PUBLIC DEBT IN REPUBLIC OF SRPSKA

Ljiljana Jović,
High Business School of Vocational Studies, Novi Sad, Republic of Serbia,
joviclj@hotmail.rs
Branislav Mitić,
ITS Com Trade, Belgrade
mmmbane@gmail.com
Mladen Ivić,
University of Business Engineering and Management, Banja Luka, Republic of Srpska
ivic.mm81@gmail.com
Ljiljana Stošić Mihajlović
High School of Applied Studies, Vranje, Serbia
mihajlovicp@ptt.rs

Original Scientific Paper
doi:10.5937/jouproman5-15347

Abstract: The global crisis has led to the re-questioning of the justification of economic growth based on borrowing. The issue of public spending and public debt has become particularly important for small and opened economies that are not sufficiently competitive on the world market. If one such country seeks to enter the EU, the rules on the amount of total borrowing and public debt can be a significant obstacle. In recent years, Republic of Srpska has been borrowing rapidly, so in the academic community is already concerned about the possibility and price of servicing those debts. The paper gives a theoretical explanation of the public debt and the needs for borrowing, then to set out the rules on debt level limitation. In the final part, the indicators of indebtedness of Republic of Srpska were presented on the basis of the available information, with the conclusion that this is a medium-indebted country, but also a country that is very vulnerable when it comes to maintaining macroeconomic stability and regular debt servicing.

Keywords: *Public debt, budget deficit, Republic of Srpska, debt burden rules.*

1. Public sector borrowing

Public or state debt represents the amount of funds the state borrowed to finance its previous deficits. Public debt can be defined as the accumulated borrowed state money, that is, the sum of all claims that the public sector to its creditors has at a certain moment.

The word "debt" is often used, thinking about and meaning "deficit." The difference between these two terms can be simply explained: If government expenditures are higher than its revenues, the budget shows the deficit that must be financed by borrowing. The amount of deficit increases the debt, and only the surplus can reduce it.

In a narrower sense (from the perspective of fiscal policy), public debt can be observed as a means of financing expenditures that are not covered by tax revenues. In practice, two arguments to justify structural borrowing are often used: a) Since the benefits of long-term public goods financed by borrowing have future generations, it is fair that they also bear part of the investment burden; b) borrowing allows financing of more public investment than it can be financed by taxes.

True, at first glance it seems unfair to finance infrastructure projects (e.g. building roads, railways, etc.) in today's taxpayers' money, but it should be borne in mind that future generations will enjoy from those benefits, since the debt returns for a longer period. For many years, future generations will also be involved in financing these goods.

Today the thesis about the redistribution of debt burden to the future is considered generally accepted, and it is based on a very simple argument: the debt from today is a tax from tomorrow. However, due to forced transfer for payment of debt and interest in the future, a negative impact on the creation of capital and future credible growth is realistic. On the other hand, the budget must and will be solvent in the present and the future, which depends on the amount of total available state revenues, the level of public spending and the amount of public debt that is achieved through skillful management of public finances and the implementation of appropriate economic policy measures in general. Although borrowing is justified by investment needs, public debt today largely represents the growth of public sector spending.

Deficit financing i.e. public debt issuance can be done in several ways. One of them is the issue of securities with the obligation of the issuer to pay off the principal and the related interest in the future. This kind of financing implies that there is a developed financial market and free financial resources in the household and economy sector. If these prerequisites are fulfilled, investment in government bonds is considered to be low-risk investments, and as such has lower yields than investment in other types of securities that are considered to be higher risk and higher interest on borrowed funds. In literature and contemporary practice, it is often emphasized that the emergence of a state as an issuer of securities affects supply of financial capital, interest rate and can lead to the effect of extortion of the so-called. crowding out effect. Financial assets move to the public sector as less risky, leaving less available funds to finance the economy, which negatively impacts the long-term rates of real economic growth.

On developed and stable financial market, the general level of interest rates depends on the supply and demand for capital, and on this basis, when issuing securities, anticipated changes in interest rates in the future. Economic theory suggests that if an increase in interest rates is expected, the issuer will issue securities with a longer maturity, while if interest rates are expected to be shorter, then maturity will be shorter, too. A well-balanced public debt means such a maturity that will not lead the economy to illiquidity and inflation.

However, it should be borne in mind that in a less developed country with underdeveloped financial markets, the impact of government bonds issue appears to be less intense since there are not enough free funds.

