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Ratings

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Research Update:

Croatian City of Zagreb Upgraded To 'BBB-' On Improved Institutional Framework; Outlook Positive

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Overview

- We think that the institutional framework for Croatian municipalities has strengthened, as transparency and accountability standards gradually improve.
- Croatia's eurozone accession last year and its continuous alignment with EU practices provide important policy anchors.
- We therefore raised our long-term rating on Zagreb to 'BBB-' from 'BB+'.
- The outlook is positive, reflecting our view that Zagreb's credit profile could strengthen further if prudent management practices are embedded further, supporting the city's sustained improvement in its financial metrics, or if income levels rise significantly.

Rating Action

On March 22, 2024, S&P Global Ratings raised its long-term foreign and local currency issuer credit ratings on the Croatian capital city of Zagreb to 'BBB-' from 'BB+'. The outlook on the rating is positive.

Outlook

The positive outlook reflects our view that improving management practices, rising income, and better funding access in the wake of eurozone accession could further strengthen the city's creditworthiness.

Upside scenario

We could raise the rating on Zagreb over the next 12-24 months if we observed that the improvments in financial management practices are further institutionalized in areas such as debt and liquidity management and more effective governance of the government-related entities. A significant rise in the income level of the local economy, a stronger-than-expected budgetary performance, or further improvements in the city's liquidity position could also lead to an upgrade.

Downside scenario

We could revise the outlook to stable if Croatia's and Zagreb's economic growth falters, and the city's management fails to sustain improvements in liquidity management, or if budgetary performance deteriorates substantially.

Rationale

The upgrade reflects our view of the strengthened institutional framework for Croatian municipalities. We believe that the setup under which Croatian municipalities operate has been continuously improving, not least as Croatia's eurozone accession last year adds another anchor for the fiscal framework. We think that this fosters improving transparency and accountability standards for Croatia's municipalities, including the country's capital, Zagreb. We think that the gradual alignment with EU standards over recent years has contributed for example to lower use of quasi-debt for funding and stronger oversight, not least given the strong push for EU-funded investments. The improvements have been building over time and we think that eurozone accession adds another pillar that prevents a reversal of institutional improvements.

Our ratings also reflect Croatia's and Zagreb's rising income and continued integration and convergence with the EU economy. We also expect the city to achieve stronger, albeit volatile, budgetary performance and maintain a strong liquidity position, given its stronger access to funding within the eurozone. Zagreb has moderately-high tax-supported debt that includes the debt of Zagrebacki Holding (ZGH) and public transport company Zagrebacki Elektricni Tramvaj (ZET). We expect the city's debt burden to increase further with high investment spending, co-funding projects supported by EU funds. The city also has comparably limited budgetary flexibility and a relatively short track record in some areas of financial management, for example, effective governance of the city's government-related entities (GREs) and liquidity management.

Improved institutional anchors and a resilient economy support Zagreb's credit profile

We note improvements in Croatia's local government fiscal settings, and we anticipate that eurozone accession will serve as a further institutional anchor in various areas. We think that this adds another pillar to cement past improvements in Croatia's fiscal framework, as the alignment with EU standards has over time strengthened oversight of municipal finances and supported for example a reduction in quasi-debt practices. Coupled with a strong push for EU-funded investments and the requirements attached, this will strengthen transparency and accountability standards for local governments. We have thus improved our institutional framework assessment for Croatian municipalities.

We now characterize the institutional framework as evolving and unbalanced. Despite improvements in transparency and accountability over time, frequent changes, such as the tax reform introduced in 2024, hamper predictability for local governments. At the same time, past reforms have brought progress on fiscal decentralization. Revenue and expenditure balance is solid on aggregate, but disparities between financially strong and weaker municipalities remain substantial. We think the system is set to evolve further as the government plans reforms to: implement property tax; merge local and regional governments (LRGs) to achieve savings; build administrative capacities for more efficient use of EU funds and to better train personnel; improve municipal asset management; increase access to digital infrastructure and services. We think that LRGs' ability to withstand unwanted changes is limited as they have no legislative responsibilities. Most decisions on the financial framework and its parameters are taken by the central government, which was demonstrated by the recent tax reform. Tough limits on direct debt have led to a low debt burden overall. However, loopholes exist that could, in an adverse scenario, lead to rapid debt accumulation outside the central government's immediate control. We understand that debt limitations exclude debt for projects co-financed by the EU or for projects in the field of energy. Oversight of GREs also remains as a key weakness.

Zagreb is Croatia's capital and dominant economic center. The city contributes over one-third of Croatia's GDP, and its economic structure is more diversified compared with the national economy, where tourism is dominant. Zagreb has a stronger socioeconomic profile than the national average, with GDP per capita exceeding the national average by about 75%. Over the past decade, Zagreb's population decreased at a much lower rate than Croatia's, reflecting the attractiveness of the city's labor market. We expect a broadly stable population trend going forward.

