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Financing of the sub-national government investments in the Republic of Croatia

1. INTRODUCTION

Fiscal consolidation goals of the EU countries created strong pressure on to the local budgets. It is a well known fact that the burden of debt in all EU and EU accession countries has been created by expansionary fiscal policy of central government levels of these countries (primarily social security net funds). These revenue sources were often used for financing current expenditure needs. There have been attempts to solve the problem of excessive debt and deficit by reducing the deficits on all levels of governance. However, these attempts do not respect economic logic. Investments in public infrastructure are necessary for normal functioning of delivery of public services and form the basis for the productivity of the private sector. Local development of the EU accession countries is especially restricted due to low levels of national and local accumulation. So, by respecting the given constraints by supranational authorities, there is a possibility within the particular country debt policy to make it optimal. There is a need for "internal stability pact "in every country aiming at exploiting the deficit resources most efficiently and accomplishing the fiscal consolidation goals. Experiences of western European economies present good basis for modeling this kind of agreement between the tiers of governance.

Decentralization and urbanization processes that occurred in emerging economies created increased needs for expenditure on local levels of governments. Devolution of responsibilities for delivering the public sector functions, following the subsidiary[1] principle, was usually not encompassed by adequate revenues. In the majority of these economies, local government unit's revenues were barely sufficient for sustaining the level of delivery of local public goods and services. Capital expenditures relied mostly on central government capital transfers. The growing needs for the local public investment demanded new financing sources for local government.

The Croatian goals of accessing the EU made the fiscal consolidation efforts as primary targets of macroeconomic goals. High level of government debt accumulated by the central government level and "off-budget" funds created the pressure on the local borrowing as well. The fact is that local deficit financing was not used in large scale for financing investments. Investment needs of sub-national tiers of government were matched by capital transfers from the central authority. However, theoretical findings as well as EU countries' experience show that local borrowing should have a significant role in financing investments.

[1] principle of efficient division of responsibility for delivery of public goods and services across the tiers of public governance

Following the introduction, dynamics of the government capital expenditures in Croatia is analyzed, after that regulatory framework and the features of the financing system are discussed. Numerous advantages for the utilization of the long-term based instruments of financing are stated. Nevertheless, there are reasons to be cautious in using this instrument of financing. At the end some recommendations are drafted.

2. GOVERNMENT INVESTMENTS IN CROATIA

Croatia is one of the European countries with the highest ratio of investments in GDP. Investment spending especially intensified from the year 2002 when large scale construction of the new highways and roads started. These investments were financed through the extra budgetary funds Croatian highways and Croatian roads. However, in the same time level of capital spending of sub-national government also increased. It can be seen from the data in the table 1 that sub-national government investments in the year 2006 almost doubled the size of investments of the central government budget. That means that the basis for the increase of the productivity of economy is more and more dependent on the local sector representatives.

