

# National finances in the period January-June 2001

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# NEWSLETTER

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Anto Bajo

## The state of the national finances in the period January-June 2001

The first half-year period of 2001 was marked by numerous steps towards reform, the purpose of which was to reduce the level of government spending, reduce the deficit and the public debt, and bring them down to some viable level. Thus an analysis of the main budgetary aggregates will indicate the condition of the national finances in the first half year so as to ascertain the conditions in which the main reform steps are being carried out, the first concrete results of which should become apparent in the year to come. In the methodological approach there is an attempt to highlight shortcomings that should be removed in the statistical recording of fiscal transactions, in order to get a more comprehensive picture of the state of the national finances. The methodological explanations given should make it possible to come to grips more easily with the concepts mentioned and with their significance and scope. Data from the Finance Ministry (FM) and the Croatian National Bank (CNB) have been used as sources of data. It should be said that because of the temporal lack of adjustment between the publication of FM and CNB data, data for June have not been entered into some of the tables and graphs.

### 1. Basic features of the national finances

In the first six months alone, the government undertook more fundamental reform steps (aimed mostly at a reduction in government spending) than in the whole of the last ten years. The necessity of the

reforms is not in question; however, the question remains of whether it is possible to carry them all out at the same time during the existing unfavourable trends in the national finances. That is, the state of the national finances in the first six months shows that there was no such current and primary deficit for such a long time in the previous years, and this indicates the necessity of carrying out the reforms rapidly. For this reason, today's national finances and their sustainability are directly dependent on the ability of the government to borrow on the foreign financial market.

Since April, the government has no longer been able to make use of the CNB as the last resort at home for riding out short-term deficits.

For this reason, only the coming six months will perhaps be able to offer part of the answer about the ability to implement the reforming steps that we mention in order of beginning of application.

**Reducing the rate of income and profits tax.** From January 1 the new laws about tax on income and profits, or corporate income, (NN 127/00) have been in force. The rates of income tax have been changed, reduced from 25 and 35% to 15, 20 and 35% and of profit tax from 35% to 20%. The aim has been to decrease the tax burden on individual taxpayers and the private sector of the economy.

**Fiscal decentralisation.** From 1 July, as part of the measures of fiscal decentralisation, authority for the financing of elementary and secondary education, welfare, and health care has been devolved on the local units. Funds to the tune of 605 million kuna

have been provided for the implementation of the fiscal decentralisation reform in the national Budget (in the Equalisation Fund).

**Pay cuts for government employees.** New coefficients for the calculation of salaries in the government services and a new systematisation of jobs have been brought in. During 2001, the total amount of funds for the payment of salaries was to be reduced by 10% from the 2000 level. It was assumed that the new system of calculating wages would enable savings of 1.7 billion kuna. The planned implementation of the salaries system was supposed to start on January 1. However, because of delays, the implementation actually started on 1 May. For this reason the planned savings of 1.7 billion kuna were not accomplished.

**Abolition of the Financial Police.** In July the Financial Police was abolished, and its employees were assigned to work in the Tax Administration and the National Inspectorate. The objective is rationalisation, and increased efficiency in the work of the civil service.

**Pensions to the national Budget.** Pensions from 1 July on are paid into the single account of the state treasury, and pensions are run as an integral part of the national Budget. The objective of the direct financing of pensions from the Budget is an improvement in the efficiency of the management of public money and to provide prompt supervision of the dynamics of the inflow and outflow of funds for the payment of pensions.

**Announced rebalancing of the Budget.** During the first half year, an unfavourable trend in government finances was noticed, above all a rise in the deficit of the Budget and increased transfers and a growth in the deficit of the extra-budgetary funds. For this reason, as early as the first few months, it was confirmed that the 2001 Budget, of 49.6 billion kuna, would not be able to cover the growing expenditure. For this reason, in July a rebalancing of the Budget was announced; this will increase the total expenditure by 8.5 billion kuna, i.e., from 49.6 billion kuna, the Budget will rise to 58.1 billion. With this rebalancing, the borrowing will be increased to 2.8 billion kuna, and the estimated amount of income from privatisation will be reduced from the planned 8.7 billion kuna to 6.5 billion kuna.

**Planned reduction of the rights of war veterans, maternity benefits and children's benefits.** The objective here is to bring more order into expenditure (or receipts) that has a welfare component.

