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NEWSLETTER

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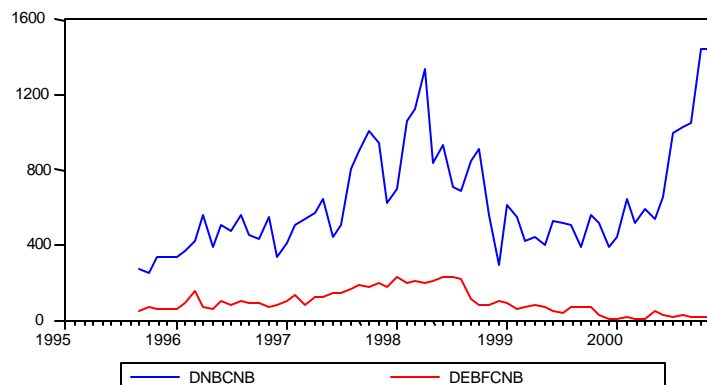
Government Finances in 2000: On the Way to the End of the Tunnel or Just Round the Roundabout?

The Deficit of the National Budget

According to data of the Croatian National Bank and the Finance Ministry, August was the seventh successive month in which the balance of revenue and expenditure in the national Budget was in the red. Both general public and professional circles found the news about the extent of the monthly level of the deficit in July rather alarming. It came to as much as 1,367 billion kuna, a rise of 22% over June. According to the Finance Ministry, the reasons for

this kind of rise in the deficit in July can be found, in the main, in capital expenditure, the payment of subsidies and the payment of interest for the internal public debt. These obligations, it is explained, arise at regular intervals, for example, in the middle of the financial year. This is confirmed by the data for August and September, when the overall deficit in the Budget considered in monthly terms came to 655 million and 351 million kuna respectively.

Figure 1. The total deficit/surplus of the national Budget at a monthly level in 2000



Source: Ministry of Finance, RC

The Institute for Public Finances 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 for Public Finances 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>

Realisation of the Revenue of the National Budget

On the revenue side of the national Budget, a fall of current revenue (which consists 95% of taxation revenue) was recorded in July, it being 0.5% lower than in the same period the preceding year. However, when August and September are compared with the same months for 1999, the national Budget records a rise in current revenue of 5.5% and 2.3%. In the first nine months of this year current revenue was 3.3% greater than in the same period last year, which is to be attributed to better yields from VAT and excise.

The taxes that during the first nine months of this year were lower than in the previous year are mainly profits tax, income tax and customs duties. Considering the general economic picture and the operations of the government in fiscal policy, this cannot be considered an unexpected phenomenon. What can, on the revenue side of the national Budget in this year, be considered unexpected is the non-delivery of revenue from capital, that is, the sums planned to be realised from the sale of HT (Croatian Telecom).

Table 1. Total revenue of the national Budget (in %)

	VIII. 2000. VIII. 1999.	IX. 2000. IX. 1999.	I. - IX. 2000. I. - IX. 1999.	I. - IX. 2000. Plan 2000.
I. Total revenue (II+V)	105.6	102.3	113.0	70.4
II. Current revenue (III+IV)	105.5	102.3	103.3	77.9
III. Taxation revenue Composed of:	107.8	101.2	104.1	78.1
a) income tax	85.0	86.4	93.8	91.2
b) profits tax	61.6	69.3	72.6	65.7
c) VAT	123.6	99.1	108.2	77.5
d) excise taxes	115.6	141.8	126.3	81.4
e) taxes on international trade	75.8	80.1	91.3	73.2
IV. Non-tax revenue	57.6	123.8	85.9	74.6
V. Revenue from capital	121.8	109.2	1561.0	35.9

Source: Finance Ministry, RC.

A look at consolidated central government: where the source of the deficit is.

A much better insight into the state of public finances is afforded by the figures for consolidated central government, since as well as the national Budget, they cover the extra-budgetary funds. According to the Ministry of Finance, **consolidated central government had a 1.81 billion kuna deficit in the first half year, while for the whole of 2000 a consolidated central government deficit of only 2.4 billion kuna was planned. In other words, in the first six months of the year, more than 75% of the entire planned consolidated central government deficit for the year was used up.** If one starts out from the rather optimistic assumption that the picture of revenue and expenditure of consolidated central government will not be essentially different from that of the first half, then the total deficit of consolidated central government will be somewhere in the range of 4 and 5 billion

kuna. A slightly less optimistic, and hence more realistic, projection, in which the rise of current revenues over the planned level is cancelled out by the failure of capital-derived revenue to appear, points to a **consolidated central government deficit of around 6 billion kuna, or 3.8% of GDP, in 2000.**

Available figures about consolidated central government warn that the **generator of the deficit of central government is not the Budget, but the extra-budgetary funds.** While during the first six months, the national Budget recorded a surplus of about 5 billion kuna in the consolidated balance sheet, the extra-budgetary funds had a loss of almost 7 billion kuna. About 6 billion kuna, or 88.6% of the entire consolidated deficit of the extra-budgetary funds in the first six months of 2000, were accounted for by the Retirement and Health Insurance Institutes (Funds).

