MUNICIPAL BONDS AS A SOURCE OF REVENUES FOR BUDGETS OF LOCAL GOVERNMENTS IN CROATIA

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ABSTRACT

Local and regional governments in Croatia are organized in the forms of cities, municipalities and counties. Each local unit has a legally prescribed responsibilities and scope of work. At the moment, there are 576 local and regional government units in Croatia, of which 20 are counties, City of Zagreb has a dual status as a city and a county, 126 are cities and 429 are municipalities. In order to fulfill their tasks, local governments must have sufficient budget revenues at their disposal. Partly because of a large number of local governments and inefficient territorial division, there is a problem of low fiscal capacity of many local units that are unable to fund all the public needs on the local level. Especially difficult for local governments to finance are investments in long-term capital (development) projects. According to present legal regulation, local governments acquire budget revenues such as tax and non-tax revenues, grants and capital revenues. Beside these, local units can borrow financial funds from banks and other financial institution and/or issue debt securities on the market.

This paper examines the role of debt securities, namely municipal bonds issued by the local governments in the Croatia in order to acquire sufficient financial funds for financing long term capital projects on the local level. The main legal regulation in Croatia and basic criteria and constrains on local government borrowing and municipal bond issuing will be analyzed. Additionally, the relative contribution of borrowed funds and municipal bonds in the overall budget structure will be discussed along with possibilities and challenges for their increase in the future. The paper will present an overview of municipal bonds and their characteristics issued by local governments in the period to present date. A proper model of financing capital investments on the local level is of great importance for development of local communities. Therefore, local governments must find new ways to acquire additional financial funds to finance large capital projects, such as infrastructure, schools, hospitals, roads and similar. Issuing of municipal bonds by some local governments is certainly one of the models that should be utilized in the future more often. This paper attempts to indicate main advantages of municipal bonds as a source of revenues of local government budgets, as well as to point out possibilities for further developments in the field.

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Keywords: municipal bonds, debt, local government budget, local capital investment

1. INTRODUCTION

Organization of local and regional self-governmental units in Croatia has been determined by the actual Local and Regional Self-government Act (Narodne Novine, No. 33/01, 60/01, 129/05, 109/07, 125/08 and 36/09). According to the Act, there are cities and municipalities as local self-governmental units and counties as regional self-governmental units. Each local and regional unit must perform tasks of local importance within their jurisdiction and scope of work as stipulated by the Act. In order to implement tasks within their scope of work, such as housing and settlement development, communal services, child and social care, education and similar, local units must have adequate source of revenues. Disposable budgetary funds, which local units freely and independently allocate for budgetary expenses, must be in relation with tasks that must be fulfilled by local units (Marković & Stojanović; 2007, 21). Hence, it is of great importance for any state to create proper model of local government financing which will secure sufficient financial funds for current and developmental needs of local units. Budgetary analysis of revenues and expenses of local units in Croatia indicate problems in financing of large investments on local level. One of available tools at disposal is issuing of municipal bonds. Local units have rarely used this option although legal preconditions for this sort of financing have been in existence since 1993. There are many different reasons for this situation, which could mostly be explained with inadequate territorial organization, low fiscal capacity of local units and some legal constraints.

2. LOCAL GOVERNMENTS AND BUDGET REVENUE STRUCTURE IN CROATIA

Legal framework establishes in total 576 local and regional governmental units in Croatia, of which 20 counties, 126 cities and 429 municipalities with City of Zagreb which has a dual status as a city and a county. According to data for 2003, small municipalities (population less than 5,000) make 84.3%, medium municipalities (population of 5-10,000) make 14.1% and large municipalities (population more than 10,000) make 1.6% of all municipalities in Croatia. Similar situation could be applied to cities, where even 46% of all cities have population less than 10,000 and 18 cities have population of less than 5,000 (Pavić; 2006, 229). Such a great number of small and fragmented local units populated by only 4,4 million inhabitants points to the potential problem of financial self-sufficiency of local units with respect to budgetary financing of their current and developmental needs.

Local units financing model has been determined by the Local and Regional Self-government Financing Act (Narodne Novine, No. 117/93, 69/97, 33/00, 73/00, 127/00, 59/01, 107/01, 117/01, 150/02, 147/03, 132/06, 26/07 and 73/08). The Act regulates financing methods and revenue sources of local units in Croatia. Unfortunately, the level of a fiscal autonomy, which is defined as a capability of local units to independently ascertain sources of tax and non-tax revenues (Bajo & Bronić; 2004, 448), is very restricted by the central government. The problem of insufficient budgetary resources is at best visible with regards to financing of long term projects. Local unit revenues can be divided into several categories, such as tax and non-tax revenues, grants and capital revenues. According to data of the Finance Ministry, total budgetary revenues of all local units are more than doubled in period 2002 to 2008, from KN12.43 billion to KN25.94 billion respectively (see Table 1). The trend of decreasing tax revenues and increasing non-tax and capital revenues and grants is clearly visible. One of the main reasons influencing this trend is a great number of economically weak local units.

