Manuals for preparation and implementation of the Public Private Partnership Program

Manual 5

Version 1

Determining the affordability of the local and regional self-government (LRS) in public-private partnership

Republic of Croatia
Agency for Public Private Partnership

August, 2012

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Quote:

Public-Private Partnership Agency of the Republic of Croatia (2012): *Determining the affordability of the local and regional self-government (LRS) in public-private*

partnership, Manual for preparation and implementation of the public-private partnership model, Manual no. 1, Version 1, Zagreb.

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1. FOREWORD

Investing in private buildings in order to provide public services requires considerable investments. The units of local and regional self-government (LRS) obtain funds from three financial sources: own financial sources, debt (loans or bonds) and acquisition of services through the public-private partnership model. Borrowing or the public-private partnership model implies taking on long-term liabilities on an annuity basis or through public-private partnerships, which can effect, to a greater or lesser extent, the preservation of long-term financial and budgetary stability.

The Budget Act (Official Gazette 87/08) defines the debt limits for LRS and public-private partnership costs. However, taking on long-term liabilities within legal boundaries can have divers' effects on the financial stability of LRS). It is therefore of special importance to establish the economic (actual) capacity to take on long-term liabilities.

This manual represents a systematic approach to determining the affordability of LRS to take on long-term liabilities. Therefore the main goal of this manual is to present a procedure that will help LRS calculate the annual financial obligation and debt limits or the limitations of the liabilities taken on in a public-private partnership contract. Such a systematic, socially responsible

and methodological framework can help LRS improve the management of their long-term liabilities and the determining of the actual ability to take on liabilities, which in turn should result in long-term financial stability of the budget.

I would like to take this opportunity to thank Prof. Ante Bajo and Dr. Saša Drezgić, whose comments and suggestions contributed significantly to the quality of the manual.

The main idea and goal of the series of manual published by Agency for Public-Private Partnership is to provide more information on funding of projects of public institutions from different financial sources, among which the public-private partnership model still needs to find its right place.

Damir Juričić, PhD

Director of the Agency for Public-Private Partnership

2. INTRODUCTION

Investments in public interest projects depend on the determining of the ability to take on long-term liabilities incurred as a result of finding and using third party financial sources. The reason for it is to preserve the long-term financial stability of the country and to avoid potential fiscal shocks resulting from rash decisions. Debt and lease are the two main third party financial sources.

Debt involves a direct obligation to repay the principal and interest within an agreed period of time. The direct financial burden of lease is the regular payment of lease.

The process of determining the affordability of public institutions like LRS and ministries to take on long-term liabilities involves a study and analysis of their long-term ability to take on financial liabilities such as long-term lease, as is the case in public-private partnership contracts. The goal of the determining the affordability to take on long-term liabilities is to assess the capacity to sustain debts and to pay the lease without undermining the long-term financial stability of public sector institution and of the financial system as a whole.

It is understandable and socially justifiable that, prior to the formal closure of a debt agreement (loan, bonds) or a PPP contract, the management of a public body needs to assess the actual ability to meet the payments of

long-term liabilities and to analyse debt capacity and lease capacity. The management of public institutions should not rely solely on the analyses of the adherence to legal limits for debts and the payment of PPP fees. Such analyses often focus on the formal compliance with the requirements for obtaining a permission to incur indebtedness; however they do not present the actual financial position of public bodies over a long time frame.

The guide for assessing the ability to take on long-term liabilities *(Analyzing Debt Capacity and Establishing Debt Limits* (2004) AMANS; NSMFC; FMCBC, Recommended Practice, August) helps the users to:

1. Determine the affordability to repay the debt within the specified period and in the amounts which will not jeopardise the provision of the existing public services as defined in the budget;
2. Analyse whether there is a satisfactory level of flexibility in the financial source management, which implies that possible future changes in budget revenues and expenditures were taken into consideration;
3. Determine the influence of the existing and new debts and fees on the long-term financial stability of the budget;
4. Determine the long-term influence of debt and PPP fees on the fiscal burden on tax payers and the economy.

Indebtedness and public-private partnership contract[1] represent a long-term, fixed liability[2] which a public body took on, making a long-term commitment to provide funds from budgetary financing sources. Having in mind the long-term and fixed nature of payment, it only seems reasonable and publicly justified that, prior to closing a loan agreement or a public-private partnership contract, a public body needs to assess the debt capacity (ability to sustain debts) and rent capacity (ability to pay fixed rents pursuant to public-private partnership contracts).