The resilience of Croatia's economy despite a subdued economic environment in Europe underpins our projection of sound tax revenue growth for Zagreb. We project the city's economy will continue to expand in tandem with the robust growth that we project for Croatia. Our projections for Croatia factor in growth of 2%-3% over 2024-2027. This reflects continued dynamism of the tourism sector and benefits from the 2023 eurozone accession, as well as substantial EU-funded investments. Croatia is among the top EU countries in terms of the share of funds already disbursed from the Recovery and Resilience Facility (RRF). Zagreb is set to ramp up its investment activities by utilizing RRF and other EU funds, which will have a positive long-term economic impact.

Strong economic activity is likely to result in robust overall tax revenue growth that would compensate for potential shortfalls resulting from the recent tax reform, effective since January 2024. Among several changes, such as an increase in the basic allowance, a key element of the reform concerned local governments, with the stated goal of increasing their fiscal autonomy: The surtax to the personal income tax (PIT), which cities previously collected, has been abolished. Instead, each city can determine its own PIT rate within certain ranges. The upper thresholds for the ranges are based on the city size, with Zagreb allowed to set the highest rate. Cities can also opt to reduce rates. Zagreb has opted to set the new PIT rate at the maximum level to mitigate potential revenue losses.

While the reform increases local governments' revenue autonomy, it also highlights our view that some elements of the tax-sharing and institutional framework for Croatian municipalities remain prone to frequent changes. Despite the progress in fiscal decentralization, many important parameters remain under central government authority and can be volatile, which hampers predictability for the local government sector. The policy environment could become contentious between government tiers as elections draw closer--national elections in 2024 and municipal in 2025--but we don't think improvements in fiscal settings will be reversed. That said, the central government has provided support to address the pandemic and energy crisis and is supporting earthquake reconstruction in Zagreb. Another important source of financial support for the latter has been the EU, through the European Solidarity Fund.

The city's administration under Mayor Tomislav Tomasevic, in office since 2021, has made significant strides to improve the city's financial management practices, for example transparency of the budgetary process. Liquidity levels and liquidity management have substantially improved and the management of key municipal enterprises has changed, with the aim of improving oversight and reducing risk. Fiscal prudence remains a goal, but this might be tested, given significant cost and salary increases, and substantial investment needs. We note positively the successful efforts to settle liabilities between city companies and the intention to end past quasi-debt practices, but the track record is relatively short and it remains to be seen if improvements are sustained through political cycles. Given the dependence on decisions made at the national level for Zagreb's finances, good relations with the central government remain crucial for the city, especially if party affiliations of the administration are different.

Sizable investment spending drives debt increase, albeit coupled with favorable funding access

We project Zagreb's operating performance will remain strong over 2024-2026, with an average operating surplus of about 14% of operating revenues. At the same time, we project sizable investment spending plans will lead to deficits after capital accounts from next year. We understand that the investment spending is tied to EU-funded projects and corresponding favorable financing from European promotional banks. We anticipate that deficits after capital accounts are set to recede again after a peak in the coming two to three years.

In 2023, Zagreb posted an exceptionally strong budgetary performance with a large surplus after capital accounts. This extraordinarily strong result stems from robust tax revenue growth at about 20%, but also other inflows such as from the European Solidarity Fund for Zagreb's earthquake reconstruction. The city had access to the EU Solidarity Fund until midyear 2023 to alleviate the cost of rebuilding infrastructure after two earthquakes in March 2020 and withdrew about €200 million by that deadline. The unfinished remaining work will be financed by the central government and some eligible parts by RRF funds. While we expect strong tax revenue growth, we anticipate that operating expenditures will also rise due to higher material costs, personnel expenditure, and subsidies for items such as public transport, leading to a slight moderation of operating surpluses through 2026.

Zagreb's budgetary flexibility is limited because large parts of the revenue structure depend on the central government's decisions. The legislative framework also limits the city's borrowing capacity, curbing flexibility on financing investments. Under the reformed income tax system as of 2024, the city has set the highest rates permissible under the new system to protect its revenues, with no flexibility to adjust the rate upwards. Therefore, further flexibility remains limited to certain municipal fees and taxes, which account for less than 20% of the city's income. Expenditure flexibility is also constrained by subsidies granted to municipal companies ZGH and ZET, both of which supply essential public services. ZGH is responsible for gas distribution and supply; water supply and sewerage; road maintenance; waste disposal; and real estate projects.

Asset sales have been difficult to achieve in recent years, although revenues from a transaction in 2023 were used to settle liabilities with the central government. That said, we do not think asset sales will provide additional room to maneuver in the near term.

