FISCAL POLICY COMMISSION

EVALUATION

OF THE PROGRESS REPORT ON THE NATIONAL MEDIUM-TERM FISCAL-STRUCTURAL PLAN OF THE REPUBLIC OF CROATIA FOR 2024 AND 2025

June 2025

Published by:

Fiscal Policy Commission

For the publisher:

Prof. Sandra Krtalić, PhD

President of the Commission

Address:

Boškovićeva 23

10000 Zagreb

Phone:

+385 1 6341 070

Official web page:

www.pfp.hr

E-mail:

info@pfp.hr

Within the scope of application of the Fiscal Responsibility Act (FRA, Official Gazette 111/18, 83/23) in the Republic of Croatia, the establishment of a permanent, independent and autonomous fiscal body was defined and implemented: the Fiscal Policy Commission tasked with performing works within its area of activities and competence laid down by the above-mentioned Act.

The Fiscal Policy Commission is an independent and expert institution whose primary mission is to monitor public finances to ensure their long-term sustainability and improvement. It serves as a supervisor overseeing the implementation of the country's fiscal policy in its entirety. The Commission advocates for transparency and fosters a culture of fiscal responsibility in the execution of fiscal policy in the Republic of Croatia through its independent analysis and by encouraging professional discussions on fiscal policy matters.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

At its 8th session held on 27 June 2025, the Fiscal Policy Commission (hereinafter: the Commission), examined the Progress Report on the National Medium-Term Fiscal-Structural Plan for 2024 and 2025 (hereinafter: the Progress Report), accepted at the 92nd session of the Government of the Republic of Croatia held on 22 May 2025.

This is the Fiscal Policy Commission's first evaluation of the annual Progress Report which concerns the evaluation of the implementation of the National Medium-Term Fiscal-Structural Plan (hereinafter: the Plan or NMFSP). From the perspective of planning and managing fiscal policy, it is instrumental to focus not only on this year or the next one, but also to be aware of the consequences that will ensue from the current decisions of the Government of the Republic of Croatia (hereinafter: the Government) and the adopted measures in five or ten years. Although the Government's document concerns 2024 and partially 2025, we would like to emphasize that fiscal policy must be directed at ensuring the sustainability of public finance in a longer period of time.

Pursuant to the reformed economic governance framework of the European Union (hereinafter: EU), each member state shall compose a strategic document (NMFSP) whereby it defines its fiscal path (including sustainable long-term development of public debt), as well as priority public investments and reforms for a period of four to five years. The fiscal instrument for attaining the objectives under the national plans, defined by the target level of structural primary balance, is the upper limit of the cumulative growth rate of nationally financed net primary expenditure.

The projected development of net expenditure in 2025 represents a postponement of the fiscal adjustment stipulated by the NMFSP and implies a continuation of the trends in the last two years characterized by a procyclical and expansionary fiscal policy. According to the Progress Report, the annual growth of nationally financed net primary expenditure in 2025 should be 7.6 %, noticeably more than the prescribed upper limit of 6.4 %. However, cumulatively with 2024, when growth was below the plan, this difference is somewhat smaller, i.e. 26.6 % compared to the binding limit of 26.2 %. In fact, general government balance amounted to -2.4 % of GDP in 2024, additionally limiting the space for fiscal policy management, whereas for 2025 the Government is expecting further growth of general government budgetary deficit to -2.9 % of GDP, which is close to the upper reference limit of -3.0 %. The projections in the Progress Report also show that, contrary to the NMFSP, structural primary balance should also continue to increase.

The projected net expenditure growth this year reflects the reforms announced by the Government, some of which have already been implemented, as well as the agreed increase of the wages of public and civil servants and pension adjustment. Also worth noting is that the Progress Report provides for a somewhat lower nominal

GDP growth than the one initially projected, which affects the level of fiscal indicators expressed through the share in GDP.

