Local government units borrowing in Croatia: opportunities and constraints

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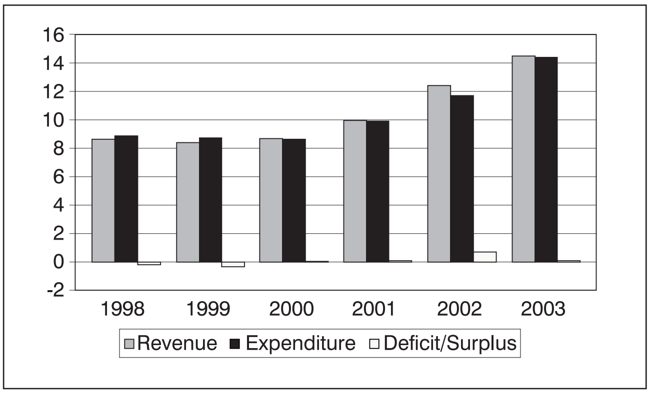
Local government units borrowing in Croatia: opportunities and constraints[1]

The objective of this article is to demonstrate that the financial position of local government units (LGUs) is improving and that their liquid resources (financial assets) exceed their financial liabilities. The Government and the Ministry of Finance hence must determine the reasons for the increased solvency of LGUs, put a brake on their borrowing, reduce the set limit and impose additional constraints on borrowing, leave the financing of capital projects to the commercial banks and define separate constraints for borrowing by the City of Zagreb and by other LGUs. For more details, consult the sequel.

The financial position of the local government units

From 2000 on the financial position of the LGUs has been improving. There are many reasons, but the most important is that in 2001 the process of fiscal decentralisation started (in elementary and secondary education, health care and welfare) according to which authorities as well as resources for their financing from the central government budget in the form of grants were transferred to LGUs. Apart from that, most of the LGUs have made use of the possibility of introducing surtax on income tax, while the central government has additionally increased the share of income tax going to LGUs. The result is an improvement of the financial position of LGUs, that is, a balancing of their budgets, and even the appearance of budgetary surpluses from 2002.

Figure 1 The budgets of LGUs from 1998 to 2003 (in billion kuna)



Source: Ministry of Finance (2004)

[1] The complete text of this article was published in *Financijska teorija i praksa,* 27 (2), 2004, 203-219. Available at: [http://www.ijf.hr/financijska_praksa/PDF-2004/2-04/bajo.pdf].

From 2001 on, an increasingly large number of LGUs met the basic criteria to be able to borrow, according to which current revenue is greater than current expenditure, or that operating revenue is greater than operating expenses[2]. In 2002, of the 566 LGUs (422 municipalities and 122 cities) 380 of them (70% of all LGUs) were able to meet the basic conditions to be able to borrow. In 2003 the situation improved and 85% fulfilled the basic (first) condition for borrowing.

Conditions for local government units borrowing

All LGUs (municipalities, cities, counties) can assume long-term debt by taking on loans on the domestic money and capital market, and also by becoming indebted to contractors (suppliers), although exclusively for capital projects of reconstruction and development that are financed from their budgets. They borrow pursuant to a decision from the representative body of the LGU with the prior consent of the Government. From 2003 on the provision concerning borrowing from contractors has been abolished. Short-term borrowing on the part of LGUs is possible for the financing of the regular activities of the bodies and spending agencies of their budgets, that is, when the revenue of the budget is not obtained evenly throughout the year.

Table 1 Conditions for the borrowing of LGUs from 1997 to 2004

<table>
<tr><th>Year</th><th>Permitted purpose of borrowing</th><th colspan="2">Annual borrowing limit (annual servicing)</th><th>Additional limit</th></tr>
<tr><td>1996
1997</td><td rowspan="3">reconstruction and development (financing capital investment)</td><td>30% of budgetary expenditure</td><td></td><td>does not exist</td></tr>
<tr><td>1998
1999
2000
2001
2002</td><td rowspan="2">20% of revenue obtained</td><td rowspan="2">sum of mean annual annuity on loans, guarantees from previous years issued, and short-term outstanding liabilities</td><td>does not exist</td></tr>
<tr><td>2003
2004</td><td>3% of revenue of all LGUs</td></tr>
</table>

