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NEWSLETTER



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The Croatian Public Debt: Current State and Trends

The public debt consists of all the liabilities of government, that is, the sum of all outstanding debts that the public sector owes to its creditors at any given moment. For an analysis of the public debt and its sustainability, it is essential to have comprehensive a view of the liabilities of the public sector. As well as direct liabilities of government, of the extra-budgetary funds, of local government units and public enterprises, it is also essential to have information about debts that are still outstanding to suppliers and about potential government liabilities, i.e., guarantees for loans, for pensions. Many developed and transition countries, it is true, often have problems in obtaining comprehensive pictures of the public debt. Whatever the practice in other countries, though, Croatia must possess comprehensive information concerning the public debt in order to ensure quality management of the debt. Records concerning the public debt in Croatia on the whole deal with the debts of general government (central government, local government units and extra-budgetary funds) and only part of the potential debt (government guarantees).

The World Bank uses a broader definition of public debt, which includes domestic and external debt of central government, plus guarantees (financial and performance),

short-term liabilities of the healthcare sector and other due public sector liabilities and the direct debts of local government units. According to the World Bank the Croatian public debt had as early as 2000 and 2001 crossed the level of 60% of GDP (WB, Strategy of Economic Growth through European Integration, <http://www.worldbank.hr>)

Public debt scope and problems

Only since 2001 have public debt statistics been improved, thanks to the encouragement of the International Monetary Fund (IMF). The Croatian National Bank (CNB) still has the best insight into it and keeps public debt records in terms of instruments and users, which it tracks at a monthly level (www.hnb.hr). Unfortunately the Ministry of Finance still has problems in presenting an overall picture of the public debt. An additional problem has been brought about in the Ministry of Finance's records about the public debt by the transition to a new system of records of budgetary transactions according to a modified accrual principle. Thus from 2000 and 2001 the categories of outstanding liabilities have appeared, which should be part of the public debt.

The question of the position of bills issued is unsettled; these have been more frequently issued since

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>.

1997 to cover debts to suppliers. Although they are not a classical instrument for borrowing, rather for security of payments, it is not clear what the amount in total of bills issued is and when they will fall due. Also still in doubt is the structure of the direct and the potential debts of local government units.

got into debt by issuing bonds, although loans still constitute a considerable part (11 billion kuna) of the foreign debt of central government. Abroad, the extra-budgetary funds and local units take on debt to a much smaller extent.

Table 1 Public debt of the Republic of Croatia

| Million kuna, current prices | XII 1998 | XII 1999 | XII 2000 | XII 2001 | XII 2002 | VI 2003 |
|---|----------------|----------------|----------------|----------------|----------------|-----------------|
| Total debt, general government | 35,115 | 46,781 | 59,864 | 66,349 | 71,455 | 78,435 |
| Central government budget | 34,614 | 44,629 | 55,355 | 61,125 | 65,995 | 73,193 |
| Extrabudgetary funds | 501 | 826 | 2,884 | 3,470 | 4,002 | 3,785 |
| Local government units | | 1,326 | 1,625 | 1,754 | 1,458 | 1,458 |
| Guarantees | 8,487 | 9,849 | 15,447 | 18,403 | 21,138 | 17,880 |
| Debt and guarantees | 43,602 | 56,630 | 75,311 | 84,752 | 92,594 | 96,316 |
| GDP, current prices, mil. kuna | 137,703 | 141,579 | 152,519 | 162,909 | 176,429 | 189,908* |
| As percentage of GDP | XII 1998 | XII 1999 | XII 2000 | XII 2001 | XII 2002 | VI 2003 |
| Total debt of general government | 25.5 | 33.0 | 39.3 | 40.7 | 40.5 | 41.3 |
| Central government budget | 25.1 | 31.5 | 36.3 | 37.5 | 37.4 | 38.5 |
| Extra budgetary funds | 0.4 | 0.6 | 1.9 | 2.1 | 2.3 | 2.0 |
| Local government units | 0.0 | 0.9 | 1.1 | 1.1 | 0.8 | 0.8 |
| Guarantees | 6.2 | 7.0 | 10.1 | 11.3 | 12.0 | 9.4 |
| Debt and guarantees | 31.7 | 40.0 | 49.4 | 52.0 | 52.5 | 50.7 |

* Estimate of Central Statistics Office

Source: CNB and Ministry of Finance 2003

Size and structure of the public debt

In the last six years in Croatia the level of the public debt (public and potential) has doubled in absolute terms.