The Government is also faced with several other increasing challenges and pressures on consumption in the next ten years which currently have not been addressed neither in the NMFSP nor in the Report. The intention is to increase defence expenditure from 1.3 % of GDP in 2023 to 3.5 % of GDP in 2035, that is to 5.0 %, including expenditure for safety with both a military and civil purpose. The permanent nature of increasing defence expenditure requires difficult political decisions to decrease public spending or increase taxes in order to protect the medium-term fiscal position. On the other hand, the Government activated the national escape clause to exempt defence expenditure from fiscal rules. According to the European Commission (hereinafter: the EC), the exemption may not be more than 1.5 % of GDP and might last for four years. Escape clause activation enables a temporary additional increase of the fiscal deficit and increased without breaking fiscal rules, that is, it enables a temporary postponement of the decisions necessary for stabilizing public finance. After the expiry of the temporary four-year period, fiscal deficit and public debt might increase, leading to even more difficult decision making.

Due to all of the above, the Commission wants to use this opportunity to invite the Government to prepare and adopt Autumn budgetary documents which address the risks and challenges in public finance (expenditure growth control) and ensure long-term sustainability of public finance. Doing so might prevent requests for adjustment of public finance in the future, which would inevitably have negative consequences for economic growth and citizens' well-being.

1 INTRODUCTION

With the coming into force of the reformed economic governance framework at the EU level on 30 April 2024, the process of its reform (European Governance Review – EGR), updated in late 2021, was concluded. The purpose of this process was to streamline fiscal rules and make them more flexible, with the possibility of adjustment to the individual member state's needs, leaving more room for targeted investments, mostly in green transition, digital transformation and defence.

New rules stipulate that each member state shall draft an NMFSP for a period of four years or a prolonged period of seven years, presenting in it, according to the frameworks set by the EC, the fiscal adjustment, relevant reforms and planned public investments. The pertaining fiscal basis are still the rules under the Stability and Growth Pact (hereinafter: the Pact), which limit the annual general government budget deficit to 3 % of GDP and the level of public debt to 60 % of GDP. These criteria were also used to differentiate between member states in the framework for drafting the NMFSP. Member states who failed to meet both or one of these two criteria in 2023 or whose level of public debt failed to decrease at a satisfactory rate were given so-called reference paths from the EC, whereas the member states with better fiscal indicators (including Croatia) were given so-called technical information which leave more room for fiscal adjustment. The technical information does not include the safeguard providing additional protection of fiscal stability and imposing the strictest adjustment requirements.

In drafting the NMFSP, the fiscal adjustment was defined by the projected structural primary balance of the general government, and the binding fiscal path by which it is achieved determines the trend of nationally financed net primary expenditure of the general government. The achievement of the target value of the structural primary balance, that is, the decrease of the structural primary deficit, allows for a medium-term decrease of the share of general government deficit and public debt in GDP, that is, their remaining within the limits defined by the Pact.

Before the delivery of its Plan, the Republic of Croatia requested technical information which the EC delivered on 21 June 2024 and published on 14 November. Technical information is composed and delivered to member states in two scenarios: one implies alignment with the deficit resilience safeguard, pursuant to Article 9(3) of the Regulation (EU) 2024/1263, while the other does not include this safeguard. Technical information indicates the level of the structural primary balance in 2028 necessary for general government deficit to remain below 3 % of GDP and general government debt below 60 % of GDP in the medium term (defined as the period of ten years after the expiry of the adjustment period), even without further budgetary measures after the four-year adjustment period. It was determined in the technical information for the Republic of Croatia that structural primary deficit should amount to not more than -0.4 % of GDP at the end of the adjustment period (2028, in the scenario without the deficit resilience safeguard). To achieve this, the path of nationally financed net primary expenditure[1] was defined for the period from 2024 to 2028 with growth ranging from 6.4 % in 2025 to 3.7 % in 2028, which is consistent with the average net expenditure growth of 4.8 %.

On 14 November 2024, the Republic of Croatia submitted to the Council of the EU and the EC the first National Medium-Term Fiscal-Structural Plan of the Republic of Croatia for the 2025-2028 period as a strategic document that lays down the macroeconomic and fiscal framework as well as priority reforms and public

[1] Net primary expenditure is defined as general government expenditure net of i) discretionary revenue measures, ii) interest expenditure, iii) cyclical elements of unemployment benefit expenditure, iv) national expenditure on co-financing of programmes funded by the Union and v) one-offs and other temporary measures.

investment for the said medium-term period. On 21 November 2024, the Republic of Croatia supplemented its submission with a revision of the net expenditure growth path referred to in the Plan, that is, it applied a more conservative approach to fiscal policy (expenditure) planning during the adjustment period, ensuring that the foreseen general government debt convincingly remains at acceptable levels.

