implemented structural measures in all the above categories of expenditures resulted in the overall fiscal effect of 0.4% of the GDP.

Structural savings of extra-budgetary users and companies owned by the Republic of Croatia in 2015 were achieved in the amount of 0.5% of the GDP. Savings were primarily achieved in the water sector, the health care system and in the Croatian Motorways and Croatian Railways Infrastructure

(CRI). Savings based on reducing the number of agencies, institutes and funds did not materialize as planned.

Local units implemented various structural measures to increase revenue and reduce expenditures in order to avoid further deepening of fiscal imbalances and to maintain fiscal stability. On the revenue side, specific local units increased surtaxes and achieved a smaller negative effect from reduction of personal income tax. Also, they have achieved better revenue from utility fees and property taxes. Increased efforts were undertaken in order to improve the collection of interest revenue and revenue from leasing and renting property. In addition, higher revenues were collected from projects funded by EU funds. The results of implemented measures indicate that the loss of revenue due to legislative changes was smaller than originally expected. On the expenditure side, significant savings were achieved on the expenditure for gross capital formation. The net effect of structural cost savings of local units is 0.4% of the GDP, which is more favourable than expected.

3.3. Measures for reducing excessive budget deficit in 2016

Table 3.1 Structural measures for reducing excessive budget deficit

	OUTTURN IN 2014		PRELIMINARY OUTTURN IN 2015		ADDITIONAL EFFECT IN 2016	
	HRK million	% of GDP	HRK million	% of GDP	HRK million	% GDP-a
REVENUE STRUCTURAL MEASURES						
1. Taxes on gains from games of chance	90	0.03	180	0.05		
2. Changes in pension contribution system on behalf accelerated retirement	400	0.12	140	0.04		
3. Withdrawal of revenue from profits of the state-owned companies	70	0.02			700	0.20
4. Increase of health contributions from 13% to 15%	1,600	0.49	800	0.24		
5. Reinvested profits					500	0.15
6. Introduction of tax on savings interest			250	0.07		
7. Fees for telecommunication services	160	0.05				
8. Increase of energy excises	350	0.11	450	0.13	150	0.04
9. Increase of tobacco excises			110	0.03	70	0.02
10. Income tax reduction			-1,240	-0.37		
TOTAL REVENUE MEASURES	2,670	0.8	690	0.2	1,420	0.4
EXPENDITURE STRUCTURAL MEASURES						
1. Compensation of employees			173	0.05		
2. Intermediate consumption	1,098	0.3	277	0.08	169	0.05
3. Subsidies	1,211	0.37	104	0.03	542	0.16
4. Social benefits and social transfers in kind	936	0.3	114	0.03	458	0.133
5. Other current transfers and capital transfers	376	0.11	434	0.13	720	0.21
6. Gross capital formation	568	0.2	250	0.07	253	0.07
TOTAL EXPENDITURE MEASURES	4,188	1.3	1,353	0.4	2,140	0.6
EXTRABUDGETARY USERS AND COMPANIES OWNED BY THE REPUBLIC OF CROATIA						
	1,337	0.4	1,771	0.53	100	0.03
LOCAL AND REGIONAL SELF-GOVERNMENT UNITS						
			1,399	0.42		
TOTAL FISCAL ADJUSTMENT	8,196	2.5	5,213	1.6	3,660	1.1
AGENCIES, INSTITUTES, FUNDS AND OTHER LEGAL ENTITIES WITH PUBLIC AUTHORITIES						
			2	0.001	5	0.001
TOTAL FISCAL ADJUSTMENT	8,196	2.5	5,215	1.6	3,665	1.1

Source: Ministry of Finance

Box 1: Recommendations of the EU Council for resolving excessive budget deficit

I. Binding recommendations

Table 3.2 Recommendations of the EU Council for correcting the excessive deficit

% of GDP	2014	2015	2016
General government deficit	4.6	3.5	2.7
Structural deficit change	-0.5	-0.9	-0.7
Implementation of structural measures	2.3	1.0	1.0

Source: Ministry of Finance

Table 3.3 Fiscal projections - Recommendations of the EU Council have been fully adopted and incorporated into the fiscal projections of the Republic of Croatia

% of GDP	2014	2015	2016
General government deficit	5.5	3.2	2.6
Structural deficit change		-1.9	-0.3
Implementation of structural measures	2.5	1.6	1.1

Source: Ministry of Finance

II. Additional recommendations - non-binding

1) Detailed analysis of expenditures with a view to rationalizing wages, social welfare and aid for the purpose of freeing fiscal space for expenditures that contribute to growth, including co-financing of EU projects

Measures for the implementation of recommendations:

- in-depth analysis of state budgetary expenditures has been carried out;
- improving the application of the Central Salary Calculation (COP) for the entire public sector;
- measures for reducing and improving the efficiency of social transfers;
 - consolidation of the social benefits system;
 - introduction of the income threshold and means-testing;
 - establishment of a One Stop Shop for compensation in social welfare centers;
- permanent abolition of some state subsidies in accordance with adopted structural measures.

2) Strengthening the tax discipline and increasing efficiency

Measures for the implementation of recommendations:

- comprehensive analysis of the tax system and drafting corresponding proposals of new legal solutions;
- continued reorganization of the Tax Administration;
- continued implementation of the cash transaction fiscalization system;
- implementation of the Report on receipt, personal income tax, surtax and contributions for compulsory insurance (JOPPD form) in order to get a complete overview of revenues and receipts for individual taxpayers.

Box 1: Recommendations of the EU Council for resolving excessive budget deficit

3) *Improving the institutional framework of public finances, including the strengthening of multi-annual budget planning, strengthening the role and independence of the Fiscal Policy Committee and ensuring compliance with the fiscal rules*

Measures for the implementation of recommendations:

- drafting the Amendments to the Proposal of the Fiscal Responsibility Act is currently in progress;
 - fiscal rules in accordance with the legal framework of the EU;
 - strengthening the independence of the Fiscal Policy Committee;
- drafting the Amendments to the Budget Act;
 - linking strategic planning and the National Reform Programme;
 - introduction of adjustment mechanism for fiscal rule on deficit;
 - strengthening the medium-term budgetary planning;
 - *ex-post* evaluation of the effects of budget programmes, activities and projects;
- strengthening responsibilities with regard to the State Audit Office (SAO) recommendations;
 - adopting the Amendments to the State Audit Office Act;
- improving public debt management;
 - drafting a Strategy for Public Debt Management;
 - strengthening the institutional capacities of the organizational unit for public debt management within the State Treasury;
- continuous improvement of fiscal statistics.

Structural measures on the revenue side of the budget

Withdrawal of income from profits of state-owned companies

Act on Execution of State Budget of the Republic of Croatia for 2016 stipulates the possibility of implementing an additional measure in order to reduce the excessive budget deficit. This measure applies to companies of strategic and special interest to the Republic of Croatia which undertake to pay part of their profit or surplus of revenues over expenditures into the State Budget. The decision on said payments is issued by the Government of the Republic of Croatia acting on the proposal of the Government Committee for management in strategic companies. In this regard, we plan to withdraw part of the profit from 2015 for the above mentioned companies. The fiscal impact of this measure is estimated at 0.2% of the GDP in 2016. Payment applies only to profits earned in the previous calendar year so it is not subject to the statistical treatment of the superdividend.

Changes to the taxation system of reinvested profits

Pursuant to the amendments to the Corporate Income Tax Act of 2014, the criteria regarding the usage of benefits for reinvested profit are further tightened. The tax benefit will not be abolished, but its use is conditional upon actual investments to encourage economic growth. Accordingly, from 1 January 2015, the tax benefit for reinvested profit, along with previously set obligations (obligation to increase share capital) that were applied in the period between 2012 and 2014, will be available

for use to those taxpayers who invested in long-term tangible and intangible assets during the tax period, provided that they did not reduce the number of jobs during the reinvestment period and the subsequent two years. Thus, by prescribing these two new conditions it is assumed that the number of tax benefit users will decrease and it will have a less negative impact on budget revenues of up to 0.15% of the GDP in 2016.

Excise taxes on energy sources and electricity

The proposal of a Regulation on amending the Regulation on excise tax amount for unleaded petrol, gas oil and kerosene for fuel of April 2015 increased the excise tax on leaded petrol, unleaded petrol and gas oil for power by HRK 0.20/liter. This increase secured an additional fiscal impact of 0.04% of the GDP in 2016.

Excise taxes on tobacco and tobacco products

The increase in excise taxes on tobacco and tobacco products, implemented in April 2015, provided an additional fiscal effect in 2016 which amounted to approximately 0.02% of the GDP. Excise taxes on tobacco and tobacco products have been changed with a view of reaching the minimum excise tax on cigarettes required by the relevant EU regulations, taking into account that the Republic of Croatia has been granted a transitional period until 31 December 2017 for the implementation of the above.

Structural measures on the expenditure side of the budget

Intermediate consumption

The projected fiscal impact of structural savings in the intermediate consumption will amount to 0.05% of the GDP in 2016. Most of the measures relate to the reduction of expenditures for materials and energy as well as expenditures for services in the agriculture, science, interior and justice systems. Said savings are mainly based on the implementation of rationalization via the Guidelines for the Establishment of Standard Material Costs for Budgetary and Extra-budgetary Users of the State Budget. They restrictively manage the use of official cars, mobile phones, business trips and representation, sending mail (emphasis on electronic communication instead of paper), provides for a reduction in renting costs, as well as the achievement of savings due to the unified management and administration of databases and IT infrastructure. The rationalization of the judicial system, including the reduction of the number of municipal and misdemeanour courts and state attorney's offices and merging land registry departments of municipal courts with central courts, will achieve lower costs of regular court operations.

Subsidies

Structural subsidies savings are projected at the level of 0.16% of the GDP. They primarily refer to the sectors of agriculture, transport, postal services, labour market, economy, entrepreneurship and tourism. The biggest savings in the agricultural sector result from the termination of certain activities: intervention measures in the market of agricultural food products, organic agricultural production which will be funded from 2016 under the Rural Development Programme and harder management conditions in agriculture and the conservation of indigenous and protected breeds. Additionally, we

plan on further reducing national funds for making direct payments to farmers as they will be more actively financed from EU funds. The most significant cost reduction in the area of transport infrastructure will be achieved related to the incentives for rail passenger transport, due to business restructuring, rationalization of passenger railway lines, handling redundant employees, full implementation of the ticket sale and reservation system and the fleet management system with related resources. In accordance with the reduction in fuel prices on the basis of which benefits are paid to shippers, additional savings are planned regarding relevant subsidies in this area. During 2015, shippers received a bigger amount of subsidies than necessary due to the aforementioned decline in fuel prices that occurred in the meantime, so we expect that the shippers will refund the excess subsidies into the State Budget or the contractual subsidy for 2016 will be reduced by the amount overpaid in 2015. Furthermore, we will reduce the subsidized fees for providing the universal postal service due to the decrease of total expenditure in the business operations of HP-Hrvatska pošta d.d. (HP Croatian Post Ltd.) based on which such fee is calculated. Active labour market measures financed from domestic sources will be reduced this year because they will be financed from the European Social Fund. However, we expect that the total number of users involved in active employment policy measures in the coming period will not significantly deviate from the previous years, particularly since the implementation and financing of these measures includes the use of EU funds. The economy sector will see a planned reduction in expenditures for the implementation of the industrial strategy since these are not contractual obligations - instead, a new tender for the allocation of funds is published each year. Regarding entrepreneurship, activities aimed at young and beginner entrepreneurs will be terminated, while additional national fund savings will be achieved with funding of entrepreneurial impulse that will for the most part be financed from the European Structural Funds. In addition, permanent reduction of the amount of funds for publishing scientific books and university textbooks is planned. Savings will also be achieved in the area of credit programme subsidies in tourism due to the closure of some 40 loans in 2015 and because of a number of loans that are in the second half of the repayment period when the subsidy is reduced under the terms of the Programme. Furthermore, the total interest rate of loans is linked to the annual variable EURIBOR which is currently extremely low, so the subsidies are also reduced.

Social benefits and social transfers

Social benefits, whose structural savings amount to 0.13% of the GDP, include savings related to the recovery of flood damages, labour market, social protection, secondary and higher education, and housing. In 2016, we will not secure funds for the recovery of flood damages given that all obligations on this basis were performed in the previous year. In the labour market sector and in line with the projections of the Croatian Employment Service (CES), assuming economic growth and the expected stoppage of negative trends, we expect to reduce the number of users of unemployment benefits, which affects a smaller amount of funds planned for this purpose. We must also mention savings in the area of active employment policy because it will be more actively financed from the European Structural Funds, as previously mentioned. Reduced expenditures in the social welfare sector primarily result from the consolidation of the social benefits system under the Guaranteed Minimum Benefit framework which currently includes four benefits with a social component, and a further expansion of its scope is also planned. Additional activities regarding the implementation of the SocSkrb application are also planned and include connecting SocSkrb with all institutions which keep records of properties and revenues of Croatian citizens and better connectivity with branch offices of

the CES. Guaranteed Minimum Benefit is also used to define the income threshold and means-testing as a prerequisite for granting rights, thus achieving the best routing of benefits to the poorest citizens. The plan is also to facilitate the administrative processing of social benefits through the introduction of a single administrative centre (unique centre for fees) in social welfare centres. All of the above should result in a reduction of expenditures for this purpose. Savings are also planned regarding the allowance for assistance and care due to further rationalization and declining number of users. Savings are also planned regarding the low income buyers of energy benefits since these are financed from dedicated revenues which the supplier of electricity transfers into the State Budget. Regarding the science sector, when drafting the next amendments to the Contributions Act, we propose to significantly reduce the rate of contributions for pension and health insurance for pupils and students in practical training and professional practice due to large disparities in the amount of paid contributions and actual rights deriving therefrom. Therefore, significantly reduced expenditures on this basis are expected. The Government plans to achieve permanent savings in the housing sector in connection with the return of the purchase price of housing units to Croatian Homeland War Veterans and members of families of killed Croatian Homeland War soldiers²⁹ since this project has been successfully completed. Pursuant to the Act on Subsidies and State Guarantees for Housing Loans, Real estate agency subsidizes part of the interest in the first four years of using housing loans. Subsidies were approved in 2011 and 2012. Reduced payment of the remaining instalments was carried out in 2015 for subsidies approved in 2012, which is why there are no liabilities on this basis in 2016.

Other current transfers and capital transfers

Structural savings are planned in the amount of 0.21% of the GDP in the areas of economy, agriculture, maritime affairs, regional development, construction, science and tourism, among other current and capital transfers. Permanent savings will be achieved in relation to energy efficiency and infrastructural expenditures. Specifically, funds for this purpose were granted via tenders in 2015, which is why there is no payment obligation this year. No support for clusters has been planned because such projects will be financed from the European Regional Development Fund with technical support provided through two strategic projects: "Support to cluster competitiveness initiatives" and "Support to establishing the innovation network for industry and thematic innovation platforms". Resources for the entrepreneurial impulse will be significantly reduced because it will be financed from the European Structural Funds and simultaneously support for the innovation process will be abolished. Significant savings have also been achieved in the agricultural sector due to the completion of projects related to the irrigation of the Biđ-Bosutsko field and Valtura-Bakranjša, as well as projects in horse breeding, plant protection and investment supports in agriculture and fisheries. Also, savings are anticipated in relation with the project of protecting the Adriatic Sea from pollution. Reduction of expenditures in connection with the public intercity transportation of secondary school students is also planned following the introduction of means-testing from the start of the next school year. Also, no further funding of public-private partnership in the education system of Varaždin and Koprivnica is planned. Savings will also be achieved due to the fact that the

²⁹ In accordance with the Regulation on the return of the purchase price without interest to Croatian Homeland War Veterans and members of the family of a killed, captured or missing and dead Croatian Homeland War soldier, Official Gazette no. 137/2014.

recovery of the Student Centre has been successfully completed while other projects in sport and science were terminated or transferred to other sources of funding. Regional development projects also show a decrease in planned expenditures from the State Budget as the sustainable development of local communities will be more actively financed through the EU Rural Development Programme. Furthermore, due to the slower dynamics of the implementation of projects regarding the integrated development of local communities during 2015, we plan to reduce expenditures on this basis in 2016, and after that the projects will not be funded. Savings in the area of housing improvement and communal activities that contribute to a greater quality of life of the local population primarily result from redirecting funding to the source of legalization fees, which does not affect the budget deficit. The budget for 2016 does not allocate funds on the basis of debt pursuant to the provisions of the Pact on Economic Issues and the Agreement on regulating specific financial obligations of the Republic of Croatia towards the Catholic Church for the period 2000-2003 because these obligations were fully settled in the period between 2013 and 2015. Reduced expenditures are also planned in relation to the promotion of Croatian cultural activities and cooperation. We must also mention savings regarding the maintenance of the railway infrastructure and traffic regulation due to the planned restructuring of the HŽ Infrastruktura d.o.o. (Croatian Railways Infrastructure Ltd.) which will contribute to its efficiency, and redirecting resources for maintaining the railway infrastructure to funding from EU projects. Planned State Budget expenditures for the modernization of railway vehicles will also be reduced because the planned procurement of new trains will be financed by funds from the HŽ Putnički prijevoz d.o.o. (Croatian Railways Passenger Transport Ltd.). Regarding the support granted to port authorities, most of the savings will result from reduced support given to the Port of Rijeka Authority since part of the planned reconstruction activities will be funded from donations granted by the Connecting Europe Facility (CEF). Furthermore, reduced support to the Port of Ploče Authority for the implementation of the Trade and Transport Integration project is planned since it will be completed soon. Also, further reduction of expenditures for the tourist promotion of the Republic of Croatia is planned, especially with regard to off-line advertising which will be funded with tourist tax and tourist memberships from the Croatian National Tourist Board.

