Institute of Public Finance

NEWSLETTER

AN OCCASIONAL PUBLICATION OF THE INSTITUTE OF PUBLIC FINANCE

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no. 54 | March 2011 | ISSN 1333-4263

Capital investment plans and local government debt in Croatia

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The Republic of Croatia is a fiscally centralised country with the lowest local unit debt in Europe and fairly restrictive borrowing criteria for local units. In order to be able to make high quality decisions concerning future borrowing, the finding of alternative sources of financing and a more realistic setting of criteria and budgetary constraints it is high time to draw up a unified review of the programmes of capital investments financed from central and local government budgets and of central and local government companies. The findings of the State Audit Office also indicate the need for such an approach.

1. INTRODUCTION

Croatian governments to date have not drawn up lists of capital investments either at central or at local government level. Only in 2000 did there exist a list of capital projects with sources of funding for the period 1996-1999. In the years after this report there was no such report, nor did the governments have any integral discussion of capital investment plans for the public sector over the long term (per government sector). Nor does such a unified list exist for local unit infrastructure projects. This involves extra work, but the centralisation of information about projects at central and county government level would contribute to a more realistic ascertainment of the requirements of central and local unit government for debt financing for capital projects and would assist in the choice of other desirable financing instruments. Demands for the financing of capital projects would have to come up against the existing debt obligations of central and local government and of their companies. The creation of a register of capital projects at central and local government level is not complicated thanks to budgetary planning according to programmes that has already been brought in and to the classifications of local and central budgets according to programmes and sources of financing. The obligation to keep a register of capital projects at central government level could be taken on by the Ministry of Maritime Affairs, Transport and Infrastructure or the Ministry of the Economy, while for local units the Ministry of Regional Development, which takes care of the harmonisation of regional development policies, could be made responsible. It could also be taken on by the State Audit Office, which anyway carries out financial and effectiveness audits of local units and public sector institutions. The Audit Office report for 2009[1] reveals possible reasons for such an approach, which would be of assistance in a more realistic setting of limits to the borrowing of local units.

2. LOCAL GOVERNMENT DEBT

The Budget Law (OG 87/08) governs the borrowing of, and central government guarantees for the borrowing of, local units. Local units can take on debt by taking out credit lines, loans and issuing securities if their revenues and operational expenditures are in balance. Over the long term they can take on debt only for investment financed from their own budget, certified by the representative body, with the consent of the Government and at the recommendation of the finance minister. Local units may not borrow on behalf of their institutions and local economy firms, but without the consent of the Government they can guarantee that companies and the public institutions of which they are the founders or

1 State Audit Office (2010), Report on the work of the State Audit Office for 2010. Accessible at: http://www.sabor.hr/Default.aspx?art=37337

majority owners will meet their obligations. In this case they are bound to inform the Ministry of Finance about the amount of the guarantees issued.

The debt of local units consists of direct debts of local unit budgets together with the borrowing of companies they own from commercial banks and the Croatian bank for reconstruction and development (CBRD) and capital market bond issues. The local units work with their companies like connected vessels, and there is no need to consider their debt separately, nor is there any obstacle in the way of formalising their status in the public sector system (by changes to the Companies Law) and to pronounce them extra-budgetary spending agencies of local units. The total debt of local units in 2009 came to 6 billion kuna, which was a reduction of 200 million since the previous year (see table 1). This was on the whole the result of the reduction of the debt of local companies. In the structure of local unit debt, guarantees are dominant, that is the liabilities for loans of companies they own. Loan liabilities and bonds increased as a proportion of the total debt of local units.

Table 1

Total debt of local units (in billion kuna and in %)

	2008	2009	Indeks
Loans and bonds	2.6	2.9	113
Guarantees	3.6	3.1	85
Total	6.2	6.0	97
	Debt in %		
Loans and bonds	42	49	
Guarantees	58	51	
Total	100	100	

Source: Author's computation from information supplied by the State Audit Office, 2010

The total direct debt of local units in loans and bonds rose while the active guarantees to local companies fell. The debt of local units expressed as a proportion of GDP and in total public debt (debt of general government augmented by local and central government guarantees) is not large and is reducing (see table 2).

The direct debt and the guarantees of local units are falling as percentage of total government (central and local) guarantees and of the direct debt of general government.

Table 2

Debt of local units in 2008 and 2009 (% of GDP and % of public debt)

	2008			2009		
Local debt	**Loans and bonds**	**Guarantees**	**Total**	**Loans and bonds**	**Guarantees**	**Total**
% of public debt	2.58	9.66	4.51	2.49	7.43	3.77
% of GDP	0.76	1.09	1.81	0.88	0.92	1.80

Source: author's computation from figures supplied by the State Audit Office, Finance Ministry, Croatian Bureau of Statistics

Eurostat figures on the direct debt of local units as percentage of GDP (loans and bonds, not including guarantees to local government-owned companies) show that the total direct debt of Croatian local units is not large and is the smallest of all the countries considered (see table 5, annex). The direct debt of local units of 26 European countries constitutes on average 5.6% of GDP, while that in Croatian comes to about 0.6% of GDP according to Croatian Ministry of Finance data or 0.9% of GDP according to State Audit Office data. The total debt of Croatian local units (loans and bonds augmented by guarantees) is only 1.8% of GDP, and still among the lowest in Europe.

