Do Utility Companies Increase Local Government Debt in Croatia?

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Introduction

The rising trend in Croatian local units indebtedness contracted through local government-owned utility companies gives cause for concern. Institutions and corporate entities the founder and majority shareholder of which are local government units may contract debt only with the prior consent of the representative body of the local government. Such assemblies can issue guarantees above the permitted level of local government borrowing. Thus additional indebtedness can be concealed if consent is given, or guarantees are issued for corporate or institutional borrowing. For local government units can state debt servicing in their budgets through capital donations, aid and grants that they give to the establishments and companies that get into debt. For this reason the Government and the Finance Ministry should seek information from the local government units about the amounts of and conditions attached to utility firm borrowing, for their debts can create additional financial risks, destabilise the local budgets and increase the non-tax burden on the citizen.

Can utility firm borrowing affect the debts of local government units?

Institutions and utility firms (extra-budgetary spending agents) owned by local government units can take on short-term and long-term debts. They take on short-term debts because of the uneven dynamics with which revenues come into their budgets, usually with the commercial banks at which they have their transaction accounts for regular operations. Although it is not so statutorily defined, the local government units should not give their consent to institutional and utility firm loans for the financing of current expenditure, but only for capital investments. For the financing of capital projects, local institutions and firms can take on long-term loans at banks and, increasingly, by the issue of corporate bonds.

Corporate bonds can be issued by private and public corporations; they are bought and sold on the Zagreb Stock Exchange. Although they provide high yields, investors have to be wary of the risks of utility firm operations. They are not secured by any collateral such as tangible assets. Hence investors who invest in these bonds are exposed to the risks of changes of interest rates and the potential credit risk when the issuer cannot service the debt. The risk of changes to the interest rates can reduce investor yields, but it is the risk that the principal on the debt will never be repaid that is the greatest for the investor.

Local government units may not take on debt in the name and for the account of establishments and utility firms but can, without any assent from the Government, give a guarantee for the meeting of these entities' liabilities. The procedure for issuing guarantees is determined in detail in the statutes of the local government unit, and the authorisation, conditions and procedure for borrowing must be given by the representative assembly of the local government unit. The total amount of debt and guarantee issues is prescribed in the yearly decision on the execution of the budget of the local government unit. A local government unit is bound to inform the Finance Ministry about the amount of guarantees issued. However, the Government and the Finance Ministry make no further demands on it with respect to the reporting liability.

Decisions about the borrowings of utility firms must be based on calculations of the liabilities and the way in which they are to be serviced. For example, the new borrowing of the Zagreb city utility corporation (holding), announced at the end of 2006, raises the issue of whether the increased financial liabilities of the city holding will result in an increase in the non-tax burden on the citizen (i.e., an increased in local authority charges and contributions and various kinds of water charges) aimed at providing the resources for the servicing of the debt. Unluckily, there is little information in Croatia about the operations of the utility firms and the amount and structure of their assets and liabilities. Without systematic information the borrowing of the utility firms will continue to be decided on by the heads of the local government units, without there having been any serious prior evaluation of the state of the assets and the manner in which the servicing will be carried out from the budgets of the local government units. Clearly borrowings for the financing of capital projects via the utility firms have become a resource for circumventing the Government's budgetary restriction. The example of the Zagreb city utility holding encourages other local government units to avoid laws and restrictions. Thus in 2006, the city of Rijeka announced borrowing via the utility firms. However, they obtained the guarantee of the Government and the Finance Ministry for the borrowing, and issued local municipal bonds. The issue is to what extent the other local government units will make use of extra-budgetary financing if they are faced with additional demands for developing the transportation infrastructure, sports facilities and how the real costs of the new borrowing will affect the growth in the debts of the local government units.