Table 1: Dynamics of the public sector investments

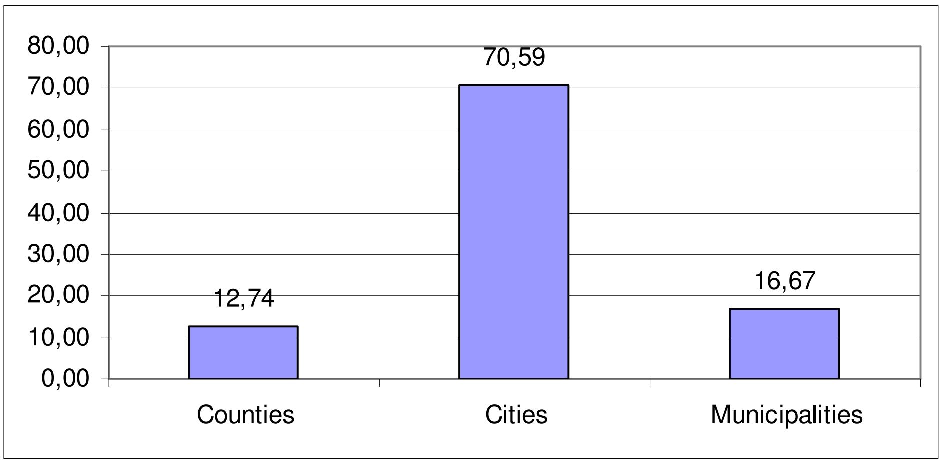
	Central government budget		**Extra budgetary funds and agencies**		**Sub-national governments**		**TOTAL**	
	- bln. HRK	**structure (%)**	**- bln. HRK**	**structure (%)**	**- bln. HRK**	**structure (%)**	**- bln. HRK**	**structure (%)**
2002	1377,0	19,0	4752,4	65,4	1135,9	15,6	7265,4	100,0
2003	1812,4	18,8	6183,6	64,0	1668,4	17,3	9664,4	100,0
2004	1419,5	13,5	6954,0	66,3	2121,4	20,2	10494,8	100,0
2005	1553,7	17,1	5145,7	56,8	2360,3	26,1	9059,7	100,0
2006	1043,2	14,9	4003,7	57,0	1974,2	28,1	7021,1	100,0
TOTAL	7205,7	16,6	27039,5	62,2	9260,2	21,3	43505,4	100,0

Source: Ministry of Finance (2007)

However, significant differences in terms of investment activity within the sub-national sector are present. Inequality of the fiscal capacity can be seen in the figure 1 where the structure of net investments of counties, cities and municipalities is presented[2]. Majority of investments is financed by cities. Due to fact that law does not allow much more freedom for the cities from other entities, city governments that have more than sufficient resources have to struggle with restrictive provisions of regulation and control of the central government.

Figure 1: Investment activity of counties, cities and municipalities for the year 2006

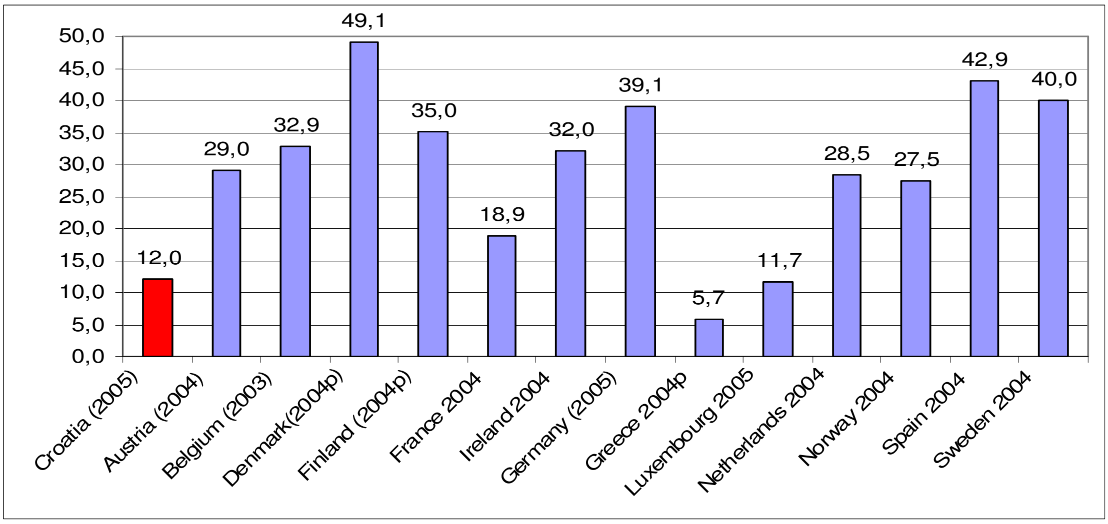
[2] By the Constitution Croatia is formed as the federal country with three tyers of government – central government, regional and local (cities and municipalities). However due to fact thar regions do not function in practice they are classified as the local level of governance. Therefore, Croatia is actually unitary country and international statistics publications refer to Croatia in the same manner (i.e. IMF's Government Finance Statistics manual and yearbooks).



