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LOCAL GOVERNMENT UNIT BORROWING IN CROATIA: OPPORTUNITIES AND CONSTRAINTS

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LOCAL GOVERNMENT UNIT BORROWING IN CROATIA: OPPORTUNITIES AND CONSTRAINTS[1]

Abstract

The paper analyses the practice and basic features of local government unit borrowing in Croatia from 1997 to 2003. Local government units still rely on classical forms of loans as a form of security for resources for financing capital projects and there is little incentive for the issue of local government bonds. The borrowing conditions laid down are not a good basis on which to develop a local debt market or for facilitating local government borrowing. One of the reasons is also the dominant role of the city of Zagreb, which should be excluded from the establishment of budgetary restrictions on the borrowing of the other local government units in Croatia. Subsidised loans to local government units via the government financial institutions have been in some periods more expensive than via the commercial banks, and it is necessary to carry out a review of their role in the financing of local government unit capital projects. In any analysis of the borrowing and the size of the debt of local government units it is necessary to include the categories of financial assets as a better indicator of solvency and ability to repay debt. The article draws attention to a potential hold-up in the implementation of fiscal decentralisation, because local government units are investing some of their funds in the financial assets (shares and equity) of local utility firms.

JEL Classification: O16

Key words: local government, borrowing, loans, bonds, budgetary constraints

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Introduction

The article gives an overview of the basic characteristics of local government unit (LGU) borrowing in Croatia. The main thesis of the paper is that an increasing number of LGUs meet the conditions to be able to borrow to finance capital investment, but central government should better define constraints on LGUs borrowing. The main reasons for such a state of affairs are the absence of any criteria for the transfer of capital grants from the central government budget, poorly defined budgetary constraints, a vaguely defined position for the central government financial institutions and agencies, and the dominant position of the city of Zagreb in the system of local government financing. Analysis of the debts and financial assets of LGUs should directly draw attention to the problems in the implementation of the process of fiscal decentralisation that started in 2001.

In the first part, we shall review the legislative framework and the budgetary constraints on borrowing. In part two, we evaluate the fiscal position of the LGUs and give an account of the practice of borrowing from 1997 to 2003. In part three we analyse separately the financial position of the city of Zagreb according to the size and structure of gross and net debt. In the fourth part we give a list of the opportunities and also the main constraints on the borrowing of LGUs. Part five explains consequences of fiscal decentralization on LGU financial assets and part six are conclusions.

1. The Framework for Local Government Unit Borrowing – Budgetary Constraints

All local government units (municipalities, cities and counties) can take long-term debt by taking out loans on the money and capital market, and contract debts to their contractors exclusively for a capital investment project, for reconstruction and development, financed from their budgets. They can take on debt pursuant to the decision of the representative body of the local government unit (LGU) with the prior consent of the Government of the Republic of Croatia. In 2003, the provision about contracting debts with contractors of works was rescinded. Short-term borrowing of LGUs is possible for the financing of the regular activities of the body and the spending agencies of their budgets, only when the revenue of the budget does not come in evenly all through the year.

Table 1 Conditions for local government unit borrowing for capital investment (reconstruction and development) from 1997-2004

<table>
<tr><th>Year</th><th colspan="2">Annual borrowing limit (annual liability)</th><th>Additional limit</th></tr>
<tr><td>1996
1997</td><td>30% of budgetary expenditure</td><td></td><td>None</td></tr>
<tr><td>1998
1999
2000
2001
2002</td><td>20% of realised revenue</td><td rowspan="2">Included is the amount of the average annual annuities on loans, guarantees given from the previous years, and short-term outstanding liabilities</td><td>None</td></tr>
<tr><td>2003
2004</td><td>20% of realised revenue</td><td>3% of the total revenue of all local government units</td></tr>
</table>

Source: Official Gazette.

All LGUs the current revenues of which are greater than current expenditure, or whose operating revenues are greater than operating expenditures, meet the criteria for being able to borrow[2].

From 1996 to 1998 LGUs were able to borrow on the domestic and foreign capital markets up to 30% of the budgetary expenditures incurred in the previous year, that is the total annual liabilities (annuity) for borrowings must not exceed 30% of the budgetary expenditures of the preceding year.

