

PUBLIC INVESTMENTS AND BORROWING: NEW CHALLENGES FOR THE LOCAL GOVERNMENTS IN EASTERN CROATIA

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Abstract

In Croatia there is recognized growing interest and effort gain by authorities to give all areas equal opportunities to gain economic and social resources above all needed for EU accession. Allocation of budget which can ensure expected quick economic growth of eastern parts of Croatia justifies budget deficit. The paper shows necessity to accept a challenge of change the mainstream of financing capital investments because conventional patterns slow down and make difficult to run development projects. There is a great extend of opportunities of financial sources but not used in enough scale. The goal is to answer on questions: what kind of sources of financing are suitable to use in public sector, and is their current way of borrowing fit efficiently enough to be adequate for quick economic development?

This paper contributes in attempt to present some solutions to problem of areas legged behind in Eastern Croatia which plead for strengthening development and economic prosperity because nominated projects for public goods exceed their budgets possibilities. Many factors depend about financial productivity of local units. For that purpose the current mainstream of public debts will be considered. The potential of different pattern of public debt will be foreseen and at the same time identify the possibilities which could bring new patters of financing public investments like involvement of private sector in projects of public interest like public-private partnership.

JEL classification: E61, E62, H10

Keywords: public investment, debt, means of finance, local development.

1. Introduction

The structure of public sector financing is usually the most important and the greatest challenge for government officials on all levels of management. The way it is managed has great effect on financial stability and independence, and they, in turn, affect the possibility of economic disturbances in the country. Problems of excessive indebtedness of the state or its inability to pay debts are often emphasized, and the need for refinancing emerges. The sense of

instability that can sometimes be noticed in the public sector has a direct influence on the state of private sector, the growth of interest rates, the stagnation in investments etc. On the other hand, if the government uses efficient models of capital investments financing, under sensible ratio of risk and refund, different results are to be expected.

This paper will be examining the current state of public borrowing and capital investments in some of the counties and cities in Eastern Croatia. Its goal is to suggest some measures that could bring faster and more efficient development of the region to the local public sector. The purpose is to introduce modern models of public services provision for a better satisfaction of the needs of citizens, with contractual relation between public and private partners. New challenges lie in changes on the local level that should be suggested to the government officials, in order to make public sector more supportive to the development of the private sector. This includes developed infrastructure, better health care, greater and more diverse possibilities for education etc. The partnership between the public and the private sector, in regard to the development projects execution and the use of the final product is considered an important factor in the advancement of the local development.

Due to the extremely difficult circumstances that occurred as a result of the war, this region's economic development, when comparing growth rates with the other parts of Croatia where such circumstances were not as present, was delayed. Restoration of the devastated, and at the same time modernization of the outdated infrastructure, development of the educational, cultural and social potential, require greater funds and means of financing of the capital budget than the current ones that rely on the income from the local budget, state funds and bank credits.

2. Financing of public investments on the local level

In the macroeconomic and theoretical sense, the governing structure must, in its annual budget, provide similar conditions for the development of all the regions of the country. According to Bajo and Jurlina Alibegović (2008, 99) such distribution is achieved by fiscal balancing that starts with the reduction of the differences in the fiscal capacities of the local governments. However, natural, demographic, historical, political and other circumstances have created different conditions in certain parts of Croatia. Inequality of income sources in each of the local and regional part requires income distribution and the donations from central governing body, but only with the purpose of maintaining the minimum level of public service.

In private, as well as in public sector, regular income can just partially, or not at all support the investment decision, we have to focus on the external sources of financing, in which case we have to consider a number of leasing factors. According to Bratić (2008, 155), the power of making decisions concerning financial aspects of the local self-government focuses on the central level of government, so that those local units were, or for the most part still are, financially dependent on these transfers (grants) of the central level of government. Thus the capital investments, often financed by planned capital transfers and state funds, are unable to yield sufficient results for the stimulation of the healthier development due to weak fiscal capacity of such sources.

"The golden rule of public sector borrowing" claims that a budget deficit is justified if it is a consequence of some new public investments, and all that with the purpose of preserving the public goods in a good state (Kellerman; 2007, 1089). If current expenditure is financed through taxation and investment is financed through borrowing, current taxpayers pay for current spending but future generations bear the costs of borrowing, as it will be they who gain from investment. It does not greatly matter whether the government invests in public consumption durables such as operas or parks or in productive projects that generate growth and improve the private factor productivity. If the government uses borrowing to finance public investment, the golden rule states that tax revenue covers public interest payments plus depreciation, so that net investment equals net borrowing.

