Local Government
and Public Service
Reform Initiative

Local Government Borrowing: Risks and Rewards

A Report on Central and Eastern Europe

Edited by

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Contents

List of Tables and Figures

TABLES

CHAPTER 1

CHAPTER 2

CHAPTER 3

CHAPTER 4

CHAPTER 5

CHAPTER 6

FIGURES

CHAPTER 1

CHAPTER 2

CHAPTER 3

CHAPTER 9

Foreword

This book was prepared under the "Local Government Policy Partnership" Program, the joint project of two donor organizations. The British Government's Department for International Development (DFID) and the Open Society Institute, Budapest's Local Government and Public Service Initiative (LGI), launched this regional program in the year 2000. The "Local Government Policy Partnership" (LGPP) projects intend to contribute to policy development and innovation within the countries of Central and Southern Europe (http://lgi.osi.hu/lgpp/).

The LGPP hopes to develop expertise and support professional cooperation amongst local government specialists throughout the region. The experiences of the countries participating in this program should be made available in other regions, such as the countries of Central Asia. The core partner countries are the Czech Republic, Hungary, Poland and Slovakia. However, other countries have been invited to participate in the LGPP regional projects, in order to help facilitate direct information exchange and comparison of policy efforts.

LGPP publications include policy studies and proposals that have been presented to government officials and experts in the countries involved. Targeted beneficiaries of LGPP projects are national government ministries, local government associations, research and training institutions, and individual local authorities. LGPP intends to publish three studies a year.

In the first two years of the LGPP project, various policy areas were selected for analysis: education financing and management; regulation and competition of local utility services; public perception of local governments; the relationship between local government size, local democracy and local services delivery; local government and housing; capital investment financing. These policy studies were widely disseminated in the region. They supported policy dialogue (e.g., on education reform in Macedonia) and served as training materials (e.g., for regulatory experts).

Topics for the third and last year of LGPP in 2002–2003 were as follows:

a) the role of local governments in local economic development
b) local government borrowing and
c) regulation on conflict of interest in local governments.

In this volume LGPP project teams have analyzed recent trends in local government borrowing in the Czech Republic, Estonia, Hungary, Poland, Romania, Russia and Slovakia. They give an overview of the present status of lending to municipalities after various technical assistance programs have attempted to develop a local credit market in this region. The seven country papers and the summary reports focus on the fiscal and legal conditions, control and supervision of municipal borrowing. Lending to local governments will be particularly important in the new European Union member countries, for gaining access to EU funding. The policy recommendations formulated in this volume will assist them and other countries with emerging local credit markets.

Ken Davey *Gábor Péteri*

November 2003

PART I.

The Theory of Local Borrowing and the West-European Experience

Introduction

Pawel Swianiewicz

Table of Contents

The Theory of Local Borrowing and the West-European Experience

Paweł Swianiewicz

1. WHY BORROW?

Should local governments borrow, and should local politicians support the practice? Definite answers to these questions are not to be found in the theory and practice of European countries. What is clear, however, is the need to distinguish between borrowing for capital investment or for the financing of operations. The "golden rule" of the balanced budget prescribes that local authorities should never take on debt to cover current costs, but it allows—in some formulations even promotes—prudent borrowing for capital purposes. Before turning to the practical experiences of various countries with borrowing, we will briefly consider some possible consequences of contracting loans.

1.1 Why Borrowing to Finance Investments Makes Sense

Classic *fiscal federalism* theory suggests that in certain cases it is preferable to finance investment projects from borrowing rather than from current local revenues (see, for example, King, 1984). But why would this be? After all, borrowing results in additional costs related to bank charges, interest, etc. Surely it would be better to wait until the project could be financed from current revenues, thus avoiding the additional and unnecessary costs of borrowing. In response to this concern, the most important arguments for borrowing by local governments are as follows:

- *Equitable burden of cost and access to benefits* ("*inter-temporal equity*"). Borrowing over time is an effective way to overcome the problem of inequitable burden of costs among tax payers. Normally, the costs of an investment are incurred when the project is implemented (e.g., when a sewage treatment plant is constructed or a city bus is purchased), but the benefits from it are spread out over a longer period. When the capital project is financed from current revenues, those who financed it through their local taxes may not always benefit from it in the future if, for example, they move to another city. At the same time, those who benefit from the project may not have participated in financing it if they moved in to the city after it was completed, or if the project was completed either when they were small children or before they were born. But with financing through bank credit or the issuing of bonds, there is an assurance that most users will pay for the benefits either through local taxes or directly through user charges. Payments from current users are partially used to repay the loan. Some may argue that there is no problem in any case, since financing of local investments is a constant process and each year local tax payers are paying for some new investment project or another, while benefiting from those that were finished earlier. This might be convincing if the stream of capital spending were relatively constant throughout several subsequent years. But this assumption does not hold true, especially in relatively small units such as municipal-level local governments in which the volume of investments fluctuates considerably from year to year.

- *Optimal allocation of resources.* A close relationship between those who benefit from and those who pay for a project encourages optimal allocation of resources. Financing capital projects through borrowing usually makes this relationship much closer, for reasons made clear in the previous point. Though this argument may appear abstract, virtually any text on management or economics supports it.
- *Benefits from accelerated local development overshadow the cost of borrowing.* This can be illustrated by a simple example. Imagine that a certain city possesses a piece of land that may be very attractive to a potential investor, but there is no good access road to the plot. The city government could do one of the following: (i) finance the road construction from current revenues, allowing a few years to complete the project and then try to attract an investor a few years from now; (ii) try to find a potential investor now, agreeing that the price received for the plot has to be lower and understanding that some potential investors may withdraw from the tender; (iii) take a credit, complete the construction of the road as quickly as possible and negotiate the sale of the plot. The benefits of the third alternative (higher price or rent, wider scope of interested investors, quicker economic development resulting in multiple-effects by attracting new projects, providing additional jobs and tax revenues) may well be much greater than the costs resulting from interest payments to the bank.
- *Reduction of operational costs.* Consider another simple example: a local public transport company has ten old buses that require frequent repairs and consume a lot of fuel. The city can replace them using current revenues, but will only be able to purchase one new bus every two years. Alternatively, the city could contract a loan or issue bonds and replace more buses at once. The benefits

of borrowing are considerable, including the comfort of local citizens, lower consumption of fuel, higher reliability of local transport, savings in the cost of repairs and employment of service staff, etc. Such reductions in current expenditures may in fact be much larger than the costs related to borrowing.

- *Longer projects cost more.* Financing from current revenues usually delays the completion of the project for a longer period of time. This leads to higher constant costs and higher total volume of spent resources.
- *Stabilization of required budget resources.* As noted above, the volume of capital spending in local government units fluctuates from one year to another. If capital projects are financed from current revenues, the demand for resources changes over time as well. In countries where a large proportion of local revenues is raised through local taxes, an irrational fluctuation of local tax rates may result.
- *Access to grants from European and other development funds.* This rationale for borrowing is more specific to Central and Eastern European countries, where there are several investment grants available for local authorities. A necessary condition, however, is to provide own matching funds. Usually this is at least 25% of the total project costs (such as SAPARD or ISPA projects). Moreover, in many cases the local government is required to cover all costs related to the investment, and reimbursement occurs only after completion of the project. Borrowing may be a means of increasing local capacity to apply for these development grants.

But along with these clear benefits there are also potential hazards in borrowing, both of a microeconomic and a macroeconomic nature. The microeconomic danger lies in the potential for excessive indebtedness of some local governments, which may lead to serious difficulties in repayment of loans and may jeopardize the provision of vital public services. At the macroeconomic level, local governments contribute to the overall level of public debt. Local government indebtedness may thus have a negative effect on inflation and other important parameters of the national economy.

1.2 Why Local Governments Should Not Borrow to Cover Operating Expenses

There is common agreement that borrowing to cover current expenditures is acceptable only in very rare, specific cases—usually for very short periods, to cover deficits arising from uneven cash flows within a budgetary year. The most typical arguments for maintaining a balanced operating budget may be summarized as follows (for details see Dafflon, 2002a):

- Borrowing for operating spending would lead to an unmanageable debt burden. It would quickly lead to the rolling over of loans (financing payment of previous debt with new loans) and to very serious indebtedness problems reflecting a structurally imbalanced financial situation.
- Covering current costs from current revenues prevents the local public sector from growing beyond its optimal size, which may be defined here as the fiscal burden that voters/taxpayers agree to bear in order to finance the desired provision of public goods. Borrowing can create a short term fiscal illusion and cause the demand for public services to be artificially high, since it reflects the supply financed partially by credit or bonds rather than by local tax effort.
- An unbalanced current budget may result in negative macro- and microeconomic consequences, since private investments could be crowded out. This could happen for the following reasons:
  - Public sector borrowing draws on the pool of limited financial resources available from local banks, etc. Local government borrowers are more attractive to banks than private borrowers, because giving credit to public entities implies lower risk;
  - The competition for borrowing from the public sector exerts an upward pressure on the interest rate, making private investments more costly;
  - An increase in budget deficits negatively affects concerns about inflation, adding more to the upward trend in interest rates.

It is worthwhile to note that the contracting of loans by local governments to finance investments does not have such negative "crowding-out" consequences (assuming that the current account includes debt service), unless someone postulates that public investments are less productive then private ones.

Some theoretical discussions have suggested that the principle of the balanced current budget could be applied over a longer time frame (perhaps a few years) than the regular annual budget. This is not a common solution in practice, as we shall see later. But if we were to accept this more flexible, medium-term definition of what a balanced budget is, then it should probably coincide with a political term. The operating budget must then balance over a period of years that begin in one and end in the next term of the elected local authorities. In the public choice model of "electoral cycle," it is very likely that there would be a large deficit in the year or two prior to an election, when governments would try to increase the consumption of public goods in order to please the electorate. At the same time, of course, the government would try to avoid an increase in local taxes or user charges, so a considerable proportion of the consumption might be financed through borrowing (Tufte, 1978; Mouritzen, 1989). The resulting deficit would then need to be balanced by the newly elected authorities.

1.3 The "Golden Rule" of the Balanced Budget and Separation of Current and Capital Budgets

As Musgrave (1959) argued, to follow the "golden rule" that borrowing is allowed for capital projects but prohibited for current purposes requires a clear distinction between the current and capital budgets of local governments. In this situation a capital budget includes capital receipts (such as revenues from municipal property, various grants received for capital purposes and borrowed funds) which are spent on local investments, while the current budget includes current revenues used basically to cover operating expenditures. The surplus in the current budget can also be used to support capital needs—typically to repay loans contracted for investment projects.

This system increases the transparency of local financial management. It makes it easier to assess whether current revenues are sufficient to cover operating costs, or what the level of operating surplus is. This information supports the building of viable capital development programs and helps in assessing creditworthiness.

The separation of current and capital budgets is generally followed in Western Europe (with some exceptions) but is rarely the case in Central and Eastern Europe, as we will see in the following chapters.

2. ARE EXTERNAL REGULATIONS ON LOCAL BORROWING NECESSARY?

Is regulation of local government debt necessary? Some may argue that it is enough to rely on financial market discipline. In this situation, adopting legal rules is redundant since tighter credit market conditions—in particular, higher interest rates—already impose effective sanctions. This would indeed happen, if the total debt of local governments in the country were to grow too high. Also, banks would be unwilling or would demand higher interest from those municipalities that borrow more than they can effectively bear. The same would happen if local governments tried to issue bonds—the rating would be low and the market would refuse to buy bonds or would demand a very high interest premium.

Dafflon (2002a) suggests, however, that there are several assumptions behind these arguments that do not hold true in reality. They are:

- that lenders possess adequate information on the local governments whom they are financing;
- that local governments react appropriately to market signals, and act to avoid exclusion from the credit market;
- that lenders could assume they would receive a bailout by central government in case of local government default (note that although a local government bank-

ruptcy is technically possible in several countries, it is politically unacceptable and thus rarely observed in practice).

Given that these conditions are not always present, external regulations and control of local borrowing may play a positive role in supporting the development of the local credit market.

3. LOCAL BORROWING AND REGULATIONS IN WESTERN EUROPE

Before turning to recent experiences of local government borrowing in Central and Eastern Europe, we will examine the more long-standing practices in Western Europe. In the concluding chapter of the book we will compare relevant local policies and the shape of regulations and control over local borrowing in Western and Eastern Europe.

3.1 Borrowing for Current Expenditure

In most West European countries, long-term borrowing for operating expenditure is prohibited. This is the case, for example, in Austria, Denmark, France, Germany, Italy, Norway, Spain, Switzerland and the United Kingdom. Usually it is permissible to borrow funds for short-term (not longer than one budget year) cash liquidity purposes. However, these general rules are not always very strictly followed.

In **Norway**, if the local government presents an unbalanced current budget it will not receive approval from the state regional commissioner. But during the last few years, 18% of local governments on average have been running a deficit budget in practice. To some extent such deficits have been caused by creative accounting (e.g., when a municipality consciously overestimates its revenues in preparing the budget plan) and to some extent by unexpected changes in local revenues or expenditures. If a deficit occurs, Norwegian local governments are required to repay it within two years (Borge, Rattso 2002).

In **Denmark** there is no approval process for the budget plan, but there is a compulsory external audit (Jorgen, Pedersen, 2002). If a current deficit appears, it has to be paid down within the budget year. This is a very common regulation in several European countries including the UK, France, Spain, and in Switzerland where the canton may also impose a compulsory increase in the municipal tax rate if a deficit occurs and the municipality has done nothing to avoid it. In the Fribourg canton, for example, such an increase is automatic when the current deficit exceeds 3% of the budget (Dafflon, 2002b).

There are, or there used to be, some exceptions to the general rules formulated above. Borrowing for current purposes used to be allowed in Italy. In 1976 current revenues financed only 70% of current spending, and at the beginning of 1977 the local debt exceeded 11% of GDP, of which more than half was contracted to finance current deficits. Two-thirds of new loans were made to finance old ones! But since 1978 Italian local governments have been allowed to borrow for public works (infrastructure) only (Fraschini, 2002).

Spain is one of a few exceptions to the rule on the separation of current and capital local budgets (Monasterio-Escudero, Suarez-Pandiello, 2002). Consequently, it is difficult to control and monitor this situation, even though on principle borrowing is only allowed for investment purposes.

3.2 Regulations on Borrowing for Capital Projects

In general there are two modes of regulation found in European countries (Dafflon, 2002a):

1) based on borrowing controls, including individual borrowing limits and permissions;
2) based on control of the level of indebtedness and control of the current budget, which needs to include resources for servicing debt on capital projects.

Denmark provides a very peculiar example of the former mode of control. As a general rule borrowing is prohibited, regardless of the purpose for contracting a loan. But this rule is waived in some cases. Jorgen and Pedersen (2002) suggest that through this control, central government has the opportunity to influence the behavior of local governments, which otherwise are very autonomous. Danish municipalities can receive two kinds of permissions to borrow:

1) automatic permissions, which are granted for investments in public utilities and in "priority areas" defined in advance by the central government (e.g., energy conservation or shelters for the elderly);
2) discretionary permissions, for which the government announces an upper ceiling every year. The ceiling is negotiated annually with local government associations, together with negotiations on state grants or local tax rates. Local governments apply individually for borrowing permissions, which are granted if the overall ceiling has not been exceeded and if the municipality's debt does not exceed 30% of total gross outlays.

Theoretically, one might expect that the central government would want to lower the ceiling while local governments would want to raise it. But the reality is much more complicated. If the central government wants to avoid a local tax increase (Danish municipalities are free to set their own local income tax rates) it has to either allow for higher debt or increase central grants. On the other hand, the motivation of local governments is to obtain grants rather than to borrow. The interplay of these three factors (loan limit, amount of grants, local tax rates) makes the negotiations a very complicated exercise.

As a consequence, in spite of the general rule that both current and capital budgets should be balanced, during the 1990s between 40% and 80% of Danish local investments were financed through borrowing. In 1998 the local debt amounted to 4.5% of GDP, and most of this was the debt of public utility companies owned by municipalities or counties.

The **United Kingdom** also provides a model of an administrative ceiling for borrowing, but in this case each local government receives an individual borrowing limit (Watt 2002, *Councillors Guide*…, 1996). Borrowing limits also include leasing arrangements. As in Denmark, "sale and lease back" is forbidden. The borrowing limit consists of two parts: basic approvals and supplementary approval for specific projects. Basic approval is calculated in the following way:

Basic Credit Approval (BCA) = Annual Capital Guidance (ACG) – Receipts Taken Into Account (RTIA)

ACG is calculated separately for each main sector, but local government is free to reallocate it between sectors. For example, the BCA for housing is divided among ten regions of England on the basis of a complicated housing needs index. The government office in each region then allocates the limit among individual local governments on the basis of housing needs, and the allocation is increased or decreased according to the efficiency and effectiveness of the local government as judged by the regional office. In education, the allocation of limits is on a per capita basis, with an adjustment for special needs.