On 21 January 2025, the Council of the EU adopted recommendations approving NMFSPs and defining the binding paths of net primary expenditure for 21 EU member states, including Croatia. The net primary expenditure path became binding, and frameworks were defined for national fiscal policy in the 2025 - 2028 period.

Each year, member states are obligated to present their annual Progress Report. In accordance with Article 21 of the Regulation (EU) 2024/1263 of the European Parliament and of the Council of 29 April on the effective coordination of economic policies and on multilateral budgetary surveillance, the Republic of Croatia composed and delivered to the EC the Progress Report for 2024 and 2025.

The Government prepared the Progress Report for 2024 and 2025 following the Instructions to EU member states concerning the information necessary for the national medium-term fiscal-structural plan and the annual progress report on its implementation provided by the EC in June 2024. The Report was adopted at the Government's session on 22 May 2025. The Progress Report on the implementation of the NMFSP of the Republic of Croatia for 2024 and 2025, in addition to presenting the most recent projections of macroeconomic and fiscal indicators, also provides an overview of macroeconomic and fiscal paths in 2024 and 2025, a look at the compliance with the binding net primary expenditure path and an overview of the status and progress of the planned reforms and investments, focusing especially on the implementation of the National Recovery and Resilience Plan.

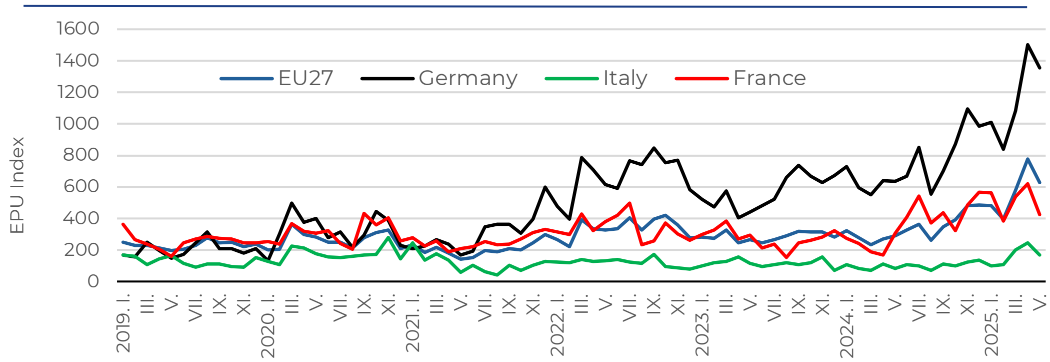
2 GLOBAL AND MACROECONOMIC DEVELOPMENTS

The Commission underscores that, since the publication of the National Medium-Term Fiscal-Structural Plan for the 2025-2028 period, the economic environment has been marked by pronounced geopolitical tension and increased uncertainty in trade policy, which contributes to the deceleration of global growth. This is confirmed by various global indicators such as the Trade Policy Uncertainty Index which saw significant growth since November 2024, initially as a consequence of the announced introduction of new custom duties by the USA.

Inflationary pressures also remain pronounced because inflation is expected to accelerate as a direct consequence of the newly imposed custom duties. At the national level, despite Croatia's relatively limited direct exposure due to the low share of trade with the USA, its national economy might be indirectly affected because of its high level of openness and integration within the global supply chains. Economic growth forecasts for Croatia's main trade partners, especially those within the European Union, have already been subjected to mild downward revisions compared to the forecasts from late 2024.