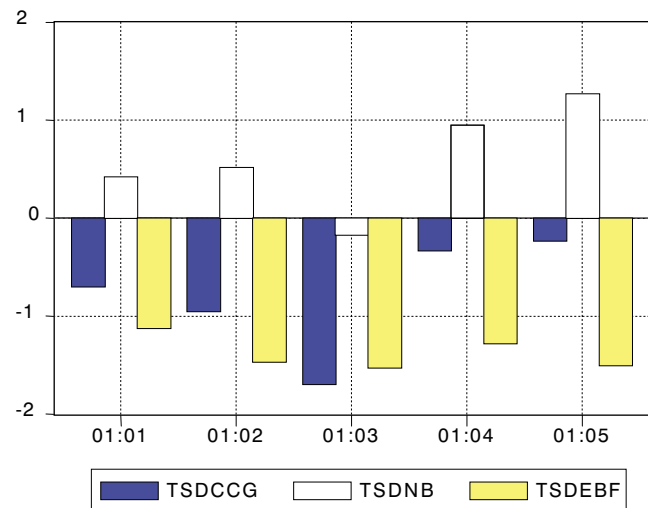
## 2. The indicators

Alarming less favourable performance of government or state operations - this is the shortest explanation of the situation of the government finances in the first six months of 2001. In short, the short time borrowing of the government in June was at a record high, of 5.6 billion kuna; the total public debt of the country came to 66.3 billion kuna, guarantees issued at home 6.2 billion and abroad to 12.5 billion. Nevertheless, let us proceed in order.

### 2.1. The consolidated surplus/deficit of central government

The consolidated Budget of central government in the first five months has continued the negative trends of the previous years. Looked at as a whole, the consolidated Budgetary balance sheet of central government is incessantly in deficit. The greatest level of total deficit of the consolidated budgetary balance sheet of the central government was recorded in March and came to 1.7 billion kuna. We should recall that the deficit of the total consolidated balance sheet of central government came to 7.7 billion kuna in 2000 (Graph 1).

Graph 1.



TSDCCG - total deficit/surplus of consolidated central government

TDSNB - total deficit/surplus of the national Budget

TDSEBF - total deficit/surplus of the extra-budgetary funds

NB: sums in billions of kuna

In January and February, there were surpluses of 423 and 516 million kuna in the consolidated balance sheet of central government, in the national Budget. In March the national Budget recorded a deficit of 169 million kuna. In the next two months national Budget in the consolidated balance sheet showed positive results, and in May, a surplus of 1.2 billion

kuna. The relatively good position of the national Budget in the consolidated balance sheet is not reflected in the balance sheets of the extra-budgetary funds. Thus, in the period under observation, the extra-budgetary funds were in deficit on average about 1.3 billion kuna month. The greatest level of the deficit, about 1.5 billion kuna, was seen in March.

## 2.2. The surplus/deficit of the extra-budgetary funds (in the consolidated balance sheet of central government)

In the January-May period, all the extra-budgetary funds had a deficit, with the exception of the Employment Fund, which in May, for the first time, was in surplus to the tune of 2 million kuna. Still in the first place for the level of deficit is the Pension fund, which had deficits of a billion kuna in February and April. Attention should be paid to the Child Benefit Fund, the deficits of which increased in the period, and came to 336 million kuna in May. The deficit of the extra-budgetary funds was financed mainly by transfers from the national Budget, and borrowing from domestic commercial banks. The following table gives an outline picture of the amounts of transfers from the national Budget to the extra-budgetary funds (Table 1).

## 2.3. Transfers from the national Budget to the extra-budgetary funds

The overall level of transfers from the national Budget to the extra-budgetary funds in the first six

months of 2001 came to 7.2 billion kuna. Of this, the greatest part is accounted for by transfers to Pension fund - 5.1 billion kuna; then comes the Child Benefit Fund, with 1.1 billion, and 1 billion for health fund. The lowest level of transfers was found in the Employment Fund - only 2 million kuna. There were no transfers to the Public Corporation Croatian Water (Table 2).

**Consolidated budget of general government** - the basic indicator of the fiscal position of general government. General government includes the central government Budget, the budget of the extra-budgetary funds and the local units. The consolidated budget of general government is the result of the consolidation of the financial transactions among the government or national Budget and the budgets of the extra-budgetary funds, and the national Budget and the budget(s) of the local units. Through consolidation, transactions between units of national government being cancelled out, the duplication of transactions on both the revenue and the expenditure side is avoided.

