REPUBLIC OF CROATIA

CONVERGENCE PROGRAMME OF THE REPUBLIC OF CROATIA FOR THE PERIOD 2019-2022

APRIL 2019

Foreword

At its session on April 18 2019, the Government of the Republic of Croatia adopted the Convergence Programme of the Republic of Croatia for the period 2019-2022. This is the sixth 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 annual cycles of the European Semester, within which each Member State submits its strategic documents to the European Commission (hereinafter referred to as: EC) 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 has been characterized by a series of positive economic indicators. Thus, in 2018, real growth of gross domestic product (hereinafter referred to as: GDP) amounted to 2.6%, whereby the economic activity recovery trend, which began in 2015 after a six-year recession period, continued. Following the realized budget surplus in 2017 in the amount of HRK 2.9 billion, i.e. 0.8% of GDP, due to the tax reform effect as well as to rational budget spending, in 2018 the budget surplus was realized again in the amount of HRK 758 million or 0.2% of GDP, which would have been even more significant had not the one-off liabilities linked with Uljanik group been materialized. Further reduction in the share of general government public debt in GDP also continued, from 77.8% in 2017 to 74.6% in 2018. In addition, the responsible fiscal policy management, accompanied by the active policy of public debt management, contributed to the continuation of the reduction trend of costs for general government interests. Macroeconomic imbalances have also been decreasing, which was confirmed by EC in their report of February 2019, where it is stated that the Republic of Croatia made progress from the category of excessive macroeconomic imbalances into the category of macroeconomic imbalances. Positive economic and fiscal results were also recognized by international financial institutions; at the end of March 2019, the S&P rating agency upgraded the rating of the Republic of Croatia to the investment level. All the abovementioned is an indicator of the importance of political and institutional stability for economic progress.

In spite of such positive indicators, the country's economy continues to be characterized by low potential growth challenges, high levels of public debt and the existing macroeconomic imbalances. Important economic and political activities that the Government of the Republic of Croatia is facing should also be pointed out, especially with regard to economic dialogue with the EU. For instance, after exiting the excessive budgetary deficit procedure in June 2017, the Republic of Croatia is obliged to adhere to the fiscal rules from the preventive part of the Stability and Growth Pact. Furthermore, in accordance with the plans for joining the ERM II exchange rate mechanism, the Republic of Croatia commits itself to a more ambitious medium-term budgetary objective of -1% of GDP, which is in line with the more restrictive conditions that have to be met by the member states of the exchange rate mechanism.

All of this requires decisive measures and clearly defined goals in order to address the existing imbalances and to realize the planned activities. In this regard, the economic policy of the Government of the Republic of Croatia in the medium-term will focus on 3 pillars: high-quality investments, effective structural reforms, macroeconomic stability and sustainable public finances. There is a broad political consensus that macro-fiscal stability and sustainability are based on proper economic growth.

Therefore, special attention will be devoted to the efforts to further strengthen macroeconomic stability and sustainability of public finances in the following medium-term period. This will, along with the simultaneous implementation of structural reforms in 2019 (systematized and described in details in the National Reform Programme), create preconditions for stronger and lasting economic growth and real convergence, especially towards the euro area countries. All the aforementioned should contribute to the successful fulfilment of the preconditions for entry into the ERM II mechanism and then for the introduction of the euro as a national currency, which is also one of the key strategic goals of the Government of the Republic of Croatia.

The economic growth is expected to continue in the forthcoming period. In 2019 real GDP growth of 2.5% is expected, in 2020 it will amount to 2.4%, while in the last two years of the projection period the rates of 2.3% will be recorded. Personal consumption will be the main driver of economic growth in the first two years, while the role of exports of goods and services will gradually increase and gross fixed capital formation will significantly contribute as well, in particular under the influence of the inflow of EU funds.

Fiscal policy in the observed medium-term period will be characterized by efforts to strengthen fiscal sustainability and economic growth along with adequate care for the standard of all citizens. Special attention will be given to the allocation of budget funds for the implementation of structural reforms, activities will be carried out in order to define the potential for more efficient use of budget funds and the expenditure side of the budget will continue to be strictly controlled. In addition, any surplus of revenue in relation to the planned ones will be used for further reduction of public debt.

The revenue side of the budget will be characterized by the effects of the third round of tax unburdening. This reduces the regressive effect of the value-added tax on the most vulnerable groups of citizens and also increases the available income. Amendments in labour taxation reduce the total cost to employers and encourage the retention of educated employees in high value-added sectors. At the same time, the realization of a number of significant infrastructure and scientific-research projects is planned through financing from EU funds, which will thus strengthen the development potential of the entire country.

The expenditure side of the budget is determined by further strengthening of fiscal sustainability along with carrying out the activities to boost economic competitiveness, as well as appropriate care for all layers of the population. Thus, measures aimed at improving the business environment, improving the efficiency of the judicial system and public administration, and the activation of state property will be implemented, which is the foundation and additional impetus for the planned growth of investments. In order to strengthen the potential growth, measures will also be taken to improve the knowledge and skills of present and future labour force and their alignment with the needs of the labour market. Taking into account fiscal stability, as well as the provision of adequate living standards for the citizens of the Republic of Croatia, reforms will be pursued with the aim of strengthening the efficiency of health and social care systems. In this context, special attention will be paid to the measures of demographic renewal. It should also be emphasized that in 2020, the Republic of Croatia will be chairing over the EU Council for the first time, which is an extremely important opportunity for the political affirmation of the Republic of Croatia, but also for its more intensive integration into the decision-making and policy-making system at EU level. In that sense, additional funds are provided in the budget for this purpose.

The described direction of fiscal trends both on the revenue side and on the expenditure side of the budget will result in a slight deficit of the general budget according to the ESA 2010 methodology in the amount of 0.3% of GDP in 2019. In 2020, the surplus of 0.2% of GDP is again anticipated, while in 2021 and 2022 a positive fiscal balance will amount to 0.4% of GDP, i.e. 0.8% of GDP. It is also planned to further reduce the public debt share in GDP by additional 12.5 percentage points by 2022. In addition, the fiscal projections presented in this document indicate that the Republic of Croatia fulfils a new, stricter medium-term budgetary objective of -1% of GDP throughout the projection period, as well as the fiscal rules in accordance with the provisions of the preventive arm of the Stability and Growth Pact, as well as the provisions of the Fiscal Responsibility Act, thus ensuring a sustainable trend of the general government budget deficit and public debt.

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 European Central Bank[2], the International Monetary Fund[3] and EC[4].

According to the latest projections of international institutions, compared to their previous projections, slightly more unfavourable global economic trends are now being expected due to weaker economic activity trend at the end of 2018 than the expected one, and more negative short-term economic indicators at the beginning of 2019, but also as a consequence of trade tensions between USA and China, signs of slowing-down of economic growth in China and the EU countries, materialization of some negative risks in certain countries with macroeconomic imbalances and the uncertainty linked to the exit of the United Kingdom from the EU. The corrections of the 2019 projections are slightly more pronounced, while in the remainder of the projection period the expected growth rates of global GDP and trade remained almost unchanged in relation to the previous projections. We would also like to point out that the corrections of the EU's economic growth in 2019 are particularly pronounced, and of the Eurozone even more, which represents unfavourable correction from the point of view of domestic economy, given the high and growing integration of the Republic of Croatia into the EU. Thus, the slowing-down of the world economy's growth is expected from 3.6% in 2018 to 3.3% in 2019, and then the return to a growth rate of 3.6% in the period 2020-2022. In addition, in 2019, the global trade growth is expected to slow down to 3.4%[5] and then to accelerate to 3.9% in the remainder of the projection period. It is anticipated that in the upcoming medium term, global financing conditions will remain largely favourable, as the key ECB and Fed interest rates are expected to remain at the existing levels in 2019 and that short-term interest rates in the euro area will remain negative at least by 2020. The average exchange rate of euro against the US dollar is expected to amount to 1.13 USD/EUR throughout the projection period, which represents strengthening of the dollar against euro of 4.2% in 2019. As far as price developments are concerned, the inflation in the Eurozone is expected to slow down in 2019 and to remain relatively low in the medium term with slightly accelerating dynamics. Oil prices will record decreases throughout the observed period, while the price of primary commodities excluding oil is expected, after a minor fall in 2019, to slightly increase in the remainder of the projection period.

[1] Based on the data available by April 10, 2019
[2] ECB staff macroeconomic projections for the euro area, March 2019
[3] World Economic Outlook, April 2019
[4] Spring 2019 forecast assumptions
[5] This represents a significant correction in relation to the previous projections (by 0.6 percentage points)

2.1. Gross Domestic Product

During 2018, positive trends in economic activity which started in 2015 after the six-year recession period, continued. The real growth of GDP amounted to 2.6%[6], primarily stimulated by domestic demand, while the contribution of net foreign demand was negative, and the contribution of the change in inventories was positive. By observing the quarterly dynamics, economic growth was the strongest in the first half of the year and it began to weaken towards the end of the year, whereby the economic activity realized in the last quarter of 2018 was below expectations, with a recorded minor growth rate of seasonally adjusted GDP of 0.1%. However, despite the reduced carry-over effect to growth in 2019, high-frequency indicators available from the beginning of the year, as well as economic sentiment indicators, again indicate the positive change of trend in economic activity.

In the medium-term, the continuation of economic growth by slightly slowing rates is expected, under the conditions of retaining positive output gap. In 2019, it is anticipated that the growth of GDP in real terms will amount to 2.5%, which will then slow down to 2.4% in 2020 and then to 2.3% in 2021 and 2022[7]. Throughout the whole medium-term period, the economic growth will be based solely on the contribution of domestic demand, while the contribution of net foreign demand will be negative and will be slightly decreasing, in the absolute value, towards the end of the period. The insignificant contribution of the change in inventories to economic growth was projected, with a negative sign at the beginning and a positive sign at the end of the projection period.

Table 2.1: Gross Domestic Product Forecast

	2018	2019 projection	2020 projection	2021 projection	2022 projection
GDP - real growth (%)	**2,6**	**2,5**	**2,4**	**2,3**	**2,3**
Personal consumption	3,5	3,7	3,3	2,9	2,7
Government consumption	2,9	2,7	1,9	1,9	2,0
Gross fixed capital formation	4,1	6,4	5,3	4,3	4,7
Exports of goods and services	2,8	2,7	3,2	3,3	3,4
Exports of goods	2,8	3,2	4,3	4,4	4,3
Exports of services	2,9	2,2	2,2	2,4	2,5
Imports of goods and services	5,5	5,3	5,2	5,0	5,0
Imports of goods	5,2	5,2	5,1	4,9	4,9
Imports of services	6,6	5,7	5,4	5,2	5,2
Contribution to real GDP growth (percentage points)	**2,6**	**2,5**	**2,4**	**2,3**	**2,3**
Personal consumption	2,0	2,1	1,9	1,7	1,6
Government consumption	0,6	0,5	0,4	0,4	0,4
Gross fixed capital formation	0,8	1,3	1,1	0,9	1,0
Changes in inventories	0,5	-0,1	0,0	0,1	0,1
Exports of goods and services	1,5	1,4	1,6	1,7	1,7
Imports of goods and services	-2,7	-2,6	-2,6	-2,6	-2,6

Note: Preliminary data for 2018.

Source: Croatian Bureau of Statistics, Ministry of Finance

[6] Data on gross domestic product for 2017 and 2018 are provisional

[7] The estimation of macroeconomic impact of the third round of tax reform to real growth of GDP was integrated in this framework and it amounts to 0.25 percentage points in 2019 and 2020 and to 0.07 percentage points in 2021.

Compared with the latest macroeconomic projections of the Government of the Republic of Croatia of November 2018[8], the GDP growth forecast in this macroeconomic framework was corrected slightly downwards in all the years of the projection period, mostly in 2019. This negative correction is primarily a consequence of more unfavourable economic developments in 2018 in domestic economy, most of all in terms of exports of goods and private investments, and of the negative correction of the expected dynamics of foreign demand for goods and services, as well as of volume of global trade. Thus, as observed by the contributions to GDP growth, the largest negative correction was made in the projection of the exports of goods and services in all years of the projection period, especially in the first one, under the influence of significant weakening of the expected dynamics of the exports of goods and slight weakening of the expected dynamics of the exports of services. It should be emphasized here that, in addition to the unfavourable correction of the trajectory of foreign demand for domestic goods, significant impact on the correction of the exports of goods forecast in the medium term came from the negative correction of expected changes in the share of domestic goods exports on Croatian outbound markets, which are still expected to reach positive values, though now only marginal, at the end of the observed period,. On the other hand, the correction of the foreign demand for domestic tourist services had a dominating role in negatively correcting the projected trajectory of the exports of services in relation to the last projections. To a lesser extent, the projection of the contribution of gross fixed capital formation to GDP growth, particularly in 2020 and 2021, was also negatively corrected, primarily due to the negative correction of the dynamics of private sector investment, as a result of weaker performance relative to earlier expectations, slower GDP growth than in the previous period, and worse expectations of the future demand trends. On the other hand, the dynamics of public sector investment is accelerated in 2019 and 2020, under the influence of the expectations of a more intensive inflow of capital EU funds. Contrary to exports and investments, the projection of personal consumption growth is corrected slightly positively throughout the whole period due to favourable realizations at the end of 2018, lower expected inflation over the entire period, especially in 2019, and slight speeding up of dynamics of compensations of employees towards the end of the observed period, as compared with previous forecast. In line with the lower growth rate of final demand, especially exports of goods and services and investments characterized by the largest import contents, the growth in imports of goods and services was corrected slightly downwards during the entire projection period, especially in 2019. The projection of government spending contribution to economic growth was not more significantly changed in relation to the last projections.

Personal consumption will remain the main driver of domestic demand growth in the medium-term period, but also of the total economic growth in the first two years, in spite of its slightly slowing dynamics which reflects the projected trends of the disposable income of the household sector. It is anticipated that the growth of personal consumption in 2019 will be somewhat higher than in 2018, reflecting primarily a slight acceleration of the real growth of the disposable income of households due to the continuation of favourable trends on the labour market, slowdown of the inflation of consumer prices and other positive effects of the third round of the tax reform. In addition, a favourable effect on personal consumption is also expected from the continuation of the increase in consumer loans, which, however, will not be so pronounced as in 2018, under the conditions of

[8] Explanation of the state budget and financial plans of extra-budgetary users for 2019 and the projections for 2020 and 2021

retaining the consumer sentiment index at high levels, as well as of the continuation of the period of low prevailing interest rates, which additionally reduce the burden of household sector debt. The slowdown of the dynamics of deleveraging of household sector is expected in the remainder of the observed period, along with the slight decrease in the saving rate towards the equilibrium medium-term values.

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 is not expected to be pronounced. The largest contribution to the government consumption growth throughout the whole projection period will be coming from the increase in the intermediate consumption. The contribution from the compensations of employees will be slightly positive and stable during the whole medium-term period due to the expected moderate public sector employment dynamics, which will be slower than the rate recorded in 2018 and slower compared to the private sector dynamics as well. Lower positive and stable contribution to the increase in government consumption is also expected from the category of social transfers in kind, while the slightly negative contribution in the period 2019-2020 is expected from the market output[9].

In 2018, gross fixed capital formation registered slight acceleration of growth in relation to the previous year, to which the realization in the last quarter contributed the most as a result of the strong investment activity of the general government, particularly pronounced in the second half of the year, while private sector investments in 2018 registered a decline[10]. In the following medium-term period, somewhat more pronounced growth in the investment activity is expected, whereby in 2019 it will be generated primarily by public sector investments (general government and majority state-owned enterprises that are not within the scope of the general government according to the ESA 2010 methodology[11]), while in other years stronger contribution to the growth of total investments will come from the private sector. Thus, this macroeconomic framework incorporates weaker private sector investment dynamics in the period 2018-2020, following strong registered increases in 2016 and 2017, which will again be strengthened towards the end of the projection period. It is envisaged that the usage of capital EU funds will increase considerably in the projection period, especially in the general government sector. Furthermore, in the medium term, further improvement of the investment climate is expected in the context of continued good business results and less burdened balances of the corporate sector, favourable trends in the economic sentiment indices, as well as the continuation of favourable financing conditions that will surely be positively influenced also by the recent upgrading of the credit rating of the country. It should also be noted that business surveys show that in the last years the main factor limiting their production is a shortage of labour force, while factors such as insufficient demand, financial constraints or equipment become less and less relevant. Further tax unburdening, as well as the continuation of the implementation of measures for the reduction of the administrative burden on the economy, should also have a favourable impact on facilitation of business operations of entrepreneurs. Due to all the aforementioned, the recovery of inflows of foreign direct investment is also anticipated. Under the conditions of the acceleration of growth in housing prices and the growth of the construction costs

[9] This category refers to the market output, output produced for own final use and payments for non-market output.
[10] Data on GDP for 2018 are provisional.
[11] Investments of the majority state-owned enterprises in this macroeconomic framework are projected more conservatively in relation to their financial plans.

during 2018, the construction activity accelerated, especially in the second half of the year, solely due to the growth of construction works on buildings, while civil engineering works[12] registered further decline. The continuation of the increase in the construction activity is expected in the forthcoming period as well, including the recovery of civil engineering works due to enhanced usage of EU funds, but with persisting constraints linked with the shortage of labour force and high level of indebtedness of companies in this activity.

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

	2018	2019 projection	2020 projection	2021 projection	2022 projection
Total gross fixed capital formation	**4,1**	**6,4**	**5,3**	**4,3**	**4,7**
Broader public sector[1]	**25,9**	**20,1**	**7,0**	**-0,1**	**0,3**
General government	33,1	19,9	6,0	-1,9	1,7
Public enterprises	8,9	20,6	9,7	4,9	-3,2
Private sector	**-1,1**	**2,3**	**4,6**	**5,8**	**6,2**

[1] Consolidated

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

Source: Croatian Bureau of Statistics, Ministry of Finance

The accession of the Republic of Croatia to the EU triggered some positive structural changes which resulted in exports being the main generator of the economic growth, observing the individual components from the expenditure side. However, during 2018, exports realizations were more unfavourable than in the previous years, primarily due to the exports of goods[13]. After five years of consecutive growth in the export markets share, in 2018, for the first time since entering EU, a fall in the share was recorded, under the conditions of a slowdown of foreign demand growth. In the coming years, in line with the aforementioned negative correction of the projection of the foreign demand growth, especially in 2019, as well as the negative correction of the dynamics of changes in shares on Croatian export markets, the growth of exports of goods and services is now expected at considerably lower levels than it was the case in the years after joining the EU. Throughout the projection period, the contribution of the exports of goods will be higher than the contribution of the exports of services. Therefore, not until the last two years of the observed period will exports make the strongest contribution to the economic growth again. As positive effects of EU accession will fade, the exports of goods will to a greater extent follow the export markets dynamics in the coming period. Therefore, after a slight decrease again in 2019, in the rest of the projection period an insignificant but steady increase in the share of exports of goods on domestic export markets is anticipated. Although in 2018 a record tourist season was again registered, there is a noticeable slowdown in the growth of physical indicators as well as revenues from tourism compared to previous years, especially at the peak of the tourist season, which is primarily a consequence of consecutive records achieved over the past period. It should be noted that, unlike the exports of goods growth which have been slowing down only since 2018, the slowdown of growth of exports of services has been visible for the last three years. The accommodation capacity occupancy rate

[12] Include roads, railway tracks, pipelines, bridges, dams, sports fields, etc.