The second method of obtaining financial resources, mainly in order to finance investment projects in the long run, is credit indebtedness on the domestic or international market, where banks (domestic or foreign) or international financial organizations appear as lenders.

The public debt owned by domestic creditors is an internal public debt whose repayment represents the redistribution of purchasing power from taxpayers to those who in the previous period were sovereign debtors.

When the state borrows abroad, we are talking about external public debt. With the repayment of funds, the funds are leaving the country, a trade deficit grows and its repayment can have serious consequences on the actual loss of the country's production capacity.

Such borrowing has multiple effects on domestic economy. It exerts pressure on exports because it is necessary to obtain more financial resources in foreign currency, the demand for foreign currency increases which leads to changes in the foreign exchange rate, affects the balance of payments and the country's credit rating as well as its further borrowing. Arrangements with the International Monetary Fund also require changes in the conducting of economic policy in the direction of reducing the deficit and public debt.

This results not only in the savings and rationalization of the public sector, but the overall reduction in public spending can also affect the quantity of delivered public goods, social security of citizens and social peace.

Having in mind previously mentioned circumstances, it becomes clear that public debt has to be carefully managed and that its existence and level of indebtedness can be dangerous for the country and its economy.

It is of utmost importance to determine the actual size of the public debt as well as its structure. The size of public debt is reflected by its share (together with interest rates) in gross domestic product (GDP). Contemporary finances in global terms record an increase in public debt relative to GDP. In modern finance, characterized by an increase in public debt, public debt policy has become an important instrument of economic policy influence and consists of changes in the public debt structure in terms of maturity and ownership.

Public debt can be repaid in three ways: fiscal policy, i.e. taxation where the burden falls on consumption of present generation; domestic borrowing where the burden falls on cash accumulation and burdens future generations or lending abroad; and "printing" of money, which is a monetization of debt. Depending on the choice of funding, the consequences will also depend on the increase in taxes, government borrowing or additional monetary growth. The higher the level of indebtedness, the larger budget surplus is needed which can be achieved by increasing budget revenues or by reducing expenditure.

2. Rules on debt limitation

The convergence criteria or, as they are called, the Maastricht criteria are the requirements that EU member states must meet to start the third phase of the Economic and enter Monetary Union (EMU), i.e. to introduce the euro as the official currency. These criteria have been elaborated pursuant to the provisions of Article 121 (1) of the Treaty on European Union, according to which those Member States which are preparing to introduce a common European currency must meet the following criteria:

- the inflation rate of a Member State should not exceed 1.5 percentage points of the average inflation rate for the three EU countries with the lowest inflation in the year preceding the review of the situation in the EMU candidate country. The inflation rate is measured by the consumer price index,
- the share of the budget deficit of the general government in the gross domestic product (GDP) must not exceed 3% at the end of the previous fiscal year, with the possibility of temporary and small exceeding of this limit,
- the share of gross government debt in GDP must not exceed 60% at the end of the previous fiscal year. If it passes, the debt must show a tendency of significant reduction and must be brought closer to the reference value by satisfactory dynamics, and
- maintaining normal fluctuations within the limits set by the European Monetary System Exchange Mechanism, for at least two years, without devaluation in relation to any currency of a Member State.

Here we can see that the two criteria are related to public finances and public debt management. What's interesting is that the Maastricht criteria have become one of the most commonly used criteria for borrowing and with 25 years since their inception, Deutsche Welle asked myself how are they a specific (www.dw.com) and came up with some interesting answers.

Reporter interviewing Oliver Zifering from the High School of public administration and finance in Ludvigsburg, received the response that the entire story started with arbitrarily certain level of 3% of the permitted State deficit in France in 1982. On the other hand, at the time of negotiations on the establishment of the euro zone, the total debt of most countries was about 60% of the GDP. Taking into account that projected optimal growth is 5%, and the new indebtedness has been defined for the 3% of GDP, three fifths of this new growth is 60 and that's how it came to the numbers of allowed indebtedness of 60%. Later, it was shown that for many countries the projected growth of 5% was not realistic, and therefore the set of limitations sustainability, too.

However, such budgetary rules first violated some of the EU's strongest economies - Germany and France, in the course of the crisis; other countries also began to follow that path. However, it is important to mention that no country has paid the penalties initially provided for by the Stability and Growth Pact (Šabić, A., 2006.).