From 1998 to 2004 the Ministry of Finance (MF) and the Government established a lower borrowing ceiling and total annual liabilities (annuities) of a LGU were not to exceed 20% of the budgetary revenue realised in the preceding year. The amount of the average annuities on loans, guarantees issued was included in the amount of the total annual liabilities, as well as the amount of outstanding liabilities carried over from the previous years.

The Government and the MF introduced an additional restriction in 2003 and 2004, and LGUs can now take on debt up to at most 3% of the totally realised operating revenue of all LGUs. For example, if in 2004 the total operating revenue of all the LGUs is 13 billion kuna, 3% of this comes to 390 million kuna, and this is the maximum amount of debt that all LGUs can take on in that year. The total of applications for LGU loans can be greater, but the Government and the MF will authorise borrowing only up to that amount.

The reason for the introduction of the additional restriction is the increased number of LGUs that meet the conditions for borrowing. By laying down an additional limit, the Government and the MF have tightened the conditions for borrowing and indirectly stimulated competition among LGUs for gaining authorisation for their borrowing. We should mention that LGUs can authorise loan guarantees for the companies in which they have a majority holding. The representative body of the LGUs gives authorisations for loans, although the LGUs can in their statutes lay down the procedure for the issue of guarantees for the borrowings of their companies.

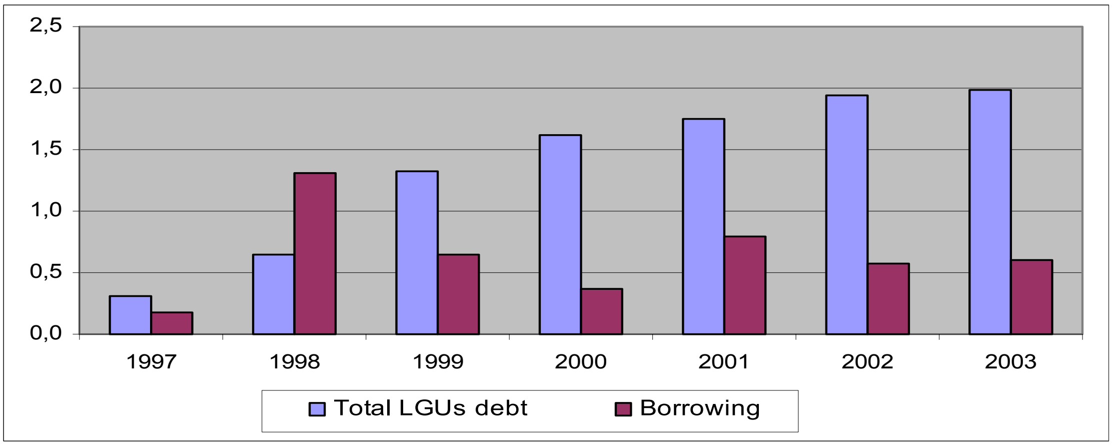
2. Borrowing Practice from 1997 to 2003

An increasing number of LGUs meet the basic criteria for borrowing according to which current revenue is greater than current expenditure, or operating revenue is greater than operating expenditure. In 2002, of the 566 LGUs (422 municipalities and 122 cities), 380 of them (70% of all local units) did meet the basic condition for being able to borrow. In 2003 the situation improved, and of the 561 units, 497 of them (85%) met the basic, first, condition for borrowing.

Gross debt and local government unit borrowing Total gross debt of LGUs units increased considerably from 270 million kuna in 1997 to 2 billion kuna in 2003.

[2] The following are excluded from operating receipts: (1) from domestic and foreign grants, subsidies and transfers from the central government budget and the budgets of other local government units; (2) from special contracts about citizen co-financing and voluntary levies.

Figure 1 Total debt and annual amount of local government unit borrowing (in billion kuna)