Source: Ministry of Finance

In addition, importance of the local government's activities is not appreciated in the terms of delegation of financial power to the sub-national governments. Croatia is one of the most centralized countries in the Europe. Figures 2 and 3 shows the comparison of Croatian share of sub-national revenues in total government revenues and European developed and transition economies. It is obvious that the degree of fiscal decentralization is among the lowest.

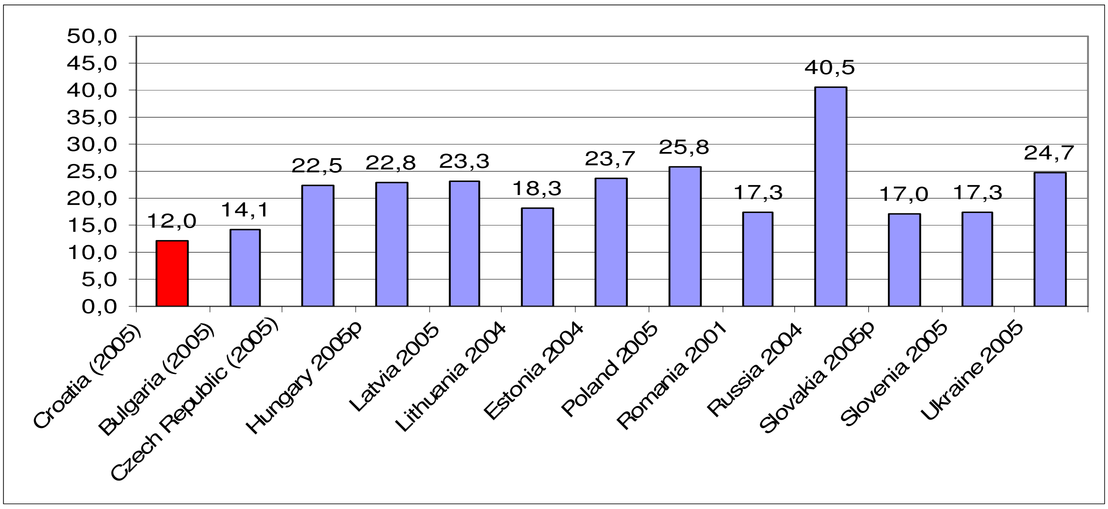
Figure 2: Comparison of the share of sub-national revenues in the total government outlays of Croatia and European developed economies



Source: IMF (2006), Government Finance Statistics Yearbook

In spite of the nominal efforts towards the higher level of decentralization, sub-national government budgets (570 regional and local government units) still amounts around 12% of the total consolidated government revenues. Nevertheless, sub-national government finances high share of government investments. In addition to that, there are high divergences regarding the fiscal capacity of counties, cities and municipalities. Role of the cities is dominant. The problem is in fact that delegated functions and responsibilities do not follow the financial capabilities. Counties have wide responsibility but their fiscal capacity is often much lower than the capacity of cities within their border. Numerous municipalities are formed without any financial capabilities to justify the purpose of their existence. Investment activities of local governments in those areas are not possible without donations of the central government. Territorial-administrative reform of the sub-national government sector is necessary. Present situation is one of the obstacles for progress of the fiscal decentralization.

Figure 3: Comparison of the share of sub-national revenues in the total government outlays of Croatia and European transition economies



Source: IMF (2006), Government Finance Statistics Yearbook

Although fiscal decentralization process started in the year of 1994 by the new territorial-administrative organization setup, the results are not significant. Financial powers of the local sector are still on the low level. In addition, governance autonomy of the local sector is also limited by restrictive laws. Therefore it is surprising how these local units keep so high level of investments under such circumstances. In the next part of the paper features of the system of financing are addressed.

3. FINANCING OF THE GOVERNMENT INVESTMENTS

In this paper necessity of utilization of financial instruments that are based on the long-term relationship is argued. That means not only deficit financing but also different kinds of project financing that by the economic logic has the same effects as borrowing (annual payments for the services of the private sector burden the budgets in the same manner like borrowing). Therefore term borrowing refers also to the other long-term based instruments.