Table 2: The balance of consolidated central government according to levels of government.

	Plan 2000.	Realisation I. – VI. 2000.	Realisation I. – VII. 2000.
I. Total deficit / surplus (II. + III.)	-2,400,190	-1,809,994	-4,124,665
II. National Budget	9,838,081	5,055,169	4,932,901
III. Extra-budgetary funds	-12,238,271	-6,865,163	-9,057,566
Composed of:			
Retirement Insurance Fund	-7,819,693	-4,288,293	-5,075,679
Health Insurance Fund	-2,473,594	-1,796,773	-3,070,496

NB: Balance calculated as (total revenue and grants) minus (total expenditure and loans minus repayments).
Source: Ministry of Finance, RC

Some 5.2 billion kuna were planned for the Retirement Insurance Institute, 1.766 billion kuna for the Health Insurance Institute, 17.6 million kuna for the Employment Institute, 1.132 billion kuna for the Child Benefit Fund, and 388.7 million kuna for Croatian Water PC. If these sums are combined, together with planned transfers to local government,

the result is planned transfers to other levels of government coming to a total of 8.63 billion kuna. However, during the first nine months of the execution of the Budget, 8.19 billion kuna were transferred to other levels of government, or on average about 910 million kuna per month.

Table 3: Transfers to other levels of government from the national Budget in 2000

	Plan 2000.	Realisation I. – IX. 2000.	Average I. – IX. 2000.	Projection 2000.
I. Transfers to other levels of government (II.+III.)	8,628,470	8,191,716	910,191	10,922,288
II. Transfers to the extra-budgetary funds	8,424,726	-	-	-
III. Transfers to local government	203,744	-	-	-

Source: Ministry of Finance, RC

If for the period from October to December 2000 one makes a conservative (optimistic!) assumption that the monthly transfers to other levels of government will be equivalent to at least the average monthly amount, then the planned expenditure of the national Budget for this item for 2000 has to be adjusted by about 2.3 billion kuna. In other words, with the optimistic assumption that all other items of expenditure remain within the plan, transfers to other levels of government will increase the total deficit of the national Budget for 2000 from a planned 1.27 billion kuna to about 3.6 billion kuna. Part of the budgetary deficit will be palliated by better tax revenue, but when one puts into the equation the loss of planned revenue from capital because of the postponement of HT privatisation, one comes to the conclusion that when the bottom line is drawn on the national Budget on December 31 2000, it is almost impossible to imagine it being in the red less than 6.3 billion kuna, or 4% of GDP.¹

Borrowing: the price of the Croatian cure, or the consequences of the sickness

Since the deficit of the national Budget and of consolidated central government does not fall within the planned framework, and with very reasonable doubt about the manoeuvring space for redistribution, **the major part of the burden of the rebalance of 2000 will have to be borne by the financing account.** In other words, after the establishment of the new planned level of revenue and expenditure, the gap between them will be covered by additional government borrowing. From a comparison of data from the CNB about the debt of the central government from the end of 1999 and June 2000, it can be seen that the total debt of central government has risen by about 4 billion kuna. Of this, about 50% relates to an increase in the internal public debt, and the second half to an increase in the external public debt; the total debt of central government at the end of June came to 50.5 billion kuna, or about 32% of total anticipated GDP for 2000.

¹ With respect to resources borrowed against future revenue from the sales of HT shares, this is actually a bridging loan between this year's need for resources and the value of the assets being sold. How much money will be obtained from the sale of the shares in HT remains to be seen, for this does not depend on government calculations, only on the financial market. Although the sales of the HT shares should cancel out the loan of 5 billion kuna, statistics for the end of this fiscal year should show these 5 billion under the heading of the growth of public debt.