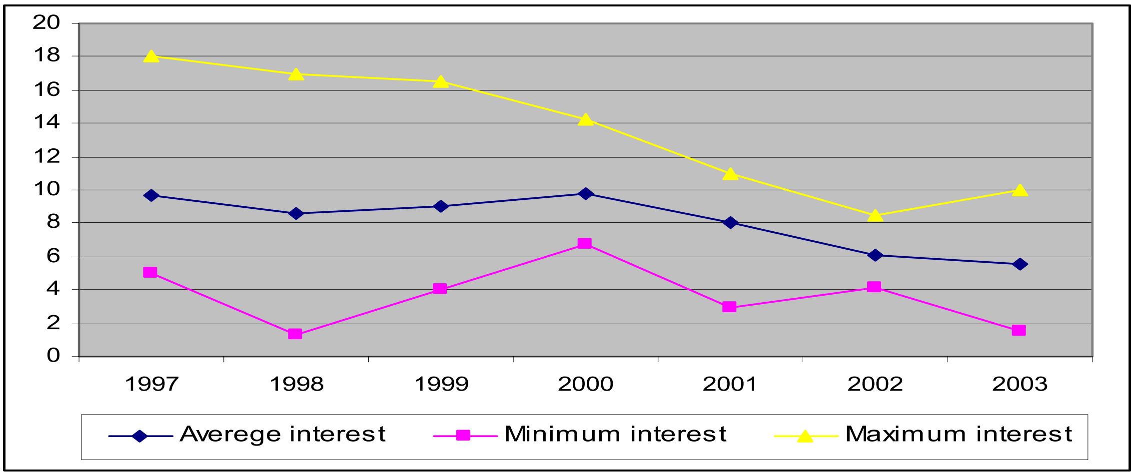


Source: Ministry of Finance (2004); CNB (2004).

LGUs on the whole borrow on the domestic capital market. The dynamics of LGUs borrowing varies. The greatest part of the debt of the LGUs was incurred in 1998, when the Government authorised borrowing in the amount of 1.3 billion kuna. Since 1998, LGUs have owed an average of 600 million kuna p.a.

Borrowing conditions. From 1997 to 2004 LGUs used all their instruments for borrowing, from the issue of bonds, taking on loans, to borrowing from contractors of works. Some of the LGUs also took on short-term loans. The Croatian Bank for Reconstruction and Development (HBOR) is an additional governmental financial player that was supposed to provide favourable loans with a lower rate of interest for the financing of LGUs capital projects.

Figure 2 The nominal average interest rates paid on the borrowing of local government units from 1997 to 2003 (%)



Note: this is the arithmetical mean.

Source: author's calculation according to Ministry of Finance and CNB information.

From 1997 to 2000 the differences between minimum and maximum interest rates were very large. Medium term interest rates might come to 2 to 4%, but they might also be as great as 14 or 16%. The great differences are the result of the lack of development of the capital market and a feeble banking system. We should mention that the LGUs took on short-term loans at an average interest rate of 14%.

From 2000, the average interest rate and the differences in the interest rates on the borrowings of LGUs have been decreasing, thanks to increased competition of banks on the capital market. In 2002, we can also record the smallest difference in the interest rates authorised for the borrowing of LGUs. It is interesting that in Croatia LGUs rarely borrow over the long term (for more than 10 years). Most borrowing is related to loans with a repayment period of from 2 to 5 years, and from 5 to 10 years.

Table 2 Average nominal interest rates on local government unit borrowing at the commercial banks and HBOR from 1997 to 2003 (%)

Year	Short term		From 2 to 5 years		From 5 to 10 years		Over 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 calculation, Ministry of Finance (2004), CNB (2004).

Commercial bank loans. LGUs took out short term loans with unfavourable rates of interest of from16.6% in 1997 to 11.5% in 2000. In 2001 and 2002 the units did not take on short term loans. An exception was 2003, in which the average interest rate on short-term borrowing was 7.2%. At the same time the interest rates on long-term loans were 7.5%. We should point out that the commercial banks link the interest rates for LGU loans to some of the reference rates of interest on the domestic and also on the international capital market (with Libor, Euribor, Zibor, MF treasury bills with an 180 day maturity).

HBOR loans. As government owned bank, HBOR (Croatian Bank for Reconstruction and Development) was supposed to provide better conditions for borrowing (soft loans) via the funds or on its own. From 1997 to 2003 HBOR on the whole provided more favourable conditions for LGUs borrowing than did the commercial banks. HBOR interest rates in some of the periods however did not differ essentially from the rates of the commercial banks and sometimes in fact exceeded them. In this manner, HBOR entered into market competition with the commercial banks through its interest rates. HBOR, we should point out, is the only financial institution that links its interest rates with the discount rate of the Croatian National Bank (CNB). Since 2001, the Regional Development Fund[3] has also made some of its loans available through the agency of HBOR.

