REPUBLIC OF CROATIA

CONVERGENCE PROGRAMME OF THE REPUBLIC OF CROATIA FOR THE PERIOD 2018-2021

APRIL 2018

Foreword

At its session on April 26 2017, the Government of the Republic of Croatia adopted the Convergence Programme of the Republic of Croatia for 2018. This is the fifth Convergence Programme drafted by the Republic of Croatia as a Member State of the European Union (hereinafter referred to as: EU). 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 a part of the annual cycle of the European Semester, within which each Member State submits its strategic documents to the European Commission by the end of April. This is followed by an economic dialogue, drafting and adoption of country-specific recommendations and the practical implementation thereof. This 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 is characterized by the continuation of positive macroeconomic and fiscal trends. Thus, in 2017, the positive trends in economic activity, which began in 2015 after a six-year recession period, continued. Real GDP growth amounted to 2.8%, primarily stimulated by domestic demand.

The implemented fiscal consolidation and results achieved in 2016 were fundamental when deciding about the Republic of Croatia exiting the excessive deficit procedure in June 2017. In 2016, budget deficit was reduced to 0.9% of GDP, while at the same time, not only was the growth in public debt halted but also, for the first time in 2016, the public debt was nominally decreased by HRK 2.5 billion and it amounted to HRK 281.7 billion, i.e. 80.6% of GDP, whereby its share in GDP was reduced by 3.2 percentage points.

According to the data of the Croatian Bureau of Statistics (CBS), as a result of favourable macroeconomic trends due to the implemented tax reform on one hand, and rational budget spending on the other hand, in 2017, the surplus of the general government budget was realized for the first time according to the European statistical methodology, ESA 2010, in the amount of HRK 2.8 billion or 0.8% of GDP, while at the same time, the share of public debt in GDP was additionally decreased by 2.7 percentage points, i.e. to the level of 78% of GDP. With this, in the last two years, the share of public debt in GDP was decreased by 5.9 percentage points, while the savings on interests amounted to HRK 2 billion.

Such positive trends, primarily the decrease in the public debt and improved fiscal position and the improvement of the perception of the Republic of Croatia, were also recognized by international financial institutions and rating agencies. After the credit rating was lowered two times in the period from 2012 to 2015, there has been a shift made within the public finances from the situation of large budget deficits and significant increase in public debt, so in January this year the Fitch Agency raised the credit rating of the Republic of Croatia, as well as Standard & Poor's (S&P) in March, which happened for the first time since 2004.

Positive trends are expected in the medium-term period. In 2018, real growth of gross domestic product of 2.8% is expected, which will then slightly slow down to 2.7% in 2019 and 2.5% in 2020 and 2021. This slowing-down in the projection period is the result of the convergence of GDP growth towards the potential GDP growth in the medium-term period.

The continuation of the implementation of the responsible fiscal policy, which has led to the big progress in relatively short time period, remains the priority of the Government of the Republic of Croatia. In that regard, in the following years, the trends in budget balance and public debt will be aligned with the provisions of the preventive part of the Stability and Growth Pact, which the Republic of Croatia is obliged to adhere to after exiting the Excessive Deficit Procedure. This means that by 2020, the Republic of Croatia will have a balanced budget, i.e. it will realize a surplus of 0.5% of GDP in 2021.

Therefore, in the forthcoming medium-term period, the fiscal policy of the Republic of Croatia will be determined by the efforts for the purpose of further strengthening of fiscal sustainability and stimulating economic growth and development while providing adequate care for the citizens of the Republic of Croatia. In doing so, the key emphasis will be on the strict control of budget spending and use of every surplus of revenues in relation to the planned ones for further reduction of public debt and tax unburdening of citizens and enterprises.

In line with these positive trends, the Government of the Republic of Croatia will continue with the activities directed towards the implementation of reforms the goal of which is to strengthen the long-term potential of the Croatian economy, revival of the convergence and the continuation of the decrease in macroeconomic imbalances. The preconditions for stronger and long-term sustainable growth of the Croatian economy and real convergence will be created by structural reforms directed towards the strengthening of the competitiveness of the economy, towards the increase in employment and linking of the education with the labour market, and towards the provision of sustainability of public finances, described in more details in the 2018 National Reform Programme, as well as by the continuation of the current prudential fiscal policy.

2. MACROECONOMIC TRENDS

The macroeconomic framework described in the following chapters was drafted in April of this year.[1] The external assumptions for the preparation of macroeconomic projections are taken from the latest projections of the International Monetary Fund[2], EC[3] and EIU[4]. The projections of international environment in the medium-term period experienced positive corrections and are exceptionally favourable. Following 3.8% in 2017, it is anticipated that the growth of the world economy will amount to 3.9% in 2018 and 2019, and 3.8% in 2020 and 2021. The growth of the world trade amounted to 4.9% in 2017, while in 2018 it is expected to accelerate to 5.1% and then to gradually slow down by the end of the projection period. In comparison to previous projections, the expectations of the world economic growth have slightly increased, while the projections of the growth of the world trade to significantly higher levels, particularly in the first years of the projection period. It is expected that financial conditions will remain exceptionally favourable during 2018 and 2019, whereby the faster normalization of interest rates in the USA is anticipated than previously forecast, while the monetary policy of the European Central Bank will remain accommodative so the short-term interest rates will stay negative until 2019. In the rest of the projection period, we expect a slight increase in interest rates, but they will still remainat relatively low levels. Average exchange rate of euro against US dollar is expected at the level of 1.23 USD/EUR throughout the whole projection period, which represents the strengthening of euro against dollar of 8.8% in 2018. In 2018, the continuation of the increase in the price of oil on global markets is expected, along with the slight slowing-down of the increase in the prices of primary raw materials excluding oil. In the remaining years of the projection period, the prices of oil are expected at lower levels, while the price of primary raw materials without oil will stagnate.

2.1. Gross Domestic Product

During 2017, positive trends in economic activity which started in 2015 after the six-year recession period, continued. The real growth of gross domestic product (hereinafter referred to as: GDP) amounted to 2.8%[5], primarily stimulated by domestic demand, while the contribution of net foreign demand was negative. In the medium-term, the continuation of positive trends is expected. In 2018, it is anticipated that the real growth of gross domestic product will amount to 2.8%, which will then slightly slow down to 2.7% in 2019 and 2.5% in 2020 and 2021. This slow-down in the projection period is the result of the convergence of GDP growth towards the potential GDP growth in the medium-term period. Economic growth will be based, throughout the whole projection period, solely on the contribution of the domestic demand, while the contribution of net foreign demand will be

[1] Based on the data available by April 20, 2018.
[2] World Economic Outlook, April 2018.
[3] Spring 2018 forecast assumptions.
[4] The Economist Intelligence Unit, April 2018.
[5] Data on gross domestic product for 2016 and 2017 are preliminary.

slightly negative in the whole projection period, although it will gradually decrease towards the end of the period.

Table 2.1: Projection of Gross Domestic Product

	2017	2018 forecast	2019 forecast	2020 forecast	2021 forecast
GDP - real growth (%)	**2.8**	**2.8**	**2.7**	**2.5**	**2.5**
Personal consumption	3.6	2.9	2.8	2.6	2.5
Government consumption	2.0	2.2	2.2	1.8	1.5
Gross fixed capital formation	3.4	6.7	6.3	5.6	5.2
Exports of goods and services	6.1	5.3	5.2	4.9	4.7
Exports of goods	8.7	7.3	7.1	6.4	6.1
Exports of services	3.8	3.6	3.5	3.5	3.4
Imports of goods and services	8.1	7.4	6.8	6.0	5.7
Imports of goods	7.5	7.0	6.7	6.0	5.7
Imports of services	11.2	9.1	7.4	6.1	5.7
Contribution to real GDP growth (percentage points)	**2.8**	**2.8**	**2.7**	**2.5**	**2.5**
Personal consumption	2.0	1.7	1.6	1.5	1.4
Government consumption	0.4	0.4	0.4	0.4	0.3
Gross fixed capital formation	0.7	1.3	1.3	1.2	1.1
Changes in inventories	0.4	0.1	0.1	0.0	0.1
Exports of goods and services	3.0	2.7	2.7	2.6	2.6
Imports of goods and services	-3.7	-3.6	-3.5	-3.2	-3.2

Source: Croatian Bureau of Statistics, Ministry of Finance

In spite of exceptionally favourable trends in the international environment and the above-mentioned upward corrections of the projections of activity and trade, the projection of economic growth in 2018 was lowered by 0.1 percentage point in relation to the previous projections of the Government of the Republic of Croatia from the end of 2017. In the last quarter of 2017, there was a slowing-down of economic activity and the realized GDP growth was below expectations. However, in spite of significantly decreased expected carry-over effect in 2018 due to slowing-down in 2017, high-frequency indicators from the beginning of the year indicate again the positive change in trends of the economic activity. The mentioned upward correction of foreign demand had an impact in 2019 on the raising of the projections of the GDP growth by 0.1 percentage point, while the projection for 2020 is equal to that from the end of 2017 and it amounts 2.5%.

Personal consumption will remain the main driver of domestic demand growth in the medium-term period. It is anticipated that the real growth of personal consumption will moderately slowdown in 2018, primarily as a result of slowing-down of the gross wage bill growth and fading of positive effects of the tax reform. On the other hand, a favourable impact on personal consumption in 2018 will be provided by a full-year effect of the agreement of the Government of the Republic of Croatia with labour unions on the increase in the base for the salaries paid to employees in civil and public services in 2017[6]. Due to the positive correction of the expected trends in all relevant factors, in relation to the previous projections of the Government of the Republic of Croatia from the end of 2017, the projection of personal consumption is corrected slightly upwards in 2018 and somewhat more pronouncedly in the rest of the projection period when expected further tax unburdening will

[6] The effect of the increase in the compensations of employees in the public sector on total increase in gross wages in 2018 is estimated at the level of almost 0.7 percentage points, only slightly less than in 2017. Besides, it is expected that this increase in wages in the public sector will result in a slight demonstration effects outside the general government sector.

also have an impact on its trends. Slowing-down of the real growth in personal consumption throughout the observed period reflects the declining dynamics of the disposable income of the household sector. A slow weakening of the limitations on the side of the labour force supply, as well as gradual slowing down of employment dynamics and a slight strengthening of the inflation of consumer prices, will also have an impact on such trends, in addition to the fading of the above-mentioned positive effects of increasing the base for salaries in the public sector. On the other hand, personal consumption in this period will be supported by the continuation of recovery of the loans to households under the conditions of favourable trends in consumer confidence, low interest rates that decrease the burden of the household sector debt, and low and stable inflation. Here, the recovery of growth in consumer loans in 2017 should be particularly pointed out, as well as its further acceleration at the beginning of 2018. Further expected increase in the revenues from tourism should also be added to positive factors. Personal consumption will still continue to increase faster than the disposable income only in 2018, while in the remaining years the household saving rate will gradually decrease towards its equilibrium values.[7]

In line with the projections of fiscal categories at the level of the general government, during the medium-term period the contribution of government consumption to the economic growth will not be significant and its slowing-down is expected towards the end of the period. The largest contribution to the increase in government consumption, with an exception in 2021, will be coming from the increase in the intermediary consumption of the general government. The most pronounced contribution from the compensations of employees will be realized in 2018 due to the expected moderate increase in the employment at the level of the general government, while in the last year, a significant contribution to the increase in government consumption will come from the category of social transfers in kind.

In 2017, gross fixed capital formation realized its weakest growth rate in the last three years, with pronounced slowing-down in the last quarter. Such trends stem exclusively from the reduction of investments of the broader public sector[8], while the private sector investments slightly accelerated its growth in 2017 in relation to already strong growth from 2016. In the following years, more pronounced growth is expected in total investment activity, whereby it will be generated primarily by the private sector investments. However, the positive contribution is anticipated also from the investments of the broader public sector the share of which in aggregate investments ranges at the level of about 20%.[9] During the medium-term period, further improvement of the investment climate is expected under the conditions of good business results of the enterprises sector as well as of optimistic expectations regarding future trends and favourable financing conditions. The positive impact of the improved credit rating of the country and of the tax reform in the last year should be

[7] Taking into consideration all mentioned factors as well as the recent trends in the index of consumer confidence, in the first years of the projection period the increase in personal consumption could slightly exceed the projected values; however, the conservative approach has been retained when preparing the projections.

[8] Broader public sector includes the general government and enterprises with the majority state ownership which are classified outside the general government sector according to the ESA 2010 methodology.

[9] Broader public sector investments in this macroeconomic framework are projected in the entire projection period more conservatively in relation to fiscal projections presented in this document as well as the financial plans of state owned public enterprises. In spite of that, since even within this macroeconomic framework a strong investment upswing of the broader public sector is expected, in 2018 the slight slowing-down of the growth dynamics of the private investments sector is projected, which is then followed again by the acceleration in 2019, because on the contrary, the rate of growth of total investments in 2018 would be significantly higher than the one projected.

added here, as well as the expected further tax unburdening. In addition, further support to investments is also expected from the stronger use of the EU Structural and Investment Funds. Along with all the aforementioned, the continuation of the implementation of structural reforms directed at the improvement of the business environment in terms of further reduction in administrative and non-tax burdening of the economy would have a favourable impact to the business operations and competitiveness of entrepreneurs. As a consequence of all the above-mentioned, the recovery of the inflows of foreign direct investments is also anticipated. In 2016, the long-lived decline in the construction activity and in the real estate prices of was halted and in 2017 their dynamics accelerated, which indicates the closing of the gap between the supply and demand in dwellings. The intensification of the recovery of the construction activity is anticipated in the following period, which the continuation of the government programme of subsidising housing loans will contribute to as well.

Table 2.2: Gross Fixed Capital Formation by Sectors (Real Growth, in %)

	2017	2018 forecast	2019 forecast	2020 forecast	2021 forecast
Total gross fixed capital formation	**3.4**	**6.7**	**6.3**	**5.6**	**5.2**
Broader public sector*	**-10.2**	**13.3**	**5.3**	**3.8**	**2.7**
General government	-13.5	12.8	7.2	3.6	2.1
Public enterprises	-1.7	14.5	1.1	4.1	3.9
Private sector	**7.4**	**5.2**	**6.6**	**6.1**	**5.8**

Note: Deflated by the deflator of total gross fixed capital formation.

**Consolidated*

Source: Croatian Bureau of Statistics, Ministry of Finance

Since the accession of Croatia to the EU, exports of goods and services have been registering positive structural changes that resulted in the fact that the export has become the main generator of the economic growth, observing the individual components from the expenditure side of the GDP. In 2017, the acceleration of the increase in export of goods and services compared to the previous year was registered under the conditions of intensification of the dynamics of foreign demand for domestic export. Furthermore, the increase in the share on Croatian export markets was also registered in comparison to 2016. The acceleration of growth of export of goods exclusively contributed to that, while the export of services, due to the unfavourable base effect, realized somewhat weaker real growth than in 2016. In the following period, it is still expected that the export of goods and services will be the component that will provide the strongest positive contribution to economic growth. However, in line with the expected trends in foreign demand for domestic goods and services, the growth of exports will register gradual slowing-down towards the end of the projection period. In addition, as positive effects of the accession to the EU market will further fade, the export of goods and services will to a much greater extent reflect the dynamics of the foreign demand. Thus, throughout the whole medium-term period, the increase in the share of the domestic export on foreign markets is anticipated, which will gradually slow down and will be at lower levels in relation to the first three years since the accession to the EU, being the lowest in 2018, exclusively due to export of goods. In 2018, the pronounced slowing down of the increase in export of goods is expected, which will be just somewhat higher than the increase in the foreign demand for domestic products. As a consequence, the increase in the domestic share on the export markets of goods will slow down, in spite of the above mentioned strong upward correction of the foreign demand for domestic goods. The realizations of the export of goods at the beginning of 2018 also indicate to that. In 2019, in spite of the further slowing-down of export of goods, the increase in the share on the export markets will again slightly accelerate. After 2018, certain positive effect on the export is expected also from the trends in real effective exchange rate of kuna, which will register a mild depreciation in the period 2019 – 2021. In 2018, the successful tourist season is again expected. This is confirmed by tourist bookings and promotional activities at tourism fairs. However, dominantly under the impact of unfavourable base effect, in 2018, we expect a slightly slower real growth of export of services. In the following medium-term period, a moderate and stable growth of the export of services is expected, which will be secured by new significant investments in the expansion of tourist capacities, extension of the offer and raising of the quality of tourist products, as well as further prolongation of tourist season, although in that regard there has been a significant progress achieved already in the last years. The increased quality and innovations in the offer could also have a positive impact on the dynamics of the average tourists' consumption which was, according to the existing statistics, suppressed in the previous period.