[13] Such unfavourable export trends are a consequence of negative trends in the first and the last quarter of 2018. In the first quarter of 2018, a year-on-year decline in the exports of goods was partly influenced by the unfavourable base effect, while in the last quarter of 2018 its marginal year-on-year increase was largely due to the worsening of the trends in economic activity and foreign demand of major trading partners.

increased in 2018 in relation to the previous years, although during the most of the tourist season it was at a lower level than in the previous two years, whereby it should be noted that the Republic of Croatia has the most pronounced seasonality in tourism compared to EU competitors. Due to the high level of the export of services already reached, high occupancy of accommodation capacities at the peak season, as well as the infrastructure constraints, real growth in the exports of services in the medium term is expected at lower levels than it was in the previous years. Furthermore, the prevailing circumstances in the international environment will also have a negative impact on domestic tourism, referring to the re-strengthening of the Mediterranean competition, increase in the uncertainty over world economic trends, weakening of the economic growth of our major outbound markets and the exit of the United Kingdom from the EU[14]. In the context of intensifying competition, it is important to point out that it is expected that the increase in the quality of tourist services will have a favourable impact on the average tourist consumption. The mild appreciation of the real effective kuna exchange rates will have an unfavourable impact on the price competitiveness of the entire export sector in the forthcoming period, under the conditions of faster growth of domestic unit labour costs compared to the EU. It should be noted that the profit margins in the export sector, largely based on price competitiveness, were under pressure during the recent period due to the increase in labour costs and costs of energy products.

After five years of pronounced import elasticity indexes in relation to the final demand, primarily related to the continued strong growth of exports of goods and services characterized by significant import dependence, in 2018, with a marked slowdown in the exports growth, this elasticity was realized at a somewhat lower level. In the medium-term period, in line with the projected final demand trends, a gradual slowdown in the real growth of imports of goods and services is expected. It is anticipated that the high and growing level of the import dependence of domestic economy, reflected in the shares of import contents in individual components of final demand from the expenditure side of GDP, will condition that the elasticity of imports in relation to the final demand stabilizes at high levels by the end of the period, even with somewhat lower rates of economic growth. It should be noted that, in the observed period, the most dynamic component of GDP with a particularly pronounced import content will be the investment spending and not exports of goods and services as in the past period. Consequently, taking into account the projected economic activity trajectory, the balance of goods and services trade, expressed in current prices, will turn to a negative sign in 2020 and will continue to worsen by the end of the period. Accordingly, the contribution of net exports to economic growth, although slightly falling (in absolute terms), will be negative throughout the period, at absolutely higher levels than expected in the previous projections, primarily due to the mentioned corrections of the export dynamics. The growth in the imports of services will remain more dynamic than the growth of imports of goods over the entire period.

The last year's Convergence Programme projected a growth in economic activity of 2.8% in 2018 and the realization was by 0.1 percentage points lower than expected. The biggest deviation from the projection derives from the realization of exports of goods and services (by 1.3 percentage points lower contribution to GDP), to a greater extent due to the weaker realization of exports of goods and

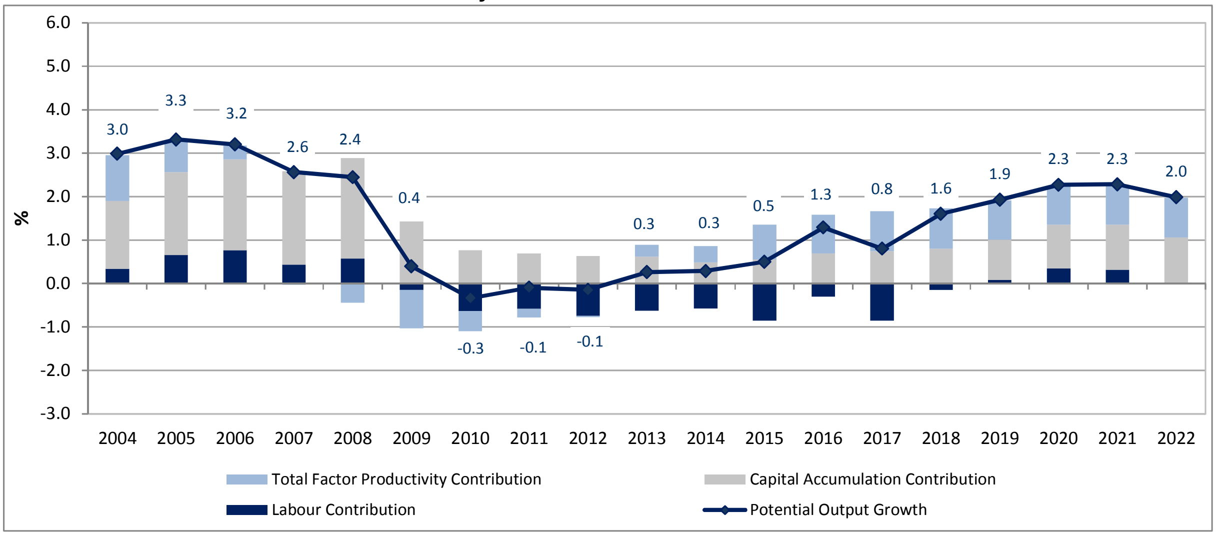
[14] In 2018, Germany, Italy and Great Britain accounted for 36% of revenues from our exports of services. According to the UNWTO, in 2018 the increase of 6% in international tourist arrivals in the world was realized, while in 2019 the increase of 3-4% in international tourist arrivals is expected.

to a lesser extent to the weaker realization of exports of services than anticipated. In addition, a more significant negative deviation (-0.5 percentage points in terms of contribution to growth) arises from the realization of gross fixed capital formation, which is exclusively due to the more unfavourable realization of private investments, while general government investments recorded significantly stronger growth than expected. On the other hand, lower growth in imports of goods and services than anticipated (lower negative contribution of imports by 0.9 percentage points) had a favourable impact on the GDP growth, as a consequence of lower final demand growth than expected. Household consumption and changes in inventories contributed slightly more positively to GDP than expected (by 0.3 percentage points each), while the contribution of government spending was only marginally higher than anticipated (by 0.1 percentage points).

2.2. Cyclical Trends

After the potential GDP had been falling or slightly increasing in the period between 2009 and 2015, since 2016 it has been growing at somewhat higher rates reaching a growth rate of 1.6% in 2018. The biggest contribution to growth in 2018 came from trend total factor productivity, which has been gradually accelerating its growth dynamics since 2013. Slightly lower contribution to growth came from the capital factor, while the labour factor recorded small negative contribution to the potential growth, primarily as a consequence of the decrease of the working-age population.

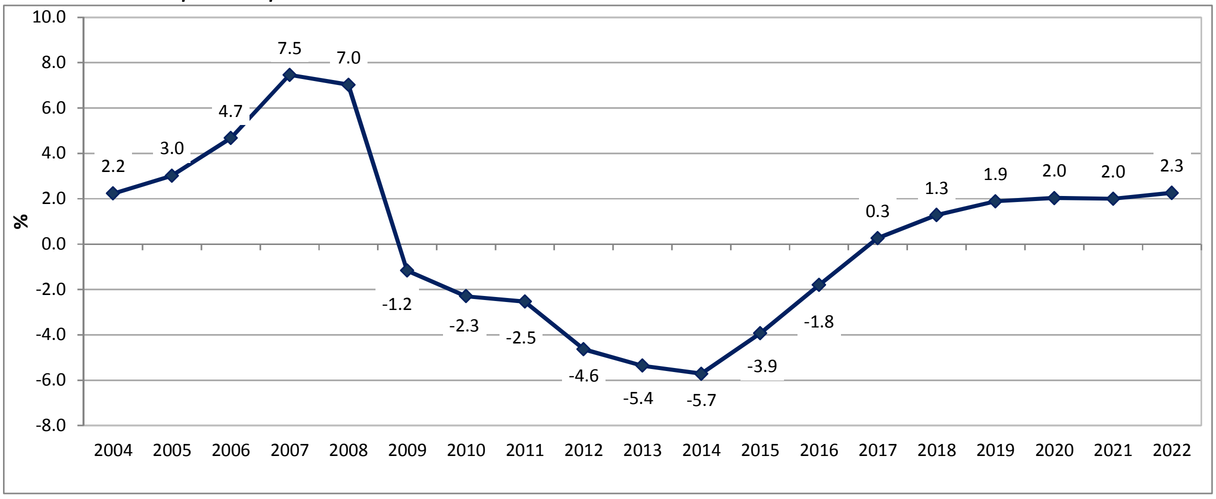
Chart 2.1: Contributions to the Growth of Potential GDP



Source: Ministry of Finance calculation

In the period between 2019 and 2022, the average potential GDP growth of 2.1% is expected. Throughout the projection period, the capital factor will have the highest contribution to the potential growth, due to further intensification of the investment activity. Its contribution to the potential growth will amount to 1.0 percentage points on average, while the total factor productivity will realize the contribution of 0.9 percentage points. Although it is expected that, throughout the medium-term period, the decrease in the number of working-age population15 will have a negative contribution to the labour factor, it will, over the next few years, be surpassed by positive contributions resulting from the reduction in the unemployment rate and the increase in the labour force participation rate. As a consequence, the average contribution of the labour factor will be slightly positive in the period between 2019 and 2021, to become negligible in 2022, primarily due to the gradual slowdown in the unemployment rate reduction.

Chart 2.2: Output Gap



Source: Ministry of Finance calculation

Since real GDP was growing by rates significantly above its potential between 2015 and 2017, there was an accelerated closing-down of the negative output gap, which became slightly positive in 2017. Given that since 2017 the real GDP growth rate has been gradually approaching the potential growth, the positive GDP gap will increase at considerably slower pace and it should reach the level of 2.3% by the end of the projection period.

2.3. Prices

Inflation, measured by the consumer price index, stayed at relatively low levels in 2018 and recorded an average rate of 1.5%, which is a slight acceleration compared to 2017. The most significant factor of inflationary trends during 2018 were prices of fuels and lubricants for personal transport equipment[16], which increased by 7.1% on average, and the prices of food and electricity. Should the components of energy and food be excluded from the consumer price index, there was a mild year-on-year increase of remaining components of 0.9% registered in 2018.

[15] The decline of working-age population, aged from 15 to 74, which has been continuously present since 2006, in the period between 2015 and 2018 amounted to, on average, 1.0%, and the continuation of this trend, along with its gradual slowdown, is also expected in the medium-term period.

[16] The increase in the prices of oils and lubricants for personal transport equipment is a consequence of the year-on-year increase in the price of crude oil, type Brent, on world markets, which in 2018 amounted to 30.6%.

Growth of consumer prices is expected to slow down to 0.8% in 2019 as a result of the expected slowdown in consumer prices in the Eurozone and the application of the reduced VAT rate for certain food products, baby diapers and medicines, the impact of which on inflation is estimated at -0.6 percentage points. It is expected that the effect of the fall in oil prices on the world market on domestic consumer price index will be mitigated by the depreciation of kuna against US dollar exchange rate. In 2019, the positive contribution to inflation will come from the effect of the transfer of the increase of excise duties on tobacco and tobacco products from December 2018 in the amount of 0.2 percentage points, as well as from the rise in gas prices at the beginning of April 2019 in the amount of 0.1 percentage point[17]. As a result, in 2019, food prices are expected to decline and energy prices growth will slow down compared to 2018, while the increase in consumer prices without food and energy will remain at the same level as in the previous year.

As a result of the acceleration of inflation in the Eurozone and the fading of the negative impact of the reduction in the VAT rate from 2019, in 2020 the acceleration of the inflation rate is expected to the level of 1.4%. In 2020, the negative contribution to the inflation trend by -0.2 percentage points will come from the reduction in the general VAT rate from 25% to 24%. In the rest of the projection period, only a slight acceleration of inflation is expected to the levels of 1.5% in 2021 and 1.6% in 2022, due to a slight increase in inflation in the Eurozone, continued increase in household spending, although at slowing dynamics, and continuous increase in unit labor cost, under the conditions of the stagnation of raw material prices in the world market[18].

Table 2.3: Price Developments

	2018	2019 projection	2020 projection	2021 projection	2022 projection
GDP deflator, change (%)	**1.7**	**1.4**	**1.8**	**1.8**	**1.9**
Personal consumption	1.2	0.7	1.3	1.4	1.5
Government consumption	2.7	2.3	2.1	2.1	2.1
Gross fixed capital formation	0.5	1.1	1.7	1.8	1.8
Exports of goods and services	1.8	1.5	1.6	1.6	1.6
Exports of goods	0.6	0.9	1.3	1.5	1.6
Exports of services	2.8	1.9	1.7	1.7	1.7
Imports of goods and services	1.1	0.9	1.1	1.2	1.3
Imports of goods	1.1	0.9	1.1	1.2	1.2
Imports of services	0.8	0.8	1.1	1.3	1.4
Consumer price index, change (%)	**1.5**	**0.8**	**1.4**	**1.5**	**1.6**

Note: Preliminary data for 2018.

Source: Croatian Bureau of Statistics, Ministry of Finance

After the GDP deflator increased by 1.7% in 2018, it is expected that its growth will slow to 1.4% in 2019, mainly as a result of slower growth dynamics of the increase in personal consumption expenditure deflator, which will slow down in line with the consumer prices trend. On the other hand, the investment deflator is expected to accelerate in 2019, primarily driven by the rise in costs in the construction sector and the rise in real estate prices, while the trend in producer prices of capital goods continues to indicate moderate dynamics. The continuation of a strong growth of the

[17] It is expected that as of April 2019 the increase in the price of gas will amount to 6.9%, which will result in the effect to the increase in consumer price index of 0.11 percentage points in 2019 and of 0.04 percentage points in 2020.

[18] According to the projections of the International Monetary Fund (April 2019), the price of oil, type Brent, (in US dollars) should register slight decreases in 2021 and 2022 (of -1.2% and -0.7%, respectively), while the primary commodity prices excluding oil are expected to slightly increase by on average 0.6% in the same period.

government consumption deflator is also expected, under the influence of the increase in the base for salaries of employees in civil and public services. The growth slowdown of the deflator of imports of goods and services during 2019 will reflect a decline in raw material prices on world markets and somewhat slower growth of prices in the Eurozone. The slowdown in growth of exports of goods and services deflator is a consequence of a lower growth rate of the deflator of the export of services, under the assumption that the price competitiveness is maintained under the conditions of the tourist demand weakening. Despite the continued internal cost pressures, the exports of goods deflator is still not expected to accelerate significantly in 2019. In the next three years, the GDP deflator will gradually accelerate to the level of 1.9% in 2022, whereby it is expected that the most dynamic components will be the government consumption deflator, which will reflect the expected trajectory of salaries in civil and public services, and gradual acceleration of consumer prices, and the deflator of investments, due to the higher growth of capital goods prices and the continuation of the rise in prices in the construction sector. In addition, in the rest of the projection period, the continuation of the positive contribution of the improvement in terms of trade of goods and services is expected, whereby terms of trade of services will reflect further weakening of the price growth in tourism, regarding the terms of trade of goods stronger spillovers of domestic cost pressures to the exports of goods deflator is expected.

2.4. Labour Market

In spite of the significant recovery due to favourable cyclical trends, domestic labour market faces structural challenges which have particularly intensified in recent years, with the opening of the EU labour market for domestic workers. Labour supply and demand mismatch (inadequate education, lack of skills, low participation in lifelong learning), low labour force participation and short working life duration have been additionally strengthened by negative demographic trends. In the circumstances of the strong labour demand, described trends have led to a significant lack of labour force, increased necessity for the import of labour force, and consequently upward pressures on the wage growth in certain deficient industries.

After last year's stagnation the labour force declined again in 2018, while the growth of employment had slowed down. In the forthcoming period, it is expected that the continuation of economic growth will have a positive impact on the mild increase in the labour force, which will be contributed by the measures directed towards the adjustment of the educational system to labour market needs and the stimulation of longer working life duration within the pension reform framework. Regarding this, the key assumption taken into account involves gradual medium-term slowdown of the outflow of working-age population and further planned immigration through the system of quotas. Employment growth will continue in the upcoming mid-term period, although with a slowdown in dynamics, along with the halt in the trend of the decrease in the number of self-employed. As a consequence of the described trends, a further reduction in the unemployment rate is expected, which will be negligible at the end of the projection period when the unemployment rate based on a survey is expected to be stabilized at the level below 6%. The trends in GDP and the employment will result in mild increase in the labour productivity.

It is expected that the increase in gross earnings (received by persons in paid employment in legal entities) will slightly slowdown in 2019, following a noticeable change of trend at the end of 2018, and will continue to be mostly influenced by imbalances of supply and demand for labour in certain industries, and positively contributed by the increase in the base for salaries in public and civil service sector[19] and minimum wage increase[20]. As a result of faster growth in gross compensation per employee than increase in the labour productivity, the unit labour cost growth of about 2% is anticipated throughout the medium term period.

Table 2.4: Labour Market Developments

	2018	2019 projection	2020 projection	2021 projection	2022 projection
	change, %	change, %	change, %	change, %	change, %
Labour force (15+)[1]	-1,2	0,0	0,4	1,0	1,1
Unemployment rate, level (%)[1]	8,4	7,0	6,0	5,8	5,8
Employment[2]	1,8	1,6	1,5	1,3	1,2
Labour productivity, persons[2]	0,8	1,0	1,0	1,0	1,1
Unit labour cost[2]	1,4	1,9	2,2	2,0	1,9
Compensation per employee[2]	2,2	2,9	3,1	3,0	3,0
Gross earnings in legal entities[3]	4,9	4,0	3,5	3,4	3,4

[1] *ILO methodology*
[2] *National accounts definition*
[3] *Administrative sources*
Source: Croatian Bureau of Statistics, Ministry of Finance

2.5. External Sector

In 2018, the multiannual trend of the reduction in external imbalances of the domestic economy continued. Net international investment position improved to -54.1% of GDP in 2018, which is its highest level in the last fourteen years. In 2018, for the sixth consecutive year, a positive balance of the current account of the balance of payments was registered, in the amount of 2.6% of GDP. Compared to the previous year, the surplus of the current account was reduced by 1.0 percentage point, primarily due to the increase in the negative balance on the goods account, while the most

[19] In 2019, the effect of the increase in the base for salaries received by persons employed in public and civil service sectors to total increase in gross earnings is estimated at 0.8 percentage points, along with the assumed mild spill-over effect to the increase in salaries in the rest of the economy.
[20] In 2019, the effect of the increase in minimum salary to total increase in gross earnings is estimated at 0.3 percentage points.

significant positive contribution to the current account came from the increase in the positive balance of the services account.

In the forthcoming mid-term period, a further gradual reduction in surplus on the current account of the balance of payments is expected. The decrease in the positive balance of the current account will primarily derive from the continuous increase in the negative balance of goods, due to stronger increase in the import than in the export of goods. The services account will record further growth in the positive balance, but at lower rates than in the previous years, due to, as already mentioned, the dominant impact of tourism on the export of services[21], which will lead to the continued mild decline in the share of the balance of services in GDP. The described trends will result in the negative growing balance of goods and services from 2020 until the end of the projection period. In the primary income account, the steady and moderate increase in the deficit is expected, under the influence of the continued increase in the income of foreign-owned domestic companies, further increase in the income from compensations of employees and the stabilization of interest costs on the basis of foreign debt liabilities. This will result in the stable share of the primary income negative balance in GDP over the entire projection period, which will still be significantly exceeded by the secondary income positive balance. In the forthcoming mid-term period, much more intensive use of EU funds is envisaged than it was the case in the previous years, so higher levels of positive balance of the secondary income and capital transactions are expected than in earlier years.