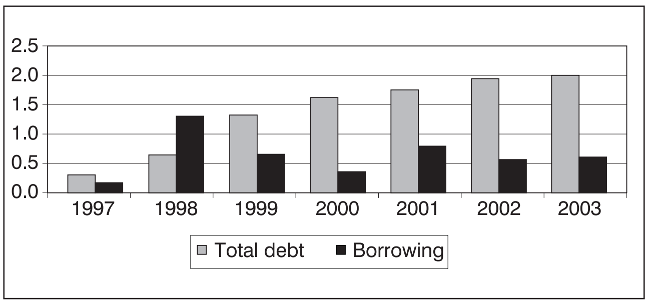
Source: Official Gazette

From 1996 to 1998 LGUs were able to borrow on the domestic and foreign capital markets up to 30% of the budgetary expenditure, that is the total annual liabilities (annual annuity) for debts may not exceed 30% of the budgetary expenditure for the preceding year. From 1998 to 2004, the Ministry of Finance and the Government laid down a lower limit for borrowing and the overall annual liability (annual annuity) was not allowed to exceed 20% of budgetary revenue realised in the preceding year. Additional constraints were instituted by the Ministry of Finance and the Government in 2003 and 2004, and LGUs were able to borrow up to 3% of the total operational revenue realised by all LGUs. For example if total operational revenue realised in 2004 was 13 billion kuna, 3% thus coming to 390 million kuna, was the maximum amount of debt that a LGU could take on in that year. Total requests for LGU borrowing can be greater, but the Government and the Ministry of Finance will give permission for borrowing only up to that amount.

The practice in borrowing from 1997 to 2003

The total gross debt of LGUs rose from 270 million kuna in 1997 to 2 billion kuna in 2003.

Figure 2 Total debt and annual amount of borrowing of LGUs from 1997 to 2003 (in billion kuna)

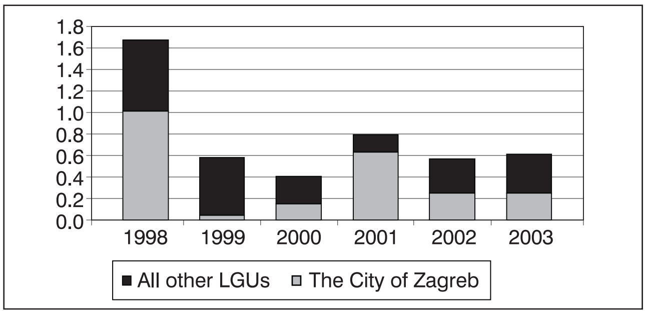


Source: Ministry of Finance (2004); Croatian National Bank (2004)

LGUs on the whole borrow on the domestic capital market. The dynamics with which LGUs borrow varies. Most of the debt of LGUs was incurred in 1998, when the Government approved borrowing up to the amount of 1.3 billion kuna. From 1998 on LGUs have borrowed on average 600 million kuna per year.

[2] Operational revenue excludes revenue from: (1) domestic and foreign grants, donations and transfers from the central government budget and the budgets of other LGUs and (2) from special contracts (voluntary local taxes and co-financing by citizens).

Figure 3 Annual borrowing of the City of Zagreb and all other LGUs according to the decisions of the Government (in billion kuna)



Source: Ministry of Finance (2004); Croatian National Bank (2004)

The City of Zagreb constantly has the average greatest share in the annual amount of borrowing.

Instruments for and conditions of borrowing. LGUs used all instruments for borrowing, from the issue of bonds, taking of loans, to becoming indebted to contractors. Some LGUs also took short-term loans. The Croatian Bank for Reconstruction and Development (HBOR, in Croatian) is an additional government financial player that was supposed to have provided more favourable loans, with lower rates of interest, for the financing of the capital projects of LGUs.

Table 2 Average rates of interest on the borrowing of LGUs at commercial banks and HBOR from 1997 to 2003 (in %)

Year	Short-term		From 2 to 5 years		From 5 to 10 years		More than 10 years	
	HBOR	Banks	HBOR	Banks	HBOR	Banks	HBOR	Banks
1997	-	16.67	7.00	10.12	5.50	7.76	-	-
1998	-	13.21	9.50	10.24	6.00	7.32	6.75	12.00
1999	-	12.49	7.00	11.45	7.02	6.87	8.50	7.62
2000	-	11.50	-	10.30	-	9.17	-	8.00
2001	-	-	-	8.72	6.00	7.95	7.33	7.00
2002	-	-	6.00	6.51	6.50	6.07	6.00	5.00
2003	-	7.20	3.98	5.72	-	4.60	3.61	7.50

Source: Author's calculations, Ministry of Finance (2004) and Croatian National Bank (2004)

LGUs on the whole secured short-term accommodation from the banks with rather unfavourable rates of interest. From 2001 to 2003 interest rates on long-term loans came to 7.5%. HBOR, as state-owned bank, was supposed to provide favourable conditions of borrowing *(soft loans)* via the funds or independently. From 1997 to 2003 HBOR on the whole provided better conditions for borrowing for LGUs than the commercial banks. However, in some periods, HBOR interest rates did not essential differ from the rates of the commercial banks, and sometimes even exceeded the rates of these banks. In this way HBOR joined the market competition in interest rates with the commercial banks. We should say that from 2001, the Regional Development Fund[3] made capital investment loans to LGUs via the agency of HBOR.