RTIA indicates which capital receipts of local governments can be used for capital spending (*Councillors Guide*…, 1996). Capital receipts mainly come from the sale of communal property, of which part is reserved by law for servicing existing debt, while part may be spent on new investments.

Total debt cannot exceed the Aggregate Credit Limit (ACL). Every year, each local government has to spend an amount equal to at least 2% of ACL to pay debt on housing and at least 4% of ACL to pay debt related to other sectors.

In **Germany** the basis for borrowing regulations is a four-year financial plan of the local government. Precise regulations vary from one Länder to another, but in general the municipality is required to demonstrate that borrowing will not lead to a current deficit resulting from planned repayments within the next four-year period. There is also a general regulation that borrowing is allowed only "after other sources of financing are exhausted." There was quite high local debt in Germany in the 1970s (7.2% of GDP in 1975), but it has decreased significantly in subsequent years and in 2000 it was only about 5% (*Local Finance in the Fifteen...*, 2002). But these statistics are to some extent misleading. The 1980s and 1990s saw the privatization of several municipal in-house service delivery units. The newly created companies are still owned by local governments, but their debt does not count against limits for local governments. (As we will see later in this book, similar rules can be observed in some countries of Central and Eastern Europe, such as Poland.) In Saarbrucken, for example, the formal debt of the city decreased from 658 million marks in 1990 to 632 million in 1994, but at the same time the debt of municipal companies increased from 0 to 237 million. Farber (2002) quotes similar data for Frankfurt.

In **Switzerland**, specific regulations are different in each of the 26 cantons. Dafflon (2002b) discusses the example of Fribourg canton, where every capital project that cannot be covered from the annual budget goes to a local referendum. Contracting a loan for an investment requires approval by the canton. As mentioned earlier, the canton may increase the local tax rate if there are problems with debt service. However, if the local tax rate reaches the maximum limit set in the law, then the canton may take responsibility for a local loan. In Fribourg canton, there were a few cases in which the canton actually repaid the municipal debt and then forced an amalgamation of the indebted commune with a larger, neighboring local government.

The regulation on borrowing in **France** is closer to the second mode of regulation, as there are no administrative approvals for borrowing but *ex ante* review of the debt service level. The central government almost entirely lifted all forms of *a priori* control by the state administration during the decentralization reform of the 1980s (Cacheux, Tourjansky, 1993). The law protects local governments from bankruptcy, so the risk for banks is low. The Prefect checks the legality of local borrowing every year, and if it is not in accordance with law, the case is passed to the Regional Audit Chamber (*Chambre Régionale des Comptes*). The current operating budget surplus has to be higher than the annual debt repayment. But not surprisingly, the budget forecast of current revenues and expenditures is not precise (either incidentally or purposefully) and in practice, it may happen that the current surplus is lower than the initial forecast. However, if the current deficit exceeds 5% or 10% (depending on the size of local government), the relevant *Chambre Régionale des Comptes* may propose appropriate fiscal measures.

In **Italy**, financing through borrowing is a relatively new phenomenon (Fraschini, 2002). Until 1985, local investments were almost entirely financed by the central government, and from 1986 to 1992, the role of central government was still dominant. This experience illustrates very well that financing at zero cost to the local community does not provide an incentive to make the best choices, and also leads to underestimating the operating expenses resulting from investment projects. During the 1980s, there were several cases of public works that were constructed and then never used. Currently, the burden of local investments is financed to a large extent by local borrowing (3.3% of GDP in 1999), and there is a limit that interest and capital payments in municipalities cannot exceed 25% of current revenues. Recently, an effort to reduce local debt is in evidence, and is seen as an attempt to fulfill Maastricht criteria and to enter the Eurozone. As part of this attempt, a special prize is awarded to those local authorities who have respected the Stability Pact and reduced their debt. They obtain a reduction of the interest rate on loans granted by the Deposit and Loans Fund, a main local lender in Italy.

In **Spain** also, borrowing is legally allowed for capital projects, although this rule is hampered by the lack of separation of the operating and capital budgets (Monasterio-Escudero, Suarez-Pandiello, 2002). Central government and the regions together decide the annual limits of deficit and debt for local governments. There are no individual limits for local governments (as is the case in the UK), although the concentration of debt in the biggest cities has opened a debate on whether individual targets may indeed be appropriate in those cities. Long-term borrowing requires the approval of the Ministry of Finance if total debt exceeds 110% of annual current revenues or if there was a negative balance in the current budget during the previous year. Approval of the Ministry of Finance is also required for bonds or debt in foreign currencies.

3.3 Indebtedness of Local Governments in Western Europe: Practical Experiences

Where do West European local governments go to borrow money? First of all, and unlike the North American (US or Canadian) model, contracting bank loans is much more important than issuing bonds, although the latter method has been increasingly popular during the last few years in Europe as well. This can be illustrated by the number of ratings of local governments presented in the recent publication of one of the leading rating agencies—Standards and Poors (*Local and Regional*…, 2002).[1] The publication includes a list of rated local governments below the regional tier. There are 28 in Canada alone, 51 in the whole of Western Europe, with the highest numbers in Italy—15, France—12 and Sweden—12, and 17 in the whole of Central and Eastern Europe, including 6 in Poland, 4 in the Czech Republic and 4 in Russia.

In 1997 in France, for example, banks lent over 70 billion French francs to local governments in the form of loans, while the amount of bonds issued was just about 5 billion French francs. Bonds are usually considered by French local governments to be more expensive and less flexible than bank credits. A similar situation exists in other countries, although it should be noted that issuing bonds has gradually become more "fashionable" during the last 15–20 years. In Italy, issuing bonds has been possible since 1990, and some big cities such as Rome, Naples and Turin as well as regions (Sicily) decided to use this path to finance their projects. However, bank loans also remain the main method in Italy.

If bank loans are the main source of credit, the next question is whether there are special institutions or special lines of financing for local governments (perhaps with subsidized interest rates). Or, do cities and regions simply go through normal borrowing procedures in commercial banks? The practice in this respect varies from one country to another. In Italy there is a special Deposit and Loans Fund aimed at financing local infrastructure projects. Until 1989 it was the only source of local borrowing; since 1989 there has been no obligation to use this Fund, but the interest rate is usually lower than in commercial banks. In England there is a Public Works Loan Board, which in 1991 financed 78% of total local debt. In some other countries local governments are basically free to go to any commercial bank. In France a special line of loans with sometimes negative real interest rates existed until 1984, but this was later closed and local governments must now go to commercial banks. This change resulted in a decline of local borrowing in France—in 1982 loans financed 55% of investment projects, but the share dropped to 28% in 1990 and about 30%–40% during the 1990s. The free choice of banks does not mean there are no institutions specializing in lending to local governments, and having a considerable share of the market. *Crédit Local de France* held almost 50% of local debt in 1991 (Cacehux, Tourjansky, 1993) and still held about 40% in 1998. It was followed by *Crédit Agricole* (Gilbert, Guengant, 2002). There has been a similar change in Norway, where local borrowing used to be regulated by central government banks, but the liberalization of the credit markets in the 1980s changed the situation (Oulasvirta 1993).

There is considerable evidence that in practice the biggest cities account for the large bulk of local indebtedness. Their capital needs are enormous, and at a time of fiscal austerity they are often the most severely hit (Sharpe, 1981). One of the most famous crises related to indebtedness occurred in New York in the mid-1970s and was soon followed by similar, although less spectacular, problems in other big cities in North America and Western Europe (Clark, Fergusson, 1983). As mentioned previously, in Spain most local debt has been contracted by large cities. Six cities having over half a million citizens are responsible for one-third of the total local debt. Together with cities having populations over two hundred thousand, their debt is well over half of all indebtedness of local governments. Similar concentrations of indebtedness occur in France (Le Cacheux, Tourjansky, 1993) and in Germany, where the most indebted local government is the city of Frankfurt with an outstanding debt of almost 10,000 deutch marks per capita in 1994 (Farber, 2002). It is also clearly seen in the British data presented in Table 1.1.

This aspect will be more closely analyzed in the following chapters, but a similar concentration of debt in large cities can be observed in Central and Eastern Europe as well.

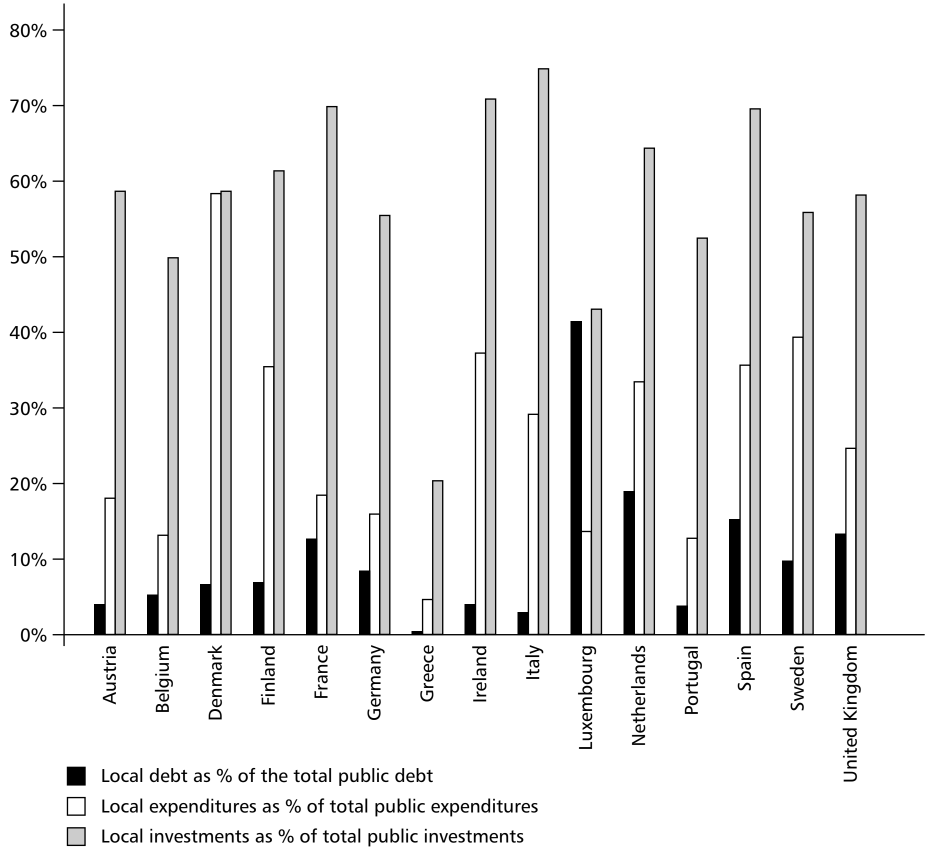
Table 1.1
The Size of Local Government Debt in West European Countries

	Local Debt as % of Annual Revenues (2000)	Debt Service as % of Annual Revenues	Debt Per Capita [USD]	% of Local Investments Financed by Borrowing
Austria	6	11 (1995)	1305 (1995)	
Belgium	9		1500 (1999)	56 (1999)
Denmark	2			73 (1998)
Finland	3	4 (1992)	410 (1992)	
France	8			31 (1997)
• Communes below 10,000 pop.			205 (1991)	
• Communes over 10,000 pop.			320 (1991)	
• Departments			100 (1991)	
• Regions			20 (1991)	
Germany	6			
• West Landers			1100 (2000)	
• East Landers			1255 (2000)	
Italy	6			
Netherlands	8			
Norway				39 (1998)
Spain	7	11 (1988)	485 (1988)	
Sweden	3			
United Kingdom				33 (1999/00)
• Counties			120 (1993)	
• Metropolitan districts			830 (1993)	
• Non-metropolitan districts			245 (1993)	

Source: Own calculations based on: "Local Authorities…" 1996, Dafflon, 2002a, "Local Finance..." 2002.

The recent regulations of the Maastricht stabilization pact related to the introduction of the "Euro zone" have brought a new element into discussions on local indebtedness. The Masstricht agreement limits both the overall level of public debt (which should not exceed 60% of GDP) as well as the annual total public budgets' deficit (limited to 3% of GDP). It raises the question of how much local governments contribute and to what extent they should contribute to "eating up" the overall limit of debt. In some countries there have been discussions about whether the debt limit should be distributed among tiers of government. This discussion was the most advanced in Germany, where it was proposed to give 1.93% (out of 3%) to federal and the rest to Länder and local governments (Farber, 2002), although this was not adopted in the end. In most other countries it is assumed that the overall level of public debt is a responsibility of central government which—directly or indirectly—controls the level of subnational debts. It should also be noted that the level of public debt is usually much higher at the central than the local level. For example, in Germany local debt constitutes just above 8% and in Switzerland 19% of the total public debt (Dafflon, 2002b). More precise data are presented in Figure 1.1. As can be seen, in all EU countries except Luxembourg the local share in public debt is much lower than the local share in public spending. Also, in

Figure 1.1
Public Debt, Spending and Investments—the Role of Local Governments (2000)

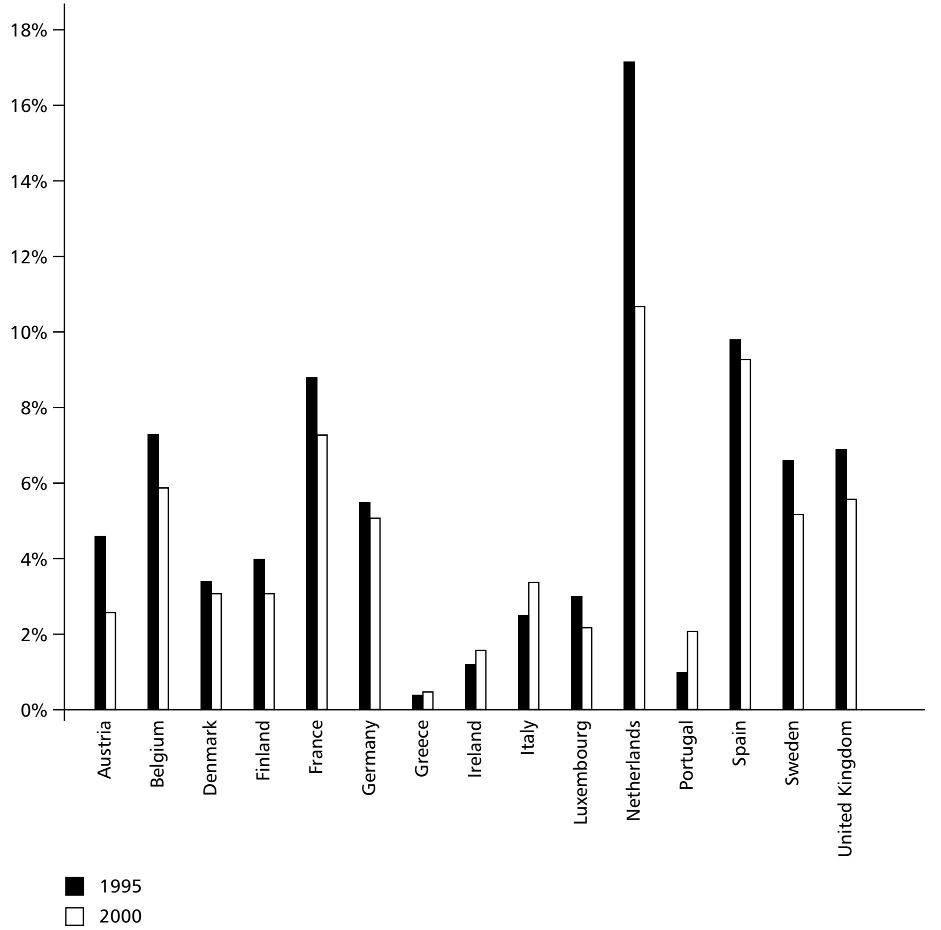


Source: Local Finance in the Fifteen..., 2002.

all 15 countries, local governments finance the bulk of public investments. In France, Ireland, Italy and Spain, the local share exceeds two-thirds.

As illustrated in Figure 1.2, in most EU countries the ratio of local debt to GDP is rather low—on average about 5%. The Netherlands and Spain with a local debt ratio over 8% are the only exceptions to this rule. It is noteworthy that in 11 out of 15 EU countries the local debt to GDP ratio decreased between 1995 and 2000 (*Local Finance in the Fifteen...*, 2002).