Purpose of borrowing. Central government has got into debt by issuing bonds for the execution of the central budget, mainly for the financing of the budgetary deficit. Since 2000 the growth of the budgetary deficit has been the result of the increased expenditure for additional capitalisation of several banks and government-owned enterprises, the payment of the outstanding debts of the healthcare system and so on. Government has taken on loans mainly through the mediation of the extra-budgetary funds (or public enterprises) to finance public investment (e.g., the building of motorways).

Domestic and foreign debt. The average ratio of domestic and foreign debt is 40:60 percent in favour of foreign debt. Domestically, government has mainly got into debt via the transparent issuing of government bonds. The extra-budgetary funds and local government units still dominantly borrow through credit arrangements with the banks. Abroad, government has

Costs of borrowing

The costs of borrowing, i.e., expenditure for interest, are increasing every year. The vigorous growth of government borrowing since 2000 is reflected in an increase in the level of expenditure for the repayment of the principal and for interest payments for the public debt.

Table 2 Public debt repayment costs

| | 1999 | 2000 | 2001 | 2002 | plan 2003 |
|---|------|------|------|------|-----------|
| Expenditure for interest, billion kuna | 2.4 | 3.0 | 3.6 | 3.7 | 4.5 |
| Interest/total revenue of general government, % | 3.1 | 3.9 | 4.3 | 4.3 | 4.9 |
| Interest/total tax revenue of general government, % | 3.9 | 4.8 | 5.3 | 5.1 | 5.9 |
| Interest/total expenditure of general government, % | 3.1 | 3.9 | 4.3 | 4.3 | 4.9 |
| Interest/GDP, % | 1.7 | 2.0 | 2.2 | 2.1 | 2.4 |

Source: IMF and MF, 2003

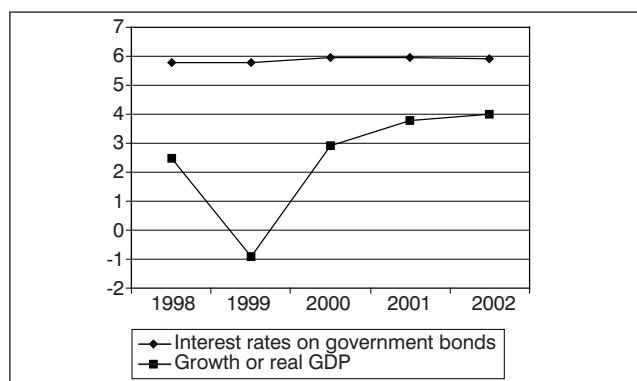
Table 3 Public debt as percentage of revenue and expenditure of general government

| | 1999 | 2000 | 2001 | 2002 | plan 2003 |
|-------------------------------------|------|-------|-------|-------|-----------|
| Total revenue, bill. kuna | 68.5 | 70.6 | 72.8 | 79.7 | 85.3 |
| Total expenditure, bill. kuna | 80.1 | 80.4 | 83.9 | 88.2 | 94.0 |
| Debt/revenue, % | 68.3 | 85.0 | 91.1 | 89.6 | 92.0 |
| Debt/expenditure, % | 58.4 | 74.5 | 79.1 | 81.0 | 83.4 |
| Debt and guarantees /revenue; % | 82.6 | 106.9 | 116.4 | 116.1 | 113.0 |
| Debt and guarantees/ expenditure; % | 70.7 | 93.7 | 101.0 | 105.0 | 102.5 |

Like the amount of the public debt since 1999, interest costs have risen too. Debt repayment in the coming period will increasingly place a burden on the central budget and the revenue of the central budget. Ever since 2001, total public debt (including guarantees) has exceeded the level of available revenue, and also of the expenditure of general government.

Interest rates on borrowings. For a complete analysis of the costs of borrowing it is necessary to identify the interest rate on government borrowings, of the extra-budgetary spending agencies, of local government units and public enterprises at commercial banks (domestic and foreign). To this day there is no complete set of information in Croatia about the different interest, as the indicators of the costs of government borrowing. Only a little more information about the costs of borrowing is provided by the amount of interest rates on bonds during the 1998 to 2002 period.

Figure 1 Interest rates on government bonds of GDP, 1998-2003, in %



Source: Ministry of Finance and Central Statistics Office, 2003

Rates of interest on bonds are still greater than the rate of the growth of the economy and show that the Croatian public debt is not sustainable and that a greater rate of economic growth has to be achieved in order to secure the financing of it.