It is particularly important to assess the ability to sustain debts and to pay fixed fees. However, there is a series of external factors which need to be taken into consideration as they can significantly affect the ability to meet contractual obligations. Therefore, an analysis of the ability to sustain debts and to pay fixed fees (Juričić, 2011) should take account of the following:

- quality of structure of spatial plans; development plans of LRS and
- LRS balance sheet and the capacity to sell public assets (buildings and land which are not used to provide public services to LRS).

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[1] The reference is, first of all, to the type of a contract in which the public partner pays to the private partner a fixed fee for the service of sustaining the public infrastructure facility in the available state.

[2] An important characteristic of fixed liability in PPP contracts regard the right of the public partner to withdraw payment to the private partner if the latter does not sustain the public infrastructure facility in the available state.

The basis for stable long-term development of LRS lies in the quality of structure of spatial plans and strategic plans for economic development. Spatial plans contain information on the long-term use of an area within the responsibility of a public body, whereas strategic plans for economic development provides investors with clear information on actual public needs for public infrastructure facilities, of course in synergy with private investments. Strategic plans for economic development of LRS provides information on the direction of the economic activity as a whole. It goes without saying that LRS need to have a healthy balance sheet, that is an overview of available fixed assets (buildings, land) under their ownership and a good overview of the status of the financial assets, especially of the shares and stocks in the companies in which they have major or minor ownership. The overview helps LRS to define their asset management strategies, as well as to decide whether there is a need for privatization, sale or changes of use of some parts of the assets that might be used more rationally in the provision of public goods and services.

It only seems appropriate to place so much importance on the overall ability of a public body to meet fixed long-term liabilities (debt and rent), whereas the extent to which they will be used will depend on the analysis of the justifiability of a public investment model, as well as on the market (interest rates and private investors), severity of debt restrictions, etc.

3. PURPOSE OF THE MANUAL

The purpose of this Manual is to direct the attention of public bodies – future public partners in public-private partnership projects – on the need to assess the ability to take on long-term liabilities, regardless whether they be debt or rent. The assessment of the actual capacity to take on long-term liabilities is a socially responsible and economically rational act. This manual is intended for a wide public, but first of all for the public bodies in the local public sector, as it may help them in understanding the importance of analysing debt capacity and rent capacity in order to preserve the long-term financial stability and security while investing in public infrastructure facilities and taking on long-term liabilities.

4. DETERMINING OF THE AFFORDABILITY OF LRS TO TAKE ON LONG-TERM LIABILITIES

Indicators of the affordability to take on long-term liabilities

Analysing debt capacity and rent capacity is not a mere calculation of the ability of LRS to incur a certain amount of debt or to determine a rental fee in a public-private partnership contract.

An analysis of debt capacity is needed in order to prepare a forecast of budget revenues and expenditures, which represent in numbers the total of all public policies. The forecasts are aimed at determining the amount of funds sufficient for the payment of long-term loans and long-term rent fees. The determination of the affordability to take on long-term liabilities is based on the calculation of several indicators of budget revenues and expenditures, and then by comparing the indicators we can have better information on the affordability to take on financial liabilities. It is necessary, first of all to:

- calculate the ratio between the sources of repayment of long-term loans and the expenditures financed from general purpose revenues;
- calculate the difference between specific purpose revenues and expenditures in order to estimate the structural budget balance;
- establish the possibility to modify the existing public policies in order to establish the possibility to use the free cash flow to finance long-term loans and rents.

1. Financial indicators of budget revenues

The ability of LRS to pay off arrears in time and in full depends directly on the quality and quantity of the revenues that were generated. LRS can earn revenues from the business and the sale of non-financial assets.

In the determination of the affordability to meet liabilities revenues is the most important category. This item of the budget reflects the actual ability to earn revenues. Other revenue categories can be influenced by outside factor or by one-time factors that can distort the picture of the financial potential and stability. Revenues can be divided into tax revenues, foreign financial assistance and from entities within the general government sector, revenues from assets, revenues from administrative fees, revenues pursuant to special regulations and other revenues.