Figure 1.2
Local Government Debt as % of GDP



Source: Local Finance in the Fifteen..., 2002.

4. THE STRUCTURE OF THE BOOK

The decentralization reform introduced in most of the countries in the region provided a new role for local governments as public authorities that enjoy considerable discretion in policy-making, but are also responsible for several tasks of vital importance. Local governments provide several infrastructure services, which usually require very substantial capital improvements. At the same time, decentralization reforms created municipal property (as separate from state property), gave limited power of taxation to local governments, and allowed them to make independent decisions on financial policy. These changes in regulations related to local finance included the formal right to use credit instruments.

Considering these formal changes allowing for contracting loans or issuing bonds, together with the outstanding demand for huge infrastructure investments, one should not wonder that the development of local capital markets in Central and Eastern Europe has become one of the hottest issues of the last decade. The discussion has often been supported by foreign advisors working for USAID, other bilateral donors and—especially—World Bank projects. This has contributed significantly to the development of relevant legal regulations and of technical skills in the local administrations. But this does not mean that the process has been completed. Indeed, the data suggest that the situation is very dynamic in most countries in the region.

The following chapters analyze the borrowing regulations adopted by central governments and the practical experience of local governments in seven countries of Central and Eastern Europe:

- Czech Republic;
- Estonia;
- Hungary;
- Poland;
- Romania;
- Russia;
- Slovakia.

These seem to provide a good mix of cases and approaches. The analysis includes both big and small countries, from Russia with almost 150 million inhabitants and Poland with over 38 million, to Slovakia with over five million and Estonia with a population of just below 1.5 million.

With a slight risk of oversimplification we may say that these countries fall into two categories. In some, local governments have been using credit instruments very carefully, frequently not taking the opportunity to use all of the new tools available to them. In other countries, local governments have been very eager to borrow and many of them have fallen into the trap of excessive indebtedness. For various reasons, the issues related to regulations and to proper credit policies are very significant in both groups of countries.

Our sample includes countries with relatively precise restrictions on borrowing, as in the case of Poland, where credit cannot be contracted if it results in local indebtedness exceeding 60% of total annual revenues, or when the future debt service would be higher than 15% of total annual revenues. On the other hand, we have Slovakia or the Czech Republic in which local governments until recently have not been restricted in their borrowing.

Some of the countries analyzed have relatively well-developed local credit markets, by Central and East European standards. Hungary and Poland are probably good examples. In other cases, such as Romania, borrowing is relatively rare and what we can talk about is rather prospects for the future and recommendations for regulations to help in the development of a healthy market. Sometimes, especially in countries created from the former Soviet republics and in the Balkans, considerable arrears in local government payments may be found, rather than modern credit markets. For example in Bulgaria, Sofia remains the only local government without payment arrears (Ivanov *et al.,* 2002). In Ukraine, local government arrears peaked at 6.4% of GDP at the end of 1998, and were reduced to "only" 0.8% of GDP at the end of 2001.

The structure of each of the country reports presented in the book is organized in a similar way and presents answers to these key questions:

- What are the most important regulations on local borrowing? What are the legal limits on local indebtedness? Is it legal to borrow for current operations or it is limited to capital projects only?
- What has been the development of borrowing by local governments over the last decade?
- What is the current debt ratio and what is the structure of the debt (bonds, short-term credit, long-term bank loans, etc.)?
- Are there any banking or non-banking institutions specializing in lending to local governments? Do they offer loans with subsidized interest? Are they available for all or just some sectors of local investments?
- How have changes in the macroeconomic situation (e.g., the inflation rate) influenced the development of local borrowing?
- What has been the evolution of local government attitudes to borrowing?
- What is the local government attitude towards bank loans versus bonds? How many local governments have gone through a local and/or international agency rating process?
- What proportion of capital spending is financed through borrowing? How often is borrowing applied to operational spending?
- In which sectors is spending most often covered by borrowing?
- What is the internal variation in borrowing policies? For example, are there

differences between big cities and small local governments or between local governments of different tiers?
- What are the major barriers for more efficient functioning of the credit market?

When we examine the particular experiences of CEE countries, the scope of our analysis cannot be limited to borrowing regulations and practices as discussed in the theoretical sections of this chapter. We need to refer also to the wider concept of local indebtedness. Of course, debt is usually the result of borrowing money from banks or taking out bond issues. But in some of the CEE countries, a more frequent form of debt is related to arrears in payments such as unpaid invoices or staff wages. Arrears have an immediate and obvious impact on creditworthiness and the capacity to use credit instruments to develop capital programs. Most often it is a form of "hidden operating deficit;" i.e., the budget is formally balanced, but a part of the obligations is forwarded to the next generation or to the central government on the assumption that sooner or later it will provide additional support. It is important, then, for our empirical analysis to capture and not abstract from this peculiar but quite common form of local government debt.

In addition to fact-finding, the book attempts to reflect on how the theoretical arguments presented in the opening sections fit with Central and Eastern European reality. Are they valid? And if so, are they present in the consciousness of legislators and those who are responsible for the formulation and implementation of local policies?

Last but not least, each chapter provides conclusions and practical recommendations. The recommendations include both suggestions related to general regulations and the institutional framework for borrowing, as well as proposals for policies implemented at the local government level.

The country reports are followed by a concluding chapter which summarizes the various experiences and draws more general conclusions and recommendations.

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NOTE

1 A rating received from one of the major agencies is usually a precondition to major bond issuance.

The Regulation and Development of the Subsovereign Debt Market in Poland: 1993–2002

Agnieszka Kopańska
Tony Levitas

Table of Contents

The Regulation and Development of the Subsovereign Debt Market in Poland: 1993–2002

Agnieszka Kopańska and Tony Levitas

1. INTRODUCTION: THE SIGNIFICANCE OF LOCAL GOVERNMENT BORROWING IN POLAND

Since the mid-1990s, Polish local governments have increasingly used loans and bonds to finance their capital investments. By 2001, the total outstanding debt of the sector had risen to over USD 4.3 billion from virtually nothing in the early 1990s. This growth, while dominated by large cities, has included smaller towns and rural areas and, at least thus far, has been unaccompanied by significant cases of financial distress. Indeed, not only is the Polish municipal capital market among the most dynamic in the region, but it has clearly become a permanent and increasingly important component of the country's local government finance system.

Nonetheless, the market is still in its infancy. The total outstanding debt of local governments remains less than 16% of their annual revenues. More importantly, most local governments continue to finance the vast majority of their investments on a pay-as-you-go basis with debt being used to finance less than 20% of their capital expenditures. Moreover, approximately half this debt comes from subsidized credit lines for the improvement of environmental infrastructure and thus is not strictly market-based.

At the same time, the market is filled with all sorts of anomalies, some of which are potentially dangerous. For example, the Polish bond market has grown rapidly over the last six years. Most of the issues, however, have been for less than a million dollars and have been purchased in their entirety by the underwriting bank. Similarly, the maturities of most municipal credits rarely exceed five to seven years, and their interest rates are almost always variable. This is odd not only because inflation has fallen dramatically over the last few years—and stayed relatively low—but because the national government has begun to issue fixed-rate instruments with ten-year maturities that could and should serve as benchmarks for subsovereign lending.

Finally and most importantly, there are indications that over the last two years increasing numbers of local governments are using long-term debt to finance operating deficits.[1] Obviously, if this is the case it could lead to serious problems for the country in general and for the still immature municipal capital market in particular. In short, the development of local government borrowing in Poland has been both dynamic and promising, while at the same time fraught with all sorts of curious behaviors, regulatory weaknesses and potential dangers.

In the following, we attempt to explain both this dynamic growth and to analyze the outstanding structural weaknesses of the market. We will argue that the foundations of this growth lie above all in the essential soundness of the finances of Poland's primary and most important tier of local government, the *gminas* (municipalities). At the same time, we will argue that most if not all of the most important threats to the market lie in the relative weakness of the two new levels of government that Poland created in 1999, the recent weakening of municipal financial standing and the challenges posed by the absorption of EU funds.

2. STRUCTURE AND REGULATION OF POLISH LOCAL GOVERNMENTS

2.1 The Basic Structure of Subnational Governments

Poland now has a three-tier system of local government. The first tier was created in 1990 and consists of 2,489 *gminas* or communal governments with an average of about 16,000 inhabitants. The boundaries of municipalities were basically inherited from the old regime and Polish reformers permitted the creation of new jurisdictions only under exceptional circumstances. As a result, Poland has managed to avoid the kind of jurisdictional fragmentation that has complicated the decentralization process in other countries of Central and Eastern Europe, and the vast majority of local governments are of reasonable size.

Municipalities are the most important level of local government in terms of functions and expenditures. Over the course of the decade, their responsibilities have been progressively expanded and there have been considerable shifts in the services that they provide as "own" and "delegated" functions.[2]

Municipalities are now responsible for pre-school and primary education, water and waste-water services, solid waste services, local roads, public housing, land-use and urban planning, some social welfare functions, some cultural functions and preventative public health. Municipalities enjoy the presumptive right to involve themselves in the provision of any local public service not specifically assigned to other levels of government, and there are no hierarchical relations between Polish local governments. They can also establish special purpose associations to provide any of their service responsibilities in common.[3]

County or *powiat* governments constitute the second tier of local government. They took shape on an experimental basis during the mid-1990s and were made universal in 1999. There are 381 counties, of which 66 are cities that have been granted county rights and responsibilities in addition to those they have as municipalities. These include the 46 largest cities and 19 smaller towns that were granted county powers as compensation for their loss of status as provincial or regional capitals in 1999.

Counties are responsible for secondary education, local roads, a wide variety of inspection and permitting services, some land use planning, some cultural functions, local labor market policy, some social welfare functions, and the ownership and management, but not the financing, of primary health care institutions.

The creation of cities with county rights has separated substantial numbers of rural inhabitants from the infrastructure associated with county functions and created a number of problems with commuting—particularly for students in secondary education. Similarly, it has left a substantial number of rural counties with very low revenues from shared taxes, and with important infrastructure deficits, raising questions about their long term sustainability. Indeed, as we shall see, the fiscal weakness of counties may be creating problems for the operation of the subsovereign capital market.

With the establishment of counties in 1999, Poland also consolidated the number of regional (*województwo*) authorities from 49 to 16 while also extending self-government to this level of public administration. Self-governing regions, or *Sejmiks*, have been assigned select service responsibilities in secondary education, culture, roads and inspectorates. More importantly, they are responsible for regional development planning.[4] The *Sejmiks* share power at the regional level with nationally appointed governors (*wojewoda*) who, among other things, retain control over public safety functions and the disbursement of special purpose grants to subnational governments.

As can be seen from Table 2.1, municipalities are the most important level of local government and their expenditures account for almost 80% of all local government spending. Indeed, this share would be substantially higher if these figures included the expenditures of off-budget local government service providers.

As can be seen from Table 2.2 below, local governments are now responsible for more than 30% of all public expenditures and a remarkable 58% of all public investment spending. Moreover, while only 4% of national government expenditures are spent on investments, 13% of local government expenditures are devoted to capital improvements. Indeed, as we shall see later, municipalities have been devoting a remarkable 20% of their total revenues to capital improvements.

Table 2.1
Shares of Local Government Expenditure (2001)

	[PLN/m]	Share [%]
Municipalities	38,568	46.6
Cities with county rights (big cities)	25,137	30.4
Counties	14,293	17.3
Regions	4,737	5.7
Total	82,734	100.0

Source: Ministry of Finance Reports.

In short, decentralization in Poland over the last decade has been both fast and profound.[5] It has also been remarkably rational in the sense that basic public services have been assigned to levels of local government that are—in general—of sufficient size and fiscal capacity to comfortably carry out their assigned responsibilities.

Table 2.2
Consolidated Public Expenditures by Level of Government (2000)

Public Expenditure	All Levels [PLN/m]	National Government		Local Governments	
		[PLN/m]	Share [%]	[PLN/m]	Share [%]
Total	343,570	236,711	68.9	106,859	31.1
Current	320,091	226,921	70.9	93,170	29.1
Capital	23,479	9,790	41.7	13,689	58.3
Capital expenditures as % of total	6,8%	4,1%		12,8%	

Source: GUS Statistical Yearbook, 2001.

These figures include the expenditures of the off-budget units of both national and local governments, according to IMF methodology (general government sector). Hence the substantially higher total expenditure figures for local governments than those shown in Table 2.1.

This does not mean the system is perfect. Poland has a large number of relatively small *gminas* that do have trouble providing many services at acceptable standards. Similarly, there are probably too many counties, and the establishment of cities with county rights has placed many rural citizens in jurisdictions that lack the infrastructure necessary to perform county functions. This has created a variety of transportation problems and has led to some disputes between local governments about how the costs of certain services should be paid for. Nonetheless, and in comparison with many countries of the region, it seems fair to say that Poland has done reasonably well in assigning service responsibilities to the appropriate levels of government.

Equally importantly, and as the investment levels of local governments suggest, Poland has also done a reasonably good job in creating an intergovernmental finance system that actually provides local governments with the revenues they need to meet the tasks they have been assigned.

2.2 Local Government Revenues and the Intergovernmental Finance System

Local government revenues are regulated by the "Law on Local Government Revenues, 1999–2000." This law was adopted with the creation of regions and counties in 1999 and was initially conceived as a temporary measure. Since 1999 the government has attempted to replace it with new legislation on at least two occasions, so far without success. The law preserved the previous legislation's basic revenue categories for municipalities but extended most of them to counties and regions. Indeed, while there has been considerable adjustment of the shares and composition of the categories since the early 1990s, the basic structure of the law has remained relatively stable.

Local governments have four basic types of revenues: shared-taxes, conditional grants (dotacja), non-conditional fiscal transfers (*subwencja*) and own revenues. Own revenues include income from user fees and charges, from the sale or rental of municipal property, and from "own" taxes.

The category of user fees and charges consists of fees for classic urban services like water supply and treatment, public transport and solid waste collection and disposal, as well as stamp duties on official documents, fees for the sale of real estate, and fees for the exploitation of mineral rights. In many areas, however, the ability of local governments to set user fees and charges is constrained by the national government. For example, the rates for stamp duties, transaction fees and exploitation rights are set by the Ministry of Finance. As a result, local governments' ability to generate additional revenues by raising local fees and user charges is fairly limited.

Municipalities, unlike counties and regions, have the right to impose "own taxes"[6] on real estate, agricultural and forestry activities, small businesses (*an octroi*)[7] and dogs. With the exception of the tax on dogs, however, the Ministry of Finance determines both the base and maximum rates of these taxes. The most important own tax is the real estate tax. This is a flat, per square meter charge on land and buildings.[8] Meanwhile, agricultural and forestry taxes are based on the average price of expected per hectare yields of particular types of land. As a result, municipalities have no true own taxes of any significance and their capacity to generate additional revenues is based primarily on the sale or rental of municipal property.[9]

Table 2.3
Structure of Municipal Revenues [%] (1991–2001)

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total revenue		100	100	100	100	100	100	100	100	100	100	100
Own-revenues: of which[10]		45.5	47.3	46.5	40.3	40.1	35.0	35.3	33.5	37.1	36.6	37.5
Real estate tax		15.3	16.4	14.8	13.4	14.1	11.4	11.2	11.3	11.7	12.3	14.8
Transport tax		1.1	3.5	3.3	2.8	3.0	2.7	2.9	0.8	0.7	0.7	0.8
Agricultural tax		3.9	2.7	3.8	2.8	2.6	2.2	2.0	1.8	2.3	2.0	2.1
Stamp fees		4.6	5.3	5.0	4.0	3.7	3.4	3.3	3.4	4.3	3.8	1.1
Asset sales		NA	NA	NA	3.0	3.1	3.6	4.0	4.1	7.8	7.9	4.8
Shared taxes		28.9	22.2	25.4	23.1	23.1	24.5	24.3	24.7	17.7	15.9	14.6
of which	CIT	0.0	2.6	3.6	2.5	2.3	1.8	1.8	1.7	1.4	1.6	1.1
	PIT	0.0	19.6	21.8	20.6	20.7	22.7	22.4	23.0	16.3	14.3	13.5
Grants		12.0	18.8	16.7	21.6	20.6	13.9	14.1	14.3	11.6	13.7	11.7
of which	Delegated	10.8	16.3	13.1	18.4	13.7	7.3	7.5	7.4	7.1	7.2	7.0
	Own	1.2	2.5	3.6	3.2	4.2	4.8	4.8	5.0	2.9	4.4	2.8
General subsidy		13.5	11.7	11.4	14.9	15.2	25.3	24.1	25.4	33.6	33.8	36.2

Source: GUS Statistical Yearbooks.