It should be stated that interest rates on bonds are not a sufficient or a realistic indicator of the costs of borrowing because the rates of interest that the government has made with domestic as well as foreign financial institutions are not thus taken into account. We should recall that complete information about the costs of government borrowing (especially loans, domestic and foreign) is essential so that government can meet the basic objective of public debt management - borrowing with the best possible conditions, where the amount of the interest rate is one of the key factors.

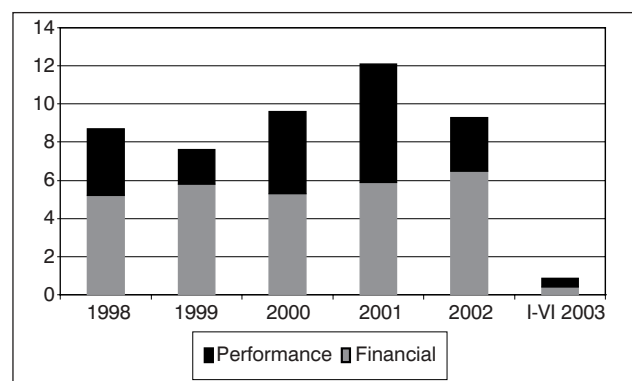
Government expenditure arrears. In 2000 for the first time information showed up about the size of the government expenditure arrears. Then the Government and the Ministry of Finance made up a list according to which there was in Croatia 9.5 billion kuna worth of government arrears from previous years. In 2000 government got into debt on the financial market by issuing bonds and met most of its liabilities thanks mainly to receipts from borrowing. Nevertheless, outstanding government arrears, in spite of their being recorded monthly, are not publicly available and usable, although the IMF used them in the calculation of the budgetary deficit on the accrual principle.

Guarantees - part of the potential debt

Guarantees (financial and performance) are one category of potential debt that is officially prescribed and determined. Information about potential debts to the pensioners is not publicly accessible but should be to make possible an insight into the real size and structure of the public debt (which includes potential government liabilities).

Government guarantees are probably one of the least transparent parts of government finances. The Croatian National Bank keeps records about guarantees and splits them into foreign and domestic; the Ministry of Finance divides them into financial and performance, domestic and foreign as well as per sector.

Figure 2 Size and structure of guarantees issued from 1998 to 2003, bill. kn



Source: MF, 2003

Since 1996 there have been figures about guarantees issued, classified into the categories of financial and performance. In the period from 1996 to 2003 government issued guarantees in the amount of 56.3 billion kuna. Of this amount, according to CNB records, about 18 billion kuna guarantees, or one third of the guarantees, are still active. Financial guarantees are dominant in the structure of all guarantees. It is dubious to what extent guarantees have led to payments, and what the risk is of some of them to fall due. Since 2001 the Ministry of Finance has had an initiative for recovering the liabilities from the debtors. Officially, since 2003, there is the provision for debtors to have their accounts frozen for the sake of recovering claims for guarantees issued that have been presented for payment, while an agreement with the Ministry of Finance about payment in instalments is possible.

The information system concerning guarantees issued has improved. Yet there is still no revised information about the extent of active guarantees and the amount of the costs government has had to bear through the activation of guarantees. We should remark that between 2000 and 2003 there have been cases in which these guarantees have been called upon and in which they became a direct burden upon government and increased the level of the direct public debt (in for example the shipbuilding sector).

Public debt management

The SPRINT model on which public debt management has been based since 1997 has still not been activated and the information department of the public debt management system is not connected with the other parts of the government treasury. Alas, there is still no effective public debt management in the Ministry of Finance, because the Ministry of Finance has not managed to take any significant step in recording and monitoring the maturation of and projections of the dimensions and repayment of the public debt and the guarantees.

Guarantee risk assessment. The extent to which the Ministry of Finance really does carry out an assessment of the risk of guarantees being called upon when it approves guarantees is dubious. That is, there is no risk management section in the Ministry of Finance to be able to assess the creditworthiness of the recipient of the guarantee and the degree of risk of a potential debt. Other ministries, in whose jurisdiction the party seeking the guarantee falls, do carry out credit rating checks. In formal terms, some progress has been made through the adoption of the Decree on Criteria for Acquiring Guarantees, which the Government adopted in 2003, with the emphasis on checks of the creditworthiness of the guarantee applicant.