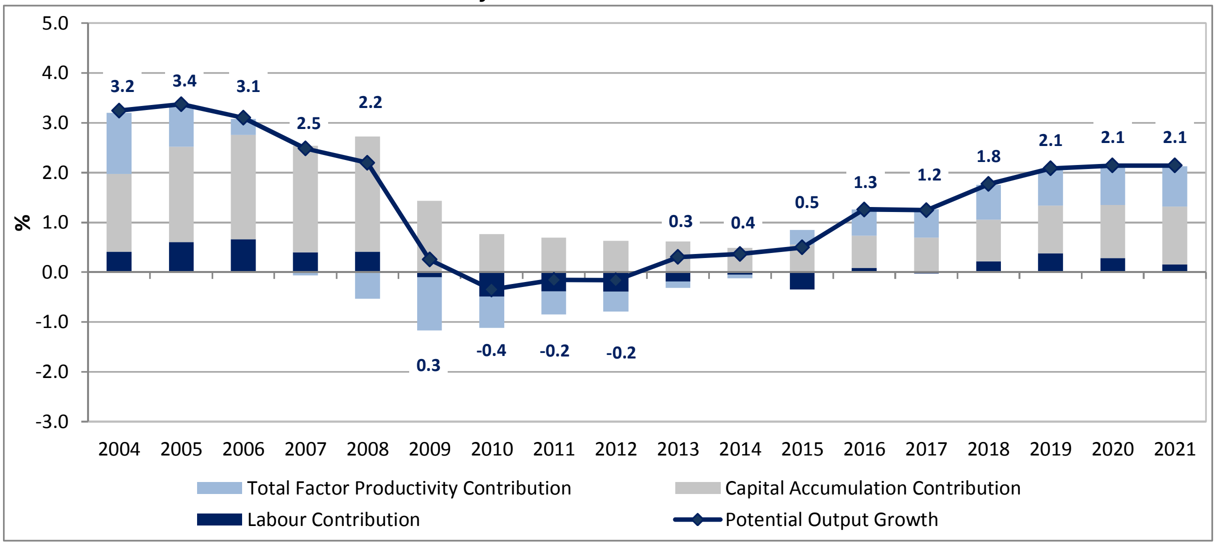
In 2017, a strong increase in the import of goods and services was registered along with a pronounced rise in elasticity of imports in relation to final demand. A large contribution to such trends came from the above described strong dynamics of export of goods and services taking into consideration an exceptionally pronounced import content of exports present as of the accession to the EU. In line with the trends in final demand, in the projection period the gradual slowing-down of the real growth of import of goods and services is expected, whereby it is anticipated that the high level of import dependency of the domestic economy, as well as unfavourable outlook of its shift in the medium-term, will condition that the elasticity of imports with respect to the categories of final demand remain high in the whole period, even with somewhat lower rates of economic growth. Along with the strengthening of economic activity, the trade balance of goods and services will gradually decrease, so it is anticipated that at the end of the period, imports of goods and services expressed in current prices will exceed exports. In accordance with that, the contribution of net exports to economic growth, although declining, will be negative throughout the period, reaching higher levels in absolute terms than it was expected in the previous projections.

The last year's Convergence Programme projected a growth in economic activity of 3.2% in 2017 and the realization was by 0.4 percentage points lower than expected. As it has already been mentioned, this deviation is primarily the result of the weaker dynamics of the GDP growth in the last quarter. By observing the components, this deviation primarily derives from the significantly weaker realization of gross fixed capital formation, the real growth of which was significantly lower than expected, which is exclusively the consequence of the decrease in investments of broader public sector. Besides, the stronger increase in imports of goods and services also had an impact on the weaker growth of GDP than expected, which is exclusively a consequence of a significantly higher increase in the import of services than the projected one, while the increase in import of goods was realized at somewhat lower level than the anticipated one. The positive contribution of changes in inventories and government consumption was slightly higher than the expected one, while the contribution of personal consumption and export of goods and services was realized in line with the plan, although their realized rates of growth were insignificantly higher than expected.

2.2. Cyclical Trends

The growth of potential gross domestic product slowed down significantly in the six-year recession period. The potential gross domestic product was growing by average rates of more than 3.0% in the pre-crisis period, while it registered a drop or stagnation in the entire period between 2009 and 2014, and only after 2015 it started to grow at somewhat higher rates. The pronounced contribution to the growth of potential GDP which came from the capital accumulation due to strong investment activity before the crisis was significantly reduced at the beginning of the crisis. There was also a significant decrease in the positive contribution of trend total factor productivity which registered negative values throughout the whole period between 2007 and 2014. Negative contributions to the growth of potential GDP in the crisis period were also attributed to the labour factor, as a consequence of the labour force decline and the increase in the trend unemployment rate.

Chart 2.1: Contributions to the Growth of Potential GDP



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

In the medium-term period, the potential GDP growth is expected to accelerate, whereby in 2019 the GDP growth rates should exceed the level of 2.0%, and remain at similar levels by the end of the observed period.

Throughout the whole projection period, the largest contribution to the potential growth will come from capital accumulation as a result of re-intensification of the investment activity, and its contribution to the potential growth will, on average, amount to 1.0 percentage points, which is still lower than its average contribution in the pre-crisis period. Somewhat lower contribution to the potential growth will come from trend total factor productivity, which began to increase again after 2014. In addition, it is expected that the negative contribution of the labour factor will fade after 2017, and it will stay at slightly positive levels until the end of the period. Although it is expected that throughout the whole medium-term period, the reduction in the working-age population in the 15 to 74 age group will have a negative contribution to the labour component, it will be exceeded by positive contributions of the reduction in unemployment rate and the increase in the participation rate.

2.3. Prices

Inflation, measured by the consumer price index, stayed at relatively low levels in 2017 and recorded the average level of 1.1%, after a three-year period marked by the decline in the level of prices in the economy. The most significant factor of inflationary trends during 2017 were prices of food, which on average increased by 3.0%, and the prices of fuels and lubricants for personal transport equipment.[10] On the other hand, the largest negative contribution to the increase in consumer prices came from the decline in the price of electricity[11]. Should the components of energy and food be excluded from the consumer price index, there was a mild year-on-year increase of 0.7% registered in 2017.

The slight acceleration of inflation to 1.4% is expected in 2018. The increase in the prices of energy and the prices excluding energy and food will contribute in the approximately same extent to the increase of consumer prices in 2018, while the prices of food are expected to have somewhat lower contribution as a consequence of significantly slower growth dynamics in comparison to the previous year. The expected increase in the prices of energy is a consequence of the increase in the prices of oil in the global market, but also of the base effect of the administrative increase in the prices of electricity of September 2017.[12] In addition, the strengthening of the household consumption and the increase in the unit labour cost, as well as the continuation of the stable dynamics of the increase in the prices in the Eurozone, should act towards the increase in the consumer price index. As a consequence of the expected stagnation of commodity prices in the global market[13] and stable inflation in the Eurozone that will slightly accelerate towards the end of the period, the inflation rate is expected to stay at the level of 1.4% in 2019 and mildly accelerate to the levels of 1.5% in 2020 and 1.6% in 2021.

After three consecutive years of stagnation of the GDP deflator, it recorded a year-on-year increase of 1.2% in 2017. Further acceleration in the GDP deflator growth to the level of 1.6% is expected in 2018, whereby the deflator of the household consumption will increase in accordance with the increase in consumer prices, while the investment deflator is expected to accelerate more significantly under the influence of the increase in the prices of real estate and pronounced increase in salaries of the employees working in the construction sector, as well as a visible trend of the increase in industrial producer prices of capital goods and their import prices. In addition, more pronounced increase in the government consumption deflator is expected under the influence of the full-year effect of the increase in salaries of the employees working in civil and public services in 2017. The increase in the import of goods and services deflator will reflect the continuation of the increase in the prices of raw materials in global markets and the increase in prices in the Eurozone, along with mild weakening of the dynamics of the prices of the import of goods, which is in line with

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[10] Increase in the prices of fuels and lubricants for personal transport equipment is a consequence of a year-on-year increase in the prices of crude oil on the global market which amounted to 23.5%.

[11] In January 2017, the VAT rate on the delivery of electricity was decreased from 25% to 13%.

[12] Due to the increase in the renewable energy sources tariffs, the price of electricity increased by 6.3% on a monthly level at the beginning of September 2017. Also, the positive contribution to consumer prices growth will come from the base effect of the increase in excise duties on tobacco in December 2017, waste management in September 2017, as well as from the increase in the prices of water supply at the beginning of 2018, while the amendments to the system of taxation of personal cars will act towards the decrease of consumer prices.

[13] According to the projections of the Economic Intelligence Unit (April 2018), the prices of oil (in USD) should register the decrease in 2019 and 2020 (by 5.6% and 4.5%, respectively) and increase by 5.0% in 2021. The prices of primary commodities excluding oil are expected to stagnate in the period between 2018 and 2021.

the trends in the unit value indices of the import of goods at the beginning of this year. The slight slowing down of the export of goods deflator is also expected, while the slowing-down of the export of services deflator will be somewhat more pronounced, due to fading of the impact of the increase in the rate of VAT on services in the catering industry, although it is expected that their increase will still remain relatively high in the conditions of continuation of the strong tourist demand. In the following years, the GDP deflator will be stable, and remain at the level of about 1.5%.

Table 2.3: Price Developments

	2017	2018 forecast	2019 forecast	2020 forecast	2021 forecast
GDP deflator, change (%)	**1.2**	**1.6**	**1.6**	**1.5**	**1.5**
Personal consumption	1.0	1.3	1.2	1.4	1.5
Government consumption	1.8	2.7	2.2	1.6	1.4
Gross fixed capital formation	0.4	1.5	1.7	1.8	1.7
Exports of goods and services	2.5	2.0	1.9	1.8	1.7
Exports of goods	1.2	1.0	1.8	1.7	1.6
Exports of services	3.7	3.0	2.0	1.8	1.8
Imports of goods and services	2.2	2.1	1.7	1.7	1.7
Imports of goods	2.5	2.1	1.7	1.7	1.7
Imports of services	0.8	1.6	1.6	1.7	1.8
Consumer price index, change (%)	**1.1**	**1.4**	**1.4**	**1.5**	**1.6**

Source: Croatian Bureau of Statistics, Ministry of Finance

2.4. Labour Market

In spite of the significant recovery due to favourable cyclical trends, domestic labour market faces many structural challenges which have intensified for the last years. Mismatches between supply and demand for labour (inadequate education, lack of skills, weak participation in life-long learning), low labour force participation and short working life duration have been additionally strengthened by negative demographic trends. Under the current conditions of the strong demand for labour, described trends have led to a significant lack of labour force and consequential increase in the salaries in certain scarce industries.

Growth in employment significantly accelerated in 2017 and was primarily the consequence of the increase in the employment in the activities such as trade, transport and tourism. The trend of the increase in the number of employees continued, as well as the decline in the number of self-employed persons, primarily in the agriculture sector. After a strong decrease in the labour force in 2016, during 2017 negative trends were partially mitigated and the labour force stagnated at annual level, and it even increased in the second half of the year. In the following period it is expected that favourable economic trends will have a positive impact on the continuation of a mild increase in the labour force, which will also be supported by measures directed towards the adjustment of the educational system to the needs of the labour marketand stimulation of a longer working life duration. Here, the assumption on gradual medium-term slowing down of the outflows of working-age population and on further moderate dynamics of planned immigration through the system of quotas was taken into account. Under the conditions of the continuation of the increase in the demand for labour, the increase in the employment will continue in the following period as well, whereby the gradual ending of the decline in the number of self-employed is expected. As a consequence of the described trends, the continuous decrease in the unemployment rate is anticipated. It is expected that the trends in GDP and the employment will result in mild increase in the labour productivity.

It is projected that the gross earnings (received by persons in paid employment in legal entities) in 2018 will insignificantly slow down in relation to the strong increase in 2017, and will remain mostly influenced by imbalances of supply and demand for labour in certain industries.[14] The dynamics thereof will not weaken until the last two years of the projection period, along with the open immigration policy under the conditions of slowing down the increase in aggregate demand. The mild and slowing-down increase in the unit labour cost is also anticipated, due to just somewhat faster increase in gross compensation per employee than the increase in the labour productivity.

Table 2.4: Labour Market Developments

	2017	**2018 forecast**	**2019 forecast**	**2020 forecast**	**2021 forecast**
	change, %	change, %	change, %	change, %	change, %
Labour force (15+)[1]	0.0	0.5	0.5	0.4	0.3
Employment[2]	2.2	1.8	1.6	1.4	1.3
Unemployment rate, level (%)[1]	11.2	10.0	9.1	8.2	7.3
Labour productivity, persons	0.6	1.0	1.1	1.1	1.1
Unit labour cost	-1.7	1.6	1.4	1.4	1.3
Compensation per employee	-1.1	2.6	2.5	2.4	2.4
Gross earnings in legal entities	3.9	3.7	3.1	2.6	2.6
Disposable income of households, real	2.9	3.2	2.6	1.7	1.6
Saving rate, level (%)	8.6	8.9	8.8	8.2	7.6

[1]According to ILO methodology. [2]Domestic concept national accounts definition.
Note: Preliminary data for 2017.
Source: Croatian Bureau of Statistics, Ministry of Finance

2.5. External Sector

In 2017, the multiannual trend of the reduction in external imbalances of the domestic economy continued. Net international investment position improved from -70.1% of GDP in 2016 to -62.3% of

[14] The series of data on the compensation of employees from national accounts deviates from administrative data on gross salaries in legal entities so the projection of the compensation per employee for the calculation of the income side of GDP has been smoothed.

GDP in 2017, which is its highest level in the last twelve years. In 2017, for the fifth consecutive year, a positive balance of the current account of the balance of payments was registered, in the amount of 3.9% of GDP. Compared to 2016, the surplus of the current account increased, primarily due to the improvement of the positive balance of services, and then of the balance of secondary income, as well as due to the decrease in the negative balance of the primary income first of all due to the decrease in the expenditures on reinvested earnings of foreign-owned domestic business entities.[15] On the other hand, there was an increase in the negative balance of goods.

In the following period, gradual decrease in the surplus on the current account of the balance of payment is expected, dominantly due to the increase in the negative balance of goods, which will be followed by further increase in the positive balance of services. The effects of the increased provisioning costs of banks will be to a significantly lesser extent present in 2018 as well, but along with the anticipated dynamics of the economic activity, there will be a gradual increase in the negative balance of primary income throughout the projection period. The anticipated stronger use of EU funds will lead to the continuous increase in the positive balance on the account of secondary income and capital transactions throughout the whole projection period.

The previous Programme predicted a positive balance of current and capital account in the amount of 3.5% of GDP (2.3% of GDP if we only observe the current account) in 2017. Higher realization is primarily a consequence of more favourable trends in the positive balance of the secondary income and then of a lower negative balance of the primary income than expected. The realization on the account of goods and services does not deviate more significantly from the expectation.

2.6. Monetary Developments

The high liquidity of the financial sector along with the record low interest rates continued in 2017, and is additionally increased at the beginning of 2018. The average exchange rate of kuna against euro amounted to 7.46 HRK/EUR in 2017 and, for the third consecutive year, it registered the appreciation, in the amount of 0.9%. In 2018, the continuation of the mild strengthening of the domestic currency is expected, and the average exchange rate is anticipated at the level of 7.43 HRK/EUR throughout the whole projection period.

The increase in placements of banks to the private sector[16] that began in 2016 was accelerated in 2017 and it reached almost 3%, whereby this increase was primarily generated by the increase in the placements to households, along with the simultaneous increase in the placements to enterprises. In the following medium-term period, further acceleration of the credit activity of banks is expected, in line with the continuation of the increase in the economic activity, the increase in consumer and business optimism, and of retaining favourable financing conditions along with further decrease in

[15] In 2017, banking sector realized almost 33% lower profit because of increased expenses on value adjustment and provisions that amounted to approximately 1% of GDP.
[16] The data on placements are transaction-based, which means that the effects of exchange rate and price adjustments and bank claims write-offs are excluded from the total stock of placements.

the country risk premium. However, credit activity will still be restricted by a high share of non-performing loans and still high level of indebtedness of the private sector, particularly enterprises, along with a significant exposure to the currency and interest rate risk.

Primarily due to increased provisioning costs, profitability of the banking sector in 2017 was significantly lower in comparison with the previous year[17], when the record amount of the profit of banks was registered. The decrease in non-performing loans continued although by somewhat slower dynamics than the previous year, and their share in total loans was reduced by 2.4 percentage points in relation to 2016. The record sales of non-performing loans of banks in 2017[18] had a significant impact on the improvement of this indicator. The continuation of the decrease in the share of non-performing loans is expected in the forthcoming period as well, primarily due to favourable economic trends and the continuation of sales. In spite of the decrease in profitability in 2017, the banking system remained highly capitalized and the capital adequacy ratio amounted to 23.2% at the end of 2017.

2.7. Risks to the Macroeconomic Projections

The described macroeconomic scenario is exposed to mildly prevailingly negative risks, both external and domestic. Regarding the domestic risks, this macroeconomic framework includes the assumption of orderly and relatively swift process of the restructuring of the Agrokor Group. It should be pointed out that so far the crisis in the Agrokor Group has not more severely affected any of the components of GDP, not even gross fixed capital formation. Furthermore, there are negative risks for the trajectory of the economic growth that refer to medium-term limitations on the supply side. This is visible from the business surveys, noticeable increase in wages in certain activities with a critical lack of labour force, rise in indicator of capacity utilization in industry which has almost reached the pre-crisis level and the increase in orders and expectations of the future demand in industry, services and the construction sector. The risks for the dynamics of global economic growth are balanced in the short term, while in the medium-term negative risks prevail, particularly regarding the trade dynamics. Negative impact on the economic growth may also come from the trends in global interest rates, intensification of protectionist policies or geopolitical tensions. Main risks that could cause a different realization of the inflation rate than the anticipated one are linked to trends in oil prices and in prices of other primary commodities in the global market, as well as to the trends in administratively regulated prices.

