FINANCING LOCAL PUBLIC SECTOR IN CROATIA BY ISSUING MUNICIPAL BONDS

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Abstract: Modern democratic societies are characterised by the tendency of decentralisation and especially the decentralisation of public needs which has to be conveyed to the local level.

Therefore, traditional concept of local government financing by tax revenues and governmental transfers are not sufficient to meet growing local public needs. There are several new types of financing local government units with a leading role of issuing municipal bonds.

Considering the development of Croatian municipal bond market, there are some macroeconomic prerequisites, as well as additional ones, regarding potential issuers, that have to be taken into account.

Croatia's municipal bond market is at an early stage of development considering the fact that there are only two examples of municipal bond issues: two series of the Istrian County bonds in 1995 and entrance of the Town of Opatija to the capital market.

In the focus of our research will be primarily the issue of Istrian County bonds – first series or IŽ 0195 and also the second one, or IŽ 0295. Analysis will be carried out in terms of the basic elements that determined the municipal bonds issuing project, like the purpose of the issues, the bonds' type and their characteristics, secondary trading on the Croatian capital market, redemption etc.

As mentioned above, the Croatian experience with municipal securities is limited, but not a negligible one. The aim of this research is to point out that these projects have been of significant importance for the development of Croatia's capital market.

Key words: local public sector, municipal bonds, capital market

1. INTRODUCTION

In the last two decades, fiscal decentralisation and local public finance have been considered of great importance, because public local government is taken responsible for investments in local infrastructure and maintenance of public property. Local public needs were mostly financed by tax revenues and governmental transfers. However, today there is quite different situation in almost all local governments, because of the default of financial resources for publics needs.

In practice there are several new types of financing local government, with a great importance of financial sector, especially capital market. The best known forms of non-fiscal financing are: project financing, build-operate-transfer projects, privatisation and getting into debt through issuing municipal bonds and short - term securities.

A debt issue is acceptable option in cases where there is no interest for direct investments. Usually, this way of financing is used for unprofitable programs, which should be financed from taxes taking into account their public purpose.

Municipal bonds issue is leading type of financing local government units in all developed countries. Municipal bonds are debt obligations issued by state, cities, counties and other governmental entities. They are used for permanent financing of acquisition, building or general reconstruction of the capital objects, but also for covering current expenses. There is a quite difference between them and traditional government bonds, which are mostly, used as one of the instruments for implementation general, macroeconomic policy. Municipal bonds issue is acceptable for financing significant capital expenses on the local level.

This type of financing is at the beginning of the development in Croatia, but it shows that municipal bonds are very attractive for investors, first of all because of the low risk and fixed income. Croatian municipal bond market has been established by Istrian County bond issue. This was a great contribution for the development of Croatian capital market and it showed that local government can also have a great impact in the revival of Croatian economy.

2. MUNICIPAL MARKET OF THE TRANSITION COUNTRIES

Local government units endeavour to finance their capital projects from their budgets, and sometimes state financial transfers. Since in most cases in practice, those resources aren't sufficient to finance their local capital projects, that has to be solved by indebtedness. In many transition countries, local government incurs debt at a commercial bank or other specialised institutions which often demand state's guarantee, which always means very complex and long procedures.

However, in the beginning of the last decade, with the start of the transition process, these countries started to develop municipal market. This market enables getting into debt on the basis of the local taxation or based on generated revenues of the bond-financing project. The main goal is to develop, so called market oriented financing of local government units, by defining of individual and institutional investors.

Municipal bonds with all their advantages have found confirmation on American municipal market - the most active and the biggest municipal market in the world. Using American model, transition countries have identified all the relevant factors necessary for municipal market development. They are presented in Table 1. considering the point of view of two sides - the investors and the issuers.