Zagreb's sizable investment agenda--for example in public buildings, public transport, and digital and revitalization projects--will lead to an increase of tax-supported debt to 86% of operating revenues in 2026 from 81% in 2024. We include the debt of ZGH and ZET in our tax-supported debt ratio, which includes the debt of various municipal companies and nontraditional debt, like factoring. We consider the city's debt burden high compared with its Central and Eastern European peers. We understand that the city intends to limit most of its debt intake to loans for EU-funded projects and the lion's share will be borrowed from European promotional banks. We note positively that Zagreb has reduced its payables and substantially increased cash holdings compared with previous years. We understand that the city intends to end past off-budget financing practices and support ZGH's deleveraging.

Direct debt is less than a quarter of the city's tax-supported debt, given the past use of nontraditional means like factoring and substantial borrowing by municipal companies. Direct debt consists of loans from domestic banks for investment projects and small amounts of short-term debt, but we think that direct debt will increase as the city is preparing to borrow from European promotional banks to finance its investment agenda. Following the adoption of the euro, foreign exchange risk has diminished since all debt is in euros.

We regard the city's contingent liabilities as low overall, given that the debt of ZGH and ZET is already included in the tax-supported debt calculation. These consist of spending on earthquake-related repairs to private buildings with low yearly drawings, liabilities of other GREs apart from ZGH and ZET, and some litigation risks. By law, Zagreb needs to cover 20% of the costs of rebuilding the more heavily damaged private buildings. The costs are hard to estimate, but effective drawings on Zagreb's finances were well below budgeted funds so far, which we believe is likely to continue, effectively limiting the city's contingent liabilities relating to earthquake-related damage. In our view, the city might support ZGH and ZET by taking on additional payables from the companies or by injecting capital.

In our view, Zagreb's liquidity situation has improved compared with previous years. Cash on hand increased to €105 million on average in December 2023 from €19 million the year before, substantially raising the coverage of the next 12 months' debt service and financing needs. We think cash balances might slightly fall from next year, depending on the timing of loan drawings and investment project implementation, but will stay at over €100 million in 2025-2026. The city reduced payables outstanding in 2023 to a negligible amount, which helped further ease stress on liquidity. We view Zagreb's access to external liquidity as satisfactory because the city has access to a pool of international banks willing to provide loans. We anticipate that eurozone accession will further improve Zagreb's capital market access.

Key Statistics

Table 1

Zagreb (City of) selected indicators

	2021	2022	2023	2024bc	2025bc	2026bc
Operating revenues	1,019	1,198	1,329	1,368	1,399	1,427
Operating expenditures	938	1,020	1,104	1,162	1,215	1,258
Operating balance	81	178	225	206	183	169
Operating balance (% of operating revenues)	8.0	14.8	16.9	15.1	13.1	11.8
Capital revenues	41	8	187	183	145	58
Capital expenditures	205	158	197	367	436	281
Balance after capital accounts	(82)	28	215	22	(108)	(55)
Balance after capital accounts (% of total revenues)	(7.7)	2.3	14.2	1.4	(7.0)	(3.7)
Debt repaid	110	220	170	68	122	82
Gross borrowings	185	130	83	157	180	137
Balance after borrowings	(6)	(62)	128	112	(50)	1
Direct debt (outstanding at year-end)	411	323	235	324	382	437
Direct debt (% of operating revenues)	40.3	27.0	17.7	23.7	27.3	30.6

Table 1

Zagreb (City of) selected indicators (cont.)

	2021	2022	2023	2024bc	2025bc	2026bc
Tax-supported debt (outstanding at year-end)	1,364	1,285	1,299	1,424	1,502	1,591
Tax-supported debt (% of consolidated operating revenues)	103.3	82.7	76.0	80.8	83.2	86.2
Interest (% of operating revenues)	0.6	0.5	0.4	0.6	0.6	0.6
Local GDP per capita (single units)	22,783	26,180	28,271	29,642	31,200	32,477
National GDP per capita (single units)	15,070	17,634	19,127	20,056	20,947	21,642

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

Zagreb (City of) ratings score snapshot

Key rating factors	
Institutional framework	4
Economy	3
Financial management	4
Budgetary perfomance	3
Liquidity	3
Debt burden	3
Stand-alone credit profile	bbb-
Issuer credit rating	BBB-

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Croatia, March 18, 2024

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Subnational Debt 2024: Focus on debt sustainability, Feb. 29, 2024
- Subnational Debt 2024: Chinese Governments Reach Their Limits; Other Emerging Markets Taper Borrowing, Feb. 29, 2024
- Global Ratings List: International Public Finance Entities, Jan. 18, 2024
- Sovereign Risk Indicators, Dec. 11, 2023. Interactive version available at http://www.spratings.com/sri
- Local And Regional Governments' Workarounds Are Running Out Of Time, Dec. 06, 2023
- Comparative Statistics: Local And Regional Government Risk Indicators: European LRG Indicators Remain Solid Amid Economic Slowdown, Sept. 20, 2023

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Upgraded

	To	From
Zagreb (City of)		
Issuer Credit Rating	BBB-/Positive/--	BB+/Positive/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such