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Analysis by the Commission services of the budgetary situation in Croatia

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Croatia

{COM(2013) 914 final}

1. INTRODUCTION

Croatia joined the European Union on 1 July 2013, following the completion of the ratification process of the Accession Treaty and is a subject to the procedures of the surveillance of the excessive deficits as laid down in Article 126 of the Treaty on the Functioning of the European Union (TFEU).

According to the 2013 budget revision and the draft 2014 budget[1] adopted by the government and sent to Parliament on 14 November 2013, the Croatian authorities plan a general government deficit of 5.5% of GDP for 2013, after 5% in 2012, and expect the ratio to remain unchanged in 2014 and to decrease only gradually in 2015 and 2016. The Commission 2013 Autumn forecast, released on 5 November, projects the general government deficit significantly above the 3% of GDP reference value in the Treaty already in 2013, rising above 6% of GDP in the period 2014-2015 in the absence of countervailing measures.

The report prepared by the European Commission under Article 126(3) of the Treaty on the Functioning of the European Union ('the Treaty'), which represents the first step in the Excessive Deficit Procedure (EDP), analysed the reasons for the breach of the deficit and debt criteria of the Treaty, with due regard to the economic background and all other relevant factors. According to the report, both the deficit and debt criteria of the Treaty are not fulfilled.

2. RECENT MACRO-ECONOMIC DEVELOPMENTS

Croatia is experiencing a protracted economic downturn in the aftermath of the global financial crisis. The pre-crisis boom fuelled by a high inflow of foreign investment was followed by a prolonged recessionary period, amplified by structural impediments to growth such as insufficient capital flows in the tradable sector in the pre-crisis years, gradually eroding price and cost competitiveness, an unfavourable business environment, a relatively rigid labour market. The post-crisis weakness in some of the country's main trading partners (particularly Italy and Slovenia) accentuated the slump in economic activity.

Although not yet a Member State of the EU at the time, Croatia participated in the 2013 European Semester on an informal basis. As such, Croatia submitted an "Economic Programme" in April 2013. The document was assessed by Commission services but the Council did not adopt country specific recommendations. However, the Commission Staff Working Document identified certain areas in which Croatia would benefit from reforms notably as regards labour market rigidities, the business environment and the quality of public administration in order to ensure an outcome most conducive to economic prosperity in the medium to long run.

In 2013, Croatia continued to struggle with negative economic developments. In the first half of 2013, real GDP fell by 1.1%, echoing developments of both foreign and domestic demand. While domestic demand was under pressure from high unemployment and on-going private sector deleveraging, external trade was negatively affected by the short-term impact of changes in the trade regime associated with EU accession and the termination of CEFTA membership. Going forward, some monthly indicators, notably on industrial production and

[1] The draft 2014 budget is not prepared according to the ESA 95 methodology. Deficit estimates for 2009-2012 based on ESA95 are between 1.5 and 3.3 percentage points higher than those reported according to the national methodology. Differences stem mainly from the fact that general government deficit figures according to ESA95 include certain guarantees payments, debt assumptions and the repayment of the debt to pensioners.

construction, suggest that economic activity will remain subdued towards the end of the year. Overall, the economy is expected to stagnate in the second half of 2013.

Weak economic activity continues to negatively impact the labour market. The survey-based unemployment rate is projected to increase to 16.9% in 2013 from 15.9% in 2012. Before the country entered into recession in 2009, this rate had been slightly above 8%. Depressed domestic demand dampens the inflationary impact stemming from tax hikes and increases in administrative prices. On the whole, the average CPI inflation is projected to moderate to 2.6% in 2013 from 3.4% in 2012, and to slow down further in 2014.

Table 1: Comparison of macroeconomic developments and forecasts

	2012	2013		2014		2015	
	Outturn	COM	National authorities	COM	National authorities	COM	National authorities
Real GDP (% change)	-2.0	-0.7	0.2	0.5	1.3	1.2	2.2
Contributions to real GDP growth:							
- Final domestic demand	-2.9	-0.5	0.5	0.2	1.2	1.6	2.3
- Change in inventories	-0.2	0.1	0.2	0.0	0.1	0.0	0.2
- Net exports	1.1	-0.3	-0.5	0.3	0.0	-0.4	-0.3
Output gap[1]	-2.3	-2.0		-1.2		-0.5	
Employment (% change)	-3.9	-1.7	-2.4	0.1	0.3	0.5	1.2
Unemployment rate (%)	15.9	16.9		16.7		16.1	
Labour productivity (% change)	2.0	1.1		0.4		0.7	
HICP inflation (%)	3.4	2.6	2.4	1.8	2.0	2.0	2.0
GDP deflator (% change)	2.0	1.7	1.6	1.9	1.9	1.9	2.0
Comp. of employees (per head, % change)	3.2	1.0		1.5		2.0	
General government balance (% of GDP)	-5.0	-5.4	-5.5	-6.5	-5.5	-6.2	-4.6
Government gross debt (% of GDP)	55.5	59.6	58.1	64.7	62.0	69.0	64.1

Note:
[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.
Source:
Eurostat, COM 2013 Autumn Forecast, National authorities (2014 draft budget).