Table 1: Development factors of municipal market

Factor	Description
municipal bonds demand - Attractiveness of the municipal bonds and investor's trust - Possibility of trading with municipal bonds - Freedom of investing - Acceptable rate of return - Credit quality - Transparency in regard to investment risk Assistance in data interpreting	**attractiveness for municipal bonds investors** • tradition of investing in municipal bonds in the USA during the last 200 years • developed secondary market with possibility of selling before expiration • absence of state control in terms of giving investing premission to a various investors • in USA this factor refer to exemption of paying federal taxes • safety of investing in municipal bonds • existance of standard legal and financial data • existence of financial agents (rating agencies, financial advisors, insurance companies, investment fonds, brokers, etc.)
municipal bond offer - acceptable debt expenses - long - term debt depreciation - legislation	**Attractiveness for municipal bonds issuers** • rate of interest and issue expenses • possibility of getting in long - term debts • municipal market regulating

Source: Leigland, J., Accelerating Municipal Bond Market Development in Emerging Economies: An Asseeement of Strategies and Progress, Public Budgeting & Finance, New Brunswick, no. 2, 1997.

As the result of municipal market development in transitional countries, credit rating has become necessary for potential issuers or local government units. It can give some indicative information to potential investor and directly influence by the amount of interest rate for the bonds. Credit rating has numerous advantages for the issuers and one of the most important is the increase of investor's reliance, considering rating procedure transparency and openness.

The most famous and internationally recognised agencies, Standard & Poor's, Fitch IBCA and Moody's have been present in all transitional countries, from the beginning of the municipal market development. They use a range of criteria, which are different from those used in developed countries. These criteria take into consideration macroeconomic development, legislation and international influences, which are specific for each country. For all transition countries it is important to recognise all the risk elements of evaluation. According to Standard & Poor's opinion these risks can be in connection with these elements:[1]

- legislative
- adequacy of financial reports
- numerousness and non profitability of a local government ownership
- big infrastructure necessities
- non-collected taxes and other duties.

Rating of a state is an upper limit for a possible credit rating for local government units. Therefore, a town or a county can't have higher credit rating than its own state.

The Republic of Croatia announced it's rating on January 1997 and in that time it was BBB- or lower investing category. In 1999 during regularly revision of rating, agency Fitch IBCA reduced it on BB+ which means zone of speculation and high risk for the investors. However, the rest of the two agencies left it on BBB-. In 2002 long term credit rating remained on BBB-. [2]

3. LEGAL REGULATIONS OF THE MUNICIPAL BONDS ISSUE IN THE REPUBLIC OF CROATIA

To enable the municipal market to function, it is necessary that appropriate legal regulations control all the questions related to issuing and trading with the municipal bonds. In the Republic of Croatia that covers a number of laws, which regulate above mentioned problems:

- Constitution of the Republic of Croatia;
- Local Government Law;
- Law of Financing the Local Government;
- Budget Law
- Law of Fulfilment the Budget of the Republic of Croatia for the 2001.;
- Law of Credit Business with Foreign Countries;
- Law of Securities Issuing and Trading.

Law of financing the Local Government predicts the possibility of indebtedness up to 20 per cent of assets value of the local units and also the possibility giving a guarantee to budget users. Indebtedness is possible in case of financing a construction, an attached building, redecorating or adaptation the objects and acquisition of the equipment to achieve permanent work conditions. Also, indebtedness is allowed only in the case that State Bureau for the Revision estimates that paying back won't influence financing their expenditures and that Ministry of Finance approves that bond issue.

According to the Budget Law for the 2001, local government can run into debt only for the purpose of financing their capital expenditures. Total annual liabilities can reach only to 20 per cent of their budget revenues reduced for the subventions, donations, transfers, receipts from the special contracts and indebtedness'. A total annual liability includes annuities by the credits, given guarantees and other obligations from previous years.

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[1] *View Point on Local and Regional Government, Standard & Poor's Public Finance, Standard & Poor's, Fall 1997/Winter 1998, p. 14*

[2] *www.hnb.hr*

Law of Credit Business with Foreign Countries regulates contracting methods and conditions, registrations and performing of credit contracts with foreign countries. That includes issue of debt securities in international financial market.

Law of Securities Issuing and Trading stipulates terms of public issuing of securities. Public quotation for subscribing and/or buying the securities is so-called Brochure approved by the CROSEC of the Republic of Croatia. The brochure has to contain all relevant information and offer the real insight of the securities issuer.