Some important revenue indicators are as follows:

a) ratio between *current revenues* and *total revenues*. A larger share of current revenues is a sign of lower dependence on one-time revenues and a higher level of financial stability of the budget, which renders budget planning easier;

b) ratio between *local (autonomous-own) revenues* and *current*

revenues of a local unit. The financial picture of local units will be better when the coefficient, that is the share of own revenues in total revenues is higher;

c) ratio between *state assistance for enterprise* and *current revenues*. Lower dependence of LRS on state assistance is desirable, and the fiscal ability of local units is higher, the lower the value of the indicator is;

d) ratio of *revenues from property sales* and *total revenues*. Having in mind the fact the revenues from property sales represent surplus revenues of local units, which cannot be counted on every year, it is less important for the increase of the ability of local units to meet long-term liabilities, and therefore it is desirable for that indicator to be low. Certainly, depending on the value of available assets of LRS, local units need to manage and plan well their use, maintenance and sales;

e) ratio between *current surplus decreased by interests* and *current revenues*. Higher value of the indicator indicates a higher ability to take on long-term liabilities. The ratio between the current expenditures decreased by principal payments and interest expenses and total current revenues can also be used here.

2. Financial indicators of expenditures

The revenues of LRS are a key factor in the assessment of the ability to meet liabilities. However, an analysis of expenditures can offer an insight into the amount and structure of liabilities. The expenditures of local units can be divided into business expenditures, expenditure for acquisition of non-financial assets.

The financial indicators of business expenditures are mostly drawn from the ration between individual types of expenditures and a non-financial value like the number of inhabitants, which is only logical if we take into consideration the fact that it is equally important to meet any expenditure. Therefore, it does not make sense to prefer one type of expenditure to another one without taking into consideration possible positive effects of some types of expenditure (e.g. capital investments). It is not possible to express desirable values of the indicator of the expenditures of LRS, however a decrease in some types of expenditures has a positive impact on the assessment of the ability to take on long-term liabilities.

The indicators of expenditures are:

- ratio between *total expenditures* and *number of inhabitants* of a local unit. This simple indicator shows total expenditure per capita;
- ratio between *business expenditures* and *number of inhabitants* of a local unit.

The following two indicators are used to determine the structure of expenditures that is of the share of individual types of expenditures in total expenditures.

- ratio between *business expenditures* and *total expenditures*,
- ratio between *capital investments* and *total expenditures*.

Both indicators are used for the estimate of a possible change the future structure of expenditures depending on desired goals.

3. Financial indicators of net results

The relationship between revenues and expenditures of LRS can be quantified by the indicators of net results. The most frequent indicators of net results are as follows:

- ratio between *total expenditures* and *total revenues* of local units. It is desirable that the values are below one because it means that LRS are producing surplus. On the other hand, the values of the indicator which are over one imply that LRS have a budget deficit in the given year;
- ratio between *business expenditures* and *current revenues* of local units. The ratio between business expenditures and business revenues shows the quality of business revenues that is the ability to finance public goods and services through current (business)

revenues. The value of that indicator is inversely proportional to the assessment of the ability of local units to meet liabilities. In other words, it is in the interest of local units to keep the value of the ration as low as possible.

The budget result of local units largely depends on their fiscal autonomy.

a) Financial situation

The analysis of the financial situation looks at the accounting standards and estimates their impact on local unit budget and other financial statements. Based on the analysis, the items with considerable amounts in the reserve are identified and their use is determined, liquidity policy and cash management system are revised, historical and forecast requirements for gross and net financing are analysed. Potential liabilities are also taken into consideration in the analysis, whereas the financial situation analysis includes an estimate of the debt of the companies owned by LRS.

b) Debt, liquidity and indirect risks

The analysis of the debt structure of local units determined the method of debt repayment and potential indebtedness risks. Financing by debt is

generally positive if it is used for long-term investments, especially when they are profitable and with short-term repayments. On the other hand, long-term debts incurred to cover short-term costs or budget deficits is not desirable as it decreases the ability of LRS to take on long-term liabilities. Apart from taking out loans or issuing debt securities, the debt structure of local units also contains potential liabilities resulting from guaranteeing the liabilities taken on by the public utility companies owned by LRS. Due to potential risks of the indebtedness of public utility companies it is necessary to assess the indirect risks to the business activity of LRS.