Between 1991 and 1993 other income included income from asset sales and rentals. In 1991 and 1992 it also included surpluses from the previous year. Of other income, the most important categories are the small business tax, the forest tax and the mineral exploitation tax.

As can be seen from Table 2.3, the most important own revenues have consistently been the real-estate tax, followed by stamp taxes and asset sales.[11] Here, it is worth noting that the share of revenues coming from asset sales has increased over time, indicating just how much property was assigned to *gminas*. Municipalities now derive about a third of their income from "own" revenues, down from 45% at the beginning of the decade.

All local governments receive revenues from shared personal income taxes (PIT), and municipalities and regions are also entitled to shares of corporate income taxes (CIT). Between 1992 and 1998 shared taxes consistently represented 23% to 25% of all municipal revenues. Currently, municipalities receive 27.6% of the PIT taxes paid by residents of their jurisdictions, and 5% of the CIT taxes paid by firms doing business in their jurisdictions.[12]

The Law on Local Government Revenues also guarantees all local governments a block grant, known as the general subsidy (*subwencja ogolna*). The composition of the general subsidy has evolved over the course of the decade and now includes three basic components for all levels of local government: an equalization component, a component for roads and, most importantly, an education component. For municipalities, the equalization component of the subsidy is provided to local governments whose per capita revenues are at least 15% below the national average. These local governments receive 90% of the difference between their per capita revenues and 85% of the national average.[13] The operation of the Polish equalization system has helped ensure that even fiscally weak jurisdictions have the financial means to meet their basic service responsibilities. It has also helped rural jurisdictions make use of debt finance and to extend investment borrowing well beyond the larger cities.

In this context, it is also important to understand how the education component of the general subsidy works. This component is the largest element of the general subsidy and for both rural *gminas* and counties often represents their single most important source of revenue. The funds available for the component are set by the Law on Local Government Revenues and must equal 12.8% of state budget revenues.[14] These funds are allocated to local governments on the basis of a formula determined by the Ministry of Education, and approved by the Ministry of Finance.

In 1999, the government substantially increased teachers' pay without accordingly increasing the sum of funds to be allocated to local governments through the education subvention. This produced an immediate crisis in local government finances that resulted in a partial correction of the subvention by the national government. Nonetheless, the costs of the wage hikes lowered the disposable resources of local governments and probably constituted the single most important reason for the decline in municipal investment spending after 1999.

Finally, the Law on Local Government Revenues states that local governments can receive earmarked grants for the execution of their own functions and for functions delegated or commissioned to them by the national government. Earmarked grants now account for a relatively modest 14% of municipal revenues, a fair share of which go for investments. As a result, municipalities can be said to have very significant expenditure authority since more than 85% of their total revenues are freely disposable.

Until 1999, allocation of these earmarked grants was not subject to objective criteria. Instead, decisions were made by state-appointed governors on a discretionary basis. Their decisions, however, were subject to review by the Regional Parliaments (*Sejmik Samorządowy*).[15] Despite the absence of objective criteria for the allocation of these funds, a significant share flowed to rural *gminas* with weak fiscal capacities.[16] This helped at least some rural jurisdictions to use debt to finance investments without getting into financial trouble.

Despite the limited tax powers of municipalities, and the constant shifts in the way all forms of state transfers have been calculated (shared taxes, earmarked grants and the general subsidy), municipal revenues have been remarkably stable and robust. Indeed, municipalities have been able to devote more than 20% of their income to investments, as can be seen from Table 2.4. In fact, the equalization system (and the nature of the education subvention) has made this true for all types of municipalities. Nonetheless, it is important to note that investment spending has fallen in both real and nominal terms since 1999, mostly because of the problems with the education subvention described above.

Table 2.4

Municipal Investments as a Share of Revenues and GDP [PLN/m] (1994–2001)

	1994	1995	1996	1997	1998	1999	2000	2001
Total Municipal Revenues	14,808	1999	30,956	39,518	46,119	51,742	56,350	60,954
Investment Expenditures	3,364	4,657	7,056	9,681	10,937	10,637	11,176	11,210
Investment Expenditures as % of revenues	22.7	23.3	22.8	24.5	23.7	20.2	19.8	18.4
Municipal investment as % of GDP	1.6	1.5	1.8	2.1	2.0	1.7	1.6	1.5

Source: Ministry of Finance.

This high rate of investment suggests that the intergovernmental finance system has generally provided municipalities with revenues adequate to meet their responsibilities. After all, no other economic actor on the Polish scene—meaning households, firms and the central government—has had similar levels of freely disposable income. This is not to say that the intergovernmental finance system has been perfectly aligned or stable. It is to say, however, that the system has been sufficiently predictable and robust to make the prudent use of debt finance possible for both urban and rural jurisdictions. Indeed, there is little question that the general stability and robustness of municipal revenues in Poland is exceptional for the region.

Unfortunately, however, the picture with respect to the revenue adequacy and expenditure authority of Poland's counties and regions is less clear, particularly for counties. As can be seen from Table 2.5, neither level of government has significant own revenues, and for both, close to 50% of income is derived from earmarked grants. Moreover, and particularly for counties, the percentage of revenue derived from shared taxes—income that (all things being equal) can be expected to grow with the economy—is small.

Table 2.5
Revenues of Counties and Regions in 2001

	County		Region	
	[PLN/m]	Share [%]	[PLN/m]	Share [%]
1. Own revenues	1,029.9	7.3	84.2	1.8
1.1 Income from assets	162.8	1.2	28.3	0.6
2. Shared taxes	181.2	1.3	558.6	11.6
2.1 PIT	181.2	1.3	69.0	1.5
2.2 CIT	—	—	462.6	10.1
3. Earmarked grants	6,459.5	45.1	2,401.5	52.2
3.1 For own tasks	2,249.1	16.0	1,074.7	23.4
3.2 For delegated tasks	3,932.7	28.0	1,082.6	23.5
4. General subsidy	6,503.9	46.3	1,582.2	34.4
Total	14,041.1	100.0	4,599.5	100.0

Source: Ministry of Finance Report.

Thus, the revenue base of both these new levels of government is considerably weaker than that of municipalities. Only 6.5% of counties' expenditures went to investments, raising serious questions about the adequacy of their revenues. The situation for regions on this score is better, and a robust 30% of their expenditures went to investments in 1999.

2.3 The Regulation of Local Government Budgeting, Borrowing, Financial Reporting and Accounting

Alongside the Law on Local Government of 1990 and the Law on Local Government Revenues of 1998, the financial management of municipalities, counties and regions are regulated by a number of other pieces of legislation. The most important of these are the Public Finance Law, the Law on Regional Accounting Offices and the Ministry of Finance's Ordinance on the Classification of Budgetary Revenue and Expenditures.

In the following, we discuss the most important aspects of these laws and the regulatory system they create.

2.3.1 The Regulation of Local Government Budgeting and Borrowing

In Poland, a single legislative act—the Law on Public Finance of 1998[17]—governs the constitution, execution and control of both the national budget and the budgets of local governments. The law defines both the state budget and local budgets as annual, unitary (*jednolity*) constructs (Misiąg, 1996). The principle of unitary budgets means that all revenues must flow into the general budget, and that no revenues may be segregated for specific purposes.[18] Among other things, this makes it impossible for local governments to formally separate their operating revenues and expenditures from their capital revenues and expenditures, or to dedicate specific revenue streams to particular expenditure items.[19]

Similarly, the principle of annual budgets means that budgets are conceived of as one-year financial plans, and that all appropriations lapse at the end of the year. As a result, multi-year financial obligations are subject to political risk and it is unclear whether it is legally possible to create so-called sinking funds dedicated to the repayment of future debt liabilities (Spofford, 1997). To reduce these risks, and to encourage long-term financial planning at the local level, the law contains provisions that allow but do not require local governments to include in their budgets appendices that define multi-year investment plans.

It remains unclear, however, whether these appendices really make possible legally binding, multi-year appropriations because the appendices can be changed by a normal budget resolution (Article 110, Law on Public Finance, Spofford, 1997). Moreover, while many municipalities have indeed begun to attach such appendices to their budgets, the treatment of them remains rather formalistic.

The Law states that the total expenditures contained in a budget define the maximum expenditures a government can incur in given year. The Law also requires that expenditures be broken down into operating expenditures, capital expenditures and debt service payments (Article 28, Law on Public Finance). As a result, it is relatively easy for local governments to say how much they spend on investments from their general budgets every year. Nonetheless, being able to determine annual investment expenditure is not the same thing as having clearly separated operating and capital budgets. In fact, the way the law defines budget deficits, having both a surplus and revenues from asset sales impedes a clear determination of how investments and operating expenditures are in fact being funded.

First, the law states that planned expenditures can exceed planned revenues, but that the budget resolution must indicate how the resulting "deficit" is to be funded

(Article 112, Spofford, 1997; Oles, 1997). It also states that deficits can be funded by surpluses carried over from the previous year, by revenues from asset sales or by debt. This means that debt is authorized—by council resolution—to fund a "deficit," and is not specifically linked to investment purposes. Second, surpluses carried over from previous years are considered below-the-line income (*przychody*) and not general revenues (*dochody*). Indeed, they can only be used to finance a "deficit" or to make debt service payments.

Taken together, the definition of debt as an instrument to finance a deficit, and the definition of a surplus as income that can be used only to fund deficits or make debt service payments, make it difficult in practice to determine whether long term borrowing and/or surpluses from previous years are being used to finance capital investments or short-falls in operating revenue. In practice this means that it is difficult to determine whether local governments are using long term debt to finance operating deficits or investments.

The Law on Public Finance (1998) imposes three different types of restrictions on local government borrowing. The first limits the flow and stock of local government debt by prohibiting annual debt service and financial guarantees from exceeding 15% of annual revenues, and total outstanding debt from exceeding 60% of annual revenues.[20] So far only a few local governments have exceeded these limits, as we will discuss in the next section. More generally, there have been no cases of outright default by municipalities and little evidence that borrowing has led to any financial distress.

The second restriction limits the right of local governments to borrow in foreign currencies by stating that the full value of a debt must be stated in zlotys at the moment that the debt is incurred.[21] Originally, this provision put a freeze on all hard currency borrowing from local governments. Eventually, however, the Ministry of Finance issued an ordinance that specified how loans in other currencies could be incurred if they originated from multilateral financial institutions or received an investment grade rating by an international rating agency.[22]

Finally, the Law on Public Finance ties the borrowing rights of local governments to the borrowing practices of the national government once the consolidated public debt exceeds 50% of the GDP.[23] If this threshold is crossed, no local government can incur new debt greater than the percentage of the national government's planned annual deficit to its planned annual revenues.

If, for instance, the consolidated public debt (plus guarantees) stood at 50% of the GDP and the national government decided to limit its borrowing to 5% of its revenues, then no local government could borrow more than 5% of its revenues during the same year. By the same logic, if the national government simply decided to suspend all borrowing that year, then no local government could borrow at all. Moreover, if the consolidated public debt were to exceed 60% of the GDP then both local governments and the national government would be prohibited from incurring new debt.

Because national government borrowing accounts for more than 98% of the consolidated public debt today, and because this debt is not far from the 50% threshold,[24] these procedures essentially hold local governments hostage to the borrowing practices of the national government. Moreover, they place local government borrowing for investment purposes in de facto competition with national government borrowing for current operating expenses and social entitlements.

Not only does this seem unwise, but it also introduces all sorts of uncertainties and moral hazards into the subsovereign debt market for creditors and local governments.[25] Indeed, these uncertainties could be affecting the market now because for the first time the Ministry of Finance expects the consolidated public debt to exceed 50% in of the GDP. According to the Budget Law of 2003, the consolidated public debt (including guarantees) will exceed 50% of the GDP and is expected to be 52.5% in 2003, from 52.7% to 54.2% in 2004, and from 52.2% to 54% in 2005.

These uncertainties could dampen the growth of the market as a whole and discourage local governments from developing sound, long-term planning practices. Obviously, this should be monitored closely. Following Maastricht, however, the law explicitly exempts debt incurred by commercialized municipal utilities from the statutory debt limits described above, and from all calculations of the consolidated public debt.

The Law contains no regulations governing workout or bankruptcy procedures in the case of the non-payment of debt by local government. There are also no rules for what kind of assets local governments can or cannot use as collateral for loans and bonds, and indeed no definition of what constitutes an essential public service. As a result, the fact that a loan may be fully or partially collateralized has no bearing on the calculation of any of the debt limits.

There are also no prudential regulations concerning the types of investment local governments can make. This is important because recent American experience shows that local governments are as likely to get into financial trouble through imprudent investments as they are through imprudent borrowing.[26] Finally, local governments are required to submit to the Ministry of Finance and the Regional Accounting Offices quarterly statements concerning their borrowing, cash holdings and any guarantees they may have issued to third parties.[27]

2.3.2 Financial Transparency, Financial Reporting and Accounting

The Law on Public Finance states that finances of all public entities must be open and transparent. It does not require local governments to hold public budget hearings or to have their accounts independently audited.[28] It does, however, require them to present their budgets in accordance with a general classification system for the public sector and to use this system in making financial reports. The classification system is set by an

Ordinance of the Ministry of Finance in agreement with the Main Statistical Office.[29] All local government entities must also file periodic financial reports to the Ministry of Finance, the Main Statistical Office and the 16 Regional Accounting Offices that were established to insure that local government budgeting and financial management is in compliance with the law.

The Regional Accounting Offices (RIOs) were established in 1993 and are governed by the Law on Regional Accounting Offices. Each RIO is an independent government agency responsible to the Council of Ministers, and while a presidium composed of RIO presidents and other members was created in 1997, it does not have the power to ensure that all RIOs follow the same standards. Indeed, there has been considerable variation in the practices and quality of different RIOs since their inception.

The RIOs are responsible for reviewing the legality of local government budget resolutions and for monitoring the propriety and timeliness of their accounting practices and financial reporting. They are also required to issue an opinion on all long-term debt resolutions adopted by local governments, except for those credits coming from the bank that holds their main account. In theory, judgment on this issue should be limited to whether the budget resolution to incur the debt was carried out in accordance with the law, and whether the debt will push a local government over one or another statutory limit. In practice, however, some RIOs have used this authority to question the purpose of a borrowing or its terms, though in recent years this kind of intervention seems to be on the decline.[30]

Alongside the RIOs, a private, indigenous rating agency, CERA,[31] was established with the help of USAID support in the mid-1990s and then subsequently bought by Fitch Ratings. Fitch Ratings monitors the creditworthiness of banks and other major institutional lenders and borrowers, including local governments, and it has rated a few municipal bond issues. The demand for Fitch Ratings' services, however, has been limited for at least three reasons. First, there has been only one public issue of municipal bonds. Second, investors still tend to regard the creditworthiness of most local governments, or at least those with name recognition, as equal. And third, the regulations forbidding bond issues in hard currencies have limited the demand for ratings designed to assure foreign investors.[32]

The accounting practices of local governments are regulated by the Law on Accounting of 1994 and an ordinance of the Ministry of Finance specifying in what ways public sector accounting differs from the regulations contained in the Accounting Law.[33] Under these rules local governments should keep both cash and accrual accounts, though it is the former that are legally binding for the reporting of their budgets. As a result, many local governments do not keep accrual accounts.

Local governments and their subsidiary units are also required to inventory and value the public property they own or administer and to submit to the Ministry of Finance and the RIOs' consolidated balance sheets that summarize their assets and liabilities. Thus, in theory, local governments should have reasonable information about the value of their assets. In practice, however, this is rarely the case and the asset value data contained in these balance sheets is considered too unreliable to be of much use.[34]

2.4 Financial Sector Framework

2.4.1 Banking Law

Unlike in many transitional societies, Polish local governments are not required to keep their cash holdings in sub-accounts of the national treasury system. Instead they are free to place their deposits with, or to borrow from, any of the country's commercial banks. This has facilitated an organic linkage between local governments and the banking sector and has undoubtedly helped the development of the subsovereign capital market.

Moreover, the way the country's banking laws regulate credit risk has encouraged banks to see local governments as good borrowers. The risk weighting of bank loans is governed by Article 128 of the Banking Law and rulings issued by the National Bank of Poland's Commission for Banking Supervision. Article 128 states that a bank's own funds must be equal to at least 8% of it risk-weighted assets and its extra balance-sheet obligations. The Commission for Banking Supervision's ordinance of December 2, 1998 (*Zarzadzenie 5/98*) sets out the risk coefficients for particular types of assets and extra balance-sheet obligations.[35]

The ordinance distinguishes between three classes of borrowers. Class I is composed of the Polish Treasury, the central bank, the Bank Guarantee Fund, the Export Credit Corporation, the Warsaw Stock Exchange and the central banks and stock exchanges of EU member states. Class II is composed of Polish local governments, the local governments of EU member states and multilateral financial institutions such as the World Bank and the EBRD. Class III covers all other economic agents.