[17] According to the preliminary unaudited data, the profit of banks before the taxation amounted to HRK 4.1 billion in 2017, which is a reduction of 33% in comparison to 2016.
[18] Which amounted to HRK 8.4 billion and were 40% higher than in the previous year.

3. GENERAL GOVERNMENT BUDGET AND PUBLIC DEBT

3.1. Fiscal Policy

In terms of fiscal policy, in the last two years, a big shift forward was made and significant efforts were achieved in the area of public finances, whereby the trends that used to be very unfavourable were turned over. Due to pronounced fiscal imbalances, in January 2014, the Council of Ministers of the European Union adopted the Recommendations within which it asked from the Republic of Croatia to reduce, by the end of 2016, its budget deficit below 3% of GDP and to put back the public debt on the sustainable trajectory of decrease. As observed from the public finance perspective, during 2016, a strong progress was made in the fiscal consolidation process which also represented one of the obligations of the Republic of Croatia under the framework of solving the excessive deficit procedure. In this context, a significant reduction of the budget deficit was realized, which amounted to 0.9% of GDP in 2016. At the same time, public debt growth was stopped and for the first time was nominally reduced already in 2016 by HRK 2.5 billion and it amounted to HRK 281.7 billion, i.e. 80.6% of GDP, whereby its share in GDP was decreased by 3.2 percentage points. The responsible fiscal policy management also resulted in the decrease in the interest expenditure which, in 2016, was reduced by almost HRK 1 billion at a year-on-year level. All mentioned efforts provided the fulfilment of the EU Council Recommendations and the exit from the excessive deficit procedure in June 2017.

Positive fiscal trends continued in 2017 as well. Thus, according to the data of the Croatian Bureau of Statistics, as a result of favourable macroeconomic trends due to implemented tax reform on one hand and rational budget spending on the other hand, in 2017, for the first time the surplus of the general government budget was realized, according to the European statistical methodology ESA 2010, in the amount of HRK 2.8 billion or 0.8% of GDP, while at the same time the share of public debt in GDP was additionally reduced by 2.7 percentage points, i.e. at the level of 78% of GDP. Furthermore, during 2017, additional savings were realized on the interest expenditure of HRK 1 billion. In other words, in the last two years the share of public debt in GDP was reduced by 5.9 percentage points, while the savings on interests amounted to HRK 2 billion.

The responsible fiscal policy management was also recognized by international financial institutions so in 2017 all three leading global rating agencies improved the outlook of the credit rating of the Republic of Croatia which had been decreased twice in the 2012-2015 period. In addition, in January and March 2018, rating agencies Fitch and S&P raised the rating by one level with stable outlook, which represents the first increase in the rating of the Republic of Croatia by leading global rating agencies since 2004.

Regardless of these positive trends, the economy of the Republic of Croatia is further characterized by challenges, especially linked with excessive macroeconomic imbalances, including a low potential growth as well as a high nominal level of public debt, which require decisive measures to be taken for the solving thereof.

By exiting the excessive deficit procedure, the Republic of Croatia is obliged to adhere to the rules from the preventive part of the Stability and Growth Pact. Thus, in the forthcoming period, fiscal policy of the Republic of Croatia will be determined by the efforts for the purpose of further strengthening of the fiscal sustainability and stimulating economic growth and development along with providing adequate care for citizens of the Republic of Croatia, whereby the key emphasis will be on the strong control of budget spending and on the use of every surplus of revenues in relation to the planned one for further decreasing in the public debt and tax unburdening of population and enterprises.

At the same time, the preconditions for further improvement of the credit rating and decrease in the costs of interests will be created not just for the budget, but also for citizens and the economy as a whole. All the aforementioned contributes to the strengthening of the stability of public finances which is also a basis of the whole economic stability, as well as the precondition of long-term economic growth in the Republic of Croatia.

In line with the above mentioned, the revenues side of the budget is based on the expected growth of the economic activity, taking into consideration the effects of the comprehensive tax reform which entered into force at the beginning of 2017, and the effects of further tax unburdening. The withdrawal of means from EU funds that will be directed towards the various development and infrastructural projects will also have a significant effect on the revenues of the budget, as well as the activities of research and innovations, whereby they will become one of the key instruments of strengthening of development capacities of all parts of the Republic of Croatia.

The expenditure side of the budget is characterized by further strengthening of fiscal sustainability along with the implementation of measures for the purpose of stimulating the development and adequate care for all layers of population. Special attention will be dedicated to the strengthening of demographic sustainability. Furthermore, in the process of preparing and managing the economic policy, the social inclusion will be taken into account so that all social groups could ber given an opportunity to have the appropriate protection and solidarity. Taking global security issues into consideration, as well as geopolitical risks, the Government of the Republic of Croatia will also carry out the efforts for the purpose of the development of a modern, comprehensive and efficient system of homeland security, so there will also be investments into further modernization of armed forces, including the procurement of fighter jets.

The overall fiscal trends, on both the revenue and the expenditure side of the budget, will result in the general government budget deficit, according to ESA 2010 methodology, in the amount of 0.5% of GDP in 2018. In 2019, the anticipated deficit will amount to 0.4% of GDP, while in 2020 balanced budget is expected and the surplus of 0.5% of GDP in 2021. Further decrease in the share of public debt in GDP is also expected, by 12 percentage points by the end of 2021, whereby the main strategic goal of the Government of the Republic of Croatia defined in the 2017-2019 Strategy of Public Debt management will be met, as well as the requirements from the preventive part of the Stability and Growth Pact.

3.2. Budget Implementation in 2017

During 2017, the Government of the Republic of Croatia continued to implement fiscal consolidation. As it has been previously mentioned, the general government budget for 2017, according to the European statistical methodology ESA 2010, registers a surplus of 0.8% of GDP, which is a significant improvement in relation to the originally planned deficit of 1.3% of GDP.

Total revenue of the general government budget was realized at the level of 46% of GDP, due to positive effects of the comprehensive tax reform that had been carried out at the end of 2016 with an aim of increasing the disposable income of population, decreasing the tax burden of entrepreneurs and consequentially increasing the economic growth. The taxes on production and import amounted to 19.7% of GDP and they registered a year-on-year increase of 5.5%. Within their structure, the most significant revenue is the value-added tax which, in relation to the previous year, was higher by 6.8%. The revenues from social contributions also registered a significant increase of 4.1% and in 2017 they amounted to 11.9% of GDP. Current taxes on income and wealth, which include the personal income tax and corporate income tax, increase by 0.2% which is a consequence of the reduction in the revenues from income tax due to the implemented tax reform. Along with tax revenues, the revenues from other current and capital transfers, that include revenues from EU funds, were also significant and in 2017 they amounted to 2.8% of GDP.

Total expenditure of the general government budget was realized at the level of 45.3% of GDP in 2017, i.e. they were reduced by 1.9 percentage point.

Compensations of employees register the level of 11.4% of GDP. The increase in the compensations of employees is primarily the result of the increase in the base for the calculation of salaries received by civil and public servants by total of 6% in three parts (2% as of January 1, 2% as of August 1, and 2% as of November 1, 2017). The dynamics of trends in the compensations of employees is also determined by the disbursement of the bonus for years of services of 0.5%.

Intermediate consumption was realized at the level of 7.9% of GDP. This category includes material expenses of the general government sector units, and inter alia the costs of healthcare institutions for medicines and medical material.

Expenditure for subsidies registers the level of 1.7% of GDP. There is a noticeable increase in the share of subsidies in GDP by 0.2 percentage points primarily due to the increased disbursement of subsidies for the producers of energy from renewable sources, which are financed from the compensation for stimulating electricity from renewable sources. A significant share in this category of expenditure is allocations in agriculture and expenditure for the implementation of the concession contracts, as well as for the stimulation of maritime passenger transport. Besides the aforementioned, a part of funds refers to the finalization of the shipyard restructuring process in 2017.

Interest expenditure was realized with a 2.7% share of GDP. Compared to the previous year, they decreased by 0.4 percentage points of GDP due to more favourable conditions on financial markets, which resulted in lower public service debt costs.

Social benefits and social transfers represent the most significant category of total general government expenditure and record a level of 15.7% of GDP. These expenditures are, to the greatest extent, determined by the trends in expenditure for pensions, expenditure for prescription medications, maternity benefits, social welfare benefits, child allowance and unemployment benefits. Expenditure for pensions were realized at 10.4% of GDP, which includes increased allocations resulting from the adjustment of pensions by 2.75%, realized under the general regulation, whereby from January 2017 it was adjusted by 0.65% and from July 1, 2017 by 2.1%. In addition, with the application of the Act on Amendments to the Pension Insurance Act[19], the method of determining and adjusting the pensions realized according to special regulations and pensions realized according to the general regulation is equalized. As of October 2017, by applying the Decision on cessation of the reduction of pensions, i.e. pension bonuses pursuant to Article 3a of the Act on the Reduction of Pensions Determined or Realized under Special Pension Insurance Regulations[20], the temporary measure of the reduction of pensions and pension incomes, i.e. pension bonuses of 10% for pensions exceeding HRK 5,000, has been abolished. The allocations for child allowance amount to 0.4% of GDP and are reduced based on the trend of decreasing the average number of beneficiaries and the average number of children receiving child allowance. Maternity benefits were realized at the level of 0.6% of GDP. The Amendments to the Maternity and Parental Benefits Act[21], which entered into force on 1 July 2017, increased the amount of financial support while using the additional parental leave. Unemployment benefits were realized at the level of 0.2% of GDP. Social welfare benefits, including guaranteed minimum benefit, personal disability allowances and allowances for assistance and care, amounted to 0.6% of GDP. This group of expenses includes the allocations for the war veterans' care based on the Act on Croatian Homeland War Veterans and Their Family Members' Rights[22].

Other expenditures, mostly related to current and capital transfers, were realized at the level of 3.1% of GDP. They mostly refer to the activities financed from EU funds as well as the payment of own contribution of the Republic of Croatia to the EU budget.

Gross fixed capital formation expenditure was realized at the level of 2.7% of GDP, which was 13.1% less than in the previous year due to the changed dynamics of the implementation of investment projects in relation to the planned ones.

[19] Official Gazette, number 120/2016
[20] Official Gazette, number 88/2017
[21] Official Gazette, number 59/2017
[22] Official Gazette, number 174/2004, 92/2005, 2/2007, 107/2007, 65/2009, 137/2009, 146/2010, 55/2011, 140/2012, 19/2013, 33/2013, 148/2013 and 92/2014

3.3. General Government Budget in 2018

Consolidated General Government Revenues

In 2018, total general government revenues are planned at the level of 46% of GDP, and are based on the expected growth of economic activity, taking into account the effects of further tax cuts that came into effect in early 2018. These changes refer to the increase in the threshold for entry into the VAT system to HRK 300,000 and the introduction of the possibility for entrepreneurs of deducting the input tax in the amount of 50%, for the cost of purchasing personal cars and other personal transport equipment and other related direct costs. In addition, the special tax on motor vehicles is reduced and the tax on the purchase of second-hand motor vehicles is abolished and replaced by the administrative fees charged when purchasing used vehicles. With the aim of further unburdening of entrepreneurs or employees, the Personal Income Tax Ordinance[23], which includes changes in the determination of personal income from employment, salaries in kind and taxable receipts from employment, was also amended. It should be noted that since 2018, the personal income tax has been entirely given over to local and regional self-government units due to the implementation of the new Act on Financing Local and Regional Self-Government Units[24]. This change in the personal income tax system does not affect the overall level of projected general government revenue, but only their redistribution between central government and local and regional self-government units.

Taxes on production and import represent the most significant category of total revenue. They are projected at the level of 19.8% of GDP. Value-added tax revenue is projected in the amount of 13.5% of GDP based on the calculation of the value-added tax base, which includes the expected trends in the nominal personal consumption, taking into account the effects of the above-mentioned tax changes in the amount of 0.14% of GDP.

Revenues from excise duties, customs duties and other consumption taxes are also included in the category of taxes on production and import, except VAT. Excise taxes amount to 4.3% of GDP, and include the expected trends in the consumption of excise products, taking into account the effects of the amendments to the regulations in the excise system, i.e. special taxes on motor vehicles and excise duties on tobacco. This amendment reduces the taxation by special tax on motor vehicles and, thus, the total tax burden on taxpayers by 0.1% of GDP. The amendments to the level of excise tax on tobacco products imply reaching the agreed level of the excise tax according to the EU directive, as the transition period for harmonization of these excise taxes was completed on 1 January 2018. The effect of this change is estimated in the amount of 0.04% of GDP.

The second most significant group of general government budget revenues are social contributions, projected at a level of 12% of GDP. Their dynamics is determined by the trends in the labour market, taking into account the amendments to the Minimum Salary Act[25], which increased the minimum salary by 5%, whereby the monthly base for calculating salary contribution reduced by 50% of the minimum salary or proportional part of the minimum salary. The reduction of the base is applied when calculating contributions for compulsory health insurance (15% rate), health protection at work

[23] Official Gazette, number 128/2017
[24] Official Gazette, number 127/2017
[25] Official Gazette, number 39/2013 and 130/2017

(0.5% rate) and employment (1.7% rate). The effect of this measure is estimated at the level of 0,1% of GDP.

Estimated revenue from current taxes on income and wealth will register the level of 6.2% of GDP. The personal income tax revenue is planned based on expected labour market trends, taking into account the above-mentioned amendments to the Ordinance with an effect of 0.1% of GDP. Corporate income tax revenue in the current year is paid on the basis of the entrepreneurs' business operations of the previous year and is prepared on the basis of the estimation of business operations of enterprises and banks in 2017.

The category of other current and capital transfers, projected at the level of 3.1% of GDP, also include the revenues from the aids of EU institutions and bodies, which are directly linked to the projects financed from EU funds, and they record a significant increase of 13.9% in relation to the previous year.

Consolidated General Government Expenditures

In 2018, total general government expenditures are planned at a level of 46.5% of GDP.

Compensations of employees are projected at the level of 11.5% of GDP on the basis of the yearly effect of increasing the base by 6% for civil and public servants in 2017 as well as the corrections for the years of service and the expected trends in the level of the number of employees. Furthermore, these expenditures also include increased allocations for employees financed from EU funds as well as the funds for the compensations of employees from the HAC-ONC company, which has been merged with HAC since December 2017 and thus classified into the general government sector.

Intermediate consumption expenditures are planned at the level of 7.9% of GDP. The increase in this category of expenditures compared to 2017 is primarily a result of the trends in the material consumption by the general government sector units, whereby increased spending on medicines and consumables and sanitary material of healthcare institutions are expected as a result of the expected increase in the revenues of the Croatian Health Insurance Fund.

In 2018, expenditures for subsidies will be at the level of 2% of GDP. Significant share in this category of expenditure refers to payments in agriculture that are financed from national funds. A large part of subsidies of 0.8% of GDP refers to the subsidies of the Croatian Energy Market Operator (*HROTE*) for the producers of energy from renewable sources, which are financed from the fee for stimulating electricity production from renewable sources. These subsidies register an increase of 47.4% in 2018. In addition, the funds for the implementation of concession contracts and the promotion of maritime passenger transport are also allocated within this category.

Property income expenditure, which is largely determined by the trends in interest expenditure in line with the conditions on financial markets, i.e. the costs of public debt service, registers a level of 2.5% of GDP in 2018. It should be noted here that by the end of the second phase of the financial restructuring of the road sector debt, the interest expenditures are significantly reduced in this sector by more than 30% compared to their earlier costs.

Social benefits and social transfers constitute the most significant category of total expenditures with a share in gross domestic product of 15.6%, whereby the pension expenditures are planned at the level of 10.2% of GDP. In 2018, the increase in total expenditures for pensions and pension receipts will be influenced by the transferred cumulative effect of changes in the number and structure of pension beneficiaries and the adjustment of pensions from 2017, changes in the number and structure of pension beneficiaries and the adjustment of total pensions in 2018, the cessation of the reduction of pensions realized according to special regulations and higher than HRK 5,000 by 10% from 2017, and the application of a part of the provisions of the new Act on Croatian Homeland War Veterans and Their Family Members[26]. The allocations for child allowances amount to 0.5% of GDP, while maternity benefits are planned at 0.6% of GDP. This category of expenditures also includes the full-year effect of the Act on Maternity and Parental Benefits[27] from July 2017, i.e. of the increase in the amount of financial support during the use of the parental leave for a period of six months if the right is exercised by one parent, or eight months if that right is exercised by both parents. Unemployment benefits are planned at the level of 0.2% of GDP. Social welfare benefits, including a guaranteed minimum benefit, are planned at a level of 0.6% of GDP. This group of expenditures also includes increased allocations for war veterans' care based on the new Act on Croatian Homeland War Veterans and Their Family Members [28] of December 2017, extending the scope of their rights.

Other expenditures, mostly related to current and capital transfers, are planned at the level of 3.5% of GDP, and are largely determined by the payment of the own contribution of the Republic of Croatia to the EU budget as well as by activities financed from EU funds.