c) Liquidity indicators

Liquidity indicators are measures of the ability to meet short-term financial obligations *(Žager and Žager, 1999).* Apart for the ratio between current debt and current revenues, which clearly and directly shows the ability of local units to finance the current debt from the current revenues, there is a series of other indicators which help determine the quality of individual categories which are important for meeting the current financial obligations. The main liquidity indicators are as follows:

- ratio between *current debt* and *current revenues*. The ability of local units to take on liabilities is higher the higher the difference between the value of the current revenue and current debts;

- ratio between *short-term assets* and *short-term financial obligations*. The positive difference between the short-term assets and short-term financial obligations reflects the value of the short-term asset financing from long-term sources, which is important for the liquidity of LRS;
- ratio between *total surplus* and *current revenues*.

d) Debt indicators

Debt indicators have also an important role in the assessment of the ability of LRS to take on long-term liabilities. These indicators show the relative amount of long-term debt of local units. The indebtedness of local units can be calculated as the share of debt in a balance sheet item. The amount of debt is often calculated per capita.

There is no debt benchmark as a debt indicator. Any amount of debt has an unfavourable impact on the ability to take on new liabilities. However, its low values indicate its greater ability to take on new loan or rent liabilities. Among useful indicators are as follows:

- ratio between *long-term debt* and *total assets*. Total assets is the sum of financial and non-financial assets of LRS;
- ratio between *long-term debt* and *number of inhabitants*. The indicators show the amount of long-term debt per capita.

e) Indicators of debt payments

Every year a part of long-term liabilities of LRS turn into short-term liabilities which are to be repaid as interests that is as the annuity which includes the interests and a part of the principal. In some cases the entire

amount of principal is due. Based on the indicators of debt payments it is also possible to assess the burden of debt *(Lamb et al., 1993)*. The indicators of debt payments are as follows:

- ratio between *total annual debt payments* and *current assets*. The ratio thus calculated shows the ability of LRS to finance the current part of debt from current revenues;
- ratio between *interest repayment* and *current revenues*. This ration indicates the ability to finance the current part of debt, that is only due interests, from current revenues;
- ratio between *total annual debt payment* and *short-term financial assets*.

5. DETERMINATION OF THE FINANCIAL POSITION OF LRS

The analysis is aimed at determining the financial position of LRS, especially their ability to create and increase savings and current surplus for capital investment financing.

In the analysis it is necessary to evaluate the current surplus/deficit and determine their share in own financing (self-financing) of capital investments (expenditures for acquisition of non-financial assets). This is the formula for the assessment of the financial ability of LRS to finance a part of capital investments directly from the budget, by debt or by rent.

The analysis of the financial position also shows the ability to meet liabilities based on the level of debt payment (rent) and adequate amount of debt (rent) in relation to the financial situation. The analysis determines the capital investment level compared to the current budget, the level of dependency of the city on state budget assistance, and the total surplus at the end of the year (total surplus or deficit from year N-1 should be included in the budget for year N).

Figure 1 Structure of the current and capital budget

	Revenues	Expenditures
CURRENT REVENUE	Tax revenues Subsidies (assistance) Other (service and asset revenues) Difference in year N-1 (only current)	Salaries Current and investment maintenance Debt repayment (rent) Deficit in year N-1 (only current)
		Current surplus

CAPITAL INVESTMENT BUDGET	Self-financing (current surplus)	Public works Acquisition of equipment and land Debt repayment
	Asset sale Subsidies Loans	

Source: World Bank 2012

The current (operating) budget includes outflows and inflows provided by regular (current) business activities. They are often considered as stable and relatively predictable. Current revenues includes: tax revenues, subsidies

(assistance) paid out from the budget of the central government of some other level of government, and sources of revenues which LRS raises from established prices, chargers, tariffs (revenues according to special regulations), whereas revenues from assets are mostly derived from the exploitation of the assets owned by local units (e.g. lease of land, public communal services and activities, etc.). The current expenditures include employee expenditures (salaries, social insurance contributions and other human resources management charges), material costs, business and maintenance costs (often difficult to identify due to subsidies given by local authorities as assistance to other institutions – associations, affiliated companies, etc.) and repayment of debt and payment of rent.

Capital revenues and expenditures (revenues from sale of non-financial assets and expenditures for acquisition of non-financial assets) increase or decrease the value of LRS assets (acquisition or sale, public works). The majority of accounting systems of LRS applies the cash principle and therefore do not register the influences and effects of the depreciation or amortization of LRS assets. As a result, capital revenues and expenditures are registered at the annual level. The effects of capital expenditures are usually seen in a period longer than a year (12 months) and need to be divided into several fiscal years. The amount of these expenditures changes in the course of the years.