The risk coefficient for the debt obligations of institutions belonging to Class I is 0% and Class II 20%, unless the obligations are guaranteed by or collateralized with the securities of institutions belonging to Class I, in which case the risk coefficient is zero. The basic risk coefficient for the obligations of institutions belonging to Class III is 50% if they are collateralized by liens on real property, and 100% if they are not collateralized by such liens. If the obligations of Class III institutions are guaranteed by or collateralized with the securities of Class I or II institutions, then the risk coefficient on these obligations can be 0% or 20%.

The fact that the risk coefficients for the debts of companies (50% and 100%) are substantially higher than those for local governments (20%) and are not dependent on liens on real estate, creates strong incentives for the banking sector to lend to local governments. By the same token, however, it creates fairly strong disincentives to lend to municipal utilities, especially if the real property of these utilities is considered an integral part of an essential service that should not be mortgaged. It should be added that the ordinance does not enumerate different risk coefficients for different types of debt instruments and is thus neutral with respect to loans and bonds, or for that matter, public and private issues.[36]

Other aspects of the banking law, however, may create incentives for banks to prefer municipal bonds to loans. In short, the law requires that banks monitor the behavior of borrowers with respect to the use of loan proceeds, particularly where permitting and construction schedules are concerned. With bonds no such obligation exists for the purchaser, or indeed the underwriter, because Polish bond law does not require that the organizer of an issue fulfill any trustee-type functions.

This seems to have encouraged the banks to prefer underwriting private placements and then purchasing the entire, or almost the entire issue, rather than entering into loan agreements for same purpose.[37] It may also contribute to the apparent economic viability of very small bond issues, one of the stranger anomalies of the Polish bond market, as we shall see later.

2.4.2 Capital Market Legislation

There is no single piece of securities law in Poland devoted to the issuance of municipal bonds. Municipal bonds are, however given specific treatment in the Law on Bonds and the ordinances of the Council of Ministers governing the disclosure requirements for bonds traded on the Warsaw Stock Exchange and the over-the-counter market, CeTO.[38]

Article 2 of the Law on Bonds states that local governments, special purpose associations and the capital city of Warsaw can issue bonds. Until 2000, Article 8 of the Law made all issuers liable for the repayment of bonds with their entire assets. As a result, local governments (and other entities) could not issue revenue bonds.[39] In June 2000 a new paragraph was added to Article 8, making it possible for issuers to state that a particular bond issue is secured only with the asset that is to be created by the loan and/or the revenues from it.[40] But to date, no revenue bonds have been issued despite some interest in the instrument by local governments.[41]

Article 9 defines privately placed issues as issues directed at a maximum of 300 subscribers. Article 10 defines the content of information memorandums for private placements and requires that all issuers state the purpose for which bond proceeds will be used. These information requirements distinguish between local governments and corporate bond issuers. Local governments are required to submit their budgets for the year prior to the issue along with the opinion of the Regional Accounting Office on the credit, while issuers of corporate bonds must submit independently audited financial statements and balance sheets.

With regard to the bond law itself, this is the major distinction between the treatment of municipal and corporate issues. Further distinctions, however, are made in the ordinance of the Council of Ministers (December 30, 1998) concerning the continuous and periodic information requirements for publicly traded securities, as well as in the ordinance of the Council of Ministers (December 22, 1998) concerning the information requirements for securities traded on the secondary market (CeTO).

The placement of substantially different types of information requirements in the same pieces of legislation is awkward. But it is fair to say that the disclosure requirements for publicly traded municipal bonds on both the primary and secondary market, including the requirement for independent audits, are reasonably comprehensive and do not differ significantly from those found in developed market economies.

Commercial banks are free to invest in municipal bonds as long as no more than 25% of their total portfolio is tied to a single borrower. There are no restrictions imposed on investment funds with respect to municipal bonds,[42] but pension funds and insurance companies can invest no more than 5% of their portfolios in privately issued municipal bonds and no more than 15% in publicly traded municipal bonds. Thus far, neither of these types of institutional investor has begun to approach its statutory limit.

It is also worth noting that the Ministry of Finance requires the payment of a stamp tax of 1.5% on the sale of all securities outside of the banking sector. This tax has reduced the liquidity of municipal bonds and increased the tendency for banks to hold large shares of the issues they underwrite on their portfolios.[43]

2.4.3 Special Purpose Financial Institutions

As in many other countries of the region, the (re)creation of local governments in Poland was accompanied by a debate about whether to establish special purpose financial institutions to help them access loan capital. In the early 1990s, this debate was motivated by two lines of thought.

On the one hand, there was a group of municipal officials who thought Poland should create a special purpose municipal bank that would hold municipal deposits and issue subsidized credit loans to local governments. Little came of this idea for at least two reasons. First, municipal officials could not agree among themselves on whether local governments should capitalize this institution, or whether they should be legally required to keep their deposits with it. And second, representatives of the national government in general and the Ministry of Finance in particular were not only ideologically opposed to such an institution but argued that the national government could not afford to help with its capitalization. As a result, the idea never really got off the ground.

On the other hand, there were reformers looking for ways to help local governments to gain access to loan capital in a situation where newly privatized and weak commercial banks were not yet up to the task. This group was strongly backed by the World Bank and USAID in the early 1990s, and for a while it looked as though the Polish government was going to try to develop a temporary Municipal Development Fund to on-lend donor resources to local governments. But the Ministry of Finance ultimately rejected these plans, arguing that reform of the commercial banking sector was moving forward and that donors who wanted to lend to the sector should do so through specialized credit lines to the commercial banks.

Nonetheless, the national government did decide, with USAID encouragement and support, to create a para-statal Municipal Development Agency. The purpose of this Agency was not to lend to local governments, but to facilitate the growth of the subsovereign capital market by helping local governments prepare bankable projects, improve their budgeting practices and lobby for necessary changes in the laws regulating their finances and the capital market. Indeed, this institution played an important role in helping to jump-start the market in the mid-1990s by helping to prepare the country's first municipal bond issues and by developing standards of budget preparation and forecasting that were useful to both banks and local governments.

At the same time, Poland has a set of special purpose Environmental Funds that in the 1990s were given the right to issue not only grants but subsidized loans for the improvement of environmental infrastructure.[44] And while reformers were not thinking specifically about local governments when redesigning these funds, the funds have proved important for the development of the Polish subsovereign capital market.

The Funds get their resources from the fees and fines imposed on firms and individuals for the use and abuse of the environment. They then use these monies to provide financial support to projects designed to improve environmental conditions. Because Polish local governments have important responsibilities in the areas of water supply and sewage treatment, solid waste and, to a lesser extent, district heating, a significant share of the Funds' total financial support has gone to them.

Until the end of 1998, the revenue stream from environmental user fees and fines was divided between three different types of funds: the National Environmental Fund (NFOS), 49 Regional Environmental Funds and 2,489 municipal funds. With the second round of administrative reforms in 1999, new county-level funds were established while the number of Regional Funds was reduced from 49 to 16. As a result, revenues from environmental fees and fines are now divided four ways.

Municipal and County environmental funds do not have separate legal identities, cannot lend money and are basically controlled by their respective local government councils. As such, these funds are essentially special purpose, though off-budget, local government revenues. Both the National and Regional Funds (FOS), however, have legal identities and each is empowered—within the boundaries of the law regulating their operation—to make independent decisions about the types of financial instruments they employ to promote their statutory goal of environmental protection. The most important of these instruments are:

- Grants;
- Preferential loans that can be partially or entirely forgiven;
- Interest rate subsidies paid to commercial banks for environmental credits.

The cost of the loans provided by the National and Regional Funds are typically a few percentage points lower than those available from commercial banks and are most often set between 20% and 90% of the NBP rediscount rate.[45] Sometimes these preferential loans are accompanied by pure grants. Often, fund loans allow for the partial forgiveness of capital and interest payments if investment projects are completed on schedule and meet their environmental goals. Many funds also provide interest rate subsidies to commercial banks issuing loans for environmental infrastructure projects.[46] We discuss their role in the development of this market in the next section.

There are also some less important but still significant institutions that lend to local governments on a preferential basis. These include:

- The national government's National Housing Fund which offers local governments loans for improving infrastructure directly related to apartment construction;
- The national government's Program for the Support of Thermal-Insulation which provides low-interest loans to improve the heating efficiency of apartment buildings and heating systems;
- The Catholic Church's Foundation for the Support of Rural Areas, which provides loans and credit lines for rural local governments for water supply, environmental protection and educational endeavors;
- The European Fund for the Development of Polish Agriculture,[47] which provides credit for rural health and environmental projects.

Also active in Poland are a variety of bilateral and multilateral lending agencies such as the World Bank, the European Bank for Reconstruction and Development, the European Investment Bank and the Nordic Investment Bank, among others. These institutions provide investment credits to local governments either directly or through lines of credit managed by Polish Banks.

3. THE DEVELOPMENT OF THE COMMUNAL CAPITAL MARKET (1990–2001)

To the end of 1998, the only borrowers on Poland's subsovereign debt market were municipalities. As we have noted, in 1999 they were joined by counties and regions.

At the same time new regulations were put into effect regarding the reporting of municipal debt, and Poland's official statistics began to contain information on the level of municipal borrowing. Thus, we present the history of the market's development in two periods, from 1990 to 1998, and from 1999 on.

3.1 The Borrowing of Polish Local Governments (1990–1998)

As we have already noted, Polish municipalities were given the legal right to borrow at the moment of decentralization in the early 1990s. Nonetheless, in the first years of the decade local government borrowing was virtually non-existent, due to the general political and economic situation of Poland. It is necessary to remember that these were years of radical economic change and even more radical uncertainty about the effects of this change, making any financial planning extremely difficult. This was compounded by extremely high inflation rates (70% in 1991 falling to 20% in 1995) and high costs of credit.

In addition, Poland's financial market was new and inexperienced, and its financial institutions had yet to develop credit instruments designed for local governments. At the same time, local governments were only beginning to learn how to manage their financial resources and to execute their assigned responsibilities. Finally, the mental and practical habits inherited from the old system had to be overcome. Generally this meant accepting the idea that local problems had to be identified and solved locally.

More specifically, it meant moving away from the notion—widely accepted by most local government officials—that debt is an unjust way of financing local tasks because it encumbers future budgets. This idea was in part a carry-over from the dramatic problems Poland had with paying the national debt that the previous communist governments had incurred. Whatever its source, this attitude acted as a serious brake on the development of the municipal capital market in the early years of the transition.

Indeed, it is fair to say that because Polish municipalities were endowed from the start of the transition period with both fairly robust and fairly stable revenues, they underutilized their borrowing potential both in financial terms and in relationship to their huge investment needs for most of the decade. This is because of the political and economic uncertainty and because of the time it took to overcome old habits and to learn new techniques.

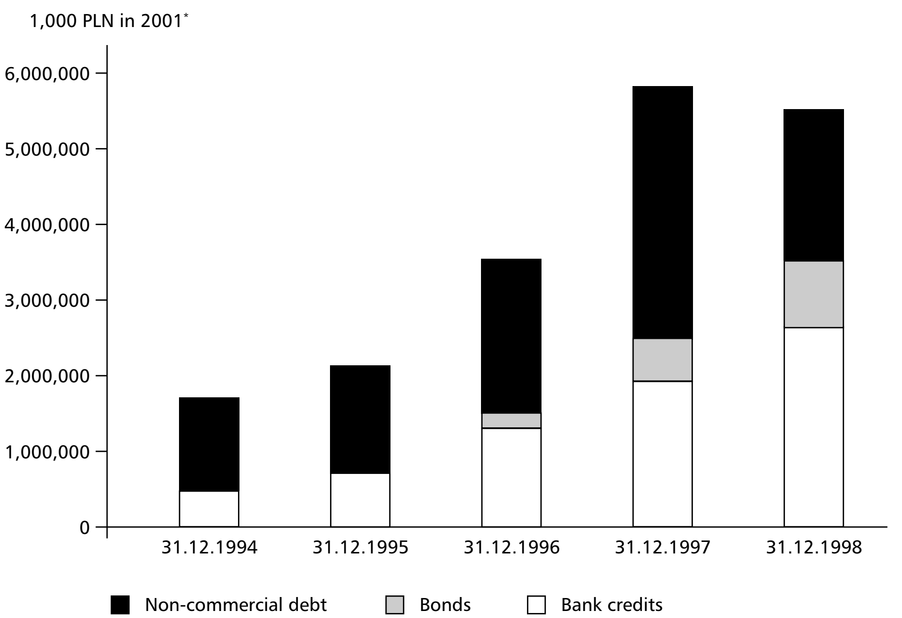
As a result, Polish local governments were initially extremely cautious about incurring debt, and financed almost all of their investments on a pay-as-you-go basis from current operating surpluses (See Table 2.6). At the same time, we should point out that the extreme caution with which Polish municipalities approached debt financing has meant that Poland has had few of the problems with local government insolvency that have occurred in some other transitional countries.

Table 2.6
Local Government Investment Funds by Revenue Type [%] (1995–1998)

	1995	1996	1997	1998
Operating surpluses	75.79	69.97	71.99	71.14
National government investment grants	11.36	12.70	11.75	11.85
Grants from Environmental Funds	6.50	6.17	4.57	4.24
Loans from the Environmental Funds	2.58	4.37	3.59	4.48
Bank loans	3.61	6.03	6.87	6.41
Municipal Bonds	0.00	0.50	1.00	1.48
Other	0.15	0.27	0.22	0.40

Source: Own calculations based on data from the Main Statistical Office (GUS), the Regional Accounting Offices (RIO,) the Supreme Chamber of Control (NIK) and the National Environmental Fund (NFOS).

Figure 2.1
New Loans Contracted by Local Governments (1995–1998)



Source: Own calculations based on data from the Ministry of Finance, NBP and NFOS.

* Data expressed in 2001 constant prices.

Up until 1999, there were no official national statistics concerning the level or type of local borrowing. Local governments were obligated to include information about the size and types of their debt in their financial reports to the Ministry of Finance only with the passage of the Law on Public Finance, and particularly the provisions that called for the national government to calculate—as per Maastricht—the country's consolidated public debt. As a result, analysis of the municipal capital market prior to 1999 can only be pieced together with (not fully commensurable) data from the National Bank of Poland (NBP) on the level of local government debt held by commercial banks, surveys of the municipal bond markets carried out by the Fitch rating agency (CERA) and data from the Environmental Funds about loans to local governments and their utilities.

Municipalities' use of debt instruments increased from virtually nothing at the beginning of the decade to over six billion PLN (USD 1.3 billion) by the end of 1998, equal to approximately 10% of all municipal revenues. But the market's real growth began in 1995, in part because the passage of new securities legislation made the issuance of municipal bonds more feasible, and in part because USAID-sponsored efforts to facilitate municipal borrowing began to have a serious effect on the practices of both local government and banks.

3.1.1 Cooperation between Local Governments and the Funds for Environmental Protection and Water Economy

In analyzing the development of the municipal capital market through 1998, it is necessary to observe the important role played by non-commercial sources of (preferential) credit. As can be seen from Figure 2.1, non-commercial credit was used by local governments significantly more often than commercial loans and bond issues until 1998. Unlike some other countries, however, Poland has not created a special-purpose financial institution to facilitate local government investments. Instead this role has to a large extent been fulfilled by the Funds for Environmental Protection and Water Economy.

Not surprisingly, the often heavily subsidized loans and grants offered by the funds have enjoyed—and still enjoy—great popularity among local government officials. Indeed, while most officials were initially opposed to using commercial debt to finance infrastructure projects, they tended to regard the grants and subsidized loans of the funds as an offer they could not afford to turn down. As a result, the vast majority of Polish local governments first got involved with debt financing through the funds and only later turned to the use of commercial lending.

As an example, in 1995 only 98 local governments had received loans from commercial banks while more than 1,000 had entered into credit agreements with the National and Regional Environmental Funds. Moreover, and again not surprisingly, many of them continue to line up for preferential loans from the funds before turning to commercial sources of credit. In short, the funds have created and continue to create serious competition for more commercial lenders, and have to one degree or another dampened or crowded out the demand for commercial credit.