Debt and borrowing of local institutions and utility firms

In order to protect themselves against possible risks, local government units while they are still only suggesting and making a decision about giving guarantees to institutions and corporations should assess their financial capacity. Assessment is essential, so as not to cast any doubt on their ability to carry out the essential functions of the local government units (see for example the case of Pozesko-slavonska County) because they have to shoulder the servicing of the debt according to the guarantees they have given. If local government units do not have enough facts and figures, the borrowings of local institutions and companies can create additional liabilities. Stronger supervision and control of the authorisation of guarantees by the local government units is necessary, for in the words of the head of the Units of Local and Regional Self-Government Financing Department of the Finance Ministry, Maja Lukes-Petrović "local government units give guarantees even to private firms and associations. As well as this they authorise guarantees for loans to finance current cash flow problems, and sometimes without having had the

Table 1. Local government guarantees issued and active in 2004 and 2005 in million kuna

	Active guarantees, Dec. 31, 2004	Revoked guarantees in 2005	Amount charged in 2005 according to revoked guarantees	Guarantees issued in 2005	Guarantees expired in 2005	Active guarantees, Dec. 31, 2005	Change in the balance of active guarantees, 2005/2004
Total	1.747	12	16	475	121	2.101	355
Zagreb municipal authority	471	0	0	335	0	806	335
Not inc. Zagreb	1.276	12	16	140	121	1.295	19
Share in total guarantees in %							
Local units (63)	100	100	100	100	100	100	–
Zagreb municipal authority	27	0	0	71	0	38	–
Not inc. Zagreb	73	100	100	29	100	62	–

Source: Ministry of Finance

Table 2. The state of active guarantees in 2004 and 2005 in million kuna

	Number of local units	2004	2005
Counties	13	361	361
Cities	38	877	897
Zagreb municipal authority	1	471	806
Municipalities	12	38	37
Total		1,747	2,101
Guarantees as % of total active guarantees			
Counties		21	17
Cities		50	43
Zagreb		27	38
Municipalities		2	2
Total		100	100

decision of the representative assembly”.[1] Such procedures increase the risks respecting repayment of the debt, which can have a direct effect on the increase of the total debt of local government units and the imposition of additional fiscal burdens on citizens.

The debt of extra-budgetary spending agencies of local government units

Guarantees approved for the borrowings of utility firms are potential liabilities of local government units, who are now, with their own revenue, guaranteeing the service of the debts of the institutions and utility firms. For this reason the guarantees issued should be reckoned into the debt of the local government units. From 2005 on local government units have kept special auxiliary records concerning guarantees issued and in the budgets must plan for the amount of the guarantee reserves if the guarantee should be called upon. However, it is still not known if the local government units do actually earmark resources for this budgetary reserve, and there has never been any formal setting of the amounts of budgetary reserves. Table 1 shows the state of affairs with guarantees, issued and active, in 2004.

In 2004 and 2005 63 local government units authorised guarantees for the borrowing of their extra-budgetary spending agencies (on the whole the utility firms). The amount of active guarantees increased from 2004 to 2005 by about 350 million kuna. In 2005, new guarantees worth 475 million kuna were issued, the most of it being accounted for by the borrowing of the utility firms of the Zagreb city authority.

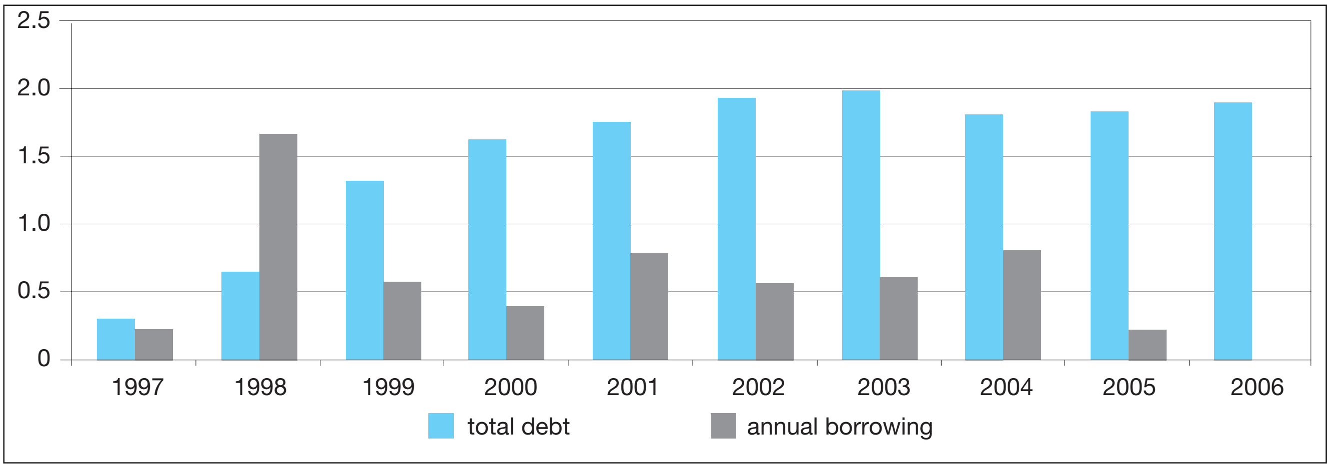
Issued, active and called upon guarantees