Debt repayment needs to be divided between the current (operating) budget, where *interest* expenditures are registered, and the capital part of the budget, where *principal payment* expenditures appear. In a more pragmatic

approach, the whole repayment of debt (interests and principal) should be covered by the current surplus, which is, at the same time, a good indicator of the ability of local units to repay debts. The total LRS budget can be balanced in surplus or in deficit.

Table 1. Financial situation of a local unit

	Items	Calculation	2008	2009	2010	2011	CAGR %
1	Total current revenue						
2	Surplus N-1 (if existing)						
3	Current revenue in year N	(1-2)					
4	Expenditures						
5	Current surplus/deficit	(1-4)					
6	Debt repayment						
7	Net margin (difference)	(5-6)					
8	Capital expenditures						
9	Financial requirements	(8-7)					
10	- Own capital revenues						
11	- Investment subsidy						
12	- Loans	(9-(10+11))					
13	State of investments	(8-(7+10+11+12))					
14	Total final/closing state	(1+10+11+12)-(4+8)					

Source: World Bank, 2012

In order to gain a detail insight into the financial position of local units, an additional analysis needs to be performed, which would show capital investments, long-term asset maintenance, and other related activities and characteristics of LRS activities, as suggested in table 2.

Table 2. Selected indicators of the business activity of local units

Indicator (definition)	*Purpose (description)*
Capital investment expenditures / business revenues	*LRS prefer development costs*
Capital investment expenditures approved by the state / total investment expenditures	*Local units still do not have heavy responsibilities*
Maintenance cost expenditures / business expenditures	*LRS maintain important long-term assets*
Total number of local public servants / inhabitants	*LRS are limited when it comes to financing maintenance and capital investments*
Salaries and wages / business expenditures	
Actual revenues / planned revenues	*LRS have a good forecasting ability and the budget is reliable*
Amount of outstanding arrears / net cash (at the end of the year)	*LRS accumulate long-term debts and undermine their credibility before suppliers*

Source: World Bank, 2012.

6. ANALYSIS OF HISTORICAL PERFORMANCE

In the analysis of the historical budget information the structure and dynamics of budget revenues and expenditures are determined in order to identify trends in the changes of individual budget items. That part of the analysis is important in order to assess whether there are favourable conditions for generating certain types of budgetary revenues, as well as to establish the monetary reflection of local government policies and the financial consequences of the changes in those policies.

When preparing a forecast it is necessary to analyse the following:

- policies which the local government will implement,
- effects of the projects which are being implemented or which will be implemented in the future, and
- economic trends and indicators.

After having made projections of budget revenues and expenditures based on the business forecasts, it is possible to assess the ability to take on long-term liabilities.

Budget revenues provide information on the total amount of the budget and the average annual rate of growth of budget revenues, but the

important information they do not provide is their use. Therefore, budget revenues need to be distributed according to their use in order to be able to determine the size of the structural budget imbalance.

The structural budget imbalance results from the ratio between specific purpose budget revenues and expenditures. Budget is structurally balanced when the respective amounts of specific purpose budget revenues and expenditures are the same. Budget is structurally imbalanced when a part of specific purpose expenditures, not covered by corresponding specific purpose revenues, is financed from general purpose budget revenues.

The analysis of the structural budget imbalance is important because it decreases the economic debt capacity and rent capacity. Considering that general purpose revenues form the basis for the analysis of debt capacity, financing restricted expenditures from general purpose revenues decreases the basis, as well as the total debt or rent which can burden the budget. If, in case of structural budget balance, restricted expenditures are covered by specific purpose revenues, and rent fees, annuities, operative costs and programmes by general purpose revenues, then the difference between general purpose revenues (potential financial sources for payment of annuities and rent fees) and the existing annuities, rent fees, operative costs and programmes represents the basis for the payment of future annuities and rent fees.

As part of the analysis of structural budget balance, an estimate is made of the amount of revenues which can cover outstanding annuities and

rent fees and which result from a difference between potential revenues which can cover annuities and rent fees, on the one hand, and the costs of the existing annuities, operative costs and programme costs (sport, culture, childcare, etc.) on the other. Based on these insights, and in case of an important future investment period, the executive and representative city groups should decide on possible changes to the policies which are responsible for such effect and they should harmonise the policies with the effects of new investments.