**The consolidated budget of the central government** - the budget after the consolidation of financial transactions between the national budget and the extra-budgetary funds and consolidation among the actual funds themselves have been carried out.

## 2.4. The total deficit/surplus of the national Budget

The total revenues of the national Budget are insufficient to cover expenditure. This long-known fact is

Table 1. The surplus/deficit of the extra-budgetary funds in the consolidated balance sheet of central government (millions of kuna)

Extrabudgetary funds	2000	2001				
		I.	II.	III.	IV.	V.
Pension fund	-8,927	-675	-1,050	-998	-1,035	-991
Health fund	-4,951	-248	-169	-305	-231	-153
Employment fund	-173	-13	-16	-6	-7	2
Child benefit fund	-1,244	-161	-201	-215	-1	-336
Public Corporation Croatian Waters	-308	-23	-32	-2	-2	-22
Total	-15,602	-1,120	-1,467	-1,526	-1,279	-1,501

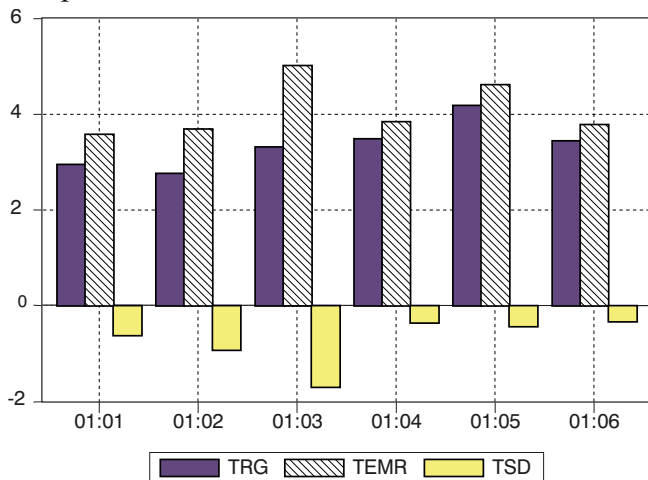
Table 2. Transfers from the national Budget to the extra-budgetary funds in 2001 (millions of kuna)

Extrabudgetary funds	I.	II.	III.	IV.	V.	VI.	I-VI.
Pension fund	0.5	939	864	900	982	906	5,115
Health fund							1,065
Employment fund							0,002
Child benefit fund	160	198	214	0	337	206	1,115
Public Corporation Croatian Waters							0

backed up by the latest FM figures. In only the first three months, the national Budget deficit increased from 619 million to 1.7 billion kuna. This kind of negative trend was partially palliated in April, May and June, when the budgetary deficit was gradually reduced, and in June remained at the relatively low level of 335 million kuna.

Looked at overall, in the first six months, the national Budget is in deficit to the extent of 4.3 billion kuna (Graph 2).

Graph 2.



TRGNB - total revenues and grants  
 TEMR - total expenditure minus repayments  
 TSD - total surplus or deficit  
 NB: sums in billions of kuna

## 2.5. Current deficit/surplus in the budgetary balance sheet

According to the total deficit ascertained, it can easily be seen that current revenue (tax and non-tax) cannot cover current budgetary expenditure. There is a current budgetary deficit in the whole of period under observation. The greatest level of current budgetary deficit, of 1.4 billion kuna, was recorded in March. In the next two months the level of the current deficit decreased, and in June it was at the level of 26 million kuna.

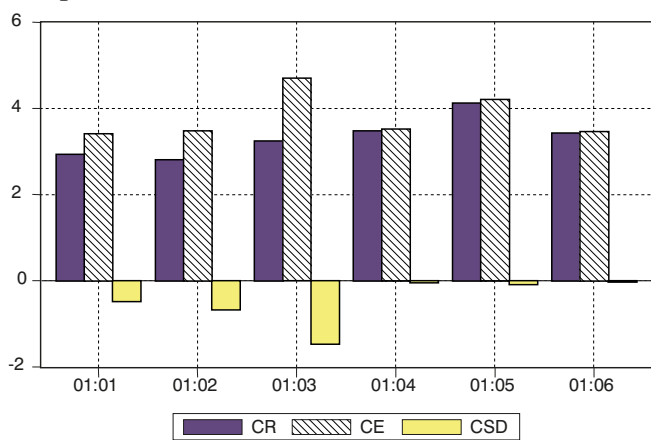
The current budgetary deficit for the first half-year amounted to 2.6 billion kuna (Graph 3).