Trading of the securities issued by the public quotation is organised on the stock-exchange and other organised public markets, which are the Zagreb Stock Exchange and Varazdin Stock Exchange. The law defines insertion of corporate bonds and the state bonds in the stock market, while the insertion of the municipal bonds isn't defined separately. Therefore, it can be concluded that municipal bonds are comprised in the group of the state bonds.

Law of Obligatory and Voluntary Pension Funds allows investing in municipal bonds, corporate bonds or shares in the open investment funds up to 30 per cent of fund assets.

In conclusion, issue of municipal bonds for local government unit is determined by legal regulations, and although it isn't completely co-ordinated it prescribes the following documentation:

- Confirmation of the State Bureau for the Revision that paying off the debt won't threaten financing the expenditures of local government units;
- Consonance of the Government of the Republic of Croatia;
- Officials decision to approve the Brochure by the CROSEC of the Republic of Croatia.

4. PREREQUISITES FOR CROATIAN MUNICIPAL MARKET DEVELOPMENT

Local governments in the Republic of Croatia are in a very difficult position. In the process of the country decentralisation, the state has transferred a substantial number of authorities for consumption to the lower, local units, but at the same time authorities for revenue collection have remained the same as before, strictly under state distinction. As a consequence, local budgets aren't strong enough to meet all the requirements of the local population, so there is a great demand for central government additional funds. But in most of the cases, state doesn't approve capital transfers. Hence, local government units have to find some alternative ways of financing, like municipal bonds issue in a capital market.

There are two main reasons for the indebtedness of a lower government units. The most important reason is deficiency of current resources for capital expenditures and the second reason is the necessity of infrastructure for future local development. These are the reasons for the most often use of municipal bonds as a type of local financing, but to issue them it is required to fulfil some preconditions.

Maybe the most important of them is the question of macroeconomic environment, with the task of effective allocation resources from surplus economic subjects to scarce one's. Municipal market has been developing as a part of domestic capital market and it demands transparent fiscal relations between local and central government, effective organisation to meet all local needs and clearly defined legislation.

Unavoidable condition for issuing municipal bonds is also a transparent and developed capital market. In the Republic of Croatia there are Zagreb Stock Exchange and Varazdin Stock Exchange. The prerequisite for a successful primary bond issue is existence of a secondary capital market, because investors can at all times sell their bonds without waiting until maturity, which in the case of municipal bonds can be very long, even more than twenty years.

The development of the municipal market can't be realised without investors, especially institutional ones. In the Croatian market there are few investment funds and seven privatisation investment funds[3], but banks, insurance companies and pension funds are also investors. Privatisation investment funds, created for the process of coupon privatisation, as their assets primarily have equities and liquid assets deposited on bank accounts. Therefore, they are interested to invest in bonds, because they offer some certainty and also bigger profits than bank deposits.

Important institutional investors are also compulsory and voluntary pension funds established at the beginning of 2001. They are allowed to invest in municipal bonds up to 30 per cent of the fund value. Since the separation of compulsory pension funds into the first and second pillar that began on January 1, 2002, a total of 1.97 billion Kn of contribution was paid until the end of 2002 into the second pillar of the pension insurance. Beside this amount, a total of 1.94 billion Kn was transferred to compulsory pension funds.[4] If 10 per cent of that amount would be invested in municipal bonds, their potential buyers will have municipal bonds in the value of about 194 million Kn.

A great impulse to the growth of municipal market authorities can give by tax reliefs, which means that local government can reduce the cost of securing funds through the capital market.

Along with above-mentioned prerequisite, which have macroeconomic character, there are also some additional factors regarding potential issuers. These prerequisites are:

- Fiscal capacity - ability of the local government to discharge debts. Fiscal capacity includes local revenues, on whose estimation depends the capacity of indebtedness.
- Local government management - for a successful program of capital project financing it is necessary to create a team of experts.
- Capital budget - it is important to separate it from current budget, because capital budget is financed through debts, donations and extra taxation.
- Planning, development and forecasting the rate of return – the decision about public projects has to be based on understanding community needs and available resources.

5. MUNICIPAL BONDS IN THE REPUBLIC OF CROATIA

Croatian's municipal market is at the beginning of the development considering minor Croatian experience based on only two examples of the municipal bonds issue: entering of the Istrian County and the town of Opatija the international capital market.