The recession has also contributed to a significant adjustment of the country's current account position, which swung into a slight surplus in 2012 following high deficits (in the order of 7% to 9% of GDP) during the pre-crisis years. The current account adjustment mainly came from the import side, reflecting depressed household and investment demand. At the same time, exports remained constrained by the unfavourable external environment, compounded by the generally low competitiveness of domestic products as well as a crisis induced readjustment of some key export sectors (in particular the shipyard industry). Foreign direct investment (FDI) declined sharply in recent years, averaging 2.5% of GDP in 2011-2012, down from some 8% of GDP in the pre-crisis period. Despite bank and corporate deleveraging in the last two years, the country's gross external debt ratio remains elevated at above 100% of GDP reflecting weak economic activity and significant borrowing by the state.

According to the Commission 2013 Autumn forecast, economic growth in Croatia will continue to be weak in 2014 and 2015, with domestic demand still exerting a drag on growth and net exports no longer expected to exert a significant counterbalance. The labour market situation is expected to continue to deteriorate in 2014 and this in turn would hold back private consumption. However, investment growth is projected to resume under the combined effect of the impulse of the expected improvement in the international environment, the perspectives opened by EU accession and access to EU cohesion and structural funds, and new legislation adopted to improve the investment climate. As a result, real GDP growth is projected to reach 0.5% in 2014 and to pick up to 1.2% in 2015, supported by a gradual recovery in domestic demand. However, the labour market situation is forecast to improve only marginally, hindered by existing structural weaknesses. Chiefly reflecting weak domestic demand, inflation is forecast to moderate, after having spiked in 2012 largely due to aligning of the tax system with the acquis communautaire. The subdued near-term growth outlook will weigh on public finances, as regards constraining fiscal revenue and putting pressure on expenditures.

3. BUDGETARY OUTLOOK

Croatia's budgetary situation deteriorated rapidly in the course of 2013, reflecting a worse outturn relative to the initial budgetary plan and unexpected revenue shortfalls. The general government deficit on a cash basis reached 4.2% of GDP in the first nine months of the year. With EU accession, tax revenues were adversely affected by the change in the system of VAT collection, resulting in a one-off delay in payments. The shortfall in corporate income tax receipts following the introduction of a tax break on reinvested profits was significantly larger than originally estimated by the authorities. Total expenditures increased by 4.1% year-on-year chiefly due to higher payments for social benefits (including a 1%-of-GDP clearance of arrears of the state health insurance fund) and rapidly growing interest expenditures. These were partly offset by a 3% cut in the public sector wage bill.

In view of the abovementioned negative trends in revenues and higher-than-planned expenditures, on 14 November 2013 the government revised the general government deficit projection for 2013 to 5.5% of GDP. This is a marked increase compared to the September EDP notification[2], but only marginally above the Commission 2013 Autumn forecast of 5.4% of GDP published on 5 November. According to the draft 2014 budget, the planned general government deficit for 2014 is expected to remain unchanged in 2014, at 5.5% of GDP. The draft 2014 budget foresees a reduction in the headline general government deficit in 2015 and 2016 to 4.6% and 3.5% of GDP, respectively, but without providing substantive details about the measures underpinning this projected decrease.

It is difficult to assess planned deficit trends for 2014-2016 since the government projections are not harmonised in terms of coverage nor in terms of the methodology applied – in particular with respect to conformity to ESA 95. As regards the draft 2014 budgetary projections only those for the central government can be compared to previous ones: for 2014 the amended budget expects the growth of expenditures of the central government to be around 1.1% of GDP higher compared to 2013 budget, mostly due to higher interest expenditures and contributions to the EU budget. According to the government projections, revenues are also estimated to be higher, by around 0.8% of GDP, mostly due to higher growth in grants and social contributions.