This crowding-out raises an important question about whether the operation of the Funds has facilitated or retarded the development of Poland's municipal capital market. Unfortunately we have not done the research necessary to really answer this question. Nonetheless, we think it is probably fair to say that on the whole the Funds have done more to facilitate the growth of the market than retard it.

This is mainly because whatever the crowding-out effect of the funds' practices may have been, it has not been sufficiently strong to prevent local governments from turning increasingly towards commercial sources of finance. As can be seen from Figure 2.1 above, both the volume of commercial debt and its share in overall municipal borrowing grew steadily over the course of the 1990's. This trend has continued in more recent years, as we shall discuss later. Given this trend, it seems unreasonable to claim that the operation of the funds has retarded the development of a market that has in fact emerged with them. Indeed, it can be argued that the funds have actually promoted the development of a viable commercial debt market by playing an important educational role for local governments with respect to debt finance. Again, while we lack evidence on this, it seems that at least three of the funds' general practices served to promote the willingness and ability of municipalities to use commercial debt.

First, the funds required local governments to fully document the environmental impact of their investment plans and to define clear and realistic construction schedules for their realization. Local governments were also required to demonstrate how they expected to repay the loan, although these requirements were lax by commercial standards. Nonetheless, these conditions seem to have helped familiarize local governments with loan procedures and to have increased their project-planning capacities.

Second, and related to the first, the funds typically made the partial forgiveness of loans contingent on the timely repayment of debt-service obligations, the completion of construction plans according to schedule and the fulfillment of the expected environmental impact targets. Together these practices, while clearly not universal, seem to have encouraged local government officials to impose some financial and managerial discipline on the investment process, a discipline that helped prepare them for commercial borrowing.

Finally, Table 2.7 below shows that the National Fund in particular, but many of the regional funds as well, adjusted loan subsidy levels to measures of local governments' ability to pay (means testing). This seems to have impressed upon richer jurisdictions the idea that they would be increasingly expected to solve their infrastructure problems on their own.

The clearly positive role of the Environmental Funds in the development of the Polish municipal capital market raises an even more interesting and fundamental question. Simply put, why—given the extremely checkered history of special-purpose (municipal) lending facilities in the developing world[48]—have the Funds worked so well in Poland, not only in providing local governments with low-cost capital for environmental infrastructure projects, but in facilitating the development of a truly commercial municipal capital market? We have little more than informed speculation to offer in response to this question. But we suspect that a combination of three factors has allowed the Polish system of Environmental Funds not only to avoid the bad lending practices that have haunted similar institutional interventions in other countries, but to actually promote a viable, commercial municipal debt market.

Table 2.7

Interest Rate Policies of the National Fund for Environmental Protection (2003*)

Local Governments	**Percentage of the Rediscount Rate in Relation to the Per Capita Income of Local Governments in 2001 (*minus two years)**			
	0.45 (0.5 in cities)	**0.3 (0.35 in cities)**	**0.2**	**0.1**
Municipalities	> 1,511	1,271–1,511	1,134–1,270	<1,133
Cities with county rights	> 2,188	1,972–2,188	1,653–1,971	<1,652
The capital city of Warsaw and its component municipalities	All	—	—	—
Counties	—	—	All	—

Source: Data from the NFOSiGW. www.nfosigw.gov.pl.

First and most basically, the Environmental Funds were not designed specifically to serve local governments. Indeed, our guess is that their architects had little idea about how much of the funds' ultimate activity would be directed to them. But precisely because of this, the construction of the larger municipal finance system was considered independently of them.

At a minimum, this meant that nobody looked to the funds as a substitute for a healthy system of intergovernmental financial relations. And at a maximum it meant that no attempt was made to require that local government revenues (deposits) serve as a source of low-cost loan funds. As a result, the funds never pretended to be nor became a comprehensive municipal lending system, while elsewhere they have not only tended to exclude the commercial banks from the sector but—with a few notable exceptions—to implode over time.

Second, and perhaps more interestingly, the funds were designed as off-budget institutions with clearly defined revenue streams. Moreover, rightly or wrongly, everybody involved with the funds seems to have assumed that the yield of this revenue stream would decrease over time as environmental problems were resolved.

Taken together, the separation of the funds from the general budget of the government and the expectation of a decline in their revenues seems to have imparted to fund managers a sense that they were operating not only under a serious budget constraint, but a diminishing one. And this in turn seems to have led them to take their fiduciary responsibilities seriously. Even though the loans undoubtedly have been and remain preferential, they have been treated as loans whose conditions must be respected.

Finally but most speculatively, we suspect that the politics influencing the operation of the funds, particularly in the 1990s, worked in ways that served to minimize the crowding-out effect. In short, we suspect that because the funds were subordinated to the Ministry of the Environment, and throughout the 1990s the Ministry of the Environment was almost always controlled by representatives of the Peasant Party, the funds' activities were disproportionately focused on poorer/rural jurisdictions.[49]

Consequently, fund resources tended to flow to those jurisdictions that had a harder time accessing commercial debt and away from those larger, generally richer jurisdictions that could, thus minimizing the crowding-out effect. If this is true, the political logic of the funds was good for the overall development of the municipal capital market, but at the same time probably less effective from an environmental economics perspective: greater environmental effects would probably have been achieved by focusing on the problems of larger—yet richer—jurisdictions.

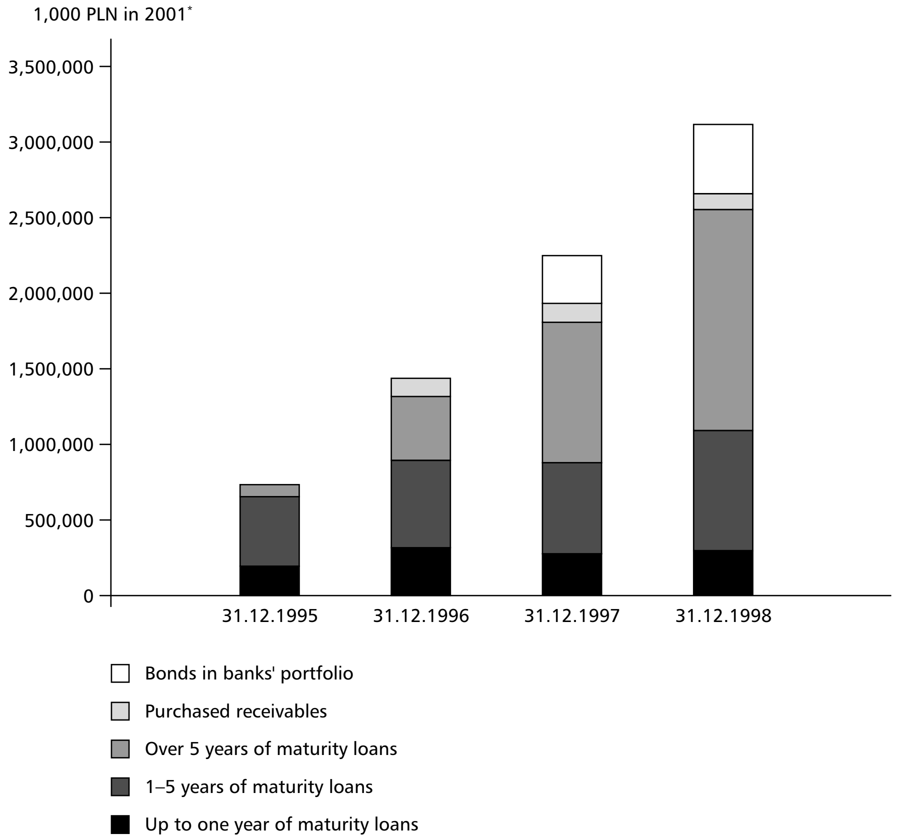
3.1.2 Commercial Banks in the Municipal Capital Market

The bank that most frequently cooperates with the Environmental Funds is the Bank for Environmental Protection (BOS). BOS was set up by the National Environmental Fund in the early 1990s and the fund remains its most important shareholder. BOS provides loans for environmental infrastructure projects both on its own and in conjunction with the funds. During the 1990s, as much as 80% of its portfolio consisted of preferential loans. Recently, however, this figure has been declining, and according to bank officials only about half of BOS's portfolio in 2002 was issued at below-market rates.

Either way, BOS's ability to lend to local governments on preferential terms has allowed it to win a large share of the local government market. Indeed, BOS estimates that it is the single largest player on the market and is responsible for about 30% of all bank loans issued to local governments. If this estimate is correct, then it is clear that even in 1998 (see Figure 2.1) most Polish municipalities were still borrowing on preferential terms even from "commercial" banks.

Nonetheless, what was said earlier about local governments' increasing willingness to borrow on commercial terms remains true, as can be seen in Figure 2.2. Over the course of the 1990s local governments progressively overcame their reluctance to deal with commercial banks. This was partly because more and more of them were becoming more capable and knowledgeable about debt finance, and partly because the overall economic and political situation was stabilizing and interest rates were falling. Also, local governments were under increasing pressure from their electorates to improve local infrastructure in areas where support from the funds and BOS was unlikely to be forthcoming (e.g., roads, schools and public transport).

Figure 2.2
Local Government Debt Held by Commercial Banks (1995–1998)



Source: Own calculations based on NBP data.

* Data expressed in 2001 constant prices.

The role of the banks themselves has been equally important. From virtually the start of the reform process, Poland's new commercial banks have been interested in local governments, first as significant depositors and then as potential borrowers. Initially, this interest was fairly uninformed and naive. For example, many commercial bankers thought that local governments were ideal clients because they could not legally be declared bankrupt. Meanwhile, others sought to secure loans with collateral associated with essential public services, not realizing that this collateral was unrealizable even in the case of non-payment.

Nonetheless, by the end of the 1990s banks increasingly found themselves competing with each other for local government business and adjusting both their general service and credit offers to the specific needs of local governments. Indeed, as the margins on national government treasury bills and bonds fell over the course of the decade and turbulence in the industrial sector continued, banks became ever more interested in local government debt: after all, not only were their revenues significant and stable, but they had been paying back their obligations in a timely fashion.

By 1998, the national government had recognized this by lowering the risk factor associated with local government debt used to calculate the reserve ratio requirement of individual banks. Like the debt of enterprises and persons, local government bank debt, securities and other obligations have a zero risk factor if the debt is secured by cash deposits or appropriately rated securities. But if no such collateral is provided, local government debt has a reserve risk ratio of 20% while that of firms and individuals is 50%.[50] Similarly, banks can lower the amount they have to set aside for bad debts in the case of the non-timely payment of obligations, if the credit is guaranteed by local governments.[51] These regulatory provisions have further increased the interest of the commercial banks in the local government sector (see the earlier sections on banking and capital market regulation).

3.1.3 Municipal Bonds

The growth of the commercial banks' interest in municipal clients has also influenced the nature of the municipal bond market in Poland. If one compares Figures 2.1 and 2.2 above, two things immediately become apparent: First, the value of municipal bond issues rose from zero in 1990 to more than PLN 900,000 million (USD 220 million) in 1998. And second, virtually all of these bonds were held by commercial banks. In other words, not only were banks ready to organize the issuance of municipal bonds and to guarantee their sale, but they were extremely ready to actually purchase the securities once issued.

Indeed, the competition between banks to get involved in the infant municipal credit market has lowered issuance fees to close to zero and made it possible for local governments to go to the bond market for very small amounts (See Table 2.8).

Table 2.8
Number of Municipal Bond Issues by Value (1996–1998)

[PLN]	1996	1997	1998
	Number of Issues		
0–5 million	2	13	12
5–10 million	2	2	2
10–20 million	2	3	0
Over 20 million	4	1	5
All issues	10	19	19
	Value of Issues		
Minimum	0.9	1.3	0.95
Maximum	99.3	25	2,06.3

Source: Own calculation on the basis of Rating & Rynek, Fitch Ratings oraz Raport, SRGG.

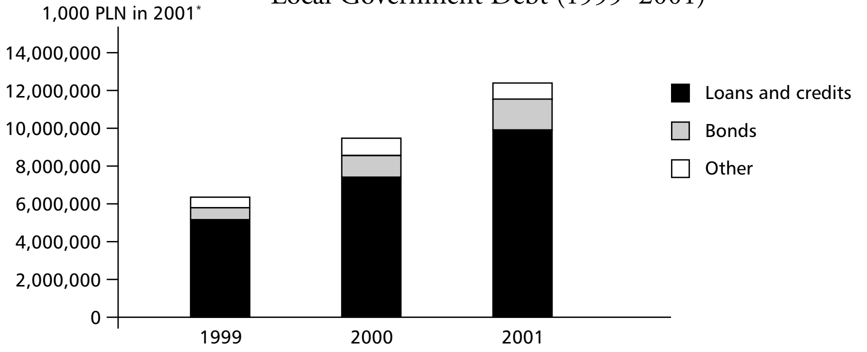
3.2 The Development of the Subsovereign Capital Market (1999–2001)

As Figure 2.3 shows, local government debt has continued to grow in the three years since the second round of territorial reform. In 2001, the total outstanding debt of all local governments in relation to their total revenues stood at 15.4%. The highest level of debt has been incurred by municipalities and cities with county rights. The ratio of outstanding debt to income for municipalities in 2001 was 16.7% and for cities with county rights 22%. Meanwhile for counties it was 3.8% and for regions 6%.

Figure 2.3 also shows that the municipal bond market has also grown substantially since 1999. This growth was in both the volume and number of issues; in 2001, 70 local governments issued bonds, the largest number since the start of the reform period.

According to NBP data, local government borrowing from the banks increased even more dramatically (see Figures 2.4 and 2.2). By 2001 local government bank debt had increased 150% compared to 1998. In addition, the most dramatic increase in bank debt was for medium- and long-term credits. This is an extremely positive tendency, demonstrating both an increase in all actors’ confidence in the market, and a rise in the long-term planning capacities of local governments.

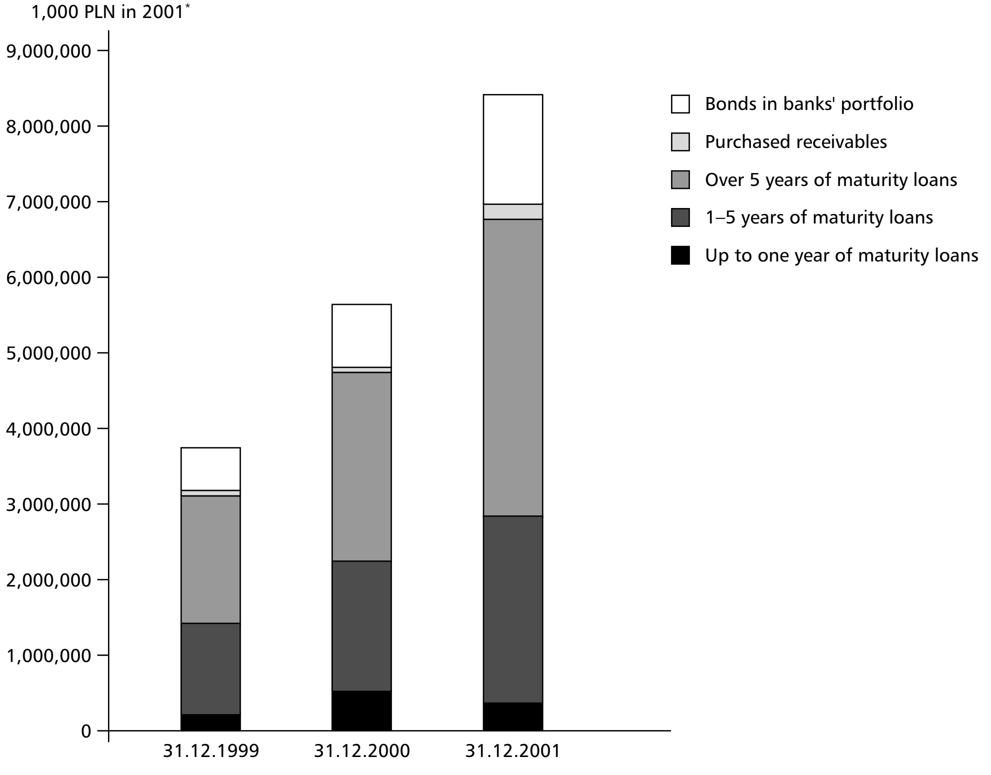
Figure 2.3
Local Government Debt (1999–2001)



Source: Own calculations on the basis of data from the Ministry of Finance.

* Data expressed in 2001 constant prices.

Figure 2.4
Local Government Debt Held by Commercial Banks (1999–2001)



Source: Own calculation based on National Bank of Poland data.

* Data expressed in 2001 constant prices.