Gross fixed capital formation expenditures are planned at the level of 3.5% of GDP and they register a strong growth of 35.4% compared to 2017. They are mostly determined by the activities related to capital investments of all general government units, especially public enterprises in the central government sector, in the part of road construction (Croatian Roads and Croatian Motorways) and railway infrastructure (HŽ Infrastructure and HŽ passenger transport). A significant increase in relation to the previous year was also registered by the local government investments.

Net Lending/Borrowing

Following the planned revenues and expenditures, the general government budget deficit is expected at the level of 0.5% of GDP in 2018, whereby the central government deficit will amount to 0.7% of GDP, while local and regional self-government units will have the surplus of 0.1% of GDP. Social security funds will register a balanced budget.

[26] Official Gazette, number 121/17
[27] Official Gazette, number 85/2008, 110/2008, 34/2011, 54/2013, 152/2014, 59/2017
[28] Official Gazette, number 121/2017

3.4. Medium-Term Budgetary Framework (2019-2021)

Consolidated General Government Revenues

In the period 2019-2021, the revenues of the general government budget will be determined by the trends in the economic activity, taking into account the fiscal effects of further tax cuts. Therefore, in 2019, they will register the level of 45.2% of GDP, in 2020 the level of 45.1% of GDP, and in 2021 the level of 44.6% of GDP.

Taxes on production and import in the medium-term will range from 19.1% of GDP in 2019 to 19% of GDP in 2021. Value-added tax revenues will be at an average level of 13.1% of GDP.

More significant tax forms in the category of taxes on production and import also include excise taxes. They are projected on the basis of the expected consumption of excise products, and in the medium-term they will be at an average level of 4% of GDP in the period 2019-2021.

Furthermore, revenues from current tax on income and wealth will register an average level of 6.1% of GDP in the observed period. The share of social contributions revenue will register the level of 12% of GDP, while other revenues will be determined by the projected increased absorption from EU funds.

Consolidated General Government Expenditures

In 2019, the expenditures of the general government budget are projected at the level of 45.6% of GDP, in 2020 at the level of 45.1% of GDP, and in 2021 at the level of 44.1% of GDP.

Compensations of employees will register an average level of 11.3% of GDP in the observed period due to the expected trends in the level of the number of employed civil and public servants and the rights deriving from collective agreements. In addition, this category of expenditures includes the increase in the allocations for the purpose of the presidency of the Republic of Croatia over the Council of the EU which the Republic of Croatia takes up from 1 January 2020.

Intermediate consumption expenditures will be at an average of 7.9% of GDP. This category of expenditures includes an increase in expenditures for medicines and medical materials of hospital institutions, as well as the costs of the presidency of the Council of the EU.

Subsidy expenditures reduce its share in GDP from 1.8% in 2019 to 1.6% in 2021.

Property income expenditure, largely determined by the trends in the interest expenditure, registers an average level of 1.7% of GDP in the medium-term.

Social benefits and social transfers will be at an average rate of 15.3% of GDP. The increase in the allocations for pensions is anticipated as a result of the indexation of pensions and the expected trends in the number of pensioners. In addition, this category includes the effects of the implementation of the Act on Amendments to the Child Allowance Act, which is currently in the public consultation process, and according to which the increase in the number of beneficiaries is expected due to the increase in the income testing. Furthermore, the implementation of the Act on the Amendments to the Social Welfare Act[29] is included, according to which the amount of personal disability living allowance and the assistance and care allowance are increased. The Amendments to the Housing Loan Subsidies Act is also under the adoption process, and it will introduce the subsidizing of the loans that citizens take to buy an apartment or a house, or to build a house, in a way that a part of monthly payments or annuities is subsidized for a period of five years.

Other expenditures, mainly related to other current and capital transfers, increase their share in gross domestic product from 3.3% in 2019 to 3.6% in 2021.

Expenditures for gross fixed capital formation will be at an average level of 3.6% of GDP in the observed medium-term. These expenditures are determined by the planned dynamics of investments of extrabudgetary users and public companies that enter the general government sector and are largely financed from EU funds. In addition, the plans for the delivery of fighter jets are also included in the projections 2020 and 2021.

Net Lending/Borrowing

In accordance with the projected trends in revenues and expenditures of the general government budget, a deficit of 0.4% of GDP is expected in 2019, balanced budget in 2020, and the surplus of 0.5% of GDP is expected in 2021.

3.5. Assessment of Structural Balance and Medium-Term Budgetary Objective (MTO)

The structural balance represents a deficit or a surplus of the general government budget which does not include 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 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 the general government deficit and 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 the Republic of Croatia confirmed as its objective for the period 2016-2019 in the 2016 Convergence Programme.

[29] Official Gazette, number 130/2017

Fiscal projections of the Republic of Croatia represented in this document indicate that the Republic of Croatia meets its medium-term budgetary objective in the period 2018-2021. Thus, in 2018, the structural balance registers the level of -0.8% of GDP, of -0.9% of GDP in 2019, of -0.8% of GDP in 2020 and of -0.4% of GDP in 2021, whereby this ensures the sustainable trends in general government budget deficit and public debt.

Table 3.1: Trends in Structural Balance of Consolidated General Government in the Period 2016-2021

	2016 Outturn	2017 Projection	2018 Projection	2019 Projection	2020 Projection	2021 Projection
CYCLICALLY-ADJUSTED BALANCE						
TOTAL DEFICIT/SURPLUS, corrected for one-off measures, % of GDP	**-0,9**	**0,8**	**-0,5**	**-0,4**	**0,0**	**0,5**
OUTPUT GAP	-1,8	-0,4	0,6	1,2	1,6	1,9
CYCLICALLY-ADJUSTED BALANCE, % of GDP	**-0,1**	**0,9**	**-0,8**	**-0,9**	**-0,8**	**-0,4**
CYCLICALLY-ADJUSTED BALANCE CHANGE	***-1,5***	***-1,0***	***1,7***	***0,1***	***-0,2***	***-0,4***

Source: Ministry of Finance, CBS

3.6. Stock and Projection of Trends of Public Debt and Stock of Guarantees

Stock of Public Debt and Guarantees

According to the Excessive Deficit Procedure Report for the period 2014-2017, according to ESA 2010 methodology, published by the Croatian Bureau of Statistics, the public debt amounted to HRK 283.3 billion at the end of 2017, whereby the share of public debt in gross domestic product was reduced from 80.6% at the end of 2016 to 78% at the end of 2017, which means that in the last two years the public debt dropped by 5.9 percentage points, i.e. by HRK 890 million. Several key factors contributed to such a shift in the trends in the public debt last year. Fiscal improvements, including the rationalization of budget spending and the positive effects of tax reform, eventually led to the general government budget surplus in the amount of HRK 2.8 billion or 0.8% of GDP in 2017, and thus to the reduced needs of the state for borrowing. In addition, in the context of the high level of liquidity and low interest rates, borrowing conditions in the domestic and international financial markets improved as well, resulting in lower interest expenditure. A positive contribution to the reduction of debt-to-GDP ratio in 2017 also came from a mild appreciation of kuna against euro (by 0.6% at an annual level). The domestic component of the public debt was decreased by 0.2% in relation to 2016, and it amounts to HRK 172.8 billion, representing a share of 61% in total public debt, while the foreign component registered an increase of 1.8% and it amounts to HRK 110.5 billion, i.e. 39% of the total public debt.

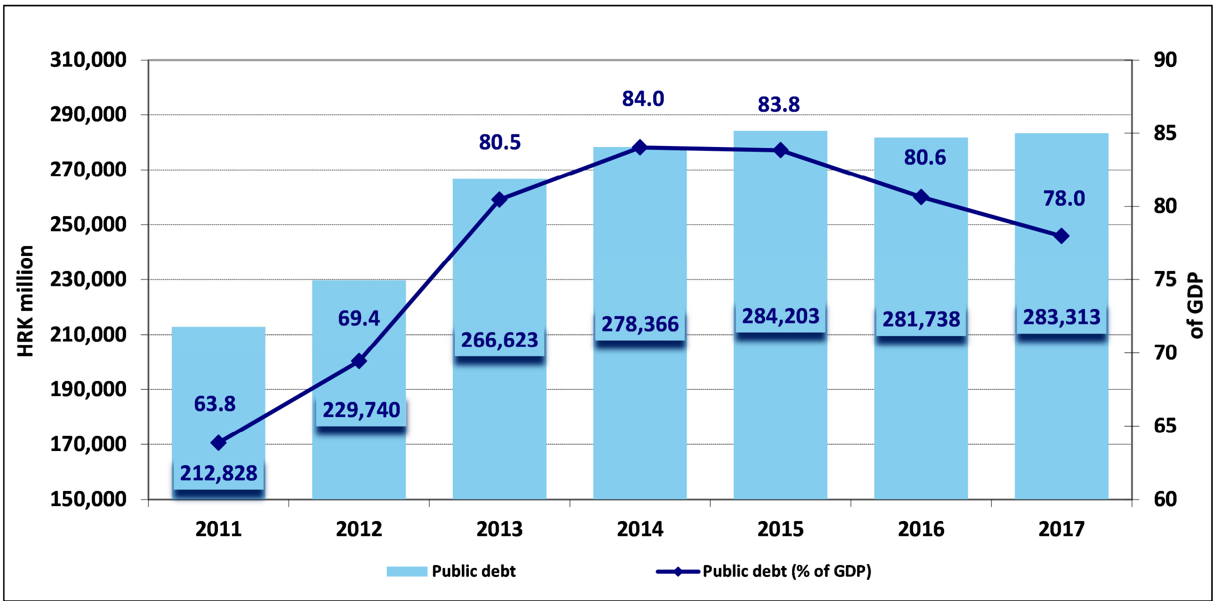
As observed according to the state government levels, the majority of public debt refers to the central government sector in the amount of HRK 278.3 billion, while the rest of the debt of HRK 5 billion refers to the local government sector.

Regarding the borrowing mechanisms, the largest part of public debt occurred by borrowing via long-term securities, i.e. bonds (64%), and then by borrowing via loans (31.5%) and short-term securities (4.5%).

The currency structure of public debt shows that a significant part of the debt was denominated in a foreign currency, whereby the debt denominated in EUR accounts for 71.9%, the debt denominated in HRK for 24.6%, and the debt denominated in USD for 3.5% of total debt. An insignificant part of the debt (0.04%) was denominated in Swiss francs. In 2017, the share of the debt denominated in EUR decreased by 0.6 percentage points in relation to 2016 as a result of the orientation to the borrowing on the domestic market via bonds.

The maturity structure of public debt shows that the share of public debt with the maturity of up to one year amounted to 7.1% of total debt at the end of 2017. The share of public debt with the maturity of one to five years amounted to 10%, while the share of debt with the maturity of five to ten years amounted to 41.7%. The debt with the maturity of over 10 years accounted for 41.3% of total public debt.

Chart 3.1: Public Debt Trends in the Period 2011-2017



Source: CNB, CBS

At the end of 2017, total issued guarantees of the Republic of Croatia amounted to HRK 9.7 billion, i.e. 2.7% of GDP and, in relation to the end of 2016, they were increased by HRK 564 million.

According to the latest available data of the Croatian Bureau of Statistics on the potential liabilities of the general government sector in line with the Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, at the end of 2016, the liabilities of public enterprises that are under the state control but are not within the statistical scope of the general government, amounted to only 10.7% of GDP, which puts the Republic of Croatia near the bottom in terms of the level of these potential liabilities in comparison with other EU Member States. Such a relatively low level of potential liabilities is primarily the result of the earlier alignment with the ESA 2010 methodology and of the reclassification of a large part of state-owned enterprises into the general government sector, i.e. into the public debt.

The 2018 Act on the Execution of the State Budget of the Republic of Croatia[30] established that the annual value of new financial guarantees for 2018 amounts to HRK 5.7 billion, of which HRK 2.3 billion pertains to extra-budgetary users of the state budget.

Financing the General Government Budget and Projection of Trends in the Public Debt

The total level of required funding will be determined by the trends in the fiscal balance, financial assets and general government budgetary liabilities that are falling due in the observed period. The need for financing the total budget deficit and matured liabilities will be settled on domestic and foreign financial markets, while in terms of borrowing mechanisms in the observed period, the focus will be on instruments with a longer maturity, primarily on bonds. 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 2018-2021, receipts are expected from the privatization in the amount of average 0.3% of GDP per year.

The majority of maturing state budget liabilities in the period 2018-2021 refers to nine maturities of bonds, of which five are domestic and four are foreign. Among domestic bonds, two are denominated in EUR, in the amount of EUR 2 billion, while three bonds are denominated in HRK, in total amount of HRK 17 billion. Foreign liabilities pertain to four Eurobonds. The first Eurobond in the amount of EUR 750 million is due in 2018, the second Eurobond in the amount of USD 1.5 billion matures in 2019, the third one in the amount of USD 1.3 billion matures in 2020, while the fourth one in the amount of USD 1.5 billion is due in 2021. On the side of loans, most maturities in the observed period refer to loans issued in the domestic financial market and to the loans of international financial institution. Thus, total state budget loan maturities range from HRK 5.2 billion in 2018, HRK 4 billion in 2019, HRK 3 billion in 2020, to HRK 5.8 billion in 2021.

The Public Debt Management Strategy for a three-year period, to be adopted in May this year, will contain a detailed debt and repayment plan that will be consistent with the fiscal projections of this document.

[30] Official Gazette, number 124/2017

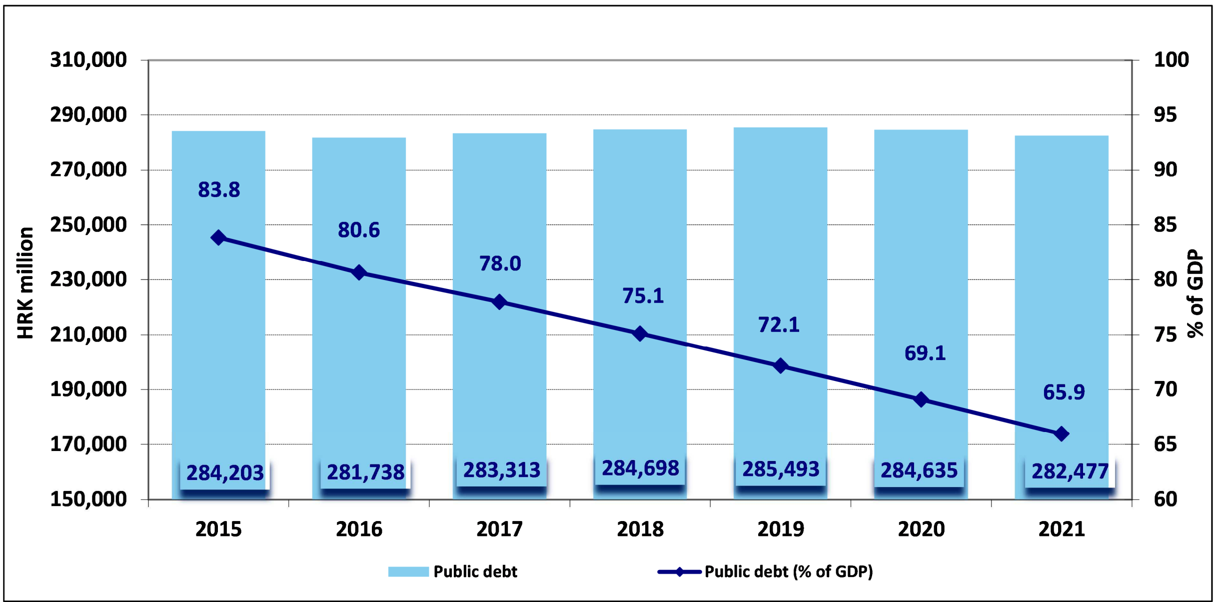
Table 3.2: Overview of the Bonds Maturity of the Republic of Croatia in the Period 2018-2021

Bond	Date of issue	Currency	Amount (in million)	Intrestrate	Date of maturity
Domestic bonds					
Series 18 D-18	10.07.2013	HRK	6,000	5.250%	10.07.2018
Series 07 D-19	29.11.2004	EUR	1,000	5.375%	29.11.2019
Series 13 D-20	05.03.2010	HRK	5,000	6.750%	05.03.2020
Series 14 D-20	05.03.2010	EUR	1,000	6.500%	05.03.2020
Series 22 D-21	08.07.2016	HRK	6,000	2.750%	08.07.2021
Forein bonds					
Euro-EUR VIII	08.07.2011	EUR	750	5.875%	09.07.2018
Euro-USD I D 2019	05.11.2009	USD	1,500	6.750%	05.11.2019
Euro-USD II D 2020 (swap)	14.07.2010	USD	1,250	6.625%	14.07.2020
Euro-USD III D 2021 (swap)	24.03.2011	USD	1,500	6.375%	24.03.2021

Source: Ministry of Finance

On the basis of the trends in the general government budget deficit, and taking into account the planned privatization receipts in the amount of 0.3% of GDP, it is expected that in 2018 the share of public debt in GDP will register further reduction by 3 percentage points and will amount to 75.1% of GDP. Furthermore, the share of public debt in GDP will continue to decline to the level of 72.1% of GDP in 2019, of 69.1% of GDP in 2020, while in 2021 it will amount to 65.9% of GDP. By conducting such a sustainable, reasonable and balanced fiscal policy, the prerequisites will be created for further reduction of fiscal imbalances and debt burdens.