However, although most often quoted, these are not the only parameters for measuring the indebtedness of a country (Đurić, Marčetić, 2012).Traditional criteria used as a measure of indebtedness indicate the ratio of public debt not only to GDP, but also to exports of goods and services (plus remittances) and the ratio of public debt to budget expenditures. In addition, the repayment of public debt by years is analyzed, whereby repayment of public debt is placed in relation to the same indicators - gross domestic product, exports of goods and services plus remittances, as well as in relation to budget revenues.

The World Bank has three categories:

- Low indebtedness if the ratio of external debt to GDP is below 48%,
- Medium indebted land if the ratio is 48-80%
- Highly indebtedness if the ratio of external debt to GDP is over 80%.

Concerning the ratio of public debt and exports, the low indebtedness is characterized if this ratio is under 132%, the average indebtedness between 132 and 220% and the high indebtedness is characterized by the debt-to-export ratio of 220% and more (Đurić, Marčetić, 2012).

It is considered that all indicators of external indebtedness can be classified into two groups stock and flow indicators (Andrijević-Matovac, V, Jošić, H, 2010).

Stock indicators are:

- Total debt to GDP ratio,
- total debt to export of goods and services,
- foreign reserves and foreign debt ratio,
- short term debt to total debt ratio and
- multilateral to total debt ratio.

Flow indicators are:

- The ratio of repayment of debt to exports of goods and services,
- the ratio of the annual liability for interest on exports,
- the ratio of principal repayment to used loans,
- the ratio of international reserves and repayment of external debt,
- the ratio of net transfers to exports,
- the ratio of net transfers of financial assets from abroad,
- the ratio of used loans to imports and
- the ratio of the annual liability for interest and debt.

The debt is sustainable if the real GDP growth rate is higher than the interest rate on the total debt. If more than 30% of the income from exports of goods and services should be allocated for repayment of debt, there is a real danger that the debt will not be repaid.

According to the IMF criteria, the indebtedness margin is achieved if 25% of the current foreign exchange inflow of the debtor country is to be committed for repayment of the loan.

In addition, relating debt to the original income makes sense because in the debt repayment projection it is necessary to compare the repayment with future own revenues, as the borrower would not be forced to take a new loan in order to return the old one. In any case, in the long run, the growth rate of own revenues should be higher than the increase in borrowing, in order to avoid over-indebtedness.

Below is a table showing the share of debt in GDP of selected EU countries and Republic of Srpska.

State/area/year	2014	2015	2016
Euro area (19 countries)	92	90,3	89,2
EU (28 countries)	86,7	84,9	83,6
Bulgaria	27	26	29,5
Czech Republic	42,2	40	36,8
Germany	74,9	71,2	68,3
Ireland	104,5	76,9	72,8
Greece	179,7	177,4	179,0
Croatia	86,6	86,3	83,7
Italy	131,8	132,1	132,6
Hungary	75,7	74,7	74,1
Austria	84,4	85,5	84,6
Poland	50,2	51,1	54,4
Portugal	130,6	129	130,3
Romania	39,4	38	37,6
Slovenia	80,9	83,1	79,7
Slovakia	53,6	52,5	51,9
Republic of Srpska*	55,8	57,1	56,7

Source:Eurostat
http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina225&plugin=1
* Debt information as of 31.12.2016, Government of Republika Srpska, June 2017,p. 30

From the table it can be seen that the EU countries as a whole, as well as euro zone, recorded a debt-to-GDP ratio of more than 80%, which is a high indebtedness according to the World Bank criteria. In Italy, Portugal and Greece, this indicator exceeds 100%. The smallest debt among the observed EU countries have Bulgaria, Romania and Slovakia.

3. Jurisdiction and debt limitation of Republic of Srpska

The indebtedness of Republic of Srpska cannot be observed separately from its competencies and authorizations, or goods to which public spending is directed. As a part of the wider state union – Bosnia and Herzegovina, Republic of Srpska has wide powers of economic policy pursuing, but with certain limitations that come mostly from the conduction of monetary policy according to the currency board principle, which means the inability to monetize public debt. In addition, there is the fact that the regulation of indirect taxes, that are the most sophisticated, is not within its jurisdiction. This suggests that the potential for growth in public spending based on growth in tax revenues is limited.