Expenditures for gross capital formation

Planned structural savings on capital investments amount to 0.07% of the GDP. Reduced expenditures for projects in defence, health care, science and justice are expected. The most significant reduction in the defence sector results from lower planned expenditures for infrastructural projects as well as the postponement of certain projects regarding equipping and modernization. In the health care system, further reduction of expenditures related to the reconstruction of the health care infrastructure is planned as well as redirection to significantly higher funding from EU funds. Also, by implementing a unified procedure of public procurement or purchasing identical medical equipment for multiple users of health care institutions, we will achieve rationalization of capital investments in terms of procurement of medical equipment (renewal of equipment). The justice system will experience a planned reduction in national funding for projects that will be redirected to using the EU funds, which are aimed at improving and establishing the judicial information system. The intention is to purchase IT equipment that will be used to establish a single system of land registry data and provide information services to citizens and businesses. Similar trends of redirecting projects to EU funds are also present in the science sector.

Extra-budgetary users and companies owned by the Republic of Croatia

Structural reduction of extra-budgetary user's deficit in the amount of 0.03% of the GDP in 2016 will be achieved fully by the Croatian Health Insurance Fund (CHIF). Increase in the cost of supplementary health insurance from HRK 70 to HRK 89 is planned, starting from 1 June 2016. Also, increase in the maximum amount of participation in health care costs from HRK 2,000 to HRK 3,000 for those who do not have supplementary health insurance is planned, as well as introduction of a new type of insurance for non-standard health services, the so-called additional health insurance. A reform of emergency medicine services in terms of reorganizing integrated emergency hospital admission system and outpatient emergency medical services, as well as including primary health care in order to ease the burden on the integrated emergency admission systems is also planned. Furthermore, primary health care reform and the organization of palliative care, as well as a reform of the hospital system are also planned in order to increase the efficiency and quality of service. We should also mention the planned rationalization and reorganization of non-medical services in hospitals and the rationalization of expenditures in the health care system through a unified public procurement procedure, stricter control of prescribing medicines and system computerization.

Agencies, institutions, funds and other legal entities with public authorities

For the purpose of further streamlining the system of legal entities with public authorities, we plan to terminate the Croatia House foundation and merge the Fund for the Compensation of Expropriated Property with the Ministry of Finance during 2016. It should also be noted that the Action Plan for the modernization of public administration was drafted in April of this year, defining the plan for further rationalization of agencies, institutes, funds and other legal entities with public authorities. The Rationalization Implementation Plan was created on the basis of the said Action Plan. The necessary amendments to relevant legislation will be implemented in the last quarter of this year to allow for the rationalization of additional legal entities of the agency type, and should enter into force in early 2017. The overall fiscal impact of these measures is estimated to 0.001% of the GDP in 2016, while the rest of the effect is expected in 2017.

3.4. General government budget in 2016

Consolidated general government revenues

The projection of budget revenues for the period 2016-2018 is based on the expected recovery of economic activity, taking into account tax policy changes that have already been adopted, but will have additional effects in 2016. Furthermore, projections also include measures adopted by the Government of the Republic of Croatia for the purpose of implementing the excessive budget deficit procedure, and which will be put into effect in the coming period. It should be noted that tax revenues and contributions are projected more conservatively in comparison with basic macroeconomic budgetary assumptions. However, if certain macroeconomic risks described in this

document happen to materialize, they should not have a negative impact on the overall level of tax revenues and contributions, as evidenced by the outturn of certain revenue categories in the first quarter of this year.

Total revenues of consolidated general government in 2016 are planned at a level of 44.1% of the GDP. The most significant budget revenue is the revenue from value-added tax which is planned in the amount of 12.9% of the GDP, and projected based on the expected nominal personal consumption. In the next mid-term period, the Ministry of Finance will continue the activities aimed at improving tax collection, preventing tax evasion and gradual resolving of tax liabilities. Revenues from customs and custom duties have been projected in the amount of 0.1% of GDP.

The taxes on products, except VAT and customs category, includes expected revenues from tax on gains from games of chance and revenues from special taxes and excise taxes. Revenues from special taxes and excise taxes will amount to 4.1% of GDP. These revenues were projected on the basis of the expected trend of consumption of products subject to excise taxes. Year-long effects on regulatory changes to excise taxes, i.e. to excise taxes on energy sources and electricity, as well as excise taxes on tobacco implemented in 2015 were taken into account in order to increase budget revenues necessary for the implementation of excessive budget deficit procedures. The total fiscal effect of the aforementioned changes amounts to 0.06% of GDP.

In the structure of total revenues, property income amounting to 1.2% of GDP in 2016 should be mentioned. Namely, property income, in addition to permanent revenues, also includes increased revenues based on the ownership of the Republic of Croatia in specific companies.

The level of revenues from personal income tax is estimated at 3.5% of GDP and the level of corporate income tax revenues at 1.7% of GDP. Revenues from personal income tax were planned on the basis of the expected trend on the labour market, and they include amendments to the personal income taxation system that entered into force during 2015 and at the beginning of 2016. Pursuant to the amendments to the Personal Income Tax Act that entered into force in 2015, whose effects were visible in both the annual account for 2015 and its continued application in 2016, due personal deduction increased from HRK 2,200 to 2,600 for employees and from HRK 3,400 to 3,800 for pensioners. Personal deduction also increased in subsidized areas. At the same time, tax brackets for the application of the 25% and 40% tax rates also changed. The taxation of capital gains on financial assets was introduced in 2016. This implied the taxation of income from the sale of securities and shares in companies in the period lasting three years. In order to equalize the taxation of all types of income from capital, the usage of benefits for dividends and shares in profit of up to HRK 12,000 was abolished. Considering the fact that the employment income in the Republic of Croatia was burdened by tax rates significantly higher than in the case of income from capital, greater fairness in taxation and tax base expansion was achieved by introducing the taxation of savings interest and capital gains from financial assets.

Revenue from corporate income tax in the current year will be calculated based on the business realized in the previous year. The plan of corporate income tax revenue movements was made based on the assessment of business generated by companies and banks in the previous year, taking into account the legislative changes that came into force at the time, whereas the effect on budget revenues will be observed in 2016, after the submission of annual tax returns for 2015. Pursuant to

the aforementioned amendments to the Corporate Income Tax Act, the usage of benefits for reinvested profit is further conditioned by investments in fixed assets and maintaining the number of employees, as further described in the section on structural measures. Furthermore, the estimate of corporate income tax revenue for 2016 took into the account the impact of decreased bank profit caused by the conversion of loans in Swiss francs. The increase of corporate income tax revenue due to a different definition of reinvested profit is estimated at 0.15% of GDP, and a reduction in similar amount caused by a decrease in bank profit is also estimated. The second most significant group of revenues for the general government budget are social contributions, which are planned at the level of 11.8% of GDP. Their dynamics will be determined by trends on the labour market. In addition, it should be noted that the reduction of revenue in this category stems from the fact that funds for insured persons in the accelerated retirement, whose pensions were calculated as if they were insured only in the 1st pension pillar, were transferred from the 2nd pension pillar to the 1st pension pillar in the previous two years.

The categories of other current transfers and capital transfers, planned at the level of 6% of GDP, included revenues from the assistance of EU institutions and bodies which were directly tied to the projects financed from EU funds.

Expenditures of consolidated general government

Total expenditures of consolidated general government in 2016 are planned at a level of 46.8% of GDP.

Compensations of employees in the public and civil services are at the level of 11.2% of GDP in 2016. The planned amount of these expenditures was largely determined by trends in the number of civil servants and public employees. In this year, it is planned to increase the expenditures for employees financed by the EU funds because budget users who participate in the system of management and control of the use of EU funds in the period 2014-2020 will co-finance salaries of workers who perform these jobs from EU funds (through Technical Assistance priority in individual Operational Programmes). There is no planned payment of reimbursements and Christmas bonuses for employees in the public and civil services in 2016. Also, further restriction of new employment is still in effect and recruitment is allowed on positions which remain vacant by application of the clause 2 for 1, which means that one new employee may be hired only if two employees terminate their employment. Implementation of the Central Salary Calculation (CSC) will continue.

Expenditures for intermediate consumption are planned at the level of 7.8% of GDP, taking into account the structural savings on expenditures for materials and energy and expenditures for services. At the beginning of the year, the Guidelines for the Establishment of Standard Material Costs for Budgetary and Extra-budgetary Users of the State Budget were prepared, and the said Guidelines were taken into account in the process of drafting this year's budget.

Expenditures for subsidies record the level of 1.6% of GDP, in which the largest share of structural savings belongs to the sectors of agriculture, economy, entrepreneurship, transport and labour market. Liabilities arising from the restructuring of shipbuilding include amendments to the Contract

on Sale and Transfer of Shares of the Shipbuilding Industry and based on factoring agreements of the past two years and unpaid liabilities in 2013 and 2015.

Expenditures for property income record a share of 3.5% of GDP. This category of expenditures is mostly determined by the movements of expenditures for interest rates in line with the financing needs envisaged in 2016.

Social benefits and social transfers account for the most significant category of total general government budget expenditures, at a level of 16.2% of GDP. These expenditures are mostly determined by movements of expenditures for pensions, expenditures for health care, maternity benefits, social welfare benefits, child benefits and unemployment benefits. In 2016, expenditures for pensions were planned at the level of 10.7% of GDP, which includes increased allocations resulting from the alignment of pensions and expected increase in the number of users in 2015 and 2016. Expenditures for health care are part of the financial plan of the Croatian Institute for Health Insurance (HZZO) based on their exit from the State Treasury System, and record the level of 6.1% of GDP. Maternity benefits are planned at the level of 0.6% of GDP, and also include the funds planned for the new measure of population policy regarding approximately HRK 7,600 for a newborn child. Social welfare benefits that include the guaranteed minimal benefit are planned at the level of 0.6% of GDP, child benefit at the level of 0.5% of GDP and unemployment benefits in the amount of 0.4% of GDP.

Other expenditures, which mainly relate to current and capital transfers, are planned at the level of 1.9% of GDP in 2016. The previously described structural savings of around 0.2% of GDP are planned in this category, mainly regarding projects in economy, agriculture, regional development, construction, science, labour market, entrepreneurship, culture, transport and tourism. In addition, a large part of activities planned in these areas is financed from EU funds. Also, these expenditures are largely determined by the payments of own contributions of the Republic of Croatia into the EU budget, which amounts to 1% of GDP. The transfer to the Croatian Institute for Health Insurance in the amount of 0.7% of GDP is also recorded in this category of the State Budget, in accordance with the rights of insured persons exercised on the basis of compulsory health insurance.

Expenditures for gross capital formation are planned at the level of 3.4% of GDP, in which structural savings total 0.07% of GDP. The largest part is determined by activities tied to capital investments of all general government budget units, particularly in water and road transport.

Net lending/borrowing

Following the planned revenues and expenditures, reduction of the consolidated general government net lending/borrowing is expected from -3.2% of GDP in 2015 to -2.6% of GDP in 2016, observed by ESA 2010 methodology and by the statistical coverage. Therefore, the State Budget net lending/borrowing will amount to -2.5% of GDP, and of 576 local units to -0.1% of GDP.

3.5. Mid-term budgetary framework (2017-2019)

Consolidated general government revenues

In the period 2017-2019, the revenues of the general government budget will be determined by the gradual recovery of economic activity and fiscal impacts of structural measures implemented in previous years. As such, they will record a level of 43.7% of GDP in 2017 and 2018, and 43.1% of GDP in 2019.

Revenues from the value-added tax, which follow the expected recovery of personal spending in the following years, will move at the average level of 12.8% of GDP. Import taxes and duties will stay at the level of 0.1% GDP in the observed period. Taxes on products, except VAT and customs, which mostly include special taxes and excises and revenues from taxes on gains from games of chance, will in the mid-term period range from 19.2% of GDP in 2017 to 18.8% of GDP in 2019. In the mid-term period, the revenues from property will range from 1.1% of GDP in 2017 and 2018 to 1.0% of GDP in 2019. Furthermore, the revenues from personal income tax in the observed period will record an average level of 3.5% of GDP, and revenues from corporate income tax, with included changes in the system of non-taxation of reinvested profits, will stay at the level of 1.7% of GDP.

The share of social contributions in the period 2017-2019 will achieve the level of about 11.6% of GDP in 2017, 11.4% of GDP in 2018, up to 11.2% of GDP in 2019. Other revenues in 2017 are planned at the level of 6.1% of GDP, and in 2018 and 2019 at the level of 6.6% of GDP.

Expenditures of consolidated general government

In 2017, the expenditures of the general government budget are projected at the level of 45.7% of GDP, in 2018 at the level of 45.3% of GDP, and in 2019 at the level of 44.2% of GDP.

Compensations of employees, with their share of about 24% in total expenditures, form the second largest group of expenditures of the general government budget. In the observed period, an increase in these expenditures is expected due to the correction of past performance and expected trends regarding the number of employed civil and public servants. At the same time, a decrease in the share of gross domestic product from 11% in 2017 to 10.5% in 2019 is expected. The projections of these expenditures do not anticipate the payment of material rights, such as Christmas bonuses and holiday allowances, in the observed mid-term period. Expenditures for intermediate consumption record a reduced share in the value of the gross domestic product from 7.6% in 2017 to 7.4% in 2019 under the influence of the continuous rationalisation measures regarding these expenditures. Expenditures for subsidies in 2017 will be at the level of 1.5% of GDP, while in the following two years, reduction to 1.2% of GDP is predicted. It is important to note that complete fulfilment of all obligations arising from subsidies to the shipbuilding industry is anticipated in 2017, which is why these expenditures are no longer planned in 2018. The expenditures for property income, which are mostly determined by the movements of expenditures for interest rates in line with costs of servicing the public debt, will record an average level of 3.4% of GDP in the following mid-term period. Social benefits and social transfers account for the most significant category of total expenditures, with an

average share of 36% of GDP. By the end of 2019, reduction of its share to a level of 15.5% GDP is expected. This results from the planned further implementation of the reform of the health system, as well as continuing rationalization of social benefits and their better targeting, in particular by establishing a guaranteed minimum standard as total social benefit that can be achieved from state and local sources. Other expenditures, mostly other current and capital transfers, will decrease their share in the value of the gross domestic product from 1.4% in 2017 to 1.2% in 2019. Expenditures for gross capital formation of all general government budget units will move at an average level of 3.8% of GDP in the observed mid-term period.

Net lending/borrowing

In accordance with the projected trends in revenues and expenditures of the general government budget, a net lending/borrowing of -2.0% of BDP is expected in 2017, -1.6% of GDP in 2018 and -1.0% of GDP in 2019. Thereby, the central government will provide the largest contribution to the overall net lending/borrowing in the mid-term period, and local units will record a surplus at the average level of 0.1% of GDP.

3.6. Assessment of the structural balance and medium-term budgetary objective (MTO)

The structural budget balance indicates a deficit or a surplus of the general government budget that excludes the cyclical economic effects and one-off and temporary measures that have an impact on the budget revenues and expenditures. The calculation of the cyclically adjusted balance is based on the methodology and calculations of the European Commission for the EU Member States, whereby cyclically sensitive components observed on the revenue side include personal income tax, corporate income tax, indirect taxes, social security contributions and non-tax payments, while unemployment benefits are observed on the expenditure side. The medium-term budgetary objective (MTO) refers to the amount of the structural budget balance, which ensures the alignment of trends in general government deficit and the public debt with the provisions of the Stability and Growth Pact.