Kellerman (2007, 1101) concludes that borrowing and investment quotas of EMU countries provide evidence in which high public borrowing does not particularly cause a high level of public investment. "Golden rule" accepted by the countries of the EMU zone, should also be applied in Croatia, because borrowing by the local and regional governments is not always motivated by financing capital investments, but also by the financing of short term budget deficits which were not the result of the investment. For the financing of the planned public investments (non-financial asset) through borrowing from banks or the issuing of securities, local and regional governing bodies in Croatia have to ask for an approval from the Government. They can borrow only for the purpose of the investment in the capital projects, in such a way that the yearly installment of the credit, including previous borrowing does not exceed 20% of the income in the previous year¹. Furthermore, borrowing will not be granted to

¹ Finance Act (Narodne novine, No. 92/94, 96/03 i 87/08), The Republic of Croatia Budget Receipts and Expenses Act (Narodne novine, No. 171/04, 148/05, 137/06, 28/08) and Encumbering Procedure JP(R)S and warranty granting JP(R)S Protocol (Narodne novine, No. 55/04).

the units whose business income in the previous year exceeded the business expenditure. So, the units which do not meet the criteria have to resort to some other efficient solutions in financing the capital investments.

Most economic studies focus on public investment in infrastructure such as highways and other transportation facilities or communication systems owned by the public sector. In recent empirical analysis, different methodologies have been followed to investigate the impact of public investment on economic activities. In most of this research, measures of public investment are found to increase aggregate output. Yet there are exceptions (Romp and de Haan; 2005, 72). However, if certain public investment is assumed to be growth enhancing, the question remains whether governments choose the right projects and the right level of investment or the appropriate means of finance, and whether public investment decisions are efficient.

3. Financial status of regional and local units in Eastern Croatia

Three counties, out of five that geographically make up the region of Eastern Croatia, occupy the lowest positions on the scale of Gross Domestic Product (GDP *per capita*) in 2004². This should motivate the search for the causes of this state and introduction of changes.

Bratić (2008, 155) concludes that the most common differences in the development of local self-governing units are related to the structure of the local self-governments, the way that local administrations are structured and different solutions for fiscal activities of a local self-government. Reforms often turn out not to be the best for problem solving on the local level. The ones that should be mentioned are the existence of extremely small municipalities, the problem of insufficient fiscal capacity of lower governing levels, uneven distribution of power among local bodies or the bodies of the central government, as well as the problem of local ownership.

Fiscal decentralization and grants from the central government can help to solve the problem of current expenditure in the local budgets, however, it is obvious that values of such transfers are unable to keep up with the continuous pace of the capital investments. The set pace is expected to meet the development needs of those parts of Croatia that have been war-stricken.

Table 1. The level of borrowing and capital investments in non-financial assets and the investing share in the overall budget expenditure in the counties and the

² Županija u brojkama, 2006. Publication of State statistical office in Osijek-baranya County, Osijek, 2006.

larger cities on the territory of Eastern Croatia in the period from 2004 to 2007 and the plan for 2008

in 000 kn

Local or Regional Public Unit	2004.		2005.		2006.		2007.		Plan 2008.	
	Borrowing*	Investment**	Borrowing*	Investment**	Borrowing*	Investment**	Borrowing*	Investment**	Borrowing*	Investment**
Osječko-baranjska	-	29.120	14.500	52.878	10.000	46.560	20.000	35.578	-	58.884
Share in total expenditures		15%		21%		18%		12%		17%
Vukovarsko-srijemska	2.577	6.848	2.000	9.732	230	12.980	44.311	23.811	37.500	63.812
Share in total expenditures		6%		7%		8%		13%		28%
Brodsko-posavska	-	13.235	-	15.711	-	16.629	-	20.128	10.000	20.964
Share in total expenditures		14%		15%		16%		16%		13%
Požeško-slavonska	-	10.093	-	10.562	35.525	3.386	-	4.035	-	13.426
Share in total expenditures		18%		17%		9%		12%		14%
Osijek	50.789	50.057	5.510	58.845	1.319	48.437	24.879	55.234	25.000	96.945
Share in total expenditures		15%		16%		12%		13%		20%
Beli Manastir	2.620	7.581	-	6.086	-	9.472	-	4.947	-	13.472
Share in total expenditures		22%		21%		28%		14%		30%
Našice	-	4.270	-	2.842	-	7.241	-	7.746	3.675	9.483
Share in total expenditures		17%		11%		24%		23%		25%
Vinkovci	542	9.289	-	6.767	-	4.938	41.927	10.893	-	114.663
Share in total expenditures		14%		10%		7%		12%		55%
Vukovar	-	3.768	-	6.499	-	23.628	-	23.922	-	46.898
Share in total expenditures		6%		9%		28%		26%		30%
Županja	-	4.397	-	1.736	-	4.993	-	7.530	12.000	7.315
Share in total expenditures		21%		9%		18%		22%		17%
Brod	7.733	22.525	9.806	12.287	2.741	15.895	-	23.779	72.444	87.270
Share in total expenditures		20%		11%		13%		17%		39%
Požega	-	10.233	-	4.778	5.000	5.807	10.000	7.609	-	15.285
Share in total expenditures		18%		8%		10%		11%		17%