Municipal bonds. LGUs have not taken a very active role in the capital market with bond issues. Only three LGUs with stable fiscal capacities have managed to issue bonds, mainly for the financing of infrastructure projects and to meet liabilities to suppliers.

[3]The Regional Development Fund (OG 107/01) was founded to prompt an even regional development of areas of special national interest, the islands, hill and mountain areas and other areas, especially those the GDP of which was below the national 65% GDP average. The Fund obtains its resources from privatization, the central government budget, bonds, loans, donations and other sources.

Table 3 Conditions for borrowing by the issue of municipal bonds

Local government unit		Year of issue	Maturity (in years)	Amount expressed in DEM (millions)	Kuna (million)	Interest (%)
Istria County	Eco bonds	1995	2.5	2.0		11
	Healthcare bonds A series	1996	2	4.0	4.3	
	Healthcare bonds B series	1996	3		5.7	7
Opatija	Municipal economy infrastructure	1998	4		14.0	8.5
Koprivnica	Municipal economy infrastructure	2003	7		60.0	6.5

The first bonds of Istria County were sold on the secondary market, and these were the first bonds of the kind that appeared on the Zagreb Stock Exchange. Istria County second issue and Opatija City first issue were sold by private placement in advance. Istria County, with the first issue of what were called eco-bonds, solved the problem of effluent, partially financed also by a loan from the World Bank. The second bond issue (healthcare bonds) was directed to the settlement of the Pula Hospital debt to suppliers. Opatija and Koprivnica on the whole financed municipal infrastructure projects with their bonds (pools, schools, roads and so on).

Net debt of local government units. Apart from the gross debt, one of the indicators of the financial position of LGUs is the net debt. Net debt is the difference between financial assets and financial liabilities, and is a useful indicator of solvency and the ability of LGUs to pay off principal and interest of the existing debt.

Financial assets of LGUs consist of cash on hand, deposits, loans made and securities as well as shares and equity in the capital of institutions in and out of the public sector. Financial liabilities include all the liabilities of a LGU that relate to cheques and bills, securities and loans received.

In an assessment of financial assets it should be pointed out that most of the shares and the major part of the equity are not expressed in terms of market value, for there is no active trading on Stock Exchange of the shares of firms in which LGUs have equity, and the book value of these shares is probably much higher than the market value. As against this, financial liabilities are expressed in their market value, for this is a matter of loans and other contractual liabilities the market value of which is easy to assess. For this reason it is necessary to distinguish the net financial position of the local government including the value of shares and not including them from the share of the local government. This is necessary in order the better to evaluate the capacity of LGUs to borrow and to avoid the erroneous impression that the LGU capacity to borrow is greatly exaggerated by the book value of financial assets.

Table 4 Size and structure of net debt of local government units from 2001 to 2003 (in million kuna)

	2001	2002	2003
a) Financial assets	5,929.4	7,104.9	8,357.2
Money in the cash	989.5	1,894.2	2,001.3
Deposits, guarantee deposits	359.8	360.1	540.9
Loans extended	505.4	551.8	676.6
domestic	502.6	551.0	676.1
foreign	2.8	0.8	0.5
Securities	126.2	94.9	90.4
Shares and equity	3,948.5	4,203.9	5,047.9
a) 1. Financial assets (not inc. shares)	1.980.9	2,901.0	3,309.4
b) Liabilities for financial assets	1,726.5	1,941.3	1,987.5
Cheques and bills	0.2	0.1	0.1
Other securities	3.0	3.0	0.1
Loans received		1,938.3	1,987.3
domestic loans	1,448.8	1,666.3	1,594.6
foreign loans	274.5	272.0	392.7
c) Net financial position (inc. shares and equity) (a-b)	4,202.8	5,163.6	6,369.8
d) Net financial position (not inc. shares and equity) (a.1.-b)	254.4	959.7	1.321.9

Source: Ministry of Finance (2004), CNB (2004).

