LOCAL GOVERNMENT BORROWING PRACTICE IN CROATIA

Anto BAJO, PhD*
Institute of Public Finance, Zagreb
bajo@ijf.hr

Review article**
JEL: H74
UDC: 336.3(497.5)

Marko PRIMORAC, MA*
Faculty of Economics and Business, Zagreb
mprimorac@efzg.hr

Abstract

The purpose of this paper is to analyze local government units' borrowing in Croatia. Throughout the paper, we present the financial positions of local government units according to the size and structure of their gross and net debts, analyze borrowing conditions with commercial banks and the state development bank and discuss potential opportunities for and constraints on the issue of municipal bonds. Croatian local government units are not overindebted but do use guarantees to avoid central government borrowing restrictions. Sources of potential financial instability and risks to the creditworthiness of local government units can be found in the financial operations of utility companies. Inaugurating a credit rating system would improve control of adherence to budgetary constraints and determination of priorities for approving local government units' borrowing.

Keywords: local government units, LGU borrowing, LGU debt, LGU creditworthiness

1 Introduction

In this paper we analyze local government unit (LGU) borrowing in the last decade, with a special emphasis on the financial position of local government units according to the size and structure of their gross and net debt. Borrowing conditions with commercial banks and the state development bank are analyzed in detail, and potential opportunities

* The authors would like to thank two anonymous referees for their useful comments and suggestions.
** *Received:* March 1, 2010
Accepted: September 10, 2010

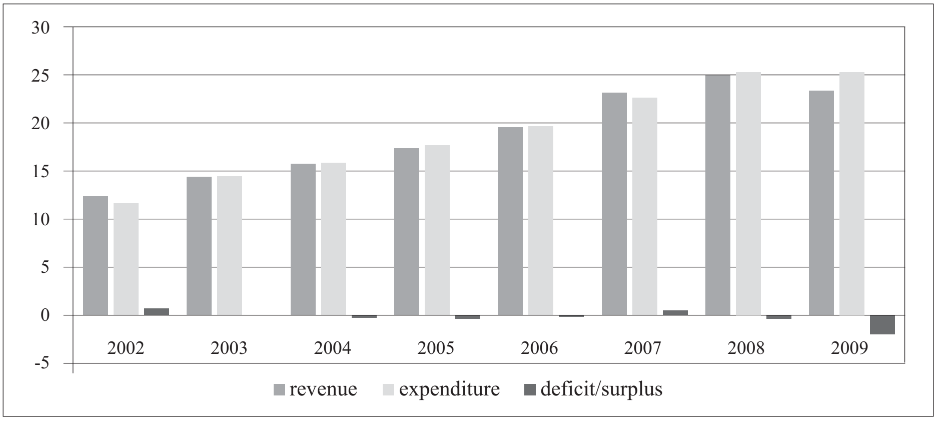
for and constraints on issuing municipal bonds are discussed separately. The main hypothesis of the paper is that Croatian local government units are not overindebted but use guarantees to avoid central government borrowing restriction. In order to determine whether local government units are overindebted, the structure of their net debt is analyzed. We conclude with final recommendations for improving LGU borrowing in Croatia.

2 Financial position of local government units

Since 2000 the financial position of local government units has been improving. The reasons for this are numerous, but one of the main causes is the beginning of the process of fiscal decentralization in 2001. As a result of decentralization, the authority for managing basic local government functions was devolved to local governments, in conjunction with the provision of allowances for their financing from the central government budget. The majority of local government units benefited from the opportunity to introduce surtax and from the increased share in personal income tax inaugurated by modifications of legislation.

In the period from 2002 to 2009 alone, local government budgets increased from 12 to more than 25 billion kuna. As a consequence, the financial situation of local government units improved, i.e. local government budgets stabilized (balanced), even recording a surpluses.

Figure 1: Local government unit budget from 2002 to 2009 (in billion kuna)



Source: Ministry of Finance of the Republic of Croatia, 2010.

The financial position of local government units until 2009 is stable. This can be observed through various budgetary surplus/deficit measures. LGUs do not have significant liquidity problems. Current revenue is more than enough to cover current expenditure causing current and primary surpluses in LGU budgets. A deficit in non-financial assets is visible throughout the observed period as a result of an increasing growth of expenditure for capital financing. Until 2009 LGU budget was generally balanced. Only in 2009 did the total budget deficit increase to 0.6% of GDP as a consequence of the global financial crisis.

Table 1: Measures of local government unit budget deficit from 2002 to 2009 (in billion kuna, and as % of GDP)

	Current		Primary		Nonfinancial assets		Total	
	billion kuna	% of GDP	billion kuna	% of GDP	billion kuna	% of GDP	billion kuna	% of GDP
2002	2.5	1.2	2.6	1.2	-1.7	-0.8	0.7	0.3
2003	2.9	1.3	3.0	1.3	-2.8	-1.2	0.1	0.0
2004	3.1	1.3	3.2	1.3	-3.2	-1.3	-0.1	-0.1
2005	3.2	1.2	3.3	1.3	-3.6	-1.3	-0.3	-0.1
2006	4.3	1.5	4.4	1.5	-4.3	-1.5	0.0	0.0
2007	5.4	1.7	5.5	1.7	-4.8	-1.5	0.5	0.2
2008	4.8	1.4	4.9	1.4	-5.0	-1.5	-0.3	-0.1
2009	3.0	0.9	3.2	1.0	-5.0	-1.5	-1.9	-0.6

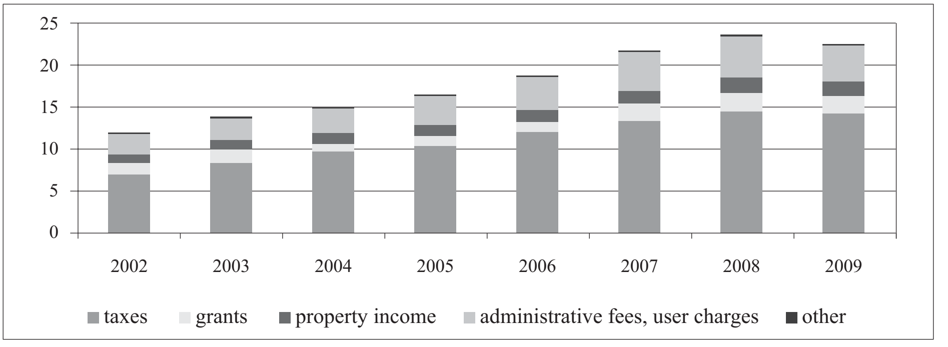
Source: Ministry of Finance of the Republic of Croatia, 2010.

Up to 2009 the number of local government units fulfilling the main borrowing criteria increased (meaning that their current revenue exceeds current expenditure, i.e. their operating revenue exceeds their operating expenditure[1]). For example, in 2003 around 85% of local government units met the main borrowing criteria. Therefore, in the following parts of this paper, we present the key attributes of local government borrowing criteria as well as those for the institutions and utility companies they own.

Tax revenue dominated in the structure of aggregate LGU revenue. Financing of LGUs strongly relies on income tax revenue sharing. Tax revenue (mostly income tax) represents from 59 to 65% of total current revenue. The second most important source of LGU financing consists of administrative fees and user charges (mostly municipal economy fees and contributions), with a significant share of around 20% in total current revenue. The share of property income ranges from 7 to 9%, of grants from 6 to 12%, whereas other sources of current revenue amount to a negligible share, of 1%. Figure 2 presents a detailed sketch of the current revenue composition of local government units from 2002 to 2009.

[1] Following items are excluded from operating revenue: domestic and foreign subsidies, grants and transfers from government budget, other LGU budgets and special contracts (local levies and citizen cofinancing).

Figure 2: Structure of local government unit current revenue 2002-2009 (in billion kuna)



Source: Ministry of Finance of the Republic of Croatia, 2009.

3 Key attributes of local government borrowing

The Budget Law[2] regulates the borrowing of local units and the giving of guarantees. In the annual execution of the central government budget laws, central government determines the budgetary restrictions in the borrowing of local units and the giving of guarantees for the borrowings of their extra-budgetary spending agencies, that is, institutions and companies in the majority ownership of the local units. Most legal provisions that relate to borrowing and central government debt management are also applied to local units. There are some exceptions, for the government regulates in detail the borrowing of local units by additional sets of regulations and the provisions of other laws.