The Economic and Financial Committee has established a minimum medium-term budgetary objective for the Republic of Croatia of -1.75% of GDP, which would ensure compliance with the above provisions of the Stability and Growth Pact. However, the EC encourages Croatia to set the medium-term budgetary objective at -1% of GDP, in order to ensure its sustainability in the medium term, given the level of the public debt.

Considering the projections of the Republic of Croatia presented in this document, the structural balance in 2016 recorded a level of -1.5% of GDP, whereby a total change of the structural balance in 2015 and 2016 was 2.2 percentage points, which is 0.6 percentage points more than predicted by the Recommendations of the EU Council for 2015 and 2016. Thereby, this criterion of the Council of the

EU to reduce excessive budget deficit was also met. Furthermore, at the end of the medium-term, structural balance amounts to -1.7% of GDP, thus ensuring sustainability of general government deficit and public debt.

If we take into account the calculations of the European Commission for potential GDP and the output gap from the Winter Forecast, fiscal projections of the Republic of Croatia indicate a stronger reduction in the structural balance to the level of -1.1% of GDP in 2019, thus enabling the Republic of Croatia to come closer to the recommendation of the European Commission on the medium-term budgetary objective of -1% of GDP, which ensures compliance of public debt trends with the provisions of the Stability and Growth Pact and EC recommendations.

Table 3.4 Trends in structural balance of consolidated general government in the period 2015-2019

	2015	2016	2017	2018	2019
	Outturn	Projection	Projection	Projection	Projection
MINISTRY OF FINANCE					
<i>CYCLICALLY-ADJUSTED BALANCE</i>					
TOTAL DEFICIT/SURPLUS, corrected for one-off measures, % of GDP	-3,2	-2,4	-2,0	-1,6	-1,0
OUTPUT GAP	-3,0	-1,9	-0,7	0,3	1,4
CYCLICALLY-ADJUSTED BALANCE, % of GDP	-1,8	-1,5	-1,7	-1,8	-1,7
<i>CYCLICALLY-ADJUSTED BALANCE CHANGE</i>	<i>-1,9</i>	<i>-0,3</i>	<i>0,2</i>	<i>0,1</i>	<i>-0,1</i>
EUROPEAN COMMISSION					
<i>CYCLICALLY-ADJUSTED BALANCE</i>					
TOTAL DEFICIT/SURPLUS, corrected for one-off measures, % of GDP	-3,2	-2,4	-2,0	-1,6	-1,0
OUTPUT GAP	-3,0	-1,4	0,2	0,1	0,1
CYCLICALLY-ADJUSTED BALANCE, % of GDP	-1,8	-1,7	-2,1	-1,7	-1,1
<i>CYCLICALLY-ADJUSTED BALANCE CHANGE</i>	<i>-1,8</i>	<i>-0,1</i>	<i>0,4</i>	<i>-0,5</i>	<i>-0,6</i>

Source: Ministry of Finance, EC, CBS

3.7. Stock and projection of trends of public debt and stock of guarantees

Stock of public debt and guarantees

In the period 2008-2014, the general government debt, i.e. public debt, increased from 39.6% of GDP to 86.5% of GDP. Such increase of debt since 2008 has been affected by the accumulation of budget deficits and factors that are mainly related to the realization of potential risks related to companies in state ownership. In addition, the level of general government debt was significantly influenced by the reclassification of several highly indebted companies in state ownership to the general government sector, which occurred due to the transition to the European System of National and Regional Accounts (ESA 2010). The biggest impact on the general government debt so far was marked by the inclusion of the three following subjects: Croatian Motorways, Motorway Rijeka - Zagreb and the Croatian Bank for Reconstruction and Development (HBOR). The debt of these companies in 2015 amounted to HRK 45.3 billion. Furthermore, by applying the new methodology,

the Bina Istra d.d. debt has been reclassified as a general government debt, thus increasing the public debt by an additional 1.4% of GDP.

According to the Fiscal Notification Report for the period 2012-2015, and based on ESA 2010 methodology published by the Central Bureau of Statistics, the public debt amounted to HRK 289.7 billion or 86.7% of GDP at the end of 2015, which presents an annual increase of HRK 5.5 billion. The debt increase was noticeably slower in comparison with the last period because general government budget deficit was decreased and funds from the deposit account, provided by borrowing in previous years, were used for settling new liabilities. The foreign component of the public debt was increased in comparison to 2014 by HRK 106 million, while the domestic component of the public debt in the same period recorded an increase of about HRK 5.6 billion.

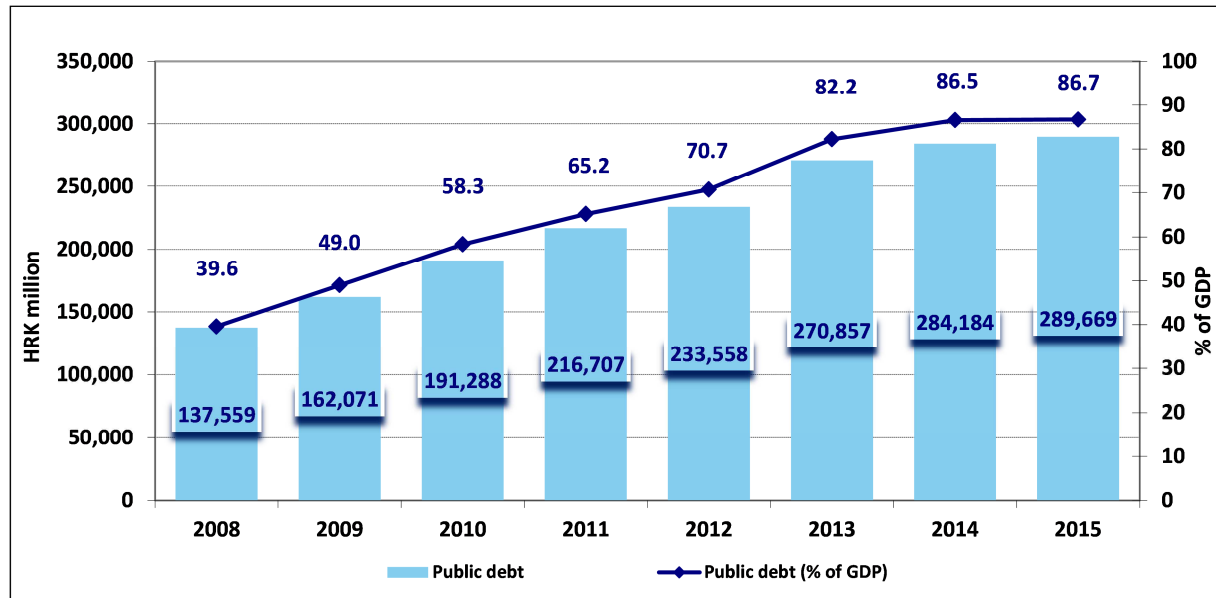
When viewed by the level of government, most of the public debt refers to the central government, in the amount of HRK 284.3 billion, while the debt of local and regional self-government units amounts to HRK 5.4 billion, with only an insignificant portion of HRK 1.9 million pertaining to social security funds. It is important to emphasize that the central government sector debt, in addition to the debt of state budget budgetary users, also includes the debt of extra-budgetary users (Croatian Waters, Environmental Protection and Energy Efficiency Fund, Croatian Roads, State Agency For Deposit Insurance and Bank Rehabilitation, Croatian Privatisation Fund by 31 March 2011, State Property Management Agency by 30 September 2013, Restructuring and Sales Centre, as well as State Property Management Administration and its legal successors) in the amount of HRK 12.2 billion, and the debt of the following subjects: Croatian Railways Infrastructure, Croatian Radiotelevision, Croatian Motorways, Motorway Rijeka - Zagreb and the Croatian Bank for Reconstruction and Development in the total amount of HRK 52.7 billion.

Viewed in terms of borrowing instruments, the largest share of the public debt was generated by borrowing in long-term securities, i.e. bonds (56.1%), then borrowing via loans (37.4%) and short-term securities (6.5%).

The currency structure of public debt shows that a significant part of the debt was denominated in foreign currency, whereas the debt in EUR accounts for 74.4%, the debt in HRK for 21.4% and the debt in USD for 4.1% of the total debt. A small part of the debt (0.1%) was denominated in Swiss francs. The debt denominated in EUR has been gradually increasing in recent years, and has primarily been caused by the issuance of domestic and foreign bonds denominated in EUR, borrowing on the domestic market via syndicated loans, and the use of project loans of international financial institutions.

The maturity structure of public debt shows that the share of public debt with the maturity of up to one year amounted to 6.7% of the total debt at the end of 2015. The share of public debt with the maturity of one to five years amounted to 16.4%, while the share of debt with the maturity of five to ten years amounted to 35.9%. The debt with the maturity of over 10 years accounted for 41% of the total public debt.

Chart 3.1. Public debt trends in the period 2008-2015



Source: CNB, CBS

The total issued guarantees of the Republic of Croatia at the end of 2015 amounted to HRK 7.6 billion, or 2.3% of GDP, which is HRK 754.1 million more than at the end of 2014. Such an amount of total guarantees is primarily a result of the aforementioned adjustment with the ESA 2010 methodology and the inclusion of public company liabilities into the public debt.

The Act on Execution of the 2016 State Budget of the Republic of Croatia³⁰ established that the annual value of new financial guarantees for 2016 amounts to HRK 6 billion, out of which HRK 2.5 billion pertains to extra-budgetary users of the state budget.

Financing the general government budget and projection of trends of the public debt

The total level of required funding will be determined by the trends in the fiscal deficit, financial assets, as well as general government budgetary liabilities that are falling due in the observed period, while the financing method of budgetary requirements in the following period will depend on financial market circumstances. Consequently, the need for financing the total budget deficit and matured liabilities will be ensured on domestic and foreign financial markets, while in the sense of borrowing mechanisms in the observed period, the focus will be on instruments with a longer maturity, primarily on bonds. The current favourable conditions in the financial markets offer the possibility of extending the average debt maturity and balancing the maturity profile, while reducing the share of short-term debt in total public debt. Special attention will thus be paid to the adjustment of future maturities by their amount and due dates, while creating an additional room for financing other sectors at the same time. Borrowing by loans will primarily focus on domestic financial market, while foreign financing by loans pertains to project loans of international financial institutions. On the side of financial assets, in the period 2016-2019, receipts are expected from

³⁰Official Gazette no. 26/2016

privatisation in the average amount of 0.5% of GDP per year. In addition, the reduction of the total stock of deposits by HRK 1.2 billion is planned in 2016.

The bulk of maturing liabilities in the period 2016-2019 pertains to eight maturities of bonds, of which five are domestic and three are foreign. Among domestic bonds, one is denominated in EUR, in the amount of EUR 1 billion, while four bonds are denominated in HRK, in the total amount of HRK 19 billion. Foreign matured liabilities pertain to three Eurobonds. The first Eurobond in the amount of USD 1.5 billion, converted to EUR at the time of issuing, matures in 2017, the second Eurobond in the amount of EUR 750 million is due in 2018, and the third Eurobond in the amount of USD 1.5 billion matures in 2019. On the side of loans, most maturities in the observed period refer to syndicated loan maturities issued on the domestic financial market and to the international financial institution loans. Thus, total loan maturities are in the amount of HRK 13.9 billion in 2016, HRK 8.9 billion in 2017, HRK 5.3 billion in 2018 and HRK 3.3 billion in 2019.

Table 3.5 Overview of the bonds maturity of the Republic of Croatia in the period 2016-2019

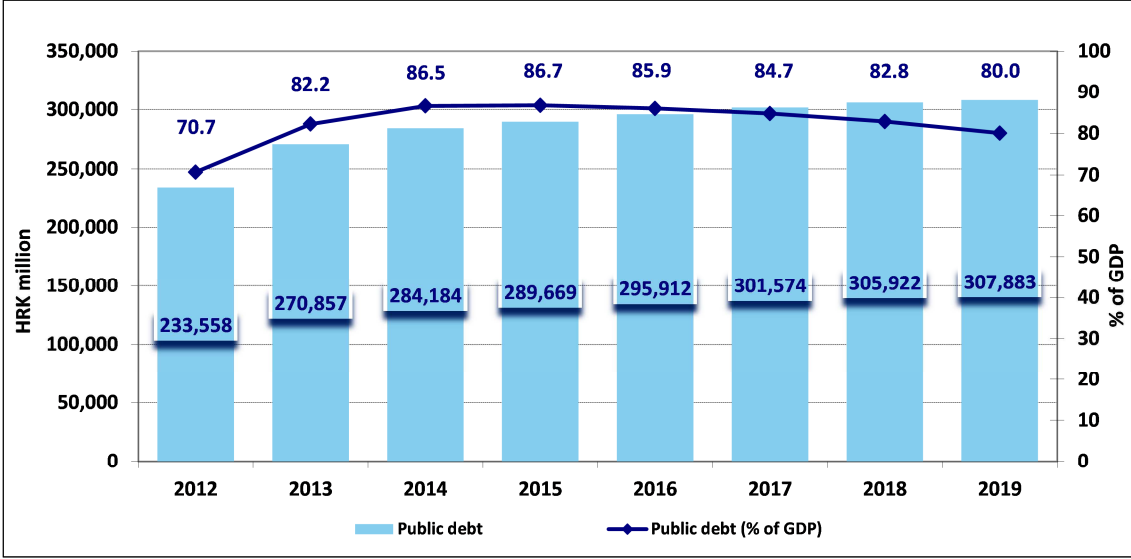
Bond	Date of issue	Amount (in million)	Intrest rate	Date of maturity
DOMESTIC BONDS				
Series 16 D-16	22.7.2011	HRK 3,500	5.75%	22.7.2016
Series 15 D-17	8.2.2007	HRK 5,500	4.75%	8.2.2017
Series 12 D-17	25.11.2010	HRK 4,000	6.25%	25.11.2017
Series 18 D-18	10.7.2013	HRK 6,000	5.25%	10.7.2018
Series 07 D-19	29.11.2004	EUR 1,000	5.38%	29.11.2019
FOREIGN BONDS				
Euro - USD IV	27.4.2012	USD 1,500	6.25%	27.4.2017
Euro - EUR VIII	8.7.2011	EUR 750	5.88%	9.7.2018
Euro-USD I D 2019	5.11.2009	USD 1,500	6.75%	5.11.2019

Source: Ministry of Finance

In accordance with the trends in consolidated general government budget deficit, and taking into account the privatization receipts and a change in stock of deposits, it is expected that the public debt will be reduced and amount to 85.9% of GDP in 2016.

In the course of further implementation of fiscal consolidation measures and reduction of budgetary deficit, as well as the activation of state property, i.e. the privatization income in the average amount of 0.5% of GDP per year, the public debt to GDP ratio will continue to decline to the level of 84.7% of GDP in 2017, 82.8% of GDP in 2018, while the public debt in 2019 will amount to 80% of GDP.

Chart 3.2. Projection of public debt trends by 2019



Source: CBS, CNB, Ministry of Finance

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS PROGRAMME

4.1. Fiscal risks and public debt trend sensitivity analysis

The sustainability of public debt represents the greatest macroeconomic risk for the domestic economy and it is therefore of paramount importance to achieve fiscal adjustment which aims to stabilize and consequently reduce the public debt, and return it to a sustainable path. It is important to emphasize that the increase of public debt in recent years was greatly influenced by the so-called snowball effect, which arose from the difference between the total financing expenses and the nominal GDP growth. As interest rates in recent years were significantly higher than nominal GDP growth, this led to an automatic increase in public debt. The snowball effect can therefore explain half of the increase in public debt in the period 2011-2015. Taking into account fiscal projections contained in this document, the snowball effect will continue to have negative consequences by 2019.

Given the level of indebtedness, a long-term increase in reference market interest rates would represent a substantial threat to fiscal sustainability and consequently generate a substantial public debt increase. The increase in the cost of financing would lead to the increase in the burden of debt repayment and the payment of interests, thus putting more pressure on the current state operations. Thus, in a scenario where the average implicit interest rate on the debt would increase by 2 percentage points in the period 2017-2019, public debt would increase above the projected one and would increase by 5 percentage points at the end of the projection period, compared to the baseline scenario.

Furthermore, in view of the negative impacts on the public debt trend in the medium-term period, the risk of a considerable change in the domestic currency exchange rate should be singled out. Indeed, having in mind that almost 75% of public debt has been denominated in EUR, domestic currency depreciation would result in a higher public debt level, as well as in more difficult debt service. The performed sensitivity test shows that the depreciation of 15% of HRK against EUR increases the public debt level to over 94% of GDP in 2018.