LGUs did not get involved in any very active way in the capital market via the issue of bonds. Only three LGUs with stable fiscal capacities managed to issue bonds, mainly for the financing of infrastructure projects and to meet debts to suppliers. LGUs on the whole used bonds to finance municipal infrastructure projects (pools, schools, roads and so on).

Are local government units over-indebted?

Apart from the gross debt, net debt can also serve as one of the indicators of the financial position of LGUs. Net debt is the difference between the financial assets and the financial liabilities, and is a useful indicator of liquidity and the capacity of LGUs to service principal and interest on existing debt.

The financial assets of LGUs consist of money in the treasury, deposits, loans issued, securities and shares and equity in the principal of institutions inside or outside the public sector.

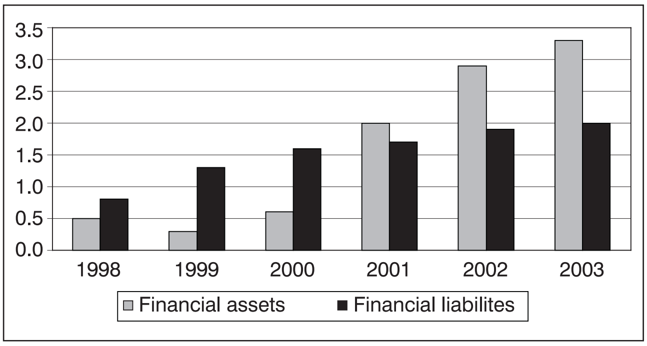
Financial liabilities cover all the liabilities of LGUs that relate to cheques and bills issued, securities and loans received.

In an assessment of financial assets it should be said that the major part of shares and equity is not expressed in market value, because there is no active stock market trading in the shares of firms in which the LGUs have equity, and the book value of such equity is probably much greater than the market value. As against this, the financial liabilities are expressed in terms of market value, for they concern loans and other contractual liabilities the market value of which is easy to assess. Hence it is necessary to distinguish the net financial position of the local government inclu-

[3] *The Croatian Regional Development Fund* (Official Gazette 107/01) was founded to encourage the equalisation of regional development of the areas of special national concern, the islands, hill and mountain regions and other areas, particularly of those whose gross domestic product (GDP) is lower than 65% of the GDP of the Republic of Croatia. The Fund obtains its resources from privatisation, the national budget, bonds, loans, donations and other sources.

ding the value of the shares in communal enterprises and without them from the shares of the LGUs in order to give a better assessment of the capacity of LGUs to borrow and avoid a mistaken impression that the capacity of LGUs is very much inflated by the book value of their financial value.

Figure 4 Net debt of LGUs from 1998 to 2003 (in billion kuna)



Source: Ministry of Finance (2004); Croatian National Bank (2004)

From 2001 the financial assets of LGUs were greater than their financial liabilities. In 2003, the net financial position (net debt) of LGUs was 1.3 billion kuna. The financial assets available (mainly deposits) were larger than the liabilities (mainly for loans) of LGUs.

It should be said that the greater part of the financial assets and liabilities of LGUs in 2003 related to the City of Zagreb. The financial assets of the City of Zagreb constitute 42% of the financial assets and 45% of all the liabilities of all LGUs.

Conclusion and recommendations

- The financial position of the LGUs has improved since 2000, and an increasingly large number of LGUs now meet the basic conditions for being able to borrow and the possibilities for receiving approval (guarantee) from the Government and the Ministry of Finance for borrowing. The increase in the financial assets of LGUs additionally shows that LGUs mainly have liquid resources that exceed the amount of their liabilities.
- The Government and the Ministry of Finance should determine the reason for the increased liquidity, that is, determine whether the large liquid resources are the result of increased revenue of LGUs thanks to the introduction of surtax on income tax, the increased proportion of income tax going to LGUs, or high transfers from the central government to finance the decentralised functions.
- The favourable financial position of the LGUs is the basic reason why the Government and the Ministry of Finance should *slow down the rising dynamics of LGU borrowing*.
- Budgetary restrictions on local government borrowing have been placed high. The Government and the Ministry of Finance should reduce the set limit of 20% of the revenue of LGUs for borrowing, as well as the *additional restriction* of 3% of the revenue of all LGUs.
- *The financing of capital projects*, in conditions of the reduction of interest rates, should be *left directly to the commercial banks, without any involvement of government financial institutions.*
- The Government and the Ministry of Finance should considered borrowing from the City of Zagreb separately from the borrowing of all the other LGUs, and *determine the budgetary restrictions for Zagreb and other LGUs separately.*

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