The existing level of local unit debt shows that budgetary borrowing constraints are over-restrictive. This is the consequence of a poor overview of the amount, structure and source of financing of capital investment. There are several reasons for this: the absence of any complete programme of capital investment at the level of central government; weakness in the drawing up of programmes of capital investment at the county, city and municipality level; and poor financial coordination. Coordination of financing is necessary, for most of the capital projects of counties, municipalities and cities are co-financed by the competent central government ministries and public corporations, in particular Croatian Water.

COUNTIES DEBT

Much of the overall debt of local units is concentrated in the city of Zagreb, the Primorska-goranska, Splitsko-dalmatinska, Zagrebačka and Istarska counties (see graph 1). Local units guarantee the loan liabilities of their companies, and these are the real debt liabilities of companies (see graph 2). The city of Zagreb is in the lead in terms of the amount of guarantees issued, which are actually the debts of the municipal companies. The active guarantees of the city of Zagreb, 1.2 billion kuna, greatly exceed its direct liabilities. The liabilities of the companies of Osječko-baranjska (380 million kuna) and Primorsko-goranska and Splitsko-dalamatinska counties (more than 200 million kuna) are much lower. The other local units have not issued any very significant guarantees.

Direct borrowings of local units are substituted for by the borrowings of utility companies (see graph 3). In seven counties, local units have on the whole borrowed via their companies, and their debt amounts to more than 50% of total debt (particularly in these counties: Osječko-baranjska, Dubrovačko-neretvanska, Sisačko-moslavačka, Zagreb city, Šibensko-kninska, Karlovačka, Međimurska and Varaždinska). In some of the counties the total liabilities of local units are not large, but they are on the whole created by the companies. It can be said that a large number of local units have avoided direct borrowing, preferring to take on debt via their majority-owned firms. On the other hand, local units in thirteen companies have on average shown themselves more inclined to finance capital projects by direct borrowing.

In short, by summing all the loan liabilities of local government units with their companies it becomes clear that the main generators of debt are the city of Zagreb, the Primorsko-goranska, the Splitsko-dalmatinska and Osječko-baranjska counties (see graph 2). The total per capita debt of local units again shows great inequality in the burden of debt servicing (see graph 5). Most burdened by local unit and utility firm debt are the inhabitants of Zagreb and the Primorsko-goranska county; after them come inhabitants of the Šibensko-kninska, Dubrovačko-neretvanska, Zadarska and Osječko-baranjska counties. The lowest burden of debt is borne by the inhabitants of the Brodsko-posavska, Koprivničko-križevačka, Zagrebačka, Krapinsko-zagorska Varaždinska and Vukovarskao-srijemska counties.

3. BORROWING WITH THE CONSENT OF LOCAL GOVERNMENT

Analysis of debt show that there is a need to coordinate sensible local unit borrowing with coordinated planning of capital investment bringing together local budgets and utility companies. The preparation of harmonised capital programmes of investment at local unit level uniting the counties would be a step forward in determination of borrowing needs and the running of a harmonised policy for the financing of public requirements.

The absolute need to draw up such plans (programmes) of capital investment is still more patent when one takes into account the borrowing of institutions and companies with the consent of the local units, which can, as well as debt borrowing and given guarantees, give consent to the borrowing of their institutions and companies. Of course, these consents to not have to be used in the first year they are issued, but do represent in principle the agreement of local units to their institutions and companies getting into debt for the sake of financing capital projects. The implementation and financing of these projects might last a dozen years and, judging from county level experience, are usually fitted into some conception or programme of capital investment in given municipal economy sectors (water supply for instance). The probability of these consents being put into practice depends on the budgetary restrictions set and also on the autonomous decisions of the utility forms to take on debt.

Consents for borrowing on the part of institutions and utility firms came in 2009 to 5.8 billion kuna (see table 3), which was about 191 million kuna lower than in 2008. Local units approved new debts, and used some of the consents for new borrowings.

Table 3

Borrowings of institutions and companies with the consent of local units (in million kuna)

	Consents in million kuna
31/12/2008	6,046
Consents given in 2009	250
Repayments in 2009	441
State as of 31/12/2009	5,855

Source: State Audit Office, 2010

Judging from the findings of the State Audit Office, consents for the financing of capital projects by borrowing are large: they refer, above all, to the borrowings of companies in Zagreb and the Primorsko-goranska and Istarska counties (see graph 6). A full 90% of all consents relate to the institutions and companies of these counties and of the city of Zagreb, that is, 5.3 billion kuna. Zagreb gave consents to companies in its Holding to the tune of 3.8 billion kuna; Primorsko-goranska gave about 800 million kuna, and Istarska county about 680 million kuna. A mere 10% of all consents (about 500 million kuna) were spread out among 14 counties, and local units in four counties (Vukovarsko-srijemska, Osječko-baranjska, Ličko-senjska and Zagrebačka) issued no consents whatsoever to their institutions and companies.

There are three possible scenarios for new borrowings.
1. Some of the local units (city of Zagreb, Primorsko-goranska and Istarska counties) have prepared development projects and capital investment programmes that they cannot finance from their regular revenue. Such

projects are waiting to be put into practice and the first possibility of implementation by borrowing, using any of the models of public-private partnership or a combination of joint-financing from the local budget, companies, ministries and public companies of central government.

2. Most of the counties and their local units are not capable of preparing, planning and drawing up development programmes of capital investment with designated possible sources of financing, nor can they coordinate the plans of local units with the development plans and strategies of the county.