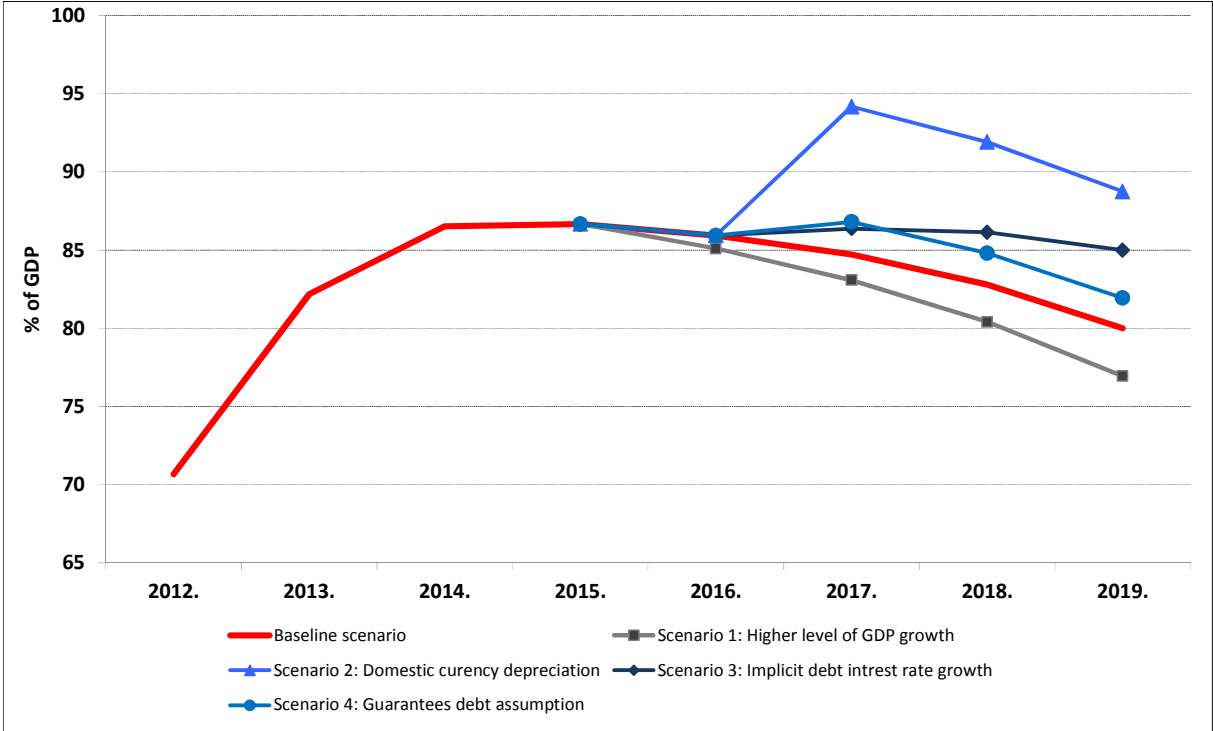
In addition, public companies still present a potential big risk for public finances, especially if we consider the activation of guarantees in previous years, i.e. the assumption of debts pertaining to companies in state ownership into the public debt. Thus, in the assumed scenario of conditional liabilities transfer to the public debt in the amount of 2% of GDP, the public debt would reach the level of 88% of GDP in 2016. Consequently, the utmost importance lies in the implementation of the financial and business restructuring process among the users of government guarantees in order to increase the efficiency and the sustainability of their business operations, thus reducing potential risks of activating government guarantees reflected in a negative impact on fiscal aggregates, i.e. budgetary deficit and public debt.

On the other hand, higher rates of economic growth would cause a rapid reduction of public debt to GDP ratio in the medium term. Compared to the baseline scenario, in the scenario of stronger GDP

growth, by 1 percentage point each year, public debt would, therefore, fall to a level of 76.9% of GDP in 2019.

To sum up, the debt sensitivity analysis shows that in order to avoid specified fiscal risks and ensure a fiscal sustainability, it is necessary to resolutely implement planned structural reforms in the areas of public administration, tax system, public companies, health and pension system, as well as social welfare system, which would ensure long-term fiscal sustainability and create a foundation for stronger economic growth and employment.

Chart 4.1. Public debt share trend in GDP according to specific scenarios



Source: Ministry of Finance

4.2. Comparison with the previous Programme

The comparison of total revenue, expenditure and net lending/borrowing of a consolidated general government in the new and previous Convergence Programme shows considerable differences. They arise from the difference in levels of nominal gross domestic product, a better realization of revenues and stronger structural effort compared to the previously expected.

The Convergence Programme 2015-2018 rested on the assumption of a real growth of the gross domestic product of 1.0% in 2016, 1.2% in 2017 and 1.5% in 2018. The Convergence Programme from 2016 expects greater economic growth, thus in 2016, there is a projection of 2.0% of real growth, 2.1% in 2017, 2.3% in 2018 and 2.5% in 2019.

Differences in certain fiscal values of these two Programmes are caused by the more favourable budgetary movement on both the revenue and the expenditure side. Namely, while revenues are being realized better than the 2015 expectations, the expenditure side is determined by the intensification of efforts to address the excessive budget deficit procedure.

Table 4.1 Comparison of revenue, expenditure and net lending/borrowing of the general government

	2015	2016	2017	2018	2019
CP RoC 2015-2018 (% of GDP)					
Total revenue	43.7	44.1	43.7	43.7	43.1
Total expenditure	46.9	46.8	45.7	45.3	44.2
Net lending/borrowing	-3.2	-2.6	-2.0	-1.6	-1.0
CP RoC 2014-2017 (% of GDP)					
Total revenue	42.9	43.3	43.7	43.5	
Total expenditure	47.9	47.3	46.4	45.9	
Net lending/borrowing	-5.0	-3.9	-2.7	-2.4	
Difference					
Total revenue	0.8	0.8	0.0	0.2	
Total expenditure	-1.0	-0.5	-0.7	-0.6	
Net lending/borrowing	1.8	1.3	0.7	0.8	

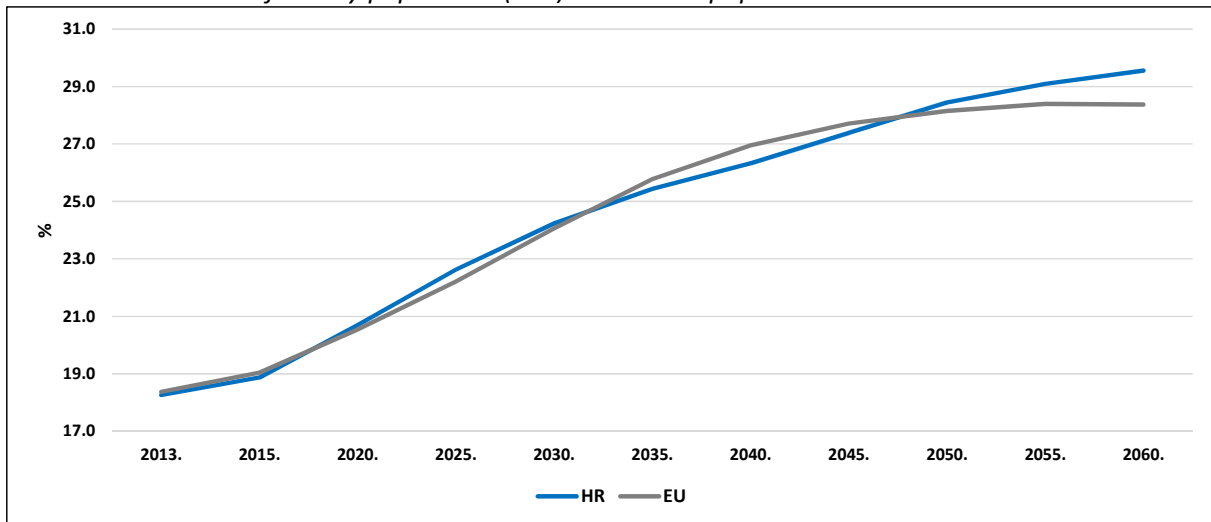
Source: Ministry of Finance

5. SUSTAINABILITY OF PUBLIC FINANCES

Like all the EU countries, the Republic of Croatia is significantly influenced by accelerated demographic trends that are primarily related to the aging population and the extension of life expectancy. The same can be seen in the following graphics comparison of Croatia and the EU for the period up to 2060.

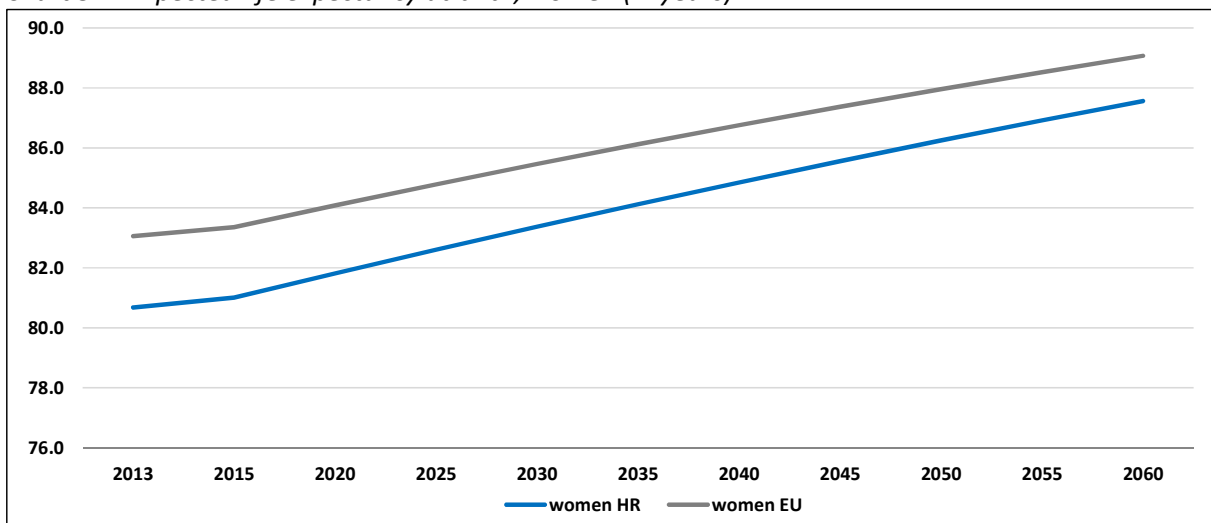
In the period 2013-2060, the population number decrease by 13% has been projected, that is, from 4.3 to 3.7 million. At the same time, a considerably extended life expectancy is expected - the remaining life expectancy in the age of 65 will be extended for 5.8 years for men and 5.5 years for women in the mentioned period. These demographic trends will put strong pressure on the sustainability of public finances.

Chart 5.1. The share of elderly population (65+) in the total population



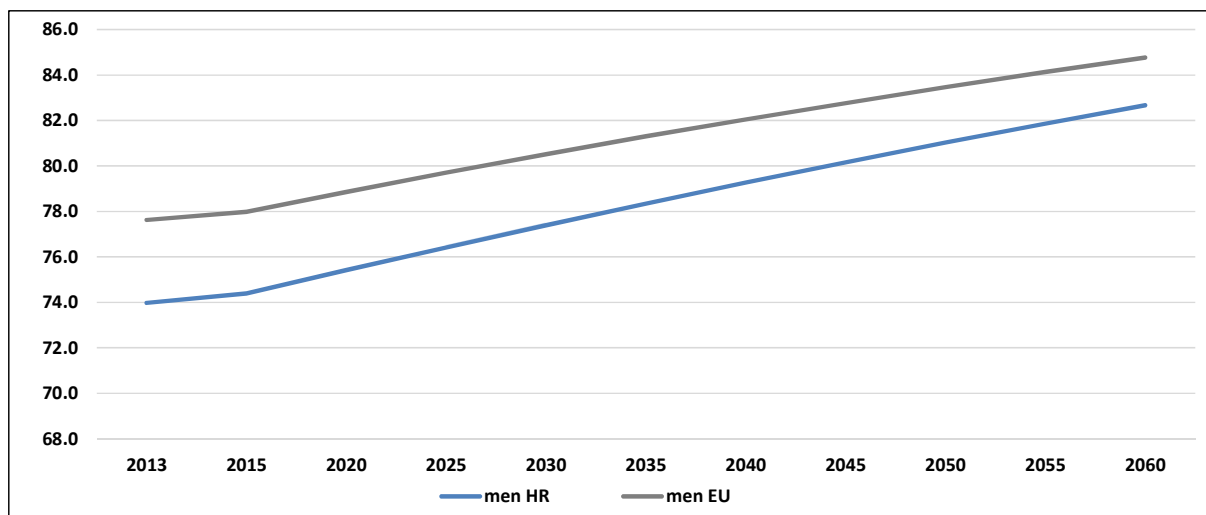
Source: Ageing Report 2015, EUROPOP2013

Chart 5.2. Expected life expectancy at birth, women (in years)



Source: Ageing Report 2015, EUROPOP2013

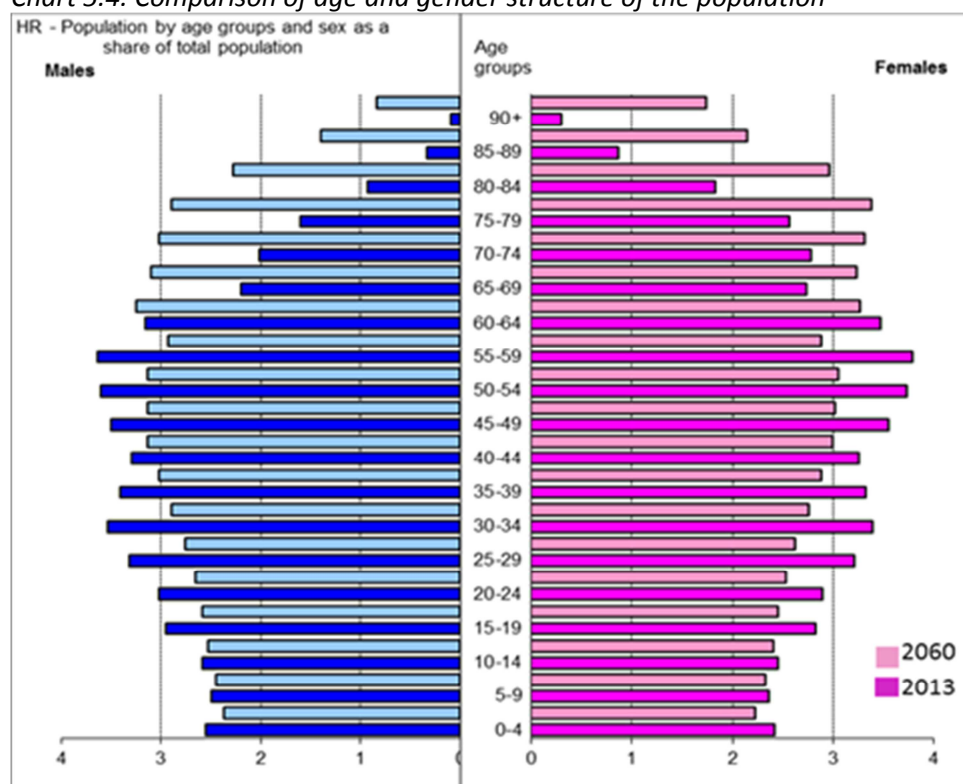
Chart 5.3. Expected life expectancy at birth, men (in years)



Source: Ageing Report 2015, EUROPOP2013

These unfavourable demographic trends will put a lot of pressure on the generational solidarity system. The gradual equalization of the age required for retirement for men and women by 2030, as well as the prolongation of working years up to 67 years in the period 2030-2038 should reduce this pressure. Chart 5.4 shows a comparison of age and gender structure of the population in 2013 compared to 2060.