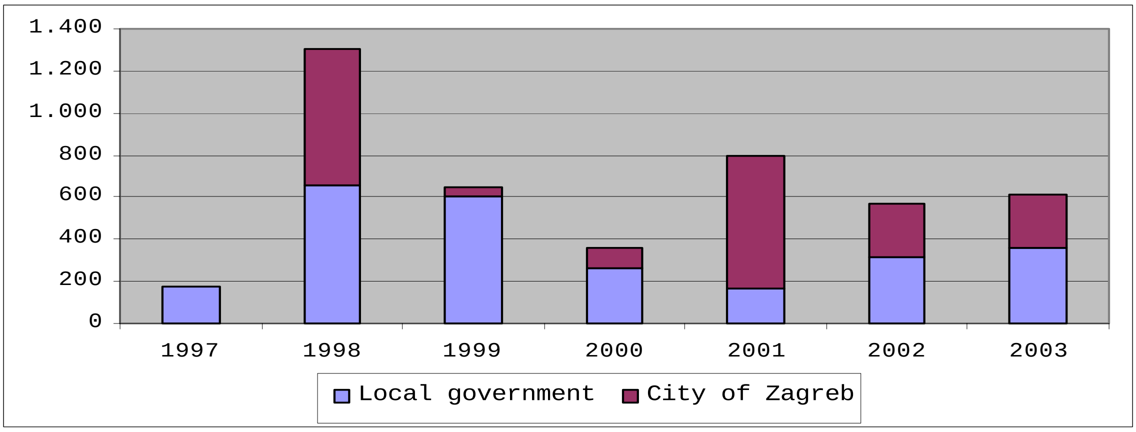
Most of the liabilities of LGUs relate to loans obtained on the domestic financial market. Total liabilities for financial assets (gross debt) in 2003 amounted to 2 billion kuna.

In the financial assets of LGUs, shares and equity in firms, mainly in the public sector, are dominant. The size of this equity rose from 3.9 billion kuna in 2001 to as much as 5 billion kuna in 2003. Then come money in the treasury, 2 billion kuna, and loans made. Financial assets including shares and equity greatly outweigh the liabilities of LGUs and come to as much as 6 billion kuna. The net financial position (net debt) not including shares and equity is not as strong and the financial assets of LGUs in 2003 was 1.3 billion kuna more than the liabilities. We should say that the analysis of debts is not complete because of the lack of information about guarantees that LGUs have given for the borrowing of firms. Only with the inclusion of such potential debts would it be possible to get a realistic insight into the size and structure of the debt of LGUs.

3. Borrowing of the city of Zagreb

The city of Zagreb has a special position in the system of LGU financing and must often be excluded from the analysis of the financial position of the LGUs, and be examined on its own. Analysis of the debts of LGUs with the city of Zagreb excluded gives a better picture of the structure and milder consequences of borrowing. The city of Zagreb accounts for a very considerable proportion of the annual borrowings of LGUs.

Figure 3 The annual borrowing of the city of Zagreb and other local government units according to the decisions of the Government of the Republic of Croatia (in million kuna)



Source: Ministry of Finance (2004).

In 1998 and 2001 the major part of LGU borrowing relates to the city of Zagreb. The total amount of LGU borrowing from 1997 to 2003 was 4.4 billion kuna, of which 1.9 billion consists of the borrowing of the city of Zagreb, and the other 2.5 billion is the borrowing of the other LGUs. The sudden jump in the borrowing of LGUs in 1998 is on the whole related to Zagreb borrowing. We should point out that the city of Zagreb largely borrowed from domestic commercial banks, at an average rate of interest of 7%.

Table 5 Terms of borrowing of the city of Zagreb

	Amount of loans	Interest rates (%)	
Year	(million kuna)	From 2 to 5 years	From 5 to 10 years
1997	-	-	-
1998	645	7.50	5.70
1999	47	-	8.50
2000	100	9.00	-
2001	634	-	7.80
2002	250	-	5.00
2003	250	-	7.05

Source: Ministry of Finance (2004); CNB (2004).

Interestingly, the city of Zagreb did not take on long-term loans. These are mainly medium-term loans with varying interest rates ranging from 5 to 8%. The total debt of the city of Zagreb in 2003 came to 885 million kuna, which comprised 45% of the total debt of all LGUs. The major part of the debt of the city of Zagreb incurred in 1998 was due in 2002 and 2003.

Net financial position of the city of Zagreb – net debt. The city of Zagreb is remarkably solvent, which is confirmed by the state of its financial assets.