3. Local units do not give consents to borrowing because of low fiscal capacities, and expect financing or a greater share of joint-financing of capital projects from the central government via the mediation of the competent ministries or public corporations (for example, Croatian Water).

Notwithstanding the existing state of affairs, coordinated plans of capital investment at the level of central and local government would help to reduce risk in the financing of long term capital infrastructure projects. The example of the city of Krk and island municipalities in the Primorsko-goranska county water supply project vividly shows the essence of the problem.

In the Concept for the development of water supply on the island of Krk 2001-2012, capital projects are financed via the utility firm Ponikve d.o.o. Also taking part in the project are Krk city and the municipalities in proportion to their shares in the company (city 26% and municipalities 74%). The Government agreed to joint financing of the programme through the Ministry of Construction and the public corporation Croatian Water. In total, for the implementation of the project for 2001-2008, 114 million kuna were provided, and for 2009-2012, another 165 million were earmarked.

Resources for the financing of the project from 2009 to 2012 were provided by city and municipalities from revenue from income tax that the central government refunds to local units on islands. Some of the resources are provided from the budgets of the local units in proportion to their shares in the equity of the utility firm, and some from its amortisation. Additional funds for the project can be provided by long-term borrowing of the utility firm, to be repaid by 2020 by funds from the special-purpose increase in water charges, while some of the funds have to be provided by Croatian Water and the line ministry.

Should the said ministry and Croatian Water not provide funds for the programme of this capital investment, they will be provided by long-term financial borrowing of the utility company, and the repayment of this long term loan will be provided from an increase in the water charge for this purpose, to be charged to consumers, up to the final repayment of the loan, by the end of 2020 at the latest.

In this case, the implementation of the project is threatened by four risks: 1. uncertainty as to whether the public corporation and the ministry will actually take part in the financing; 2. uncertainty about the possibility of new borrowing because of budgetary restrictions; 3. uncertainty concerning debt servicing in spite of increase of the water charge; 4 unknown reaction of consumers to the increase in the water charge.

All these risks can threaten the implementation of the programme to supply local island units with water.

4. ARE BUDGETARY CONSTRAINTS ON THE BORROWINGS OF LOCAL GOVERNMENT UNITS REALISTIC?

Total annual debt of a local unit (municipality, city, county) can come at most up to 20% of revenue achieved in the preceding year. [2] The total annual liability includes the amount of the average annuity (loans and credit lines), liabilities on bonds and consents for the borrowing of legal entities majority owned by the local unit and institutions founded by the local unit, as well as due but outstanding liabilities from previous years. With the consent of the Government, the county can give a guarantee to a municipality or city in its area, and this is included in the scope of borrowing of a local unit. A local unit can give a guarantee to a legal entity of which it is majority owner, and this guarantee too is included in the scope of possible borrowing of a local unit

The Government and Finance Ministry have over the course of time brought in additional restrictions, shown in table 4.

In certain years the real amount of direct borrowing of local units exceeds the budgetary constraints. However, in the last two years considered, local units have shown no very great interest in borrowing, and have not even used up the possible annual quota for borrowing. In the case of existing budgetary constraints on the borrowings of local units there are two linked problems.

2 Budgetary revenue obtained means revenue of a local unit diminished by receipts from domestic and foreign aid and donations, special contracts (citizen joint financing for local self-government) and revenue acquired from additional shares in income tax and equalisation aid for financing decentralised functions.

Table 4

Budgetary constraints on the borrowings of local units, 2004-2009

	2004	2005	2006	2007	2008	2009
Set % of opening revenue	3	2	2	2.3	2.3	2.3
Budgetary constraint (million kuna)	413	298	330	430	499	570
Annual amount of real direct borrowing (million kuna)	681	314	314	520	448	496

Source: author's computation.

First, over-restrictive budgetary constraints, in which all the liabilities of a local unit are included (direct and guarantees for firms), of the kind that do not exist in the case of borrowings by central government and its majority owned firms. While the annual liabilities of local units and their companies are restricted to 500 million kuna, the debt of the 52 companies owned by central government grew in a single year by 3 billion kuna (from 54 billion in 2008 to 57 billion in 2009). Government guarantees (not including CBRD guarantees) for the debts of central government firms grew by 4.4 billion kuna (from 33.8 in 2008 to 48.2 billion in 2009), and yet in local units, the same kind of guarantee was reduced by 500 million kuna (from 3.6 billion in 2008 to 3.1 billion kuna in 2009).

Secondly, because of the uneven criteria for borrowing, local units might deliberately infringe the set budgetary constraints and resort to the financing of capital projects by borrowing via their companies, exposing themselves to additional responsibility to central government bodies.

The reasons for such great restrictiveness in the borrowing of local units might be as follows:

- When the Government's guidelines for economic and fiscal policy are drawn up, representatives of local units do not take part nor do they clearly show any need for increasing their share in the annual needs for borrowing for the sake of financing capital projects.
- Representatives of local units in associations of cities, municipalities and counties do not define their requirements and take part too little in the creation of that part of fiscal policy that relates to the financing of local units.

But the real cause is there being no clear insight into the existing state of capital investment and sources of financing at the level of central government and local units. This is directly felt by local units that are set too restrictive borrowing criteria, which restricts their ability to decide independently on the conception of development and the financing of local economy infrastructure.