The previous Programme predicted a positive balance of current and capital account in the amount of 4.1% of GDP in 2018 (2.9% of GDP if we observe only the current account). Slightly lower realization of the balance of current account and capital account (4.0% of GDP) arises primarily from more unfavourable realization of the balance of goods account than expected, while the capital account, on the other hand, recorded a slightly more favourable balance than the projected one.

2.6. Monetary Developments

In 2018, the domestic currency strengthened for the fourth consecutive year, so the average kuna to euro exchange rate amounted to 7.41 HRK/EUR, representing an appreciation of 0.6% compared to the previous year. In 2019, the continuation of mild appreciation pressures is expected, so an average exchange rate of 7.39 HRK/EUR is expected throughout the projection period. During 2018 a record amount of central bank´s foreign exchange interventions was recorded, which resulted in a significant increase in average liquidity surplus[22]. Short-term interest rates remained at low levels and the continuation of similar trends is expected in the future period.

In 2018, increase in the domestic credit to the private sector[23] accelerated to 4.4%, whereby this increase was primarily generated by the increase in loans to households, along with the simultaneous

[21] Revenues from tourism account for over 70% of total revenues from domestic economy services.
[22] At the beginning of 2019, the liquidity surplus exceeded the amount of HRK 30 billion (more than 8% of GDP).
[23] The data on the domestic credit is based on transactions, which exclude the effects of exchange rate and price adjustments and banks' claims write-offs from the total domestic credit stock.

increase in the loans to enterprises. The increase in any-purpose cash loans contributed the most to the increase in loans to households, which in 2018 recorded double-digit increase and accounted for almost 40% of total loans to households[24]. Since the banks, when approving these types of loans, apply milder credit rating standards than when approving housing loans, and since the number of loans without collateral and with a maturity of ten years or more increased significantly, the continuation of such trends might lead to the increase in non-performing loans in the event of unfavourable economic developments. Therefore, in February 2019, the Croatian National Bank issued the Recommendation on actions in granting non-housing consumer loans, which advises credit institutions to apply equal creditworthiness criteria for all non- housing loans with maturity of 60 months or more, as they apply for housing loans[25], while it requires from banks to include all risks that might derive from any-purpose cash loans in the internal procedure of the capital adequacy assessment. In the forthcoming medium term period, increase in the credit activity is expected to continue in line with further economic recovery, by maintaining favourable financing conditions and increasing consumer and business optimism. The slight slowdown is expected in the increase in households loans as a consequence of consumer loans approval standards becoming stricter, while accelerating increase in the loans to enterprises, whereby the high level of indebtedness and share of non-performing loans to enterprises continue to be a limiting factor for more significant increase acceleration.

In 2018, banking sector profit recorded a significant improvement compared to the previous year, primarily as a result of a significant decrease in cost of value adjustments and provisioning compared to 2017[26]. For the fourth consecutive years, the reduction of share of non-performing loans was registered, although at slightly slower dynamic compared to the previous year[27]. Consequently, the share of non-performing loans in total loans at end of 2018 was 9.8%, whereby the largest share of non-performing loans is still recorded by enterprises, primarily in the construction industry. The slowdown of the reduction in shares of non-performing loans was considerably affected by the lower amount of sold claims compared to the previous year. The continuation of these trends is expected in the forthcoming period, given the narrowed basis for the sellable claims, so that the growth rate of loans stock, at the end of the mid-term period, could come closer to the growth rate of loans based on transactions. In 2018, the banking sector capitalization slightly declined compared to the previous year, so the total capital ratio amounted to 22.9%, which is mostly due to changes in the weighting of banks' exposure to the central government and the associated risk exposure increase[28].

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[24] Structure of total loans according to stock

[25] i.e. to take into account minimum cost of living which cannot be smaller than the amount prescribed by the Enforcement Act.

[26] According to the preliminary unaudited data on credit institutions, the banks profit before the taxation amounted to HRK 5.6 billion in 2018, which is an increase by 44.6% compared to the previous year.

[27] In 2018, the reduction amounted to 1.5 percentage points, while in 2017 the reduction in the share of non-performing loans was registered by 2.5 percentage points compared to 2016.

[28] Until the end of 2017, a favourable risk weighting of 0% was assigned for the exposure towards central governments and central banks of EU member states, which were not denominated and financed in the domestic currency of that member state, while in 2018 the risk weighting depending on the country’s credit rating is applied. This means, in terms of the exposure of domestic banks towards the Republic of Croatia, which are not denominated in kuna, the increase in the risk weighting in 2018, which had an impact on the increase in total risk exposure by 5.3%.

2.7. Risks to the Macroeconomic Projections

The described macroeconomic scenario is exposed to prevailingly negative risks, arising primarily from the external environment. They primarily refer to the re-strengthening of trade tensions between the USA and China, as well as to the extension of customs duties on other products, stronger slowdown in Chinese economic growth than expected, possible abrupt tightening of financial conditions which would increase the vulnerability of heavily indebted countries, especially under the conditions of a still high level of uncertainty regarding the United Kingdom's exit from the EU. Domestic risks in the medium term largely stem from the constraints on the supply side, mostly the lack of labour force. Main risks that could cause a different realization of the inflation rate than the anticipated one are related to trends in oil prices in the global market, as well as to the trends in administratively regulated prices, primarily electricity prices for households.

3. GENERAL GOVERNMENT BUDGET AND PUBLIC DEBT

3.1. Fiscal Policy

In the area of fiscal policy, significant efforts were made in the past few years to strengthen the sustainability of public finances and a number of positive indicators were achieved. After the realized surplus in 2017 of 0.8% of GDP, in 2018, due to the implemented tax reform on the one hand and rational budget spending on the other hand, the surplus of the general government budget was realized again and it amounted to HRK 758 million, i.e. 0.2% of GDP. This surplus would have been even higher if the one-off liabilities on the basis of protested guarantees for the Uljanik group in the amount of HRK 2.5 billion, i.e. 0.7% of GDP had not been materialized.

Furthermore, the share of general government debt in GDP continued to decrease, amounting to HRK 284.7 billion, i.e. 74.6% of GDP at the end of 2018, whereby the share of public debt, compared to the previous year, decreased by 3.2 percentage points, while in the last three years it decreased by more than 9 percentage points. Responsible fiscal policy management, followed by an active public debt management policy, also resulted in the reduction in interest expenses, which in 2018 were reduced to HRK 900 million at a year-on-year level. This represents the continuation of the trend of the reduction in general government interest costs which have been reduced by almost HRK 3 billion since 2015. All of this resulted in the primary fiscal surplus of the average 2.7% of GDP in the last three years.

Macroeconomic imbalances have also been decreasing, as confirmed by the EC, and in line with their report of February 2019, the Republic of Croatia has made progress from the category of excessive macroeconomic imbalances to the category of macroeconomic imbalances.

Positive economic and especially fiscal results were also recognized by international financial institutions. Therefore, at the end of March 2019, the S&P rating agency raised the credit rating of the Republic of Croatia to the level of investment rating, from BB+/B to BBB-/A-3. Such an assessment is primarily based on an improved fiscal position, which the economic recovery, due to increased domestic demand driven by the effects of tax reform, and fiscal consolidation measures contribute to.

Regardless of these positive indicators, the economy of the Republic of Croatia is further characterized by challenges associated with low potential growth, high nominal public debt level and the presence of the macroeconomic imbalance. It should be pointed out that the Government of the Republic of Croatia is facing important economic-political objectives, especially in the context of the economic dialogue with the EU. For example, after leaving the excessive budgetary deficit procedure in June 2017, the Republic of Croatia is obliged to abide by the fiscal rules from the preventive part of the Stability and Growth Pact. In addition, considering the plans linked with the access to the ERM II exchange rate mechanism, the Republic of Croatia also commits itself to an ambitious mid-term budgetary objective of -1% of GDP, which is in line with the more restrictive conditions that must be respected by the member states of the mentioned exchange rate mechanism.

All of this requires decisive measures to address the present imbalances and achieve the defined goals. Thus, the fiscal policy of the Republic of Croatia in the observed medium-term will be determined by the efforts for the purpose of strengthening fiscal sustainability and economic growth along with providing adequate care for the standard of all citizens. Special attention will be given to the allocation of budget funds for the implementation of structural reforms; activities will be carried out in order to define the potential for more efficient use of budget resources and the strict control of the expenditure side of the budget will continue to be applied. In addition, any surplus of revenue in relation to the planned ones will be used for further reduction of the public debt.

The revenue side of the budget will be marked by the effects of the third round of tax unburdening, i.e. the continuation of the implementation of the tax reform which started in 2017. For example, changes in value-added tax provisions reduce the regressive effect of this tax on the most vulnerable groups of citizens, thereby increasing the disposable income of households. In the part of the taxation of labour, changes in the system of contributions on salaries reduce the total cost of labour for employers, while changes in the income tax system will have a positive impact on the reduction of negative demographic trends, i.e. the retention of highly qualified employees such as IT specialists, medical doctors, engineers and others. It is also important to point out the withdrawal of resources from EU funds that are intended to be used for a number of significant development and infrastructure projects and research and innovation activities, with a view to strengthening the development capacities of all parts of the country.

The expenditure side of the budget is characterized by further strengthening of fiscal sustainability along with the implementation of activities for the purpose of boosting economic competitiveness, as well as providing adequate care for all layers of the population. Thus, measures aimed at improving the business environment, improving the efficiency of the judiciary system and public administration and the activation of state property will be implemented, which is the foundation and additional impetus for the planned growth of investments. In order to strengthen the potential growth, measures will also be taken to improve the knowledge and skills of present and future labour force and the alignment thereof with the needs of the labour market. Taking into account the fiscal stability, as well as ensuring adequate living standard for the citizens of the Republic of Croatia, reforms will be pursued with the aim of strengthening the efficiency of healthcare and social care systems. In this context special attention will be paid to the measures of demographic renewal. It should also be emphasized that in 2020, the Republic of Croatia will be chairing the EU Council for the first time, which is an extremely important opportunity for the political affirmation of the Republic of Croatia, as well as its more intensive integration into the decision-making and policy-making system at the EU level. In that sense, additional funds are provided in the budget for this purpose.

The abovementioned direction of fiscal trends on both the revenue and the expenditure side of the budget will result in a slight general government budget deficit, according to ESA 2010 methodology, in the amount of 0.3% of GDP in 2019. In 2020, the surplus of 0.2% of GDP is anticipated again, while the fiscal balance in 2021 and 2022 will amount to 0.4% of GDP and 0.8% of GDP, respectively. It is also planned to further reduce the public debt share in GDP by additional 12.5 percentage points by 2022. In addition, the fiscal projections presented in this document indicate that the Republic of

Croatia fulfils the new, stricter medium-term budgetary objective of -1% of GDP throughout the projection period.

3.2. Budget Implementation in 2018

Following the positive trends in 2016 and 2017, the same direction continued in 2018 as a result of favourable macroeconomic developments, tax reforms and rational budget spending.

As aforementioned, the general government budget for 2018, according to the European statistical methodology ESA 2010, registers a surplus of 0.2% of GDP, which represents a significant improvement in relation to the initially planned deficit of 0.5% of GDP. This surplus would have been even higher if one-off liabilities on the basis of the protested guarantees for the Uljanik Group had not been materialized in the amount of HRK 2.5 billion, i.e. 0.7% of GDP. The activation thereof led to a one-off increase in capital transfers on the expenditure side, which directly affected the general government budget surplus reduction.

In 2018, total general government budget revenues were collected at the level of 46.6% of GDP as a result of positive macroeconomic developments and the full-year effect of tax reform, which came into effect in early 2017, and further tax unburdening as of January 1, 2018. Effective changes in 2018 referred to the reduction in the taxation by special tax on motor vehicles and the annulment of the tax on purchasing second-hand motor vehicles and replacement thereof with administrative fees, but in smaller amounts. In addition, by the end of 2017, excise duties on tobacco products were increased with an aim of reaching the agreed excise duty level under Council Directive 2011/64/EU of June 21, 2011 on the structure and rates of excise duty applied to manufactured tobacco. As of January 2018, within the value-added tax system, the threshold for entry into the VAT system was increased to HRK 300,000 and the possibility of deducting 50 percent of subscription for entrepreneurs was introduced for the purchase of personal cars and other personal means of transport and other related costs.

Taxes on production and imports amounted to 20.1% of GDP and registered a year-on-year increase of 7.2%. Within their structure, the largest income is the value- added tax which was by 6.8% higher than in the previous year. The collected revenues from VAT are the result of increased personal consumption due to the growth of disposable income of households, supported by favourable labour market trends and a successful tourist season.

The revenues from social contributions also register a significant increase of 5.2%, which in 2018 amounted to 12% of GDP, as a result of favourable labour market trends. Current income and wealth taxes, which include income tax and corporate income tax, are up 6.7% due to the aforementioned positive trends in the labour market and good results of businesses operations of enterprises and banks during 2017. In addition to tax revenues, there are also significant revenues from other current and capital transfers, including resources from EU funds, and in 2018 they amounted to 2.7% of GDP, whereby the revenues from EU funds register an increase by 32.1% at the annual level.

Total expenditures of the general government budget were executed at the level of 46.4% of GDP in 2018.

Compensation of employees register the level of 11.7% of GDP and they increased by 7%. This increase is primarily the result of a full-year effect of the increase of 6% for public and civil servants in 2017, corrections for years of service by 0.5%, and the change of sectoral collective agreements in certain public service activities, as well as the amendments to Regulations regulating salaries in services of external and internal affairs and social care. In addition, these expenditures also include increased allocations for employees financed from EU funds, as well as compensation of employees from the HAC-ONC company, which has been assigned to the HAC since December 2017 and thus classified into the general government sector. Furthermore, there was an increase in compensation of employees registered in local and regional self-government units.

Intermediate consumption expenditures were realized at the level of 8.2% of GDP. This category includes material expenditures of all units of the general government sector, including, *inter alia*, the costs of healthcare institutions for medicines and medical and sanitary materials. Major allocations were also registered on expenditures on materials and energy and on current and investment maintenance.

Expenditure for subsidies registers the level of 1.5% of GDP. The most significant amount of subsidies refers to subsidies of the Croatian Energy Market Operator ltd. (hereinafter referred to as: HROTE) for producers of energy from renewable sources, which are funded from the fee for stimulating electrical energy from renewable sources. Significant share of this category of expenditure stems from allocations in agriculture as well as allocations for the implementation of concession contracts and the stimulation of maritime passenger transport.

Interest expenditure was executed with a share of 2.3% in GDP. Compared to last year, they decreased by 0.3 percentage points of GDP or almost HRK 900 million. Such trends are the result of the responsible fiscal policy management, followed by the active public debt management policy, which led to a reduction in the costs of public debt servicing. It should be noted here that by the end of the second phase of the financial restructuring of the road sector debt, interest costs in this sector were significantly lowered by more than 30% compared to their earlier costs.

Social benefits and social transfers represent the most significant category of total general government expenditure and record a level of 15.6% 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 and retirement benefits were realized at the level of 10.3% of GDP, which is primarily the result of the adjustment of pensions realized under the general regulation and special regulations as of January 2018 by 0.94% and as of July 1, 2018 by 2.7%. Furthermore, the increase thereof was influenced by the transferred cumulative effect of the change in the number and structure of the pension beneficiaries from 2017, the cessation of the reduction of pensions earned under special regulations of more than HRK 5,000 by 10% from 2017[29], application of the provisions on the minimum pension of the new Act on Croatian Homeland War Veterans and

[29] Official Gazette, number 88/2017

Their Family Members' Rights[30] and the payment of unpaid sums of buyback pensions under the Act on the Continuation of Payment of Buyback Pensions[31]. Allocations for child allowance amount to 0.3% of GDP and are reduced due to the application of the Act on Amendments to the Child Allowance Act[32] and the trend of reducing the average number of beneficiaries and the average number of children receiving child allowance. Maternity benefits were realized at the level of 0.7% of GDP. Within this category of expenditure, the full-year effect of the Amendments to the Maternity and Parental Benefits Act[33], which came into force on July 1, 2017, was included, and on the basis of which the amount of financial support during the use of additional parental leave increased. Unemployment benefits were realized at the level of 0.2% of GDP. Social welfare benefits including guaranteed minimum benefit, personal disability allowance and allowance for help and care were realized at the level of 0.6% of GDP. This category of expenditure includes increased appropriations for war veterans' care based on the new Act on Croatian Homeland War Veterans and Their Family Members' Rights[34] of December 2017, which extends the scope of their rights. In addition, in 2018 funds were also provided for the implementation of the Act on the Amendments to the Housing Loan Subsidies Act[35], which came into force on July 19, 2018, which enabled the subsidizing of loans for the purchase of a flat or a house, i.e. for the house construction.

Other expenditures, mostly related to current and capital transfers, were realized at the level of 3.7% 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. In addition, the increase in capital transfers is due to the payment by protested guarantees for the Uljanik group and the takeover of Petrokemija's debt in the process of its privatization.

Gross fixed capital formation expenditure was realized at the level of 3.5% of GDP, which was an increase of 33.8% in relation to the previous year due to the significant growth of investments of local and regional self-government units as well as of public enterprises in the general government sector.

3.3. General Government Budget in 2019

The Fiscal Policy of the Republic of Croatia in the medium term will be determined by the efforts to be undertaken, in line with the provisions of the Stability and Growth Pact, for the purpose of further strengthening of fiscal sustainability and economic growth and development, and ensuring adequate care for all citizens of the Republic of Croatia. A key emphasis will continue to be on the reform activities undertaken on both the revenue and the expenditure side of the budget, aimed at strengthening the long-term potential of the Croatian economy and real convergence towards

[30] Official Gazette, number 121/2017
[31] Official Gazette, number 113/2017
[32] Official Gazette, number 58/2018
[33] Official Gazette, number 59/2017
[34] Official Gazette, number 121/2017
[35] Official Gazette, number 61/2018

countries within the euro area and at reducing macroeconomic imbalances. Strict control of the expenditure side of the budget will continue, and any revenue surplus in relation to the projected one will be used to further reduce the public debt.

Consolidated General Government Revenues

In 2019, total general government budget revenues are planned at the level of 47% of GDP. They are based on the expected growth of economic activity, taking into account the fiscal effects of the third round of tax unburdening, primarily within the system of VAT, contributions and excise duties, which came into effect at the beginning of 2019.

The main change in the VAT system, with the aim of reducing the regressive effect of this tax on the most vulnerable group of citizens, is the reduction of the VAT rate from 25% to 13% for live animals, fresh and frozen meat, fish, fruits and vegetables, eggs, baby diapers, and all medicines are taxed at a rate of 5%. The total fiscal impact of these changes is estimated at HRK 1.5 billion or 0.4% of GDP. Furthermore, the amendments in the system of special taxes and excise duties provide for the reimbursement of a part of the excise duty paid on diesel fuel used in the commercial transport of goods by trucks of certain payload (tonnage capacity) and for the commercial transport of passengers. This measure provides for tax unburdening of HRK 290 million or 0.1% of GDP. Regarding the excise duties on tobacco products, the amount of excise duties on cigarettes was changed in order to comply with the requirements of EU legislation, the fiscal impact of which is estimated at HRK 350 million or 0.1% of GDP.

In the contribution system, the contribution for compulsory insurance in the case of unemployment of 1.7% and the contribution for health protection at work of 0.5% were abolished, and at the same time, the contribution for health insurance increased from 15% to 16.5%. In this way, total allocations by employers for salaries decreased by 0.7 percentage points, which reduces employers' costs by HRK 800 million or 0.2% of GDP and opens up room for salary increase or new investments.