Table 6 Net debt of the city of Zagreb and the share of Zagreb in the financial assets and liabilities of all the local government units in Croatia (in million kuna and in %)

Net debt of the city of Zagreb (million kuna)			Share of Zagreb in the total financial assets of LGUs (%)	
	2002	2003	2002	2003
a) Financial assets	1,328	1,352	19	16
Money in Cash	1,109	1,132	59	57
Deposits, guarantee deposits	77	62	21	12
Loans extended	75	66	14	10
domestic	75	66	13	9
foreign	0	0	0	0
Securities	29	47	30	52
b) Liabilities related to financial assets	870	885	45	45
Cheques and bills	0	0	0	0
Other securities	0	0	0	0
Liabilities related to loans	870	885	45	45
domestic	617	690	37	43
foreign	253	195	93	50
c) Net financial position (a-b)	420	422	44	32

Source: Ministry of Finance (2004); CNB (2004).

The financial assets of the city of Zagreb come to about 1.3 billion kuna and comprise about 42% of the financial assets of all the LGUs. We would point out that the financial assets largely consist of a vista deposits. In addition, the net financial position (difference between financial assets and liabilities) shows that Zagreb has about 420 million kuna left at its command (about 44% of the total available liquid resources of all the LGUs) even after it has met its financial liabilities. Unfortunately we possess no information concerning the financial assets of the city of Zagreb that includes the value of shares and equity in firms and financial institutions inside and outside the public sector.

4. Opportunities and Constraints in Local Government Unit Borrowing

According to an analysis of the debts and borrowings of local government units, and also according to research from previous years (*Local Finances and Local Budgets, Fiscal Decentralisation in Croatia*, and so on) we can say that there are real conditions and opportunities for LGU borrowing in Croatia. Unfortunately there are also a number of restrictions and constraints that should be obviated so as to develop a real local debt market.

4.1. Opportunities

Fiscal capacities. The financial position of the LGUs is improving, and an increasing number of them are able to meet the basic conditions for borrowing. The key premise for being able to borrow is still LGU fiscal capacity and the ability to guarantee debt servicing including the return of principal from future revenue.

A developed transfer system. The financing of capital projects of LGUs with weaker fiscal capacities is a priority, and most of the units are not capable of financing these projects without financial aid from the central government. Unfortunately, there are no defined criteria for the allocation of capital grants from the central government budget. For this reason these LGUs need to have a quality mechanism for transferring capital grants (aid) from the central government budget established; alternatively, the financing of these projects should be provided for directly from the central budget via the competent ministries.

Public capital investment programme. Since 2004 it has been incumbent on LGU to draw up a budget in terms of programmes. Such a programme-oriented budget should provide a detailed definition of the applications for the financing of given expenditures and necessarily result in LGUs drawing up and analysing the cost-benefits of their capital investments.

Assets balance sheet. Apart from their own budgetary revenue, non-financial assets will have an increasing role in the financing of capital projects. The majority of LGUs have already drawn up a balance sheet of their assets. LGUs with assets balance sheets and well-defined development plans have greater chances for figuring on the capital market, on which they can use their assets as collateral.

4.2 Constraints on borrowing

Inflexible budgets, immobilised resources, poor collection of non-tax revenue. A fair amount of the budget of LGUs is quite inflexible. This particularly refers to LGUs in which the major part of the revenue consists of non-tax revenue. This non-tax revenue has defined purposes for which it can be used (mainly for the costs of maintenance and for capital development). Such a linking of revenue to a precisely determined purpose makes it impossible for LGUs to make a more flexible allocation of budgetary resources. Apart from that, there is room for improvement in the financial position of LGUs because on the revenue side there is the problem of the fiscal discipline, that is, the collection of non-tax revenue (revenue according to special regulations, as it is called). For example, in 2003 the LGUs collected 2.6 billion kuna of special-regulation revenue, while as much as 2 billion kuna remained uncollected.

Management of the budget of LGUs. The competition of LGUs to borrow on the financial market results in the borrowing criteria being more rigorous. Unfortunately, the matter of the quality of the financial management of the LGUs is often raised. The poor quality of the management of the finances of the LGUs is the result of the absence of any vision about the use of financial resources. LGUs largely take on loans from the banks (or bank) at which they deposit their financial resources and in which they have accounts to manage their cash. There is little incentive or initiative for borrowing by the issue of municipal bonds. One of the constraints is lack of interest, and lack of knowledge about how to display all the costs and benefits of the capital investments foreseen, or to assess financial potential and the ability to take on debt servicing.