Local units may take on short-term and long-term loans.

Short-term borrowing of local units is possible for the funding of the regular activities of their bodies and their budgetary spending agencies, but only for occasions when the revenue is not collected evenly throughout the year. However, the Government does not approve local unit budgetary borrowing for current illiquidity or for deficit financing, that is, for overdrafts in the budget current account. For this reason a decision concerning short-term borrowing is based on the estimate of LGU ability to secure the repayment of principal and interest on a short-term loan throughout the year while properly meeting its current liabilities.

Long-term borrowing of local units is conducted by taking out loans on the domestic money and capital markets, and from contractors only for capital investment projects for reconstruction and development that are funded out of the local budget. Local units can borrow pursuant to a decision of the representative body with the prior consent of the Government. In 2003 the provision about getting into debt to contractors was abolished, and so local units may now borrow only via loans and bonds.

[2] In Croatian *Zakon o proračunu*.

The Government gives guarantees in order to provide protection in case a local unit cannot repay its debt. If the local unit cannot repay the principal and the interest, the government takes on the obligation to repay the debt, which it will finance out of the revenues of the central government budget. For this reason, before taking on debt, the local units must receive the guarantee of the Government.

In 2002, for the first time, the Ministry of Finance adopted its Instruction[3], and in 2004 and 2009 the Regulations concerning the procedure for local unit borrowing and the giving of guarantees[4]. The Government and Ministry of Finance have also laid down clearer borrowing criteria, and regulations for the implementation of the financing of capital investment projects. Capital projects or capital investments are expenditures for the procurement of non-financial assets that local units fund out of their own budgets. The investment has to be planned in the local budget for the budgetary year for which the borrowing consent is sought, and has to be stated in the decision on the execution of the local budget.

An application for consent to borrowing and for the Ministry of Finance to provide a guarantee (which is submitted to the ministry's department for the preparation of the budgets of local and regional self-government) must be submitted by the head of the local unit (head of a municipality, mayor or county prefect). According to the Budget Law (Article 87), a local government unit is obliged to inform the Ministry of Finance about the contracted loan within 8 days of the contraction. In addition to that, a local government unit has to inform Ministry of Finance within a fiscal year, every quarter (until 10th in the month) for a previous period about the repayment of a loan it has gained Government approval for.

Since some LGUs issue guarantees without the approval of the Ministry of Finance and borrow beyond their financial limits, one of the key areas of the Ministry of Finance's Budget Supervision Directorate is the review of LGU borrowing activities. Unluckily, there is little information in Croatia about 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 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 through utility companies have become a resource for circumventing the Government's budgetary restriction. Until 2008 local government units gave guarantees not only to utility companies but even to private firms and associations. In addition to that, they authorised guarantees for loans to finance current cash flow problems, and sometimes without having had the decision of the representative assembly. Such procedures increased the credit risk and had a direct effect on the increase of the total debt of local government units and the imposition of additional fiscal burdens on citizens. In some cases local government mayors ignored the rules

[3] In Croatian *Naputak o postupku zaduživanja i davanja jamstva jedinica lokalne i područne (regionale) samouprave.*

[4] In Croatian *Pravilnik o postupku zaduživanja jedinica lokalne i područne (regionalne) samouprave i davanju jamstva jedinica područne (regionalne) samouprave.*

because they had absolute authority within their local government units and councils seemed to be too weak to put them under control. For example, from 2005 to 2008 as many as17 LGUs borrowed without government approval, blatantly ignoring the rules without incurring any consequences. Formally, the Ministry of Finance might cut the level of grant (or income tax revenue share) provided by the amount the LGU borrowed without formal government approval. There are loopholes which allow municipal utility companies borrowing beyond the municipal constraints, while the municipality can issue guarantees to support that same borrowing. Unfortunately, although the Budget Law prescribes penalties for such behaviour, local government units used to take advantage of these loopholes.

3.1 Budgetary restrictions in the borrowing of local units

Assuming the prior consent of the Government, only local units the operational revenues of which made in the year proceeding the year in which the unit takes on debt are larger than its expenditures can borrow funds. From 1996 to 1998, local units took on debt on the domestic and foreign capital markets up to 30% of their budgetary expenditures made, that is, the total annual liability of debt was not allowed to exceed 30% of the budgetary expenditures from the preceding year. From 1998 to 2009 the Ministry of Finance and the Government set a lower borrowing limit, and the total annual liabilities (i.e., the yearly annuity) of a local unit were not allowed to exceed 20% of the budgetary revenues collected in the previous year. These budget restrictions are grounded on ad hoc estimations based on local government borrowing requirements from the previous period.

There is a need to ensure that the borrowing of all government levels within general government (i.e., state, extra-budgetary funds and local government) is allocated efficiently and fairly and that internal debt rules for general government are complied with. It is equally important to establish a mechanism for disseminating borrowing permits across different entities at each level of government. Unfortunately, by setting the rules for LGU borrowing, the Government and the Ministry of Finance did not take into account individual local government borrowing requirements. Existing associations of cities, municipalities and counties are weak institutions with limited capacity for influencing Government and Ministry of Finance and suggesting new borrowing limits for LGU.

From 2003 to 2007, the Government and the Finance Ministry brought in additional restrictions. And so in 2003 and 2004 local units could contract debt by at most up to 3% of the total operating revenues, and from 2004 to 2007 up to 2%, and from 2007 up to 2.3% of total collected operating revenues of all the local units. In 2010, local units to which the Government had given its consent for their borrowing up to December, which consent was not used, and local units in areas of special national concern, were exempted from the overall budgetary restriction (they cannot borrow). Nor can local units that receive credit lines for the procurement of non-financial assets from the Regional Development Fund of the Republic of Croatia borrow either, or local units that are co-financing capital investment projects from the EU pre-accession programmes.

In case of non-compliance with the legal framework (violation of borrowing limits, issuing guarantees without Ministry of Finance's approval, borrowing for current expenditure funding, etc.) the Budget Law provides sanctions ranging from 500 thousand to

2 million kuna for the legal entity, 10 to 100 thousand kuna for the responsible person (budgetary user), 50 to 100 thousand kuna for the responsible person (extrabudgetary user) and 50 to 100 thousand kuna for the responsible person (public partner). Unfortunately, these sanctions have not actually been imposed on local government units that failed to comply.

In addition to the above mentioned legislation, secondary legislation in form of a bylaw on LGU borrowing and issuing guarantees is implemented in order to ensure compliance with the provisions of the primary legislation. The bylaw on LGU borrowing and issuing guarantees prescribes arrangements, conditions and obligatory parts of an application for getting the approval for LGU borrowing and issuing guarantees, as well as an approach for reporting on borrowing and issuing guarantees.[5]

The enactment of separate public debt legislation (act) that would prescribe both state and local government borrowing, as well as the borrowing of utility enterprises would offer greater flexibility and improve the efficiency of current institutional framework. Often there is a reluctance to re-open budget legislation for fear that legislators will use the opportunity to table other amendments in unrelated areas which may disincentivize governments from tabling needed amendments to public debt related provisions. Additionally, it may be easier to include more detail on specified borrowing purposes, the objectives of public debt and the requirements to develop and implement borrowing strategies through the enactment of separate legislation.

3.2 Extra-budgetary funds and local government owned enterprises

Total direct debt of utility enterprises does not count in terms of budgetary restrictions for LGU borrowing, although the financial operations of utility enterprises and their LGU are intertwined. However, adherence to formal budgetary restrictions for LGU borrowing can be jeopardized because of the lack of data on existing debt and obligations of utility enterprises, as well as on their financial operations, size and structure of their assets and liabilities, even on their number and sectoral distribution. Until 2009, LGUs bypassed budgetary restrictions by capital financing through utility enterprises debt growth (see the box on the City of Zagreb in chapter 5). Information on the size and the structure of local government unit-owned utility companies is still unavailable. Such information would provide a fuller picture of the implicit local government debt and its structure.