These data underscore an important shift in the attitudes of local government officials to commercial debt. As we have indicated, many local government officials felt that commercial credit was an "unjust" way of financing infrastructure improvements and resisted borrowing in the early 1990s. With time, however, many more local government officials have come to better understand both the need for commercial debt and the operation of the market.

To an extent this is simply a result of the market becoming more attractive with the general fall in interest rates. Competition between banks has also led to the development of debt instruments specifically designed for local governments. At the same time, training and better investment planning and budgeting have helped local governments see debt as a tool to improve their circumstances and not as embarrassing evidence of their financial weaknesses. Nonetheless, problems in this area remain and will be discussed later.

Since 1999, counties and regions have joined municipalities as borrowers on the market. But municipalities remain the dominant players, both because of their experience and the size of their budgets which, as we have seen, dwarf those of regions and counties combined. Thus, at the end of 2001, municipalities and cities with county rights accounted for more than 93% of all local government borrowing. Moreover, the borrowing of municipalities and cities with county rights has continued to increase rapidly from year to year. Nonetheless, the borrowing of counties and regions has also increased extremely rapidly (see Table 2.9)

Table 2.9

Growth of Local Government Debt [%] (1999–2001)

	Total	Municipalities	Cities with County Rights	Counties	Regions
1999/1998	29.26	x	x	x	x
2000/1999	37.65	25.20	43.23	523.26	306.00
2001/2000	23.99	15.39	31.26	33.14	151.73

Source: Own calculations based on Ministry of Finance data, based on current prices (rates of inflation in that period were 7.3% in 1999, 10.1% in 2000 and 5.5% in 2001).

The explosion of borrowing by counties and regions is in part simply a statistical effect that results from the fact that their borrowing in the first year of their operation was near zero. But it also shows that these agents entered the market much more easily than municipalities did in the period immediately after their creation.

The increased use of debt by local governments has also translated into a significant decline in the percentage of their investments financed on a pay-as-you-go basis. Indeed, debt as a source of investment finance has risen from a mere 6% in 1995, to 13% in 1998 and about 21% in 2001 (see Tables 2.6 and 2.10). This growth is probably the strongest evidence of an increase in the long-term planning capacities of Polish local governments and their movement away from investment strategies based on attempts to do a little bit of everything at once, towards strategies based on quickly completing priority projects.

Table 2.10

Project Finance Sources in 1999 and 2000[52] [%]

	1999	2000
Earmarked grants	26.32	25.56
Operating surpluses	60.54	45.19
Deferred surplus	2.05	8.39
Bond revenues	0.82	3.72
Loans/credits	10.27	17.14

Source: Investment spending by local governments in 1997–2000. Finanse Komunalne 4/2001.

At the same time, however, the above table shows that Polish local governments on the whole are still underutilizing their debt-carrying capacities. In short, they are still financing more than half of their investments on a pay-as-you-go basis (operating revenues plus deferred surplus), which suggests that a much larger share of their revenues could be leveraged through debt, allowing for higher investment rates and the faster completion of projects.

Local government borrowing also remains—at least globally—substantially below its statutory limits. At the end of 2001, the total outstanding debt of all local governments was only 15.4% of their total annual income, even though the statutory limit for any individual local government is 60%. Not surprisingly, the Ministry of Finance's report on local government debt stressed that despite the rapid rise in local government borrowing, "the collective level of local government debt does not create a financial threat to these entities."

But this statement is not true for all local governments. Indeed, for the first time since the emergence of the subsovereign debt market in Poland, the period 1999–2002 saw some serious indications of distress across individual local governments as well as some more general disturbing tendencies.

3.2.1 Negative Signals in the Development of the Market

Despite this growth in the municipal capital market, there are still many local governments that oppose borrowing, and particularly commercial borrowing. Alongside the simple rejection of the idea of debt, expressed in statements like "our council members are wise and won't allow borrowing," one often encounters a "business" approach to local government debt. Here, local government officials claim that debt is justified only in cases where the return on the investment will pay back the costs of the loan. As a result, they will take loans to finance the preparation of undeveloped land for sale but not to repair roads or build schools where the return on investment is difficult or impossible to calculate. Such attitudes mean that despite the growth of the municipal capital market many local governments remain reluctant to borrow at all, or do so only to a very limited degree.[53]

Table 2.11

Number of Local Governments with Little or No Debt in 2001

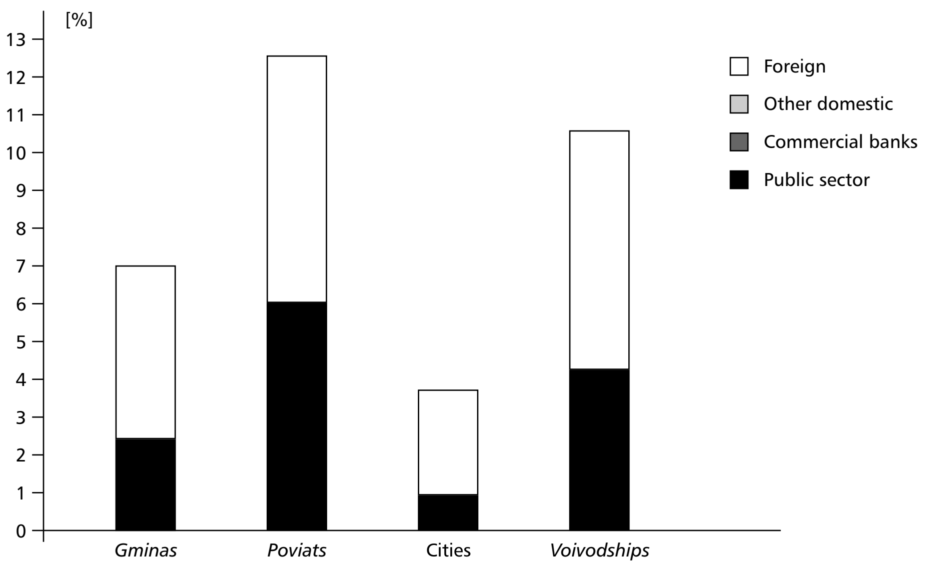
	Number of Local Governments with No Debt	% of Local Governments of Given Type	Number of Local Governments with Debt Less Than 2% of Revenues	% of Local Governments of Given Type	Liczba Number of Local Governments with Debt Equal to 2–5% of Revenues	% of Local Governments of Given Type
gmina	163	6.4	209	8.5	280	11.2
Rural *gmina*	145	9.1	168	10.5	202	12.7
Urban–rural	14	2.4	23	4.0	52	9.0
Cities	4	1.6	18	7.1	26	10.2
Counties	15	4.9	143	46.4	63	20.5
Cities with county rights	0	0	1	1.5	7	10.8
Regions	0	0	4	25	3	18.8

Source: Own calculations based on the Ministry of Finance's information about the debt of local governments for 1999–2001 as well as the first two quarters of 2002.

As Table 2.11 shows, local governments that are the least active on the municipal capital market are the smallest and financially weakest ones. This can be seen by comparing the borrowing practices of big cities with county rights to those of all other local governments. For example, at the end of 2000 only 12% of cities with county rights had incurred no, or minimal debt, while almost 72% of counties and 44% of regions were in this situation. Similarly, 26% of *gminas* and 32% of rural *gminas* had little or no debt. In short, it is fair to say that many local governments remain ill-disposed towards debt. At the same time, the strong correlation between low borrowing and low budget revenues suggests that much of this reluctance is financially justified.[54]

Alongside local governments that have yet to incur significant amounts of debt, we are beginning to see some that are having problems meeting their obligations. The data available since 1999 indicate that local governments are not quite as reliable borrowers as people have come to assume. As seen in Figure 2.5 below, they are increasingly delaying payments to their creditors. This is particularly true with respect to suppliers of goods and services and to public sector agencies like the Health Insurance Fund (ZUS—Group 3 of the public sector in Figure 2.5), or the hospitals, schools and cultural institutions under their control (Group 2). Nonetheless, local governments have thus far been very careful to pay their bank debts on time

Figure 2.5
Overdue Liabilities as a Percentage of all Local Government Liabilities (2001)



	Gminas	*Poviats*	Cities	*Voivodships*
Foreign	0.00	0.00	0.00	0.02
Other domestic	4.60	6.55	2.80	6.34
Commercial banks	0.01	0.00	0.00	0.00
Public sector	2.43	6.03	0.94	4.26

Source: Own calculation based on Ministry of Finance Reports.

This problem of delaying payments to suppliers is very apparent in discussions with local government officials. They are very aware of their strong position as buyers in an economy in which they are a major source of stable purchasing power. They are also quite conscious of the fact that they are more and more frequently postponing payments to suppliers in order to meet their priorities. In fact, local government financial liabilities to suppliers have grown sufficiently to become a commodity that the banks have begun to buy and sell.

The largest share of delayed payments comes from counties and regions. These local governments have been operating on the market for a very short time and, unlike municipalities, they have virtually no revenue-raising authority, have been given a much smaller share of the fiscal pie and are extremely dependent on transfers from the national government. All this makes their financial position much weaker. For example, delays in transfer payments that municipalities can make up from other resources immediately force counties and regions either to go to the banks or to delay payments to other agents. For example, in 2000 counties did not receive funds for the payment of health insurance fees for the unemployed. As a result, counties did not fulfill their obligations to the Health Insurance Fund (ZUS) and at the end of 2000 about 50% of all counties' debt obligations were to ZUS.

Problems of a similar though more profound and generalized nature were caused by the increase in teachers' pay that was mandated by the National Government in 1999 but insufficiently accounted for in the education subvention to local governments made in 2000. Local governments estimated the shortfall at approximately 1.3 billion zlotys (USD 320 million). Eventually the national government made up most of the difference, but this was paid out in installments at the end of 2000 and the beginning of 2001. As a result, local governments had to cover the shortfall on their own throughout most of 2000. Some local governments withdrew from other expenditures, particularly investment expenditures. Others went to the debt market, in most cases taking loans with payment periods of longer than one year, and in some cases longer than five years. Such credits were taken by 710 local governments, including 50 cities of county status, 575 other municipal governments and 81 counties. This accounted for almost a quarter of all credits taken by local governments in 2000 (Jerzmanowska, 2001).

This phenomenon of local governments incurring long-term debt to pay short-term operating deficits has become increasingly and disturbingly apparent in the last few years. As we have indicated earlier, Polish regulations state that local governments cannot have year-end deficits. At the same time, they define long-term debt as an instrument to prevent a deficit and not to realize an investment.

Nevertheless, according to recent RIO reports to the Sejm more and more local governments are incurring debt greater than their deficits in order to pay outstanding obligations from previous years.[55] In 2000 approximately 11.8% of borrowing proceeds were used to finance liabilities carried over from previous years, while by 2001 the figure had risen to 27.3%. This tendency is not only an expression of bad borrowing practices but is also against the law. It should be noted that the rolling over of debt is a practice not only of municipalities, but also of counties and regions that have only begun borrowing in the last three years. As the RIO report suggests, this "means that the level of debt that can be safely incurred by these local government units—counties and regions—is significantly lower than their statutory limits and much lower than what is safe for municipalities."[56]

Similar problems are apparent if one compares the volume of local government borrowing with the volume of local government investment spending. Long-term debt obligations should, both in theory and practice, be used exclusively for capital improvements. Nonetheless, in 2001, 160 local governments borrowed considerably more than they spent on all new assets (a category wider than simply investment expenditures). This group included 32 counties, 5 cities with county rights and 123 municipalities. Differences of a few percentage points can be explained by adjustments in spending made during the investment process. But in 44 cases the borrowing exceeded expenditures on new assets by more than 50% and in five cases more than 90%.

The worsening financial condition of many local governments is also suggested by the increasing number of them that are exceeding their statutory debt limits. As noted earlier, total outstanding local government debt is still equal to only 15% of their total annual revenues, much less than the statutory limit of 60% for individual local governments). In 2001, nevertheless, 21 local governments exceeded their statutory limits. And in one of these, outstanding debt was more than 116% of the local government's annual revenues. This is not only against the law, but has also revealed the fact that Poland has not put in place any legal procedures that would allow for the amelioration of the problem.[57] How serious these problems are or will become remains to be seen. But there are enough signs of distress to suggest that the situation should at least be monitored closely. At a minimum, it would seem advisable for regulators to clarify the purposes for which debt can be incurred (to finance investments, not deficits) and to review the equity and adequacy of the intergovernmental finance system.

At a minimum, the appearance of these problems should be producing more circumspect behavior on the part of lenders. Unfortunately, it is not clear that this is happening and the banks continue to chase after local government clients in ways that suggest they are not always really examining the creditworthiness of individual local governments. This behavior can be explained at least partially by the overall credit situation of the banks. In the first half of 2001, approximately 20% of all bank loans had been officially classified as risky because debtors had missed debt service payments. At the same time, however, only 0.01% of all local government debt had been so classified. In 2001 only five local governments missed debt-service payments on loans (four rural *gminas* for a total of about one-half million PLN, and one county for a total of PLN 3,000).

The comparative financial strength of local governments as borrowers, combined with the competition between the banks and the environmental funds as well as among each other, has allowed local governments to extract increasingly favorable credit and service terms. This can be seen in the extremely rigorous terms that local governments include in the public tenders they issue for banking services of all sorts. In fact they are frequently getting loans with interest rates equal to or even less than WIBOR. More disturbingly, bankers are increasingly complaining that local governments are refusing to provide information about their financial standing during or after these tenders, because they feel that they can always find somebody who will issue them loans on favorable terms no matter what information they provide.

The competition between banks for local government business is particular visible on the municipal bond market. Between 1999 and 2001, 131 new bond issues were made (see Table 2.12). Along with municipalities, 24 counties and 2 regions issued bonds. As before, most of the issues were small, with 73 of them being for sums of less than PLN 5 million (USD 1.2 million) and none of them being public issues.

Table 2.12
Number of Municipal Bond Issues by Value [PLN]
(1999–2001)

Year	1999	2000	2001
	Number of Issues		
>0–5 million	10	25	38
>5–10 million	3	13	15
>10–20 million	2	4	9
Over 20 million	0	5	8
All issues	15	46	70
	Value of Issues		
Minimum	1	0.7	0.8
Maximum	20	144	105

Source: Own calculations on the basis of data from Fitch Ratings, Poland.

Such bonds are obviously too small to interest serious institutional investors such as investment funds, insurance companies or the newly created private pension funds. These institutions, particularly the latter two, possess huge resources that must be invested over the long term because their financial liabilities typically fall in the relatively distant future.

Elsewhere in the world, municipal bonds are often favored by such institutions precisely because of their relative stability and their long maturities. Unfortunately this is not yet the case in Poland. Indeed the legal provisions that specifically include municipal bonds as an acceptable investment instrument for insurance companies and pension funds have not helped in this respect: representatives of the pension funds, while interested in municipal bonds, say that the size of the issues is too small at the moment to make them of interest.[58]

As a result, the vast majority of existing municipal bonds have stayed within the portfolios of the banks that have organized and underwritten the issues. In 2001, banks held 72% of all bonds issued by municipalities, 92% of those issued by counties and 100% of those issued by regions. And most of those bonds that have been sold to outside investors have been from the larger issues of cities with county rights. Here, banks held 68% of the bonds, other domestic investors 20%, and 12% were bought by foreign investors.

4. EU FUNDS AND THE DEVELOPMENT OF THE DEBT MARKET

Accession to the EU will create serious challenges for Polish local governments and the subsovereign debt market. Accession will be accompanied by a huge influx of grant funds, first through various pre-accession programs like SAPARD, and then through the EU's structural adjustment funds. The volume of these funds will depend on many factors but reasonable estimates suggest that Poland will be eligible for between 10 and 15 billion zlotys of annual support in the years immediately before and after entering the EU. Moreover, the end-users of much of this support will be local governments.

Absorbing these monies, however, with not be easy for at least three reasons:

- First, EU investment grants not only must be included in the investment plans of local governments, but they must be enumerated in the regional investment strategies of their regions, aligned with the national development plan presented by Poland to Brussels;
- Second, under many programs investments must be underway or in some cases completed (as under the SAPARD program) before grants are awarded;
- Third and most importantly, EU grants can finance a maximum of 75% of an investment's total costs.

Thus, the absorption of EU funds will require from local governments not only significant organizational effort, but significant financial engagement as well. In short, many local governments will not have the funds necessary to meet the co-financing requirements of EU aid monies, or even to begin investments whose costs are to be reimbursed by EU grants. This is already a very serious problem with the PHARE and

SAPARD program which reimburses rural jurisdictions for local infrastructure projects, but only after they are completed. Because many of these jurisdictions are among Poland's poorest, they frequently do not have the funds to begin even modest improvements. As a result they cannot access the funds designed to help them, and the consumption of SAPARD funds has been slower than expected.