Economic theory suggests that "reasonable" levels of borrowing by developing countries are likely to enhance their economic growth. Its positive influence is channeled in two directions – through capital accumulation and productivity growth. Countries at lower stages of development have small stocks of capital and are likely to have investment opportunities with rates of return higher than in advanced economies[3] (see Pattilo, Poirson and Ricci, 2004, p. 5.). These facts support the opinion that there are reasonable arguments for debt financing followed by certain principles. Economic theory, history and empirical findings proved use of deficit financing in following cases:

1. In state of recession and depression when private sector cannot induce recovery[4]
2. Financing public investments (especially those complementary to the private sector[5]) and thus enlarging and improving productive capacity of economy – the bulk of these investments is in scope of the local level of public governance
3. As a way of improving the welfare function by raising the level of public goods and services – in this way, prices in housing sector are higher at the local level. This higher price is capitalized by higher tax burden of debt repayment.

Although the local public sector in EU candidates (and new members) is limited by their budgets' size, fiscal operations of their sub-national governments can have important macroeconomic effects. They can boost the demand by balanced budget increase or by changes in the composition of their revenues – if spending is related by outlays with large multiplier effects (public works, for example). The magnitude of these effects is increased by the decentralization progress[6].

Local deficit finance, as previously mentioned, is a controversial category. Although, it is eagerly argued by the supranational organizations and institutions (like Asian Development Bank, Inter-American Development Bank, European Bank for Reconstruction and Development) that local borrowing is necessary for financing investments in the growing local sector there is strong pressure towards the local deficit financing (see Peterson E. George and Hammam Sonia, 1997., p.5.)[7]. Practical example is EU limits on public debt and deficits levels that constrained fiscal policies of member countries and accession countries as well.

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[3] At higher levels of debt, negative impact of borrowing on growth is explained by "overhang theory" – increased debt-service costs tend to discourage domestic and foreign investments.

[4] Measures undertaken in USA for overcoming the depression in 1930-ies confirm its importance.

[5] Which enlarge the productivity of private investments!

[6] Terr-Minassian (1997, p.5.) warns of the possibilities for endangering macroeconomic efforts of central government in absence of appropriate coordination between the tiers of public governance (sub-national government could run counter the determined macroeconomic goals). This possibility is known as "fiscal perversity" and has its roots in Keynesian economic doctrine.

[7] In spite of the fact that pressure (mostly coming from the International Monetary Fund) was focused primarily on excessive total public debt the local fiscal crises in Argentina, Brazil, Columbia, Hungary and Russia diverted attention on sub-national borrowing as well.

Apart from the general arguments for the use of deficit financing there are some specific advantages of borrowing on local level (compare Swianiewicz, Paul, (2003), Ebel, R.D., Yilmaz S., (2002)):

- Intergenerational equity – it is appropriate to use local borrowing for financing investments because benefits of these undertakings are spread over time. Because of that not only present but future inhabitants of certain locality have opportunity to enjoy in outputs of these investments.
- Local economic development – borrowing is a useful tool for stimulating growth on local level, local governments are better informed on local needs for physical and social investments and therefore could be more effective considering decisions about investment priorities
- Synchronization of expenditure and revenue flows – borrowing prevents possible interruptions in local public goods and services delivery caused by temporary mismatch of local revenues and expenditure needs
- Local borrowing usually has no influence on the level of interest rate (local units are to small) – limited possibilities for "crowding-out" effect
- Infrastructure projects usually cost more and take longer time to complete so borrowing is often only solution for their financing (spreading the costs through time)
- Stabilization of required budget resources – borrowing can be used for alleviating the fluctuations caused by capital spending. If investments are financed from current revenues demand for resources will probably fluctuate and cause problems for local budget solvency in particular fiscal years (depending on the size of projects and fiscal capacity of the local unit).
- Is important to mention that borrowing could be way of obtaining the grants from the European and other development funds[8]. Grants are usually available under the condition that the local unit provides at least 25 % of the total project cost.