5. CONCLUSION AND RECOMMENDATIONS

The objective of this analysis is to indicate the need to ascertain the real state of capital investment at the local and central government level and to induce the competent government bodies and counties to draw up long-term programmes of capital investment. Integral programmes to unite competent ministries and counties are a precondition for the ascertainment of real financial requirements. The objective is to determine the combination of desirable financing instruments and more realistically to set budgetary constraints on the borrowing of local units and their utility firms.

The existing system for financing capital projects of local units by borrowing simply does not enable long term development, attenuates the financing and planning horizon to a single or to two years and does not help in any more realistic determination of annual needs for borrowing or joint financing.

Central government has strongly restricted local unit borrowing and indirectly stifled local unit initiatives.
A quality plan for capital investments clearly cannot be prepared partially, without the competent bodies of central government that jointly finance projects directly or via public companies and in collaboration with local units and their utility companies.

RECOMMENDATIONS TO THE GOVERNMENT

- Draw up a list of capital public investment with sources of financing for the period 2000-2011.
- Draw up a plan and programme for public capital investment for the period 2011-2020.
- On the basis of a plan, draw up a framework and requirements for public sector borrowing by company, central government budget and local unit budget.
- Define annual requirements for borrowing at the level of the public sector make concrete the precise share of local units.
- Review existing and set more realistic budgetary restrictions for the borrowing of local units.
- Encourage local units to draw up their own plans for capital investment.

RECOMMENDATIONS TO COUNTIES, MUNICIPALITIES AND CITIES

- Draw up a review of county-level capital investments of local units and their companies for the 2000-2011 period.
- Draw up plans of capital investment for the 2011-2020 period, to be financed from their own budgets and firms.
- Ascertain possible sources of financing: borrowing, public-private partnership, joint financing from central government budget and revenues of firms owned by central government and possible assistance from EU funds.
- Via associations of cities, municipalities and counties to lobby the government to take an active part in the definition and drawing up of guidelines for economic and fiscal policy to set the amount to which local units can borrow.

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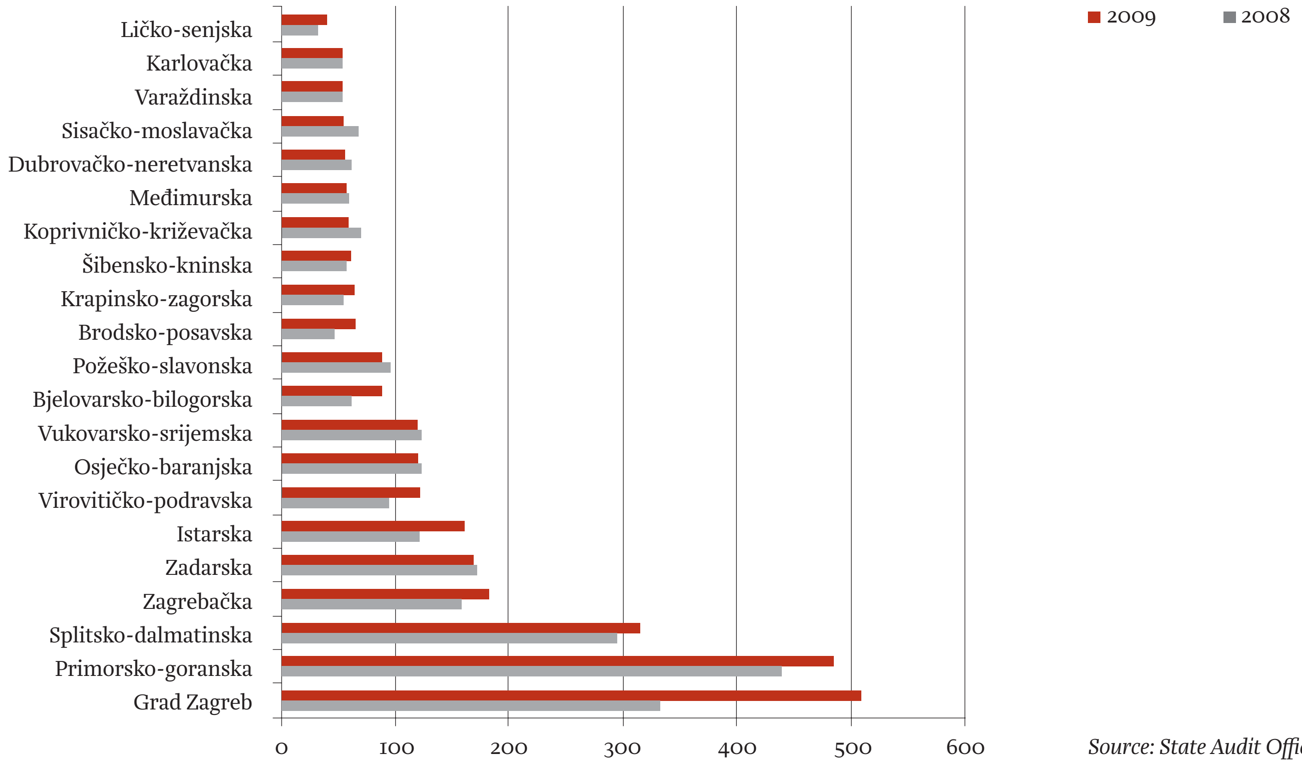
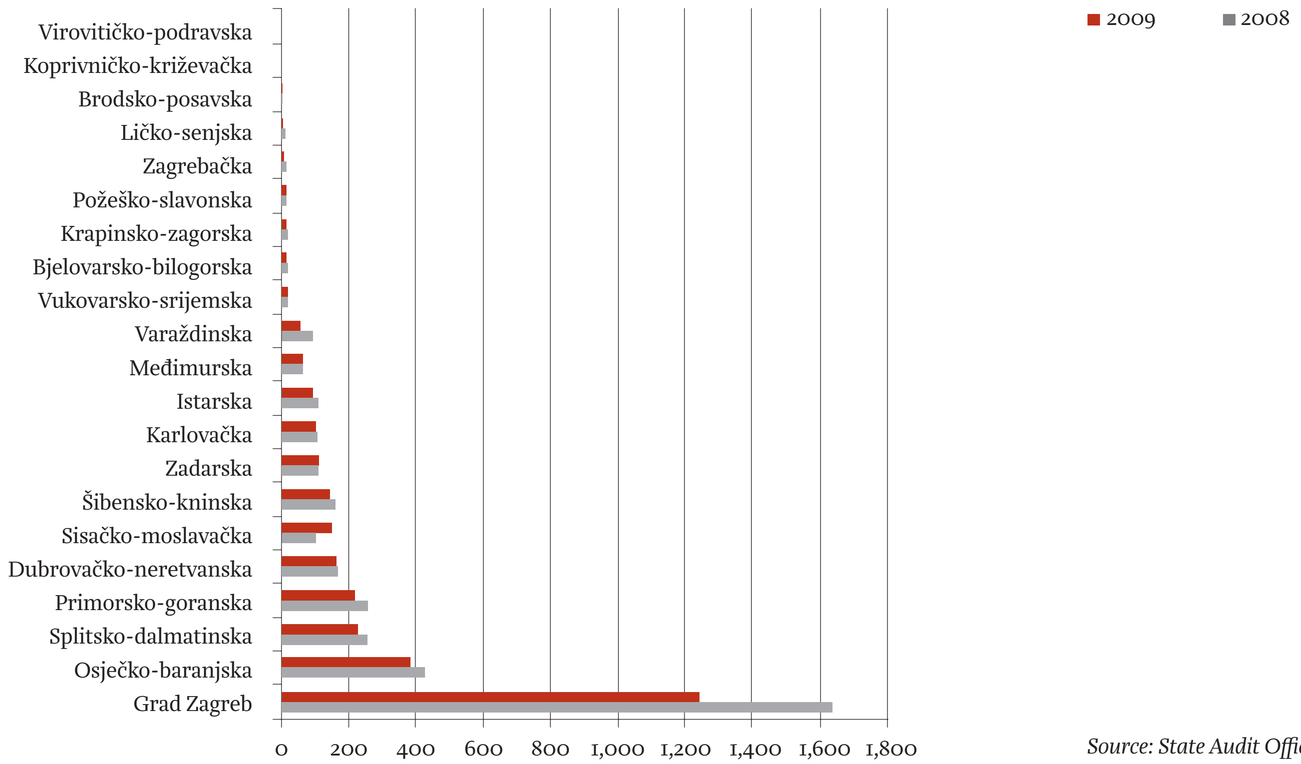
Annex