Chart 3.2: Projection of Public Debt Trends by 2021



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

Fiscal projections for the medium-term period are based on macroeconomic assumptions and, in that regard, the risks related to lower level of economic activity in relation to the macroeconomic scenario presented in this programme would have significant implications on the expected trends and results of fiscal values in the forthcoming period. Such changes in trends would have a direct impact on the balance of the general government budget.

Besides the aforementioned, it should be pointed out that fiscal risks on the expenditure side are also connected with the condition in the pension and healthcare system. More precisely, the present demographic trends which primarily refer to the population ageing and the extension of life expectancy, but also to migration pressures the Republic of Croatia is faced with, may have a negative impact on the sustainability of public finance. Such trends put a pressure on the generational solidarity system, and also influence the demand for healthcare protection services and, consequently, the increase in costs of both systems. Furthermore, the stock of matured due liabilities in the healthcare system represents an additional fiscal risk that is necessary to be addressed in as short term as possible by implementing measures directed towards the rationalization of the hospital system and the promotion of fiscally responsible hospital management in order to achieve long term financial and operational sustainability of business operations of hospitals.

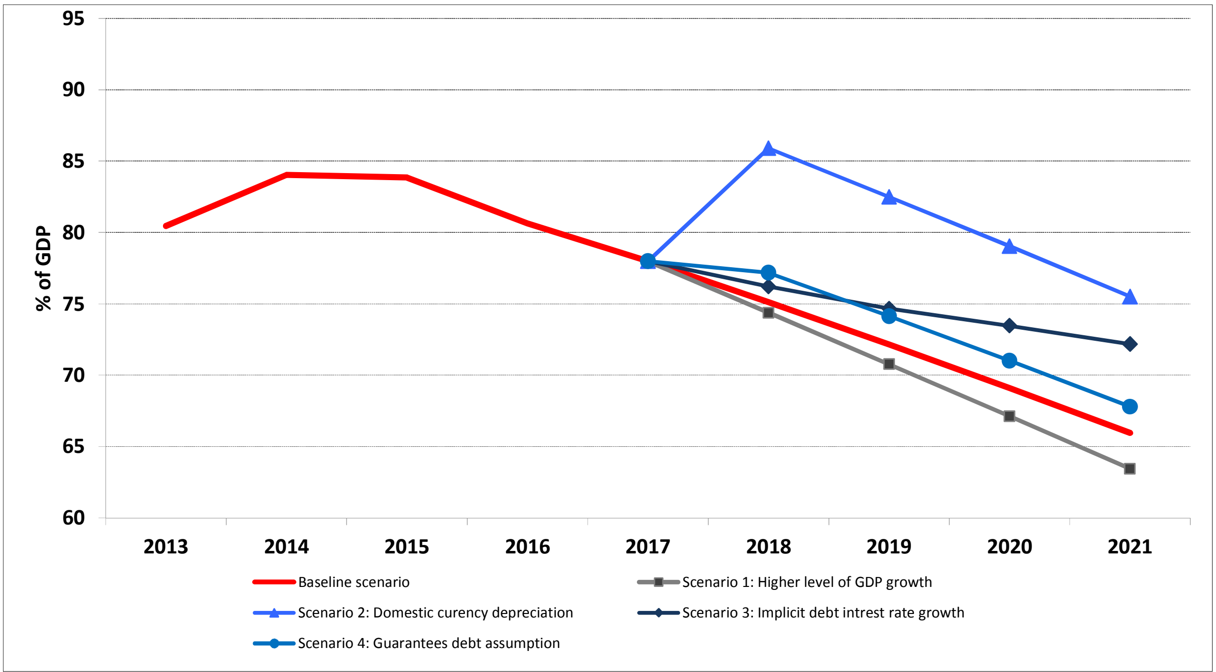
Although the public debt is reduced to 78% of GDP in 2017, its high level still represents the source of vulnerability for the Croatian economy. More precisely, considering the level of debt, long term increase in reference market interest rates would therefore represent a significant threat to fiscal sustainability. The increase in the financing cost would lead to high costs of debt service whereby a significant pressure would occur on the current business operations of the state. Thus, in the scenario of the increase in the average implicit interest rate on the debt by 1 percentage point in the period 2018–2021, the public debt would register an increase above the projected one and, at the end of the projection period, it would be higher by 6.2 percentage points than in the baseline scenario.

Furthermore, the high share of public debt denominated in EUR (72%) indicates that the trends in debt are subject to exchange rate risks. The performed sensitivity analysis shows that the depreciation of kuna against euro of 15% would raise the level of public debt to 85.9% of GDP in 2018, i.e. public debt would be higher by 10.8 percentage points than in relation to the baseline scenario.

Potential liabilities, that include the balance of issued state guarantees, still represent the potentially high risk for public finance. The current challenges associated with the restructuring of individual companies in the Republic of Croatia, for whose debts the state guarantees were issued, would lead to a one-off increase in the capital transfer on the part of the budget expenditures in the scenario of assuming a part of the guaranteed debt from the state, and consequently to an increase in the general government deficit, which would have a direct impact on the increase in public debt. Thus, in the suggested scenario of assuming liabilities into the public debt in the amount of 2% of GDP, the public debt would reach the level of 77.2% of GDP in 2018.

On the other hand, higher rates of economic growth in relation to the projected ones, would have an impact on the faster decrease of the share of public debt in GDP in the medium-term period. Thus, in the scenario of a stronger increase in GDP by 1 percentage point in each year in relation to the baseline scenario, the public debt would decrease to the level of 63.4% of GDP in 2021.

Chart 4.1: Trends in Public Debt Share in GDP according to Specific Scenarios



Source: Ministry of Finance

4.2. Comparison with the Previous Programme

The comparison of total revenue, expenditure and deficit of the general government budget in the new Convergence Programme and the previous one shows considerable differences. They arise from the different levels of nominal gross domestic product, as well as from more favourable budget trends on both the revenue and the expenditure side in relation to the previously expected.

The Convergence Programme for the period 2017-2020 rested on the assumption of a real growth of gross domestic product of 2.8% in 2018, 2.6% in 2019 and 2.5% in 2020. The 2018 Convergence Programme projects the real growth to be of 2.8% in 2018, of 2.7% in 2019, and of 2.5% in 2020 and 2021. The slowdown in growth in the projection period is the result of the convergence of GDP growth towards the growth of potential GDP in the medium-term. Differences in the amount of revenue and expenditure, observed as a share in GDP, are derived primarily from the methodological changes that have influenced the revision of the historical series of data on the trends in gross domestic product at current prices. In addition, as a consequence of the improvement of ESA 2010 aggregates and of budget accounting for the general government sector, some revenue and expenditure categories have been changed, whereby their nominal level has been reduced, without affecting the budget deficit/surplus. In line with positive economic and fiscal developments, the projection of the general government budget balance is more favourable in relation to the previous programme.

Table 4.1: Comparison of Revenue, Expenditure and Net Lending/Borrowing of the General Government

	2017	2018	2019	2020	2021
CP RoC 2018-2021 (% of GDP)					
Total revenue	46.0	46.0	45.2	45.1	44.6
Total expenditure	45.3	46.5	45.6	45.1	44.1
Net lending/borrowing	**0.8**	**-0.5**	**-0.4**	**0.0**	**0.5**
CP RoC 2017-2020 (% of GDP)					
Total revenue	47.3	47.6	47.5	47.2	n.a.
Total expenditure	48.6	48.4	47.8	46.8	n.a.
Net lending/borrowing	**-1.3**	**-0.8**	**-0.3**	**0.5**	**n.a.**
Difference					
Total revenue	-1.3	-1.6	-2.3	-2.2	n.a.
Total expenditure	-3.4	-1.9	-2.1	-1.7	n.a.
Net lending/borrowing	**2.1**	**0.3**	**-0.1**	**-0.5**	**n.a.**

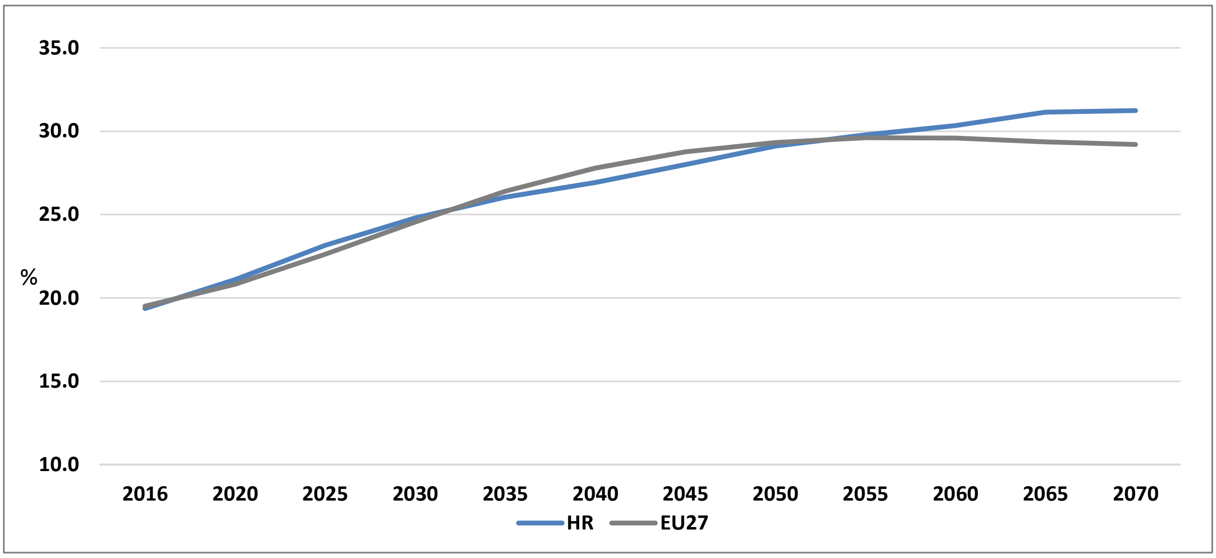
Source: Ministry of Finance

5. SUSTAINABILITY OF PUBLIC FINANCES

Like all EU countries, the Republic of Croatia is significantly influenced by accelerated demographic trends that are primarily related to the population ageing and the extension of life expectancy. This can be seen in the following graphics comparison of the Republic of Croatia and the EU for the period up to 2070.

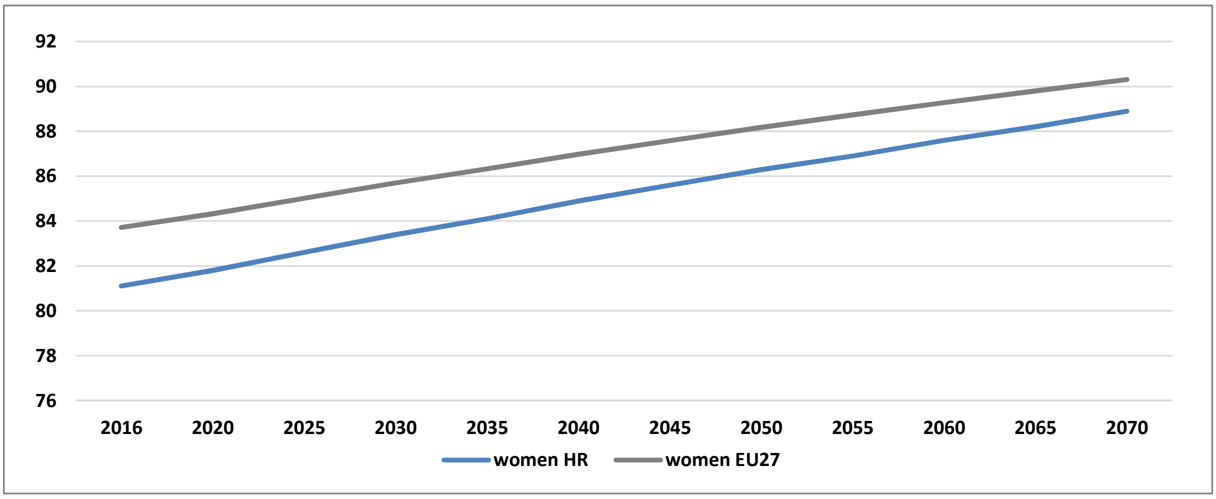
In the period 2016-2070, the decrease in the population number by 19% is projected, i.e. from 4.2 to 3.4 million. At the same time, a considerably extended life expectancy is expected. In the mentioned period, the remaining life expectancy in the age of 65 will be extended for 6.4 years for men and 6.2 years for women. These demographic trends will put strong pressure on the sustainability of public finances, including the generational solidarity system.

Chart 5.1: Share of Elderly Population (65+) in the Total Population



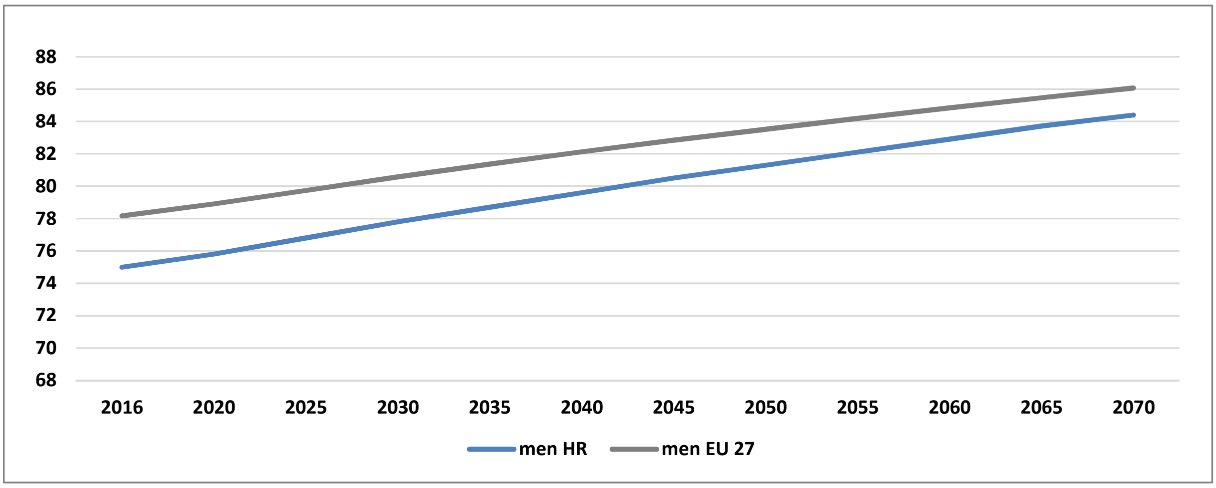
Source: The 2018 Ageing Report, EUROSTAT

Chart 5.2: Life Expectancy at Birth, women (in years)



Source: The 2018 Ageing Report, EUROSTAT

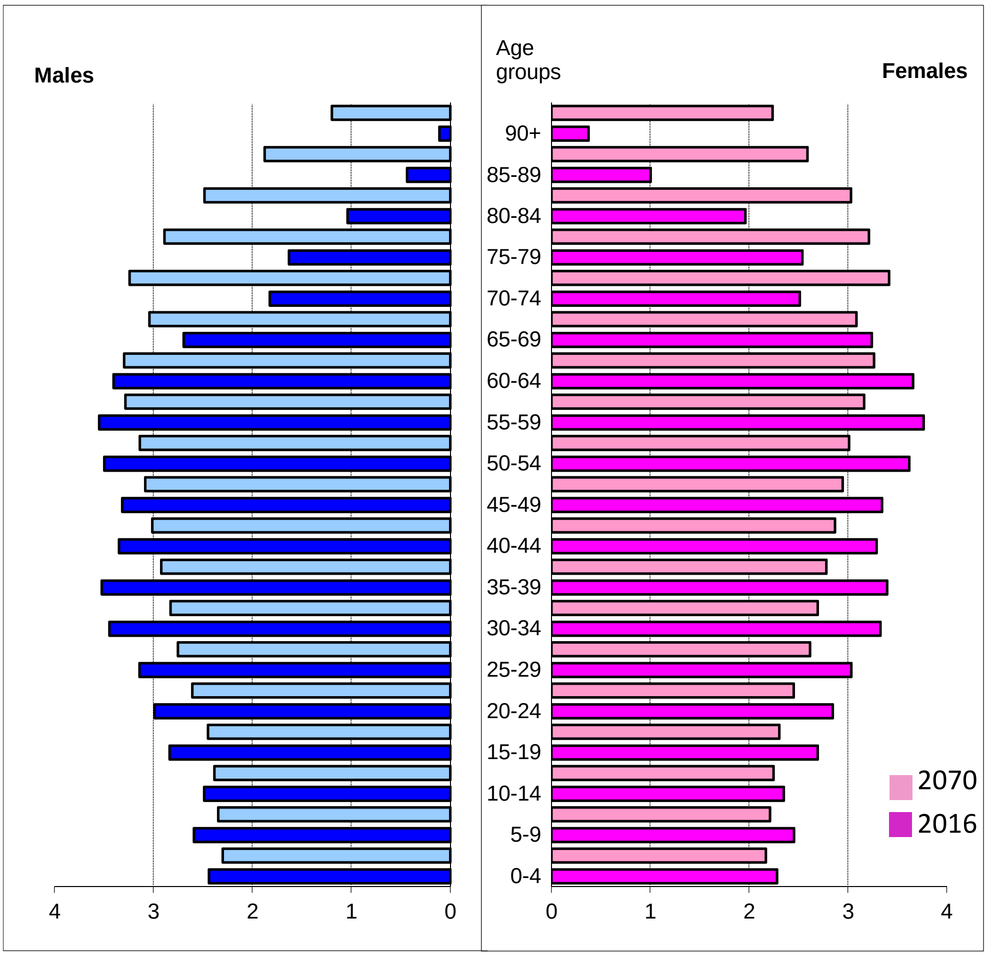
Chart 5.3: Life Expectancy at Birth, men (in years)



Source: The 2018 Ageing Report, EUROSTAT

The gradual equalization of the age required for the retirement for men and women, as well as the prolongation of working years up to the age of 67 should reduce this pressure. Chart 5.4 shows a comparison of age and gender structure of the population of the Republic of Croatia in 2016 with that in 2070.