Chart 5.4. Comparison of age and gender structure of the population



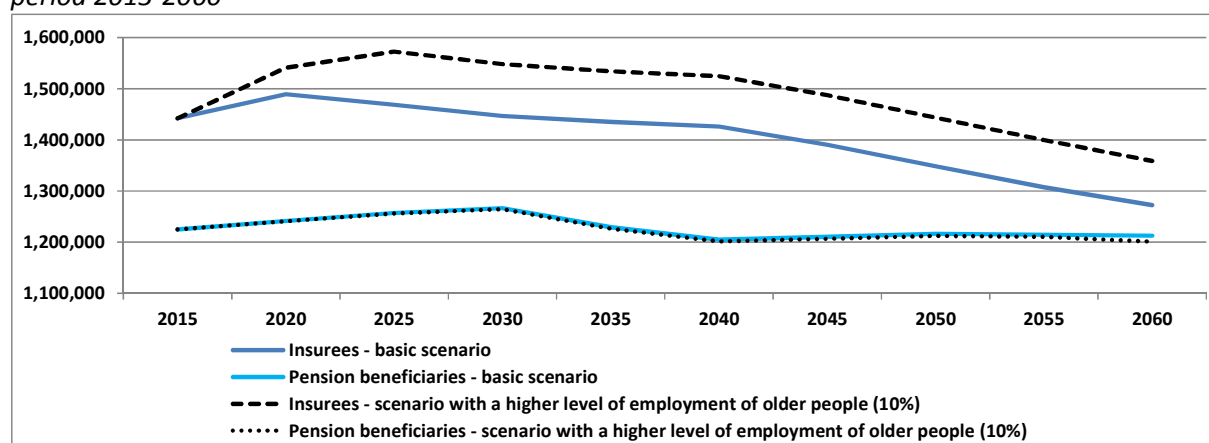
Source: European Commission

Croatia is also characterized by a low activity rate and low employment rate of the population. This especially applies to elderly population cohorts (55-64 and 65-74). The activity and employment rate of workers aged 55 to 64 years of age will be increasing until 2040, with the culmination in 2041, after which it will gradually decrease. With the increase in the activity rate for 10% and the

employment rate for 11% in the observed period, both rates will amount to only 50% by 2060. The activity rate and the employment rate for workers aged 65 to 74 years of age in the observed period will be almost doubled from 5.9% in 2013 to 13.8% in 2060, and the peak will be reached in 2048. The median age of the labour force is gradually increasing to 41 years in 2026, after which it will remain constant.

Chart 5.5 shows the projection of the number of employees (insured) and the number of pensioners in the period 2013-2060, as well as one of alternative scenarios that includes a higher activity rate of older cohorts of workers.

Chart 5.5. Projection of the number of employees (insured) and the number of pensioners in the period 2013-2060



Source: Ministry of Labour and Pension System, March 2015

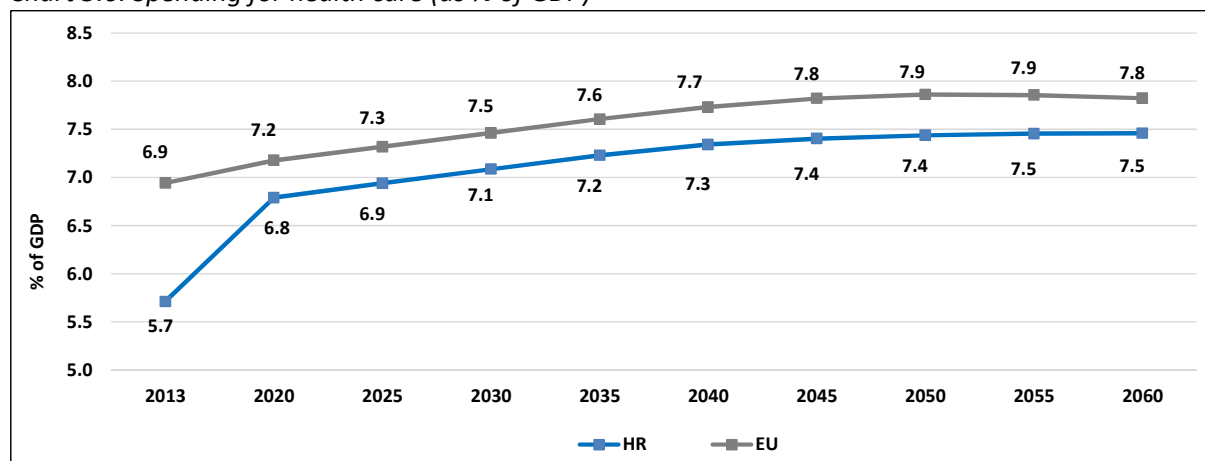
Sustainability of public finances - Health care system

From the perspective of the health care system, demographic changes have a significant impact on the demand for health care services.

Within the activities of the working group AWG-EPC, the projections related to public finances in the health care sector and long-term care have been prepared in all the EU Member States for the period 2013-2060.

According to the report of the mentioned working group (*Ageing Report 2015*), the total spending on health care in the Republic of Croatia amounted to 5.7% of GDP in 2013, which is slightly lower than the EU average of 6.9%. By comparing changes in consumption over time by 2060, it is evident that the share of planned expenditures on health care in GDP at the national level is growing faster than expenditures at the EU level (an increase of 1.7 versus 0.9 percentage points).

Chart 5.6. Spending for health care (as % of GDP)



Source: Ageing Report 2015, AWG base scenario

The key challenges in the health care sector reflect the necessary adjustments to ways of providing health care because the growing number of older people with multiple chronic diseases will require different treatment and different way of providing health services. Therefore, it is very important to strengthen the cost-effectiveness of the health care sector, with a focus on hospitals. In this sense, one of the measures which should lead to significant savings is the implementation of a unified public procurement system for public hospitals (e.g. for medications, medical products, etc.), as well as the reorganization of hospitals. The key strategic document for the future development of hospitals is the National Development Plan for Clinical Hospital Centres, Clinical Hospitals, Clinics and General Hospitals in the Republic of Croatia 2015-2016³¹ (the so called Hospital Master Plan). The Strategic Framework for Hospital Development focuses on the improved coordination of health care, avoiding excessive consumption of resources and improvement of the financing system. In addition to the Hospital Master Plan, Amendments to the Public Health Service Network³² have been adopted in October 2015, enabling the redistribution of hospital bed capacity by reducing the number of acute beds, and increasing and/or introducing the number of beds for prolonged treatment, long-term treatment, palliative care and day hospital chairs. The commencement of the full implementation of the Hospital Master Plan is expected in the second half of 2016, by initiating the transformation of the hospital system.

The Croatian Institute for Health Insurance's exit from the State Treasury in 2015 enabled better cash flow management in the health care system. The new model of contracting and funding of hospitals was initiated based on execution, efficiency and quality. With this new model, the system of advance payments was abandoned and payment per performed (provided) services was gradually introduced. Also, the hospitals were given the opportunity to obtain additional funds based on satisfying key performance indicators (KPI) and quality indicators (QI).

In addition, the changed conditions require a better coordination between different levels of health care, a faster flow of information and more effective strategies to ensure the accountability of all participants, especially a high degree of flexibility in hospitals and their resources in order to quickly respond to the current needs of Croatian citizens. There is also need to mention the implementation

³¹ Official Gazette no. 26/2015

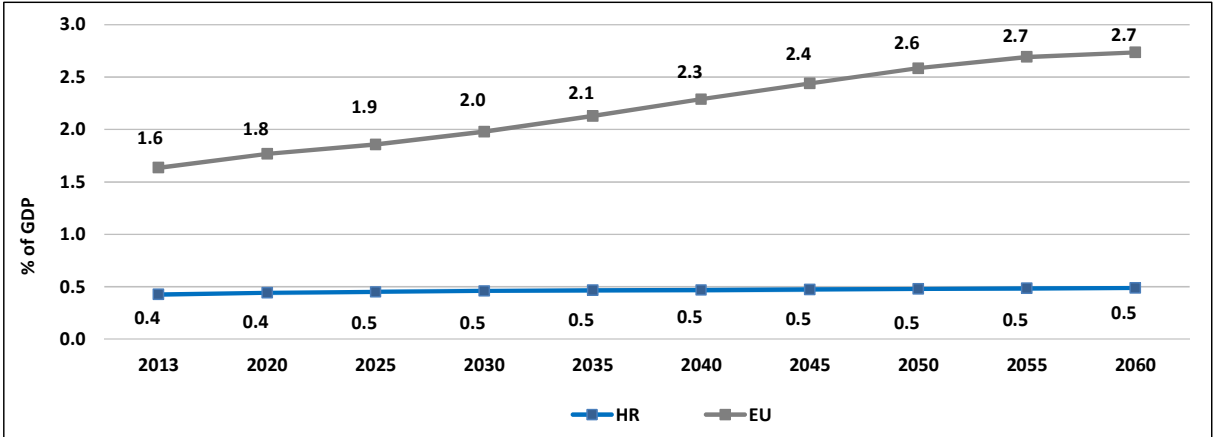
³² Official Gazette no. 113/2015

of the improvement of the existing and the development of new information and communication systems and the reorganization of primary health care aimed at improving and harmonizing the quality and accessibility of health care.

In terms of long-term care, the Republic of Croatia still does not have a comprehensive strategy for long-term care and long-term care is still dispersed between the health care and the social welfare system. There are different types of benefits in the social welfare system: social benefits in kind, cash benefits and social services. The role of the state in the social welfare system cannot be defined on a unilateral basis; the state is in the role of the provider and funder of social services, but also presents a "barrier" to prevent poverty and social exclusion. The Croatian social welfare system is based on the principle of subsidiarity and thus the state has the role of the funder only in cases where an individual does not have sufficient income or assets to fund the cost of services, nor is in a position to get help from family members or in any other acceptable manner. The development of the project of modernization of the social protection system is in progress in order to improve the efficiency and cost-effectiveness of the Croatian social protection system.

The working group AWG-EPC has developed a projection of public spending for long-term care for the period 2013-2060 on the basis of harmonized methodology and available data disclosed in detail in the Report of the working group (*Ageing Report 2015*). The establishment and improvement of the social protection system through a transparent monitoring of costs will allow a better comparison of Croatia with the EU Member States.

Chart 5.7. Spending for long-term care (as % of GDP)



Source: Ageing Report 2015, AWG base scenario

Sustainability of public finances - Pension system

As already mentioned above, the life expectancy increases, and taking into account the unfavourable expectations of natural population growth and net migration, the share of elderly in the total population is also growing, which affects the cost increase in the pension system.

A large share of the population of the Republic of Croatia is already retired. The reasons for this are manifold. First, in the past there was no policy to discourage early retirement through an effective system of early retirement penalization, and it was relatively easy to exercise the right to a disability pension. Furthermore, a significant number of war veterans from the Homeland War was retired at a

young age and thereby significantly reduced the population base from which new retirees should come. Currently, 28.6% of the total Croatian population is in retirement.

On the other hand, there are important factors that will reduce the expenses of the pension system. The baseline projection scenario anticipates a continuous reduction of allocations for pensions in the public system, measured as a share of GDP, from 10.9% in 2013 to 7% in 2060, as shown in Table 5.8.

With the introduction of the mandatory second pillar from 2027 onwards, the majority of new pensioners will receive basic pension from the 1st pillar and the pension from 2nd pillar. This means that expenditures for pensions paid from the 1st pillar will gradually reduce. This reduction will be all the more important because pensioners who will receive pensions from both pillars will not have fringe benefits of 27% to the part of the pension which is paid from the 1st pillar.

The statutory age for old-age pension for women is gradually increasing for three months annually until 2038 when it will be 67 years. The statutory age for retirement for men shall be increased from 65 to 67 years in the period from 2030 to 2038. The introduction of this measure will reduce the inflow of new pensioners.

A significant reduction of the number of disability pension beneficiaries by 2060 is projected. This is the result of a more stringent implementation of rules that allow the use of disability pensions. Disability pensions of war veterans have reached their peak and a gradual decrease in their number is expected. The share of family pensions will also gradually decrease in the total number of pensioners. This is due to demographic trends and an increasing rate of female employment.

Table 5.1. Pension expenditures and pension contributions in the period 2013-2060 (% of GDP)

Pension expenditure	2013	2020	2030	2040	2050	2060	Peak
Expenditures of 1st pension pillar	10.9	10.3	9.6	7.9	7.2	7.0	2014
Expenditures of 2nd pension pillar	0.0	0.0	0.3	0.8	1.3	1.6	2060
Total pension system expenditure	10.9	10.4	9.9	8.6	8.5	8.6	2014
Pension insurance contribution	2013	2020	2030	2040	2050	2060	Peak
Contribution paid into 1st pillar	5.9	5.9	5.6	5.6	5.6	5.6	2016
Total paid contributions	7.5	7.5	7.5	7.5	7.5	7.5	2017

Source: Ministry of Labour and Pension System, March 2015

The importance of mandatory pension savings in the 2nd pillar will gradually increase. By 2027, pensioners have the opportunity to return to the 1st pillar. Projections show that their pension from the 1st pillar will be slightly larger than the combined pension from the 1st and 2nd pillar, so it is likely that a large part of them will take this opportunity. After 2027, all persons born after 1962 will not have the opportunity to transfer to the 1st pillar and the number of pensions that will be paid from the 2nd pillar will grow.

Income from pension contributions in 2013 amounted to 5.9% of GDP, and the projections show a slight decrease to 5.6% of GDP in 2030. The reason for this is primarily an increase in the number of employees who realize pension insurance in both pillars (15% of salary contributions is paid into the 1st pillar, and 5% of the contributions is paid to the 2nd pillar). After 2030, when the 2nd pillar fully comes to life, revenues from pension contributions in the 1st pillar will stabilize at 5.6% and remain constant until the end of the projection period. The difference between the contributions and expenditures for pensions amounted to 4% of GDP in 2013, but this difference will be reduced to 1.4% of GDP by 2060.

Table 5.9 shows projected values of expenditures for certain types of pensions. Data shown in the table indicate a rather large proportion of disability pensions, for example, disability pensions accounted for 2.5% of GDP, and the old-age and early retirement pensions accounted for 5.1% of GDP in 2013. A large proportion of disability pensions results from milder criteria for acquiring disability pension in the previous period, as well as from a relatively large number of war veterans, but also from the fact that disability pensions were not translated into old-age pensions when the pensioners experienced the age required for old-age pension. This practice was changed in 2015, resulting in a sharp decline in expenditures for disability pensions in the period 2013-2020. A further reduction of expenditures for disability pensions was caused by stricter criteria for their exercise and the reduction of the number of war veterans.

Other pensions relate to the minimum pensions acquired through the general pension system, as well as some types of pensions earned under special regulations, such as the minimum veteran's pension that amounts to 45% of the average salary. Expenditures for this category of pensions will grow by 2030 primarily due to a larger share of veterans' minimum pensions.

Expenditures for old-age and early retirement pensions will be increasing until 2024, followed by their reduction due to a significant share of payments from the 2nd pillar.

Table 5.2. 1st pillar expenditures in the period 2013-2060 (% of BDP)

Pension types	2013	2020	2030	2040	2050	2060	Peak
Expenditures of 1st pension pillar	10.9	10.3	9.6	7.9	7.2	7.0	2014
Old age and early retirement pensions	5.1	5.8	5.6	4.3	3.8	3.7	2024
Disability pensions	2.5	1.3	0.7	0.6	0.5	0.5	2013
Family pensions	1.6	1.3	1.1	1.0	1.0	0.9	2013
Other pensions	1.7	1.9	2.2	2.0	1.9	1.9	2030

Source: Ministry of Labour and Pension System, March 2015

6. QUALITY OF PUBLIC FINANCES

6.1. Strategic framework

In terms of expressed macroeconomic imbalances, the scope of fiscal policy action was very limited, as evidenced by the growing deficits and high public debt. In the period 2016-2019, continued reform efforts are planned in order to strengthen the fiscal sustainability and foundations for economic growth. In this regard, the Government of the Republic of Croatia will focus on the fiscal policy in order to promote competitiveness, increase the efficiency of the public sector and strengthen public financial management, both on the revenue and the expenditure side of the budget.

6.2. Revenue measures

Comprehensive analysis of the tax system

The tax system in the Republic of Croatia was subject to frequent legislative changes in recent years, which ultimately led to an insufficient understanding of the tax system and unclear and inconsistent legal provisions. A Working Group of tax experts has been established under the guidance of the Ministry of Finance to tackle and rectify this situation. This Working Group will carry out a complete audit of the current tax system, identify main tax barriers responsible for halting the economic development of the Republic of Croatia and propose new laws and tax regulations. The purpose of the new legislation aims to achieve a stable - system that will not change year after year, sustainable - system in which tax expenditures will be known and targeted, simple - system that is understandable without additional instructions and opinions, and competitive - system that has comparable tax rates in a tax system environment.

The primary objective of the proposed new legal solutions is to find a space for lowering tax rates, while maintaining or increasing the level of income by: broadening the tax base, introducing property or environmental taxes and eliminating unproductive tax expenditures (exemptions, reliefs and exclusions). The proposed legal solutions should be simple and understandable and provide legal security to taxpayers. In this regard, special emphasis is placed on finding solutions for establishing a system of educational activities for taxpayers which would introduce first warning procedures instead of misdemeanour procedures. In addition to educational activity aimed at taxpayers, there is the requirement of opening channels for continuous and transparent communication between the tax administration and taxpayers.