The negative state of affairs in the current budgetary balance sheet is directly reflected in the primary balance sheet of the national Budget.

## 2.6. The total primary deficit/surplus of the budgetary balance sheet

Even after the cutting out of interest paid from the budgetary balance sheet, the situation of the Budget is no better. That is, the government in March had the greatest level of primary deficit, of one billion

Graph 3.



CR - current revenue  
 CE - current expenditure  
 CSD - current surplus or deficit  
 NB: amounts in billions of kuna

**Total deficit/surplus** - difference between total revenue and grants and total expenditure.

**Current deficit/surplus** - the difference between current revenue (tax and non-tax) and current expenditure (salaries, current transfers...)

**Primary deficit/surplus** - the difference between total revenue and total expenditure, from which payment of interest is excluded. The existence of a primary deficit indicates that the total deficit is not just the consequence of interest payments (the size of which is not under the discretionary influence of those currently responsible for defining fiscal policy), but that it is that part of the expenditure that those currently in charge of fiscal policy can influence that is greater than the available total revenues. As against this, a primary surplus shows that the government is directing some of current revenue to the payment of interest, and is thus reducing the pressure towards increasing indebtedness.

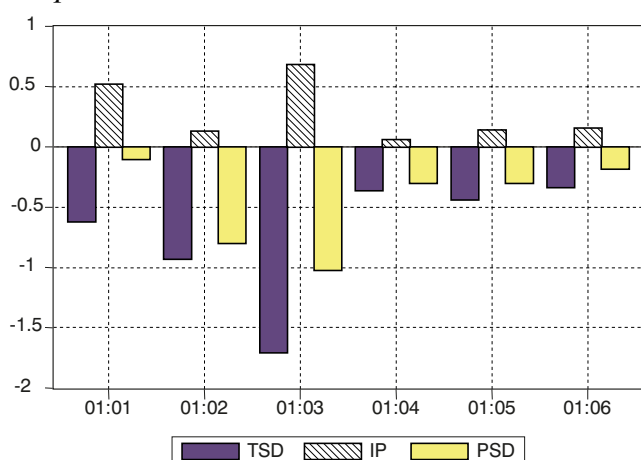
kuna. In the next two months the primary deficit level dropped and came in June to 180 million kuna. In the period under observation Croatia could not finance current expenditure with current revenue, and had to borrow in order to meet monthly current expenditure. For this reason the government could not pay off its debts from current expenditure, and had to take on new loans, and in this way increased the level of total indebtedness (Graph 4).

We should remark that the total level of primary deficit in the first six months was 2.7 billion kuna.

## 2.7. National Budget short term borrowing

In the period under observation the government vigorously made short term borrowings on the financial

Graph 4.



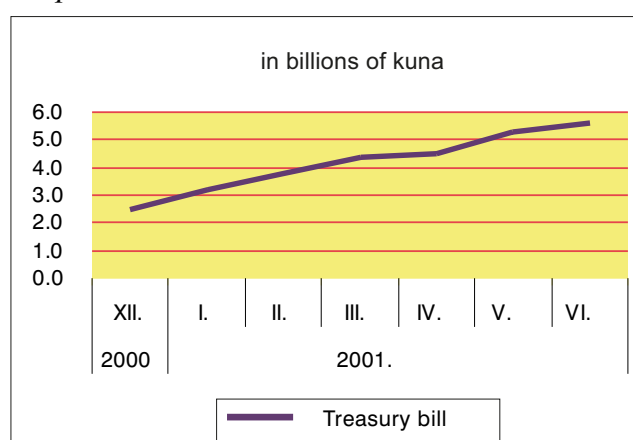
TSD - total surplus or deficit  
 IP - interest paid  
 PSD - primary surplus or deficit  
 NB: amounts in billions of kuna

market with the issue of short-term securities (treasury bills), with 42, 91 and 182 day maturity terms. We call that the FM, in December 2000, make short-term borrowings on the financial market to the tune of 2.6 billion kuna. In the next five months, there was a constant growth in the short-term borrowing of the government. In the period from December 2000 to June 2001 along, the short term borrowing more than doubled, that is, went up from 2.6 billion kuna to a record 5.6 billion kuna (Graph 5).