7. LRS PERFORMANCE FORECAST

Financial projections over several years are made in order to confirm and complete the basic results of indicator analysis. The projections give an overview of the financial situation of LRS, and are particularly important for the assessment of the ability to take on long-term liabilities. The basic goal is to formalise the assumptions about the influence of political decisions (cost changes, indebtedness, fiscal burden, etc.) on the financial position of LRS. Several assumptions and scenarios of projections are usually tested based on historical trends and important changes. Methods are adjusted according to the size of LRS and the situation/problems it is faced with (special investment programmes in the coming period, specific debt situation that needs to be solved, etc.)

1. Determination of assumptions used for performance forecast

The reliability of performance forecast depends on the reliability of pre-determined assumptions. The assumptions on which performance forecasts are made can be divided into several groups, and regard the assumptions about economy, political and other indicators (Juričić, 2011):

Assumptions about economic indicators are as follows:

- macroeconomic indicators (inflation, GDP, employment rate, etc.);
- structure of local economy and development prospects;
- dynamics of future budget revenues;
- identification of the demand for economic activity subsidies.

Assumptions about political indicators are as follows:

- drawing up of special and economic plans of LRS;
- new investment plan;
- expenditure plan for social, sports, educational and other programmes;
- changes in the existing tax regulations within the competence of the central government;
- tax changes or introduction of new taxes within the competence of LRS.

Other assumptions about future business activities are as follows:

- business organisation (new departments, total number of employees, etc.);
- relations among the companies owned by LRS;
- other factors which influence debt capacity.

The strength of economic entities depends on the inflation rate, gross social product and the employment rate, whereas fiscal capacity depends on

the strength and capacity to pay taxes. If the structure of economic activities is dominated by one activity, for example tourism and hospitality industry, the analysis of the forecast of budget revenues should be based on the analysis of the trends in that particular sector. The dynamics of earning future budget revenues, as explained below, will reflect prospects for the economic entities which engage in economic activities in the area of LRS. For the forecast of future budget expenditures it is particularly important to identify the demand for economic activity subsidies as they contribute to the preservation of the continuity of growth of budget revenues.

It is the government who mostly decides on LRS investments. It is presumed that the voters are introduced to the candidates' investment plans during political elections. The link between the intended future investment of the local authorities and the citizens' support is part of political risk and is very important in the evaluation of the final implementation of planned investments.

It has happened a lot of time that new investments were made but they were not successfully realised because they did not have the citizens' support. Financing programmes for kindergarten childcare, education and science, sports and culture, technical culture and social programmes form an intrinsic part of the citizen's everyday life. Therefore, the government's standpoint regarding these costs is especially important. Great political ambitions regarding the improvement of the standards of these public services makes the costs increase, decreasing thus the basis of debt capacity and rent capacity. The opposite is also true: once high standards of those public services are set, it is difficult to decrease it for the purpose of increasing the basis of debt capacity.

The development of local units can be enhanced if the management of the areas within their jurisdiction has been developed. If special plans have been developed, it is clear which part of the area is intended for some types of economic activity. If the competent bodies developed and implemented the economic development plan, that is the master plan, then the link between the spatial and economic development of LRS is clear. Master plans also envisage investments in strategic public infrastructure facilities like schools, kindergartens, garages, waterworks, sewage and waste water management, support for the improvement of the organisation of the existing economic activities, etc. defining also the time period. One of the political factors worth considering is the possibility that the existing tax rates, and in particular those divided among levels of government, will change. LRS can decide autonomously on some taxes, for example income tax surcharge. It that tax has not been introduced, its introduction might increase the amount of unreserved tax revenues, increasing at the same time debt capacity or rent capacity.

The formulation of spatial and economic plans, new investments, preparation of the standards for new public infrastructure facility management, preparation of a reliable budget forecast based on which the decision on new investment financing is brought, maintenance of the existing standards of public services imply adequate staff and technical equipment of LRS administration. Therefore, higher costs of work can be expected, which will decrease, perhaps, debt capacity, and, in any case, they will contribute to better management. Apart from the ownership and management relations among cities, municipalities or counties and the companies they own, financial

relations exist too. Companies are more frequently financed from the budget. Therefore, in order to conduct a reliable analysis of debt capacity, it is necessary to look at the plans and prospects of those companies.