Real estate transfer tax decreased from 4% to 3%, which should stimulate the real estate market transfer. The fiscal impact of this measure is estimated at HRK 100 million or 0.03% of GDP. Within the income tax system, tax base was increased for the application of a tax rate of 24% from HRK 17,500 to HRK 30,000, thus positively influencing the retention of highly educated experts in high value-added sectors. The expected effect of this measure is HRK 210 million or 0.1% of GDP.

Table 3.1: Discretionary Revenue Measures

		2019		2020	
		HRK million	% of GDP	HRK million	% of GDP
1.	Expansion of the tax bracket for the tax rate of 24% from the current HRK 17,500 to HRK 30,000	-210	-0.1		
2.	Increasing the excise tax for tobacco	350	0.1		
3.	VAT tax rate reduction from 25% to 13% for certain food products and baby diapers and application of 5% rate for all medicines	-1,540	-0.4		
4.	Abolishment of the contribution for unemployment and contribution for work-related injury insurance and increase of contribution for health insurance from 15% to 16.5%	-800	-0.2		
5.	Refund of the part of the excise duty on diesel fuel used in the commercial transport of goods by trucks of certain tonnage and for the commercial transport of passengers	-290	-0.1		
6.	Reduction of the real estate transfer tax rate from 4% to 3%	-100	-0.03		
7.	Reduction of standard VAT tax rate from 25% to 24%			-1,629	-0.4
TOTAL REVENUE MEASURES		**-2,590**	**-0.7**	**-1,629**	**-0.4**

Source: Ministry of Finance

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 13.3% of GDP based on macroeconomic projections, including the growth of personal consumption, tourist services, but also government expenditure for intermediate consumption, investments and social transfers in kind. In addition, the effects of the aforementioned tax changes are also taken into account. Besides VAT, the expected revenues from excise duties, customs duties and other taxes on consumption are also included in the category of taxes on production and import. Revenues from excise duties amount to 4.6% of GDP, and they include the expected trend in the consumption of excise products, and the effects of changes in regulations in the excise system, i.e. in excise duties on energy and electricity and excise duties on tobacco.

The second most significant group of general government budget revenues are social contributions, projected at a level of 11.9% of GDP. Their dynamics are determined by the trends in the labour market, taking into account the aforementioned legal amendments that came into effect in early 2019.

Estimated revenue from current taxes on income and wealth will register the level of 6.5% of GDP. The personal income tax revenue is planned based on expected labour market trends, including the effects of the aforementioned legal amendments. 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 2018.

The category of other current and capital transfers, projected at the level of 3.3% of GDP which is an increase of 24.2%, also include the revenues from the aids of EU institutions and bodies, which are directly linked to the projects financed from EU funds.

Consolidated General Government Expenditures

In 2019, total general government expenditures are planned at a level of 47.3% of GDP.

Compensation of employees is projected at the level of 11.7% of GDP on the basis of the the expected trends in the level of the number of the employed civil and public servants and rights arising from collective agreements. It is important to point out that in 2019 the base for the calculation of salaries is increased by 5%, based on collective agreements for civil and public servants (3% from as of January 2019 and 2% as of September 2019). In addition, the dynamics of the trends in compensation of employees is also determined by paying a bonus of 0.5% for years of service. Furthermore, this category of expenditures also includes the increase of the allocations for the purpose of the presidency of the Republic of Croatia of the EU Council, which the Republic of Croatia assumes as of 1 January 2020, for which a certain number of employees will be transferred to the Permanent Representation of the Republic of Croatia in Brussels already in 2019.

Intermediate consumption expenditures are planned at the level of 8.4% of GDP. The increase in this category of expenditures compared to 2018 is primarily a result of the trends in the material consumption by all general government sector units, whereby increased spending on medicines and consumables and sanitary material of healthcare institutions is expected as a result of the expected increase in the revenues of the Croatian Health Insurance Fund. In addition, this category of expenditures includes increased costs for the purpose of the presidency of the Republic of Croatia of the EU Council.

In 2019, expenditures for subsidies are projected at the level of 1.7% of GDP. A significant part of subsidies of 0.6% 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. In addition, this category also includes the subsidies in agriculture that are financed from national funds, concession contracts, as well as subsidies for the promotion of maritime passenger transport.

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 2.3% of GDP in 2019.

Social benefits and social transfers are planned at the level of 15.6% of GDP, whereby the expenditures for pensions and pension receipts account for 10.1% of GDP. The increase in 2019 is affected by the transferred cumulative effect of changes in the number and structure of pension beneficiaries and the adjustment of total pensions in 2018, changes in the number and structure of pension beneficiaries, adjustment of pensions of 2.5%, the application of a part of the provisions of the new Act on Croatian Homeland War Veterans and Their Family Members[36] and the continuation of the regular payment of buyback pensions which started in March 2018. The allocations for child allowances amount to 0.4% of GDP and are planned by taking into account the full-year effect of the application of the Act on Amendments to the Child Allowance Act[37]. To create more favourable financial conditions for families, the level of income within the means testing[38] was increased as a requirement for the realization of the right to child allowance from 50% to 70% of the budgetary base. This is in order to expand the number of beneficiaries of child allowances and thus the pro-natalist allowance realized by child allowance beneficiaries' for their third and fourth child. Maternity

[36] Official Gazette, number 121/2017
[37] Official Gazette, number 58/2018
[38] Means testing income refers to the total income realized in the calendar year per household per month.

benefits are planned at the level of 0.6% of GDP, and unemployment benefits at the level of 0.2% of GDP. Social welfare benefits are planned at a level of 0.6% of GDP. Apart from the guaranteed minimum benefit, this also includes the implementation of the Act on the Amendments to the Social Welfare Act, according to which the amount of the personal disability allowance and the allowance for assistance and care are increased. Furthermore, the full-year effect of the Act on Amendments to the Housing Loan Subsidies Act[39], which enabled the subsidizing of loans for the purchase of a flat or a house, i.e. for the house construction, for each year until December 31, 2020, was also included.

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. This category of expenditures includes expenditures for the implementation of electoral activities, of which the most significant ones are the elections for the European Parliament and the Croatian presidential elections. In addition, in 2019, the category of capital transfers also includes the expected one-off expense in respect of the protested guarantees of Uljanik Group in the amount of HRK 1 billion or 0.3% of GDP.

Gross fixed capital formation expenditures are planned at the level of 4% of GDP and they register a strong growth of 21.2% compared to 2018. The most significant growth is anticipated in the area of road and rail infrastructure construction. A Large part of the investment is financed from EU funds and the most significant project is the continuation of the construction of the Pelješac Bridge. Capital investments are also planned in the healthcare, judicial and science sectors. In addition, funds are also allocated for the refurbishment of the congress centre of the National and University Library in Zagreb for the purposes of the presidency of the Republic of Croatia of the EU Council.

Net Lending/Borrowing

Following the planned revenues and expenditures, the general government budget deficit is expected at the level of 0.3% of GDP in 2019, whereby the central government deficit will amount to 0.5% of GDP and that of the local and self-government unit will amount to 0.1% of GDP. Social security funds will register a surplus of 0.3% of GDP.

3.4. Medium-Term Budgetary Framework (2020-2022)

Consolidated General Government Revenues

In the period 2020-2022, the revenues of the general government budget will be determined by the trends in the economic activity, taking into account the fiscal effects of the implemented tax unburdening as well as those that will follow in the 2020. From January 1, 2020, the general rate of

[39] Official Gazette, number 61/2018

VAT decreases from 25% to 24%, whereby the fiscal impact of this change is estimated at HRK 1.6 billion or 0.4% of GDP. Thus, in 2020, consolidated general government revenues will register the level of 46.9% of GDP, in 2021 the level of 46.4% of GDP, and in 2022 the level of 46.2% of GDP.

Taxes on production and import in the medium-term will be at the level of 19.4% of GDP. Value-added tax revenues will range from the level of 13% of GDP in 2020 to 13.1% of GDP in 2022. More significant tax forms in the category of taxes on production and import also include revenues from excise duties. They are projected on the basis of the expected trends in the consumption of excise products, and in the observed medium-term period they will range from the level of 4.6% of GDP in 2020 to 4.5% of GDP in 2022.

Furthermore, revenues from current tax on income and wealth will register an average level of 6.4% of GDP in the observed period. The share of social contributions revenue will register an average level of 12.0% of GDP, while other current and capital revenues will be determined by the projected absorption from EU funds.

Consolidated General Government Expenditures

In 2020, the expenditures of the general government budget are projected at the level of 46.7% of GDP, in 2021 at the level of 46.0% of GDP, and in 2022 at the level of 45.4% of GDP.

Compensation of employees will register an average level of 11.6% of GDP in the period 2020-2022 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 of the Council of the EU which the Republic of Croatia assumes as of January 1, 2020.

Intermediate consumption expenditures will be at an average of 8.5% 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.

In 2020, subsidy expenditures register an increase of 1.8% of GDP, primarily as a result of the increase in HROTE's incentives for producers of energy from renewable sources. In the coming years, it will be retained at the level of 1.8% of GDP and 1.7% of GDP.

Property income expenditure, largely determined by the trends in the interest expenditure, registers an average level of 1.9% of GDP in the medium-term period.

Social benefits and social transfers will be at an average rate of 15.2% 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 full-year effect of the increased level of the means testing income as a condition for the realization of the right to child allowance and the increase in the amount of personal disability allowance and allowance for assistance and care from 2018.

Other expenditures, mainly related to other current and capital transfers, reduce their share in gross domestic product from 3.1% in 2020 to 2.9% in 2022.

Expenditures for gross fixed capital formation will be at an average level of 4.0% of GDP in the observed medium-term period. These expenditures are determined by the planned dynamics of investments of extra-budgetary users and public companies, and are largely financed from EU funds.

Net Lending/Borrowing

In accordance with the projected trends in revenues and expenditures of the general government budget, the surplus of 0.2% of GDP is expected in 2020, the surplus of 0.4% of GDP in 2022, and the surplus of 0.8% of GDP in 2022.

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[40] and calculations of the EC for EU Member States, whereby cyclically sensitive components on the revenue side include personal income tax, corporate income tax, indirect taxes, social security contributions and non-tax payments, while unemployment benefits are included on the expenditure side. The medium-term budgetary objective (MTO) refers to the amount of the structural budget balance which ensures the alignment of general government deficit and public debt with the provisions of the Stability and Growth Pact.

At the beginning of 2016, the Economic and Financial Committee established a minimum medium-term budgetary objective for the Republic of Croatia of -1.75% of GDP for the period 2017-2019, which the Republic of Croatia confirmed as its objective in the 2016 Convergence Programme. Within the framework of a regular medium-term budgetary objective revision, which is carried out every three years, at the beginning of 2019, the Economic and Financial Committee set a minimum objective for the Republic of Croatia of -1.25% of GDP, which will be valid in the period 2020-2022.

In view of its plans to join the Exchange Rate Mechanism ERM II, the Republic of Croatia commits itself by this Convergence Programme to a more ambitious medium-term budgetary objective of -1.0% of GDP, which is in line with the more restrictive conditions that have to be respected by the member states participating in ERM II.

[40] Gilles Mourre, Caterina Astarita, Savina Princen, 2014. "Adjusting the budget balance for the business cycle: the EU methodology", European Economy – Economic Papers 536

According to the calculations of the Ministry of Finance, the Republic of Croatia achieved a structural surplus of 0.3% of GDP in 2018, thus significantly outperforming its minimum medium-term budgetary objective, despite the fact that total deficit/surplus of the general government in 2018 was corrected by a one-off expense per protested guarantees for the Uljanik group in the amount of HRK 2.5 billion or 0.7% of GDP.

Fiscal projections of the Republic of Croatia represented in this document indicate that the Republic of Croatia meets its medium-term budgetary objective throughout the projection period. The planned structural balance in 2019 amounts to -0.9% of GDP, which still significantly exceeds the objective of -1.75% of GDP defined for the period 2017-2019. Furthermore, in the period 2020-2022 the structural balance is expected to range from -0.7% to -0.3% of GDP and will be, in all years, above the medium-term budgetary objective of -1.0% of GDP. This ensures sustainable trends in the general government budget deficit and public debt. It is important to note that in 2019, the total deficit/surplus corrected for one-off measures includes a one-off cost per protested guarantees for the Uljanik group in the amount of HRK 1 billion and a one-off cost for the preparations of the presidency of the Republic of Croatia of the EU Council in the amount of HRK 200 million. In other words, total one-off cost in 2019 amounts to HRK 1.2 billion or 0.3% of GDP. Furthermore, in 2020, the calculation includes a one-off cost of the presidency of the Republic of Croatia of the EU Council in the amount of HRK 400 million or 0.1% of GDP.

Table 3.2: Trends in Structural Balance of Consolidated General Government in the Period 2018-2022

	2018	2019 Projection	2020 Projection	2021 Projection	2022 Projection
TOTAL DEFICIT/SURPLUS, ESA 2010, % of GDP	0.2	-0.3	0.2	0.4	0.8
ONE-OFF MEASURES, % of GDP[1]	-0.7	-0.3	-0.1	0.0	0.0
TOTAL DEFICIT/SURPLUS, corrected for one-off measures, % of GDP	0.9	0.0	0.3	0.4	0.8
OUTPUT GAP	1.3	1.9	2.0	2.0	2.3
STRUCTURAL BUDGET BALANCE, % of GDP	**0.3**	**-0.9**	**-0.7**	**-0.6**	**-0.3**
STRUCTURAL BUDGET BALANCE CHANGE	***-0.4***	***-1.2***	***0.2***	***0.1***	***0.3***

[1] A plus sign means deficit-reducing one-off measures

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 data of the Croatian National Bank, at the end of 2018 public debt amounted to HRK 284.7 billion, i.e. 74.6% of GDP, whereby its share in GDP fell by 3.2 percentage points compared to the previous year. Such trends are the result of prudent fiscal policies and the continuation of positive fiscal trends, i.e. of the realized general government budget surplus in the amount of HRK 758 million or 0.2% of GDP. In addition, in the environment of high liquidity and low interest rates, borrowing conditions in the domestic and international financial markets improved, which had an impact on further reductions in interest expense and on achieving a primary fiscal surplus of 2.5% of GDP. In 2018, a positive contribution to reducing the debt share in GDP also came from a slight appreciation of kuna against euro (by 1.3% per annum). The domestic component of public debt increased by 4.3% compared to 2017 and amounted to HRK 180.3 billion, accounting for 63.3% of total public debt, while the foreign component recorded a decrease of 6.3% and amounted to HRK 104.4 billion or 36.7% of total public debt. It is important to note that according to the rules of ESA 2010 methodology, the total guaranteed debt of the Uljanik group of HRK 4.4 billion was reclassified into public debt in 2018. In addition, the historical series of public debt trends was revised as a result of further alignment of the division of institutional units into sectors with the ESA 2010 methodology, and a large number of new units were included into the scope of the general government by the revision, with an impact on the increase of public debt level by almost HRK 1 billion. Most of the units involved are related to tourist boards and development agencies, while the Zadar Port Authority with a debt of HRK 797.8 million contributes the most to this increase.

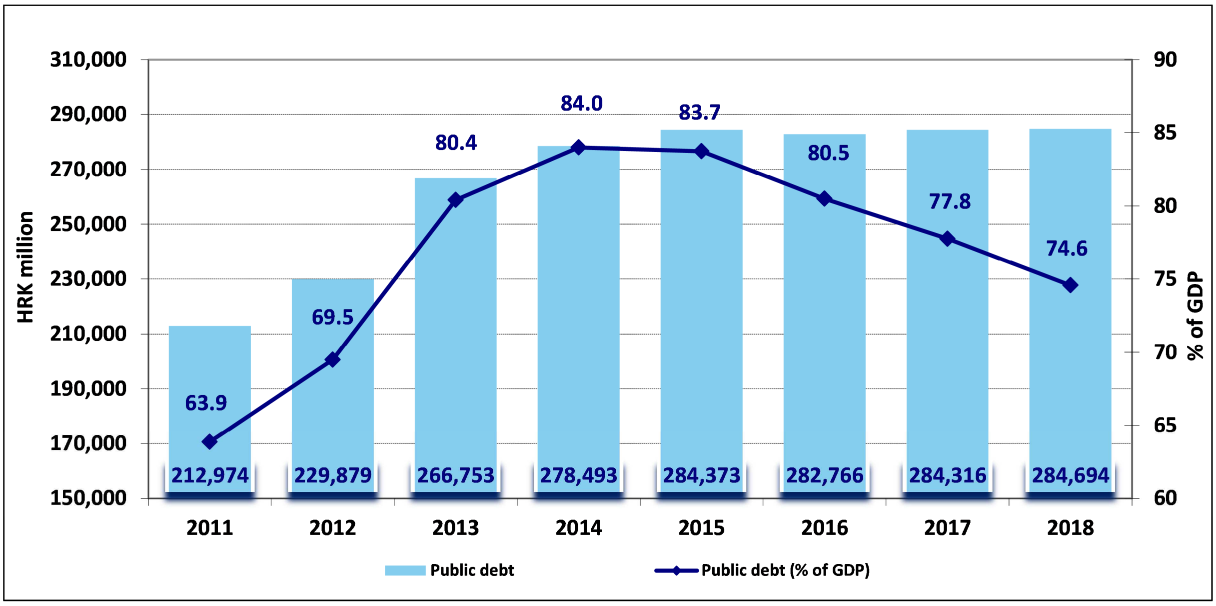
As observed according to the state government levels, the majority of public debt refers to the central government sector in the amount of HRK 279.3 billion, while the rest of the debt of HRK 5.4 billion refers to the local government sector and HRK 1.1 million to the debt of social security funds.

Regarding the borrowing mechanisms, the largest part of public debt occurred by borrowing via long-term securities, i.e. bonds (64.6%), and then by borrowing via loans (31.2%) and short-term securities (4.2%).

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 71.2%, the debt denominated in HRK for 25%, and the debt denominated in USD for 3.7% of total debt. An insignificant part of the debt (0.03%) was denominated in Swiss francs. In 2018, the share of the debt denominated in EUR decreased by 1.6 percentage points in relation to 2017 as a result of the orientation to the borrowing on the domestic market.

The maturity structure of public debt shows that the share of public debt with the maturity of up to one year amounted to 4.6% of total debt at the end of 2018. The share of public debt with the maturity of one to five years amounted to 8.5%, while the share of debt with the maturity of five to ten years amounted to 37.6%. The debt with the maturity of over 10 years accounted for 49.2% of total public debt.

Chart 3.1: Public Debt Trends in the Period 2011-2018



Source: CNB, CBS

At the end of 2018, total issued guarantees of the Republic of Croatia amounted to HRK 6.3 billion, i.e. 1.7% of GDP and, in relation to the end of 2017, they were decreased by HRK 4.9 billion, primarily as a result of the reclassification of the guarantees of the Uljanik Group into public debt.

According to the latest available data of the Croatian Bureau of Statistics (hereinafter referred to as: CBS) on the potential liabilities of the general government sector in line with the Council Directive 2011/85/EU of November 8, 2011 on requirements for budgetary frameworks of the Member States, at the end of 2017, 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 9.7% 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 2019 Act on the Execution of the State Budget of the Republic of Croatia[41] established that the annual value of new financial guarantees for 2019 amounts to HRK 3.9 billion, of which HRK 1.3 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

[41] Official Gazette, number 113/2018

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 2019-2022, receipts are expected from the privatization in the amount of average 0.2% of GDP per year.