Guarantees and approvals for extrabudgetary funds' borrowing influence LGU liabilities in terms of budgetary restrictions. Unfortunately, the definition of extrabudgetary user is pretty narrow. According to the extrabudgetary users' registry, extrabudgetary users are only county roads authorities. Other potential generators of total LGU debt, such as utility enterprises do not have a status of extrabudgetary users.

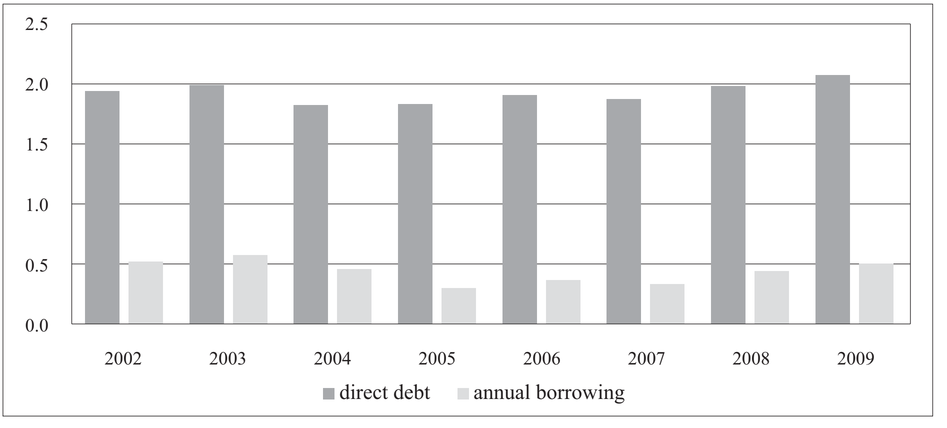
Funds from local government budgets are often transferred through subsidies and indirectly through guarantees to utility enterprises. Subsidies and capital grants from local government to utility enterprises increased from 691 million kuna in 2002 to more than 1.6 billion kuna in 2009.

[5] Provisions of this bylaw refer to LGU credit borrowing, issuing guarantees and issuing municipal bonds.

3.3 Borrowing conditions

Gross debt consists of accumulated local government units' obligations at the end of the period. It can also be defined as the sum of budget deficits of local government units and their budgetary and extrabudgetary users. Total local government sector gross debt increased from 1.45 billion kuna in 2002 to 2.2 billion kuna in 2009. It should be emphasized that the size of total local government debt does not include total local government-owned utility companies' debt.

Figure 3: Total debt and annual borrowing of local government from 2002 to 2009 (in billion kuna)



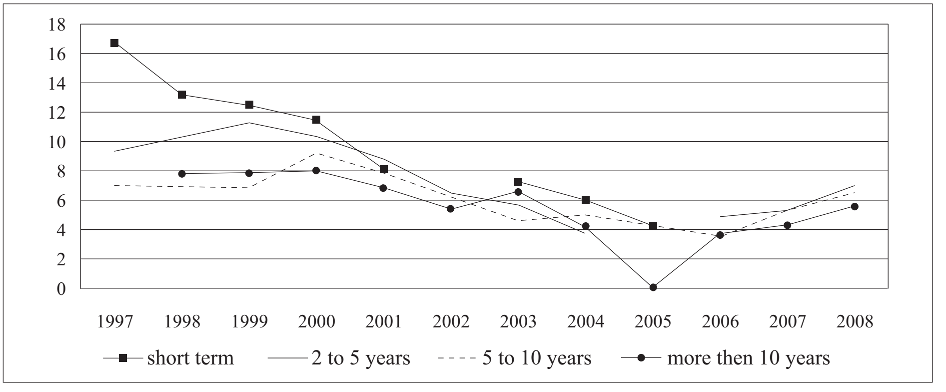
Source: Ministry of Finance and Croatian National Bank, 2010.

Local government units raise loans predominantly on the domestic capital market with varying borrowing dynamics. From a historical perspective, the biggest portion of LGU debt came into being in 1998, when central government approved borrowing worth 1.3 billion kuna. Since 1998 LGUs have on average borrowed 400 million kuna a year.

From 1997 to 2009 local government units used all possible debt instruments, including municipal bonds, loans and even getting into debt with contractors (for works). Some LGUs entered into short term debt as well. The Croatian Bank for Reconstruction and Development (CBRD) is a state financial "player" that ensures favourable loans (with lower interest rates) for LGU capital project financing. From 1997 to 2006 the borrowing conditions of local government units improved, narrowing the gap between minimum and maximum interest rates of different maturities.

From 1997 to 2000 there were quite big differences between minimum and maximum interest rates. In the middle run, interest rates were between 2 and 4%, sometimes reaching as much as 14 to 16%. Big spreads between short term and long term interest rates emerged as a consequence of an unfledged capital market and a weak banking system. The fact that the interest rate on local government short term borrowing reached on average 14% is definitely worth mentioning. Since 2000 the average interest rate and differences between interest rates for various maturities of local government units' borrowing have decreased due to the increased competition among banks on the capital market. In 2004 and 2005 the smallest difference between interest rates on local government unit borrowing amounted on average to about 4.2%. From 2003 local government units start taking out long term debts (over 10 years). After a while, from 2006, interest rates on local government unit borrowing increased again, exceeding the level of 6%.

Figure 4: Average weighted interest rates for local government units' borrowing from 1997 to 2008 (in %)



Source: Ministry of Finance of the Republic of Croatia, 2009.

The reduction in pre-crisis interest rates was not largely due to a general downward trend in international and domestic interest rates and a flattening of the yield curve as expectations of future inflation reduced.

3.3.1 Loans with commercial banks

Some years ago, local government units took on short term debts at unfavourable interest rates, from 16.6% in 1997 to 11.5% in 2000. In the years 2001 and 2002 LGUs did not make short term borrowings, whereas from 2003 a significant decrease in interest rates can be observed. Interest rates for mid term and long term loans to LGUs decreased until 2008, when they started increasing again. From 2001 commercial banks pegged interest rates for local government units' loans to reference interest rates on the domestic or foreign capital market (i.e., LIBOR, EURIBOR, ZIBOR, Ministry of Finance treasury bills with up to 180 days maturity), which increases the interest rate risk because of variable borrowing conditions in financial markets.

Box 1: LIBOR, EURIBOR, ZIBOR

EURIBOR (*Euro Interbank Offered Rate*) is the interest rate at which interbank deposits within the euro zone are offered by one prime bank to another within the EMU zone. EURI-

BOR is sponsored by the European Banking Federation. EURIBOR depends on the "base" rate provided by the European Central Bank. An increase or decrease of EURIBOR depends on economic conditions in the EU. When it needs to control inflation or strengthen the euro, ECB increases its interest rate, causing an increase of EURIBOR, whereas in a situation in which the economy stagnates, the interest rate decreases, causing a decrease of EURIBOR. [http://www.euribor.org/]

LIBOR (*London InterBank Offered Rate*) serves as a standard or reference interest rate for short term borrowings. It is calculated daily by the British Banker Association. Calculation is based on interest rates offered in the London money market (or interbank market). LIBOR is used as a reference interest rate for other financial instruments, especially those denominated in USD. Just like EURIBOR, variations in LIBOR can affect debt repayment both in a favourable and an unfavourable way. [http://www.bba.org.uk/]

ZIBOR (*Zagreb Interbank Offered Rate*) is the interest rate in the Croatian interbank market, published by the Croatian Banking Association (http://www.hub.hr). Official calculation of ZIBOR is based on a calculation of the average interest rates of the eight biggest commercial banks in Croatia, quoted every day at 11 o'clock by Reuters. The Croatian Banking Association publishes ZIBOR rates every working day at 11:30 on http://www.reuters.hr.

Table 2: Average interest rates for local government unit borrowing with commercial banks and the CBRD, from 1997 to 2008 (in %)

Year	Short term		2-5 years		5-10 years		More than 10 years	
	CBRD	Banks	CBRD	Banks	CBRD	Banks	CBRD	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
2004		6.00		3.79		5.01	4.30	4.18
2005			2.30				5.00	
2006				4.84	2.00	3.79	2.00	3.70
2007			6.00	4.62	4.00	5.24	2.24	4.92
2008				6.85	4.00	7.04	3.10	6.61

Source: Ministry of Finance of the Republic of Croatia, 2009; Croatian Bank for Reconstruction and Development (CBRD) loans.