The scope of the Working Group's activities is established by the decision of the Minister of Finance and they focus on state taxes (VAT, corporate income tax, excise duties and taxes and fees in the area of games of chance), shared taxes (personal income tax and property transfer tax) and utility charges i.e. property tax, with a view of interpreting overall effects of the transformation of utility

charges into value property tax. However, the activities of the Working Group are not limited to the aforementioned, and other taxes as well as all processes in existing tax procedures are to be looked at. The Working Group's activities should result in new legislation to be adopted after a public debate and parliamentary procedure for adopting regulations. It is expected that the new tax legislation will be implemented as of 2017.

Introduction of property tax

The value property tax will be introduced in the tax system of the Republic of Croatia as the income of local units. The introduction of the new tax will be in accordance with the recommendations provided in the IMF's report "Opportunities to modernize the property tax" of 2012. The value property tax will replace the payment of utility fees and taxes on vacation property by reducing tax rates on real property transfer, which will be introduced in two phases. The first phase will consist of the transformation of the existing utility fee system into a "simple" tax on real property, in a way that the calculation of tax will include two additional coefficients regarding the age and condition of the property aside from the existing utility fee coefficients. The coefficients will be determined according to the methodology of the profession. The determination of taxes by two additional coefficients will bring the determination of the tax base closer to the value of the property. The simple property tax will uniformly prescribe the applicable exemptions. The procedure of tax determination, calculation and collection will remain at the level of local units, which currently determine, calculate and charge utility fees. In order to allow local units to update the existing records, which they keep for the purpose of utility fees collection, regarding two additional coefficients, the introduction of the simple property tax is proposed as of 1 January 2018, with a two-year application period, followed by the second phase. In the first phase of simple property tax application, other preconditions for the transition to value property tax will be fulfilled.

Preconditions to be fulfilled are as follows:

- update of source records on real property - creation of the source base as the basic register of real property;
- entry of all required data into the records, including data required for the maintenance of the real property taxation and property valuation system;
- creation of the system for mass assessment of property values for the purpose of determining the tax base of the property tax and for other purposes;
- adjustment of all regulations, specifically concerning the unambiguous monitoring of real property transactions and property ownership, and the obligation of registration of ownership, etc.

In the second phase, based on the data available on the objects of taxation, taxpayers and property values, an analysis will be conducted and the taxpayer, tax base (as % of the value), tax rates and possible exemptions from payment of value property tax will be determined.

Completion of the second phase is expected on 1 January 2020, when the collection of value property tax will begin. The final objective is to collect property income in the amount of 1% of GDP through the implementation of this tax. In addition to the above financial objective regarding the

introduction of the value property tax, secondary objectives to be achieved are as follows: 1) strengthening of the third pillar of taxation (work, consumption, assets); 2) finding space to reduce the labour taxation rate by collecting revenues from real property taxes; 3) achieving a transparent real property market by mass assessment of property values; 4) simple administrative procedures regarding the information on property values; 5) accurate ownership records, etc.

Accelerated deleveraging by encouraging write-off of receivables

In order to reduce the level of outstanding receivables of banks, non-performing loans (NPL), amendments to the Corporate Income Tax are proposed by introducing temporary, limited measures of final write-offs as tax deductible expenditures. The Corporate Income Tax Act stipulates that provisions at banks for risks of potential losses are recognized as expenditure in the calculated amount, up to a maximum amount prescribed by the Croatian National Bank. In order to alleviate the burden of crisis on socially disadvantaged citizens, beneficiaries of housing loans and entrepreneurs in difficulty, banks (i.e. credit institutions) were provided with the possibility to perform write-off of receivables as tax-deductible expenditure for such citizens and entrepreneurs, without initiating legal or enforcement proceedings, during 2013. The condition was to prescribe the criteria and procedures equal for all. Without the initiation of legal proceedings or enforcement, banks may include the amount of receivables from unrelated persons into tax deductible expenditures, according to their prescribed criteria and procedures, and based on the given business loans and accrued interest denominated in income if it is established that these loans threaten the development of investment projects or the continuation of business activity, i.e. lead to termination of activities.

In order to achieve better results in reducing NPLs of banks, the introduction of a new temporary, limited measure from 1 January to 31 December 2017, for a period of one year, would allow, in addition to the already existing above tax deductible final write-offs of receivables, further writing off of final non-collectable receivables of banks to citizens and entrepreneurs, and removal thereof from the banks' balance sheets. It is expected that the measure, which will be valid in the proposed deadline, will encourage banks to perform write offs of the existing outstanding receivables as final non-collectable receivables with a simultaneous recognition of tax expenditures for such write-offs, without litigations or enforcement proceedings. This measure would be implemented under the supervision of the Croatian National Bank.

Other measures to increase the efficiency of Tax Administration

Risk Analysis System

The Tax Administration will finalize the establishment of the risk analysis system in 2016. The objective is to establish IT support for access to all data in the system of the Tax Administration, and to other data in the records of other institutions that are relevant for the implementation of tax procedures. The application of this system will result in information designed to enable quick response of the Tax Administration's clerks, clearly prescribed processes and procedures to be

undertaken by clerks in reaction regarding the obtained risks, all of which will ultimately contribute to the uniform work of the Tax Administration.

Tax settlements

The tax settlement institute was introduced in July 2015 with the aim of shortening the process of tax inspection and faster collection of newly established obligations in tax inspection procedures. Tax settlement may be concluded in all cases of tax inspection, except in cases where there is a suspicion of committing a criminal offence.

The condition for the conclusion of tax settlement is the acceptance of the newly established obligation in the tax inspection procedures by the taxpayer and his waiver of the right to use legal remedies, thus shortening the tax procedure. On the other hand, the taxpayer is exempted from paying the penalty interest stipulated in the tax inspection procedure for the period from the date on which tax liabilities arose until the date of the conclusion of the tax settlement, depending on the amount and agreed payment term (on the settlement date, from 10 to 100% in proportion to the amount of paid tax liability, or 50% if the obligation is paid within 90 days of the conclusion of the settlement). If the conditions of principle of opportunity are met, the Tax Administration will not initiate the misdemeanour proceeding.

The taxpayers assessed the tax settlement institute as very positive, according to findings of the Tax Administration. Since July 2015, when the tax settlement institute was introduced in the tax inspection, a total of 361 settlements were concluded until 31 March 2016, by which HRK 103.3 million of newly established tax liabilities was collected. For comparative purpose, in the same period, a total of 2,248 tax inspections was conducted (without inspection of fiscalization) according to which the newly established tax liability amounts to HRK 918.2 million. The data show that tax settlement was concluded in 16% of tax inspections and that 11% of total tax liabilities was collected through tax settlement. It is estimated that the insolvency of taxpayers has an impact on the number of concluded tax settlements (according to the General Tax Act, tax liabilities are to be paid immediately or no later than 90 days after the settlement).

Administrative agreement

Amendments to the General Tax Act, which entered into force on 17 March 2015, allow the taxpayers to conclude an administrative agreement with the tax authority. This amendment was made in order to facilitate taxpayers to meet their tax obligations. The conclusion of administrative agreements enables rescheduling of taxpayers' overdue tax liabilities up to 24 monthly annuity, thus enabling easier management of cash flows to entrepreneurs, and the tax burden of citizens is distributed in a manner that is more aligned with their monthly income.

The taxpayers recognized this institute and continuously apply for the conclusion of administrative agreements with the tax authority.

eOvrha (eEnforcement)

For the purpose of effective and efficient management of tax debt, a platform called eOvrha (eEnforcement) was also developed. This Tax Administration's portal application creates databases of

debt situation and forms lists of debtors on a monthly basis. Lists of debtors formed in this way, along with the recommendations for handling, are distributed to officials responsible for the collection procedure. In this way, eOvrha (eEnforcement) reduces the impact of human factor in recognizing the need to take measures and significantly facilitates the timely treatment. This enables measures to also cover debts which were due in the previous month, i.e. the period of time that passes from taxable financial or property inflow is shorter and therefore the burden on taxpayers is lower than in subsequent periods in which positive financial effects are used up.

Non-tax levies

The Government of the Republic of Croatia undertakes significant steps to reduce fiscal and administrative burden. One of the priority areas is to reduce the level of non-tax levies.

In April 2015, the Government adopted the Decision on the Reduction of Para-Fiscal Levies in 2015 and reduction objectives in 2016 and the establishment of the Commission for monitoring of implementation of the reduction of para-fiscal levies. The Commission's task was to draw up a list of para-fiscal levies to be reduced during 2016 in the amount of no less than 0.1% of GDP, i.e. additional HRK 330 million.

The first Register of Non-Tax Revenues was created in 2008. In early 2013, the Government adopted the Decision on the Establishment of the Working Group for Business Climate and Private Investment, whose objective, among other things, was to establish the Register of Para-Fiscal Levies and reduction/abolition thereof in order to unburden entrepreneurs. IT support to the said Register was established in October 2014. The objective of the Register's establishment was to determine non-tax levies that burden entrepreneurs' business and identify the opportunities for their reform, as well as the reduction or elimination of such burden, in a way that will not compromise the performance of the functions of the state, local units and other users of these revenues. The Register of Non-Tax Levies was published on the website of the Ministry of Finance on 10 September 2015. The Register recorded 161 different non-tax levies. The total amount of non-tax levies at the end of 2015 amounted to HRK 8.4 billion. Of the said amount, HRK 5.4 billion burdened the business of entrepreneurs, while HRK 3 billion was paid by citizens. The number of non-tax levies in the Register is not final. The Register will be continuously amended on the basis of data from the relevant ministries. The total reduction/abolition in the period 2013-2015 amounted to HRK 683 million, and included the elimination of 65 non-tax levies (HRK 380.8 million in 2013 and 2014, HRK 302 million in 2015).

The re-establishment of the Commission for regulating the non-tax levies system and their reduction is planned by the end of April. The Minister of Finance will be the President of the Commission and government officials from ten ministries will be the members. The main task of the Commission will be to determine the list of non-tax levies to be abolished or reduced in the following period. In addition, the role of the Commission will be to preliminary control the draft legislation that proposes the introduction of new or increase of the existing non-tax levies. In this regard, the Commission will act preventively. Updates of the Register of Non-Tax Levies will also continue. By 3 May 2016, the relevant ministries are obliged to establish a list of non-tax levies, which will be reduced or abolished

in 2016, and to refer to the Government of the Republic of Croatia a proposal to repeal or amend the laws in this regard by 15 June 2016.

In order to increase the transparency of non-tax levies of public authorities, the obligation of publishing data on non-tax levies, including the workflow process of determining the obligations of collection of non-tax levies will be introduced. The subject information will be published on the websites of the holders of public authority.

6.3. Measures to improve the efficiency of budget expenditures

In order to improve the efficiency of expenditures and strengthen the management of public finances, the continuation of reform efforts is planned in the following areas: 1) rationalization of material expenditures; 2) activation of inactive state property; 3) implementation of the recommendations of the State Audit Office (SAO); 4) further strengthening of internal financial controls.

Rationalization of material expenditures

The Ministry of Finance has prepared an analysis of material expenses of all budgetary and extra-budgetary state budget users in order to rationalize and optimize material expenditures. In this regard, measures are defined for each group of material expenses that form an integral part of the Guidelines for the Establishment of Standard Material Costs for Budgetary and Extra-budgetary Users of the State Budget. Their purpose is to improve the management of material expenditures, primarily through the establishment of standards and their continuous monitoring.

The state budget for the period 2016-2018 takes into consideration the measures and standards provided within the aforementioned Guidelines. In April of this year, the Government of the Republic of Croatia adopted the Decision prescribing more restrictive conditions related to the use of official cars and mobile phones, as well as approving business trips and means of representation. In addition, central state administration bodies committed to prioritize the use of electronic mail in mutual official correspondence in order to reduce shipping costs. Moreover, by planned further investment in business premises in state ownership, the Government strives to achieve long-term savings on due rents. In the next period, the realization of savings that will result from the unified leadership and management of databases and information and communication infrastructures is expected.

Budgetary and extra-budgetary users are also obliged to regularly report to the Ministry of Finance on the success of the implementation of measures referred to in the Guidelines. In order to continuously monitor the efficiency of material expenditures management, expansion of the Statement of Fiscal Responsibility with questions on effective material expenditures management self-assessment, conducted by users is planned.

Activation of inactive assets

State property of the Republic of Croatia is managed by the State Office for State Property Management - SOSPM (stocks and equity shares in trading companies of strategic and special interest for the Republic of Croatia, apartments and business premises, land), Restructuring and Sale Centre (stocks and equity shares in trading companies whose holder is the Republic of Croatia, Croatian Pension Insurance Fund and State Agency for Deposit Insurance and Bank Rehabilitation, that are not defined as companies of strategic and special interest for the Republic of Croatia), as well as the company Državne nekretnine d.o.o. (apartments and business premises for rent or lease). The most important types of managed properties include apartments and business premises, stocks and equity shares, and former military properties. Because a satisfactory result in the sale of apartments have not been achieved yet, SOSPM will amend the Decision on Sale of Apartments in order to better define the criteria, simplify procedures and speed up due sales. SOSPM will consider models of achieving special credit lines for the purchase of apartments with commercial banks.

In order to achieve faster and more efficient sale of empty office spaces, SOSPM will amend the Sale of Business Premises Act and the necessary by-laws. SOSPM is currently also conducting the verification of available spaces in state ownership that could be used by business premises users who pay rent. Furthermore, there is a plan to intensify procedures conducted by bodies responsible for legal property issues relating to former military properties, as well as the issue of regional plan changes administered to further dispose of military properties.

In order to generate revenue from companies, SOSPM plans to amend the Act on Management and Disposition of the Property Owned by the Republic of Croatia in the part referring to such companies. In addition, SOSPM will also amend the Regulation on Sales of Stocks and Business Shares in order to accelerate and simplify sales procedures, since such procedures last nine months on average, with no certain outcome.

SOSOM will begin the analysis of the three-year business plan of strategic companies in order to assess their portfolios, redefine strategic companies and adopt a plan for the privatization of non-strategic companies.

Implementation of the State Audit Office (SAO) recommendations

One of the reform measures meant to increase the sustainability of public debt and strengthen the public finances management is a stricter implementation of the State Audit Office recommendations. This measure involves the adjustment of the legal framework regarding sanctioning failure to act upon the recommendations of the aforementioned Office. Namely, according to the last Report on the State Audit Office Activities in 2015, from the total of 2,599 issued orders and recommendations, as much as 760 orders and recommendations, i.e. 29.2% were not carried out. During 2015, the Ministry of Finance and the State Audit Office considered models of sanctions for failure to comply with the orders and recommendations issued by this Office. Since after several years of implementing the State Audit Office Act³³ certain shortcomings in its application were noted and

³³ Official Gazette no. 80/2011

possible improvements were identified, it was decided to enter an entirely new act into the adoption procedure. Accordingly, the Proposal of the State Audit Office Act was drafted.

The proposal of the aforementioned Act aims to:

- introduce sanctions for audited subjects and persons responsible for the failure to execute issued orders and recommendations and the failure to submit due reports within the prescribed period;
- define subjects of audit and the scope of audit process more clearly;
- extend the deadline for the submission of reports on the performed audit of annual report on the execution of state budget;
- introduce the possibility of recruiting special experts in the function of external associates competent to address specific issues;
- further explain obligations of the State Audit Office employees.

Further strengthening the internal financial control system

It is possible to highlight the following key features regarding the implementation of the new Public Internal Financial Control System Act, which was adopted in July 2015³⁴:

Reporting and planning activities in the area of internal control system are associated with the fiscal responsibility system. In September 2015, the existing Fiscal Responsibility Questionnaire was amended with questions on strategic and annual planning, the allocation of authorities and responsibilities for the implementation of strategic goals and budgeting, documenting data on the most important risks, the procedure for collecting revenues and the coordination of internal control system development between due ministries, counties, cities and budget users under its jurisdiction. Budget users are obliged to report on the current situation in these areas by submitting the Statement of Fiscal Responsibility for 2015 until 31 March 2016.

The internal audit function covers 99% of the total expenditures on state level and 85% of expenditures on the local level. Moreover, in the area of internal audit, the scope of audit of internal audit units structured in ministries, counties and cities was expanded to the companies and other legal persons under the jurisdiction of their institutions, when they are not obliged to establish their own internal audit units. This provided the coverage of audit activity in the next period for 69 companies owned by the Republic of Croatia and 272 companies owned by local governments. In the process of drafting annual internal audit plans for 2016, internal audit executives took into account the extension of the scope of activity and planned the performance of in the central institution and institutions in their jurisdiction based on a risk assessment plan. According to results of the analysis of the received annual internal audit activity plans for 2016, control process audits of institutions under their jurisdiction, especially at the local level, were represented in the highest percentage (35%). To this there is also need to add audits pertaining to granted subsidies, transfers and capital assistance (9%), and auditing processes pertaining to the management of assets and the collection of own revenues (24%).