Table 1. Revenue structure of local budgets, 2002-2008

(in billion KN)	2002.	2003.	2004.	2005.	2006.	2007.	2008.
Tax revenues	6.928	8.381	9.656	10.335	11.926	13.315	14.390
Non-tax revenues	3.494	3.892	4.256	4.990	5.549	6.334	6.868
Grants	1.394	1.504	0.963	1.165	1.200	2.035	2.295
Capital revenues	0.610	0.710	0.852	0.908	0.937	1.483	1.485
Total revenus	12.426	14.488	15.727	17.397	19.612	23.166	25.038

Source: Authors' calculation according to data of the Finance Ministry

If capital income and capital spending movements are observed in the same period, an ever increasing gap between two categories can be noticed. According to data in Table 2, local capital revenues increased 143% along with capital expenditures growth of almost 180% in the period 2002 to 2008. Therefore, the resulting deficit increased 192%, from KN 1.724 billion in 2002 to KN 5.033 billion in 2008.

Table 2. Capital revenues and expenditures relation in local budgets (in billion KN)

	2002	2003	2004	2005	2006	2007	2008	Index (2008/2002)
Capital revenues*	0.610	0.710	0.852	0.908	0.937	1.483	1.485	243
Capital expenditures**	2.334	3.540	4.067	4.464	5.279	6.312	6.518	279
Deficit	-1.724	-2.830	-3.215	-3.556	-4.342	-4.829	-5.033	292

* The exact title as stated in the Budgetary Chart of Accounts is Revenues from sales of non-financial assets.

** The exact title as in the Budgetary Chart of Accounts is Expenditures for the acquisition of non-financial assets.

Source: Author's calculation according to data of the Finance Ministry

The analyzed deficit on a local level can be financed (1) from a surplus of current operating revenues in relation to current operating expenditures and (2) by borrowing. Although data indicates that current operating revenues are considerably higher than the current operating expenditures, the situation is much different if grants are eliminated from revenues. Therefore, the existing level of capital spending has been financed to a great extent with grants by the central government and through various forms of long term debt. The fact that almost 50% of local units are part of the so called assisted areas receiving additional support and funds from the state additionally describes the problem of capital investments on a local level.

3. TYPES AND CHARACTERISTICS OF MUNICIPAL BONDS

Municipal bonds, also known as munis, are debt securities issued by local governmental units. Local unit, called issuer, promises to repay to security buyer (investor) an amount of money borrowed, called principal, along with interests according to a time schedule and other contractual terms. Generally, maturity dates are anywhere from one to 40 years from the date they are issued (Wesalo Temel; 2001, 1). The interests are usually payable semiannually. The principal is usually paid out at the maturity date or it can be amortized over certain period of time when it is payable along with the interest. The most developed municipal bond market is the market in the USA. According to data of the US Federal Reserve, total value of outstanding municipal bonds in the US was $2.7 trillion at the end of 2008, while the number of issuers was about 50,000. Municipal bonds represent the most important channel used by local units for financing local infrastructure on a local level.

There are several characteristics that make munis desirable for investors. First of all, there is a federal tax exemption status on interest income. This feature is regular for most municipal bonds and exceptions are few and specified by the central government (Faerber; 2000, 188). Additionally, buyer who resides in issuer's area are exempted of local taxes too. The tax exemption status on interest income is defining characteristic for investors and issuers alike. Bond buyers can secure higher yields on their investments if compared to taxable bonds and local units can borrow money under the favorable terms paying lower interest rates. The fact that munis are issued by local units means that the default risk for investors is minimized. Available data show that rating agencies, like Moody's Investors Service, are giving an investment grade to more than 99% of the evaluated bonds. Additionally, over 50% of munis are insured by the special insuring companies known as financial guarantors or bond insurers that guarantee repaying of principal and interests in case issuer defaults. The low default risk contributes to market liquidity. Therefore, along with attractive tax-exempt interest yields, investors can realize capital gains trading bonds in the secondary market. Ownership structure shows individuals as the largest category of investors as opposed to other securities where institutional investors are the key players. According to data of the FEDs for 2006, households own over

70% of outstanding value of the municipal bonds either directly or through different funds such as money market funds, closed-end funds and mutual funds.