Graph 1
Direct debt (loans and bonds) of local units per county (in million kuna)



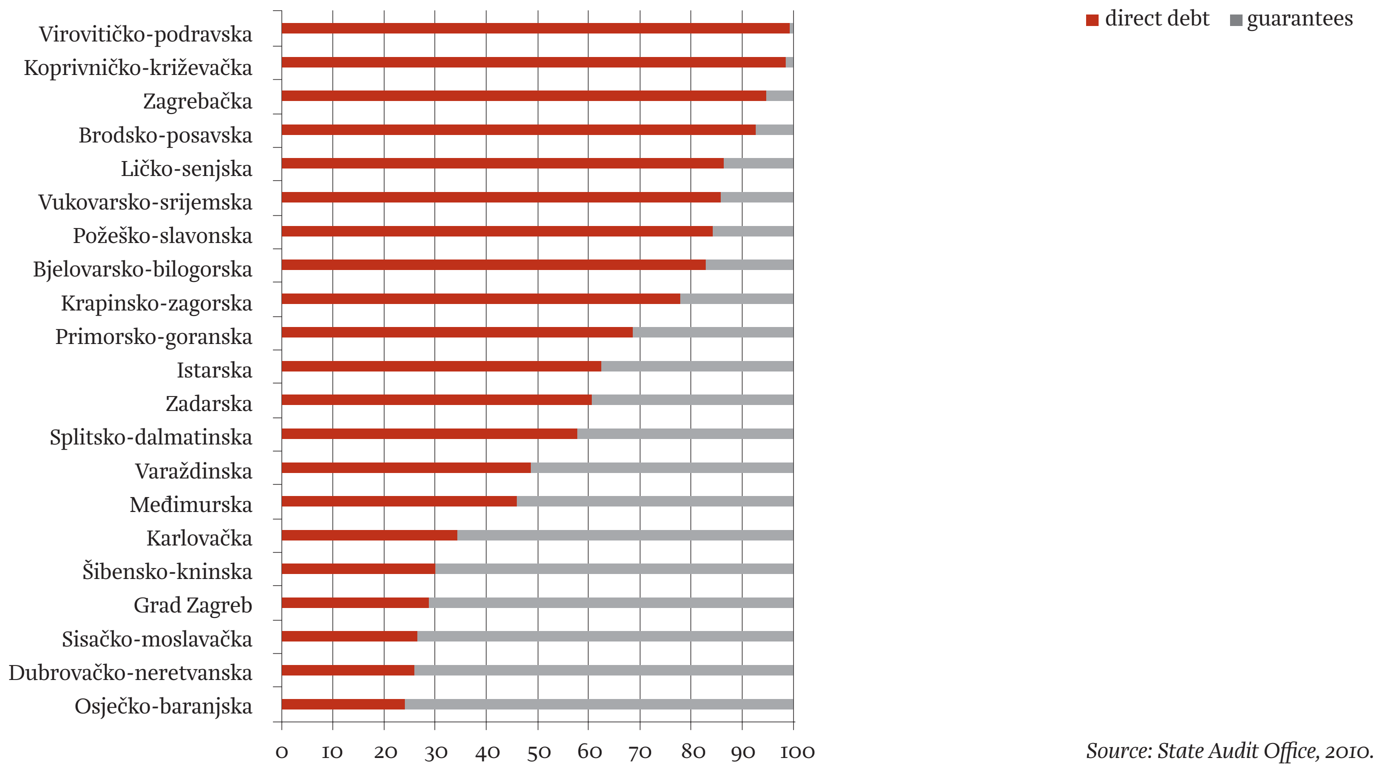
Source: State Audit Office, 2010.