The CBRD ensures favourable borrowing conditions, so called *soft loans,* which are much more attractive than the usual conditions local government units can obtain from commercial banks. Despite that, CBRD interest rates, in some periods, do not diverge a lot from commercial interest rates and are sometimes even higher. Nevertheless, local government unit borrowings with CBRD have a fixed interest rate which eliminates interest rate risk. CBRD is the only institution that pegs interest rates to the Croatian National Bank discount rate. Since 2001 the Regional Development Fund of the Republic of Croatia[6] has made some of its loans available through CBRD, which frequently approves loans with a 1 to 3 year grace period.

3.3.2 Municipal bonds

Issuing municipal bonds represents the easiest way to tap a pool of investors outside of the banking sector. In general, municipal bonds should be the most transparent, but also the most efficient way of local government borrowing. By issuing bonds, local government units get immediate access to the private capital market. Nevertheless, the use of this mechanism of borrowing makes it harder for central government to monitor and control loan supply for local government units (Peterson, 2000). Besides that, local government debt becomes more available to interested parties, because by purchasing only a part of the debt, potential investors can meet their constraints in terms of total permitted exposure to certain investments (especially commercial banks). A need for publicly available information on local government units' operations, as well as their participation in capital markets, would definitely contribute importantly to the ability of LGUs to issue municipal bonds.

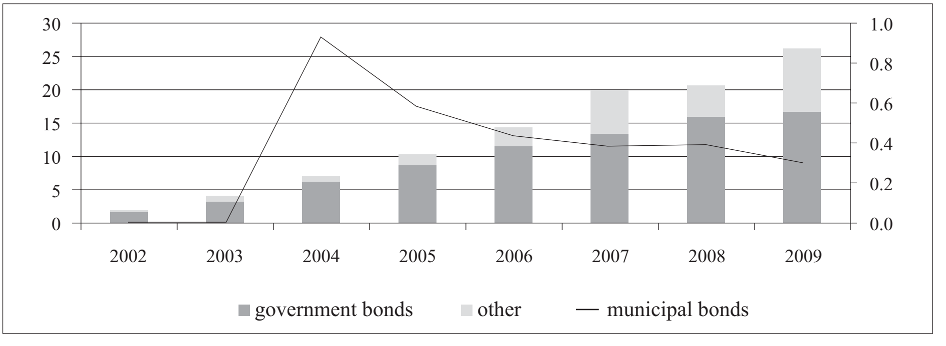
Increased activity in terms of the issue of municipal bonds would shed more light on local government units' credit rating, which would help identify failures connected to local government operations. Once identified, factors negatively influencing a local government unit's credit rating could be eliminated or approached with additional care. Efficient and transparent LGU credit rating (publicly available comparative information on LGU operations), would benefit the best local government units, whereas underperformers would be motivated to undertake positive changes. In this way it would be possible to foster positive competition between local government units, indirectly increasing efficiency of the entire local government sector.

Demand for local government bonds is provided mainly by financial institutions (investment funds, commercial banks, social security funds and insurance companies). According to the current legislative framework, insurance companies have to invest at least 50% of their assets in securities issued by the Republic of Croatia, Croatian National Bank, Croatian Bank for Reconstruction and Development, or bonds and other debt instruments issued with government guarantees (which include local government bonds). In terms of social security funds, according to the regulation in force, they are allowed to have up to 30% of assets invested in bonds and other debt instruments issued by local government. Increased activities directed to local government bond issuing would help potential investors diversify their portfolios and foster further development of the financial market.

[6] Regional Development Fund of the Republic of Croatia (NN 107/2001) is established for fostering balanced regional development of areas under special state care, islands, hill and mountain areas, especially those whose gross domestic product is below 65% of average GDP in Croatia. Fund raises its funds from privatisation, state budget, bonds, loans, donations and other sources.

In order to examine the potential of the local government bonds investor base, some data on social security funds are presented below. Net assets of social security funds increased from 2 billion kuna in 2002 to 29 billion kuna in 2009. Although the share of obligatory social security funds' assets has been decreasing over time, in 2009 it still represents more than 95% of total social security funds' assets. Annual growth rate of obligatory social security funds' assets decreased from 129.63% in 2003 to 7.57 in 2008. In the period from 2002 to 2009, 86-94% of obligatory social security funds' total assets were represented by domestic securities and deposits which include shares and GDRs, government bonds, municipal bonds, corporate bonds, closed-end funds, open-end funds, short-term securities and deposits. In the observed period (2002-2009), the value of total domestic securities and deposits rose from 1.65 billion kuna in 2002 to 16.72 billion kuna in 2009.

Figure 5: The structure of domestic securities and assets of obligatory social security funds from 2002-2009 (in billion kuna – left scale, and as % of total assets – right scale)



Source: Croatian Financial Services Supervisory Agency, 2010.

In the structure of total domestic securities and deposits, government bonds have a predominant share (64-88%). High exposure to government bonds is mainly caused by a low supply of other low-risk debt instruments on the market. From 2002 to 2009, the share of municipal bonds in the structure of domestic securities and deposits was constantly below 1%. Raising local government debt through issuing municipal bonds with varying characteristics (in terms of maturities, interest rate composition, etc.) would broaden the pool of adequate securities for social security funds and other similar investors additionally enhancing their opportunities for risk, liquidity and asset liability management.

Until 2009 only eight local government units with stabile fiscal capacities issued municipal bonds, mainly for infrastructural financing and liquidating dues towards contractors (see table 3). The first bonds, issued by Istarska County in 1995, were traded on the secondary market, representing the very first bonds of that kind traded on the Zagreb Stock Exchange. The second issue of Istarska County's bonds and the first issue of the city of Opatija's bonds were issued as a *private placement*. With its first eco-bond issue, as it was called, Istarska County solved the problem of waste water and the project was partially financed by a World Bank loan. The second issue, of health *bonds,* was issued for settling the dues of a hospital in Pula. The cities of Opatija, Koprivnica, Zadar, Rijeka, Split, Osijek and Vinkovci have issued municipal bonds for infrastructural financing (swimming pools, schools, roads, sports halls, etc.).

Table 3: Local government bonds from 1995 to 2009

Issuer	**Issued**	**Mature**	**Currency (millions)**			**Interest, (%)**	**Interest repayment**	**Principal repayment**
			kuna	**euro**	**DEM**			
Istarska County	1995	2.5 years			2.0	11		
Istarska County	1996	1998	4.3		4.0			
Istarska County	1996	1999	5.7			7		
City of Opatija	1998	2002	14.0			8.5		
City of Koprivnica	2004	2011	60			6.5	Semi annual	Semi annual
City of Zadar	2004	2011		18.5		5.5	Semi annual	At maturity
City of Rijeka	2006	2016		24.6		4.125	Semi annual	Amort.
City of Split	2006	2013		8		4.5625	Semi annual	2 instalments
City of Split	2007	2015		8.1		4.75	Semi annual	2 instalments
City of Osijek	2007	2017	25			5.5	Semi annual	Amort.
City of Vinkovci	2007	2017	42			5.5	Semi annual	Amort.
City of Split	2008	2017		8.2		6.0	Semi annual	2 instalments

Source: Zagreb Stock Exchange, 2010.

Municipal bonds have a higher risk premium than government bonds. For example, the nominal interest rate on the municipal bonds issued by Vinkovci and Osijek in 2007 in kuna is 16% higher than that on government bonds with the same maturity issued in the same year. The fact is that out of six municipal bond issues (Zadar, Split, Rijeka, Osijek, Vinkovci, and Koprivnica) the municipal bonds of Split, Osijek, and Vinkovci are not traded at all on the Zagreb Stock Exchange, and that with just three issues (municipal bonds of Zadar, Rijeka and Koprivnica) trading does exist, but rarely and sporadically. It is apparent that investors hold municipal bonds to maturity. One of the questions that emerges is why local government bonds are issued for trading in the market, when other sales techniques like *private placement* might be more appropriate.