Chart 5.4: Comparison of Age and Gender Structure of the Population

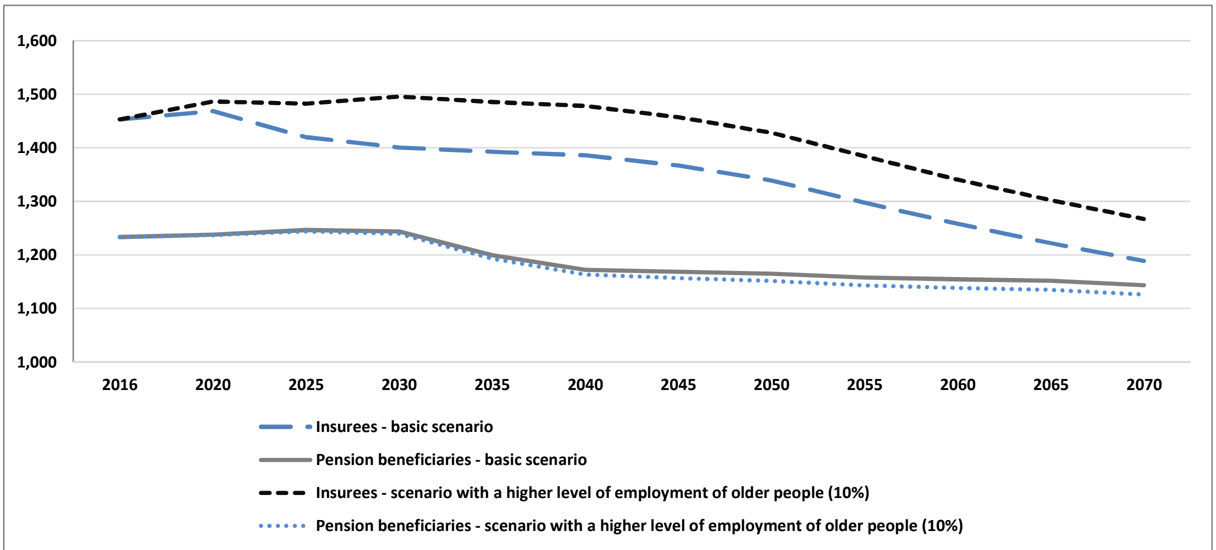


Source: European Commission

According to the EC data from the 2018 Ageing Report, the Republic of Croatia is characterized by a low activity rate and a low population employment rate. This especially refers to elderly population cohorts (age of 55-64 and 65-74). The activity and employment rate considering the workers aged 55 to 64 will have increased by 2040, with the culmination in 2041, after which it will gradually decrease. With the increase in the activity rate by 12% and the employment rate by 14% in the observed period, both rates will amount to 55%, i.e. 52% in 2070. The activity rate and the employment rate considering the workers aged 65 to 74 in the observed period will be almost doubled, from 4.8% in 2016 to 14.4% in 2070, and the peak will be reached in 2063. The median age of the labour force will be gradually increasing to 41 years in 2040, after which it will remain constant.

Chart 5.5 shows the projection of the number of employees (the insured) and the number of pensioners in the period 2016-2070, as well as one of the alternative scenarios, which includes a higher activity rate of older cohorts of population.

Chart 5.5: Projection of the Number of Employees (the Insured) and the Number of Pensioners in the Period 2013-2070

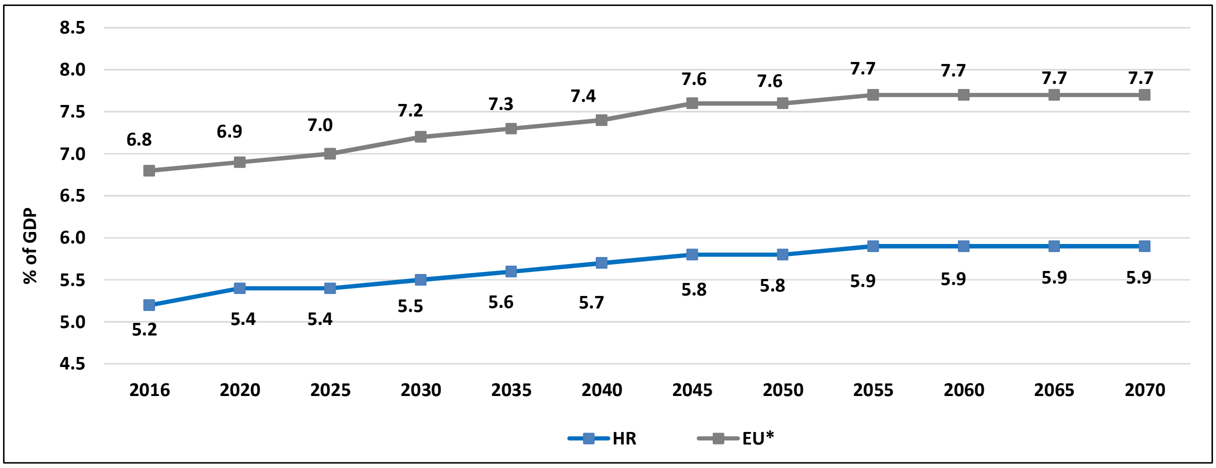


Source: Ministry of Labour and Pension System

Sustainability of Public Finances - Healthcare System

From the healthcare system perspective, demographic changes have a significant impact on the demand for healthcare protection services. According to the EC the 2018 Ageing Report, total spending on the healthcare in the Republic of Croatia amounted to 5.2% of GDP in 2016, which is slightly lower than the EU average of 6.8%. By comparing the changes in the spending over time by 2070, it is noticeable that the share of planned expenditures on healthcare in GDP at the level of the Republic of Croatia is growing by 13%, which is equal to the increase at the EU level.

Chart 5.6: Spending for Healthcare (as % of GDP)



Note: EU is the non-weighted EU average*
Source: The 2018 Ageing Report, AWG baseline scenario

The key challenge in the healthcare sector of the Republic of Croatia is the adjustment of the ways of providing healthcare protection considering the growing number of older people with multiple chronic diseases will require different way of providing healthcare services.

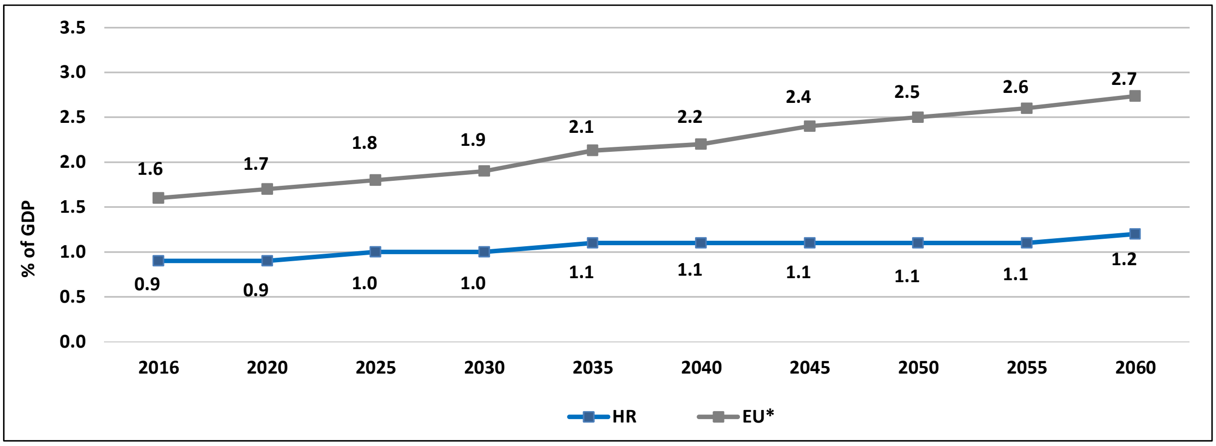
The key strategic document for the development of the healthcare system in the Republic of Croatia is the 2012-2020 National Strategy of the Healthcare Development. Pursuant to the Strategy, the National Plan for the Development of Clinical Hospital Centres, Clinical Hospitals, Clinics and General Hospitals in the Republic of Croatia for 2018-2020, prescribing measures of rationalization of the hospital system, is planned to be adopted. It will contribute to the continuation of the processes in the field of the improvement of hospital healthcare protection and to raising the quality of healthcare protection, optimization of hospital healthcare system resources and financial stability of the healthcare system. The measures by which the defined goal is to be achieved are the reform of the hospital system through functional integration of hospitals and the reform of hospital system with an aim of better human resources management.

By the functional integration, the functional co-operation, i.e. hospital connection, is to be achieved, in order to gain better quality of healthcare services, patients' safety and satisfaction, healthcare service providers' satisfaction, and financial stability and sustainability of the healthcare system. The rationalization of spending will be ensured through the control of the scope and the quality of services provision by healthcare entities.

The hospital system rationalization measures include the control of the expenditures for employees and material expenditures as well as the improved supervision of financial business operations. The Ministry of Health will, together with public institutions/healthcare institutions the founder of which is the Republic of Croatia, carry out public procurement procedures in a way that enables efficient procurement and cost-efficient use of funds. Among other things, the standardization of diagnostic procedures, better quality of healthcare services, control of hospitals' performance, reduction of waiting lists and reduction of secondary and tertiary healthcare protection levels are planned.

According to the 2018 Ageing Report, public spending in the Republic of Croatia for long-term care in 2016 amounted to 0.9% of GDP, while at the EU level it amounted to 1.6% of GDP. It is anticipated that it will increase to 1.2% of GDP by 2070, while at the EU level it will amount to 2.7% of GDP.

Chart 5.7: Spending for Long-Term Care (as % of GDP)



Note: EU is the non-weighted EU average*
Source: The 2018 Ageing Report, AWG baseline scenario

Sustainability of Public Finances - Pension System

As already mentioned above, the life expectancy is increasing, and taking into account unfavourable expectations of natural population growth and net migration, the share of the elderly in total population is also growing, which has negative effects on the costs in the pension system.

The results of the long-term projections for the Republic of Croatia for the period 2016-2070 show that public spending on pensions should be reduced from 10.6% of GDP in 2016 to 6.8% of GDP in 2070. Given that a steady share of pension insurance contributions of about 5.7% to 5.8% of GDP is expected in the projected period, the transfers from the state budget for covering the deficit will gradually decrease from the current 4.8% to around 1.2% of GDP by 2070. Second-pillar pension payments should gradually increase to 1.6% in 2070, which means that total retirement expenditures in the Republic of Croatia would amount to 8.4% of GDP in 2070.

In the forthcoming period, a slight increase in the number of pension beneficiaries is expected despite unfavourable demographic trends and ageing of the population, primarily due to the following reasons: 1) a significant share of the population in younger age groups who will reach the retirement age in the upcoming period but are already retired (e.g. Croatian Homeland War veterans' pensions); 2) the gradual increase in the statutory retirement age for women; 3) the gradual reduction in the number of pension beneficiaries pursuant to special regulations.

According to the EC Projections from the 2018 Ageing Report, a slight increase in the number of the insured persons may be expected in the next few years, primarily due to the expected growth in employment. In the long run, the impact of unfavourable demographic trends and the decreasing number of population in the younger age groups will prevail, which will cause a gradual decline in the total number of insured persons.

On the other hand, there are important factors that will reduce the expenses of the pension system in the future. The baseline scenario anticipates a continuous reduction in the allocations for pensions in the public system, measured as a share of GDP, from 10.6% in 2016 to 6.8% in 2070, as shown in Table 5.1.

With the introduction of the mandatory 2nd pillar from 2027 onwards, the majority of new pensioners will receive basic pension from the 1st pillar and the pension from the 2nd pillar. This means that the expenditures for pensions paid from the 1st pillar will be gradually reduced. The complexity of projections further increases the consideration of the possibility for introducing a pension supplement to pension beneficiaries from the first and the second pension pillars. The pensions realized so far by the insured persons from the first and the second pension pillars are lower than pensions realized only from the first pension pillar with the pension supplement, and therefore it is planned to introduce a pension supplement to the first pension pillar insured persons that are mandatorily insured in the second pension pillar. In this way, the difference in the amount of pensions for the beneficiaries of both mandatory pension pillars in relation to the pensions realized only in the first pillar will be reduced, and this will have an impact on the adequacy of their pensions.

The key measure for the improvement of the efficiency of the pension system is the stimulation of longer years in service, which is intended to be achieved by discouraging early retirement, acceleration of the equalization of the age for early retirement and the statutory-age retirement for women and men, and after that, by gradual increase in the age to 67 years for women and men. This measure will reduce the inflow of new pensioners.

Table 5.1: Expenditures for Pensions and Pension Contributions in the Period 2016-2070 (as % of GDP)

Pension expenditure	2016	2020	2030	2040	2050	2060	2070	Peak
Expenditures of first pension pillar	10.6	10.4	10.0	8.3	7.4	7.0	6.8	2016
Expenditures of second pension pillar	0.0	0.0	0.3	0.8	1.2	1.4	1.6	2070
Total pension system expenditure	**10.6**	**10.4**	**10.3**	**9.1**	**8.6**	**8.5**	**8.4**	**2016.0**
Pension insurance contributions	**2016**	**2020**	**2030**	**2040**	**2050**	**2060**	**2070**	**Peak**
Contributions paid into first pillar	5.8	5.8	5.6	5.6	5.6	5.6	5.6	2017
Contributions paid into second pillar	1.5	1.6	1.8	1.8	1.8	1.8	1.8	2017
Total paid contributions	**7.3**	**7.4**	**7.4**	**7.4**	**7.4**	**7.4**	**7.4**	**2038**

Source: Ministry of Labour and Pension System

The importance of mandatory pension savings in the 2nd pension pillar will gradually increase. By 2027, the majority of new pensioners have the opportunity to return to the 1st pension pillar. The 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 and realize the pension only in the 1st pillar. After 2027, all persons born in and 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.

In 2016, revenues from pension contributions amounted to 5.8% of GDP, and the projections show a slight decrease to 5.6% of GDP by 2030. The reason for this is primarily an increase in the number of employees who realize pension insurance in both pension 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 comes fully to life, revenues from pension contributions in the 1st pillar will stabilize at approximately 5.6% of GDP and will remain constant until the end of the projection period. The difference between the collected contributions and expenditures for pensions amounted to 4.8% of GDP in 2016, and, because of the reduction in the expenditures for pensions in the 1st pillar to 6.8% of GDP, this difference will decrease to 1.2% of GDP by 2070.

Table 5.2 shows the projected values of expenditures for certain types of pensions. The expenses for statutory-age and early-age retirement pensions will not significantly change until 2030, after which they will be reduced due to a more significant share of the pension disbursements from the 2nd pension pillar.

The projection indicates a significant reduction in the number of disability-pension users by 2070. This is the result of more strict criteria for the realization of the right to disability pension. A large share of disability pensions is a consequence of less strict criteria for acquiring disability pensions in the previous period, as well as of a relatively large number of disability pensions received by Homeland War veterans. Since 2015, disability pensions have been translated into statutory-age pensions when a beneficiary reaches the age for receiving a statutory-age pension, resulting in a decline in expenditures for disability pensions and in an increase in the expenditures for statutory-age pensions in relation to the previous period.

The share of expenditure for family pensions will also gradually decrease, primarily due to demographic trends and the increase in the female employment rate.

Table 5.2: Expenditures from the 1st Pension Pillar in the Period 2016-2070 (% of GDP)

Pension types	2016	2020	2030	2040	2050	2060	2070	Peak
Expenidures of first pension pillar	**10.6**	**10.4**	**10.0**	**8.3**	**7.4**	**7.0**	**6.8**	**2016**
Old age and early retirement pensions	6.9	6.9	6.9	5.6	5.1	4.9	4.8	2026
Disability pensions	1.84	1.75	1.47	1.25	1.03	0.91	0.86	2016
Family pensions	1.84	1.73	1.62	1.45	1.31	1.24	1.17	2016

Source: Ministry of Labour and Pension System

6. QUALITY OF PUBLIC FINANCES

6.1. Strategic Framework

In the following medium-term period, the continuation of reform efforts is planned in order to strengthen the fiscal sustainability and create foundations for economic growth. In this regard, the Government of the Republic of Croatia will focus on the creation of the fiscal policy for the purpose of promoting competitiveness of the economy, increasing the public sector efficiency and strengthening the public financial management, both on the revenue and the expenditure side of the budget.