Public sector expenditures relate to the competencies, assigned to entities in within state arrangement of BiH. The competencies of the entity include functions such as: conducting certain economic and fiscal policies, regulation of financial institutions, reconstruction programs, highways and railway lines, production and distribution of electricity. Since the Republic of Srpska is centralized, in addition to the level of the Republic, public services are also delivered by local governments – municipalities and cities, whose responsibilities we can be own, transferred and shared. As exclusive, the municipality's own, competencies may include the following: urban planning, utility services, preschool education, material maintenance of primary and secondary education facilities, organization of transport for pupils and teachers, physical education, outpatient services, health care, culture, sport, maintenance of libraries facilities, parks and city traffic signalization. In addition to these, municipalities have also been assigned responsibilities for local politics and local roads.

These functions should be financed from municipalities' own revenues.
The delegated municipal functions mainly relate to social protection, care for refugees and displaced persons, assistance to the elderly and the sick and orphans.
The joint competencies of the central government and local self-governments in Republic of Srpska are financing and administration of a part of education, as well as health and social care services.
Republic of Srpska, as well as BiH, are signatories to the European Charter of Local Self-Government, which means that the laws in force allow for municipalities and cities to borrow. This is especially important since their debt is calculated within total debt of the Republic, as well as due to the fact that the rules on debt limitation must also apply to local governments. In addition, the public sector of the Republic of Srpska consists of four other social security funds: The Health Insurance Fund, the Pension and Disability Insurance Fund, the Fund for Unemployed and the Child Protection Fund. The debt of all levels of government and social security funds is the public debt of Republic of Srpska (Law on Debt, Debt and Guarantees).

In addition, the public sector includes the Investment and Development Bank of the Republic of Srpska, as well as public enterprises that are in the majority or complete ownership of the Republic. When their debt is added to the public debt, we get the total debt of the Republic of Srpska. The borrowing procedure and the new indebtedness are regulated by the relevant laws. All public-sector actors can borrow in the country and abroad. Debt techniques are loan agreement or bond issue. The level of borrowing is limited, since Republic of Srpska has imposed the following restrictions (Law on Debt, Debt and Guarantees):

- The total debt at the end of the fiscal year should not exceed 60% of GDP in the observed year,
- Public debt at the end of the fiscal year cannot be exceed 55% of GDP in that year,
- In addition, a limit on short-term debt, which cannot exceed 8% of regular income of previous year,
- Total exposure of the Republic of Srpska's budget to issued guarantees cannot be exceed 15% of GDP in that year.

It should be noted that, according to the valid legal solutions, the debt of the Republic of Srpska based on financing the reimbursement of damage from the unique register of damages, was defined by the Law on the Solidarity Fund for the reconstruction of the Republic of Srpska, and itis excluded from the limits set for the total and public debt of the Republic of Srpska. That debt is dealing with the damage caused in the floods of 2014, which have hardly hit the territory of Republic of Srpska. As a special type of debt controlling mechanism, that can be named as the political limitation of indebtedness, can be stated the fact that the law regulates impossibility to create a direct debt of the Republic, as well as indirect debt which implies borrowing of the Republic on behalf of and for the account of another public sector entity or take the guarantee, unless the National Assembly of the Republic of Srpska has given its consent.
In addition, debt limits for local government units are defined, such as (Debt and Guarantee Act):

- The local self-government unit can only be indebted in the long run if, in the period of the creation of the debt, the total amount due for repayment, by the proposed debt and the total outstanding debt, in any subsequent year is not more than 18% of the amount of its regular revenues realized in the previous fiscal year.

- Short-term debt cannot at any time exceed 5% of regular income realized in the previous fiscal year.
- The total exposure of a local self-government unit under the issued guarantees cannot be higher of 30% of the amount of regular income realized in the previous fiscal year.

The local self-government unit can be indebted only on the basis of the decision of the local self-government assembly and with the previously obtained approval of the Ministry of Finance. All the provisions on debt limitation pertaining to local self-government units also apply to social security funds, except for provisions relating to guarantees, as social security funds are not allowed to issue guarantees.

4. Debt of Republic of Srpska information

The total debt of Republic of Srpska as of December 31, in the amount of KM 5,439.98 million[1] (Government of Republic of Srpska, 2017) and refers to:

- Debt of Republic of Srpska (budget) in the amount of 3,792.61 million KM,
- Debt of local self-government units in the amount of KM 372.30 million,
- Social security funds in the amount of KM 181.96 million,
- Debt of public enterprises and Investment Development Bank RS in the amount of 1,093.11 million KM.