There are number of types of municipal bonds depending on criteria of classification. The main classification is (1) according to the length of time to maturity and (2) according to the revenue type which guarantee the repayment of the principal and interest (Faeber; 2000, 193). According to the maturity, there are short-term municipal bonds, called municipal notes that mature in less than one year and that are issued by local units in order to balance cash-flow during one budgetary year, i.e. overcome temporary problems in liquidity, as well as long-term municipal bonds that mature in more than one year and are issued to finance capital projects. By the revenue type which guarantee the repayment, there are general obligation bonds and revenue bonds (Bajo & Jurlina Alibegović; 2008, 149). General obligation bonds are munis secured by the full faith and credit of the issuer and usually supported by the issuer's taxing power. Local unit guarantee repayment from all revenue sources at its disposal. The issuing of this type of munis usually demands voters' confirmation by referendum; hence the name voter approved munis. Due to regularity of budgetary revenues, general obligation bonds have the lowest default risk and interests are fully tax exempted. Revenue bonds guarantee debt repayment by the charges tied to the use of the facilities financed by the bonds. Such specific capital projects, that generate revenues from users' fees during their economic life cycle that are used for debt repayment, are roads, bridges, water and sewage systems and other public investments. Beside basic types of municipal bonds, there are number of munis with special features adjusted to certain categories of investors, such as insured municipal bonds, fixed rate, floating rate and variable rate munis, zero coupon bonds, put and call bonds and similar.

4. MUNICIPAL BONDS IN CROATIA

Municipal bonds are financial instrument not very often used on a local level in Croatia. Primary reasons for current situation could be found in low fiscal capacity of the most local units and in legal constraints imposed on the level of indebtedness of local units by the central government. Local and Regional Self-government Financing Act from 1993 allows the possibility of borrowing in order to obtain needed funds for capital investments. According to the Act, local unit can borrow only if the State Office for Audit assesses that debt repaying would not jeopardize financing of current expenditures. In that case, local unit can get a public loan or issue municipal bonds upon approval of the Finance Ministry. Central government closely regulates borrowing of local units and guarantee issuing with Budgetary Act from 2003 and annual budgetary execution acts. Using budgetary constraints, central government secures macroeconomic stability and prevents irresponsible policy with respect to debt on a local level. On the other hand, limits on borrowing prevent development of new credit instruments and municipal bond market as forms of capital projects financing. The basic borrowing condition which must be met by the local unit in order to get approval of the Finance Ministry is a surplus of current operating revenues in relation to current operating expenditures in the year preceding the year of the borrowing. Additionally, the borrowed funds must be solely used for financing of capital projects.

Since 1998, total annual liabilities arising from the borrowing cannot be higher than 20% of revenues realized in the year which precedes the year of the new borrowing. Total annual liabilities include annual credit annuities, liabilities deriving from issued securities and guarantees from previous year as well as unpaid obligations from previous years. As an additional limitation, in 2003 the government prescribed maximal potential annual amount of borrowing for all local units as a percentage of total operating revenues realized in the previous year. The limitation should not be applied to local units that got approval for the borrowing in previous year, but did not use it, local units in the area of special state concerns and local units that are receiving loans for capital projects from Fund for Regional Development and Fund for development and employment. Therefore, annual borrowing of all local units in one year can be higher than the amount calculated on the base of the additional limitation. Table 3 shows additional budgetary limitations in percentage and absolute amounts in period 2003 to 2008.

Table 3. Budgetary limitation on the borrowing amount by local units, 2003-2008

	2003	2004	2005	2006	2007	2008
Budgetary limitation in % of total operating revenues	3.00	3.00	2.00	2.00%	2.30	2.30
Budgetary limitation on borrowing in millions KN	354	413	298	330	430	499

Source: Authors' calculation based on budgetary execution annual acts and data from the Finance Ministry

If the share of funds collected by municipal bonds is analyzed in relation to total annual borrowing amount of all local units, it can be concluded that munis started to be used more intensively on a local level only in 2004. With the exception of 2005, the revenues from munis have stabilized between 20% and 30% depending on the year analyzed (see Table 4).