The first series of Istrian County bonds called IŽ 0195 was emitted in January 1995. and the second, IŽ 0295, in November 1995. This period was characterised by extremely inauspicious conditions in the country taking into account undeveloped and non-transparent capital market, high capital price on the domestic market and considerable political risk. Fortunately, all these problems were overcome by successful selling of the bonds.

5.1. Istrian County Bonds - Issue IŽ 0195

Istrian County bonds, issue IŽ 0195, in the total value of 2.000.000,00 DM, were issued to co-finance the development of municipal infrastructure, more precisely for the purpose of the purification the liquid waste in the territory of Pazin. Considering the insufficiency of the town budget to absorbe the whole value of the project (5.000.000,00 DM), the part of resources was collected by the issue of municipal bonds.

The issue of municipal bonds started on July 1994 by gathering a work group and drawing up a survey of municipal bonds issue. Project was finished on October 1994 by approval of Ministry of Finance based on submitted documentation. Primary sale of the bonds lasted by the end of 1994.

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[3] *see Prohaska, Z., Vehovec, M., Eltz, C. Georg (2000) Investment Funds and Corporate Governance in The Privatization Process in Croatia, International Conference: Business and Economic Development in Central and Eastern Europe: Implications for Economic Integration into Wider Europe, Conference Book, Brno, September 7-9, 2000., pp 517-533*

[4] *www.hagena.hr*

At the same time a market research was carried out and institutional investors were defined: banks, savings - banks and insurance companies in the Republic of Croatia. Individuals and enterprises weren't considered as possible investors, because of the high expenditures concerning the small issue amount. Primary issue and bond selling were done by a selling group made up of domestic banks and brokerage houses. In order to become a part of the selling group, particular institution had to fulfil a commitment to buy the bonds at minimum value of 50.000 DM or 50 bonds (one bond had a nominal value of 1.000 DM).

After primary distribution the final phase of the project started. It was characterised by the public presentation of the achieved results and bidding the bonds on the secondary capital market.

Secondary trade of the municipal bonds IŽ 0195 had to insure liquidity and also transparent market price stipulating of the bonds. However, there weren't notified any transaction with these municipal bonds on the Zagreb Stock Exchange, while in the other Croatian capital market in Varaždin there were only ten of them during the 1995.

According to the table 2 it can be seen that the total turnover of Istrian County bonds were 456.458,20 DM or only 494 of total 2.000 issued bonds changed the owner. Liquidity was only 24.7 per cent. The very low turnover was probably caused by attractiveness of interest rate, which was 11 per cent, and by very high level of security investment. Therefore, the investors decided to keep the bonds until maturity.

Table 2: The turnover of the Istrian County bonds at the Varaždin Stock Exchange (in DM)

date	denomination	Volume	turnover	current yield
12.04.95.	100.00	9	9 000.00	11.00%
27.04.95.	100.00	90	90 000.00	11.00%
27.04.95.	102.50	1	1 025.00	10.73%
05.05.95.	95.00	100	95 000.00	11.58%
09.05.95.	100.00	100	100 000.00	11.00%
31.05.95.	90.00	2	1 800.00	12.22%
10.07.95.	85.43	2	1 708.60	11.00%
11.09.95.	86.17	3	2 585.10	10.91%
11.09.95.	86.92	97	84 312.40	10.81%
05.10.95.	78.92	90	71 027.10	11.91%
TOTAL		494	456 458.20	

Source: Report of the Varaždin Stock Echange of Trading Istrian County bonds, Varazdin, March 1999.

The market price of the bonds was fluctuating and there were four transactions realised by the nominal value. There were also three cases of super pari trading, on 27th April, 1995 and 11th November, 1995. sub pari or trading below nominal value was realised on 5th May, 1995, 31st May, 1995 and 5th October, 1995. In accordance with the market price trends, current profit also changed. The highest profit (12.22 per cent) was realised on 31st May, 1995 and the minimum on 27th April, 1995 when it was dropped by the 0.27 per cent below the nominal interest rate.