Issued guarantees – guarantees for the borrowings of extra-budgetary spending agencies of local government units during the year (end of the period)

Active guarantees – balance of totally issued guarantees (from current and previous years) on a given days (end of period)

Revoked guarantees – submission of a guarantee for payment to the local unit that issued the loan guarantee, because of the inability of the extra-budgetary spending agency to meet its contractual liabilities.

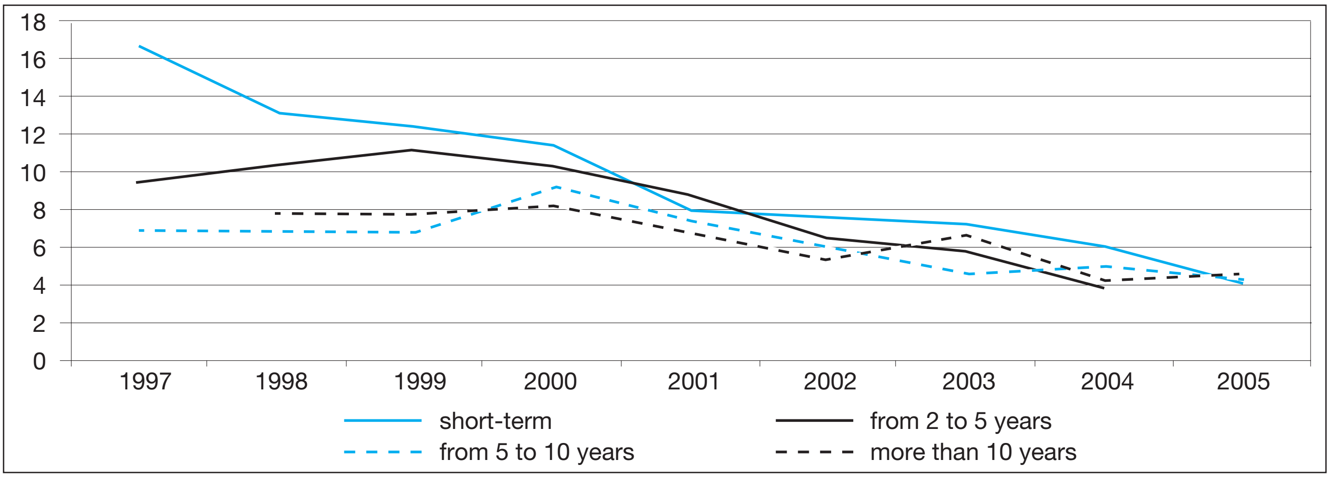
Graph 1. Total debt and annual amount of borrowing of local units from 1997 to 2006 in billion kuna



NB: Figures are not accessible about the annual borrowing of local government units in 2006.
Source: Finance Ministry and CNB

[1] Lukeš Petrović, M. 2006, Financiranje investicija u javnom sektoru, zaduživanje ili anticipiranje buduće potrošnje, *Računovodstvo i financije* no. 9., Treasury article, pp. 23-32. Zagreb: Hrvatska zajednica računovođa i financijskih djelatnika.

Graph 2. Average interest rates on the borrowing of local government units from 1997 to 2005 in %



NB: This is a weighted interest rate
Source: Author's calculation on the basis of Finance Ministry information

Unfortunately in Croatia there is no publicly available information about the terms and conditions for the borrowing of utility firms, which makes the fiscal consequences to the rise in the non-tax burden of citizens a complete unknown. An additional confusion and risk for the banks and the government is constituted by the lack of information about the value (financial and non-financial) of the assets and liabilities of the companies owned by the local government units, because of which it is very hard to assess their creditworthiness and to establish credit ratings. A credit register of the borrowing of firms owned by local government units would be a step in the right direction for the supervision of and prevention of the uncontrolled rise in their debts.