Table 4: Central government debt

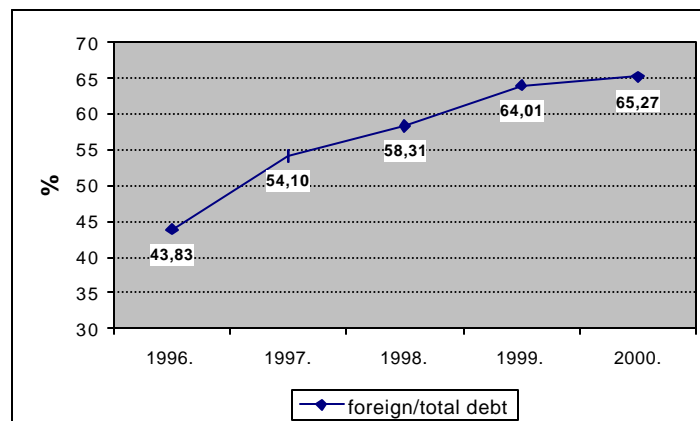
(million kuna, end of period)	XII. 1999.	VI. 2000.
Internal debt of central government	16,782.2	17,564.3
External debt of central government	29,843.6	33,010.7
Total	46,625.8	50,575.0

Source: CNB

In the light of the expected deficit it can be assumed that there will be a rise in the ratio of borrowing-to-GDP to 35% and more. Nevertheless, the level of the public debt of the Republic of Croatia is not necessarily alarming when compared with that in other European countries, or

indeed the Maastricht criteria for entry into the EMU. However the fact that should give decision-makers pause for thought is that **the foreign debt accounts for almost two thirds of the public debt of the Republic of Croatia.**

Figure 2: The proportion of external debt of central government in the total central government debt between 1996 and 2000 (end of period)

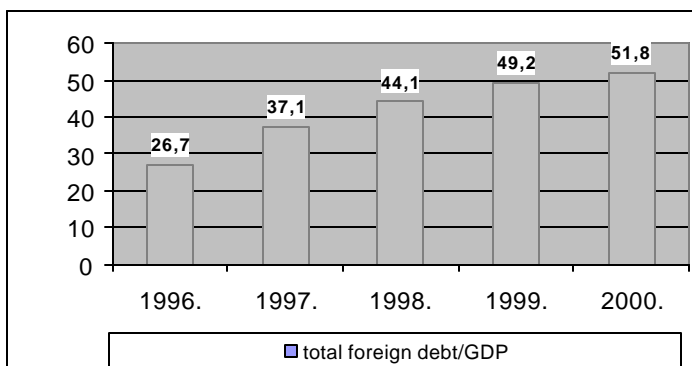


NB: For 2000, the situation as of the end of June is quoted
Source: CNB

But when one broadens the framework of indebtedness from just the public sector so as to include all the foreign borrowings of the whole of the national economy, the causes for concern grow (apart from government or public sector debt, this includes the borrowings of banks, firms and the retail sector). **With a total external debt of \$9.9 billion (as of the end of June), and an expected GDP of \$19.146**

billion in 2000, the burden that the total foreign debt places upon current economic activity comes to about 50 per cent. For the sake of comparison, the boundary value, above which the risk of insolvency grows, that is, above which there is a growing danger of the *medicane turning into poison*, is considered to be the ratio of total foreign debt to GDP of about 30%.

Figure 3: Proportion of total external debt of the national economy in GDP from 1996 to 2000 (end of period).



NB: For 2000, the situation as of the end of June is quoted.
Source: CNB

Finally, the inevitable conclusion arises: although expenditure for pay and contributions will explain about a third of the total expenditure of the national Budget, solutions for the problems of public expenditure have to be sought in reforms of the system of retirement and health insurance. Rationalisation in the civil service, and the nominal pay ceiling can, for example, have a relatively rapid effect, reducing the share of government salaries in overall budgetary expenditure. The same goes for the companies in which the state has majority holdings and in which, after privatisation, the new owners and the market will determine who will be paid, and how much. Apart from that, deferment of the radical reforms of the system of retirement and health insurance is nothing but a policy of waiting until the water level rises to the level of the taxpayer's ears. The question also arises of the policy of the public debt, and the management of the public debt from which this policy has to derive: the essential difference between private and public borrowing is that the advantages or damage that may arise as a result of public sector borrowing affect all citizens, even those, what is more, who have not yet been born. There is not much space in Croatia to wait for better times to make and put into practice the necessary decisions, because the future is tightly linked, in terms of cause and effect, with today's choices. From this point of view, to transfer funds obtained by borrowing or the sale national assets at the moment of consumption is not even to maintain the status quo.