The most important projected trends for the Republic of Croatia are those in Germany, Italy, Slovenia, Bosnia and Herzegovina, Hungary and Austria as its most important markets for the export of goods, as well as Germany, Slovenia and Austria as the most important markets for the export of (tourist) services. According to EC's latest estimates for this year, Austria will see a continuation of the last year's drop in GDP, Germany's GDP will stagnate after last year's drop, and the modest growth of 1.0 % in Italy and Hungary will continue. In fact, only the markets of Slovenia and Bosnia and Herzegovina, according to the data by *Eastern Europe Consensus Forecasts*, should have a dynamic GDP growth, even somewhat higher than in 2024. Appropriate trends have also been projected in the development of goods and services import in these states, meaning that, even without significant consequences of USA's new decisions, the Republic of Croatia cannot count on any major positive impact of foreign demand growth. Nevertheless, available data reveal a somewhat more pronounced growth of the goods export value in the first three months of this year, mostly due to an increase in the export value of petroleum products and electricity.

Figure 1.
Global Economic Policy Uncertainty Index by Month, 2019 to 2025*



*A higher index indicates the presence of greater

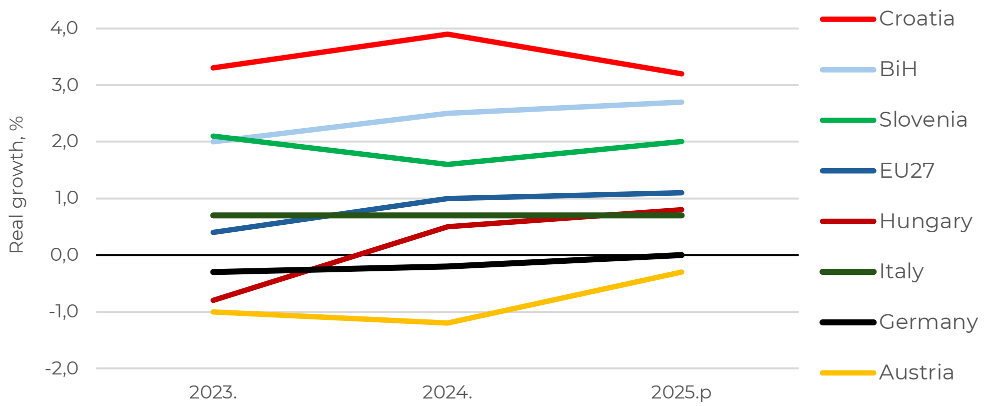
Source: EPU, https://www.policyuncertainty.com/

In addition to global trade tensions, Russia's attack on Ukraine triggered a new wave of investments in defence in the European countries, while at same time conflicts in the Middle East, North Korea, Taiwan and Kashmir additionally increased the global geopolitical risk and also negatively affected economic expectations.

Despite the unfavourable global conditions, Croatia's economy showed great resilience in 2024 when its growth rate was among the highest in the EU. Real GDP growth amounted to as much as 3.9 %, and despite the significant deceleration of price growth, nominal growth amounted to as much as 9.7 % while the GDP deflator remained high (5.6 %). Such growth was first and foremost a consequence of pronounced growth of citizens' spending, and at a lesser extent, of increased value of fixed capital investments, that is, a combination of the two.

Increased citizens spending was based on a significant real growth of net salaries, pension fees and other social benefits, positive trends on the labour market, recovery of credit activities toward the citizens and still high personal transmittances from abroad. Another important growth factor was a strong recovery of the propensity to consume. On the other hand, public investments profusely financed from EU funds (including earthquake remediation) had a great impact on investment trends, and growth was also stimulated by other forms of government spending.