Propositions of the Maastricht Treaty[9] that the ratio of government deficit to GDP must not exceed the reference value of 3 % and the ratio of government debt to GDP must not exceed 60 % made significant constraint for budgets on each tiers of governance in EU countries. Public debt and deficit are in category of national public good – they present requirement of fiscal sustainability and participation in the EMU. These criteria's severely constrained budgets and countries were trying to deal with this problem differently. Some of the countries limited local government budgets and especially their borrowing powers. Conflict between tiers of governance was accented. Some of the countries solve this problem, concerning borrowing possibilities, by determining levels of indebtedness for each tier of government[10].

[8] For example, Cohesion Fund, Community Initiative Programmes (CIP) and Structural funds like European Development Fund (EDF) and European Regional Development Fund

[10] Austria, for example, concluded the financial settlement negotiations in 1996 by making an agreement that in 1997 the federal level could use 90 % of the public deficit limits given by the Maastricht criteria (2.7 % of GDP) and local levels 10 % (0.3 % of GDP). But with this division potential problems occurred. Negotiations have not solved the question of distribution rules of determined deficit volume between the

The fiscal consolidation demands of the EU had its impact on the Croatian fiscal debt policy too. In the period from 2005 to 2007 periods the goals of the fiscal consolidation are planned to be accomplished gradually. The goal is 2,9% of the consolidated general government deficit in the year 2007. With these deficit reductions the public debt criteria should be satisfied and fixed beneath the level of 60% of GDP. The planed reduction of the local government deficit, according to the Pre-accession economic programme (PEP) of the Government of the Republic Croatia, is from 0,5% of GDP in the year 2004, to 0,3% of GDP in year 2007. The accomplishment of these goals is vested in the regulation of the local borrowing. Since the adoption of the laws regulating the local borrowing, there is a tendency towards "hard constraint" for the use of this instrument of financing investments. That is in opposition from the logic of economic efficiency because sub-national units fiscal capacity is improving and every fiscal year has more potential for exploiting the advantages of local borrowing (see Bajo, 2004). In the following part, regulative framework and its consequences will be described.

4. FINANCING OF THE SUB-NATIONAL INVESTMENTS IN CROATIA

Among the various instruments for financing investments that are presented in the table 2 Croatian local governments in the past relied on the grants from the central government level, operating and capital revenues. Sub-national borrowing was mainly utilized by the bank loans. However, revenues based on the asset sales are not expected to be substantial in the future and utilization of operating revenues has numerous negative consequences on the budgets of these units. Long-term financing investments are still not used much due to borrowing restrictions and caution for the various project financing schemes. Because of that local sector is left without important mechanism of development – investment inducement is jeopardized. It is useful, therefore to describe the regulatory framework for the utilization of the long-term instruments of financing (borrowing and public-private partnership models).

Table 2: Advantages and disadvantages of models of municipal systems

	Positive	*Negative*
Operating revenues	- financing of small scale investments - much faster than other sources	- possible illiquidity issues
Capital revenues	- preservation of the asset balance of the government	- unstable source of revenues
Grants	- increase of the investment potential	- possible influence and control of the higher level government
Stabilization funds	- continuous investment cycle	- not possible for low financial

local units. This situation created some kind of "prisoner's dilemma" problem of intergovernmental relations. If one government unit extends its deficit financing, it will benefit from both the positive effects of the national fiscal stability and its own expanded financial scope. Because of that "Austrian stability pact" followed. Fixed shares for states were determined according to corresponding population and "present fiscal necessities". Similar negotiations started in Germany in 1996 but were not finished (see Dafllon, 2002.).