Public debt transparency

Information about outstanding liabilities of government (although they are used in the calculation of the deficit) that the Ministry of Finance sends to the IMF quarterly (IMF 2003) is not publicly accessible in Croatia. The Ministry of Finance keeps monthly records, and all the spending agencies have since 2003 been obliged to fill in a form about the size and structure of their liabilities, as part of the information from the balance sheet.

Another problem is the lack of information about the real size and structure of the potential debt. The potential debt in Croatia is synonymous with performance and financial guarantees. The harmonisation of data between the Ministry of Finance

Fiscal rules

Since 2001, government has been unable to go into debt directly at the CNB. In this manner government must take on debt in a transparent manner on the money market for the financing of short-term deficit of the central budget through issues of treasury bills. An additional constraint on borrowing was announced by the Government in June 2003: the total level of government debt (together with potential debt) must not exceed the level of 60% of GDP (Official Gazette 96/03 and 108/03).

Budgetary restriction of borrowing is also laid down for local government units. Local government units may take on debt up to 20% of their revenue from the previous year, as long as they show detailed information, which have to be allowed by the Ministry of finance (Official Gazette 49/03). An additional budgetary restriction on local government units was laid down in 2003. All local government units in which revenue from operations and non-financial assets is the same or greater than the expenditure of operations and non-financial assets are entitled to take on debt (Official Gazette 154/02). But because of the vigorous growth of public debt, government made it additionally difficult for local government units to take on debt in July 2003. The total sum for borrowings for local government units is set at 420 million kuna, or 3% of the total half-yearly expenditure of all local government units (Official Gazette 147/03). All local government units that are able to finance current expenditure with current budgetary revenue have the right to borrow. A potential danger of breaching the budgetary constraint is constituted by the borrowings of local extra-budgetary (indirect) users, mainly utilities, and local government units signing guarantees for these utilities.

Conclusion

Croatia must make very comprehensive records of the public debt and evaluate government borrowing costs, as well as the sustainability of the public debt. The Ministry of Finance's Public Debt Management Department must be well equipped in terms of expertise and computer support, as well as be capable of having in a single place an insight into the size and structure of the public debt - direct and potential. Still, one has to understand that liabilities are created by many spending agencies and the extra-budgetary funds and public enterprises. All these institutions have to inform the Ministry of Finance about liabilities incurred. It is the obligation of the decision makers in the Government and Parliament to strengthen fiscal control and supervision of the borrowing of public sector institutions. Borrowing with the most favourable conditions, in conjunction with an assessment of the fiscal risks and of the costs of government borrowing, constitutes the basic objective and task of public debt management, and one that Croatia still has to satisfy.

Proposals and recommendations

- All extra-budgetary funds and public enterprises must be bound to inform the Ministry of Finance about the size and structure of their outstanding debts.
- There should be team building in the Public Debt Management Department of the Ministry of Finance, which should be strengthened, with additional training for employees.
- A Risk Management unit has to be set up within the public debt department of the Ministry of Finance.
- The real costs of government borrowing at commercial banks (domestic and foreign) have to be determined - primarily the size of the interest rates as well as the financial costs of processing government, extra-budgetary user and (particularly) public enterprises loans from the banks.
- The public debt department of the Ministry of Finance has to be computer linked with other parts of the government treasury into a System Application Product (SAP) and full records of public debt through the SAP computer system has to be provided.
- The Government and Parliament must determine the real authorities for the assignment of guarantees.
- The Ministry of Finance must finally determine the size and structure of guarantees that have been called on (activated).
- The Ministry of Finance in collaboration with local government units must provide a legible record of debts and potential debts at the level of local units, and in the event that obligations concerning the sending of information are not adhered to, it must activate the penal provisions of the Budget Law.
- The Ministry of Finance and CNB public debt statistics must be harmonised.
- The Ministry of Finance has to have complete information about the financial assets of government (deposits in bank accounts, loans given and so on).
- The Parliament, Government, Ministry of Finance and the CNB must make sure to provide accessible and complete information about the public debt.

Determination on the part of the Government and the Parliament is required for all these measures, as is the will to provide transparent records concerning the public debt and high quality debt management. A country in which the public debt (including guarantees) has long since exceeded the level of total budgetary revenue must have quality institutions and records, so as not to allow the sustainability of principal and interest servicing to be brought into question.

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