3.4 Summary of local government unit borrowing

The biggest users of commercial bank and CBRD loans are municipalities and cities. From 2005 to 2008 banks lent 2 billion kuna to local government units. Weighted average interest rates in 2008 increased to 5.84%.

Table 4: Characteristics of local government loans from 2005 to 2008

	2005	2006	2007	2008	Total
Number of loans:	34	45	41	32	152
Counties	3	4	3	3	13
Cities	14	24	17	21	76
Municipalities	17	17	21	8	63
Realized loans, in million kuna	367	652	430	524	1,974
Stipulated loans, in million kuna	368	653	451	541	2,012
Average interest rate, in %	4.48	4.73	4.79	5.84	–
Average amortization period (years)	10.7	8.1	9.0	8.6	9.0
Average grace period (years)	1.1	1.0	1.6	1.3	1.2
Number of loans without Government approval	3	7	4	3	17
Number of loans with Government approval	31	38	37	29	135

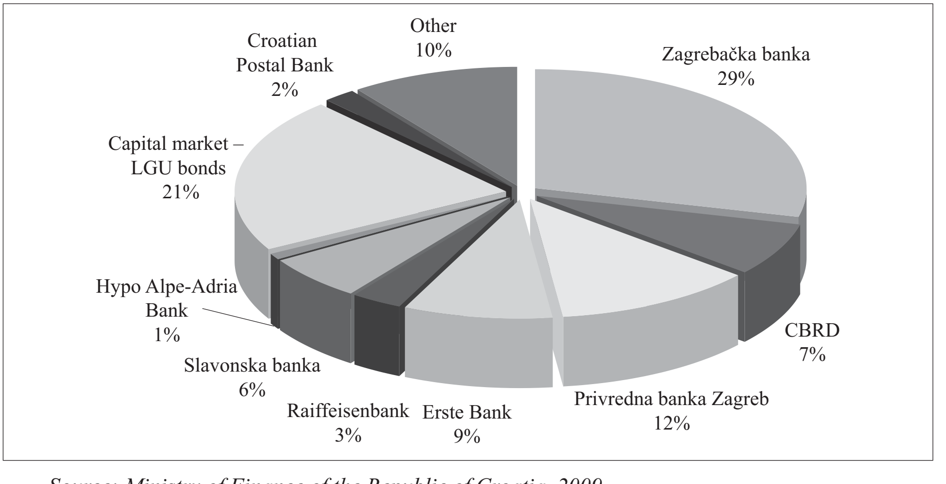
Source: Ministry of Finance of the Republic of Croatia, 2009.

Some local government borrowing was approved with a grace period of more than a year. The majority of local government units raised debt with the provisional approval of central government and the Ministry of Finance. Nevertheless, from 2005 to 2008 year 17 local government units deliberately violated the provisions of the Budget Law and contracted debts without prior approval.

3.4.1 Debt owners

Major individual local government debt owners (creditors) are the CBRD and the four largest commercial banks. Only 21% of the debt is represented by municipal bonds in the possession of commercial banks and mandatory pension funds.

Figure 6: Structure of local government units' creditors in %; June 30, 2009



Source: Ministry of Finance of the Republic of Croatia, 2009.

4 Local government gross debt

Total local government unit debt is a sum of all accumulated obligations: loans, issued guarantees for public utility companies' borrowings and arrears. *Direct debt* is represented by contractual obligations of local government units for interest and principal repayment. Local government direct debt has increased since 2002, reaching an amount of slightly less than 2 billion kuna in 2009. The debt structure is dominated by domestic loans, foreign debt taking a negligible share.

Table 5: Direct local government units' debt from 2002 to 2009 (million kuna and % GDP)

Year	Value	Foreign debt	Foreign debt (as a % of total local debt)	Domestic debt	Domestic debt (as a % of total local debt)	Total
2002	million kuna	223	15	1,235	85	1,458
	% GDP	0		0.6		0.70
2003	million kuna	349	23	1,137	77	1,486
	% GDP	0		0.5		0.7
2004	million kuna	263	16	1,420	84	1,682
	% GDP	0		0.6		0.7
2005	million kuna	199	13	1,327	87	1,526
	% GDP	0		0.5		0.6
2006	million kuna	166	12	1,164	88	1,330
	% GDP	0		0.4		0,5
2007	million kuna	48	3	1,572	97	1,619
	% GDP	0		0.5		0.5
2008	million kuna	27	1	1,863	99	1,890
	% GDP	0		0.5		0.6
2009	million kuna	9	1	2,067	99	2,076
	% GDP	0		0,6		0,6

Source: Ministry of Finance of the Republic of Croatia, 2010.

The share of debt in GDP might be helpful for getting a bigger picture of LGU debt and its impact on central government debt. Local government debt in 2009 reached 0.58 % of GDP. Foreign direct debt gradually decreased from 223 million kuna in 2002 to as little as 18 million kuna in 2009. The main reason for the increase in total direct debt was an increase in domestic debt which in 2009 amounted to 99% of total direct debt.

4.1 Guarantees for extrabudgetary user and utility company borrowings

Guarantees for utility companies' borrowings represent potential liabilities for local government units, because LGUs, with their own revenues, guarantee debt repayment in the case of a default by the original debtor. Accordingly, guarantees have to be included in local government debt. Since 2005, LGUs have had to keep specific records of guarantees issued and also to form guarantee reserves in their budget in case the guarantees fall due. Despite that, it is still unknown how much of their resources local government units assign for budgetary reserves or how much would they have to assign for guarantee reserves.

Table 6: Number of local government units issued guarantees

	Counties	Municipalities	Cities	City of Zagreb	Total
2005	2	4	6		12
2006	5	3	14		22
2007	5	9	13	1	28
2008	4	5	9	1	19
2009	3	6	7		16
2005-2009	**19**	**27**	**49**	**2**	**97**
Total no of LGU	20	429	126		575

Source: Local government units' financial statements, 2010.

From 2005 to 2009, 97 (out of a total of 575) local government units issued guarantees for utility companies' borrowings. In spite of a relatively low number of issuers, the sum of all active guarantees increased from 0.5 billion kuna in 2005 to 2.6 billion kuna in 2009.

Table 7: Active and issued local government units' guarantees from 2005 to 2009 (in billion kuna)

		Active guarantees, Jan 1	Guarantees issued in current year	Active guarantees, Dec 31
2005	City of Zagreb			
	Other LGU	0.5	0.1	0.5
	City of Zagreb			
	Total	**0.5**	**0.1**	**0.5**
2006	City of Zagreb			
	Other LGU	1.5	0.2	1.5
	Total	**1.5**	**0.2**	**1.5**
2007	City of Zagreb	1.1	0.2	1.4
	Other LGU	1.5	0.2	1.5
	Total	**2.6**	**0.4**	**2.8**
2008	City of Zagreb	1.4	0.2	1.5
	Other LGU	1.6	0.5	1.8
	Total	**2.9**	**0.6**	**3.3**
2009	City of Zagreb	1.5	0.0	1.2
	Other LGU	1.4	0.1	1.4
	Total	**3.0**	**0.1**	**2.6**

Source: Local government units' financial statements, 2010.

The cumulative value of local government unit guarantees has to be interpreted with caution. The reason for this is the extremely big share of the city of Zagreb[7].

Issued, active and called guarantees

Issued guarantees – guarantees for extrabudgetary users' borrowings throughout a year.

Active guarantees – total value of issued (not matured) guarantees (both from current and previous years) on certain date (end of period).

Called guarantees – guarantees presented for payment to the local government unit that issued guarantee for the loan, because the extrabudgetary user can not meet its obligations.

4.2 Local government unit arrears

Local government unit arrears count as a form of debt in terms of local government units' borrowing criteria and need to be discussed further. Arrears do not represent a classical debt category if debt obligations are met throughout a year. In general, an obligation exists if a transaction or event that initiates a responsibility for paying occurs and is not liquidated in time. If a liability is not liquidated after the payment date, the obligation is considered due (Bajo, 2007). Because of a paying system that does not encourage local government units (utility companies) to meet their obligations to contractors on time, local government units should consider those arrears as a debt category. An overview of LGU arrears is given in table 8.