The issue amount was two million DM and there were issued two thousand bonds with face value of 1.000 DM. The expiration was in three years period or by the end of 1997. These bonds were annuity or reiterated type with semi-annual payments of the equal annuity amounts. Nominal interest rate was 11 per cent. Bonds could have been bought by domestic and foreign enterprises and individuals from 1st December, 1994 till 31st January, 1995.

Debt settlement was executed according to the redemption plan shown in the table 3.

Table 3: The redemption plan of Istrian County bonds by the denomination (in DM)

date	annuity	repayment	Interest	Remainder of the debt
				1000.00
30.06.95.	199.266	145.706	53.560	854.294
31.12.95.	199.266	153.510	45.756	700.784
30.06.96.	199.266	161.732	37.534	539.052
31.12.96.	199.266	170.395	28.871	368.657
30.06.97.	199.266	179.521	19.745	189.136
31.12.97.	199.266	189.136	10.130	-

Source: Preliminary Shortened Brochure of the Istrian County Bonds, I series, Investco, Zagreb, 1994, p. 3

The data in Table 3. shows that the bond with nominal value of 1000 DM was being paid off through equal semi-annual annuities of 199.27 DM value during three years. Total repayment was 1195.60 DM that means that the interest in absolute amount was 195.60 DM per bond.

Table 4: The redemption plan of Istrian County bonds (in DM)

Date	Annuity	Repayment	Interest	remainder of the debt
				2 000 000.00
30.06.95.	398 540	291 400	107 140	1 708 600
31.12.95.	398 540	307 020	91 520	1 401 580
30.06.96.	398 540	323 460	75 080	1 078 120
31.12.96.	398 540	340 800	54 740	737 320
30.06.97.	398 540	359 040	39 500	378 280
31.12.97.	398 540	378 280	20 260	-

Source: Preliminary Shortened Brochure of the Istrian County Bonds, I series, Investco, Zagreb, 1994, p. 3

Total debt of 2.000.000 DM was being paid off through the same annuity of 398.540 DM. Total interest expenditure was 391.240 DM and the total payment for the whole issue was 2.391.240 DM.

5. 2. Istrian County Bonds - Issue IŽ 0295

The issue 0295 of Istrian County bonds was realised on November, 1995 with a volume of 10.000.000.00 Kn.

The purpose of the issue was to improve financial conditions of General Hospital Pula. That was a private placement, because the bonds were relinquished for hospital creditors in return for their outstanding debts. Namely, the accumulated hospital debt towards the contractors was approximately 14.5 million Kn and the hospital had to find the way to cut a loss.

Istrian County took a role of bond issuer but on condition that the hospital management and contractors agree upon a preliminary debt discount of 30 per cent, by which the total debt was reduced to 10.00.000.00 Kn.

The Issue was divided into two series, A and B. They had simultaneously issues but with different amount and expiration. Series A had the face value of 4.300.000.00 Kn and it was issued with maturity of two years. For series B, the face value was 5.700.000.00 Kn and the expiration was in three years or by 30th November, 1998.

Municipal bonds IŽ 0295 were one-shot or in other words the capital sum was paid off in one-shot at the date of expiration and interests were being paid off in periodic half-year intervals. Annual interest rate was 7 per cent or 3.5 per cent for the six months period.

In this primary bonds issue the investors were exclusively hospital contractors with a large scale of theirs outstanding debts. That was the main reason for three different bond values: 500, 1.000 and 10.000 Kn and accordingly three different denotation: A, B and C. This issue was also characterised by their callability. The issuer had a right to withdraw the whole issue or just a part of it, in amount of the face value enlarged by the calculated interest till the expiration time.

Considering the two different series of this particular issue as well as three different face values for each of them, there are several redemption plans, according to the series and also according to the denomination.

Table 5 shows a redemption plan for A and B series, and table 6 shows the whole issuer's collective liability.