6.2. Measures on the Revenue Side of the Budget

In the period 2018-2021, special attention will be paid to fair and efficient collection of public revenues, the focus of the Tax Administration's tasks on cooperation and partnership with citizens and entrepreneurs, and the creation of conditions for further tax cuts.

During 2016, on the basis of a comprehensive tax system analysis, the implementation of tax reform was initiated with the aim of making the tax system more efficient, simpler, more stable and fair. In order to achieve these goals by the end of 2016, a total of 16 tax regulations were amended. Although most of the amendments came into force on 1 January 2017, further tax cuts continued in 2018.

Changes in the Taxation by Value-Added Tax

Since January 1, 2018, taxpayers have been granted a deduction of 50% of input tax for the purchase or rental of personal cars and other personal transport equipment the value of which does not exceed HRK 400,000, including the purchase of all goods and services in connection with those goods.

In addition, the threshold for entering the VAT system has increased to HRK 300,000 instead of the previous HRK 230,000. There were also changes referring to the application of the VAT calculation category when importing machinery and equipment referred to in Annex IV of the VAT Act[31] worth more than HRK 1,000,000. This allows taxpayers who import machines and equipment to not pay VAT within 10 days but to report it as a liability in the VAT return, if they have previously been approved that by the Customs Administration's decision.

[31] Official Gazette, number 73/2013, 99/2013, 148/2013, 153/2013, 143/2014 and 115/2016

Changes in the Taxation by Corporate Income Tax

In the corporate income tax system, the Act on Amendments to the Corporate Income Tax Act[32], as of January 1, 2018, stipulates the increase in cost recognized as tax, which incurred in relation to own or leased motor vehicles and other means of personal transportation increased from 30% to 50%.

Changes in the Taxation by Personal Income Tax

New provisions on dependent family members started to apply in the personal income tax system. The amendments that entered into force on January 1, 2018 prescribe that the basic personal allowance may be increased for the personal allowance for children and dependent immediate family members, who are considered to be: spouse, taxpayer's parents, children after the first employment and persons over 18 the taxpayer is appointed a legal guardian to under a special regulation. As described, the circle of persons considered to be dependent family members is reduced.

As of January 1, 2018, tax records containing information relevant to the determination of a personal allowance may also be submitted by the Tax Administration to the employer or the taxpayer themselves electronically (via e-Tax system).

When determining the income from independent professional activity in relation to own or leased personal motor vehicles and other personal transport equipment of entrepreneurs and other persons employed, if the salary or other income is not established on the basis of the use of such personal transport equipment, 50% of these expenditures are expenditure recognized as tax. Natural persons who realize income from independent professional activity, which can be taxed in a lump sum, can determine the income in the lump sum until they realize HRK 300,000 of annual receipts.

For the purpose of further tax cuts, it is stipulated that the cost of accommodation and catering for workers who have concluded a fixed-term contract for seasonal work with the employer, under the prescribed conditions, will no longer be considered as income from the employment. This measure unburdens employers the business operations of which have a seasonal character. Furthermore, the threshold for determining the annual amount above which the salary in kind is determined, is raised from the current HRK 400 to HRK 600, while taxable receipts on the basis of the employment does not include water and hot and cold beverages (other than beverages containing alcohol) that the employer provides to workers during their working hours on his own cost.

Changes in the Taxation of Car Acquisition

Since the beginning of 2018, the amendments to the taxation by special tax on motor vehicles have entered into force, changing the way of calculating the value component of a special tax with the aim of further tax cuts for citizens and entrepreneurs, and creating more favourable tax treatment of motor vehicles with new and more environmentally acceptable technology. New vehicles with a

[32] Official Gazette, number 115/2016

selling price lower than HRK 150,000, representing 65% of all new vehicles sold, have been completely exempt from the taxation by the value criterion. Greater emphasis is placed on CO2 emissions as a taxation criterion. Furthermore, the tax on the acquisition of second-hand motor vehicles was also abolished and it was replaced by the administrative fees charged when acquiring used vehicles, without the need for certifying a contract at the notary public. This reduced the tax burden on citizens, while simplifying the process of transferring ownership over used vehicles. In addition, the part of the Local Taxes Act[33] entered into force relating to the tax on road motor vehicles (for motorcycles and light quads and quads) payable according to the strength of the engine expressed in kilowatts and years of vehicle age.

6.3. Measures to Improve the Efficiency of Budget Expenditures

Given the increasing share of liabilities assumed on the basis of multi-annual contracts in budget expenditures, and for the purpose of improving the efficiency of expenditure, i.e. strengthening public finance management, the improvement of the system of monitoring these liabilities is planned. Since, in the previous cycle, the analysis of the basis for classifying certain types of revenues into the source of financing – Revenues for Special Purpose was implemented, a continuation of the reform efforts linked with monitoring the realization and use of earmarked and own revenues of budgetary users is anticipated.

Greater Control over the Creation of Multi-Annual Liabilities

In order to ensure the continuous and multi-annual monitoring of consumption and the fiscal discipline needed for macroeconomic stability, in 2003, monitoring of the creation of multi-annual contractual liabilities was introduced. In that regard, for the first time, the Budget Act[34] stipulates that budgetary users of the state budget have to obtain the consent of the Government of the Republic of Croatia prior to the conclusion of the contracts requiring payments in subsequent years. These are the contracts that assume liabilities for payments in the following years for the acquisition of assets, provision of certain services or co-financing of programmes and projects of certain legal entities, etc. The 2008 Budget Act[35] also extended this liability to budgetary users of the budgets of local and regional (regional) self-government units that need to obtain the consent from the municipal prefect, mayor, or county prefect. The Amendments to the 2012 Budget Act[36] further stipulate that the Minister of Finance may give consent (without submitting a proposal to the Government of the Republic of Croatia) to budgetary users of the state budget for assuming the liabilities under the state budget for the following years if the amount of the total contract obligation

[33] Official Gazette, number 115/2016 and 101/2017
[34] Official Gazette, number 96/2003
[35] Official Gazette, number 87/2008
[36] Official Gazette, number 136/2012

does not exceed the amount determined by the State Budget Execution Act. Since such a provision entered into force, this amount in the annual state budget execution acts is HRK 10,000,000.

The forecast and control of the future spending is one of the basic instruments for improving the budget preparation process, as well as maintaining or reducing the level of public expenditure in the anticipated macroeconomic framework. Hence, the amendments to the 2015 Budget Act[37] extend the application of these provisions to budgetary users that assume liabilities under contracts that require payments in subsequent years, and these are financed from their earmarked or own revenues, regardless of the exemption from the obligation of payment therefor in the state budget.

With regard to the amount of liabilities assumed on the basis of multi-annual contracts, which will, along with the fulfilment of certain conditions, be carried out from budgetary funds in the coming years, in 2017 the secondary legal act for budgets and budgetary users introduced the obligation of keeping the analytical accounting records of liabilities under these contracts.

When giving the consent to budgetary users of the state budget to assume multi-annual liabilities, the Ministry of Finance considers the availability of funds for assuming future liabilities and the justification of the purpose which the assumption of a liability and the provision of consent is required for. For the sake of uniformity, and taking into account that these consents are also given by local and regional self-government units to their budgetary users, it is necessary to prescribe the criteria for giving such consent.

Currently, the consent of the Government of the Republic of Croatia, i.e. given by the Minister of Finance, is not required for liabilities related to government borrowing and government debt management, nor for liabilities assumed under international agreements and projects financed from EU funds. However, as EU funds represent an increasingly important source of financing, whereby, a part necessary for co-financing from national sources increase as well, it is also necessary to introduce better control over the creation of multi-annual contractual liabilities arising from the implementation of projects financed from these sources, in a way that will not slow down their contracting and implementation.

Harmonization of Monitoring and Better Control of the Use of Own and Earmarked Revenues

According to the provisions of the Budget Act[38], the earmarked revenues and receipts of the budget are: grants, donations, revenues for special purposes, revenues from sales or exchange of state-owned assets, or assets of local and regional self-government units, fees on the basis of insurance, and earmarked receipts from borrowing and selling of stocks and shares. The state budget execution act, i.e. the decision on the execution of the budgets of local and regional self-government units, may prescribe an exemption from the obligation to pay these revenues to the budget.

The Budget Act separates own revenues from earmarked revenues and define them as revenues realized by budgetary users from doing business on the market and under market conditions, which

[37] Official Gazette, number 15/2015
[38] Official Gazette, number 87/2008, 136/2012 and 15/2015

are not financed from the budget. Own revenues are used by users for settling the expenditures incurred by doing business on the market and under market conditions based on which revenues have been realized, and if they are realized in the amount higher than needed for settling these expenditures, they may be for settling the expenditures of regular business activity. In addition, the State Budget execution Act, i.e. the decision on the execution of the budgets of local and regional self-government units, may prescribe an exemption from the obligation to pay these revenues to the budget.

Since 2015, the own and earmarked revenues and receipts of all budgetary users of the state budget are shown in the state budget, whereby these revenues and receipts of the part of institutions are not part of the cash flow of the state treasury system. These institutions continue to realize these revenues on their accounts and they settle their liabilities financed from these sources from their accounts. The records are kept in the state treasury system on the basis of the monthly reports of institutions on the use of own and earmarked revenues. The semi-annual and annual report on the execution of the state budget includes the execution of expenditures of these users financed from the included own and earmarked revenues and receipts.

It is necessary to analyse in more detail the data on the realization and the use of earmarked revenues and receipts and of own revenues of budgetary users excluded from payment into the state budget, on the basis of which these data are recorded in the execution of the state budget. It is necessary to establish within this analysis whether there is room for the improvement in the recording process, so that the data in the annual reports on the execution of the state budget are uniformly expressed.

Annual budget execution acts provide a possibility to competent ministries to set benchmarks and the way of using the own revenues that budget users realize by performing tasks on the market and under market conditions (through ordinances or instructions), but with the consent of the Ministry of Finance. So far, such ordinances were adopted by the Ministry of Justice in 2016 and by the Ministry of Environmental Protection and Energy in 2017.

The importance of monitoring of the use of earmarked and own revenues realized by budgetary users from under the competence of individual ministries, as well as of local and regional self-government units, has also been recognized in the fiscal responsibility system. Thus, one of the questions from the Fiscal Responsibility Questionnaire, based on which the Fiscal Responsibility Statement is issued, is linked to the obligation of monitoring the use of these revenues by the competent ministry, i.e. by the competent local and regional self-government unit.

Consequently, consideration will be given to introducing an obligation for ministries and local and regional self-government units to adopt acts which will formally regulate the realization and use of earmarked revenues and receipts and own revenues of their users.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. Improvement of the Quality of Key Documents of the Budget Process

The preparation of the Amendments to the Budget Act, which are intended to strengthen budget planning, control of expenditure execution and to improve the fiscal statistics in accordance with the provisions of the Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, is underway.

Economic and Fiscal Policy Guidelines

The Convergence Programme is a key strategic starting point for the preparation of economic and fiscal policy guidelines. According to the existing legislative framework, the guidelines include:

- economic policy objectives for a three-year period;
- macroeconomic and fiscal framework with possible changed circumstances in relation to those defined in the Convergence Programme, and
- the level of the financial plan (limits) by the state budget divisions for the next three year period.

Within the guidelines themselves, it is necessary to further clarify the macroeconomic and fiscal framework that should include the assumptions on the basis of which macroeconomic projections are made, the explanation of significant differences between macroeconomic and budgetary projections and the latest available projections of EC, multi-annual budgetary targets expressed in the indicators of deficit, i.e. surplus of the general budget, public debt and the levels of revenues and expenditures of the general budget, projections by types of revenues and expenditures of the general budget based on the fiscal effects of unchanged acts, other regulations and planning acts, and the description of the anticipated changes in the acts, other regulations and planning acts with the fiscal effect in the medium-term budgetary period.

Instruction for the Preparation of Draft State Budget

Guidelines are the basis for drawing up instructions for drafting the state budget proposal. These instructions are intended for budgetary and extra-budgetary users of the state budget.

Legislative framework requires the obligation for ministries to draw up more detailed instructions for budgetary and extra-budgetary users within their competencies, in which, *inter alia*, they determine limits to their budgetary users, including the third level of users. Based on the established limits, budgetary users make draft financial plans and submit them to the competent ministry, which then prepares a harmonized draft financial plan. This will result in better quality of the consolidated financial plans of the ministry with a large number of budgetary users and ensure a smooth process of the execution thereof.

Budget

Budget is the most important public finance act. So far, it has contained exclusively a general and a special part, while that of local and regional self-government units has also contained a development program plan.

The legislative framework needs to supplement the contents of the budget in a way that the explanation becomes its integral part, both at the state level and at the level of local and regional self-government units. At the state level, it is common practice to prepare an explanation of revenues and expenses, receipts and expenditures of the budget, as well as of activities and projects of budgetary users of the state budget. At a local and regional self-government level, the situation differs significantly from unit to unit.

By introducing the medium-term budget planning and programme planning in line with best European practice, the emphasis is placed on the results achieved by the implementation of programmes, activities and projects, rather than the type and level of costs, thus requiring the user to take responsibility for the results of the implementation of the programme. Therefore, the explanation becomes an increasingly important part of the budget, i.e. of the financial plan. Along with stating the explanation as an integral part of the budget, it is also necessary to prescribe its contents.

Fiscal Statistics

For the purpose of improving fiscal statistics, a more efficient financial and statistical reporting system will be established, especially those of extra-budgetary users entering the general government sector in accordance with the ESA 2010 methodology. Furthermore, the Budget Act will also prescribe the obligation to publish information on potential liabilities with significant effect on the budget as well as the obligation to define the contents, time period and scope, and the way to publish information on the effects of tax expense on revenues. Furthermore, it is planned that the method of monitoring and publishing fiscal data for the general budget will be prescribed according to the ESA 2010 methodology.

7.2. Improvement of the Legislative Framework for Borrowing of Local and Regional Self-Government Units

Based on the existing Budget Act, local and regional self-government units can borrow a long-term loan only for the investment financed from their budget, which is confirmed by its representative body, with the prior given consent of the Government of the Republic of Croatia. The total annual liability of the local and regional self-government unit, which borrows a long-term loan or issues a long-term guarantee/consent, must not exceed 20% of the revenue realized in the year preceding the year in which it borrows, reduced by the revenues from grants and donations and revenues realized on the basis of an additional share in income tax and equalization grants for financing decentralized functions.

The scope of possible borrowing (of 20%) of the local and regional self-government unit, i.e. in the calculation of the total annual liability includes:

1. the amount of the average annual annuity for new debts, whether for credits, loans or liabilities on the basis of issued securities and given guarantees,
2. the amount of the average annual annuity for the consents given to:
    - legal persons that are majority owned or co-owned by local and regional self-government units that have reported a loss in the annual financial statements for the year preceding the year in which they borrow,
    - legal persons that are majority owned or co-owned by local and regional self-government units that borrow in the period of two years from the date of entry into the court register, or newly established legal person of the local and regional self-government unit,
    - an institution the founder of which is a local and regional self-government unit, and
3. the amount of the average annual annuity from the previous years for credits, loans, liabilities on the basis of securities and given guarantees, and
4. due liabilities from the years preceding the year in which they borrow, on the date of submitting the application.

The control of the fiscal limit of the above-mentioned 20% does not refer to projects co-financed from the EU funds in which local and regional self-government units participate. In these cases, there is no need for the consent of Government of the Republic of Croatia for the borrowing. Therefore, local and regional self-government units may borrow for the projects co-financed from the EU funds with the consent of the Minister of Finance.

Since there is a significant increase in the share of borrowing for co-financing of projects from the EU funds in relation to the revenues of individual local and regional self-government units, it is necessary to reconsider the above provisions of the Budget Act, i.e. to consider introducing limitations in relation to the revenues of a unit, whereby it is necessary to take into account that new mechanisms do not slow down the contracting and implementation of EU projects. It is also necessary to consider the status of energy efficiency projects.

Given that the decisions on the borrowing of local and regional self-government units are made by the Government of the Republic of Croatia, it is necessary to prescribe the situations in which it is not necessary to seek again the consent of the Government of the Republic of Croatia if the conditions of a credit or a loan change in a way that they are more favourable for the local and regional self-government unit, i.e. in a way that the borrowing burden is reduced for the local and regional self-government unit.

7.3. Improvement of the Fiscal Framework

In order to meet the EU Council Recommendation within the European Semester, a draft of the new Fiscal Responsibility Act has been prepared, which fully aligns fiscal rules with the provisions of the Stability and Growth Pact and strengthens the independence and extends the competence of the Fiscal Policy Committee (hereinafter: the Committee).

This Act prescribes numerical fiscal rules, i.e. the rule of structural balance, the rule of expenditure and the rule of public debt. The Act also prescribes the rule of the amount of the deficit for the projections of the state budget. The new Act also defines the obligation to adhere to the EU Council Recommendations during the excessive deficit procedure, with an aim of solving the condition of the excessive budgetary deficit and public debt. In addition, the procedures are prescribed in case the Government of the Republic of Croatia or the Committee determines the risk of significant deviations from the fiscal rules defined by the Act.