Graph 2
Active guarantees for the borrowings of local units and their companies per county (in million kuna)



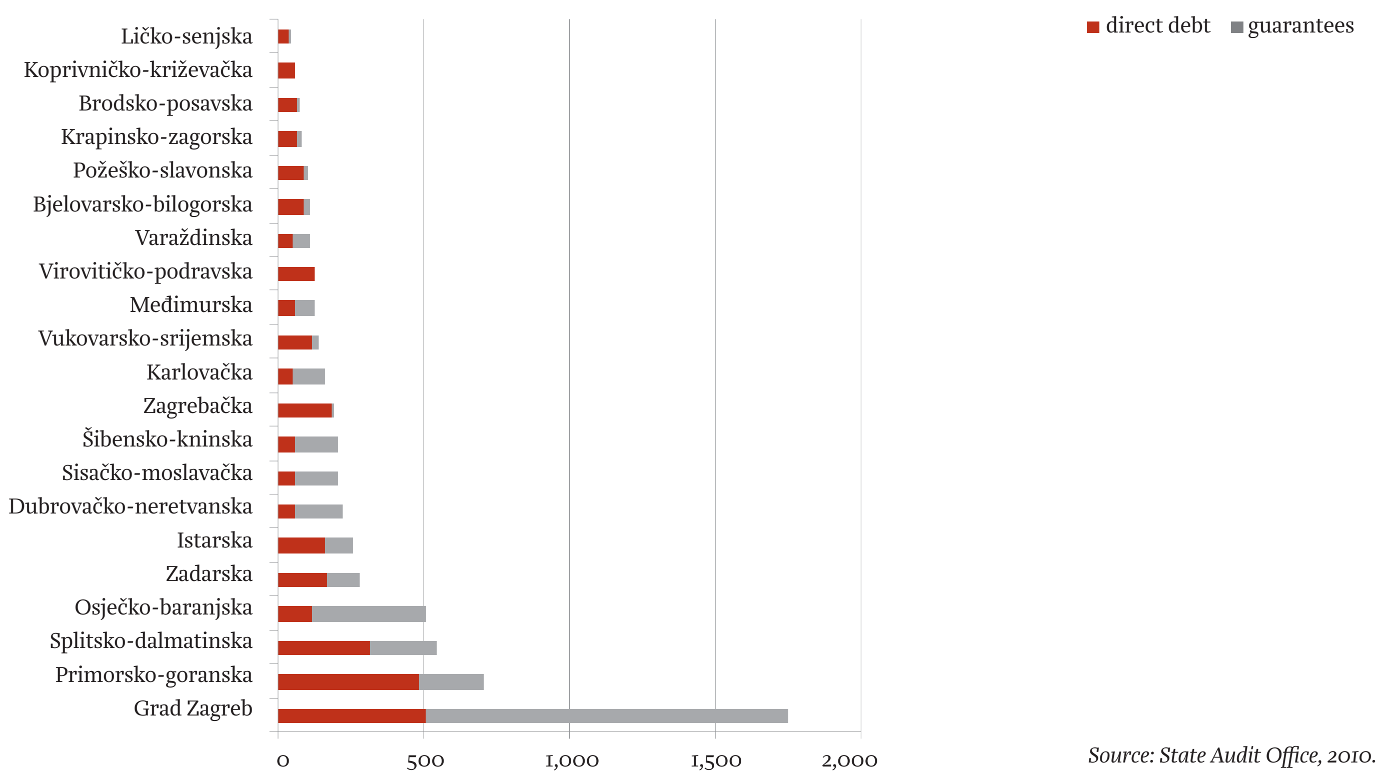
Source: State Audit Office, 2010.

Graph 3
Structure of the debts of local units per county (in %)



Source: State Audit Office, 2010.

