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PRESS RELEASES

Does the credit rating downgrade threaten Croatia?

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The Government has – at its 115 meeting, held on September 12 – discussed the **Report on the execution of the state budget for the first six months of 2013. The report clearly indicates a deepening of the fiscal crisis and warns of possible long-term problems in the sustainability of public finances.**

Excessive budget deficit. The budget deficit has already in the first half of the year reached 11.4 billion kuna, which is 1.1 billion kuna more than the amount planned for the entire 2013. By July 31 the deficit amounted to 12.2 billion kuna (increasing by another 800 million kuna in just one month).¹ The deficit was mainly due to the growth of public expenditures. This unfavourable trend confirms that the current and previous Croatian governments did not engage in serious structural reforms on the expenditure side of the budget. Total receipts from financial assets and borrowing is 21.6 billion kuna (which is more than 73% of what has been planned for the whole year). Receipts from borrowing could in 2013 approach the record amount of 35 billion kuna achieved in 2010. The receipts from borrowing through government bonds have currently reached 8.9 billion kuna (which is 58% of the amount planned for the whole 2013). Borrowings from loans reached 9.1 billion kuna (which is even 78% higher than the amount planned for the whole year). No doubt, the government will again have to issue bonds in the international financial market to close the gap and balance the budget. The price of balancing the budget is large and is reflected in the growth of public debt and borrowing costs. The government will have to do (a technical) revision to balance the budget.

The expansion of public debt. Croatian public debt reached 53.7% of GDP in June, 2013 and is likely to easily exceed 60% of GDP. This could, along with a growing budget deficit, be the reason for the European Commission to initiate the EDP.² The main reason for the growth of public debt is the conversion of called on government guarantees into direct general government debt, as well as the cost of new bail outs and subsidies to public enterprises and institutions in the health care system and financial institutions. Government guarantees are issued mainly to public enterprises that are a continuous source of financial risk. On February 29, 2012 the Government assumed 9 billion kuna of called on guarantees to the shipbuilding industry converting them into public debt. Nevertheless, the cost of 247 million kuna of called on guarantees for highways and railways were in 2013 secured from the guarantee reserves (of 472 million kuna). Anyway, called on guarantees increase expenditure and contribute to the expansion of the budget deficit. According to ESA 95, in the third year of the call of guarantees, the overall debt covered by guarantees (and not just the amount of the instalment of the

¹ Ministry of Finance, 2013. *Time series of data*.

² *Excessive Deficit Procedure* – the procedure for EU members with excessive deficits and debt.

debt paid) is added to the expenditure of the state.³ It should be noted that the Government has limited the issuance of government guarantees to 4.5 billion kuna in 2013, but issued about 3.2 billion kuna of new guarantees (71% of the annual plan) already in the first half of the year.

Stable trend in revenues. Despite the economic crisis, budget revenues are well collected. However, semi-annual outturn of the revenues from income tax, VAT and social security contributions are lower by (on average) 3-4 %, but do not differ much from the amounts planned. Income tax is considerably lower in the first half of the year (about 10%). Excise duties are at the level of the plan and will likely continue to grow in the second half of the year, which will partially offset lower VAT revenue. Contributions for pension and health insurance are relatively well collected (currently at the level of around 48-49% of the amount planned for the entire year). Budget revenues are still stable and planned better than expenditures. This is generally confirmed by the comparison of semi-annual budget outturn in 2013 with that in 2012.

Expansion of expenditures. Operating expenditures of the state continue to grow and are currently approximately 2% higher from those planned for the first half. The growth of operating expenditures is substituted by the reduction of expenditures for the acquisition of non-financial assets - expenditures for capital investments and maintenance of the property. This trend exists both at the level of the state and local government and clearly shows that the current state of social peace is maintained at the expense of capital investments. Social benefits to households amounted to 35.6 billion kuna (expenditures for health care, pensions, social welfare and unemployed) and 55 % of the amount planned for the entire year has already been carried out in the first half. Health care expenditures have been increasing for a long time (due to economic, demographic, organizational and other reasons). They have also increased due to a takeover of hospital debts. Recoveries of hospitals should not be focused only on the resolution of arrears (often for drugs) but have to be followed up with deep reforms in the organization and financing of the health care system. Without such changes it is difficult to expect positive financial effects of recoveries financed by borrowing - in the first half of 2013 the government borrowed 3 billion kuna to cover the debts of health care institutions. In addition to health care expenditures, the long-term pressure to the state finances is also caused by expenditures for pension insurance. The monthly financing of pension insurance has, for a long time, been secured with the short-term loans from commercial banks. Besides social expenditures, there is a continuous growth in subsidies which amount to more than 3.7 billion kuna (more than 62 % of the amount planned for the entire year has already been carried out in the first half). Subsidies are directed to public sector enterprises – primarily Croatian railways and shipyards, funding programs through CBRD and agriculture.

The current state of government finances points to the possibility of further downgrade of the country's credit rating. It is high time that the current and future governments manage public finances not solely according to political (electoral) but also economic cycles. The current negative economic developments suggest that the government should not primarily be concerned with its (un)popularity but has to ensure consistent implementation of structural fiscal reforms as a pledge for the future economic and political stability of the state. Without a commitment in implementing reforms on the expenditure side of the budget and in particular in restructuring of public enterprises, the expansion of expenditures, debt and borrowing will continue. The government has the opportunity to quantify the commitment to implement structural reforms in the Guidelines for the Economic and Fiscal Policy for the period 2014-16 and the proposed budget for 2014-16.

³ On the differences between the GFS that Croatia has used so far to record the government financial activities and ESA 95 to which it has to transfer as a member of the EU and the implications of these differences on the size of the deficit and debt, see Bajo, A. and Galinec, D. 2013. „Ten facts about the Excess Deficit Procedure“. *Newsletter*, No. 80. Zagreb: Institute of Public Finance.