### 2.8. The government and the commercial banks

The total kuna and foreign currency deposits of the government (the national Budget and the extra-budgetary funds) in the whole of the period move in a range of from 5.6 to 6.7 billion kuna, with the lowest level of deposits, of 5.5 billion kuna, being recorded in June. A similar trend is shown by the loans of the banks to the central government. Thus the overall level of loans moves in a range of from 19 to 21 billion kuna. It is interesting that the highest level of coverage of loans by government deposits, of 35.2%, was recorded in December 2000. However, in the following months the coverage of this loans

Graph 5.



**The single account of the treasury** - one or more bank accounts that are used for the reception, keeping, payment and transfer of all revenue, receipts, expenditure and other payments in and out of the national Budget, which the Finance Minister, in line with the law, opens at the CNB. The single treasury account includes the foreign currency account of the treasury, or the national Budget. The single account of the Budget has several sub-accounts.

with available government deposits fell, and in June 2001 loans of commercial banks were only 28.5% covered by government deposits (Table 3).

### 2.9. The government and the CNB

Since April 2001, the government has been unable to borrow at the CNB. With the passing of the new CNB Law, the previous provision according to which the government could make short term borrowings at the CNB in the amount of 5% of the revenue of the current year went out of force. In March, the government took out a short-term loan at the CNB, in the amount of 500 million kuna, for the last time. Now, the government can only borrow from the commercial banks, and the amount and the conditions of the borrowing are directly dictated by the conditions on the financial market.

It ought to be pointed out that in the whole of the period kuna and foreign currency deposits of the

Table 3. Consolidated balance sheet of the commercial banks (end of period, in billion kuna)

	2000	2001					
	XII.	I.	II.	III.	IV.	V.	VI.
Claims against central government	19.0	20.8	20.0	19.6	19.6	19.0	19.3
Central government deposits	6.7	5.6	6.0	6.2	5.9	5.6	5.5
% Coverage of loans by deposits	35.2	27.1	29.9	31.7	29.9	29.3	28.5

central government at the CNB have increased. In January the level of deposits was 1.3 billion kuna, and in the next five months this went up, reaching 2.7 billion kuna in June. It is possible that the increase of government deposits at the CNB should be ascribed to an increased number of payments from the state treasury from the single treasury account at the CNB. The increased level of deposits is the result of an increasingly larger number of budgetary beneficiaries being involved in the state treasury system (Table 4).

## 2.10. The public debt (total debt of the central government, and its potential debt)

The fiscal category that attracted the most attention is certainly the level of the public debt (Table 5). Thus in December 2000, the total level of public debt was 59.9 billion kuna. In the subsequent three months the total debt increased and in March came to a record 67.4 billion kuna. In the next two months a reduction by 1.1 billion kuna was noticed, 1.3 billion in May. The total level of debt came in June to 66.3 billion kuna. The foreign debt of the government is the most interesting item in the debt - increasing from 38.3 billion in January to 44.8 billion in March. In May and June there was a gradual reduction, and in June the total external debt came to 44.1 billion kuna. The internal public debt in the period under observation stayed on average at the level of 22.5 billion kuna. We should mention that the share of internal debt in the total debt in this period was 35%, while the remaining 65% was constituted by external debt.

**Treasury bills** - short term securities of the FM. They are issued for the financing of the uneven dynamics of the inflow and outflow of budgetary funds (short-term deficits).

## 2.11. Government guarantees

The high level of government indebtedness, especially abroad, is not the final measure of total government indebtedness. That is, in combinations for the estimate of total indebtedness, one often counts in the level of government guarantees that have been issued. Issuing government guarantees started in 1998. However, it is interesting that not even today are there any systematic records founded on some close co-operation between the CNB and the FM (or other competent ministries).

**The public debt** - the total level of indebtedness of the country at home and abroad.

**The internal public debt** - the total level of indebtedness of the government or the state at home. The total internal public debt can also be defined as the overall level of claims that certain sectors of the economy (the population at large, the banks and the companies) have against the government ("old" foreign currency savings, big bonds, reconstruction bonds, bank bail-out bonds and treasury bills).