Furthermore, this Act continues to strengthen the independence of the Committee, which is defined as a permanent, independent and autonomous state body. In order to emphasize the independence of the Committee, the Act stipulates that the Head of the Committee is a professional and that general labour regulations are applied to them appropriately. The Committee consists of seven members from among scientists and experts in the areas of public finances, macroeconomics, economic policy and accounting. It is also anticipated that there are employed civil servants performing professional, administrative and technical affairs within the Committee. In this way, the Committee is given a stronger role of the supervisor over the implementation of the Fiscal Responsibility Act, but also over the implementation of the fiscal policy in its entirety, all with the aim of improving the public finance system.

7.4. Provision of the Stricter Implementation of the State Audit Recommendations

This measure includes the adjustment of the legislative framework in relation to the sanctioning of failures to act according to the recommendations of the State Audit Office, and it is carried out with an aim of increasing the sustainability of public debt and strengthening of public finance management. More precisely, according to the Report on the Performance of the State Audit Office for 2017, even 31.8% of orders and recommendations given by the State Audit Office was not executed (in 2016, it amounted to 27.9%, and in 2015 to 29.2%). The Ministry of Finance together with the State Audit Office considered the models of sanctioning for failures to act according to orders and recommendations given by the Office. Since over the multiannual application of the State Audit Office Act there were certain defaults noticed, i.e. possible improvements were recognized, the decision was made to prepare the appropriate legislative solution. It will introduce the sanctioning of subjects of audits and responsible persons for failures to carry out given orders and recommendations and for failures to submit the reports within the set deadline; it will more clearly determine and identify the subjects of audit and what the audit procedure includes; it will extend the deadline for the submission of the reports on the performed audit of the annual report on the execution of the state budget; it will introduce the possibility to engage special experts as external co-operators for solving specific issues; and it will clarify in more details the duties of the employees working in the State Audit Office.

ANNEXES

Annex 1: Macroeconomic Prospects

	ESA Code	2017 (level)	2017 (rate of change)	2018 (rate of change)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)
1. Real GDP	B1*g	359,118	2.8	2.8	2.7	2.5	2.5
2. Nominal GDP	B1*g	363,310	4.0	4.3	4.4	4.1	4.0
Components of real GDP							
3. Private consumption expenditure[1]	P.3	207,432	3.6	2.9	2.8	2.6	2.5
4. Government consumption expenditure	P.3	70,234	2.0	2.2	2.2	1.8	1.5
5. Gross fixed capital formation	P.51	71,883	3.4	6.7	6.3	5.6	5.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	2,400	0.7	0.8	0.9	0.9	1.0
7. Exports of goods and services	P.6	181,638	6.1	5.3	5.2	4.9	4.7
- of which goods	*P.61*	*86,089*	*8.7*	*7.3*	*7.1*	*6.4*	*6.1*
- of which services	*P.62*	*95,549*	*3.8*	*3.6*	*3.5*	*3.5*	*3.4*
8. Imports of goods and services	P.7	174,469	8.1	7.4	6.8	6.0	5.7
- of which goods	*P.71*	*144,486*	*7.5*	*7.0*	*6.7*	*6.0*	*5.7*
- of which services	*P.72*	*29,983*	*11.2*	*9.1*	*7.4*	*6.1*	*5.7*
Contribution to real GDP growth							
9. Final domestic demand	P.3 + P.51	349,548	3.1	3.5	3.3	3.0	2.9
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	2,400	0.4	0.1	0.1	0.0	0.1
11. External balance of goods and services	B.11	7,170	-0.8	-0.9	-0.8	-0.6	-0.5

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

1 Includes final consumption expenditure of non-profit institutions serving households.

Source: CBS, MF

Annex 2: Price Developments

	2017 (rate of change)	2018 (rate of change)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)
1. GDP deflator	1.2	1.6	1.6	1.5	1.5
2. Private consumption deflator[1]	1.0	1.3	1.2	1.4	1.5
3. CPI[2]	1.1	1.4	1.4	1.5	1.6
4. Public consumption deflator	1.8	2.7	2.2	1.6	1.4
5. Investment deflator	0.4	1.5	1.7	1.8	1.7
6. Export price deflator (goods and services)	2.5	2.0	1.9	1.8	1.7
- of which goods	*1.2*	*1.0*	*1.8*	*1.7*	*1.6*
- of which services	*3.7*	*3.0*	*2.0*	*1.8*	*1.8*
7. Import price deflator (goods and services)	2.2	2.1	1.7	1.7	1.7
- of which goods	*2.5*	*2.1*	*1.7*	*1.7*	*1.7*
- of which services	*0.8*	*1.6*	*1.6*	*1.7*	*1.8*

1 Includes final consumption expenditure of non-profit institutions serving households.

2 Inflation as measured by consumer price index.

Source: CBS, MF

Annex 3: Labour Market Developments

	ESA Code	2017 (level)	2017 (rate of change)	2018 (rate of change)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)
1. Employment, persons[1]		1,634	2.2	1.8	1.6	1.4	1.3
- of which, employees		1,424	4.0	2.4	1.6	1.3	1.2
- of which, self-employed		210	-8.7	-2.3	1.2	2.1	2.1
2. Employment, hours worked		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)[2]			11.2	10.0	9.1	8.2	7.3
4. Labour productivity, persons[3]			0.6	1.0	1.1	1.1	1.1
5. Labour productivity, hours worked		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Unit labour cost			-1.7	1.6	1.4	1.4	1.3
7. Compensation of employees[4]	D.1	165,446	2.9	5.1	4.2	3.8	3.7
8. Compensation per employee[5]		9,682	-1.1	2.6	2.5	2.4	2.4

1 *Domestic concept 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 2017 level is in HRK million.*
5 *Data for 2017 level is an average monthly compensation per employee in HRK.*
Note: Preliminary data for 2017.
Source: CBS, MF

Annex 4: Sectoral balances

	ESA Code	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	4.3	4.1	3.1	2.3	1.5
of which:						
- Balance on goods and services		2.3	1.3	0.6	0.1	-0.4
- Balance of primary incomes and transfers		1.6	1.5	1.2	0.9	0.7
- Capital account		0.5	1.2	1.3	1.3	1.2
2. Net lending/borrowing of the private sector	B.9	2.9	4.7	3.5	2.4	1.0
3. Net lending/borrowing of general government	EDP B.9	0.8	-0.5	-0.4	0.0	0.5
4. Statistical discrepancy		0.7	0.0	0.0	0.0	0.0

Note: Forecasts of transfers and capital account are more conservative than fiscal projections.
Source: CNB, MF

Annex 5: General Government Budget

	ESA Code	2017 (level, HRK billion)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	2.8	0.8	-0.5	-0.4	0.0	0.5
2. Central government	S.1311	2.5	0.7	-0.7	-0.4	-0.1	0.4
3. State government	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	-0.1	0.0	0.1	0.0	0.0	0.0
5. Social security funds	S.1314	0.4	0.1	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	167.2	46.0	46.0	45.2	45.1	44.6
7. Total expenditure	TE[1]	164.4	45.3	46.5	45.6	45.1	44.1
8. Net lending/borrowing	EDP B.9	2.8	0.8	-0.5	-0.4	0.0	0.5
9. Interest expenditure	EDP D.41	9.8	2.7	2.5	2.1	1.5	1.4
10. Primary balance[2]		12.5	3.4	2.0	1.7	1.5	1.9
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)		94.6	26.0	26.0	25.3	25.2	25.1
12a. Taxes on production and imports	D.2	71.6	19.7	19.8	19.1	19.1	19.0
12b. Current taxes on income, wealth, etc	D.5	23.0	6.3	6.2	6.2	6.1	6.1
12c. Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	43.3	11.9	12.0	12.0	12.0	11.9
14. Property income	D.4	4.5	1.2	1.1	1.0	1.0	0.9
15. Other[4]		24.8	6.8	6.9	6.9	6.9	6.7
16=6. Total revenue	TR	167.2	46.0	46.0	45.2	45.1	44.6
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		137.9	38.0	38.0	37.3	37.2	37.0
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	70.2	19.3	19.4	19.4	19.2	18.9
17a. Compensation of employees	D.1	41.4	11.4	11.5	11.4	11.3	11.1
17b. Intermediate consumption	P.2	28.8	7.9	7.9	7.9	7.9	7.8
18. Social payments (18=18a+18b)		57.2	15.7	15.6	15.5	15.3	15.1
***of which* Unemployment benefits**[6]		0.8	0.2	0.2	0.2	0.2	0.2
18a. Social transfers in kind supplied via market producers	D632	8.4	2.3	2.2	2.2	2.2	2.3
18b. Social transfers other than in kind	D.62	48.8	13.4	13.4	13.3	13.1	12.8
19=9. Interest expenditure	EDP D.41	9.8	2.7	2.5	2.1	1.5	1.4
20. Subsidies	D.3	6.2	1.7	2.0	1.8	1.7	1.6
21. Gross fixed capital formation	P.51	9.8	2.7	3.5	3.5	3.7	3.6
22. Capital transfers	D.9	4.8	1.3	1.6	1.6	1.8	1.8
23. Other[7]		6.4	1.8	1.8	1.7	1.8	1.8
24=7. Total expenditure	TE[1]	164.4	45.3	46.5	45.6	45.1	44.1
p.m.: Government consumption (nominal)	P.3	71.3	19.6	19.7	19.7	19.6	19.3

Source: CBS, MF

Annex 6: Projections without Changes in Policy

	2017 (level, HRK billion)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)
1. Total revenue at unchanged policies	167.2	46.0	46.3	46.0	45.8	45.4
2. Total expenditure at unchanged policies	164.4	45.3	46.5	45.6	45.1	44.1

Source: CBS, MF

Annex 7: Amounts to be excluded from the Expenditure Benchmark

	2017 (level, HRK billion)	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)
1. Expenditure on EU programmes fully matched by EU funds revenue	2.5	0.7	1.9	2.0	2.3	2.1
1.a Of which investment (GFCF) fully matched by EU funds revenue	1.3	0.4	1.1	1.1	1.2	1.1
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]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Revenue increases mandated by law	0.2	0.1	0.04	n.a.	n.a.	n.a.

Source: CBS, MF

Annex 8: General Government Expenditure according to Functional Classification

	COFOG Code	2016 (% of GDP)	2021 (% of GDP)
1. General public services	1	8.8	n.a.
2. Defence	2	1.2	n.a.
3. Public order and safety	3	2.3	n.a.
4. Economic affairs	4	5.3	n.a.
5. Environmental protection	5	0.6	n.a.
6. Housing and community amenities	6	1.1	n.a.
7. Health	7	6.5	n.a.
8. Recreation, culture and religion	8	1.8	n.a.
9. Education	9	4.8	n.a.
10. Social protection	10	14.7	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	47.2	44.1

Source: CBS, MF

Annex 9: General Government Debt

	ESA Code	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)
1. Gross debt[1]		78.0	75.1	72.1	69.1	65.9
2. Change in gross debt ratio		-2.7	-2.9	-3.0	-3.0	-3.2
Contributions to changes in gross debt						
3. Primary balance[2]		3.4	2.0	1.7	1.5	1.9
4. Interest expenditure[3]	EDP D.41	2.7	2.5	2.1	1.5	1.4
5. Stock-flow adjustment*		-1.9	-3.4	-3.3	-3.1	-2.6
of which:						
- Differences between cash and accruals[4]						
- Net accumulation of financial assets[5]		0.4	0.3	0.3	0.2	0.0
of which:						
- privatisation proceeds		0.1	0.3	0.3	0.2	0.0
- Valuation effects and other[6] *		0.3				
p.m.: Implicit interest rate on debt[7]		3.5	3.3	2.9	2.2	2.1
Other relevant variables						
6. Liquid financial assets[8]						
7. Net financial debt (7=1-6)		78.0	75.1	72.1	69.1	65.9
8. Debt amortization (existing bonds) since the end of the previous year		5.0	3.1	4.6	4.7	3.3
9. Percentage of debt denominated in foreign currency		75.4				
10. Average maturity		-	-	-	-	-

**Change in deposits*
Source: CNB, CBS, MF

Annex 10: Cyclical Trends

	ESA Code	2017 (% of GDP)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)
1. Real GDP Growth (%)		2.8	2.8	2.7	2.5	2.5
2. Net Lending of general government	EDP B.9	0.8	-0.5	-0.4	0.0	0.5
3. Interest expenditure	EDP D.41	2.7	2.5	2.1	1.5	1.4
4. One-off and other temporary measures[1]						
Of which: On the revenue side: general government						
On the expenditure side: general government						
5. Potential GDP growth (%)		1.2	1.8	2.1	2.1	2.1
contributions:						
- labour		0.0	0.2	0.4	0.3	0.2
- capital		0.7	0.8	1.0	1.1	1.2
- total factor productivity		0.6	0.7	0.7	0.8	0.8
6. Output gap		-0.4	0.6	1.2	1.6	1.9
7. Cyclical budgetary component		-0.2	0.3	0.6	0.8	0.9
8. Cyclically-adjusted balance (2 - 7)		0.9	-0.8	-0.9	-0.8	-0.4
9. Cyclically-adjusted primary balance (8 + 3)		3.6	1.7	1.1	0.7	1.0
10. Structural balance (8 - 4)		0.9	-0.8	-0.9	-0.8	-0.4

1 *A plus sign means a deficit-reducing one-off measure.*

Source: CBS, MF

Annex 11: Divergence from the Previous Programme

	ESA Code	2017	2018	2019	2020	2021
Real GDP growth (%)						
Previous update		3.2	2.8	2.6	2.5	n.a.
Current update		2.8	2.8	2.7	2.5	2.5
Difference		-0.4	0.0	0.2	0.1	n.a.
General government net lending (% of GDP)	B.9					
Previous update		-1.3	-0.8	-0.3	0.5	n.a.
Current update		0.8	-0.5	-0.4	0.0	0.5
Difference		2.1	0.3	-0.1	-0.5	n.a.
General government gross debt (% of GDP)						
Previous update		81.2	78.4	75.4	72.1	n.a.
Current update		78.0	75.1	72.1	69.1	65.9
Difference		-3.2	-3.3	-3.3	-3.0	n.a.

Source: CBS, MF

Annex 12: Long-Term Sustainability of Public Finance

	2016 (% BDP-a)	2020 (% of GDP)	2030 (% of GDP)	2040 (% of GDP)	2050 (% of GDP)	2060 (% of GDP)	2070 (% of GDP)
Total expenditure							
Of which: **age-related expenditures**							
Pension expenditure	10.6	10.4	10.0	8.3	7.4	7.0	6.8
Social security pension							
Old-age and early pensions	6.9	6.9	6.9	5.6	5.1	4.9	4.8
Other pensions (disability, survivors)	3.7	3.5	3.1	2.7	2.3	2.2	2.0
Occupational pensions (if in general government)							
Health care	5.2	5.4	5.5	5.7	5.8	5.9	5.9
Long-term care (*this was earlier included in the health care*)	0.9	0.9	1.0	1.1	1.1	1.2	1.2
Education expenditure	3.7	3.5	3.3	3.1	3.0	3.1	3.2
Other age-related expenditures							
Interest expenditure							
Total revenue							
Of which: property income							
Of which: from pensions contributions (or social contributions if appropriate)	5.8	5.8	5.6	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 reforms[1]							
Social contributions diverted to mandatory private scheme[2]	1.5	1.6	1.8	1.8	1.8	1.8	1.8
Pension expenditure paid by mandatory private scheme[3]	0.0	0.0	0.3	0.8	1.2	1.4	1.6
Assumptions							
Labour productivity growth	0.9	1.5	1.1	1.8	2.1	1.8	1.5
Real GDP growth	1.1	1.0	1.0	1.6	1.6	1.2	1.0
Participation rate males (aged 20-64)	75.2	76.1	76.8	77.8	78.3	78.3	78.3
Participation rates females (aged 20-64)	65.3	67.0	70.2	72.0	72.6	72.7	72.7
Total participation rates (aged 20-64)	70.2	71.6	73.5	74.9	75.5	75.6	75.6
Unemployment rate (aged 20-64)	12.4	11.0	11.1	9.3	7.5	7.5	7.5
Population aged 65+ over total population	19.4	21.1	24.8	26.9	29.1	30.3	31.2

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

Annex 13: Contingent Liabilities

	2017 (% of GDP)	2018 (% of GDP)
Public guarantees	2.7	n.a.
Of which: linked to the financial sector	n.a.	n.a.

Source: CBS, MF

Annex 14: Basic Assumptions

	2017	2018	2019	2020	2021
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)	1.13	1.23	1.23	1.23	1.23
Nominal effective exchange rate, % change	-1.8	-1.2	0.0	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-vis the € (annual average)	7.46	7.43	7.43	7.43	7.43
World, GDP growth	3.8	3.9	3.9	3.8	3.8
EU GDP growth	2.4	2.3	2.0	n.a.	n.a.
Growth of relevant foreign markets[1]	6.2	6.2	5.1	4.5	4.2
World import volumes	4.8	5.4	4.9	4.5	4.0
Oil prices (USD/barrel)[2]	54,4	66.5	62.8	60.0	63.0

1 Goods.
2 Brent.
Source: EC, IMF, EIU, CNB, MF