The majority of maturing state budget liabilities in the period 2019-2022 refers to eleven maturities of bonds, of which seven are domestic and four are foreign. Among domestic bonds, four are denominated in EUR, in the amount of EUR 3.5 billion, while three bonds are denominated in HRK, in total amount of HRK 14 billion. Foreign liabilities pertain to four Eurobonds. The first Eurobond in the amount of EUR 1.5 billion is due in 2019, the second Eurobond in the amount of USD 1.3 billion matures in 2020, the third one in the amount of USD 1.5 billion is due in 2021, while the fourth one in the amount of EUR 1.3 billion is due in 2022. 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 4.6 billion in 2019, HRK 4.4 billion in 2020, HRK 6.7 billion in 2021, to HRK 2.8 billion in 2022.

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 contained in this document.

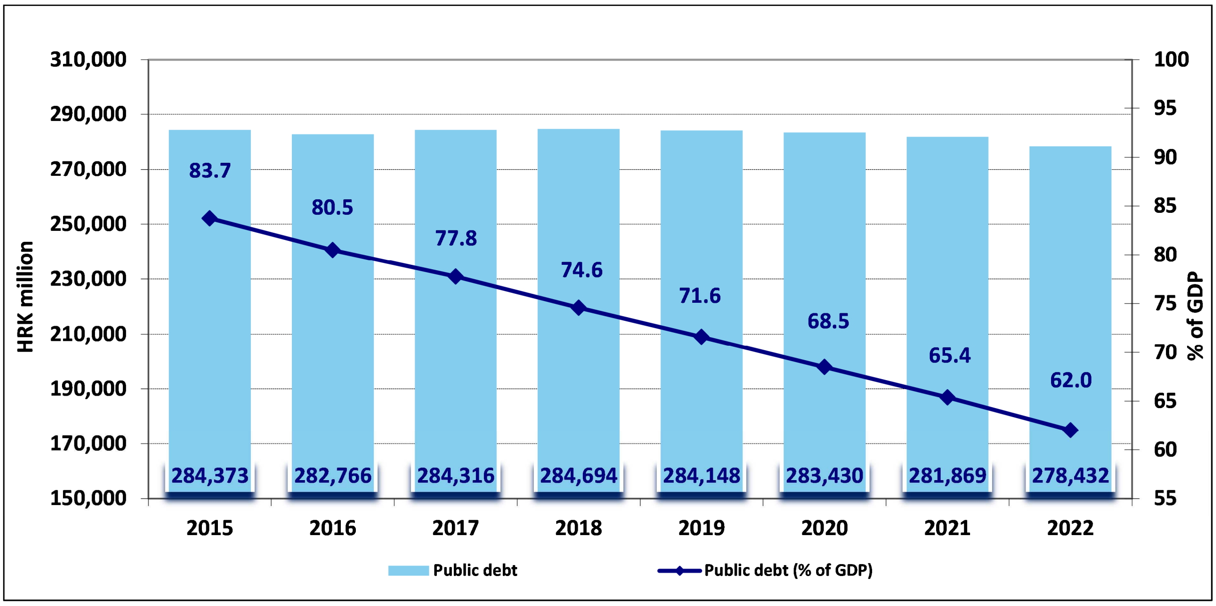
Table 3.3: Overview of the Bonds Maturity of the Republic of Croatia in the Period 2019-2022

Bond	Date of issue	Currency	Amount (in million)	Intrest rate	Date of maturity
Domestic bonds					
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
Series 23 D-22	07.02.2017	HRK	3,000	2.250%	07.02.2022
Series 17 D-22	22.07.2011	EUR	1,000	6.500%	22.07.2022
Series 28 D-22	05.02.2019	EUR	500	0.500%	05.02.2022
Foreign bonds					
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
Euro-EUR IX	29.05.2014	EUR	1,250	3.875%	30.05.2022

Source: Ministry of Finance

On the basis of the trends in the fiscal balance of the general government budget, it is expected that in 2019 the share of public debt in GDP will register further reduction by 3 percentage points and will amount to 71.6% of GDP. Furthermore, in the continuation of the medium-term period, the share of public debt in GDP will continue to decline by on average 3.2 percentage points, i.e. to the level of 68.5% of GDP in 2020, of 65.4% of GDP in 2021, while in 2022 it will amount to 62% of GDP.

Chart 3.2: Projection of Public Debt Trends by 2022



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, especially from tax revenues and contributions in the forthcoming period, which would lead to a direct impact on the level of the general government budget balance.

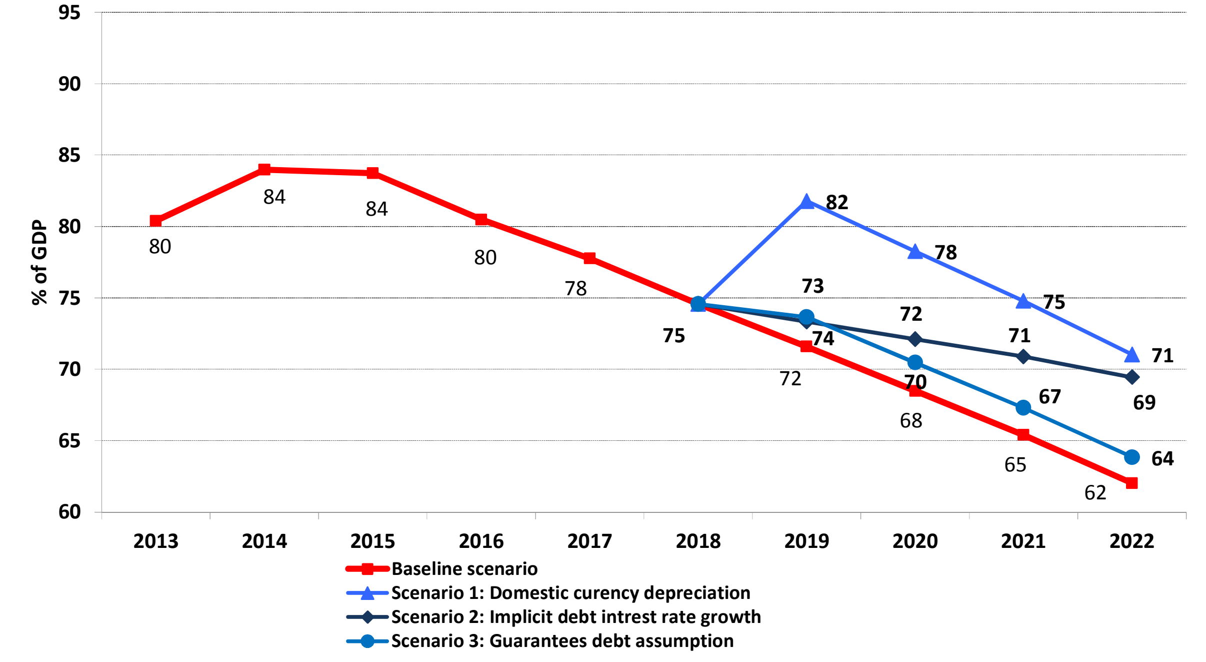
Although the last pension reform contributed to the reduction of long-term risks for the pension system, the pension system of the Republic of Croatia faces very unfavourable demographic trends, which primarily refer to the aging of the population, but also to the emigration pressures faced by the Republic of Croatia. The continuation of such trends would create additional pressure on the generational solidarity system which could have a negative impact on the sustainability of public finances in the long run. 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 over the past three years is reduced by more than 9 percentage points, its high level of HRK 284.7 billion 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 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 2 percentage points in the period 2019–2022, the public debt would register an increase above the projected one and, at the end of the projection period, it would be higher by 7.4 percentage points than in the baseline scenario, i.e. it would reach the level of 69.4 % of GDP.

Furthermore, the high share of public debt denominated in euros (71.2%) 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 20% would raise the level of public debt to 81.8% of GDP in 2019, i.e. public debt would be higher by 10.2 percentage points than in relation to the baseline scenario.

Although the Republic of Croatia is at the bottom in terms of the level of potential liabilities compared to other EU member states, such liabilities still represent the potentially high risk for public finance. Such risk materialized in 2018 when the Republic of Croatia in the name of protested guarantees for the Uljanik Group, according to the ESA 2010 methodology, reclassified the total guaranteed debt of the Uljanik Group of HRK 4.4 billion into public debt, which led to a one-off increase in the level of 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 73.7% of GDP in 2019.

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 some differences, which primarily 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 2018-2021 rested on the assumption of a real growth of gross domestic product of 2.8% in 2018, 2.7% in 2019 and 2.5% in 2020 and in 2021. The 2019 Convergence Programme projects the real growth to be of 2.5% in 2019, of 2.4% in 2020, and of 2.3% in 2021 and 2022. 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 period.

In addition, in 2018 general government sector revenues were by 0.6 percentage points higher than initially planned, while expenditures were lower by 0.1 percentage points. Such trends had an impact on significantly better realization of the general government budget balance by 0.7 percentage points. In the period 2019-2021, new projections of general government sector revenues are on average by 1.8 percentage points higher in relation to he last year's Programme. At the same time, expenditures are higher by average 1.7 percentage points. Therefore, the projection of the general government budget balance is more favourable compared to the previous Programme.

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

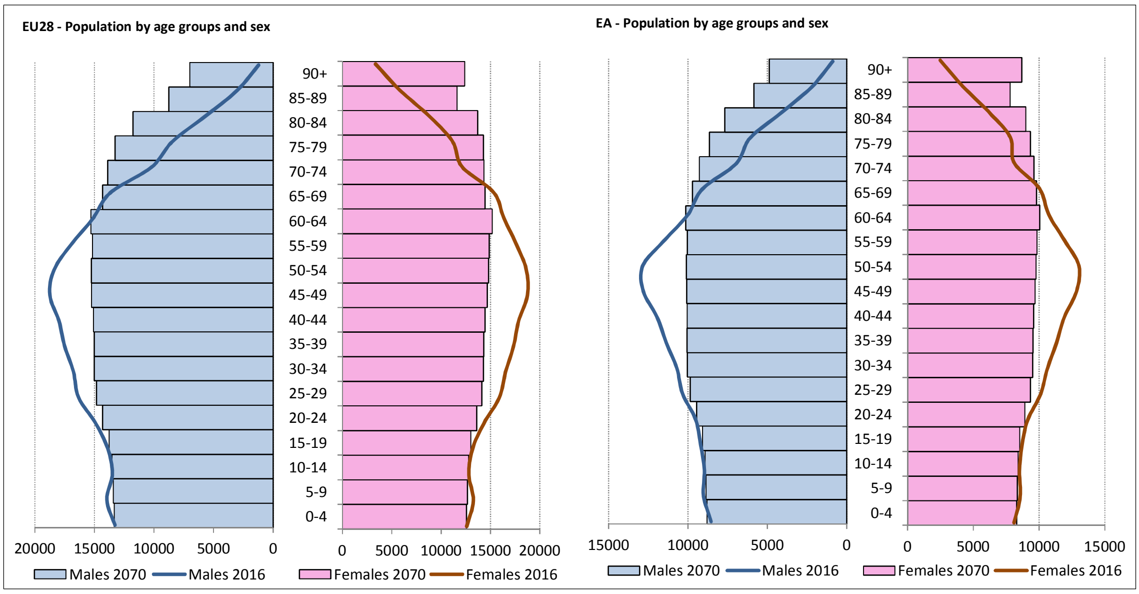
	2018	2019	2020	2021	2022
CP RoC 2019-2022 (% of GDP)					
Total revenue	46.6	47.0	46.9	46.4	46.2
Total expenditure	46.4	47.3	46.7	46.0	45.4
Net lending/borrowing	**0.2**	**-0.3**	**0.2**	**0.4**	**0.8**
CP RoC 2018-2021 (% of GDP)					
Total revenue	46.0	45.2	45.1	44.6	n.a.
Total expenditure	46.5	45.6	45.1	44.1	n.a.
Net lending/borrowing	**-0.5**	**-0.4**	**0.0**	**0.5**	**n.a.**
Difference					
Total revenue	0.6	1.7	1.8	1.7	n.a.
Total expenditure	-0.1	1.7	1.6	1.9	n.a.
Net lending/borrowing	**0.7**	**0.0**	**0.2**	**-0.1**	**n.a.**

Source: Ministry of Finance

5. SUSTAINABILITY OF PUBLIC FINANCES

As 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. According to the EC 2018 Ageing Report in the period up to 2070, there will be major changes in the trends of the number of EU residents, which show negative demographic trends (Chart 5.1), since the working-age population group (15–64 cohort) will significantly decrease, and thus the population group of above the age of 65 (65+ cohort) will increase.

Chart 5.1: Comparison of Age and Gender Structure of the Population

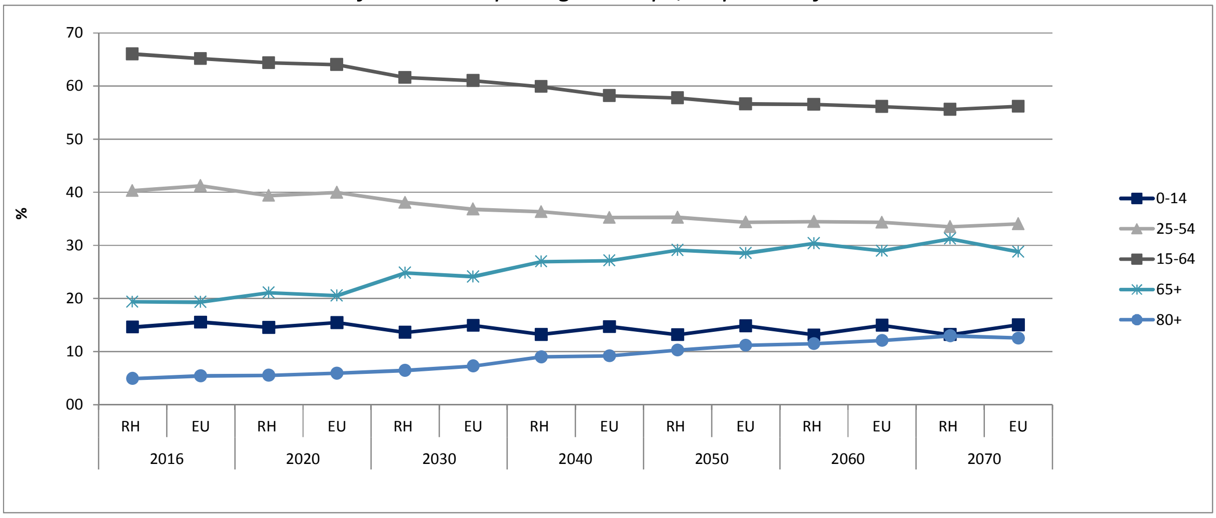


Source: European Commission

For the aforementioned period, an increase of 21.6 percentage points in the old age dependency ratio (people aged 65 or above relative to those aged 15-64) is predicted at EU level, i.e. from 29.6% in 2016 to 51.2% in 2070, or from 3.3 working-age people for every person aged over 65 years in 2016 to only 2 working-age persons per one elderly resident in 2070. In addition, the growth in the Very old-age dependency ratio (people older than 80 years in relative to those aged 15-64) has been noticed, increasing by 14 percentage points, i.e. from 8.3%, to 22.3% over the observed period.

In the period 2016-2070, the decrease in the population of the Republic of Croatia is anticipated from 4.2 to 3.4 million, along with the increase in the share of 65+ residents, i.e. 80+ residents in the total share of population, resulting in a reduction in the share of the 15-64 age group, while the share of children and the share of the oldest will be almost equalized.

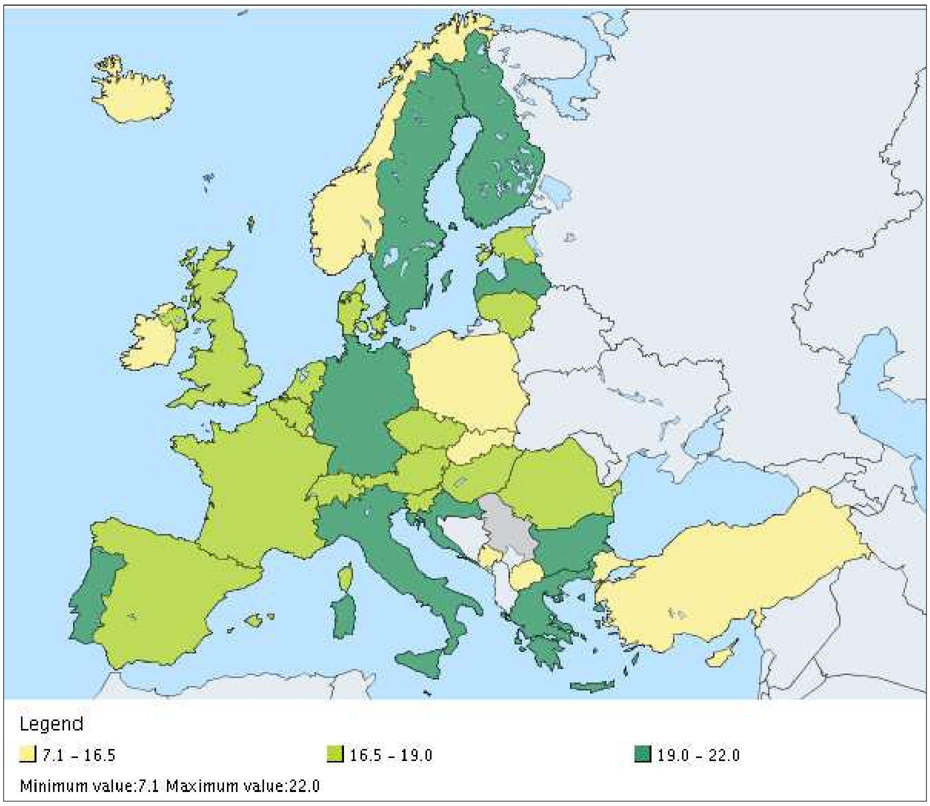
Chart 5.2: Trends in Number of Residents per Age Groups, Republic of Croatia and EU



Source: European Commission

Figure 5.1, showing people aged 65 or above, confirms the predictions that in 2070, two-thirds of Europe will have more than 20% of the population of that age group.