Table 5: A redemption plan for the Istrian County bond, issue IŽ 0295 (in Kn)

Date	"A" issue			"B" issue		
	Principal	Interest	Debt	Principal	Interest	Debt
1995.	-	-	4 902 000	-	-	6 897 000
1996. (V)	-	150 500	4 751 500	-	199 500	6 697 500
1996. (XI)	-	150 500	4 601 000	-	199 500	6 498 000
1997. (V)	-	150 500	4 450 500	-	199 500	6 298 500
1997. (XI)	4 300 000	150 500	0	-	199 500	6 099 000
1998. (V)				-	199 500	5 899 500
1998. (XI)				5 700 000	199 500	0
TOTAL	4 300 000	602 000		5 700 000	1 197 000	

Source: Survey of Issue of the Bonds IŽ 0295, Investco, Zagreb, 1995, p 4

Table 6: Total redemption plan for the Istrian County bond, issue IŽ 0295 (in Kn)

date	Principal	interest	debt
1995.	-	-	11 799 000
1996. (V)	-	350 000	11 449 000
1996. (XI)	-	350 000	11 099 000
1997. (V)	-	350 000	10 749 000
1997. (XI)	4 300 000	350 000	6 099 000
1998. (V)	-	199 500	5 899 500
1998. (XI)	5 700 000	199 500	0
TOTAL	10 000 000	1 799 000	

Source: Survey of Issue of the bonds IŽ 0295, Investco, Zagreb, 1995, p.5

The secondary trading started after primary bond issue. However, the secondary trading proceeded mostly directly between buyers and sellers, outside the regular market, on the so called OTC market. There was only one notified transaction at the Varaždin Stock Exchange on 24th May, 1996 with total turnover of 251.125.20 DM.

6. THE TOWN OF RIJEKA – A POTENTIAL BOND ISSUER

Inauspicious economic and political situation in Croatia is also reflected in the Town of Rijeka. Growing unemployment effects decreasing local tax revenues and on the other hand it increases demands for social programs of benefits and subventions. Minimal or even none profitability of the economic system reduces local incomes based on entrepreneurial profit.

Therefore it is necessary to invest in development, infrastructure and all matching projects which could generate incomes and employ citizens. For this purpose authorities of Rijeka have done a lot to attract domestic and foreign investors interested in development projects of the town, primarily municipal and town planning projects, sports and cultural infrastructure.

Rijeka entered the international financial market in the end of 1999 by raising a 7.5 million EUR value loan at European Bank for Reconstruction and Development. Loan was given with a purpose to finish the sewage system in the town. That was just the beginning of the orientation and integration of the town of Rijeka in the international financial market. Furthermore, there is also a plan for credit rating and the first issue of municipal bonds.

Before the authorities of Rijeka will make a decision about municipal bond issue they will have to decide precisely which will be the projects that have to be financed, which are the expenditures and when will they be carried out. All these data are presented in a development strategy of the town. To finance all of these projects, it is necessary to attract many foreign investors for direct and indirect investments.

The potential projects that would be recommendable to be financed by municipal bonds issue are:

PROJECT	AMOUNT
Business - trading centre “Vodovodna ulica”	25 mil. DM
Fair	10 mil. DM
Swimming pool	20 mil. DM
Complex “Zapadni Zamet”	

It would be optimal to finance all these projects with one municipal bonds issue, because the size of the municipal bond issue in the international financial market is in range from 100 million US$ to 1.5 billion US$. Therefore, a small volume issue would signify market restriction and less potential investors.

However, the first issue could be experimentally carried out in smaller volume in order to prepare the market. The success of this first issue would show if it would be advisable to issue larger series of municipal bonds in future.

7. CONCLUSION

Considering the insufficiency of local financial resources to meet public needs, local government units have to find the ways for resolving this problem.

One of the ways of financing capital projects of local government units is issuing of debt. By issuing municipal bonds, resources for different financial needs of local government units are ensured through the capital market. Municipal bonds are long - term debt securities issued by local authorities.

Negative circumstances for the Republic of Croatia, but also some other transitional countries, are undeveloped capital market and credit rating. Rating of a country represents an upper limit for the credit rating of local government units, so it can be concluded that Croatian towns or counties can't have higher credit rating than BBB-.

It was shown that considering the diversity of institutional investors (privatisation investment funds, investment and pension funds) municipal market could have a sufficient turnover.

It can be also concluded that municipal market in the Republic of Croatia is at an early stage of development. It has been established with the issuing of two series of bonds in the administrative region of Istria in 1995. Despite of non transparent and inadequately developed Croatian capital market, municipal bonds of Istrian county were successfully traded on OTC market.

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