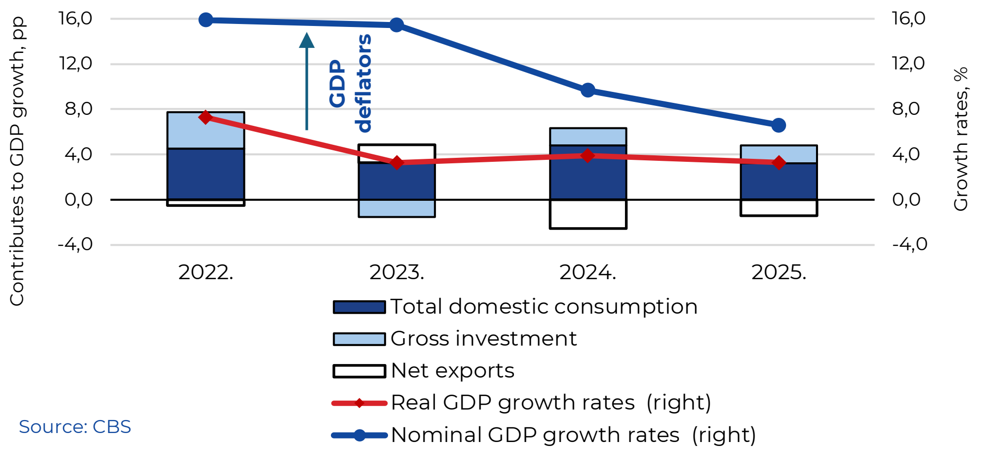
Figure 2.
Real GDP Growth of Croatia's Key Export Markets, %, from 2023 to 2025.



Source: Eurostat, European Commission, IMF

For this year, the Ministry of Finance and the EC foresee that Croatian economy will grow by 3.3 % and 3.2 %, respectively, which indicates a moderate deceleration of real (and nominal) GDP growth compared to the previous years. Economic growth in 2025 is expected to remain primarily driven by domestic demand and positive labour market trends, while external demand will contribute much less to growth due to the above reasons.

Figure 3 Real GDP growth rates and component contribution in the Republic of Croatia in the period from 2020 to 2024



Source: CBS

3 FISCAL TRENDS

In 2024, owing to general government income achieved in the amount of EUR 39.1 billion or 45.6 % of GDP and expenditure in the amount of EUR 41.1 billion or 48 % of GDP, the general government budget deficit amounted to EUR 2.03 billion or 2.4 % of GDP.

The described GDP growth resulted in the decrease of the share of certain fiscal indicators in GDP. This primarily relates to the share of public debt which, despite nominal growth by approximately one billion euros, decreased from 61.8 % in 2023 to 57.6 % last year, and to the general government deficit path in 2024. However, at the same time, the general government deficit significantly increased compared to previous year, from -0.8 % of GDP to as much as -2.4 % of GDP, despite favourable economic trends. Such deficit increase was a consequence of a significantly more pronounced increase of general government expenditure compared to income, and that being in a period of a favourable economic cycle.

Table 1

The achievements for 2024 and the projections of fiscal indicators for 2025 in the National Medium-Term Fiscal-Structural Plan and the Progress Report

	2024	**2025 NMFSP (Nove mber 2024)**	**2025 Progress Report (May)**
Maximum growth of nationally financed net primary expenditure - Binding fiscal path, %	18.6	6.4	6.4
Growth of nationally financed net primary expenditure, %*	17.5	6.3	7.6
Total general government income, share of GDP, %	45.6	46.3	46.3
Total general government expenditure, share of GDP, %	48.0	48.6	49.2
General government deficit (% of GDP)	**-2.4**	**-2.3**	**-2.9**
Public debt (% of GDP)	**57.6**	**55.8**	**56.9**

Source: Ministry of Finance

* data from the Draft Budgetary Plan for 2025

For this year and the next three years, the Republic of Croatia was somewhat more ambitious in its NMFSP than the set frameworks and, in consultations with the EC, it planned to decrease the value of structural primary balance to -0.2 % of GDP in 2028. The plan was to achieve this with an average annual growth of nationally financed net primary expenditure in the 2025 – 2028 period of 4.8 % and their cumulative growth in all four years of 20.5 % (2028 compared to 2024). In its first NMFSP, the Republic Croatia postponed any major fiscal consolidation for 2026 and, with a mild decrease of the structural primary balance of 0.2 percentage points for 2025, it projected a further increase of the general government deficit to -2.3 % of GDP (when the NMFSP was adopted, the deficit was estimated to be -2.1 % of GDP). The Progress Report from May 2025 additionally aggravates the fiscal situation: general government deficit for 2025 is estimated at -2.9 % of GDP, while the share of total expenditure increased to 49.2 % of GDP compared to the 49.6 % planned under the NMFSP. In other words, the expansionary fiscal policy, applied since 2023, was planned to continue in 2025.