The role of HBOR and the Regional Development Fund in the provision of soft loans to LGUs. In some periods, HBOR was in competition with the commercial banks to authorise loans to LGUs. This is shown by the differences in the interest rates of HBOR and the commercial banks. An additional problem is the dubious role of the Regional Development Fund, set up in 2001. Via this Fund (which can create liabilities) HBOR authorises loans to LGUs with weaker fiscal capacities. Assuming that the Government and the MF in the coming period lay down clear criteria for the transfer of capital grants, and a model for financing the capital projects of LGUs with weak fiscal capacities, there should be no need for HBOR and its role in the subsidising of lending to LGUs. The same thing applies to the Regional Development Fund. This fund should in the future be integrated into the MF, as a separate department to monitor capital investment, both at the central and at the local government level (an asset management department). The financing of capital projects in conditions of falling interest rates should be left directly to the commercial banks, without the involvement of government financial institutions.

Budgetary constraints on the borrowing of local government units. Practice to date shows that because of the large borrowing of the city of Zagreb, the other LGUs that formally meet the conditions for borrowing and the financing of capital investments were squeezed out and unable to obtain loans. For this reason the central government should consider the borrowing of the city of Zagreb and the borrowing of other LGUs separately, and lay down budgetary restrictions for Zagreb on the one hand, and other LGUs on the other. The definition of fixed budgetary restrictions on loans to cover both the LGUs and the city of Zagreb could encourage LGUs to make use of extra-budgetary sources of financing. We should recall that LGUs are able to authorise guarantees for the loans of their companies, and can provide for the financing of capital investment in this way.

Growth in the public debt. The total public debt (direct and potential) in 2003 came to 53% of GDP, and yet the debt of the LGUs was only 1% of GDP. Clearly the size of the public debt has an impact on the definition of budgetary constraints on the borrowing of LGUs. Under pressure from the growth in the debt and the increase costs of debt servicing, the government has resorted to frustrating the borrowing of LGUs.

Lack of development of the market and public debt management is one of the constraints discouraging LGUs from any more active employment of municipal loans. The central government has still not defined the criteria and terms and conditions for borrowing via bond issue. The fact that the central government has not initiated any organised management of or market for the domestic public debt has a direct effect on the LGUs, which do not show any great interest in the use of local bonds.

Publication of information about and financial indicators of local government units. There is still a problem for banks and financial institutions that make loans to LGUs in assessing the credit rating of the LGUs. There is still no comprehensive databank about LGUs combining all their financial operations. The commercial banks can indirectly prompt the publication of information, and the MF can do it directly, via publication on its Web pages.

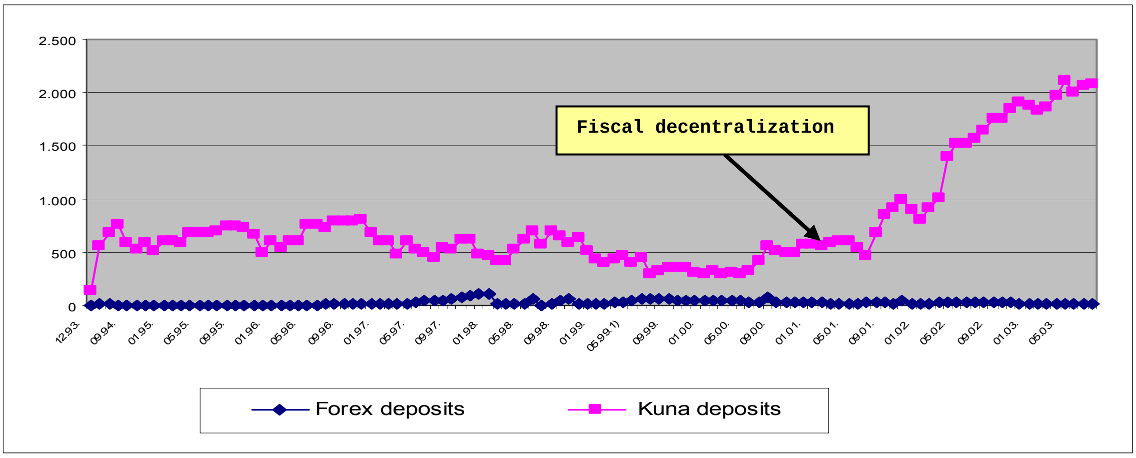
Assessment of credit rating – an alternative. A good step in the right direction would be the foundation of a credit rating agency in Croatia. An agency with a sufficient number of experts for the financial analysis of the operations of LGUs might be able to contribute to the evaluation and publication of the financial positions of the LGUs. Such an agency would indirectly, by the establishment of credit ratings, assist other financial institutions to assess the risk of loans and investments.