* Position 82 in the Budget - Revenues originated from selling securities and including position 84 - Borrowing receipts.

** Position 42 in the Budget - Expenditures on account of purchase of produced long-term assets

Source: Author's calculation, data provided by the Ministry of Finances, Republic of Croatia, Local budgets – archive 2002 – 2008, (<http://www.mfin.hr/hr/lokalni-proracun-2002>, access 12-2-2009

In this section we set out the empirical context of the problem by showing budgeting data for four of five counties in Eastern Croatia and eight belonging cities. Table 1 shows encumbering amounts by the county, i.e. the belonging cities in the period between 2004 and 2007, including a planned amount of borrowing in 2008. In the same manner, alongside with these data, the table also shows the value of capital investments and their share in the overall expenditure in the belonging local budget. The share of the executed capital investments of the units showed here goes up to no more than 22% of the overall expenditure. Quota of data correlation on the value of borrowing and investment in the counties is 0.21 which indicates that the variables are virtually unrelated. Therefore, the public investment financing is not connected to borrowing, at least not for the most part. Furthermore, regarding the correlation

of the data on the value of borrowing and the investment of all the counties and the cities from the Table 1 we come to the correlation quota of 0.16. If we include smaller towns in the result, the connection of the borrowing for the purpose of capital investment financing is even weaker.

The overall value of planned investments in public investments for the year 2008 from the Table 1, in the majority of cases significantly exceeds the value of the executed investments in the period from 2004 to 2007. That indicates the great demands which the budgets of these units have to face and are obviously too high for the units to meet.

The insight into the income of the local and regional units from the Table 1 shows the structure of the long term borrowing in conventional ways, that is to say, through business banks credits, and, on rare occasions, by giving bonds, which tells us that these units have a similar structure of the public debts, and similar ways of capital investments funding. We can conclude that the common ways of managing and funding of the public investment projects have, to a certain extent, influenced the current state of affairs in the public sector and obsolescence of the infrastructure in the Eastern parts of Croatia, in comparison to the rest of the country. Although the borrowing, above all, depends on the decision of the local authorities, the continuation of managing the capital investments in the public sector in the current fashion obstructs the development and regional balancing.

4. Modern ways of making use of public investments by including a private partner

4.1. The effects of public sector funding

When local units borrow from the banking sector, according to Bajo and Jurlina Alibegović (2008, 147) it can trigger the growth of interest rates and can lead to less favorable conditions in terms of economic subjects' encumbering. On the other hand, the increase of deficit can influence the inflation growth, which, again, can trigger the growth of interest rates. The central governing body grants the long-term leasing to the local and regional units in the form of credits, or bonds, and all that for the purpose of construction, restoration or adaptation of certain objects, as well as for purchasing of necessary equipment. The advantages of the public investment funding through the long-term loans are numerous, which is not the case with funding through the financial means gained from the current income. Thus Kellerman (2007, 1089) claims that long-term borrowing justifies long-term amortization of assets, reduces the dependence on the current income whose direction is determined by anomalies and the state of affairs in the economy. The costs of borrowing can be overcome by the benefits of the accelerated economic development which is triggered by new public investments etc.