Data on the structure of expenditure confirm the continuation of the expansionary fiscal policy. More specifically, a socially oriented fiscal policy continued in the first part of 2025. After the increase of the share of general government compensations to employees and social benefits (according to ESA 2010) in 2024 had the greatest impact on the increase of the share of total expenditure in GDP (from 46.8 % to 48.0 % of GDP), the first part of 2025 was characterized by several legal amendments continuing in the same direction. In fact, the amount of the newborn gift and the limit of the compensation during the parental leave were increased, the eight package of measures was accepted for the protection of citizens from the consequences of growing prices which included the one-off compensation for retired people and recipients of the compensation for elderly persons, the Easter bonus was disbursed to all retired people, and the proposals were presented for the Act on pension insurance and for the Act on mandatory health insurance which should lead to an increase in the amount of pension fees and compensations during temporary inability to work.

In the general government budget for this year, according the NMFSP, the share of compensations for employed persons in GDP (of 0.2 percentage points) is expected to increase slightly, and social transfers are expected to increase by 0.1 percentage points compared to the estimate given at the time for 2024. Coupled with the projection of nominal GDP growth of 7.0 %, this left space for nominal growth of compensations for employees and social benefits of approximately 8 %. It must be mentioned here that it was agreed through negotiations to increase in 2025 the basis for salary calculation twice by 3 % (February and September). It was also agreed to carry out two regular pension adjustments, the first of which was 3.03 %, while the amount of the second one will depend on salary developments and inflation in the first half of the year.

As early as the first months of the year, a significant share of fiscal space intended for compensations to employees was spent due to the salary increase resulting from the application of the new coefficients. During the last 3 quarters of 2024, the amount of the compensations was nearly 400 million euros more than in the first quarter, which resulted in a higher basis for 2025. At the same time, since pension constitutes about 65 % of the total general government social benefits, there was very limited space for additionally increasing social expenditure without negative impact on fiscal balance or without the need for a redistribution within the budget. Due to the above and because the projections of the nominal growth of GDP were slightly corrected downward, the Progress Report included a noticeable revision of the share of this expenditure in GDP, and thus also a correction of total expenditure and expected general government deficit.

Table 2

The achievements for 2024 and the projections of the share of certain general government expenditure in GDP for 2025 in the National Medium-Term Fiscal-Structural Plan and the Progress Report

	2024 The plan at NMFSP adoption	2024 Achievement	2025 NMFSP (November 2024)	2025 Progress Report (May 2025)
Compensations to employees	12.8	13.0	13.0	13.5
Intermediate consumption	7.4	7.6	7.4	7.5
Interest expenditure	1.5	1.5	1.6	1.4
Social benefits (total)	14.9	15.0	15.0	15.9
Subsidies	1.6	1.6	1.4	1.4
Other current transfers	2.2	2.0	2.2	1.9
Gross fixed capital investments	5.7	5.1	5.8	5.4
Capital transfers	1.8	2.2	2.1	2.1
Other capital expenditure	0.1	0.0	0.2	0.1
Total expenditure	**47.9**	**48.0**	**48.6**	**49.2**

Source: Ministry of Finance

4 ACHIEVING THE OBJECTIVES OF THE PLAN AND THE RISKS

Croatia's binding fiscal path is aligned with the EC in that it ensures, within the framework of its medium-term fiscal adjustment, the attainment of the target primary structural deficit of 0.4 % of GDP by the end of 2028. This value, pursuant to EC's calculations, ensures that even in the long term, after the completion of the fiscal adjustment (i.e. by 2038), the Republic of Croatia will keep its fiscal balance below 3 % of GDP and its public debt below 60 % of GDP.

In January 2025, the Council of the EU accepted the projection according to which the growth of net primary expenditure this year should not amount to more than 6.4 %. The Republic of Croatia will nevertheless fail to comply with this projection because its net primary expenditure this year, according to the new projection, will increase by 7.6 %, that is, the growth of primary expenditure in the Republic of Croatia will be 1.2 percentage points higher than the one accepted by the Council of the EU. The reason for this is, first and foremost, the above-mentioned increased expenditure for wages for public and civil servants and increased expenditure for care for the most vulnerable groups, especially in the part relating to pensions and pension benefits. However, in 2024, the achieved growth rate of net primary expenditure was lower than the defined value: 17.5 % instead of 18.6 %, and the Republic of Croatia achieved a so-called positive "credit" in the cumulative part of the control account which will be used this year according to new projections.