2. Performance forecast and assessment of debt servicing capacity

When making performance assumptions it is necessary to keep in mind that the precision and reliability of performance forecast depends on their quality. Consistent political decision regarding the intention to make some investments defined by the master development plan approved by all governing bodies and the citizens are especially important as they contribute to the reduction of political risk. This generates interest among a great number of potential investments, guaranteeing good competition conditions. Good competition conditions will result in lower budget expenditures. On the other hand, professionally drawn up financial models of certain investments will contribute to more reliable decisions being taken by the city's executive bodies regarding the organisation model of individual investments.

Financial models need to be prepared by experts specialised in that type of work, who are also able to identify with certainty performance assumptions. Based on the assumptions, complex financial models will be used to determine reliable indicators of economic and financial effects of individual investments. The analysis should be prepared in such a way as to first include a forecast of budget revenues and expenditures excluding new investments, and then a forecast which will include the effects of new investments. The analysis of the forecast without investments gives a clear picture of debt capacity and

rent capacity, ratio between future general and specific purpose revenues, and possible surplus or deficit that is the difference between future budget revenues and expenditures. It is useful to keep in mind the fact that potential surplus in budget revenues in comparison with expenditures can be used to cover the risks of actual future budgets.

3. Budget revenue and expenditure forecast excluding new investments

Budget revenue and expenditure forecast excluding new investments is based on pre-established performance assumptions. It should be clear from the forecast that it will be possible to finance budget expenditures resulting from the existing policies from the expected budget revenues.

Legal debt capacity is calculated as the percentage of budget revenues of the previous year compared to the year when the debt is incurred, excluding national and foreign subsidies, co-funding of local self-government by the citizens, and the revenues realized from additional shares in income tax and even-out assistance for financing decentralised functions. However, creating indebtedness up to the legal limits of debt capacity might have a strong impact on the implementation of the existing policies whose quantitative image in revenue and expenditure forecasts may show that there is less free money that might be used to pay outstanding annuities than is legally allowed. It is therefore particularly important to estimate free cash flow after the planned policies have been implemented. In that was the basis for debt capacity is determined.

Therefore, regardless of the legally allowed debt limits, if the existing policies are implemented, debt capacity can be much lower than envisaged by the law. Once debt capacity is recalculated taking into consideration certain risks and reserves, the result are the actual debt capacity.

The same procedure for analysing debt capacity is also used to analyse rent capacity in order to determine the basis for the payment of PPP fees (legal, economic and actual rent capacity). However, since debt and rent mean taking on long-term payment obligations, the emphasis is mostly on the legal, economic and actual ability to take on long-term liabilities.

4. Budget revenue and expenditure forecast including new investments

After having established rent and debt capacity, budget revenue and expenditure forecasts including the effects of new investments are prepared. It is good to prepare an overview of the basic elements needed for the preparation of budget forecasts, based on a description of individual investments, existing and new deposits, established uses of individual revenues and expenditures, defined standards of individual public services and the definition of other important factors that determine the implementation of the existing or future policies. The result of a budget revenue and expenditure forecast including new investments is a budget revenue surplus which can be used to cover future risks before the final cost allocation.

Items	2010	2011	2012	2013	2014	2015	...
	O	O	P	P	P	P	P
A TOTAL BUSINESS REVENUES							
Property tax revenues							
Income tax revenues							
Inheritance and gift tax revenues							
Other tax revenues							
Communal contribution revenues							
Lease revenues							
Property sale revenues							
Monument annuity revenues							
Concession revenues							
Donation and subsidy revenues							
EU structural fund revenues							
Other revenues							

Items	2010	2011	2012	2013	2014	2015	...
	0	0	P	P	P	P	P
B TOTAL BUSINESS EXPENDITURES							
Gross salaries							
Payments to councillors, political parties, etc.							
Material costs and equipment							
Other costs of the city council, offices and local boards							
Childcare programmes							
Education and science programmes							
Culture programmes							
Sports programmes							
Technical education programmes							
Social assistance programmes							
Repayment of loans, granted loans and savings							
PPP fees							
Investments in communal infrastructure							
Investments in communal infrastructure							
Other investments							
Subsidies							
Budget reserve							

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