Figure 5.1: Population of Europe aged 65 or above, in 2016

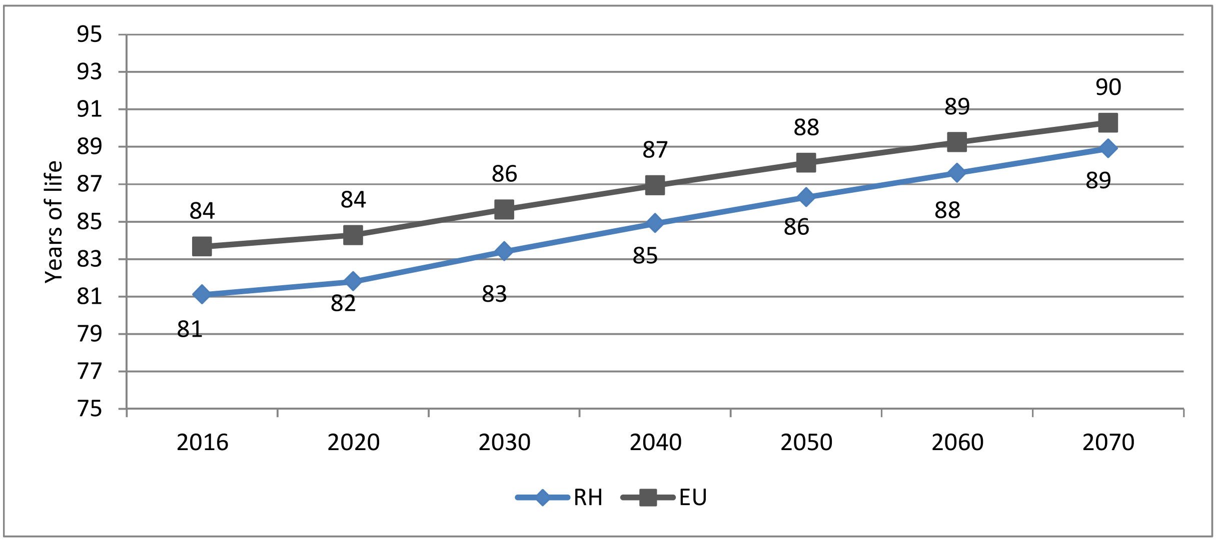


Source: Eurostat

With a decrease in the number of residents, the Republic of Croatia follows the European trend of life expectancy extension. The life expectancy at birth in 2016 was 81.1 years for women and 75 years for men. This is less than the average of EU countries where the life expectancy at birth for women was 83.7 years, while for men it was 78.3 years. However, the data for the Republic of Croatia show a tendency of the increase in life expectancy up to 2070 by 9.4 years for men and 7.8

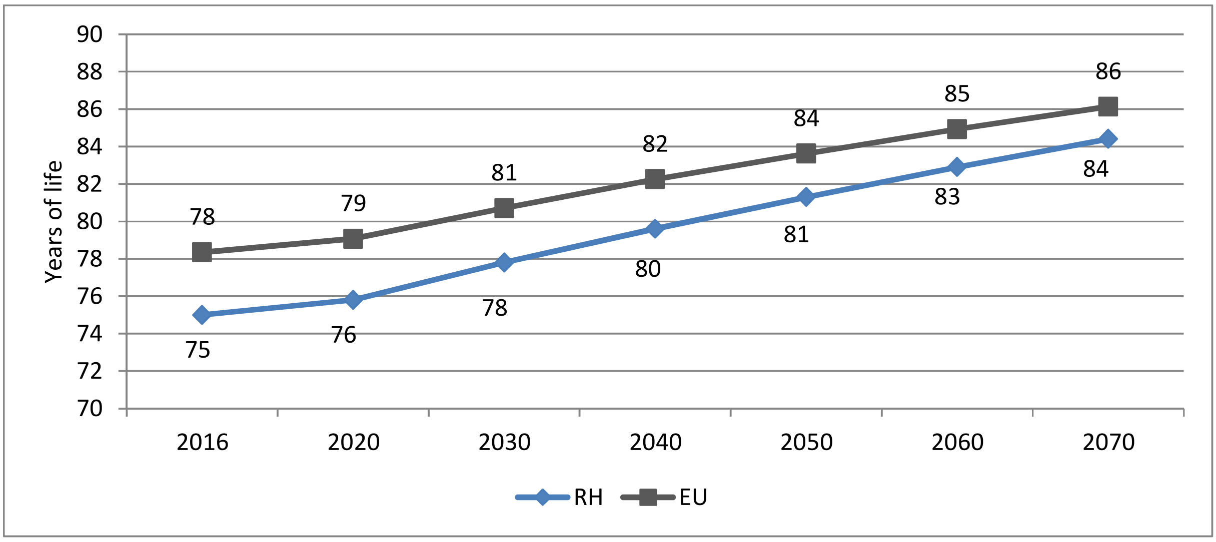
for women, while the increase in the age for men by 7.8 years and for women by 6 years is expected in the EU.

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



Source: European Commission

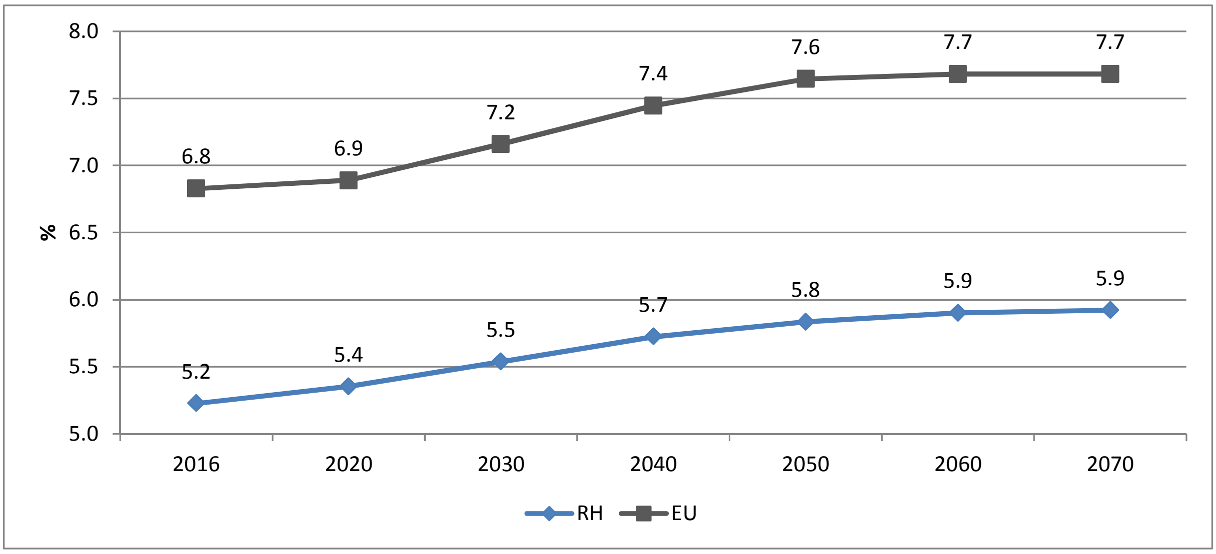
Chart 5.4: Life Expectancy at Birth, men (in years)



Source: European Commission

By comparing the EU and the Republic of Croatia in the period 2016-2070, the remaining life expectancy at the age of 65 will be extended by 6.4 years for men and by 6.2 years for women in the Republic of Croatia and in the EU by 5.3 years for men and 5.1 years for women. Such demographic trends will create strong pressure on the sustainability of public finances, including the generational solidarity system.

Chart 5.5: Spending for Healthcare (as % of GDP)



Source: European Commission

From a healthcare system perspective, demographic changes have a significant impact on the demand for healthcare protection services. According to the EC 2018 Ageing Report, in 2016 total healthcare spending in the Republic of Croatia amounted to 5.2% of GDP, being by 1.6 percentage points lower than the EU average, which amounts to 6.8%. By comparing the changes in spending over the time up to 2070, the share of planned healthcare expenditures in GDP at the level of the Republic of Croatia is increasing by 13%, which equals the increase at the EU level.

The key challenge in the healthcare sector of the Republic of Croatia is the adjustment of the ways of providing healthcare protection under the conditions of such unfavourable demographic trends. In order to sustain the healthcare system, the aim is to raise the quality of healthcare protection, resource optimization and financial stability of the system. The same is planned to be achieved through greater availability of healthcare services, reduction of multiple scheduled appointments and medical procedures, reduction of waiting lists, consolidated procurement of medicines and medical equipment. Furthermore, the aim is also to standardize and optimize the criteria and the procedure of diagnostics, treatment and patient monitoring, as well as to functionally integrate hospitals and to establish centres of excellence in individual hospitals at both the regional and the national level. The aim is also to improve primary healthcare protection, to improve access to specialist-conciliar healthcare protection, daily hospital treatments and acute and chronic care beds in hospitals as well as palliative care. All of the abovementioned is also defined by the key strategic document for the development of the healthcare system in the Republic of Croatia, i.e. by the National Strategy of the Healthcare Development 2012-2020[42] and the Decision on the adoption of the National Plan for the Development of Clinical Hospital Centres, Clinical Hospitals, Clinics and General Hospital in the Republic of Croatia for the period 2018.-2020[43].

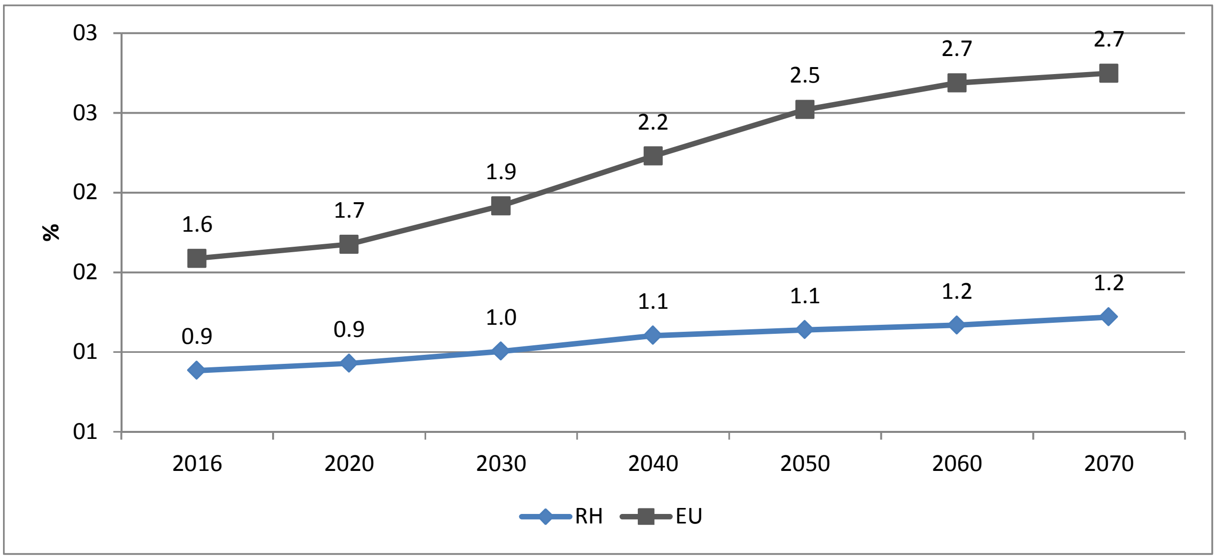
[42] Official Gazette, number 116/2012
[43] Official Gazette, number 84/2018

In order to ensure financial sustainability of the system, as many healthcare institutions as possible will be included in the model of consolidated public procurement and the number of public procurement categories will be expanded. This ensures better control through the central place of joint public procurement management, i.e. the reduction of expenditures and the achievement of savings on an annual basis.

Within the social welfare system, in January 2018, the Action Plan for the Improvement of Social Benefits System for the period 2018-2020 was adopted and a series of projects are implemented according to it. Thus, the data on all social benefits and the amounts of social benefits provided by local and regional self-government units have been collected and consolidated. During 2019, special attention will be given to better exchange of relevant data for each individual beneficiary. In addition, the plan is to enable citizens to submit an e-request (e-application) for child allowance, maternity and parental benefits and personal disability allowance and allowances for assistance and care from the social welfare system. It is also worth mentioning that the new Social Welfare Act is planned to be prepared with the aim of ensuring the adequacy of social benefits as well as better coordination and transparency of social benefits. Furthermore, it is also planned to develop a regulatory framework for the arrangement of the methodology for the calculation of social services prices, to be applied by all providers in the social welfare system irrespective of the legal status and/or the founder thereof.

With regard to long-term care, the Working Group on Ageing Populations and Sustainability (AWG-EPC) has made projections of public spending on long-term care for the period 2016-2070, based on agreed methodology and available data. According to the 2018 Ageing Report, public spending in the Republic of Croatia for long-term care amounted to 0.9% of GDP in 2016, 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 5.6: Spending for Long-Term Care (as % of GDP)



Source: European Commission

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 the expenditures for pensions from the 1st pillar should be reduced from 10.6% of GDP in 2016 to 6.8% of GDP in 2070. Given that on average a steady share of pension insurance contributions paid in the 1st pillar of about 5.7% 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. The expenditures for pensions from the 2nd pillar should gradually increase to 1.6% in 2070, which means that total pension expenditures in the Republic of Croatia would amount to 8.4% of GDP in 2070.

Table 5.1: Expenditures for Pensions and Pension Contributions in the Period 2016-2070 (% 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**
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

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. 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 pensions realized so far by the insured persons from the 1st and the 2nd pension pillars are lower than pensions realized only from the 1st pension pillar with the pension supplement, and therefore the last pension reform, inter alia, introduced a pension supplement to the 1st pension pillar insured persons that are mandatorily insured in the 2nd 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 1st 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 the acceleration in the increase in the age to 67 years for women and men. This measure will reduce the inflow of new pensioners.

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

It is important to point out that the presented projections of revenue and expenditure of the pension system do not include the amendments to the legal regulations that entered into force on January 1, 2019.

While, according to the regulations that were valid until 2018, the decline in the expenditures for pensions of the 1st pension pillar was projected, the measures of the latest pension reform described in the 2019 National Reform Programme will increase the pension adequacy and, accordingly, the expenditures for pensions in the 1st pillar. The increase in pension expenditures is the consequence of introducing a pension supplement for the insured persons of the 2nd pension pillar who opt for the realization of the pension from both pillars when retiring.

In this respect, the share of pension expenditures in GDP will continue to decline in the long term, but the intensity of the reduction will be lower than under the regulations that were valid until 2018. Compared to the 2018 projections shown in Tables 5.1 and 5.2, the annual expenditures for pensions in the 1st pillar will increase by about 0.1% of GDP per year by 2025, approximately by 0.2% of GDP in 2030 and approximately by 0.9% in 2040, while the increase in the expenditures for pensions in the 2nd pillar will be slightly smaller than projected in 2018.

At the same time, the state budget revenues on the basis of the positive effects of pension reform measures and the transfer of capitalized contributions from the 2nd to the 1st pillar for insured persons, who opt for the realization of the pension only from the 1st pillar when retiring, will increase. In relation to the 2018 projections, the state budget revenues would gradually increase by about 0.7% of GDP in 2030, after which the increased revenues would slightly decrease and amount to approximately 0.6% of GDP in 2040.

The updated projections of the long-term sustainability of the pension system, taking into account the effects of the abovementioned recent pension reform, and in accordance with the methodology of the Ageing Report, will be prepared in mid-2019.

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 2019-2022, special attention will be paid to fair and efficient collection of public revenues, co-operation and partnership of the Croatian Tax Administration with citizens and entrepreneurs, and on the creation of conditions for further tax cuts. Thus, the changes in acts and regulations based on the comprehensive tax system analysis are aimed at reducing the total tax burden and a simpler and more socially fair tax system for taxpayers, i.e. entrepreneurs and citizens.

Changes in the Taxation by Value-Added Tax

Since January 1, 2019, the Value Added Tax Act[44] stipulates that a reduced 5% VAT rate is applied on all medications (prescription and non-prescription) and delivery of books, daily newspapers and scientific journals, regardless of the form in which they are delivered.

In addition, the 13% VAT rate taxation was extended to periodical newspapers and journals, irrespective of the form in which they are delivered; baby diapers, delivery of animals, meat and meat products, fish, vegetables, fruits and eggs. The services and related copyrights of authors, composers and performers who are members of the appropriate organizations for collective realization of rights are also subject to this rate, with the prior approval of the central state authority competent for intellectual property.

It is also planned to reduce the general VAT rate from 25% to 24%, with effect from January 1, 2020.

[44] Official Gazette, number 73/2013, 99/2013, 148/2013, 153/2013, 143/2014, 115/2016 and 106/2018

The threshold of HRK 400,000 was abolished, allowing for a 50% deduction of pre-tax on all personal cars, regardless of their value. In addition, the right to deduct 50% of pre-tax for vessels and aircrafts in respect of the use thereof for private and business purposes was also abolished.

The registration in the register of VAT taxpayers is carried out on the basis of taxable deliveries in the previous or current calendar year, which means that a taxpayer registers in the register of VAT taxpayers during the year if they realize the deliveries in the amount higher than HRK 300,000.

In addition, the transfer of the tax liability is applied to the delivery of concrete steel and iron and concrete and steel products (reinforcing material), which means that the taxpayer registered in the register of VAT taxpayers in the Republic of Croatia is obliged to pay VAT when the goods are delivered to them.

Changes in the Taxation by Corporate Income Tax

During 2018, there were the amendments to the Corporate Income Tax Act[45] for the purpose of aligning with the Council Directive (EU)[46] laying down rules against tax avoidance practices that directly affect the functioning of the internal market. Thus, the Act provides for a defence measure, while the obligation to pay the withholding tax at the rate of 20% also extended to interests, dividends, copyrights and other fees if paid to persons from non-cooperative countries.

Changes in the Taxation by Personal Income Tax

In the income tax system, new provisions entered into force on January 1, 2019 have been applied. The annual tax base for the application of a rate of 24% was extended from HRK 210,000 to HRK 360,000, i.e. from HRK 17,500 to 30,000 per month. It is stipulated that the income tax is not to be paid on cash prizes related to the performance results and additional rewards of up to HRK 5,000. The non-taxable amount of support for newborns was also increased to HRK 10,000.

In order to allow the use of tax reliefs to a larger number of family supporters, a circle of persons to be considered supported close family members, i.e. supported children was extended. The scope of receipts not taken into account when determining the right to a personal allowance for supported family members was also extended. As of January 1, 2019, the means testing limit of 15,000 does not include scholarships, awards for pupils and students' excellence and grants paid out of budget, EU funds and programmes for the purpose of education and training regardless of the amount, insurance compensations paid for serious injury and acknowledged disability, support for schooling of a child up to the age of 15 which the employer pays to the child of the deceased employee/former employee.

It is stipulated that the school textbooks provided to pupils of elementary and secondary schools and by local and regional self-government units and receipts from education programs for unemployed

[45] Official Gazette, number 177/2004, 90/2005, 57/2006, 146/2008, 80/2010, 22/2012, 148/2013, 143/2014, 50/2016, 115/2016 and 106/2018

[46] 2016/1164 of July 12, 2016

persons financed from the state budget and/or the budget of a local and regional self-government unit and/or EU funds and other international funds, are not considered as income.

The tax treatment of receipts in kind on the basis of grant or optional purchase of own shares within the income of capital at the rate of 24% was equalized, irrespective of whether it is about employees or other related persons and regardless of whether the shares of the company are listed on the stock exchange or not. The taxation of receipts made on the basis of temporary or occasional jobs in agriculture was also prescribed at the rate of 12% as the final second income. Furthermore, the interest rate considered favourable in granting the loan, and which is considered as a receipt in kind, is reduced, from 3% to 2%.

Changes in the Contributions Payment Obligation

The Amendments to the Contributions Act[47] annul the contribution for employment of 1.7% and the contribution to health protection at work of 0.5%, while the contribution for health insurance increases from 15% to 16.5%, whereby the total contribution burden on salary decreases from 37.2% to 36.5%.

The same Act provides for an annual basis for members of management boards and executive directors of companies and cooperative managers who are not insured on that basis, as a multiplication of average salary, coefficient 0.65 and figure 12, proportional to the period in which the duty was performed, with effect as of January 1, 2019.

Changes in the Tax Treatment of Excise Duties

The Excise Duties Act[48] introduced the institute of the refund of the part of excise duty paid on energy products (diesel fuel) used as motor fuel for commercial transport of goods by vans of at least 7.5 gross tonnage, and for commercial transport of passengers by buses. The aim is to exclude, to the greatest extent, the impact of excise duties on energy products in the process of distribution and supply of goods and passenger transport, i.e. the reduction of carriers' costs.