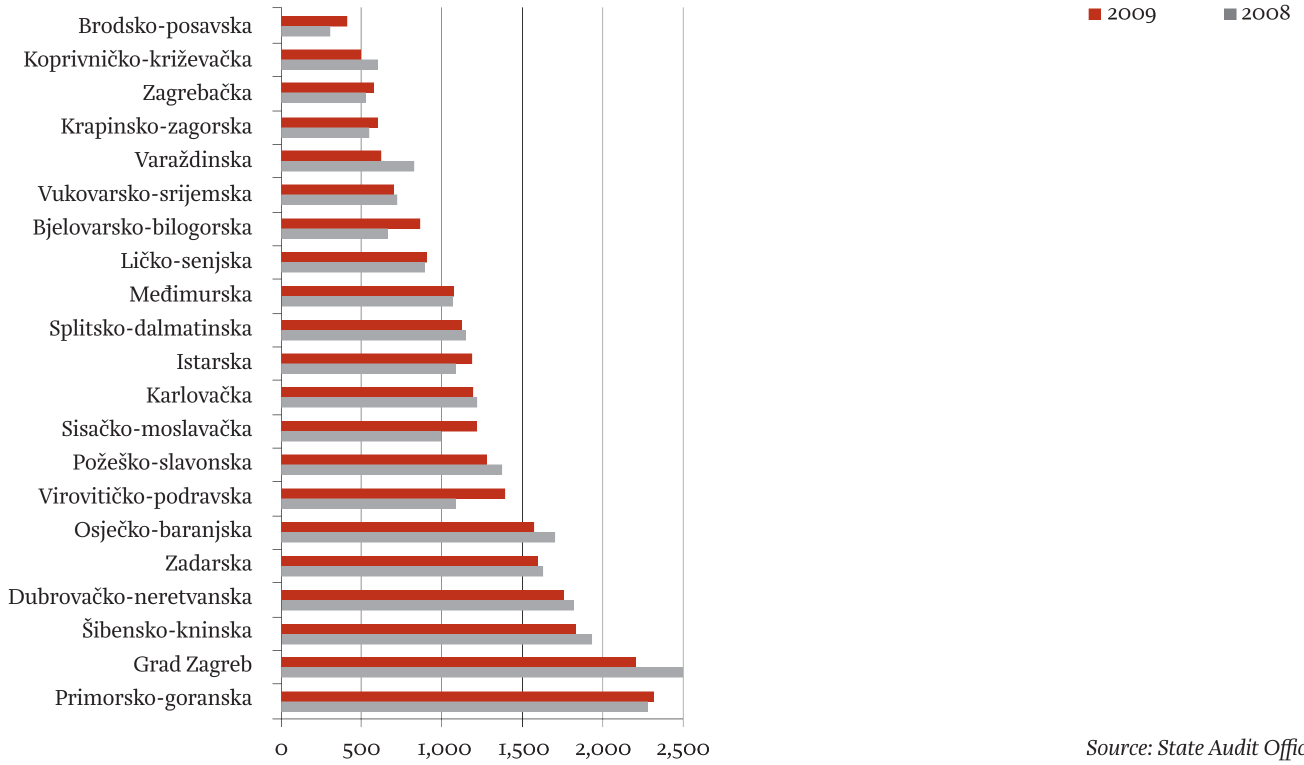
Graph 4
Total debt of local units per county (in million kuna)



Source: State Audit Office, 2010.

Graph 5

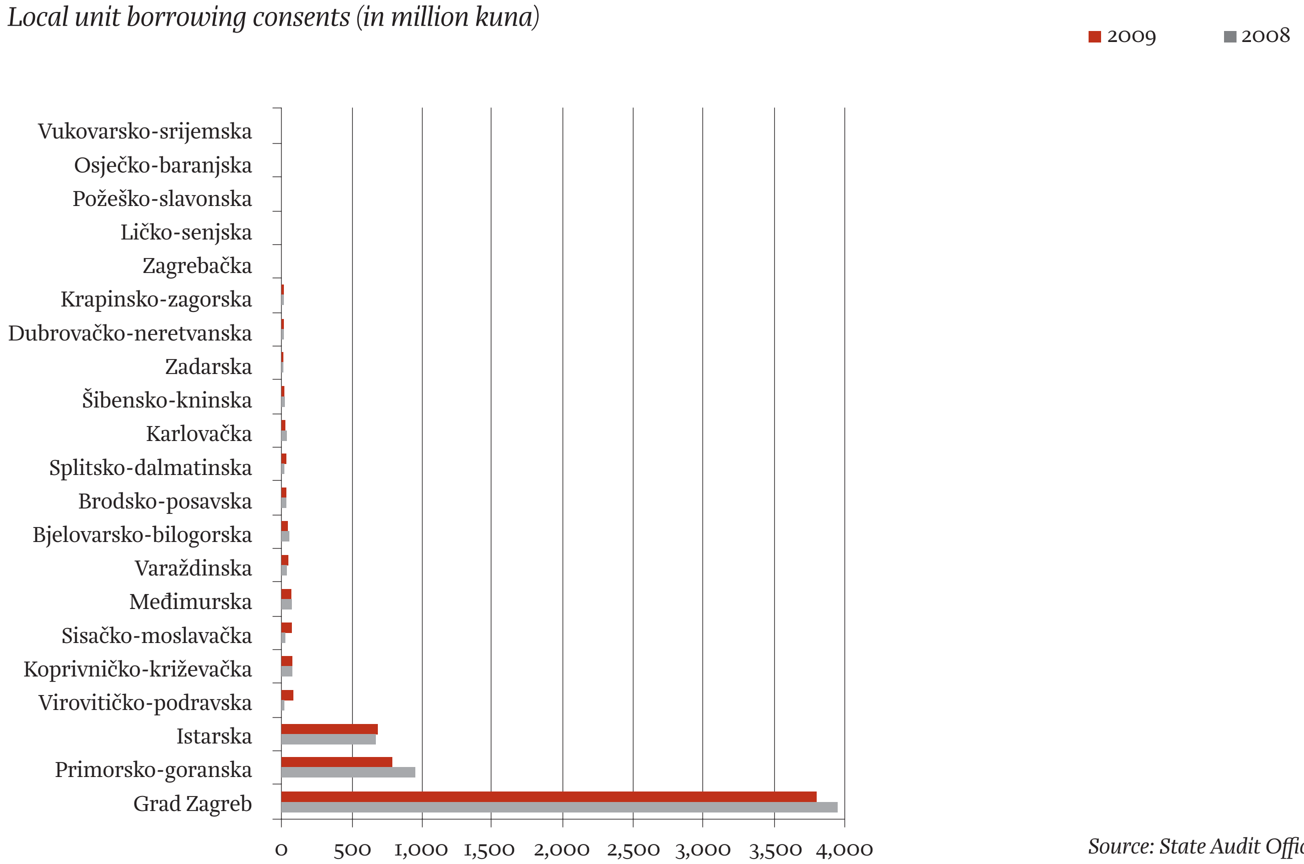
Total per capita debt of local units (in kuna)