According to the Commission 2013 Autumn forecast, the general government deficit is projected to remain above the 3% of GDP reference value in the period 2013-2015, and the structural balance is projected to continue deteriorating throughout the forecast period, from 4.1% of GDP in 2013 to 5.9% of GDP in 2015. These developments result mainly from increases on the expenditure side such as interest outlays combined with revenue shortfalls. The Commission 2013 Autumn forecast did not include the fiscal consolidation programme announced in September 2013 together with the Economic and Fiscal Policy Guidelines, as

[2] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. In the notification of autumn 2013, the government planned a general government deficit of 3.6% of GDP in 2013. The most recent notification of Croatia can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables.

the information on measures underpinning this announced consolidation package was very limited.

Measures presented in the second 2013 budget revision and draft 2014 budget adopted by the government on 14 November 2013 and sent to the Parliament do not seem to have a substantial impact in 2014. For 2015 and 2016 the authorities plan some consolidation on the expenditure side on the back of announced reforms which, however, at this stage remain insufficiently quantified in terms of actual fiscal impact.

As regards general government debt, the persistently high budget deficits, coupled with weak economic activity, resulted in its rapid expansion. According to the notified fiscal data, from 2009 to 2012 the general government gross debt ratio in Croatia increased by almost 20 percentage points – from 36.6% in 2009 to 55.5% in 2012. Moreover, the general government debt ratio reached 59.5% at the end of the second quarter of 2013. In the projections of the draft 2014 budget, the planned general government debt ratio at the end of 2014 would reach 62% and increase further in 2015 and 2016 to 64.1% and 64.7%. In the Commission 2013 Autumn forecast the general government debt ratio is expected to increase to 59.6% in 2013, and, on unchanged policies, to rise above the 60% reference value in 2014 and continuing to increase further.

Table 2: Forecast of key macroeconomic and budgetary variables under the baseline scenario

(% of GDP)	2012	2013	2014	2015	2016	2017	2018
Revenues	40.6	40.5	40.5	40.9	41.7	41.9	42.3
Current revenues	39.7	39.2	39.2	39.5	40.3	40.5	40.9
Discretionary measures with impact on current revenue[1]	0.5	0.4	0.6	0.0	0.0	0.0	0.0
Expenditure	45.5	46.0	46.9	47.0	47.6	47.8	48.0
Real GDP growth (%)	-2.0	-0.7	0.5	1.2	1.7	2.2	2.8
Nominal GDP growth (%)	0.1	1.1	2.3	3.1	3.7	4.7	5.8
Potential GDP growth (%)	-1.5	-0.9	-0.2	0.6	1.2	1.6	1.7
Structural balance	-3.9	-4.1	-5.9	-5.8	-6.1	-6.3	-6.5
General government balance	-5.0	-5.4	-6.4	-6.0	-6.0	-5.9	-5.7
General government debt	55.5	63.1	64.7	68.8	72.3	75.0	76.6
p.m CAB methodology revenue elasticity[2]	0.4	0.4	0.4	0.4	0.4	0.4	0.4
p.m Apparent revenue elasticity		-1.1	0.3	1.3	1.5	1.2	1.2
p.m Output gap (% of pot. Output)	-2.3	-2.0	-1.3	-0.7	-0.2	0.5	1.5
p.m COM 2013 Autumn forecast							
General government balance	-5.0	-5.4	-6.5	-6.2			
General government debt	55.5	59.6	64.7	69.0			

Note:

[1] Measures clearly specified and commited to by government according to the discretionary fiscal measure database.

[2] The standard revenue elasticity has been revised in line with the recently endorsed by EPC methodology for computing cyclically-adjusted balances.

Source:

Eurostat, Commission services' calculations.

The scenario reported in Table 2 has been built on the Commission 2013 Autumn forecast, updated to encompass new information that became available after its publication. In particular, the new baseline reflects the effect of those measures in the 2013 budget revision and the draft 2014 budget that could be credibly estimated. Overall, the changes compared to the projections in the Autumn 2013 forecast are marginal for the headline deficit, while the general government debt ratio rises above the 60% threshold already in 2013 because of a new USD-denominated bond issuance in November 2013. In many Member States undergoing a deep recession estimates of the structural balance are surrounded by substantial uncertainty; however the update of the Commission 2013 Autumn forecast only implied a marginal adjustment to the estimated structural balance. In order to assess compliance with the debt reduction benchmark as a necessary condition for abrogation, the baseline scenario has been extended to 2018 relying on standard assumptions about the closure of the output gap and the sensitivity of the budget to the cycle, in line with the commonly agreed methodology.[3] The relatively muted expected rebound in the economic activity in the outer years of the projection stems from the constraints of structural impediments and the deleveraging dynamics that hold back a faster recovery.