It follows that the public debt is KM 4.346,87 million.
According to the structure of total debt, external debt amounts to 3.167,97 million KM of which:

- Debt of the Republic of Srpska budget: 1,988.22 million KM,
- The debt of local government units amounts to 86.64 million KM,
- The debt of public enterprises and IRB amounts to 1,093.11million KM.

By the structure of debt, the largest share has a convertible mark of 41.77%, then Euro 31.51%, US dollar 2.67%, and Special Drawing Rights of 19.57%.
Total internal debt refers to:

- Debt of Republic of Srpska (budget) in the amount of 1,804.39 million KM,
- Debt of local self-government units in the amount of KM 285.66 million KM,
- Social security funds in the amount of KM 181.96 million KM.

By maturity, 98.33% is long-term debt and only 1.67% is short-term.
Since, according to the preliminary data of the Institute of Statistics of Republic of Serbia, GDP in 2016 was KM 9,528 million, and the debt limitation indicators are as follows:

1. Total debt/GDP:
   - Total debt that does not meet the limit/GDP – 57.09%,
   - Total debt subject to limitation/GDP – 56.66%.
2. Public debt/GDP:
   - Public debt that does not meet the limit/GDP – 45.62%,
   - Public debt subject to limitation/BDP – 45.19%.
3. Total short-term debt amounts to KM 88 million, which makes 5.47% of budget revenues realized in 2015.
4. The exposure under the given guarantees amounts to KM 346.31 million, which makes 3.63% of GDP.
5. The external debt relative to GDP – 33.24%.
6. The external debt in relation to the export amounts to 110.56%.
7. Foreign debt servicing in relation to exports amounts to 8.98%.

[1]Official exchange rate is 1 BAM = 1.95583 EUR

Conclusion

Based on the above, we can identify elements of good debt management:

- The law defines restrictions on the total indebtedness of all levels of government,
- at all levels of government, restrictions on exposure to guarantees are defined,
- the debt structure of the debt is good because more than 98.33% of the debt is long-term,
- about 60.33% of the total debt is under fixed repayment terms,
- the currency structure of the debt is acceptable because in it most of it is taken by the KM and the Euro for which it is bound,
- any indebtedness and giving guarantees require a compliance from a competent legislative authority that provides political control,
- the records are kept for which transparency is ensured,
- the government is developing strategic documents for debt management.

Based on these indicators, we can conclude that Republic of Srpska belongs to medium-indebted countries according to the criteria of the IMF and the World Bank. However, it should be kept in mind that in over 50% of cases, the debt crisis erupted when the external debt was below 60% of GDP, although according to the defined criteria, the country is considered to be the middle indebted. Moreover, in some countries, creditors are withdrawing even if the debt level is below 40% of GDP, if lenders consider the country insecure and has a bad history of debt repayment and inflation. (Marčetić, Đurić, 2012). Another danger to be kept in mind is the flow indicators. We have mainly focused here on the indicators of stock, however, it is very important that indicators are observed in the longer term and from the dynamic point of view. Here, the key purpose of the funds taken, the growth rate of GDP, and the volume of foreign trade are key. On the other hand, it is necessary to evaluate whether the fiscal burden is at an optimal level, i.e. to determine whether taxes impair the economy and whether repayment of loans in the medium term is possible, without their refinancing.

References:

[1] Ralašić, M.: *Javni ili državni dug;* Financijska praksa 17 (4), 381-383; Institut za javne financije, Zagreb
[2] http://www.dw.com/sr/ugovor-iz-mastrihta-papir-trpi-sve/a-37439170
[3] Šabić, A., 2006. "*Reforma pakta o stabilnosti i rastu“*. Financijska teorija i praksa 30 (3), 283-293.
[4] Marčetić, M, Đurić, O, *Analiza duga Republike Srbije i njegove metodološke odrednice*, Časopis za ekonomiju i tržišne komunikacije, 2012, str.274-291.
[5] Andrijević-Matovac, V, Jošić, H, 2010, *Održivost vanjskog duga Republike Hrvatske*, Zbornik Ekonomskog fakulteta u Zagrebu, 193-209.
[6] Law on Borrowing, *Debt and Guarantees*, Official Gazette of Republic of Srpska, 71/12 i 52/14
[7] Government of Republic of Srpska, *Debt information as of 31.12.2016*, Banja Luka, 2017.