Table 8: Local government units' arrears from 2005 to 2008 (in million kuna)

	2005	**2006**	**2007**	**2008**	**2009**
Local government units' arrears	1,692	1,748	2,013	2,193	2,443

Source: Local government units' financial statements, 2010.

From 2005, local government unit arrears increased from 1.6 billion to 2.4 billion kuna in 2009.

Total gross local government debt is the sum of all accumulated liabilities for loans and issued guarantees (for utility companies' borrowings) and arrears. Due to the expanded scope of local government liabilities, which now include not just direct loans, but also potential liabilities (guarantees) and arrears, local government debt significantly increased in 2005 thanks to an increase in guarantees and arrears. The potential liabilities of utility companies reveal a completely different perspective on the nature and structure of local government debt.

[7] In 2008 the city of Zagreb's guarantees amounted 1.9 billion kuna, mainly due to guarantees approved for borrowings of the Zagrebacki Holding.

Table 9: The size and the structure of local government units' debt from 1997 to 2009 (in billion kuna)

	Loans		Guarantees		Arrears		Total	
	billion kuna	% of GDP	billion kuna	% of GDP	billion kuna	% of GDP	billion kuna	% of GDP
1997	0.3	0.2					0.3	0.2
1998	0.7	0.5					0.7	0.5
1999	1.3	0.9					1.3	0.9
2000	1.6	0.6					1.6	0.6
2001	1.8	0.7					1.8	0.7
2002	1.9	0.7					1.9	0.7
2003	2.0	0.8					2.0	0.8
2004	1.8	0.7					1.8	0.7
2005	1.8	0.7	0.5	0.2	1.6	0.6	3.9	1.5
2006	1.9	0.7	1.5	0.6	1.7	0.7	5.1	1.9
2007	2.1	0.8	2.8	1.1	2.0	0.8	7.0	2.6
2008	2.1	0.8	3.3	1.2	2.2	0.8	7.6	2.9
2009	2.1	0.8	2.6	1.0	2.4	0.9	7.1	2.7

Source: Local government units' financial statements, 2010.

After 2001, local government debt significantly increased. Direct loans, which gradually decreased, had the biggest share in LGU debt structure in 2003. The predominant role was from 2004 taken over by utility companies' borrowings (approved by local government units and backed by guarantees) and arrears that caused an increase in total LGU debt to 7.1 billion kuna in 2009. LGU arrears started to increase significantly.

Although from 1997 to 2009 LGU debt increased from 0.2 to 2.7%, measured as a percentage of GDP, LGU debt in Croatia is still relatively low. Without contingent liabilities and arrears, the average LGU debt in the observed period equals 0.4% of GDP. LGU debt in Croatia is low if compared with the debt of local government units from EU member countries (see appendix).

Payment arrears are an untransparent and undesirable source of financing that has wider implications for local economies and businesses. Government should not be encouraged to run up payment arrears and a case could be made for placing restrictions on the borrowing of local government via outstanding payment arrears, irrespective of the size of the debt. This would encourage local government to replace arrears with more transparent sources of funding and disincentivize the accumulation of new arrears by local government units with substantial capital investment programs that need to be funded by borrowing.

The size of the total local government debt (local government plus utility companies) would be useful for indicating the total exposure of local government units – rather than the actual liabilities (shown in table 9). The size of utility companies' debt could significantly alter the perception of the level of local government indebtedness, especially as local units are using utility companies to hide their actual borrowing levels. Unfortunately data on the size, structure and borrowing conditions of utility companies and their influence on the total level of total local government debt are not publicly available and represent subjects for further research.

5 Local government net-debt

Net-debt is the difference between financial assets and financial liabilities. It is a very useful indicator of liquidity and the ability of local government to repay interest on and principal of an existing debt. Financial assets of local government unit consist of cash (currency), deposits, loans (given) and shares in institutions in or outside the public sector. Financial liabilities encompass all liabilities for issued financial instruments and loans (received).

When observing financial assets it has to be pointed out that the majority of shares are probably not recorded at their market value, because the shares that local government units possess are not actively traded in the market. In contrast, financial liabilities are recorded according to their market value, because liabilities consist of loans and other contractual obligations with a precise market value. Therefore, it is essential to separate the net financial position of LGUs, with and without shares, from the shares possessed by local government units, in order to assess LGU borrowing capacity more precisely.

The financial position of local government units measured as net financial assets, i.e. as a difference of liquid financial assets (currency, deposits, loans, securities) and liabilities in 2007 and 2009 (table 10) was satisfactory. Local government units, in general, are not facing major liquidity problems. Existing liabilities are completely covered with cash available on accounts in commercial banks (if local government units liquidated all liabilities, they would still have 1.7 billion kuna in 2007 or 220 million kuna in 2009 of liquid financial assets on their accounts). It is obvious how the financial crisis has adversely affected the financial health of local government units. Although in general it seems pretty liquid, even in 2009, if the local government sector is observed according to different levels of government, it can be concluded that cities were much more affected by the financial downturn than other local government levels. Taking everything into account, the financial position of LGUs is adequate, with an increase in the number of local government units that fulfil the borrowing criteria up to the period of the financial crisis. This can be further proved by observing the Croatian National Bank's data on the comparison of a part of LGUs' financial assets (deposits denominated in kuna and other currencies) and financial liabilities (loans and bonds) in the period from 2003 to 2009.

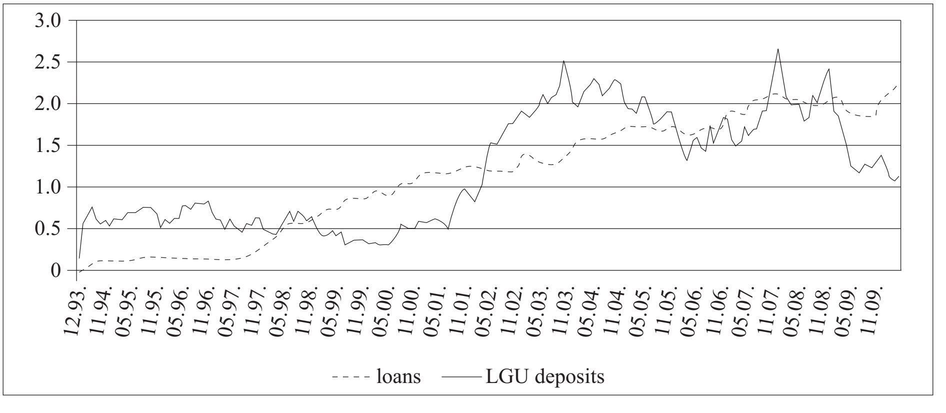
Comparing the monthly value of deposits and LGU liabilities, it turns out that local government units possess satisfactory excess liquidity, which can be used for repayment of incurred liabilities in almost the whole observed period.

Table 10: Financial position and liquidity of local government unit in 2007 and 2009 (in million kuna)

	Counties		Municipalities		Cities		City of Zagreb		Total	
	2007	**2009**	**2007**	**2009**	**2007**	**2009**	**2007**	**2009**	**2007**	**2009**
Financial assets	**780**	**789**	**859**	**723**	**1,836**	**1,568**	**593**	**300**	**4,067**	**3,114**
Currency	298	145	716	449	1,217	763	481	194	2,712	1,357
Deposits	98	285	78	223	366	592	60	65	602	1,101
Loans (given)	385	359	63	50	243	192	20	25	710	601
Domestic	409	389	63	50	244	194	20	25	736	634
Foreign	0	0	0	0	0	0	0	0	0	0
Securities	0	0	1	1	10	21	32	16	43	22
Domestic	0	0	2	1	10	21	32	16	43	22
Foreign	0	0	0	0	0	0	0	0	0	0
Financial liabilities	**221**	**295**	**251**	**294**	**1,523**	**2,304**	**350**	**509**	**2,345**	**2,894**
Securities	4	0	0	6	479	580	0	0	483	587
Domestic	4	0	0	6	479	580	0	0	483	587
Foreign	0	0	0	0	0	0	0	0	0	0
Loans	217	295	251	288	1,043	1,724	350	509	1,861	2,307
Domestic	217	295	251	287	971	1,712	350	509	1,790	2,294
Foreign	0	0	0	1	83	29	0	0	84	29
Net financial assets	**559**	**494**	**608**	**429**	**313**	**-736**	**242**	**-209**	**1,723**	**220**

Source: Local government units' financial statements, 2010.