4. PROPOSED ADJUSTMENT PATH

According to Regulation 1467/97, the correction of the excessive deficit should be completed in the year following its identification, unless there are special circumstances. Longer deadlines could be set, in particular in the case of excessive deficit procedures based on the debt criterion, when the government deficit requested to comply with the debt criterion is significantly lower than 3% of GDP. In order to correct the excessive deficit by the 2015 deadline consistent with this approach and ensure the joint compliance with the debt reduction benchmark, the required structural effort would amount to at least 1.3% of GDP both in 2014 and 2015. This would result in a significant output loss and aggravate an already protracted and deep recession. A longer adjustment path would enable Croatia to pursue the structural reforms in parallel with fiscal consolidation, addressing weak growth fundamentals.

The scenario on which the proposed adjustment path that should lead to a correction of the excessive deficit by 2016 (the EDP scenario) is based on the revised Commission 2013 Autumn forecast (the baseline scenario in Table 2).[4] The EDP scenario proposed implies the correction of the excessive deficit with respect to both the deficit and debt criteria by 2016. Specifically, with regard to general government debt, the proposed adjustment path ensures compliance with the forward-looking debt benchmark at the end of the EDP period, i.e. in 2016.

Table 3: Forecast of key macroeconomic and budgetary variables under the EDP scenario

(% of GDP)	2012	2013	2014	2015	2016
Real GDP growth (%)	-2.0	-0.7	-1.0	0.6	1.1
Potential GDP growth (%)	-1.8	-1.3	-0.7	0.1	0.8
Structural balance	-4.2	-4.5	-4.0	-3.1	-2.4
General government balance	-5.0	-5.4	-4.6	-3.5	-2.7
General government debt	55.5	63.1	63.9	66.1	66.8
p.m Output gap (% of pot. Output)	-1.9	-1.2	-1.5	-1.0	-0.7

Source:
Commission services' calculations.

The EDP scenario has been calibrated to ensure that the required fiscal effort in terms of the improvement in the structural balance is consistent with joint compliance with the deficit criterion and the debt criterion, by ensuring a sufficiently diminishing debt-to-GDP ratio. For 2014 and 2015 the scenario implies headline deficit targets of 4.6% and 3.5% of GDP and for 2016 a target of 2.7% of GDP in order to ensure the respect of the debt benchmark. The attainment of these targets is consistent with an improvement in the structural budget balance of 0.5 pp. of GDP in 2014, 0.9 pp. of GDP in 2015 and 0.7 pp. in 2016. To reach these

[3] As the impact of the measures is very limited, the real side of the baseline scenario remains essentially unchanged compared to the Autumn 2013 forecast.

[4] As revisions to the determinants of potential growth are smoothed over for the full period covered by the series, the rate of potential growth in the EDP scenario differs somewhat from the baseline even in some years before 2014.

structural targets Croatia would need to adopt consolidation measures of 2.3% of GDP in 2014 and 1.0% of GDP in 2015 and in 2016. The required amount of consolidation measures in 2014 reflects the deterioration in the structural balance in the baseline scenario compared to 2013 (1.7 pp of GDP). These targets for the annual improvement in the structural budget balance in the EDP scenario take into account the need to compensate for the negative second-round effects of fiscal consolidation on public finances, through its impact on economic activity. The debt-to-GDP ratio in this scenario would peak at close to 67% in 2016 before decreasing to close to 65% by 2018.

5. SUMMARY

According to the Commission 2013 Autumn forecast, the general government deficit is projected to remain above the 3% of GDP reference value in the period 2013-2015, on unchanged policies. The November revision of the 2013 budget led to an increase in the planned general government deficit for 2013 to 5.5% of GDP, from 3.6% of GDP in the autumn fiscal notification. The draft 2014 budget adopted by the government on 14 November 2013 and sent to the Parliament defines deficit targets for 2014, 2015 and 2016 that are above the Treaty reference value.

In the Commission 2013 Autumn forecast, the general government debt ratio is expected to increase to 59.6% of GDP in 2013, and, on unchanged policies, to rise above 60% in 2014 and continue to increase further. According to the data notified in autumn 2013, the general government debt ratio in Croatia increased from 36.6% in 2009 to 55.5% in 2012. In the projections of the draft 2014 budget, the planned general government debt ratio at the end of 2014 would reach 62% and increase further in 2015 and 2016 to 64.1% and 64.7%.

New figures presented in the budget revision and draft budget do not entail a substantive modification of the Commission 2013 Autumn forecast. Estimated effects of these measures have been nevertheless incorporated in the adjusted Commission forecast; the revised projections constitute the new baseline scenario. Additional information on debt developments has also been incorporated, updating the projections in the Commission 2013 Autumn forecast. A new USD-denominated bond issue in November will bring the forecast general government debt ratio above the 60% threshold already in 2013.