**The external public debt** - the total borrowings of the government abroad (bonds, short-term and long-term loans).

Thus the level of guarantees issued differs according to whether we use FM or CNB data. In May, the CNB for the first time since independence issued rather full data about the total guarantees issued. Thanks to these CNB statistics we can see the outline level of guarantees that have been issued, guarantees that are a potential threat to the increase of the total level of indebtedness of the government (Table 6). According to CNB records, the total level of guarantees issued is rising. Thus the level of guarantees issued at home increased from 4.1 billion kuna in December 2000 to 6.2 billion kuna in May 2001. The level of guarantees made abroad increased from 12.3

Table 4. Claims against central government and central government deposits at the CNB (billions of kuna)

CNB balance sheet	2000	2001					
	XII.	I.	II.	III.	IV.	V.	VI.
Claims against central government	0.0	0.0	0.5	-	-	-	-
Central government deposits	1.1	1.3	1.2	2.3	2.7	2.8	2.7

Table 5. Central government debt (billions of kuna)

	2000	2001					
	XII.	I.	II.	III.	IV.	V.	VI.
Internal debt of central government	21.3	23.3	22.8	22.5	22.9	22.5	20.2
Foreign debt of central government	38.6	38.3	40.6	44.8	43.4	43.5	44.1
Total	59.9	61.6	63.4	67.4	66.3	66.1	66.3

billion kuna in December 2000 to 13.2 billion in March 2001. In June, the total level of guarantees made abroad remained at the level of 12.5 billion kuna.

The FM data show a different classification of guarantees - financial and performance (Table 7).

Table 6. Potential public debt of central government - guarantees (in billions of kuna)

Guarantees	2000	2001					
	XII.	I.	II.	III.	IV.	V.	VI.
At home	4.1	5.1	5.1	5.5	6.2	6.2	
Abroad	12.3	12.4	12.7	13.2	12.6	12.5	12.5

Thus according to the FM, the situation of totally issued financial guarantees in 2000 showed 5.3 billion kuna, and of performance guarantees 4.3 billion kuna. In the first six months of 2001, the state issued 920 million kuna worth of financial and 2.7 billion kuna worth of performance guarantees.

### 3. Methodological scope and approach - drawbacks and causes

**The budget of general government.** From practice of showing data about the government finances to date, it is hard to arrive at complete information about the consolidated balance sheet of general government. Thus for example it is impossible to obtain an overall picture of revenue, expenditure and total level of deficit in the balance sheet of the general government. The last available figures about the execution of the consolidated budget of general government are for 1998. The problem here is in the budgets of the local government units, which in the last three years have not been consolidated with the budget of the central government.

**Local unit borrowings.** CNB statistics give us only an outline picture of local units' borrowings. No entire picture of the financial position of the local units exists at present, although the FM regularly publishes the annual outturn of the budgets of the local units.

**Current and capital transfers.** It is also impossible to determine any overall information about transfers (current and capital) of the Budget to the extra-budgetary funds from the current statistics. There are as yet no homogeneously adjusted and classified data for the extra-budgetary funds.

**Government guarantees.** There is no chance of comparing guarantees actually issued with planned amounts for a single year according to the categories of home and foreign, financial and performance guarantees. One of the reasons is the prescribed authorisation in the Budget Execution Law

Table 7. Guarantees (in billions of kuna)

Guarantees	2000	I-VI 2001
Financial	5.3	0.9
Performance	4.3	2.8

that the government, on behalf of the RC, should determine the amount of financial and performance guarantees issued, at the recommendation of the FM. There are no determined annual planned amounts, nor are there any restrictions in the issue of guarantees. The problem also lies in the lack of uniformity in the FM and the CNB in the methodological monitoring of guarantees issued.

**Public debt records.** CNB data about the public debt of the government are not harmonised with the data of the FM. That is, for the internal debt, the source of data are the FM's *Monthly Statistical Reviews*, the *Balance Sheet* of the CNB, and the consolidated balance sheet of the commercial banks. The source of data about the foreign debt is the foreign debt statistics drawn up by the CNB.

**Financial guarantees** - an instrument with which the government ensures the payment of loan obligations of the real debtor to domestic and foreign creditors. The government of the RC determines the amounts of the guarantees issued.

**Performance guarantees** - guarantees given according to advances in money or assets for the building of ships until delivery date, the procurement of airplanes and pursuant to long-term contracts about leases and for infrastructure projects (transport, communications, power supply, environmental protection) carried out pursuant to a concession or a joint venture.