Figure 7: Local government units' deposits and loans from commercial banks from 1993 to 2010 (in billion kuna)



Source: Croatian National Bank, 2010.

Until the end of the year 2000 financial liabilities of local government units were rarely higher than financial assets, but from 2001 disposable financial assets of local government units increased significantly. Deposits and currency on bank accounts by far outgrew total liabilities (by more than a billion kuna). Financial obligations for loans and bonds are insured with high quality financial assets. That is mainly a result of the increased funds for the decentralized functions that local government units received based on an increased share in personal income tax and an increase in grants from central budget. Growth in financial assets (deposits) is especially apparent in the period from 2002 to 2006, when central government, due to an increased share in personal income tax, passed down higher amounts, which probably caused an increase in local government units' funds in bank accounts. At the beginning of 2009 the level of financial assets decreased as a consequence of the financial crisis.

Since a portion of increased financial assets is related to earmarked or mandatory expenditures from devolved functions such as health or education services, it can not be used for other purposes, such as debt service. Therefore, in order to get a picture on the true position of the local government units' "free" cash flows available to service debt (financial health), the relationship between earmarked and non-earmarked revenue has to be identified (table 11).

Table 11: Local government unit net revenue from 2002 to 2009 (in million kuna)

Year	Total revenue	Grants from government budget	PIT and surtax revenue for 33 cities that took over decentralised functions	Total net revenue
2002	12,426	1,281	3,178	7,967
2003	14,488	1,202	3,535	9,751
2004	15,727	738	4,063	10,926
2005	17,397	880	4,164	12,354
2006	19,612	875	4,639	14,098
2007	23,166	1,571	6,924	14,671
2008	25,038	1,853	7,492	15,693
2009	23,318	1,701	7,496	14,121

Source: Local government units' financial statements.

Since there is no publicly available information on local government units' earmarked revenue, table 11 shows data on LGUs' total revenue, total grants from general government budget (mainly earmarked), and revenue from personal income tax and surtax of 33 cities that took over decentralised functions. Since just a portion of personal income tax and surtax revenue of those 33 cities is earmarked, the value of net revenue is not completely accurate, but it can provide a good approximation of total disposable (non-earmarked) revenue. The share of earmarked in total revenue is relatively stable, ranging from 28 to 39%. In other words, while total revenue from 2002 to 2009 increased by 87.65%, total net revenue increased by 77.24%.

It is obvious (from table 12) that the 33 cities that took over decentralised functions have a dominant share in local government units' aggregate financial data. Having that in mind, it is clear that aggregate data on local government units' operations could provide a misleading picture of the financial state of individual local government units. Therefore, a further examination of some major groups of local government units' operations follows in the remainder of this chapter.

Table 12 represents the structure of local government current revenue, displaying a separate structure for A – cities, B – cities that took on decentralised functions, C – cities that took on decentralised functions without city of Zagreb, D – cities that didn't take on decentralised functions.

Table 12: Structure of local government current revenue, in million kuna in 2009

	A	B	C	D
Taxes	14,256	8,238	3,368	1,547
Contribution/social	0	0	0	0
Grants	2,037	389	334	472
Property income	1,691	1,097	590	179
Administrative fees, user charges	4,292	2,808	1,569	689
Other revenue	161	85	78	27
Total current revenue	22,437	12,617	5,939	2,913
Current revenue as % of total				
Taxes	64	65	57	53
Contribution/social	0	0	0	0
Grants	9	3	6	16
Property income	8	9	10	6
Administrative fees, user charges	19	22	26	24
Other revenue	1	1	1	1
Total current revenue	100	100	100	100

Note: (A) all cities, (B) cities that took on decentralised functions, (C) cities that took on decentralised functions not including the city of Zagreb, (D) cities that didn't take on decentralised functions.
Source: Ministry of Finance.

Total revenue of cities that took over decentralised function in 2009 represented more than 56% of total local government sector revenue (cumulative revenue of all local government units). In addition to that, 52% of the revenue of the 33 cities is accounted for by the revenue of the City of Zagreb. Similarly, the total expenditure of the 33 cities represented more than 56% of total local government sector expenditure (and with its share of almost 53%, City of Zagreb has the dominant role in 33 cities' total expenditure).

Tax revenue dominated in the structure of aggregate LGU revenue. Financing of LGUs strongly relies on income tax revenue sharing. Tax revenue (mostly income tax) represents more than 65% of total current revenue for the 33 cities that took over decentralised functions. That is mainly a reflection of the revenue structure of the City of Zagreb, because if Zagreb is excluded from the sample, in the revenue structure of the remaining 32 cities, taxes represented slightly less than 57%. Comparison of the share of tax in the total revenue of cities that took over decentralised functions and those that did not reveal the interesting information that the tax revenue share for cities that took over decentralised functions is 12 percentage points higher than for the rest of the cities.

Box 2: City of Zagreb and utility company borrowing and debt

At the end of 2008, the credit rating agency Moody's Investor Services downgraded the credit rating of Zagrebacki Holding from Baa2 to Baa3 (from medium to lower solvency level) and the city of Zagreb from Baa1 to Baa2 (from higher to medium solvency level). The credit rating was downgraded because of the high borrowing activity of utility companies and the poor debt repayment conditions and overall financial position of Zagrebacki Holding. Despite the relatively low level of the City of Zagreb's direct debt, its exposure to the financial operations of Zagrebacki Holding has significantly increased. This situation enhanced the need for the determination of local government units' creditworthiness in Croatia, taking into account the total financial operations of local government units and their utility companies.

Table 13: City of Zagreb and Zagrebacki Holding debt from 2005 to 2009, in million kuna and as % of total

	2005	2006	2007	2008	2009
billion kuna					
City of Zagreb	481	349	350	467	509
Zagrebacki Holding	n.a.	1,371	4,197	4,960	5,040
Total debt		1,720	4,547	5,427	5,549
%					
City of Zagreb		20	8	9	9
Zagrebacki Holding		80	92	91	91
Total		100	100	100	100

Source: City of Zagreb and Zagrebacki Holding financial statements, 2010.

From 2006 to 2009 total consolidated debt of the City of Zagreb increased from 1.7 billion to 5.5 billion kuna. The debt of the city budget is relatively low (around 9% of total consolidated debt), whereas the debt of Zagrebacki Holding is the major share of the consolidated debt (more than 90%).

The borrowing of Zagrebacki Holding has increased significantly since 2007, when the Holding issued corporate bonds amounting to approximately 2.7 billion kuna on the London Stock Exchange. Accordingly, the total debt of Zagrebacki Holding in 2009 reached around 5 billion kuna.

Table 14: Zagrebacki Holding debt covered by guarantees and subsidies from 2005 to 2009, in million kuna

	2005	2006	2007	2008	2009
Zagrebacki Holding, total debt	n.a.	1,371	4,197	4,960	5,040
City of Zagreb guarantees	806	1,142	1,363	1,520	1,239
Subsidies from the City of Zagreb budget to Zagrebacki Holding	561	612	670	870	951
Guarantees as % of total debt	–	83	32	31	25
Subsidies as % of total debt	–	45	16	18	19

Source: Authors' calculation based on financial statements of City of Zagreb and Zagrebacki Holding.

Almost 25% of the Zagrebacki Holding debt is covered by City of Zagreb's guarantees. Additionally, Zagrebacki Holding obtains subsidies from city budget (amounting 19% of total debt only in 2009).

The status of the unguaranteed portion of the Zagrebacki Holding debt is an implicit guarantee from the City of Zagreb that makes the contingent liabilities of Zagreb much more significant that the actual liability position. Unfortunately, data on utility companies' debt are available only for the City of Zagreb.

The City of Zagreb as owner should exercise (particularly because it is a public owner) considerable supervision over how the company is operated, should ensure that the governance arrangements are appropriate, set the overall financial policy, supervise borrowing and indeed set limits and key financial parameters. The accounts of city (municipal) companies should be consolidated with those of the city/municipality as they should be if either the cash or the accrual international Public Sector Accounting Standards (IPSAS) are applied. This would then show the overall financial position of the city/municipality and in turn ought to encourage the Council to take more interest in the companies it controls.