	- focus on timing of the investment projects	capacity governments - not suitable for developing economies
Bank Loans	-“relationship banking”[11] as a reliable source of financing	-possible suppression of municipal bond market in case of bank monopoly (higher interest rates) -limits municipality to relay on a partner bank in provision of all kinds of financial services
Municipal Bonds	-Less personal and less permanent connection between borrowers and lenders -Goes in line with higher decentralization -Relies on public disclosure of municipal financial information and has positive influence on fiscal discipline -Lowers the cost of municipality’s financial activities market bidding	-Not appropriate for smaller communities (fixed costs of issuance are too high) -Central government has difficulties to monitor and control indebtedness and investment choices of local units
Public Intermediary	-Subsidized interest rates – cheaper financing for local units -Useful at the beginning of establishing the local credit market	-Possible misallocations of investment due to corruption or influence of central government on local investment decisions -Reduces local government borrowing in case of larger general government budget deficits -Possibilities of softening the budget constraint and macroeconomic stability problems -long bureaucratic procedures -appropriate for small municipalities, with lower personnel and technical capacity
Public-private partnerships	- private sector finances the delivery of public goods and services - faster implementation - additional financial options - performance measurement - innovative solutions etc...	- risk sharing - loss of control - increase of unemployment - long-term relationship - corruption

Source: Author

The borrowing of lower government tiers is regulated by the Budget Law. Local units can borrow only for the purposes of financing investments. Borrowing has to be approved by decision of its own representative body and consent of Government of Croatia is

[11] Could be positive or negative. It depends on the economic strength of borrower (with evolution of financial and technical capabilities advantages of relationship banking diminish). Banks usually subsidize their clients at the beginning and later charge higher interest rates then those on the market. On the other side, bank helps borrower with all kinds of activities necessary for investments – preparing the loan applications, supervising its payment system etc.

obligatory. General terms of borrowing of local units are given by Budget Law[12] (article 106):

- total annual debt obligations of local units can be at most 20% of realized revenues in the year previous to the year when debt is to be created (these obligations include all previously accumulated debt, given guarantees and unpaid receipts and annuity for the new borrowing)

- three sources of revenues are deducted from the realized budget revenues:

    - revenues from domestic and external grants and donations, from the central government budget or budgets from the other local units
    - revenues from the special contracts: co-financing of citizens for local government
    - revenues from the domestic or external loan

Details on limits of public debt and local debt within it are stipulated for every fiscal year. For the year 2007 further constraints are imposed:

- government is authorized to give consent on borrowing for local government unit that has current revenues that overcome current expenditures
- consent can be given for local borrowing until realized current revenues of all local government units breach the limit of 2,3%

The logic behind these limits is that local units that have deficits are not in position to borrow. This stipulation presents an attempt to prevent borrowing for financing long term investments of local units that cannot even cover current expenditures. But limits set up on the level of 2,3% of realized current revenues can impose serious consequences. In situation of increased credit demand this rule implies that many investment projects based on borrowing could not be undertaken. Drezgić (2004) conducted the econometric research with the conclusion that by such limits sub-national share of public debt converges to zero. In addition, such policy leaves maneuver space for manipulations and practical problem which local unit has advantage in getting the debt approval (given by the Ministry of Finance). Unfortunately, such approvals are not given based on the quality and cost-benefit analysis of the project but political criteria's are dominant.

During the year 2006 government brought guidelines on the public-private partnerships and allowed such instruments for each local unit of financing in the amount of 35% of the current revenues of the previous year. Of course, contracts within the PPP present long-term liability for the public partner and present a form of public debt. However, due to fact that policy towards credit financing is more restrictive local units are forced to finance by the PPP although in many cases this is not appropriate. It would be efficient that local jurisdiction chooses the most efficient instrument of financing. In order to keep the investment plans according to their plans local units more and more transfer their debt on to the communal enterprises in their ownership (in that way borrowing is less restrictive).