Source: State Audit Office, 2010.

Graph 6

Local unit borrowing consents (in million kuna)



Source: State Audit Office, 2010.

Table 5

Local government debt in European countries in % of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
EU (26 countries)	5.2	5.1	5.0	5.1	5.1	5.3	5.3	5.1	5.1	5.7
Belgium	5.2	5.5	5.4	5.4	5.4	5.2	5.2	5.0	4.8	4.8
Bulgaria	0.4	0.4	0.1	0.2	0.2	0.4	0.5	0.6	0.7	1.0
Czech R	1.6	1.7	2.0	2.3	2.6	2.7	2.7	2.5	2.5	2.7
Denmark	4.8	5.0	5.3	5.5	5.9	5.8	6.0	6.1	6.3	7.2
Germany	4.9	4.9	4.9	5.2	5.3	5.4	5.3	4.9	4.8	5.1
Estonia	1.9	2.0	2.3	2.6	2.5	2.6	2.8	2.7	3.2	4.0
Ireland	1.7	2.0	2.4	2.4	2.4	2.4	2.2	2.5	3.0	3.4
Greece	0.5	0.5	0.5	0.6	0.7	0.7	0.7	0.7	0.7	0.8
Spain	3.1	3.0	3.0	2.9	2.9	2.8	2.8	2.8	2.9	3.3
France	7.4	7.1	6.8	6.9	6.9	7.0	7.1	7.3	7.6	8.2
Italy	5.6	5.7	6.2	6.4	6.8	7.5	8.1	7.9	8.1	8.5
Cyprus	2.1	2.4	2.4	2.3	2.3	2.2	2.1	2.0	1.9	2.0
Latvia	1.4	1.5	1.6	2.4	2.4	2.6	2.9	3.3	4.1	5.6
Lithuania	1.0	1.2	1.0	1.1	0.8	0.8	0.9	1.0	1.2	1.6
Luxembourg	2.1	2.1	2.2	2.8	2.5	2.6	2.4	2.2	2.2	2.3
Hungary	1.0	1.1	1.5	1.5	1.6	1.9	2.4	3.1	3.9	4.1
Netherlands	9.1	8.4	8.3	8.2	8.0	8.0	7.5	7.1	7.2	7.9
Austria	2.8	2.6	2.4	2.1	2.1	2.0	1.9	1.8	1.8	2.0
Poland	1.1	1.3	1.7	1.8	1.9	2.1	2.4	2.2	2.3	3.0
Portugal	2.4	2.7	3.3	3.4	3.4	3.6	3.5	3.5	3.8	4.3
Romania	0.4	0.5	0.5	0.5	0.5	1.2	1.2	1.7	1.8	2.3
Slovenia	0.3	0.4	0.6	0.6	0.7	0.7	0.8	0.7	1.0	1.5
Slovakia	1.3	1.3	1.3	1.2	1.4	1.6	1.6	1.7	1.8	2.5
Finland	4.0	3.8	3.9	4.4	4.8	5.3	5.4	5.3	5.4	6.6
Sweden	5.3	5.2	6.0	6.2	5.6	5.8	5.6	5.7	5.7	5.8
UK	5.5	5.2	4.9	4.5	4.5	4.7	4.7	4.6	4.7	4.8
Norway	8.0	8.9	9.1	9.6	10.0	9.6	9.4	9.6	9.5	11.3
CROATIA 1	0.6	0.7	0.7	0.7	0.7	0.6	0.5	0.6	0.6	0.6
CROATIA 2									0.8	0.9
CROATIA 3									1.8	1.8

Croatia 1: Direct debt of local units in Croatia (loans and bonds), Ministry of finance RC, 2011
Croatia 2: Direct debt of local units in Croatia (loans and bonds), State audit office RC, 2010
Croatia 3: Total debt of local units and local unit-owned companies in Croatia, State audit Office RC, 2010.

Source: Eurostat, 2010; for Croatia, Ministry of Finance and State Audit Office (for 2008 and for 2009).