Unfortunately, in present budget legislation there is no formal consolidation requirement, which is the result of the lack of definition in the status of extrabudgetary users. The local utility companies are not even required to consolidate their budgetary financial statements, because they are legal entities that operate according to the law that regulates corporations. This is the reason why we argue that local government units should consolidate the financial statements of utility (or other) enterprises with the budget (or financial statements) of local government units. In the present circumstances we cannot see the real level of LGU consumption and investment in capital and current expenditure and can hardly get an impression about gross or net LGU debt and the LGU borrowing requirement.

6 Creditworthiness and credit rating of local government unit

Why do we need to analyse the creditworthiness of local government units? The different statuses of local government units in a certain state, variations in fiscal capacities, numbers of inhabitants, unclear rules for tax revenue sharing and many other facts uncover huge differences in the financial stability of certain local government units. Consequently, the credit ratings of local government units can vary significantly.

Rating local government units through a credit rating system can detect failures or omissions in managing certain segments of their operations. If factors that adversely influence credit rating could be detected, officials managing local government units could focus on improvements in a certain segment of operations in order to improve credit rating. A publicly available local government unit credit rating could serve as a direct way of promoting the best local government and warning those that underperform, motivating them for improvement. In that way, it would be possible to enhance positive competitiveness between local government units, which could increase the efficiency of the complete local government sector.

Budgetary constraints, credit rating and credit risk. Budgetary constraints for local government units' borrowing to a certain extent motivate local government units to use their financial resources more efficiently. Nevertheless, omitting budgetary restrictions and criteria for local government borrowing that are not so demanding (if operating revenue was higher than operating expenditure in a year before the year of borrowing) enables even not very successful local government units to take on debt as well. It has to be pointed out that borrowing legislation creates quite a big disparity between individual and cumulative borrowing constraints. If an efficient control of meeting the borrowing requirements were in place the need for the development of a credit rating system would still exist in order to determine the priority for the approval of local government units' borrowing. One of the ways for creating a ranking for local government units could be a credit rating system.

A system that grades internal and external factors from local government units' surroundings could provide a bunch of external indicators that would help identify potential failures or limiting factors set by legislation. In that way, potential institutional constraints could be identified and removed or at least restrained, very soon further enhancing the development and efficiency of the local government sector. All those facts additionally support the idea of a transparent and thorough credit rating system for local government units in Croatia.

Even though local government units' operations represent an essential credit rating indicator, utility companies' operations under the control of or owned by local government units have to be considered with special attention. Due to the fact that utility companies' debt is not considered a part of local government units' debt, local government units avoid budgetary constraints on borrowing by raising loans through their utility companies. Therefore, potential risks associated with utility companies' operations can represent a key component of a local government units' credit risk, which has to be analysed and interpreted with due caution.

7 Conclusion

Sources of potential financial instability and risks to the creditworthiness of local government units can be found in the financial operations of utility companies.

Unfortunately, the financial operations of utility companies have hitherto not been consolidated in one place. *Local government units interact with utility companies* according to the principle of connected vessels because funds from the government budget are often transfused through subsidies or grants but also through the issuing of guarantees for utility companies' borrowing. And ultimately, it is by virtue of utility companies that local government units perform the biggest part of their financial and capital investments. *Local government units' budgets and utility companies' budgets formally do not operate according to the principle of connected vessels.* The city mayor proposes and the assembly adopts the budget, but the assembly does not adopt the financial plans of the utility companies.

Through capital market liberalization, but also because of growing demands for local government unit borrowing in Croatia, the problem of determining LGU creditworthiness is going to become more significant for potential investors, for local government units, and also for regulatory and supervisory authorities at the central government level.

Recommendations

In order to acquire a thorough image of the assets involved, the financial operations of local government units and especially the size of their debts created through utility companies, the financial statements of utility companies and local government units have to be consolidated. Formally, that should not be a problem because utility companies are owned by local units. But since utility companies have the status of public corporations, this has not been possible so far.

The Government and the Ministry of Finance should regulate borrowing (purpose, instruments, security, issuance of guarantees, etc.) of central government, local government units and utility companies, in one Public Debt Act.

The Government and the Ministry of Finance should empower a system of financial controls in order to prevent wilful violation of the Budget Act's provisions and local government borrowing without prior approval.

They should introduce analysis of creditworthiness through a credit rating system for local government units. Inaugurating a credit rating system would improve control of adherence to budgetary constraints and determination of priorities for approving local government units' borrowing.

APPENDIX

Local government debt in European countries, as % of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
EU-27	5.2	5.1	5.0	5.1	5.1	5.3	5.3	5.1	5.1	5.7
EU-25	5.2	5.1	5.1	5.1	5.1	5.3	5.4	5.2	5.2	5.7
EU-15	5.4	5.3	5.2	5.3	5.3	5.5	5.5	5.3	5.4	5.9
EA-16*	5.4	5.2	5.3	5.4	5.4	5.6	5.6	5.5	5.6	6.0
EA-15	5.4	5.3	5.3	5.4	5.5	5.6	5.7	5.5	5.6	6.0
EA-13	5.4	5.3	5.3	5.4	5.5	5.6	5.7	5.5	5.6	6.1
EA-12	5.4	5.3	5.3	5.4	5.5	5.6	5.7	5.6	5.6	6.1
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 Republic	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
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1
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						**1.5**	**1.9**	**2.6**	**2.9**	**2.7**
Croatia 2	**0.6**	**0.7**	**0.7**	**0.8**	**0.7**	**0.7**	**0.7**	**0.8**	**0.8**	**0.8**

Note 1: Croatian local government debt consist of direct and potential LGU liabilities and arrears since 2005.
Note 2: Croatian local government direct debt (loans and bonds).
Source: Eurostat, 2010. For Croatia: Ministry of finance of the Republic of Croatia.

**EA – Euro area*

LITERATURE

Bajo, A. and Filipović, B., 2008. "The Efficiency of the Water Supply in Croatia". *Newsletter,* No. 37. Zagreb: Institute of Public Finance.

Bajo, A. and Primorac, M., 2009. "Zašto je lokalnim jedinicama potreban kreditni rejting". *Zbornik s III konferencije Hrvatski javni sektor u aktualnim gospodarskim uvjetima*, Hrvatska zajednica računovođa i financijskih djelatnika, Opatija, April 2 i 3, 2009.

Bajo, A., 1998. "Financiranje lokalnih jedinica zaduživanjem". *Financijska praksa,* 22 (4-5), 469-490.

Bajo, A., 2004. "Local Government Unit Borrowing in Croatia: Opportunities and Constraints". *Financial Theory and Practice,* 28 (2), 203-217.

Bajo, A., 2007. "Do Utility Companies Increase Local Government Debt in Croatia?" *Newsletter,* No. 28. Zagreb: Institute of Public Finance.

Bajo, A., 2008. "Why has the Credit Rating of Zagrebacki Holding Been Downgraded?", *Press Release, No. 5.* Zagreb: Institute of Public Finance.

International Federation of Accountants, 2007. *International Public Sector Accounting Standards*. New York: International Federation of Accountants.

Naputak o postupku zaduživanja i davanja jamstva jedinica lokalne i područne (regionale) samouprave, NN 32/2002. Zagreb: Narodne novine.

Petersen, J. and Crihfield, J. B., 2000. *Linkages Between Local Governments and Financial Markets: A Tool Kit to Developing Sub-Sovereign Credit Markets in Emerging Economies.* Washington: The World Bank.

Peterson, E. G., 1998. *Measuring Local Government Credit Risk and Improving Creditworthiness*. Washington: The World Bank.

Peterson, E. G., 2000. *Building Local Credit Systems*. Washington: The World Bank.

Pravilnik o postupku zaduživanja jedinica lokalne i područne (regionalne) samouprave i davanju jamstva jedinica područne (regionalne) samouprave, NN 55/2004, 58/2009. Zagreb: Narodne novine.

Zakon o proračunu, NN 87/08. Zagreb: Narodne novine.

** The Budget execution laws from 2003 to 2009 (Official Gazette).