³⁴ Official Gazette no. 78/2015

Pursuant to Article 44 of the Act, fines for those institutions that have not established an internal audit based on the criteria laid down in the Ordinance on Internal Audit adopted in 2013 are prescribed. By prescribing misdemeanour provisions, the resolution of the remaining six cases regarding the failure to establish internal audit was encouraged, namely, after the Act was adopted, internal audit was implemented by five budget users mainly from the local level, while the sixth remains in the process of creating formal conditions.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. Public debt management

Public debt, i.e. general government debt reached a level of HRK 289.7 billion or 86.7% of GDP at the end of 2015. This high level of public debt constitutes a big burden on overall economic policy and its associated risks highlight the vulnerability of public finances. Cyclic disruptions accompanied by structural rigidities showed the consequential extent and speed of public debt expansion in the period 2008-2014 when it increased by HRK 147 billion, or if measured as a share of gross domestic product - increased from 39.6% to 86.5%.

Recovering from a long-term economic recession during 2015 contributed to the efforts and effects of fiscal consolidation and consequently ended the long-term trend of excessive year over year increase of public debt's share in the GDP. In the short term, the current macroeconomic projections indicate the possibility of mitigating the refinancing risk and stabilization and reversal of this trend. However, the current high level of public debt requires the implementation of active policies for public debt management in order to ensure its long-term viability and to limit the negative effects of associated risks. The necessary leverages for active public debt management include regular formulation, publication and evaluation of public debt implementation strategy whose objectives are based on a cost and risk analysis, taking into account macroeconomic and market constraints.

The Ministry of Finance is drafting a Public Debt Management Strategy for the period 2016-2018, whose adoption by the Government is proposed in May 2016. The Strategy will define basic objectives and implementation methods for improving the sustainability of public debt and mitigation of associated risks. With detailed overviews of historical trends and the public debt structure, three-year projections and the principles for achieving the established funding plans, the aforementioned Strategy will identify implementation risks and the principles for mitigating such risks. Therefore, the main emphasis will be on addressing the underlying risks listed in the Report of the European Commission for Croatia 2016 (County Report Croatia 2016), which require improvement:

Legal and institutional framework for public debt management

The existing legal and institutional framework provided a relatively satisfactory implementation and control framework with the necessary flexibility at the central budget, extra-budgetary users and local units level. The framework needs to be expanded with effective control mechanisms at the level of public companies covered by the ESA 2010 methodological classification in public debt, in order to be able to define overall objectives and limits of fiscal policy.

Mitigation of refinancing risk and reducing the share of short-term debt in total public debt

The current level of public debt and the established structure of annual repayments create a significant refinancing need that comes close to 20% of GDP annually. The current favourable

conditions in the financial markets offer the possibility of extending the average debt maturity and balancing the maturity profile, while reducing the share of short-term debt in total public debt.

Mitigation of public debt currency risk

Although the domestic component is a prevalent part of the total public debt structure, its predominant portion (over 75%) is denominated or indexed in euro. This currency risk cannot be eliminated in the short term, but the conditions on the domestic capital market allow its partial mitigation since the volume, available maturity and price of HRK sources have provided adequate alternative denominated currency in the past 18 months. We expect a further growth of the HRK component in the total debt through primary issuance in the domestic market as well as the possibility of replacing a part of the existing currency instruments with HRK instruments, in case such preferences are adopted by financial institutions in terms of adapting to capital requirements pursuant to regulatory provisions.

Mitigation of interest rate risk of the public debt

Given the overall high level of indebtedness, a long-term increase in reference market interest rates would represent a substantial threat to fiscal sustainability and consequently generate a substantial public debt increase. In the short term, this threat is mitigated by the existing structure of interest rates in which more than 82% of long-term debt consists of instruments with fixed interest rates on the state budget debt level. Also, in the short term, current market conditions suggest a refinancing of maturities of current debt at a lower nominal interest rate. In the medium term, this risk can be mitigated by consistent implementation of sustainable fiscal policies and a consequent improvement of the state credit rating, and by reducing the existing high risk premium.

In addition to the analysis of the aforementioned public debt management risks, the Strategy will include a precise borrowing plan for the current year which will include planned dynamics and auction calendar, and medium term projections of the borrowing plan. Regular annual adoption and publication of the three-year strategy compliant with the convergence programme is scheduled for May of each year, preceded by the plan, dynamics and borrowing calendar that would be published after the adoption of the state budget.

In order to improve the management of public debt, increased volume and complexity of operative tasks, the Ministry of Finance will continuously work on strengthening the organizational capacity by filling systematized, and currently vacant job positions. Also, part of the operational activities that are currently performed by the public debt management sector, and which are not directly related to the public debt management activities, will be transferred to another organizational unit, thereby providing a substantial increase in the efficiency of existing facilities. Continuous additional training of existing employees will also be implemented where possible.

7.2. Proposal of the Fiscal Responsibility Act

The Fiscal Responsibility Act, which entered into force on 1 January 2011, introduced fiscal rules and rules for strengthening fiscal discipline, and the obligation of making Statements on the fiscal responsibility for heads of budget users at the state and local (regional) level. The initial fiscal rule envisaged the reduction of expenditures of the general budget, expressed in the share in the gross domestic product by at least one percentage point per year, until achieving the primary balance at the level of zero or a positive amount (in nominal amounts). In terms of severe recession and negative output gap, such rule additionally threatened the prospects of growth because of its procyclic nature. The alignment with EU requirements regarding the new framework for the management of economic policy in the EU, which is focused on strengthening the implementation of the Stability and Growth Pact, was an additional reason to change this rule.

Consequently, drafting of amendments to the Fiscal Responsibility Act was initiated in the second half of 2013, and the said amendments entered into force in February 2014. The Amendments to the Act changed the fiscal rule in such a way that the target value of the new fiscal rule became a medium-term budgetary objective, which will be realized according to the adjustment plan.

On this occasion, a professional and independent body for monitoring the implementation of the fiscal rule was also introduced, whose duties were defined by the special regulation. The Fiscal Policy Board was founded in 2011 by the decision of the Croatian Government on the Establishment of the Fiscal Policy Board, and the members of the Board were also appointed by the decision of the Croatian Government. Due to the need to strengthen the independence of the Board in accordance with the provisions of the Council Directive 2011/85/EU and to strengthen the role of the Board as a supervisor over the implementation of the Fiscal Responsibility Act, the Croatian Parliament adopted the Decision to establish the Fiscal Policy Committee as the second working body of the Croatian Parliament. The Fiscal Policy Committee (hereinafter: The Committee) of the Croatian Parliament replaced the previous Fiscal Policy Board. The members of the Committee, apart from the President of the Committee, were appointed for a period of five years by the Croatian Parliament at the end of February 2014, on the proposal of the Committee for Finance and State Budget.

The drafting of the new Fiscal Responsibility Act was initiated in the second half of 2014, on the basis of specific recommendation number 1 of the Council of the EU to the Republic of Croatia and the need for further alignment with the requirements of the Stability and Growth Pact and the Council Directive 2011/85/EU. The reasons for the revision of the Fiscal Responsibility Act include the need to: 1) revise the fiscal rule; and 2) further strengthen the independence and extend the authorities of the Committee. After a series of consultations carried out with the competent services of the EC, the drafting of the final version of the new proposed Act is currently in progress, and adoption thereof is planned in the third quarter of this year. The new draft Act includes several innovations related to the aforementioned two aspects.

Fiscal rule

The new Proposal of the Act amends the fiscal rule. The target value of the new fiscal rule becomes a medium-term budgetary objective to be realized according to the adjustment plan, on the recommendation of the Council of the EU, whereby interannual improvement of the structural balance must be in accordance with the provisions of the Stability and Growth Pact. Along with the deficit rule, the rule on public debt is also introduced stipulating that the public debt which exceeds the reference rate of 60% must be reduced in average by 1/20 of the amount above 60% of BDP per year, in accordance with the Stability and Growth Pact. In addition, the Act will more closely define the circumstances which allow temporary derogation from the application of fiscal rules, if this does not endanger the fiscal sustainability in the medium term, and based on the legal provisions of the EU. This Proposal of the Act also provides the introduction of a temporary fiscal rule for the duration of the Excessive Deficit Procedure, whose fulfilment is associated with the adherence to the Recommendations of the Council of the EU in order to correct this deficit. In general, the new Proposal provides assurance of complete alignment of national numerical fiscal rules with the legislative framework of the EU.

Independent body for monitoring of the implementation of the Fiscal Responsibility Act

The new proposal of legal solution is made in order to ensure adequate protection of political, financial and functional independence of the Committee and to create all necessary prerequisites for the calculation of fiscal rules, as well as to consider the macroeconomic and budgetary projections of the Government by the said Committee. The new provisions of the Act establish the basis for the appointment of members of the Committee, thus strengthening the legal framework of the Committee's work and providing it with an even stronger role of a supervisor over the implementation of the Fiscal Responsibility Act and over the implementation of fiscal policy in the entire country, with the aim of improving the public finance system.

The most important proposed amendments in relation to the currently valid Fiscal Responsibility Act in this regard are:

Change of the definition of the Fiscal Policy Committee

The Committee is defined as a permanent, independent and autonomous state body which acts within its scope of work, whose responsibilities are established by the Proposal. A new provision of the Act was introduced, prohibiting any form of influence on the work of the Committee, which could jeopardize its independence and autonomy in decision-making.

Composition and appointment of the Committee

It is anticipated that the Committee consists of the President of the Committee and six members who are elected for a term of five years. Members of the Committee are nominated by same institutions as before (State Audit Office, Zagreb Institute of Economics, Institute of Public Finance, the Croatian National Bank, Economic and Law Faculties). A representative of the Croatian Bureau of Statistics is additionally included. The novelty provided in the procedure for appointing members of the Committee is that the institutions nominate their representatives to the Committee for Finance and

State Budget of the Croatian Parliament, which checks their professional qualifications and other requirements stipulated by the Fiscal Responsibility Act and proposes their appointment to the Croatian Parliament.

The function of the President becomes a professional function

The Members of the Committee elect the President and Vice President among themselves. The function of the President is envisaged as a professional function, by providing the following prerequisites:

- The President of the Committee shall be entitled to regular wage.
- The President of the Committee cannot participate in political activities, hold any other public duty or be employed by other public authority or a company or other business entity, nor may he engage in any activities other than those specified in the Fiscal Responsibility Act.
- The President of the Committee has the right to return to the job he was working on before the election or to other appropriate jobs with the employer for whom he has worked before he was elected to this duty.
- Before taking up his duties, the President shall conclude an agreement on the right to return to his work position with his employer, which will specify the terms and conditions of exercising the right to return to work.
- General labour regulations shall appropriately apply to the President of the Committee.

Professional Service of the Committee - Office of the Committee

Additionally, it is provided that the Committee shall have a professional service - Office of the Committee, which performs professional, administrative and technical tasks for the Committee. The Office is managed by the Secretary who directs and coordinates its activities and is responsible for the operation of the Office to the Committee. The employees of the professional service and the Secretary are civil servants. In this way, the Committee is provided with the necessary resources for the calculation of fiscal rules and consideration of the macroeconomic and budgetary projections of the Government, as well as carrying out other tasks stipulated by the Fiscal Responsibility Act.

7.3. Proposal of Amendments to the Budget Act

Amendments to the Budget Act will be implemented during 2016 with a view to strengthen the medium-term budgetary framework, which also represents one of the recommendations of the Council of the EU.

Introduction of adjustment mechanism for fiscal rule on deficit

In order to ensure fiscal discipline, it was necessary to ensure the medium-term budget framework that will enable the achievement of sustainable public finances. The latest amendments to the

Budget Law, in Article 12, stipulate the new fiscal rule determining that deficit established by the budget for the next fiscal year must not exceed the deficit established by projection adopted by the Croatian Parliament, or representative body of local units, during the previous year for that fiscal year. Since the said rule provides no exceptions to its application, in unexpected situations, such as sudden economic slowdown, it would be hard to implement this rule and its implementation would be very difficult. That is why the amendments to the legislative framework will introduce an adjustment mechanism to be applied in specific and explicitly mentioned situations.

Revision of the strategic planning process

The Act on Amendments to the Budget Act³⁵ aligns the budget process in the Republic of Croatia with the European Semester, since Croatia, as EU Member State, is obliged to annually adopt two key documents - the Convergence Programme and the National Reform Programme. Strategic plans prepared by the obliged entities on the basis of the Instructions on the Preparation of Strategic Plans for the period 2016-2018, as a first step in the budgeting process, were no longer the basis for the development of the Strategy of Government Programmes for a three-year period because the preparation of the said Strategy is no longer required as of 2015. However, certain modifications of this process will be considered in order to shape the strategic plans as a solid basis for development of national strategic documents in the process of the European Semester. In this regard, the strategic plans must be adapted in order to, among other things, include the presentation of reform measures in the same manner as required by the National Reform Programme. The timeline of the process of national strategic planning needs to be adapted to the pace of preparation of the National Reform Programme. These efforts to simplify and strengthen the process of national strategic planning could also result in termination of semi-annual and annual reporting on the implementation of strategic plans since the objectives and performance indicators defined in the strategic plan would be translated into the financial plan, which would provide a unified mechanism for monitoring their implementation. In this way the semi-annual and annual reporting on the execution of financial plans will also include reports on the implementation of strategic plans. Thus current reporting on implementation of strategic plans becomes redundant.

Strengthening the medium-term budgetary framework

In order to strengthen the medium-term budgetary framework, amendments to the Budget Act of 2015 introduced the so called dual limits in the budget planning process. One limit shall be determined depending on the means necessary for implementation of existing programmes or activities (resulting from the currently applicable regulations), and other depending on the means necessary for implementation of new or amendment to existing programmes or activities. The costs of implementing current programmes include the costs of maintaining the existing level of service, taking into account expected changes in the number of users and, for example, ongoing costs of capital projects, which will be completed during the planned period. The costs of new programmes

³⁵ Official Gazette no. 15/2015

include, for example, the costs of changes in the level and types of services (e.g. introduction of stay for children in schools).

When drafting amendments to the Budget Act, the introduction of one and/or more new measures will be considered with the aim to strengthen the medium-term budgetary framework, such as changes in adopted projections with mandatory detailed explanation of reasons for such changes.

Evaluation of the effects of budget programmes, activities and projects

Taking into account the experience of 2014 and 2015 in carrying out in-debt analysis of expenditures for employees, subsidies, health care system, business agencies, institutes, funds and other legal entities with public authorities and tax expenditures, there is a need for continued use of these and similar tools that could contribute not only to reduction of overall public spending and fiscal consolidation, but also in ensuring a good system for setting priorities regarding expenditures, and creating fiscal space for new quality programmes, activities and projects. Amendments to the Budget Act would ensure determination of annual obligations to implement an ex-post evaluation of the effects of selected programmes, activities and/or projects in the State Budget. Evaluation will become an essential part of the strategic planning cycle. Evaluation results may show that some programmes have achieved their objectives or that additional investments will not affect their efficiency. This can be the basis for changes in the existing legislative framework, but also for development of new programmes.

Amendments to the Budget Act should prescribe the framework for evaluating the effects of selected programmes, activities or projects in the State Budget on an annual basis, including: criteria for selection of programmes, activities or projects for evaluation, institutions that would carry out such evaluation, the terms of implementation and ways to take evaluation results into account in the drafting of the State Budget.

7.4. Fiscal statistics

Extra-budgetary users of the State Budget listed in the Register of Budgetary and Extra-Budgetary Users are determined based on the coverage of general government, which is defined by the International Monetary Fund, and partially taken coverage in accordance with the European statistical methodology. The European Statistical Methodology ESA 2010, stipulated by the Regulation (EU) no. 549/2013 of the European Parliament and of the Council, contains specific rules for classifying units in institutional sectors of society, including the general government sector with its sub-sectors (primarily the central government and local government). All statistical reports must be submitted, according to the scope of the said sectors, to Eurostat as the statistical authority of the EC, including the Fiscal Report which monitors the fulfilment of the criteria for national deficit and debt pursuant to Maastricht. This statistical coverage of the general government sector and its sub-sectors in most EU countries is not identical to the coverage which is used for budget purposes.

However, the aim is to make such coverage as similar as possible, because, for example, the difference in indicators resulting from the difference of sectorial coverage must be quantified in the Fiscal Report.