Local government units debt

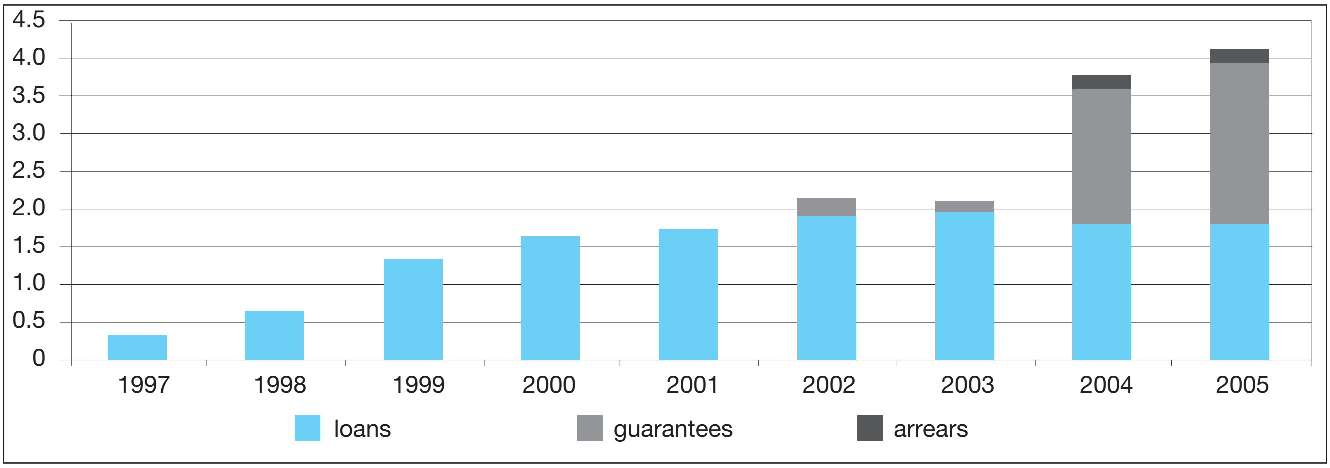
The contractual liabilities of local government units that consist of loans and issued bonds are the direct debt. The total debt of local units created by loans and the issue of bonds in 2006 came to 1.8 billion kuna.

On the whole, local government units borrow from domestic commercial banks. Most of the debt of the local government units was created in 1998 when the Government approved borrowing in the amount of 1.3 billion kuna. After that year, the local government units on average borrowed about 450 million kuna p.a. Local government units use all the possibilities available to them: from bonds and loans to getting into debt with their contractors. The Croatian Bank for Reconstruction and Development (known as HBOR) is the governmental financial player that ensures easy term loans (with a lower rate of interest) for the financing of the capital projects of the local government units, but nevertheless some of the local government units take on short term loans as well. In time, the conditions of local government unit borrowing are improving, and the difference between the minimum and maximum interest rates of different maturity periods is reducing.

The big differences between minimum and maximum interests rates from 1997 to 2000 were the result of the undeveloped capital market and a rudimentary banking system. Thanks to increased competition from banks on the capital market since 2000 the average interest rate and the differences between the interest rates on local government unit borrowings have been falling. In 2005 we can record the smallest difference of interest rates on local government borrowings. The average rate of interest for all debts in the whole of the period observed came to about 4.2%. Up to 2003, local government units did not borrow for a period of longer than ten years, but in the next two years, the maturity periods were extended, and the local government units started getting into long-term debt. Since 2001, commercial banks have been indexing the interest rates on local government units loans to some of the reference rates on the international capital market (LIBOR, for example, and EURIBOR). This indexing of loans to some of the reference rates increases the risk because of the possible rise in the interest rates in these markets.

Alongside the direct obligations, local government units should also record their liabilities that have fallen due but are still outstanding in the category of debts. This is because of the inability of local government units to meet their debts to suppliers by the contractual deadlines.

Graph 3. Size and structure of the debts of local government units from 1997 to 2005 in billion kuna



Source: Author's calculations on the basis of Finance Ministry figures

Table 3. Local government units arrears from 2002 to 2006, a sample of 53 local units, in million kuna

	2002	2003	2004	2005	2006
LGUs arrears	215	142	192	203	231

Source: Ministry of Finance

From 2002 to 2004 outstanding liabilities of local units gradually fell, and then from 2005 started rising, coming in 2006 to 231 million kuna.