When we talk about the effectiveness of borrowing, we talk about the introduction of some new, alternative sources of funding which would yield better results than the previous ones, and which the local units have at their disposal. We should take into account that the final goal is to offer a quality and universally accessible public service which can be achieved by either efficient borrowing and capital investments, or by the utilization of the model of renting specific assets from the private sector, in that the assets have the capacity for provision of public services. Such public investments can be obtained in several ways (Bajo; 2004; Bajo and Jurlina Alibegović; 2008; Bratić; 2008; Kellerman; 2007):

- Budget
- Borrowing
- Privatisation
- European Union Access funds
- Private financial initiative
- Public – private partnership

Based on the results of the analysis of the data from Table 1, it can be concluded that the budget and borrowing have not, so far, proved themselves sufficient sources of funding that can provide efficient and quality development of the public sector in the Eastern Croatia, which would generally facilitate the faster growth and development of local economy. European Union Access funds have considerable special purpose financial means at their disposal, and they often play a significant role in terms of decision-making concerning capital investments. However, their purpose is, to a large extent, restricted to specific areas in the public sector. Privatization of trade associations under the ownership of local units, can serve as a base for funding, on condition that they attract the interest of entrepreneurs. Furthermore, the financial means gained from previous privatizations have often ended up in pension, health and other state funds, so the local units did not directly benefit from them. It is important to point out that the assets belonging to a number of business subjects were destroyed during the war on the territory of Eastern Croatia.

4.2. The needs for new challenges on the local level

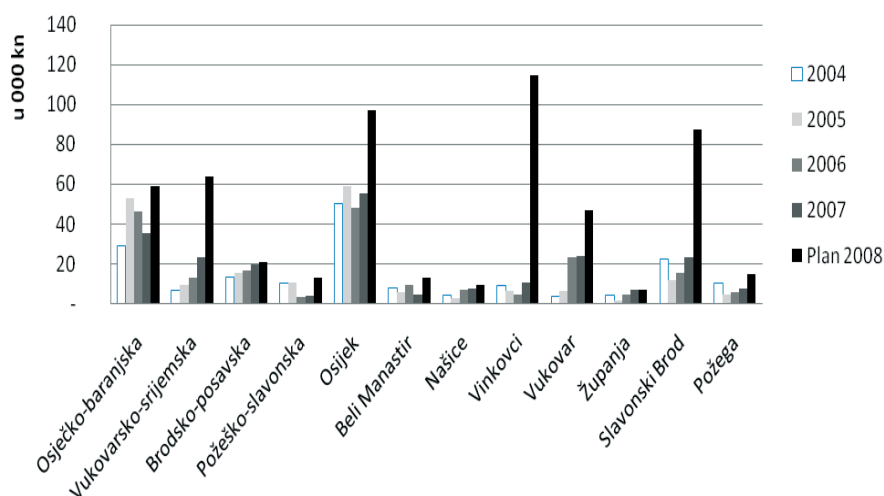
The decision on the execution of the efficient public investments is an important challenge for a local self-government which is manifested in the fact that local governments have begun with the more frequent establishing of

regional development agencies³ whose task is to mediate as well as to promote the needs of local governments, with the purpose of the best possible accumulation and distribution of financial means to the appropriate projects which have a public and economic significance, especially when it comes to EU access funds. Technological centres play an important role in that they connect the same needs with scientific research institutions.

It is only natural to expect that budget propositions which refer to the development projects with public significance exceed budget possibilities. However, it is just as justified for the government officials to ask for the possibility that these projects be accepted and executed. Management ability and the insight into different sources of financing play an important role in this process.

Graph 1 shows considerable discrepancies with the majority of the analyzed units between the executed (from 2004 to 2007) and expected values of capital investments in the non-financial assets (plan for the year 2008) within the budget. Thus, we can conclude that there are ever greater needs for public investments through which the quality of public service provisions would increase, aiming at making them more accessible to a larger number of citizens in this part of the country.

Graph 1. *The overview of the executed (2004 - 2007) and planned (2008) capital investments in the counties and cities of Eastern Croatia*



Source: Table 1.

³ Local Development Agency of Slavonija and Baranya d.o.o. in Osijek, Local Development Agency Vallis Aurea, d.o.o in Pozega, Local Development Agencies – LEDA with branches in Vinkovci and Sisak.

According to Allen (2001; 14) it is necessary to examine the ways to expand the scope for private financing of capital projects. Obviously, the interests of the taxpayer have to be protected, but it also needs to be ensured that sensible investment decisions are made whenever the opportunity arises. Central and local governments should allow greater use of leasing where it offers good value for money. As long as it can be shown that the risk stays with the private sector, public organisations will be able to enter into operating lease agreements, with only the lease payments counting as expenditure and without their capital budgets being cut.