By adopting the Regulation on the amount of excise duties on cigarettes, fine-cut smoking tobacco intended for the rolling of cigarettes and other smoking tobaccos[49], the amount of excise duty on cigarettes is changed so that now the specific excise duty amounts to HRK 335 per 1000 cigarettes, the proportional excise duty amounts to 34% of the retail price of cigarettes, and the minimum excise duty on cigarettes amounts to HRK 755 for 1000 cigarettes. The amount of excise duty on fine-cut smoking tobacco intended for the rolling of cigarettes and other smoking tobaccos has not been changed and still amounts to HRK 600 for 1 kilogramme.

[47] Official Gazette, number 84/2008, 152/2008, 94/2009, 18/2011, 22/2012, 144/2012, 148/2013, 41/2014, 143/2014, 115/2016 and 106/2018
[48] Official Gazette, number 106/2018
[49] Official Gazette, number 106/2018

Changes in the General Taxation Act

The Amendments to the General Taxation Act[50] elaborate many institutes due to the digitization and advanced communication methods between the taxpayer and the tax authority. Thus, as of January 1, 2019 binding opinions can be requested from the tax authority regardless of the topic and the tax form, and the only precondition is that it is about a future and intended transaction. In addition, the provisions of the General Taxation Act prescribe the possibility that the competent body may prohibit the operation of a business entity performing the activity, while avoiding the fulfilment of prescribed conditions, by blocking the Internet site. Taxpayers who electronically communicate with the tax authority may, occasionally and for smaller tax amounts, use the system with lower levels of identification. In terms of the OPZ-STAT form, the reporting dynamics is reduced, whereby this form is submitted once a year and thus the administrative burden on entrepreneurs is reduced. Legal preconditions were also created that tax decisions are certified by electronic signature or by electronic seal of the tax authority.

6.3. Measures to Improve the Efficiency of Budget Expenditures

The State Audit Office Act

Pursuant to the new State Audit Office Act[51], which entered into force in March 2019, this institution will independently plan the funds needed for its work, which is in accordance with the principle of financial independence prescribed by the Lima and the Mexican Declarations and the Code of Ethics. No later than June 1 of the current year, the State Audit Office will have made a proposal for a financial plan for the next year and the projections for the next two years, and will have submitted it to the committee of the Croatian Parliament responsible for finance and the state budget and to the Ministry of Finance. After the Ministry of Finance receives this document, the Government of the Republic of Croatia will, upon the proposal of the Ministry of Finance, give its opinion on it and submit it to the mentioned committee of the Croatian Parliament.

The key novelty is that the committee of the Croatian Parliament responsible for finance and the state budget approves the proposal for the financial plan for the next year and the projections for the next two years by the end of June of the current year and sends it to the Ministry of Finance for its inclusion into the proposal of the state budget of the Republic of Croatia and submits it to the State Audit Office. Such a method of planning the funds is in accordance with Principle 8 of ISSAI 10, according to which the legislative authority has the responsibility to ensure that the head audit institution has the appropriate resources to fulfil its mandate and, on the other hand, is justified by the fact that the State Audit Office has a special status in accordance with the Constitution of the Republic of Croatia.

[50] Entered into force on January 1, 2019
[51] Official Gazette, number 25/2019

Additionally, the new Act elaborates in more detail the actions to be taken after the audit is over, with a special emphasis on the audited entity's obligations, in particular on monitoring the actions according to the plan of execution of orders and recommendations. In this respect, the subject of the audit, i.e. the entity which the given order and/or recommendation refers to, is required to inform the State Audit Office in writing of the execution of a particular order or recommendation within 30 days after the expiration of the scheduled execution time. At the same time, the State Audit Office checks the execution of orders and recommendations within the framework of the audit implementation. If in such procedures it is established that certain orders and recommendations have not been carried out or that the auditing body has failed to submit the plan of the execution of orders and recommendations within the prescribed deadline, the State Audit Office shall notify the competent state attorney’s office which will then initiate the misdemeanour proceedings.

Under the new legislative framework, the State Audit Office will also be in charge of auditing the Croatian National Bank. The European Central Bank has found in its opinion that the proposed arrangement is in accordance with the principle of central bank independence, including its institutional independence. The implementation of the State Audit Office Act contributes to the legitimate, earmarked and purposeful use of budgetary resources and funds collected on the basis of public powers, and to the efficient and effective functioning of the internal control system.

More Efficient System of Financial and Statistical Planning and Reporting By Extra-Budgetary Users in the Transport Sector

According to the provisions of the Budget Act[52], extra-budgetary users, companies and other legal persons in which the state or a local and regional self-government unit has a decisive influence on management and which, according to the rules of the EU statistical methodology (ESA 2010), are classified into the general budget sector and are not budgetary users, are considered extra-budgetary users. Among the most important ones, by the size of the impact on the fiscal balance of the general budget or the public debt, are the trade companies in the transport sector: Croatian Motorways (hereinafter referred to as: HAC), Rijeka-Zagreb Motorway (hereinafter referred to as: ARZ), Croatian Railways Infrastructure (hereinafter referred to as: HŽI) and Croatian Railways Passenger Transport (hereinafter referred to as: HŽPP). Therefore, in the first phase, it is planned to harmonize the procedures of planning and reporting on the implementation of the financial plans of the abovementioned users with the existing procedure applicable to extra-budgetary users. This includes the approval of the Croatian Parliament of financial plans and reports on the execution of financial plans of extra-budgetary users in the transport sector. In this context, their data will be expressed in accordance with the rules of the budgetary accounting. Taking into account the abovementioned, it is anticipated that the Croatian Parliament will for the first time give the approval of the financial plans of extra-budgetary users in the transport sector along with the adoption of the State Budget of the Republic of Croatia for 2020 and the projections for 2021 and 2022.

[52] Official Gazette, number 87/2008, 136/2012, 15/2015

Ex-Post Evaluation of the Effects of Selected Activities in the Sectors of Healthcare, Water Management and Environmental Protection

For the purpose of continuous improvement of the system of budget planning and better control of the use of resources from public sources, an *ex-post* evaluation of the effects of the selected programmes, activities or projects was introduced. The emphasis is placed on controlling the effectiveness and foundation thereof. Specifically, it means that the special attention is paid to the justification of the implementation thereof, cost-effectiveness (which includes the cost and benefit analysis), optimization and sustainability of results. In addition, the overall effects of the programmes, activities or projects observed, including their potential positive and negative aspects, i.e. risks and reasons that led to them, are also considered. When selecting programmes, activities and projects subject to ex-post evaluation, several parameters are taken into account, in particular their fiscal value, the long-term time frame needed to implement them and the high rating of potential risks.

In 2019, the *ex-post* evaluation of the effects of selected activities in the healthcare, water management and environmental protection sectors will be carried out. The *ex-post* evaluation in the healthcare system will include the activities of prescription medications and particularly expensive medicines due to significant funds allocated to them. In 2017, total execution of activities of prescription medications and particularly expensive medicines amounted to HRK 4.5 billion or 18.8% of total executed expenditures of the Croatian Health Insurance Fund (hereinafter referred to as: HZZO). Besides significantly participating in the overall execution of the HZZO's financial plan, the expenditures of prescription medications and particularly expensive medicines register continuous and significant year-on-year growth. For example, in 2017, the total execution of these activities is higher by 8% compared to 2016.

Likewise, due to significant fiscal allocations with a marked growth trend, an *ex-post* evaluation of the activities of regular maintenance and renewal of watercourses, water structures and water resources, and of management activities with special categories of waste will be carried out in the sectors of water management and environmental protection. The use of such and similar tools will contribute to more efficient use of public resources and cost rationalization, will enable the identification of potential risks, and will open up space for better implementation of a particular programme, activity and project.

Automated Transfer of Own and Earmarked Revenues and Receipts from the Science System in the Information System of the State Treasury

The provisions of the Budget Act[53] stipulate that earmarked revenues and receipts and own revenues of budgetary users are an integral part of the state budget and are paid into the state budget. Annual Budget Execution Acts provide for exemptions from payment of these revenues and receipts for certain budgetary users where no technical prerequisites for the monitoring thereof have been created. These revenues and receipts as well as expenditures and expenses financed by these revenues and receipts are realized and executed through the accounts of the budgetary users

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

opened at commercial banks, which is why they were not previously recorded in the reports on the execution of the state budget.

The 2015 Act on the Execution of the State Budget[54] for the first time, along with the abovementioned provision on exemption, stipulates the obligation to plan revenues and receipts and expenditures and expenses from their own and earmarked sources and to pronounce their realization in the State Treasury system every month. Consequently, since January 2015, the competent ministries of budgetary users that are exempt from paying revenues and receipts to the state budget, have been pronouncing or manually recording their own and earmarked revenues and receipts from their competence in the State Treasury information system. However, prior to that, they have to collect, verify and consolidate and then manually enter the data for all users within their ministry competence into the abovementioned system. In terms of some ministries, the number of such users can be significant, and there is no easy way to automatically verify the quality of the data collected. Likewise, only when the data is entered into the State Treasury information system is their systematic verification carried out. Therefore, such a process is not fully effective and it results in delays in reporting on the execution of financial plans of budgetary users of the state budget.

Accordingly, the aim of the implementation of an appropriate IT solution is to increase the efficiency of collecting, verifying, consolidating and entering the data on revenues and receipts, and expenditures and expenses of the budgetary users excluded from the payment of own and earmarked revenues and receipts to the state budget. The formal verification at the time of the entry and the entry of the data itself will be carried out through an IT solution in the institutions that are the source of data, whereby the burden imposed on competent ministries will be reduced. On the other hand, faster and simpler implementation of control and consolidation of data collected and the automated transfer thereof to the State Treasury information system will be enabled to them, which will contribute to comprehensive and timely reporting.

By the end of 2019, the IT solution will be applied to a pilot project of the Ministry of Science and Education that was selected due to its complex organizational structure and a large number of users. By the end of 2020, it is planned to include all other users of the state budget that are exempt from paying their own and earmarked revenues and receipts to the state budget.

[54] Official Gazette, number 148/2014

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. Binding Tables

In most EU countries, the budget and statistical coverage of the general budget system is not identical, and the most significant differences are found in the coverage of extra-budgetary users. They can apply budgetary as well as entrepreneurial and non-profit accounting, depending on the legal form and business specificity. When extra-budgetary users apply entrepreneurial accounting or accounting of non-profit organizations, business transactions, for the needs of financial reporting, have to be pronounced in accordance with the rules of budgetary accounting.

Because of the specificity of accounting events, this process is extremely complex and requires specific but also comprehensive accounting knowledge. Therefore, business events arising from the operations of a single extra-budgetary user have been individually translated from the accounting system that this extra-budgetary user applies to the system of budget accounting. The translation result is a set of binding tables for extra-budgetary users that are classified into the general government sector in accordance with the rules of the EU statistical methodology and are not budgetary users, and the Manual for the Preparation of Binding Tables has been issued. By applying these results of the project the quality of the data in financial and statistical reports of the general budget entities will be improved, and the acquired knowledge and insights into the specificities of business operations will also be reflected in the drafting of financial plans of extra-budgetary users.

This process included the State Agency for Deposit Insurance and Bank Rehabilitation, HŽI, HŽPP, Croatian Roads, HAC, ARZ, Croatian Radio-Television, Fund for financing the decommissioning and the disposal of radioactive waste and spent nuclear fuel of the Krško Nuclear Power Plant, Croatian Homeland War Veterans and their Family Members Fund, Croatian Bank for Reconstruction and Development and Croatian Energy Market Operator Ltd.

7.2. Fiscal responsibility Act

The Fiscal Responsibility Act[55] came into force on January 1, 2019 with a view to ensuring medium-term and long-term sustainability of public finances and further enhancing fiscal responsibility and transparency. It fully aligns fiscal rules with the provisions of the Stability and Growth Pact, strengthens the independence of the Fiscal Policy Committee and additionally regulates the obligation of submitting the annual Fiscal Responsibility Statement[56].

[55] Official Gazette, number 111/2018

[56] The statement is described in more detail in Section 2.3.

Thus, this Act establishes three fiscal rules which refer to the structural balance rule, the expenditure rule and the public debt rule. According to the structural balance rule, the medium-term budgetary objective becomes a target value that will be realized according to the adjustment plan in line with the EU legal provisions. For the purpose of sustainable expenditure trend, the rule is introduced under which annual growth of general budget expenditures may not exceed the reference potential GDP growth rate established in accordance with the EU legal provisions, whereby the exemptions for certain categories of expenditures are permitted. The public debt rule stipulates that the share of public debt in GDP must not exceed the 60% reference value. If the share exceeds this value, the difference between public debt in GDP and the 60% reference value has to be reduced according to the dynamics that complies with the EU legal provisions. Temporarily delaying of the application of fiscal rules will be permitted in case of exceptional circumstances and provided that this does not endanger fiscal sustainability in the medium-term. The proposed Act also defines the obligation to abide by the recommendations of the EU Council during the excessive budgetary deficit procedure. Procedures have also been prescribed in case the Government of the Republic of Croatia, at the proposal of the Ministry of Finance or the Fiscal Policy Committee, finds significant deviations from the fiscal rules defined by the Act.

Furthermore, the Fiscal Policy Committee is defined as a permanent, independent and autonomous body that carries out tasks within its scope of work and competence. In order to emphasize its independence, the President of the Committee, who organizes and manages the work of the Committee professionally, is entitled to salary at the level of the salary of the vice-president of the State Electoral Commission and general labour regulations will be appropriately applied to them. In addition, in order to carry out its duties defined by this Act as professionally as possible, it is anticipated that there are civil servants working in the Committee who perform professional, administrative and technical tasks. Funding for the work of the Committee is provided in the state budget of the Republic of Croatia. All of the abovementioned strengthens the role of the Committee as a supervisor over the application of this Act, as well as over the fiscal policy of the entire state, and all for the purpose of improving the stability of public finances.

7.3. Regulation on Preparation and Submission of the Fiscal Responsibility Statement and on Reporting on the Compliance with Fiscal Rules

The aforementioned Act states that within six months from the date of its entry into force, the new Regulation on the Preparation and Submission of the Fiscal Responsibility Statement and the Report on the Compliance with Fiscal Rules (hereinafter referred to as: the Regulation) will be adopted. It shall prescribe the layout and contents of the Fiscal Responsibility Statement as well as the procedures and deadlines for preparation and submission, the way and deadlines of reporting to the Ministry of Finance on the identified irregularities when verifying the content of the statements and the form and the content of the report on the compliance with fiscal rules

Report on the Compliance with Fiscal Rules

The Report on the Compliance with Fiscal Rules will be submitted along with all key budget documents, i.e. with the convergence programme, draft state budget and financial plans of extra-budgetary users, draft amendments to the state budget and financial plans of extra-budgetary users and draft annual report on budget execution. Each report shall refer to the period which the document refers to. It will contain a brief description of macroeconomic trends as well as a description of the methodology and the calculation of fiscal rules. This will enable the Fiscal Policy Committee as well as the general public to gain insight into the fiscal policy management in the context of the alignment with fiscal rules, which at the same time strengthens fiscal transparency.

Fiscal Responsibility Statement

Heads are obliged to carry out the self-evaluation and self-assessment of the systems they manage, as well as to continuously improve and upgrade them. Each year, heads at all levels of state and local government are obliged to prepare and submit the Fiscal Responsibility Statement (hereinafter referred to as: the Statement) for the previous budgetary year, for the period in which they have been assigned the function. With this Statement they confirm the legitimate, earmarked and purposeful use of funds and the efficient and effective functioning of the financial management and control system within the funds determined by the budget. Since 2015, this obligation has also been introduced for the heads of companies and other legal persons the owners or founders of which are the Republic of Croatia and/or one or more local and regional self-government units(s).

The procedure of giving the Statement is directed towards the identification of weaknesses and irregularities in the system by users themselves. The Head gives the Statement based on the previously completed Fiscal Responsibility Questionnaire (hereinafter referred to as: Questionnaire), available information on the work of the body, results of the internal and external audit and its own assessment. All the phases of the budget process are covered by the Questionnaire, and through questions from the Questionnaire, the minimum requirements for sound financial management are tested by processes, in order to assess whether the actions are taken in accordance with the legal framework prescribed and to what extent. The system thus established enables that the identified weaknesses and irregularities are recognized in a timely manner and weaknesses and irregularities are removed in the future in accordance with the removal plan, prepared by the persons obliged to submit the Statement themselves.

When deciding on the new Regulation, the procedure of giving the Statement will be elaborated, as well as the Questionnaire, which will cover more complex issues, encouraging persons obliged to submit the Statement to make more efficient use of funds and to improve the financial management and control system.

7.4. The Budget Act

The new Budget Act currently under preparation is aimed at strengthening the institutional framework for public finance management and improving the efficiency of the use of budget funds both on the revenue side and on the expenditure side. Therefore, this Act will strengthen the budget planning and the content of key budget cycle documents and will improve the control of expenditure execution as well as monitoring of the realization and the use of earmarked and own revenues and receipts of budgetary users. The borrowing framework for local and regional self-government units as well as the provisions relating to fiscal statistics will also be improved in accordance with the provisions of Council Directive 2011/85/EU on requirements for budgetary framework of the Member States.

In terms of improving the quality of key budget cycle documents, the content of the economic and fiscal policy guidelines will also be further expanded in the area of macroeconomic and fiscal frameworks, which are also the strategic predecessor of the instructions for the preparation of the state budget proposal. The new Act will also prescribe the obligation of ministries to prepare more detailed guidelines for budgetary and extra-budgetary users within their competence, where they, inter alia, allocate them the amount of expenditure for the implementation of programmes and activities, including the third level of users. Based on the aforementioned amount of allocated expenditure, budgetary users will make financial plans drafts and submit them to the relevant ministry, which will then prepare an integrated financial plan draft. In addition, the new legal framework, along with the general and the specific part, makes the explanation an integral part of the budget, both at the state level and at the level of local and regional self-government units. The obligation to express expenditures by functional and organizational classification and sources of funding is prescribed by the explanation of the general part. By introducing mandatory performance indicators, the emphasis is placed on the results of the implementation of budget activities and projects, thus strengthening the responsibility of budgetary users with an aim of purposeful use of allocated funds.

The system of control over the creation of multi-annual liabilities has been improved in its scope since 2003 when it was first introduced through the Budget Act. Currently, the approval of the Government of the Republic of Croatia, i.e. the Minister of Finance is not required for liabilities related to government borrowing and to government debt management and for liabilities assumed pursuant to international agreements and projects funded by EU. However, as the EU funds become an increasingly important source of funding, the national component of the co-financing of such projects increases as well. Therefore, the new Act will introduce better control over the creation of multi-annual contractual obligations under EU projects, in a way that will not slow down the contracting and implementation thereof.

Furthermore, some of the amendments to the Budget Act aim to harmonize monitoring and improve control of the use of own and earmarked revenues and receipts. Since 2015, own and earmarked revenues and receipts of all budgetary users of the state budget have been expressed in the state budget, whereby at the part of institutions they are not part of the cash flow of the State Treasury system. Based on the monthly reports of these institutions on the use of own and earmarked revenues and receipts, they are recorded in the State Treasury system. The plan is to carry out a detailed analysis with the aim of identifying areas for improving the way of recording on the realization and use of earmarked revenues and receipts and own revenues of these institutions, so that the data in the reports on the execution of the state budget are uniformly expressed. As the monitoring and control of these categories of revenue is an important element of fiscal responsibility, consideration will be given to the introduction of the 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.