Table 4. Share of munis revenues in annual borrowing of local units, 2003-2008

	2003	2004	2005	2006	2007	2008
Realized annual borrowing (mill.)	587	681	314	487	520	564
Revenues from municipal bonds (mill.)	12	216	8	117	182	116
Share of munis in %	2.04%	31.72%	2.55%	24.02%	35.00%	20.57%

Source: Authors' calculation based on data of the Finance Ministry

Municipal bonds have been issued so far by 8 local units in Croatia, namely by 1 county and 7 cities. Table 5 gives an overview of municipal bond issues with their basic characteristics. Issues by Istarska County and City of Opatija had been fully redeemed, while others have been regularly serviced. The municipal bonds are listed on the Zagreb Stock Exchange and can be freely traded in secondary market. Most of the trading takes place in over-the-counter market between institutional investors. All bond issues have been sold according to negotiated model in which terms of the sale are negotiated between issuer and underwriter who is purchasing the debt with certain discount and only after sells the bonds further to other investors or holds them in his possession (Feldstein & Fabozzi; 2008, 56). It is noticeable that the lowest interest rates were in 2006, just before the outbreak of the global financial crisis. Financial funds have been used for purposes of financing local infrastructure projects. All issues have been of general obligation bond type.

Early bond issues in nineties had shorter maturity dates, while later maturities got longer. At present, all outstanding munis have maturities between 7 and 10 years. Bonds are denominated either in euros or kunas with principal amount in range between KN 25 million and KN 180 million. Interest is payable semiannually and principal is amortized over duration period according to different models, payable along with the interest. Only City of Zadar issued bonds with principal payable at the maturity date. As data in the table clearly shows, the situation with respect to basic characteristics of bond issues have improved significantly in the period after 2004.

Table 5. Municipal bonds issued by local governmental units, 1995-2008

Local unit	Purpose	Issuing year	Maturity (in years)	Principal amount (in millions)	Principal amount (millions of kn)	Interest (per anum in %)
Istarska County	Sewage water disposal system (eco-bonds)	1995	2.5	DEM 2	-	11
Istarska County	Hospital debts payment (health bonds – series A)	1996	2	DEM 2.8	4.3	7
	Hospital debts payment (health bonds – series B)	1996	3		5.7	
Opatija	Communal infrastructure (water supply and sewage system)	1997	4	-	14	8.5
Koprivnica	Schools, sport facilities, roads, sewage system	2004	7	-	60	6.5
Zadar	Sports hall, indoor swimming pool	2004	7	€ 18.5	-	5.5
Rijeka	Indoor swimming pool complex	2006*	10	€ 25.6	180	4.125
Split	Roads, sports hall, cultural facilities	2006**	7	€ 8	-	4.5625
Vinkovci	Indoor swimming pool complex, cultural facilities	2007	10	-	42	5.5
Osijek	Communal infrastructure (squares reconstr.)	2007	10	-	25	5.5

Split	Roads, sports hall, cultural facilities	2007	8	€ 8.1	-	4.75
Split	Roads, sports hall, cultural facilities	2008	9	€ 8.2	-	6

* Total amount of KN 180M was divided into 3 tranches of KN 60M each. First tranche was issued 2006, second tranche 2007 and third tranche 2008.

** Total amount of € 8M was divided into 2 tranches of € 4M each. Both tranches were issued in 2007, 5 months apart.

Source: Author's drafting according to municipal bond prospectuses

5. CONCLUSION

Territorial organization of local and regional self-governments in Croatia determines 576 local units on 4.4 million inhabitants. Such a big number of mostly small local units strongly influence their financial position in terms of their fiscal capacity and insufficient budgetary revenues. The problem is noticeable especially in financing of capital investments. In most cases, local units have not been capable to finance local developmental and long term projects on their own, without a support of the central state. One of the instruments that local units can use is issuing of municipal bonds. The so called munis are debt securities issued by the local units and bought by investors in exchange for interests and principal paid at fixed time schedule and according to contractual terms. Munis are used very often in developed market economies and represent the most important channel for financing of infrastructural projects by local units in the USA.

Munis have been hardly noticeable in Croatia until 2004. Due to improved overall economic situation and fiscal decentralization, several cities with sufficient financial strength decided to finance their communal projects with municipal bonds. Although munis could be more often used, there are some constraints that prevent their stronger development. Primarily, the low fiscal capacity, which makes bonds repayment out of budgetary revenues almost impossible. Also, some legal and budgetary limitations prevent local units to acquire additional funds for capital investments through munis. Institutional demand exists due to investors' legal obligation to invest part of his portfolio in the bonds. Additionally, professional and skilled agents and underwriters, mostly big banks, needed for issuing process are existent. Other factors such as regulated bond market, macroeconomic stability, additional legal regulations on some aspects of financial market and certain types of securities etc. require some fine-tuning, but they could not be seen as an obstacle in the process. Present economic situation in Croatia maybe doesn't seem favorable for bond issuing by local units. Nevertheless, some shifts can be expected in near future that would lead to stronger development of municipal bonds, especially if announced administrative and territorial reform of local and regional self-government results in local units with higher fiscal capacity.

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