The problem here is that the FM (Public Debt Management Department) does not manage to unify data about internal and foreign public debt. Thus the public debt is monitored in different ministries, and payments are done via different banks; there is no centralised, total coverage of this category of debt. The basic problem is the fact that loan contracts are made by people authorised by the government (ministers, ambassadors and so on), and implemented by individual ministries or institutions, public corporations for which the loans are taken on. In such conditions the government is a borrow-



er; and yet, the operative jobs of the contract are delegated to lower levels, and the data about loans cannot be obtained in a single place. There are a certain number of contracts for loans that are not recorded in the CNB because the users of these funds are not statutorily obliged to carry out any registration, and they do not even know if this has been done by a bank or some superior government body, the debtor. Even if some initial registration has been done at the CNB, the question still remains about who will do the reporting about the transactions (the use of and repayment of the funds) related to given loan operations (see Kačan, Ankica: Analiza Inozemnog duga Republike Hrvatske, Review P-4, CNB, Zagreb, 2000, p.14).

#### 4. Conclusions and recommendations

The unfavourable trends in the government funds that are manifested in the rise in the public debt and the indebtedness of the government have led ineluctably to the taking of measures to ensure good management of the government's finances and a sustainable fiscal position over the long run. This means that the government has to ensure good management of cash and the public debt in order to prevent excessive borrowing and a potential debt crisis that could well occur if the unfavourable trends of the first six months were to carry on.

Thus, first of all, it is necessary to:

- ◇ Gradually reduce the deficits of the extra-budgetary funds (especially of the healthcare and retirement funds). Also necessary is reform of these funds, which has to be accompanied by a clear, detailed and transparent picture of revenue, expenditure and borrowing of the extra/budgetary funds. It is necessary to provide more realistic planning of the budgets of the extra-budgetary funds and to estimate the amounts of transfers from the national Budget for the next three years.
- ◇ Reduce the pressure to short-term government borrowing. It is necessary to ensure control of the state of the cash in the government's accounts with the commercial banks and include the accounts of budgetary beneficiaries in the state treasury system. Authority for managing the cash in the FM should be clearly defined so as to foresee more easily any needs for short-term borrowing. The conditions (interest rate) on which the money of the budgetary beneficiaries is held at the commercial banks should be reconsidered, and a public tender invitation should be made for the selection of banks via which the government will carry out payments clearing.

**Claims against the central government** - loans and claims that have matured against the national Budget of RC. Kuna loans to the national Budget are short-term loans given to bridge the lack of harmony between the inflow of revenue and the execution of the expenditure of the national Budget, long-term loans approved according to special government decrees, and claims against the national Budget that have matured according to obligations to the IMF and foreign banks. A foreign currency loan to the national Budget was counter item to the obligations to the IMF arising on the basis of the succession to membership in that institution.

**Central government deposits with the CNB** - deposited money and foreign currency accounts of the RC and extra-budgetary funds with the CNB and treasury bills of the CNB that have been voluntarily subscribed to by central government institutions. For analytical purposes, deposits are distinguished into national Budget deposits with the CNB and extra-budgetary fund deposits with the CNB.

**Central government deposits with the commercial banks** - total kuna and foreign currency obligations of the commercial banks to the central government, with the exception of limited (kuna and foreign currency) deposits of central government at the commercial banks. Kuna and foreign currency deposits of the RC and the republic funds are shown separately. Kuna deposits include demand deposits, savings deposits, kuna time and notice deposits, and kuna loans received from central government. Foreign currency deposits include sight foreign currency deposits, savings deposits, time foreign currency time and notice deposits.

- ◇ Settle the dynamics for the privatisation of the public corporations. In order to avoid shocks in the state finances arising as a result of revenue unrealised from privatisation, it is necessary to address a higher quality and more qualified planning of revenue and the actual dynamics of privatisation. One should appoint an expert team to determine the order and amount of revenue that can be obtained from the sale of the public corporations. The privatisation plan should be ready before the beginning of the budgetary year, and its implementation has to be supervised by the FM and the Privatisation Fund.
- ◇ Regulate the issuing of guarantees. It is necessary to put in order and co-ordinate the statistics of guarantees issued in the CNB and FM versions (including both financial and performance, domestic and foreign), to lay down the criteria for their award, to impose restrictions on the amounts of guarantees and re-examine the role of the government in the giving of guarantees (for example, in the shipbuilding industry).