The new Budget Act will also improve the borrowing framework of local and regional self-government units. According to the existing Act, a local and regional self-government unit may engage in long-term borrowing (by obtaining loans and providing guarantees/consents) only for investment financed from its budget, which is confirmed by its representative body, with the prior approval of the Government of the Republic of Croatia, whereby its total liability may not exceed 20% of the revenue realized in the year preceding the year in which it borrows, minus the revenues from grants and donations and revenues realized on the basis of the additional share in personal income tax and equalization grants for financing of decentralized functions. The fiscal limit control of the aforementioned 20% does not refer to the projects of local and regional self-government units that are co-financed by EU funds. In these cases, there is no need for the Croatian Government's approval of the borrowing, only the consent of the Minister of Finance. However, since the share of borrowing for co-financing of projects from EU funds is significantly increased in relation to the revenues of individual local and regional self-government units, it is necessary to consider introducing limitations in relation to the revenues of a unit, provided they do not slow down the contracting and the implementation of EU projects. Situations will also be prescribed where re-approval of the Government of the Republic of Croatia will be unnecessary if the credit or loan term and conditions change in a way that they are more favourable, i.e. they reduce the burden of borrowing for local and regional self-government units.

Particular emphasis will be placed on provisions referring to state guarantees. The current legislative framework is based on annual acts on the execution of the state budget, i.e. on individual decisions on granting state guarantees, as well as on contracts that are concluded on the basis of such decisions of the Government of the Republic of Croatia, which determine the rights and obligations of all parties of this procedure. The new Act will also consolidate the provisions on state guarantees, which are now contained in various regulations and acts, which will contribute to a clearer arrangement of this area and will improve the system of monitoring thereof.

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

ANNEXES

Annex 1a: Macroeconomic Prospects

	ESA Code	2018 (level)	2018 (rate of change)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)	2022 (rate of change)
1. Real GDP	B1*g	375,259	2.6	2.5	2.4	2.3	2.3
2. Nominal GDP	B1*g	381,799	4.4	4.0	4.3	4.2	4.2
Components of real GDP							
3. Private consumption expenditure[1]	P.3	216,968	3.5	3.7	3.3	2.9	2.7
4. Government consumption expenditure	P.3	73,329	2.9	2.7	1.9	1.9	2.0
5. Gross fixed capital formation	P.51	76,329	4.1	6.4	5.3	4.3	4.7
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	4,863	1.3	1.1	1.1	1.2	1.3
7. Exports of goods and services	P.6	192,111	2.8	2.7	3.2	3.3	3.4
- of which goods	*P.61*	*89,513*	*2.8*	*3.2*	*4.3*	*4.4*	*4.3*
- of which services	*P.62*	*102,598*	*2.9*	*2.2*	*2.2*	*2.4*	*2.5*
8. Imports of goods and services	P.7	188,342	5.5	5.3	5.2	5.0	5.0
- of which goods	*P.71*	*155,701*	*5.2*	*5.2*	*5.1*	*4.9*	*4.9*
- of which services	*P.72*	*32,641*	*6.6*	*5.7*	*5.4*	*5.2*	*5.2*
Contribution to real GDP growth							
9. Final domestic demand	P.3 + P.51	366,627	3.4	3.9	3.4	3.0	3.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	4,863	0.5	-0.1	0.0	0.1	0.1
11. External balance of goods and services	B.11	3,769	-1.2	-1.2	-1.0	-0.9	-0.9

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.

Note: Preliminary data for 2018.

Source: CBS, MF

Annex 1b: Price Developments

	2018 (level)	2018 (rate of change)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)	2022 (rate of change)
1. GDP deflator	107.0	1.7	1.4	1.8	1.8	1.9
2. Private consumption deflator[1]	107.7	1.2	0.7	1.3	1.4	1.5
3. CPI[2]	109.0	1.5	0.8	1.4	1.5	1.6
4. Public consumption deflator	106.2	2.7	2.3	2.1	2.1	2.1
5. Investment deflator	99.2	0.5	1.1	1.7	1.8	1.8
6. Export price deflator (goods and services)	111.9	1.8	1.5	1.6	1.6	1.6
- of which goods	105.7	*0.6*	*0.9*	*1.3*	*1.5*	*1.6*
- of which services	118.0	*2.8*	*1.9*	*1.7*	*1.7*	*1.7*
7. Import price deflator (goods and services)	108.8	1.1	0.9	1.1	1.2	1.3
- of which goods	108.1	*1.1*	*0.9*	*1.1*	*1.2*	*1.2*
- of which services	113.1	*0.8*	*0.8*	*1.1*	*1.3*	*1.4*

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

[2] Inflation as measured by consumer price index.

Note: Indices reference period is 2010=100.

Note: Preliminary data for 2018.

Source: CBS, MF

Annex 1c: Labour Market Developments

	ESA Code	2018 (level)	2018 (rate of change)	2019 (rate of change)	2020 (rate of change)	2021 (rate of change)	2022 (rate of change)
1. Employment, persons[1]		1,664	1.8	1.6	1.5	1.3	1.2
- of which, employees		1,455	2.2	1.7	1.4	1.2	1.0
- of which, self-employed		209	-0.5	1.0	1.8	2.0	2.0
2. Employment, hours worked		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)[2]			8.4	7.0	6.0	5.8	5.8
4. Labour productivity, persons[3]			0.8	1.0	1.0	1.0	1.1
5. Labour productivity, hours worked		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Unit labour cost			1.4	1.9	2.2	2.0	1.9
7. Compensation of employees[4]	D.1	175,532	4.5	4.6	4.6	4.2	4.1
8. Compensation per employee[5]		10,053	2.2	2.9	3.1	3.0	3.0

[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 2018 level is in HRK million.*

[5] *Data for 2018 level is an average monthly compensation per employee in HRK.*

Note: Preliminary data for 2018.

Source: CBS, Eurostat, MF

Annex 1d: Sectoral balances

	ESA Code	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)	2022 (% of GDP)
1. Net lending/borrowing vis-a-vis the rest of the world	B.9	4.3	4.2	3.7	2.7	2.3
of which:						
- Balance on goods and services		1.4	0.4	-0.3	-0.9	-1.6
- Balance of primary incomes and transfers		1.6	1.9	2.0	1.8	1.9
- Capital account		1.4	1.9	2.0	1.9	2.1
2. Net lending/borrowing of the private sector	B.9	4.1	4.5	3.6	2.3	1.6
3. Net lending/borrowing of general government	EDP B.9	0.2	-0.3	0.2	0.4	0.8
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

Note: According to national accounts data.
Note: Preliminary data for 2018.

Source: CNB, CBS, MF

Annex 2a: General Government Budget

	ESA Code	2018 (level, HRK billion)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)	2022 (% of GDP)
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	0.8	0.2	-0.3	0.2	0.4	0.8
2. Central government	S.1311	0.5	0.1	-0.5	0.1	0.4	0.8
3. State government	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	-0.5	-0.1	-0.1	-0.1	-0.1	-0.1
5. Social security funds	S.1314	0.8	0.2	0.3	0.2	0.1	0.1
General government (S13)							
6. Total revenue	TR	178.1	46.6	47.0	46.9	46.4	46.2
7. Total expenditure	TE	177.3	46.4	47.3	46.7	46.0	45.4
8. Net lending/borrowing	EDP B.9	0.8	0.2	-0.3	0.2	0.4	0.8
9. Interest expenditure	EDP D.41	8.9	2.3	2.3	2.0	1.9	1.7
10. Primary balance		9.6	2.5	2.0	2.2	2.3	2.5
11. One-off and other temporary measures[1]		-2.5	-0.7	-0.3	-0.1	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		101.3	26.5	26.3	25.9	25.9	25.8
12a. Taxes on production and imports	D.2	76.8	20.1	19.8	19.5	19.4	19.4
12b. Current taxes on income, wealth, etc	D.5	24.5	6.4	6.5	6.5	6.4	6.4
12c. Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	45.9	12.0	11.9	12.0	12.0	12.0
14. Property income	D.4	4.7	1.2	1.2	1.2	1.1	1.1
15. Other		26.1	6.8	7.5	7.8	7.3	7.3
16=6. Total revenue	TR	178.1	46.6	47.0	46.9	46.4	46.2
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		147.2	38.6	38.2	37.9	37.9	37.8
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	75.7	19.8	20.2	20.2	20.1	20.1
17a. Compensation of employees	D.1	44.6	11.7	11.7	11.7	11.6	11.6
17b. Intermediate consumption	P.2	31.2	8.2	8.4	8.5	8.5	8.5
18. Social payments (18=18a+18b)		59.5	15.6	15.6	15.4	15.2	15.1
***of which* Unemployment benefits**		0.8	0.2	0.2	0.2	0.2	0.2
18a. Social transfers in kind supplied via market producers	D632	8.5	2.2	2.2	2.2	2.2	2.2
18b. Social transfers other than in kind	D.62	51.0	13.4	13.4	13.2	13.0	12.9
19=9. Interest expenditure	EDP D.41	8.9	2.3	2.3	2.0	1.9	1.7
20. Subsidies	D.3	5.8	1.5	1.7	1.8	1.8	1.7
21. Gross fixed capital formation	P.51	13.2	3.5	4.0	4.2	4.0	4.0
22. Capital transfers	D.9	6.9	1.8	1.5	1.3	1.3	1.3
23. Other		7.3	1.9	1.9	1.8	1.7	1.7
24=7. Total expenditure	TE	177.3	46.4	47.3	46.7	46.0	45.4
p.m.: Government consumption (nominal)	P.3	75.6	19.8	20.0	20.0	19.9	19.9

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

Source: CBS, MF

Annex 2b: Projections without Changes in Policy

	2018 (level, HRK billion)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)	2022 (% of GDP)
1. Total revenue at unchanged policies	178.1	46.6	47.6	47.9	47.4	47.2
2. Total expenditure at unchanged policies	177.3	46.4	47.3	46.7	46.0	45.4

Source: CBS, MF

Annex 2c: Amounts to be excluded from the Expenditure Benchmark

	2018 (level, HRK billion)	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)	2022 (% of GDP)
1. Expenditure on EU programmes fully matched by EU funds revenue	3.9	1.0	1.7	2.0	1.7	1.9
1.a Of which investment expenditure fully matched by EU funds revenue	1.9	0.5	1.0	1.3	1.1	1.2
2. Cyclical unemployment benefit expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Effect of discretionary revenue measures	-1.4	-0.4	-0.7	-0.4	n.a.	n.a.
4. Revenue increases mandated by law	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: CBS, MF

Annex 4: General Government Debt

	ESA Code	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)	2022 (% of GDP)
1. Gross debt		74.6	71.6	68.5	65.4	62.0
2. Change in gross debt ratio		-3.2	-3.0	-3.1	-3.1	-3.4
Contributions to changes in gross debt						
3. Primary balance		2.5	2.0	2.2	2.3	2.5
4. Interest expenditure	EDP D.41	2.3	2.3	2.0	1.9	1.7
5. Stock-flow adjustment		0.3	-0.5	0.0	0.0	0.0
of which:						
- Differences between cash and accruals						
- Net accumulation of financial assets		0.3	-0.5	0.0	0.0	0.0
of which:						
- privatisation proceeds						
- Valuation effects and other		0.3	-0.5			
p.m.: Implicit interest rate on debt		3.1	3.2	3.0	2.9	2.7
Other relevant variables						
6. Liquid financial assets						
7. Net financial debt (7=1-6)		74.6	71.6	68.5	65.4	62.0
8. Debt amortization (existing bonds) since the end of the previous year		3.1	4.4	5.0	3.7	5.2
9. Percentage of debt denominated in foreign currency		75.0				
10. Average maturity		-	-	-	-	-

Source: CNB, CBS, MF

Annex 5: Cyclical Trends

	ESA Code	2018 (% of GDP)	2019 (% of GDP)	2020 (% of GDP)	2021 (% of GDP)	2022 (% of GDP)
1. Real GDP Growth (%)		2.6	2.5	2.4	2.3	2.3
2. Net Lending of general government	EDP B.9	0.2	-0.3	0.2	0.4	0.8
3. Interest expenditure	EDP D.41	2.3	2.3	2.0	1.9	1.7
4. One-off and other temporary measures[1]		-0.7	-0.3	-0.1	0.0	0.0
Of which: **On the revenue side: general government**		0.0	0.0	0.0	0.0	0.0
On the expenditure side: general government		-0.7	-0.3	-0.1	0.0	0.0
5. Potential GDP growth (%)		1.6	1.9	2.3	2.3	2.0
contributions:						
- labour		-0.1	0.1	0.4	0.3	0.0
- capital		0.8	0.9	1.0	1.0	1.1
- total factor productivity		0.9	0.9	0.9	0.9	0.9
6. Output gap		1.3	1.9	2.0	2.0	2.3
7. Cyclical budgetary component		0.6	0.9	0.9	0.9	1.1
8. Cyclically-adjusted balance (2 - 7)		-0.4	-1.2	-0.8	-0.6	-0.3
9. Cyclically-adjusted primary balance (8 + 3)		1.9	1.1	1.3	1.3	1.4
10. Structural balance (8 - 4)		0.3	-0.9	-0.7	-0.6	-0.3

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

Source: CBS, MF

Annex 6: Divergence from the Previous Programme

	ESA Code	2018	2019	2020	2021	2022
Real GDP growth (%)						
Previous update		2.8	2.7	2.5	2.5	n.a.
Current update		2.6	2.5	2.4	2.3	2.3
Difference		-0.1	-0.2	-0.1	-0.2	n.a.
General government net lending (% of GDP)	B.9					
Previous update		-0.5	-0.4	0.0	0.5	n.a.
Current update		0.2	-0.3	0.2	0.4	0.8
Difference		0.7	0.0	0.2	-0.1	n.a.
General government gross debt (% of GDP)						
Previous update		75.1	72.1	69.1	65.9	n.a.
Current update		74.6	71.6	68.5	65.4	62.0
Difference		-0.5	-0.6	-0.6	-0.6	n.a.

Source: CBS, MF

Annex 7: 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 7a: Contingent Liabilities

	2018 (% of GDP)	2019 (% of GDP)
Public guarantees	1.7	n.a.
Of which: linked to the financial sector	n.a.	n.a.

Source: CBS, MF

Annex 8: Basic Assumptions

	2018	2019	2020	2021	2022
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)	1.18	1.13	1.13	1.13	1.13
Nominal effective exchange rate, % change	-1.1	0.1	0.0	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-vis the € (annual average)	7.41	7.39	7.39	7.39	7.39
World, GDP growth	3.6	3.3	3.6	3.6	3.6
EU GDP growth	1.9	1.5	1.7	n.a.	n.a.
Growth of relevant foreign markets[1]	4.2	3.5	4.2	4.0	3.9
World import volumes	4.1	3.6	4.0	4.1	4.0
Oil prices (USD/barrel)[2]	71.1	65.5	65.0	64.2	63.8

[1] *Goods.*

[2] *Brent.*

Source: Eurostat, EC, ECB, IMF, CNB, MF

Annex 9: REPORT ON THE COMPLIANCE WITH FISCAL RULES

The new Fiscal Responsibility Act[57], which came into force in early 2019, sets national fiscal rules for the Republic of Croatia fully in line with the provisions of the EU Stability and Growth Pact. The Act lays down three fiscal rules that refer to the structural balance rule, the expenditure rule and the public debt rule.

The structural balance represents the deficit or surplus of a general government budget that does not include cyclical economic effects and one-off and temporary measures that have an impact on the revenue or expenditure of the budget. The cyclically-adjusted balance calculation is based on EC methodology[58] and calculations for EU member states. Personal income tax, corporate income tax, indirect taxes, social security contributions and non-tax levies are included as cyclically sensitive components on the revenue side, while unemployment benefits are included on the expenditure side. The Medium-Term Budgetary Objective (MTO) refers to the level of structural budget balance that ensures that general government deficit and public debt are in line with the provisions of the Stability and Growth Pact.

At the beginning of 2016, the Committee on Economic and Financial Affairs established a minimum medium-term budgetary objective for the Republic of Croatia of -1.75% of GDP for the period 2017-2019, which the Republic of Croatia confirmed as its target in the 2016 Convergence Programme. Within the framework of the regular medium-term budgetary objective revision, which is carried out every three years, at the beginning of 2019, the Committee on Economic and Financial Affairs has set a minimum objective for the Republic of Croatia of -1.25% of GDP, which will be valid in the period 2020-2022.

In view of the plans of the Republic of Croatia to join the Exchange Rate Mechanism ERM II, the Republic of Croatia commits itself by this Convergence Programme to a more ambitious medium-term budgetary objective of -1.0% of GDP, which is in line with the more restrictive conditions that have to be respected by the member states participating in the ERM II.

According to the calculations of the Ministry of Finance, the Republic of Croatia achieved the structural surplus of 0.3% of GDP in 2018, thus significantly exceeding its medium-term budgetary objective. It should be pointed out here that in 2018 the total deficit/surplus of the general government was corrected by a one-off cost of protested guarantees for the Uljanik group in the amount of HRK 2.5 billion or 0.7% of GDP.

The fiscal projections of the Republic of Croatia presented in this document in Section 3 indicate that the Republic of Croatia fulfils the medium-term budgetary objective throughout the projection period. In 2019, the planned structural balance amounts to -0.9% of GDP, which still significantly exceeds the target of -1.75% of GDP defined for the period 2017-2019. Furthermore, in the period 2020-2022 , it is expected that the structural balance will range from -0.7 to -0.3% of GDP and will be, in all years, above the medium-term budgetary objective of -1.0% of GDP as defined for this period.

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[57] Official Gazette, number 111/2018

[58] *Gilles Mourre, Caterina Astarita, Savina Princen, 2014. "Adjusting the budget balance for the business cycle: the EU methodology", European Economy – Economic Papers 536*

For the purpose of sustainable expenditure trends, the expenditure rule was introduced, according to which the annual growth of general budget expenditures should not exceed the reference rate of potential GDP growth. In addition, the exemptions for certain categories of expenditure[59] are permitted. Exceptionally, general budget expenditures may increase above the reference rate of potential GDP growth for the amount of revenue growth due to changes in the legislative framework. On the other hand, the reduction of general budget revenue due to changes in the legislative framework has to be aligned with the reduction in general budget expenditures and/or the increase in other revenues by changing the legislative framework. If the structural balance is equal to or higher than the medium-term budgetary objective, the expenditure rule is not applied and in that case it is sufficient to adhere to the structural balance rule and the public debt rule. Given that the structural balance is higher than the medium-term budgetary objective throughout the projection period, the expenditure rule under the Fiscal Responsibility Act is not applied.

According to the public debt rule, the share of public debt in GDP shall not exceed the reference value of 60%. If the share of public debt exceeds this value, the difference between public debt in GDP and the 60% reference value has to be reduced according to the dynamics that complies with the EU legal provisions, i.e. at an average rate of one twentieth per annum over the next three years from the year in which the share of public debt in GDP exceeded the 60% reference value. The fiscal projections presented in this document show that the share of public debt in GDP decreases significantly faster than the prescribed dynamics, whereby the public debt rule has been fulfilled.

[59] In line with the EU legal provisions, the exemptions have been determined for certain categories of expenditures such as, e.g., interest expenditure, expenditure on EU programmes fully matched by EU funds revenue, annual changes in expenditures due to changes in the institutional scope of the general budget and annual change in cyclically-sensitive expenditures, while the expenditures for investments, without those financed from EU programmes, are included in an average amount on the basis of their dynamics in the previous four years.