[12] Zakon o proračunu, Narodne novine broj 96/03

One of the negative aspects of local borrowing in Croatia is related to the duration of debt. For the most part borrowing is of short-term or medium-term character. This is negative from the aspect of benefit principle of taxation (thus intergenerational justice) and also because of lack of the maneuver room for further local borrowing. In that way local units exhaust their possibilities of local investments and have problems with debt servicing. The question is why local units don't borrow funds on long-term basis. Debt management of local units is not sophisticated and in many municipalities it is not a term occupied by local decision making. On the other side, there is a possibility that lenders are not interested in tying their funds for a longer period of time. Anyway, there is a reasonable argument for shifting the demand for loans to longer periods. It is doubtful whether any analyses of the cost-benefit of investments and their debt financing has been done. In that way the burden falls on new generation. Table 3 shows the maturity of bonds issued by the national and sub-national level of government. Besides that, it can be seen that in certain periods cities borrow with lower interest rate than the national government. This is a sign of liquidity of the market and trust in the repayments of the debt by the local governments.

Table 3: Features of bonds listed on the ZSE

Issuer	Year of issue	Original maturity	Currency	Nominal value (millions)	Nominal interest rate
Republic of Croatia	2001	7 years	EUR	200	6,875%
Republic of Croatia	2002	10 years	EUR	500	6,875%
Republic of Croatia	2003	5 years	HRK	1,000	6,125%
Republic of Croatia	2004	10 years	EUR	650	5,500%
Republic of Croatia	2004	3 years	EUR	400	3,875%
The City of Koprivnica	2004	7 years	HRK	60	6,500%
The City of Zadar	2004	7 years	EUR	19	5,500%
Republic of Croatia	2004	15 years	EUR	200	5,375%
Republic of Croatia	2005	5 years	HRK	3,000	6,750%
Republic of Croatia	2005	10 years	EUR	350	4,250%
Republic of Croatia	2005	10 years	HRK	5,500	5,250%
Republic of Croatia	2006	7 years	HRK	4,000	4,500%
The City of Split	2006	7 years	EUR	8	4,563%
The City of Rijeka	2006	10 years	EUR	8	4,125%
Republic of Croatia	2007	10 years	HRK	2,500	4,750%

Source: Croatian national bank database, http://www.hnb.hr/

Therefore, it would be beneficial to modify the structure of the public debt towards the sub-national governments. That should occur in combination with institutional measures that should support transparency, decrease of the vertical fiscal imbalance and efficiency of investments. In addition, possibility of implementing the certain "internal stability pact" between the levels of public sector is Croatia could be considered. This is the case in many EU economies where tiers of government share the annual deficit (see Daflon, 2002 for the examples within the EU economies). At the end, coordination and communication within the tiers of government in Croatia has to be improved.

4. CONCLUDING REMARKS

Possible softening of hard budget constraints imposed on sub-national level of governance should be considered. Fiscal activity of sub-national level of governance generates low share of GDP so there is no real threat for macroeconomic instability caused by excessive borrowing (although there are good reasons for regulation also). Development of local debt market has to be stimulated. By curbing the local borrowing the Croatian economy could lose an important instrument of development. In efforts of the Croatian economy to accomplish higher levels of growth and development, all of the instruments for achievement of this goal have to be employed. Therefore, potential of local borrowing has to be exploited. Present limits on local borrowing do not enable this opportunity and are not efficient. Model of ensuring fiscal discipline has to be revised.

Debt management at the local level has to be improved. Taking short-term loans burdens the local budgets and has negative effects from the aspect of intergenerational equity. It also reduces freedom of maneuver for further borrowing of local units which could result in reduced capability for investments in short-term period. It would be efficient to increase the role of local borrowing instead of relaying on capital transfers from central government – projects financed by these transfers undermine local authority and do not respect the fact that local representatives are better informed on local needs for public good and services (and priority of investments).

Practical economic policy in the Republic of Croatia should be oriented from current formal regulative concept towards the system based on economic principles. However, all of these proposals cannot be realized if some of the fundamental problems concerning the sub-national government in Croatia are not solved. Some of these problems are related with low fiscal transparency of their budget, deficit in personnel, organizational and management capabilities, disclosure of information, determination of fiscal capacity of the local units, inappropriate budget methodology and other. Goals of improving these requirements for sound system of intergovernmental relations and thus borrowing requirements are addressed within the Pre-accession strategy of Croatia. There is to see if these efforts will be fruitful.

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