The most significant differences in the budgetary system of the Republic of Croatia are found in the coverage of extra-budgetary users, which is, according to the Register of Budgetary and Extra-Budgetary Users, significantly narrower than sectorial coverage. In order to align the coverage of extra-budgetary users from the Register with the sectorial classification to the maximum extent possible, amendments to the Budget Act³⁶ expanded the definition of extra-budgetary users. Accordingly, extra-budgetary users are extra-budgetary funds, companies and other legal entities, in which the state or local government unit has a decisive influence on the management and which, in accordance with the rules of the EU statistical methodology, are classified in the general government sector, but do not fall within budgetary users.

With extra-budgetary users defined in such way, the Budget Act stipulates compulsory application of budget accounting in part regarding the preparation and submission of financial reports. Depending on their legal form and business requirements, extra-budgetary users can apply the entrepreneurial accounting or non-profit accounting, as well as budgetary accounting. In cases in which extra-budgetary users apply entrepreneurial accounting or non-profit accounting, for the purposes of reporting, business transactions need to be expressed in accordance with the rules of budgetary accounting. Due to the specific accounting events of extra-budgetary users classified in general government sector, it was established that the said process is extremely complex and requires more time than originally envisaged.

Namely, it is necessary to access each extra-budgetary user individually and define the method of expressing each specific business transaction through creation of binding tables.

Therefore, the Ministry of Finance plans to establish a working group whose members will be experts from academic community, accounting experts specialized in budgetary accounting and accounting experts specialized in enterprise accounting. The task of the working group will be to prepare bridge tables for individual extra-budgetary users with a particular emphasis on business events such as warranties, write-offs, etc., which make the conversion process even more demanding. This will strengthen the statistical reporting in accordance with ESA 2010, but also create the foundations for better budgetary planning in the medium term.

³⁶Official Gazette nos. 87/2008, 136/2012 and 15/2015

ANNEXES

Annex 1a Macroeconomic prospects

	ESA Code	2015 (level)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)	2018 (rate of change)	2019 (rate of change)
1. Real GDP	B1*g	333,832	1.6	2.0	2.1	2.3	2.5
2. Nominal GDP	B1*g	334,219	1.8	3.0	3.4	3.8	4.2
Components of real GDP							
3. Private consumption expenditure¹	P.3	199,255	1.2	1.8	1.8	2.0	2.5
4. Government consumption expenditure	P.3	65,529	0.6	0.3	0.8	1.4	2.0
5. Gross fixed capital formation	P.51	63,617	1.6	2.5	3.2	3.5	4.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	-2,752	-0.8	-0.8	-0.7	-0.6	-0.7
7. Exports of goods and services	P.6	165,917	9.2	5.2	5.5	5.6	5.4
- of which goods	P.61	83,406	12.1	7.1	6.8	6.7	6.8
- of which services	P.62	82,511	6.4	3.2	4.1	4.5	4.1
8. Imports of goods and services	P.7	157,734	8.6	4.7	5.3	5.9	6.3
- of which goods	P.71	133,491	8.8	4.9	5.4	5.9	6.3
- of which services	P.72	24,244	7.4	4.1	5.0	5.9	6.1
Contribution to real GDP growth							
9. Final domestic demand		328,401	1.2	1.6	1.8	2.1	2.7
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-2,752	0.0	0.1	0.1	0.1	-0.1
11. External balance of goods and services	B.11	8,183	0.5	0.3	0.3	0.1	-0.2

Note: GDP and all of its components expressed in real terms are in constant previous year prices, HRK million.

¹ Includes spending of non-profit institutions that serve households.

Source: CBS, MF

Annex 1b Price trends

	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)	2018 (rate of change)	2019 (rate of change)
1. GDP deflator	0.1	1.0	1.2	1.5	1.7
2. Private consumption deflator¹	-0.5	0.1	1.4	1.6	1.8
3. CPI²	-0.5	0.1	1.4	1.6	1.7
4. Public consumption deflator	0.4	0.5	0.9	1.3	1.6
5. Investment deflator	0.4	1.0	1.7	1.8	1.8
6. Export price deflator (goods and services)	-0.5	0.6	1.2	1.5	1.7
- of which goods	-2.4	-0.5	0.7	1.2	1.5
- of which services	1.3	1.7	1.8	1.9	1.9
7. Import price deflator (goods and services)	-1.2	-0.7	1.5	1.7	1.8
- of which goods	-1.4	-1.0	1.5	1.7	1.8
- of which services	-0.1	1.0	1.6	1.8	1.8

¹ Includes spending of non-profit institutions that serve households.

² Inflation is measured by the consumer price index.

Source: CBS, MF

Annex 1c Labour market developments

	ESA Code	2015 (level)	2015 (rate of change)	2016 (rate of change)	2017 (rate of change)	2018 (rate of change)	2019 (rate of change)
1. Employment, persons¹		1,601,620	1.7	1.1	1.4	1.6	1.5
- of which, employees		1,345,070	1.8	1.3	1.6	1.7	1.5
- of which, self-employed		256,550	1.1	-0.5	0.4	1.1	1.6
2. Employment, hours worked		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)²		16.3	16.3	15.5	14.5	13.5	12.8
4. Labour productivity, persons³		200,175	0.0	0.9	0.7	0.7	0.9
5. Labour productivity, hours worked		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Unit labour cost			-0.5	0.6	1.3	1.4	1.4
7. Compensation of employees⁴	D.1	158,488	1.3	2.9	3.6	3.8	3.9
8. Compensation per employee		117,828	-0.5	1.5	1.9	2.1	2.3

¹ Domestic concept of national accounts definition.

² According to the ILO methodology.

³ Real GDP in constant previous year prices (2010=100), per person employed.

⁴ Data for 2015 level is in HRK million.

Source: CBS, Eurostat, MF

Annex 1d Sectorial balances

	ESA Code	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	5.6	4.9	5.2	5.3	4.9
<i>of which:</i>						
- Balance on goods and services		2.8	3.6	3.7	3.6	3.2
- Balance of primary incomes and transfers		2.4	0.4	0.5	0.6	0.5
- Capital account		0.4	0.9	1.1	1.2	1.3
2. Net lending/borrowing of the private sector	B.9	7.8	6.3	5.9	5.5	4.5
3. Net lending/borrowing of general government	EDP B.9	-3.2	-2.6	-2.0	-1.6	-1.0
4. Statistical discrepancy		1.0	1.3	1.4	1.4	1.4

Source: CBS, MF

Annex 2a General government budget

	ESA Code	2015 (level, HRK billion)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-10.7	-3.2	-2.6	-2.0	-1.6	-1.0
2. Central government	S.1311	-10.7	-3.2	-2.5	-2.1	-1.7	-1.1
3. State government	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	0.6	0.2	-0.1	0.0	0.1	0.1
5. Social security funds	S.1314	-0.6	-0.2	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	146.1	43.7	44.1	43.7	43.7	43.1
7. Total expenditure	TE ¹	156.8	46.9	46.8	45.7	45.3	44.2
8. Net lending/borrowing	EDP B.9	-10.7	-3.2	-2.6	-2.0	-1.6	-1.0
9. Interest expenditure	EDP D.41	11.9	3.6	3.5	3.5	3.4	3.3
10. Primary balance ²		1.2	0.4	0.9	1.4	1.8	2.3
11. One-off and other temporary measures ³		0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		85.1	25.5	25.2	24.9	24.6	24.3
12a. Taxes on production and imports	D.2	65.3	19.5	19.4	19.2	19.0	18.8
12b. Current taxes on income, wealth, etc	D.5	19.8	5.9	5.7	5.7	5.6	5.6
12c. Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	39.8	11.9	11.8	11.6	11.4	11.2
14. Property income	D.4	3.8	1.1	1.2	1.1	1.1	1.0
15. Other ⁴		17.4	5.2	6.0	6.1	6.6	6.6
16=6. Total revenue	TR	146.1	43.7	44.1	43.7	43.7	43.1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) ⁵		124.9	37.4	36.9	36.5	36.0	35.5
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	65.1	19.5	19.0	18.6	18.3	18.0
17a. Compensation of employees	D.1	38.1	11.4	11.2	11.0	10.8	10.5
17b. Intermediate consumption	P.2	26.9	8.1	7.8	7.6	7.6	7.4
18. Social payments (18=18a+18b)		54.8	16.4	16.2	16.0	15.7	15.5
of which Unemployment benefits ⁶		1.5	0.5	0.4	0.4	0.4	0.4
18a. Social transfers in kind supplied via market producers	D632	7.5	2.2	2.3	2.3	2.4	2.5
18b. Social transfers other than in kind	D.62	47.3	14.2	14.0	13.7	13.4	13.1
19=9. Interest expenditure	EDP D.41	11.9	3.6	3.5	3.5	3.4	3.3
20. Subsidies	D.3	5.6	1.7	1.6	1.5	1.3	1.2
21. Gross fixed capital formation	P.51	9.4	2.8	3.4	3.8	3.8	3.8
22. Capital transfers	D.9	3.3	1.0	1.1	1.0	1.3	1.1
23. Other ⁷		6.7	2.0	1.9	1.4	1.4	1.2
24=7. Total expenditure	TE ¹	156.8	46.9	46.8	45.7	45.3	44.2
p.m.: Government consumption (nominal)	P.3	64.8	19.4	19.0	18.7	18.4	18.3

Source: CBS, MF

Annex 2b No-policy change projections

	2015 (level, HRK billion)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)
1. Total revenue at unchanged policies	146.1	43.7	43.7	43.3	43.3	42.7
2. Total expenditure at unchanged policies	156.8	46.9	47.4	46.4	45.9	44.8

Source: CBS, MF

Annex 2c Amounts to be excluded from the expenditure benchmark

	2015 (level, HRK billion)	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)
1. Expenditure on EU programmes fully matched by EU funds revenue	5.4	1.6	2.5	2.8	3.6	3.6
2. Cyclical unemployment benefit expenditure ¹	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Effect of discretionary revenue measures ²	2.0	0.6	0.4	n.a.	n.a.	n.a.
4. Revenue increases mandated by law	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: CBS, MF

Annex 4 General government debt

	ESA Code	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)
1. Gross debt ¹		86.7	85.9	84.7	82.8	80.0
2. Change in gross debt ratio		0.1	-0.7	-1.2	-1.9	-2.8
Contributions to changes in gross debt						
3. Primary balance ²		0.4	0.9	1.4	1.8	2.3
4. Interest expenditure ³	EDP D.41	3.6	3.5	3.5	3.4	3.3
5. Stock-flow adjustment*		-3.1	-3.4	-3.3	-3.5	-3.8
<i>of which:</i>						
- Differences between cash and accruals ⁴						
- Net accumulation of financial assets ⁵		0.0	0.8	0.4	0.4	0.5
<i>of which:</i>						
- privatisation proceeds		0.0	0.5	0.4	0.4	0.5
- Valuation effects and other ^{6*}			0.3			
p.m.: Implicit interest rate on debt⁷		4.2	4.2	4.2	4.2	4.2
Other relevant variables						
6. Liquid financial assets ⁸						
7. Net financial debt (7=1-6)		86.7	85.9	84.7	82.8	80.0
8. Debt amortization (existing bonds) since the end of the previous year		4.1	1.0	5.5	3.2	4.5
9. Percentage of debt denominated in foreign currency		78.6				
10. Average maturity			-	-	-	-

*Change in deposits

Source: CNB, CBS, MF

Annex 5 Cyclical trends

	ESA Code	2015 (% of GDP)	2016 (% of GDP)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)
1. Real GDP Growth (%)		1.6	2.0	2.1	2.3	2.5
2. Net Lending of general government	EDP B.9	-3.2	-2.6	-2.0	-1.6	-1.0
3. Interest expenditure	EDP D.41	3.6	3.5	3.5	3.4	3.3
4. One-off and other temporary measures¹			0.3			
5. Potential GDP growth (%)		0.6	0.8	1.0	1.2	1.3
contributions:						
- labour		0.3	0.2	0.2	0.2	0.2
- capital		0.6	0.6	0.6	0.7	0.8
- total factor productivity		-0.3	-0.1	0.1	0.2	0.3
6. Output gap		-3.0	-1.9	-0.7	0.3	1.4
7. Cyclical budgetary component		-1.4	-0.9	-0.3	0.2	0.7
8. Cyclically-adjusted balance (2 - 7)		-1.8	-1.8	-1.7	-1.8	-1.7
9. Cyclically-adjusted primary balance (8 + 3)		1.8	1.8	1.8	1.7	1.6
10. Structural balance (8 - 4)		-1.8	-1.5	-1.7	-1.8	-1.7

¹ A plus sign means deficit-reducing one-off measures.

Source: CBS, MF

Annex 6 Divergence from the previous programme

	ESA Code	2015	2016	2017	2018	2019
Real GDP growth (%)						
Previous update		0.4	1.0	1.2	1.5	n.a.
Current update		1.6	2.0	2.1	2.3	2.5
Difference		1.3	1.0	1.0	0.8	n.a.
General government net lending (% of GDP)						
Previous update	B.9	-5.0	-3.9	-2.7	-2.4	n.a.
Current update		-3.2	-2.6	-2.0	-1.6	-1.0
Difference		1.8	1.3	0.7	0.8	n.a.
General government gross debt (% of GDP)						
Previous update		89.8	92.0	92.5	92.4	n.a.
Current update		86.7	85.9	84.7	82.8	80.0
Difference		-3.1	-6.1	-7.8	-9.6	n.a.

Source: CBS, MF

Annex 7 Long-term sustainability of public finances

	2013 (% of GDP)	2020 (% of GDP)	2030 (% of GDP)	2040 (% of GDP)	2050 (% of GDP)	2060 (% of GDP)
Total expenditure						
Of which: age-related expenditures						
Pension expenditure	10.9	10.3	9.6	7.9	7.2	7.0
Social security pension	1.7	1.9	2.2	2.0	1.9	1.9
Old-age and early pensions	5.1	5.8	5.6	4.3	3.8	3.7
Other pensions (disability, survivors)	4.1	2.6	1.8	1.6	1.5	1.4
Occupational pensions (if in general government)						
Health care	5.7	7.3	8.2	8.1	7.7	7.7
Long-term care (this was earlier included in the health care)	0.4	0.4	0.5	0.5	0.5	0.5
Education expenditure	3.7	3.5	3.4	3.2	3.3	3.4
Other age-related expenditures						
Interest expenditure						
Total revenue						
Of which: property income						
Of which: from pensions contributions (or social contributions if appropriate)	5.9	5.9	5.6	5.6	5.6	5.6
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
Systemic pension reforms¹						
Social contributions diverted to mandatory private scheme ²	1.6	1.6	1.9	1.9	1.9	1.9
Pension expenditure paid by mandatory private scheme ³	0.0	0.0	0.3	0.8	1.3	1.6
Assumptions						
Labour productivity growth	0.5	1.4	1.8	2.2	2.0	1.5
Real GDP growth	-1.0	1.5	1.5	1.8	1.4	1.0
Participation rate males (aged 20-64)	73.6	72.9	72.4	72.7	73.0	73.2
Participation rates females (aged 20-64)	63.4	65.0	66.5	67.3	67.1	67.3
Total participation rates (aged 20-64)	68.5	68.9	69.4	70.0	70.1	70.3
Unemployment rate	16.9	12.9	9.8	7.1	7.1	7.1
Population aged 65+ over total population	18.3	20.7	24.2	26.3	28.4	29.6

Source: Ministry of Labour and Pension System, Croatian Institute for Health Insurance, AWG

Annex 7a Contingent liabilities

	2015 (% of GDP)	2016 (% of GDP)
Public guarantees	2.3	n.a.
Of which: linked to the financial sector	n.a.	n.a.

Source: CBS, MF

Annex 8 Basic assumptions

	2015	2016	2017	2018	2019
Short-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.1	1.1	1.1	1.1	1.1
Nominal effective exchange rate, % change (for countries not in euro area or ERM II)	3.4	0.8	0.0	0.0	0.0
exchange rate vis-vis the € (annual average)	7.61	7.65	7.65	7.65	7.65
World excluding EU, GDP growth	3.2	3.6	3.8	n.a.	n.a.
EU GDP growth	1.9	1.9	2.0	n.a.	n.a.
Growth of relevant foreign markets	4.1	4.7	5.2	5.4	5.4
World import volumes	3.0	4.3	4.8	4.8	4.7
Oil prices (USD/barrel)¹	50.8	42.0	48.2	52.5	56.1

¹ Average U.K. Brent, Dubai, and West Texas Intermediate, equally weighted.

Source: EC, IMF, MF