Because of increasing expenditure (projection of the income-to-GDP ratio remained the same), the projected fiscal indicators for 2025 are significantly deteriorating. According to the new projections, the structural primary deficit should amount to -2.2 % of GDP and be 0.5 percentage points higher than in 2024, general government deficit should reach -2.9 % instead of -2.3 % of GDP, and the public debt-to-GDP ratio at the end of the year should be 56.9 % of GDP or 0.9 percentage points more than the NMFSP projections from November last year.

Table 3

Binding fiscal path, execution and projections

	2024	2025p	2026p	2027p	2028p
EC's recommendation					
Nationally financed net primary expenditure, growth rate %	18.6	6.4	4.9	4.1	3.7
Nationally financed net primary expenditure, cumulative growth rate %	18.6	26.2	32.3	37.8	42.9
Execution / projection					
Nationally financed net primary expenditure, growth rate %	17.5	7.6	-	-	-
Nationally financed net primary expenditure, cumulative growth rate %	17.4	26.6	-	-	-

Source: Ministry of Finance,
European Commission

It must also be mentioned that the Republic of Croatia will use the additional fiscal space foreseen by EC's March decision to finance defence and the defence industry. The approved national escape clause may thus lead to an even more pronounced increase of expenditure and consequently of other fiscal indicators compared to the current plan, which means that, this year, general government debt will most certainly exceed the upper limit of 3.0 % of GDP.

At the end of the adjustment period, in 2028, the general government budget deficit (EAS 2010) is expected to be 1.5 % of GDP, while the share of public debt is expected to decrease to 53.1 % of GDP. Such achievements, presuming the imposed constraints in increasing nationally financed net primary expenditure are respected, will depend mostly on annual GDP achievements. Another thing to consider is the activation of the Pact escape clause due to increased defence expenditure which might last until

2028. There is the additional risk of the usual fiscal expansion before parliamentary elections which will be held that year. If we look only at the potential impact of weaker GDP achievements, there is the risk that domestic demand might decelerate beyond the projections. However, the greatest part of the risk is currently still related to global circumstances.

The Commission understands that the Government is aiming to improve citizens' position and standard (which was also achieved through the seven cycles of the tax reform with a significant impact on the decrease of tax revenue). Nevertheless, the Commission holds that fiscal policy should be more countercyclical, that is, in the periods of economic growth, it should contribute to decreasing long-term costs of borrowing and creating fiscal space for stimulating economic activity in times of crises. Judging from the available data, the Commission still holds that the current fiscal policy is expansionary and procyclical, meaning that the Republic of Croatia is using the growth of economic activity for increasing budgetary expenditure. Such an approach, however, implies the risk of negative consequences in case of deceleration of the global, and thus also of the national economy, which will inevitably happen at some point in time.

The Commission holds that the expansionary nature of fiscal policy is particularly evident in social benefits and even more so in wages for public and civil servants. The amount of the current general government social benefits was 44.7 % higher in 2024 than in 2021 (cumulative inflation amounted to 23.3 %), and the share of social benefits in GDP remained at the level of approximately 15 % despite the dynamic nominal growth of GDP. On the other hand, compensations to employees increased by as much as 53.8 % compared to 2021, and the share of this expenditure in GDP increased from 12.4 % to 13.0 %. According to the NMFSP Progress Report, this year it will additionally increase to 13.5 % of GDP.

The Commission also emphasizes the impact of current global geopolitical uncertainties on fiscal paths, as well as the additional pressures on the budget and public debt which are expected in the near future due to demographic and climate change, developments in the global economy, interest rates on the global market and the overall fiscal policy at the EU level. It is therefore desirable and useful to comply with the fiscal frameworks imposed by EU rules and implement a reasonable fiscal policy to ensure long-term fiscal stability.