Taking into account the indicators and the structure of borrowing by the local units, it is necessary to observe a broader picture, search for more beneficial and more effective ways of public services provision, or in other words, for alternative solutions concerning the problem of the public sector development, which will be based on the provision of the public services related to the assets not owned by the local self-government, but instead, the provision of the services ensured by a private partner and arranged by a long-term contract. There are a few modern models which were created based on this assumption and some counties and cities have already put them into practice. However, this was performed in a very poor manner, and based on the experience from other European countries.

4.3. Modern models for provision of public services by the introduction of a private partner

The modern models which rule out the conventional methods of public funding as a prerequisite for initiation of public investments are encompassed by one common term - Public-Private Partnership (PPP). A number of different subtypes of partnership fall into this category, depending on their characteristics, however the primary goal is to introduce business subject from a private sector into the process of the provision of public services, in which case, in exchange, the buyer from the public sector would pay the compensation to a private partner over a long period of time. Bajo and Jurlina Alibegović (2008; 203-204) present these models as appropriate sources of the development projects funding in Croatia.

According to data from local budgets, there is no official evidence of budget expenditure related to the payment of the compensation as proposed by these models, which indicates that the units of regional and local self-government in Eastern Croatia have not yet adopted this type of contractual relations, even though the PPP models have been regulated in Croatia⁴. The government has,

⁴ There are "Guidelines on the implementation of signatory public-private partnership forms – PPP" ("Smjernice o primjeni ugovornih oblika javno-privatnog partnerstva – JPP") (Narodne

with the support from the institutions of the European Union, brought about a regulation, thus showing its interest in the matter and drawing the attention to the necessity of the implementation of these models, in order to strengthen the funding structure, as well as to facilitate, in general, the execution of the development projects proposed by the development programmes. It is up to the local governments whether these models will be followed. The models should serve as channels for the flow of major infrastructural and some other projects that satisfy certain public needs from the domain of the public government (schools, hospitals, sports facilities, airports, prisons, public utility services, transportation infrastructure).

The golden rule is not broken by funding projects through the PPP, as the capital cost of the project is allocated to the private sector. However, it is worth noting that supporting a project using conventional methods of public funding does not break the golden rule either, as the borrowing for such a project could count as capital investment and not as funding for current spending.

The private sector already builds most public facilities but the PPP also enables the design, financing and operation of public services to be carried out by the private sector. For example, under the PPP, the public sector does not own an asset, such as a hospital or school but pays the contractor a stream of committed revenue payments for the use of the facilities over the contract period. Once the contract has expired, ownership of the asset either remains with the private sector contractor, or is returned to the public sector, depending on the terms of the original contract.

Allen (2001; 20) has shown that from the very start of the implementation, it is clear that the capital costs of the public sector have been compensated for by the capital costs related to PPP, however, the results of the research also show that the later implementation of the PPP increases the overall expenditure related to the public investments within the budget. The most obvious effect of the PPP on the public finances is the immediate reduction of spending and its replacement with a stream of future liabilities. This can be explained by the fact that the compensation paid to a private partner is not, in fact, a part of the capital expenditure, but a current liability related to the capital investment that stretches over a long period of time.

novine 98/06), and The Directive on prior compliance with a conclusion of a public-private partnership agreement based on the private financial initiative model (Uredba o davanju prethodne suglasnosti za sklapanje ugovora o javno-privatnom partnerstvu po modelu privatne financijske inicijative) (Narodne novine 20/07), as well as the Act on public-private partnership which has been passed (Narodne novine 129/08).

5. Conclusion

In Croatia private sector finance should be the main source of growth in public investment projects and the Government would not approve capital projects unless private finance options had been explored. Wide application and numerous positive experiences with PPP in the countries of the European union should encourage representatives of the counties, cities and municipalities of Eastern Croatia, the same way it has been done in other parts of the country.

The analyses of data on public borrowing and the capital investments from local budgets of the counties and the bigger cities on the territory of Eastern Croatia has led to the conclusion that the borrowing structure uses only the conventional models of funding, which is insufficient, and that the borrowing and long-term investments were not connected over the period of time that has been surveyed. Another conclusion is that the needs for public investments have considerably exceeded the capacity that the present model of investment managing can ensure.

The main reason for the initiation of the radical changes in the management of the public investments lies in the fact that the previous practice of public borrowing and capital investments on the local level does not follow the conventional rules of borrowing, and thus, does not yield the expected results in terms of economic development, which has been especially pointed out in this paper through analyses of data concerning some local budgets. Furthermore, the conventional ways of funding are not efficient enough to meet the ever greater needs for public services by both the population and the economy. Apart from that, we have to bear in mind that the capital expenditures structure should be more complex and more efficiently managed.

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