The outstanding local government liabilities (arrears) register in the Finance Ministry.

In order to step up fiscal discipline, in 2000 the Finance Ministry started up a register of outstanding debts. In 2001 it required they be recorded quarterly. From 2001 all local units have in a uniform manner reported about outstanding debts, depending on the length of their failure to pay an outstanding debt: less than 30 days, 30 to 60 days, and more than 60 days. Liabilities and maturity are determined in this way: a) a liability is determined if there has been a transaction or an event producing a liability to pay, with the payment not yet having been made, b) the liability is outstanding if it has not been paid after the date given as the due date.

The total debt of local units

The total debt of local government units is the aggregate of all the accumulated liabilities according to loans, guarantees for the borrowings of utility firms and institutions issued, and outstanding liabilities. The debt of local government units increased markedly in 2004 and 2005. Graph 3 displays the reasons for the rise.

In 2005 the total debt of local government units exceeded four billion kuna, most of it being direct loans of local units, which was gradually however reducing from 2003. However, since 2005 it has been the borrowings of utility companies that have dominated the debt structure. The total level of debt has increased as a result of these borrowings. We can say that the outstanding liabilities of the local government units have stabilised at around the level of 210 million kuna p.a. Let us look

Table 4. Total debt of local government units as percentage of GDP from 1997 to 2005

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Loans	0.25	0.48	0.93	1.04	1.06	1.07	1.00	0.86	0.80
Guarantees	–	–	–	–	–	–	–	0.82	0.92
Arrears	–	–	–	–	–	0.12	0.07	0.09	0.09
Total	0.25	0.48	0.93	1.04	1.06	1.19	1.07	1.77	1.81

Source: Author's calculation on the basis of MF figures
NB: – data not available

at the total debt of local government units as a percentage of GDP.

In 2005 the total debt of local government units amounted to 1.8% of GDP. Direct liabilities because of loans are gradually reducing, and it is the guarantees that have been issued and are active, which come to about 0.9% of GDP that contribute most to the rise in the debt of the local government units. Outstanding liabilities are not high. The growing debt of institutions and utility companies could be a threat to the stability of local finances and could result in additional demands for borrowing, which realistically threatens a breach of the annually determined budgetary restrictions on local government units borrowing

Proposals and recommendations

Because of the increased needs for financing or the reconstruction of the infrastructure and the development of sporting and recreational contents, local government units have increasingly resorted to an extra-budgetary manner of financing, via their institutions and in particular via their utility firms. Thanks to an improvement in the system of financial reporting, the Government and the Finance Ministry have a better insight into the character and structure of the overall debt of local government units. Existing constraints on borrowing are being circumvented by local government units getting into debt via their own institutions and utility firms. By now, the debt of the extra-budgetary spending agencies (guaranteed by the local units) is greater than the direct debt of the local government units, and in conditions of the current asymmetry in information about borrowing (amounts and interest rates, purposes, maturity dates for repayment of principal and interest) the sustainability of local government units budgets is jeopardised.

Hence the Government and the Finance Ministry should:

- seek more detailed information about conditions of borrowing of their institutions and utility firms
- have at their disposal information about the balance sheets of the utility firms
- pass a single law to regulate the practice and conditions of local government units borrowing and of their spending agencies (as well as of government as a whole) and
- set up a credit register for local government units and the utility firms they own.

Local government units should:

- determine the value of the assets and liabilities of the firms and institutions they own,
- give guarantees for utility firm borrowing only after an assessment of the effects of the borrowing on the budget of the local government units, the institution and the utility firm,
- publish information about the terms and conditions of utility firm borrowing at banks or on the capital market and
- publish calendars about the borrowing of local government units and the utility firms as well.

The Government is faced with a serious issue of reviewing the existing constraints on local government units borrowing and clearly coming out in favour of a model of financing capital projects. But here the Government is faced with a dilemma: whether to liberalise the borrowing of local government units (which could result in an explosion of new requests for the financing of capital projects by borrowing through the mediation of the utility firms) or by a good system for the allocation of capital grants (with established criteria and high quality supervision of spending) to provide for the participation of government in the funding of local government units capital projects.

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