Local unit bankruptcy law. In Croatia there is as yet no knowledge of what to do with LGUs bankruptcy. There is a real chance that LGUs that have got into financial difficulties will be unable to provide for their own financial operations without government support. For this reason a Local Government Unit Bankruptcy Law would lay down the rights and obligations of LGUs and the central government in detail.

5. A Digression – Decentralisation of the Financing of Local Government Units

Since 2001 LGUs have taken over the decentralised functions of elementary and secondary education, of health care and welfare. The Government and the MF increased the share of LGUs in the redistribution of income tax, the most productive source of revenue of LGUs, and enabled all LGUs to introduce surtax on income tax. The Government and the MF also provided funds for financing from the Equalisation Fund (as it is called). In spite of the provision of these resources, the implementation of fiscal decentralisation has been slow. The indicators from the analysis of the financial position of LGUs and borrowing from 2001 provide support for this contention. The first proof of this claim is the increased level of LGU deposits (Fig. 4).

Figure 4 Local government units foreign and domestic currency deposits at commercial banks, (in million kuna)



Source: CNB (2004).

The second proof of this claim is found in the increased investments of LGUs in corporate shares and equity inside or outside the public sector (see Table 4). The growth in the investments of LGUs in shares and equity of companies outside the public sector or inside it opens up the issue of whether the LGUs have simply invested some of the funds that they obtained from the Equalisation Fund for the purpose of decentralisation into financial assets. This is particularly relevant to the case of the city of Zagreb, and to the financially strongest LGUs in Croatia.

LGUs (particularly the city of Zagreb) ought not to be behaving as investors in financial assets, for this is not their primary function. While central government, slowly it is true, is withdrawing from the economy by the sale of its equity to the corporate sector, local government is taking on the very same role by the purchase of shares in local firms. What is more, they are doing this perhaps to the detriment of the primary functions of local government in education, welfare and so on.

For this reason the Government and the MF should determine whether LGUs (particularly the city of Zagreb) have used the funds transferred for the decentralised functions for investment into securities (shares and equity). After such a check, they should review their criteria and the manner of the allocation of grants from the central government budget for all the LGUs. Then the LGUs that enlarge their financial assets by investment in shares and equity of corporations and financial institutions inside or outside the public sector would be denied grants from the central government budget. A question still to be answered by the central government is the first effects of the process of fiscal decentralisation and control of the use of funds transferred for the centralised functions. The assignment of the Government and the MF must be to check on whether the implementation of fiscal decentralisation has come to a halt.

6. Conclusion

The financial positions of the LGUs in Croatia are improving, and an increasing number of LGUs meet the basic conditions for being able to borrow. Unfortunately, there are a number of constraints that thwart the development of a high-quality system for the financing of capital investments of the LGUs.
It is crucial that the Government and the MF should decide which mechanism for the financing of local government capital projects they wish to develop. Do they wish to enable LGUs to take on more debt, or to finance local government capital projects themselves with a good system, including known criteria, for allocating capital grants?

In the first case, it would be essential to improve the existing conditions for LGUs borrowing. This refers primarily to a review of budgetary constraints. It is necessary to regulate Zagreb borrowing separately from that of the other LGUs, and to define the role and position of HBOR and the Regional Development Fund in the financing of the capital projects of LGUs. In conditions in which interest rates are falling, LGU borrowing should be resigned to commercial banks, and any involvement of state financial institutions in the authorisation of loans to LGUs should be avoided.

If on the other hand they decide on financing capital projects by LGUs with capital grants, then they also have to lay down clear criteria, this time for the allocation of such grants. It is necessary here to review the already existent system of financial equalisation and the allocation of grants. The reason for this is the fact that LGUs direct some of the financial resources intended for financial equalisation to the financial assets of the local government utility firms. For this reason it is essential to overhaul the system for the allocation of transfers, and to determine whether a hold-up has occurred in the process of fiscal decentralisation.

Putting these recommendations into effect would provide a more suitable environment for borrowing and the financing of the capital projects of the local government units.

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