To solve this problem, many Polish banks and also the Environmental Funds have begun to offer so-called bridge credits to local governments for SAPARD-related projects. Some local governments have been reluctant to use these loans because they see no reason why they should have to borrow at commercial rates to access grants. Others can not use them because they have already reached their statutory debt limits. In fact, 23% of *gminas* who did not apply to SAPARD in September of 2002 stated that the main reason was that the borrowing they would have had to incur to access the SAPARD funds would push them over their debt limits (Majchrzak 2002). A further 61.5% of respondents said they did not apply simply because of an overall lack of funds.

These opinions run parallel to the negative market trends that we have already described. It is among rural *gminas* that we see the greatest number of local governments that have not borrowed. This is a result both of their financial position and the skill-level of their officials who do not understand the market and are afraid of it. At the same time, it is precisely among rural *gminas* that we see the greatest number of local governments that have crossed or are close to crossing their statutory debt limits: of the 21 local governments whose total outstanding debt in 2001 exceeded 60% of their revenues, ten were rural *gminas* and seven were rural-urban jurisdictions, while of the 48 local governments whose total outstanding debt was greater than 50% of their revenues (but less than 60%) 25 were rural *gminas*, and 13 were rural–urban jurisdictions.

Many local governments also complain that their obligation to choose lenders through the use of the Public Procurement Law takes up too much time and complicates already burdensome EU grant procedures. Whether these complaints are really justified is hard to tell because many local governments would rather not use the Public Procurement Law at all[59] and/or have had difficulty mastering the art of issuing tenders that really reflect their needs.

Inexperience with the Public Procurement Law may also account for another problem raised by local governments with respect to bridge loans. In short, local government officials frequently complain that the bridge loans offered by the banks are inflexible and do not reflect their real needs. This is because the banks typically offer loans for the entire value of the project, when local governments would prefer that they provide loan capital on an as-needed basis so as to avoid paying interest costs on the entire sum while the project is being built. Much of this problem, however, could be the result of the inability of local governments to issue tenders that clearly require banks to present offers in terms of commitment fees for standby credit, and interest fees for actually loaned funds. Finally, local governments would prefer that they repay the credit when

EU funds are made available, while the banks insist that loans be repaid on schedules independent of EU promises (Bogucka, 2002).

All of these problems have resulted in less use of the bridge loans by local governments than the banks had expected. Nonetheless and despite these problems, the SAPARD program is now enjoying considerable popularity and analysts estimate that the number of applications prepared by local governments in 2002 will amount to 162% of the amount earmarked by the EU for the next round of the program.

But the larger challenge for Poland raised by the absorption of EU investment grants is simply: Where will local governments get the capital they need to meet the EU's co-financing requirements? The scale of this problem can be illustrated by making a few assumptions and simple calculations. First, assume (conservatively) that Poland will receive about 12 billion zlotys (EUR 3 billion) of assistance per year from the EU. Then assume (again conservatively) that about two-thirds of this (PLN 8 billion, or EUR 2 billion) should be consumed by local governments for infrastructure investments. Finally, assume (probably unrealistically) that local governments provide only the minimum 25% share of co-financing required by the EU for every project they engage in.

Taken together, these assumption would mean that Polish local governments will have to find a minimum of two billion zlotys (EUR 5 million) a year in new investment funds if EU grants are not to substitute for existing investment spending. Or put another way, Polish local governments will have to increase their investment spending by 18% in order to fully absorb EU grant funds under the above assumptions. Moreover, if all of this increase were to be financed from debt, the total outstanding debt of Polish local governments would increase in the first year by more than 16%. Thus, even if local governments meet a substantial share of their co-financing requirements from current operating surpluses, the absorption of EU funds will require a significant expansion of Poland's subsovereign capital market.

The ability of local governments to increase their use of debt capital, however, may be blocked by the statutory limits currently imposed on their borrowing. As we have seen, an increasing number of local governments has approached or even crossed these limits and for many, particularly rural ones, this undoubtedly raises serious questions about their creditworthiness. Nonetheless, these limits have little to do with the real capacity of many local governments to finance debt, and maintaining these limits could well block Poland's ability to absorb EU funds effectively. In short, to make full use of EU grants, Poland will probably have to liberalize the regulation of municipal debt.

Even more profound and paradoxical questions are raised by the linkage of local governments' right to borrow with the borrowing of the national government. As we have seen, Poland wrote into its constitution the Maastricht Treaty's limits on the consolidated public debt of EU members. Unlike other countries, Poland, in its effort to bootstrap its way into the EU, not only included guarantees in its calculation of the consolidated public debt, but (uniquely) imposed limits on the right of local governments to borrow when the consolidated public debt exceeded 50% of the GDP.

Until recently, exceeding this level seemed only a theoretical possibility. But unfortunately this is no longer the case and in 2003 the Ministry of Finance expects Poland's consolidated public debt to cross the 50% threshold. As a result, in 2004 the ability of all local governments to incur debt will be limited by the ratio of the national government's debt to its current revenues. Thus, if the national government attempts to reduce public debt by, for example, lowering its own borrowing to 10% of its revenues in 2004, the statutory debt limit for all local governments for servicing loans would fall from 15% to 10% of their annual revenues. Obviously this would further limit the ability of local governments to increase their investment spending in order to make use of EU loans. In short, the measures Poland took to get into the EU may ironically hamper its ability to make effective use of the gains of EU membership.

5. CONCLUSIONS AND RECOMMENDATIONS

There is little question that Poland's subsovereign debt market is one of the most robust, dynamic and sound of the post-communist world. This is due first and foremost to the fact that Poland managed to avoid the jurisdictional fragmentation that occurred in many other countries, and has done a reasonably good job in assigning service responsibilities to appropriate levels of government and equipping them with adequate revenues.

The major exception here concerns the *poviats*. Many of them are too small and too fiscally weak to support the functions they have been assigned. The amalgamation of some of the weaker units would be extremely beneficial for the operation of the debt market. Similarly, it would be desirable if their revenues were made less dependent on earmarked grants.

In the same vein, the ability of all local governments to make effective use of the debt market would be increased if they were given greater revenue-raising authority. For municipalities this could be done most easily by increasing their control over the base and rate of the property tax, and/or by moving towards a more *ad valorem* system of property valuation. This could be done for all local governments by converting shared income taxes into local income taxes. Under such a system, the base of the income tax would still be set by the national government, and the national government would remain responsible for its collection. But local government would determine the rate they would impose on their residents, perhaps between minimum and maximum levels set by the national government.

Poland has also done a fairly good job in establishing a coherent regulatory framework for local government budgeting and financial reporting, and for municipal borrowing. With respect to the former, the major shortcoming of the current system is the lack of a clear separation of operating and capital budgets at the local level, and a confusing definition of what constitutes a deficit. As a result, it would be extremely beneficial to the operation of the market and to the overall transparency of local government finances if operating and capital budgets were formally separated. This would also prevent local governments from using debt capital to finance operating deficits.

Probably Poland should also impose some prudent regulations on what local governments can invest in, because sooner or later a local government will try to maximize its revenues by taking risks on the securities market and will get itself in trouble.

More problematic are the debt regulations that link local government and national government borrowing when the consolidated public debt exceeds more than 50% of the GDP. As we have suggested, this is both unwise and unfair. More importantly, it may seriously impede the ability of local governments to absorb EU structural adjustment funds if they must borrow—as they will have to—to meet the co-financing requirement attached to these funds. The simplest way to cut this link while still ensuring that Poland could meet its obligations under the Maastricht Treaty would be to set a global limit of 3% to 5% of the GDP on the total outstanding debt of local governments (currently it is 1.5%), while lowering the ceiling on the national government's part of the consolidated public debt to between 55% and 57% of GDP. This would at once create the borrowing room that local governments will probably need to absorb EU funds effectively, while also alleviating the moral hazards inherent in the current system. It will also, however, force the national government to adopt more rigorous fiscal policies.

In the same vein, Poland might consider removing the current stock and flow limitations that are being used to regulate municipal borrowing. There are three reasons for this suggestion. First and most importantly, these limitations provide a false sense of security that encourages lax attitudes among lenders, because the real creditworthiness of a local government has little to do with these limits. Second, as we have seen, the limits are difficult to enforce in practice. And third, these limits may again restrain the ability of local governments to absorb EU funds.

Poland would also do well to make greater use of means testing in the allocation of national government investment grants, to ensure that these monies do not crowd out commercial borrowing and that those that can pay for infrastructure improvements on their own would do so. With the inflow of EU structural adjustment funds, the biggest challenge here probably lies in developing a domestic system of differentiated co-financing rates for EU monies. This would guarantee that the poorest jurisdictions were only responsible for the minimum 25% own contribution, while the richer ones would have to come up with more.

Finally, there must be a continued effort to enhance the planning skills and capacities of local governments, particularly in rural jurisdictions, in budgeting, finance and capital improvement. For many years it was outside donors who supported such training efforts. But if Poland is to make maximum use of its subsovereign credit market and prevent mishaps, the national government must make a concerted effort to continue an endeavor that has clearly seen results.

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NOTES

1 As we explain later, the term "operating deficit" is not defined in Polish law, as there is no formal separation between capital and operating budgets (and as we argue in this chapter, we think this is a serious drawback of the Polish system). When we use term "operating revenues" further in the chapter, we define it in a simplistic form as total revenues net of capital grants received by local governments. (In more sophisticated formulation we should also deduct revenues from municipal properties). The term "operating surplus" we define as operating revenues minus operating expenditures.

2 There has been considerable inconsistency in the use of the terms "own" and "delegated" functions. For example, both pre-school education for six-year olds and primary education are considered own functions. Local governments, however, must finance the education of six-year olds out of their general revenues, while they receive a per pupil subvention for primary education (as part of a freely disposable grant). See Levitas, 1999.

3 Preschool education was made an own function in 1991. Between 1991 and 1996, *gminas* could assume responsibility for primary and secondary education on a voluntary basis. After 1996, responsibility for primary education was made obligatory. In 1999, secondary education became an own function of counties.

4 The 1999 reforms created 17 self-standing health insurance funds, 16 regional funds, and one fund for certain groups of civil servants. In 2002, they were reconsolidated into a single national fund which is financed by a percentage of personal income taxes. Initially, the *Sejmiks* were responsible for the oversight of these funds. They remain responsible for the oversight of the environmental funds discussed later in the text.

5 The only major "local" responsibility that has not been transferred to local governments is the police. County authorities, however, have a role in nominating local police chiefs and a substantial part of public safety spending comes from county budgets.

6 There has been considerable confusion in Poland over the term own taxes, with many people considering shared taxes "own revenues" because of their origin basis and their stability. Indeed, the Ministry of Finance has recently and regrettably begun to treat shared taxes as own taxes in many of its statistical reports.

7 This is a flat rate tax imposed on the economic activity of business with very low turnover. Over the course of the decade the turnover minimums have not been increased in line with inflation, making fewer businesses able to use this form, and hence reducing its importance to *gminas* as a source of revenue.

8 For many years Poland has been discussing placing the property tax on an ad valorem basis.

9 *Gminas* do have the right to impose special taxes if approved through a popular referendum. To our knowledge, however, only one *gmina* has successfully used this right. See Swianiewicz, 1996.

10 Not all own revenues are included here. Of those missing the most important is the small business tax or *octroi*, whose rates and base, like most other "own revenues" are set by the national government.

11 There are very significant differences in the structure of revenues (and expenditures) across rural, urban and mixed *gminas*. It is beyond the scope of this paper to seriously examine these differences. Not surprisingly, rural *gminas* are much more dependent on transfers than other jurisdictions.

12 Municipalities now receive 5% of CIT. For firms with headquarters located in other areas, the municipality in which the branch office is located receives an amount prorated on the basis of the percentage of firms' employees working in the branch office. Nonetheless, more than a third of all CIT taxes flow to the city of Warsaw.

13 At the same time, local governments whose per capita incomes are more than 150% of the national average pay into the equalization system a percentage (20–30%) of the difference between their per capita revenues and 150% of the national average.

14 It should be noted that local governments can spend the education component of the general subsidy as they see fit. Indeed, Polish reformers have consistently defended *gminas*' right to spend education monies on other functions by arguing that since primary education is an own function under the law on Local Governments, money received for it from the national government through the Law on *Gmina* Revenues should be freely disposable. In practice, few municipalities do this.

15 Prior to the 1999 reforms, the *Sejmiks* were composed of delegates appointed by municipal councils and not popularly elected representatives. Their functions were also purely advisory.

16 Unfortunately there has been little empirical work on this issue. The one study we know of compares the allocation policies in two regions for the year 2000. In one region, more than 50% of the funds went to poorer jurisdictions, in the other less than 50%. See Goluszek, 2002.

17 It superceded the Law on the State Budget of 1991. The new law introduced significant but not radical changes in the regulatory regime governing local government budgeting practices. In the following, we discuss the structure of the current regime, indicating in the text or notes where this regime differs from the past.

18 Article 11 paragraph 4; Article 24, paragraph 2 reads: "Public resources originating from particular sources cannot be dedicated to finance specifically named expenditures unless another law specifies otherwise." There are in fact numerous exceptions to the law with respect to the state budget, and the control and transparency of off-budget funds of the national government remains a problem. See Gilowska *et al.*, 1998.

19 There is a debate about the whether it is desirable for the national government to separate its budget into operating and capital components. Most countries do not do this because such separation might compromise the national government's ability to perform its macroeconomic, fiscal and redistributive functions. There is, however, general agreement that because local governments do not—and should not—perform these functions their finances resemble those of corporations more than those of the national government. As such, most experts feel that they should be required to separate their operating and capital budgets. Indeed, many states—both unitary and federal—require this separation for local governments. See Levitas, McCullough & Pigey, 1997.

20 For flow limits, guarantees are factored into the debt limit as that portion of the obligation which a local government would have to pay in order to meet the normal debt-service schedule of a credit if the borrower defaulted. In fact, however, under Polish law a creditor has the right to demand the repayment of the entire obligation if a debt service payment has been missed. For stock limits, the value of the entire guarantee is considered part of the outstanding debt. Articles 113 & 114, Law on Public Finances.

21 Article 51, Law on Public Finances. Article 112.2 of the Public Finance Law also states that local governments can only borrow from Polish Banks, a limitation which the Article also states will be waived when Poland enters the EU.

22 It is worth adding that local governments are still making use of hard currency loans because of the appreciating value of the zloty. They do this by stating the value of the loan in zloty terms and then signing standard currency-risk agreements with the banks. According to the NBP 13.4% of outstanding local government debt at the end of 2001 was in fact in hard currency, up 41% from the previous year.

23 Article 53, Law on Public Finances. The term "consolidated public debt" is defined by the EU as the total debt of the national government plus the total debt of local governments, minus loans between levels of government. The calculation of the consolidated public debt is governed by EU regulations on national accounts. The Maastricht treaty states that the consolidated public debt of EU members should not exceed 60% of the GDP, and that the deficit of the national government should not exceed 3% of the GDP. The way Poland calculates its consolidated national debt is more rigorous than EU standards because guarantees are included. Thus, in 2001 the consolidated public debt as calculated by Polish standards stood at 43.2% of the GDP while according to EU norms it would have been 38.7%. Poland is thus—at least on this front—more "European" than the EU itself. The Italian consolidated debt was 109% of the GDP in 2001, and both France and Germany currently have budget deficits that exceed EU norms.

24 According to the Ministry of Finance the consolidated public debt stood at 49.8% of the GDP in 2002.

25 This is particularly true because information on the consolidated public debt is contained in the budget law of the national government. As a result, local governments can anticipate when debt limits might kick in in subsequent years and thus try to borrow now, to avoid limits later.

26 The most famous case in this respect is that of Orange County, one of the richest in America that got itself in severe financial trouble by investing in extremely volatile futures markets, and then defaulted on its debt when the market turned against it.

27 Ordinance of the Minister of Finance #364 of April 14, 1999, concerning the specific principles for classifying debt considered part of the state public debt.

28 Attempts by the government to include such provisions in the law in 1999 were rejected by local governments on the grounds that they were too costly, and that in fact, local government accounts were monitored by the Regional Accounting Offices (see below).

29 The Budget Classification System is a three-tier system composed of chapters (*dział*), sub-chapters (*rozdział*) and paragraphs (paragraf). The System was developed in the 1980s for use in a radically different organizational and political environment. Over the course of the 1990s, incremental changes were introduced into the system but it wasn't until 2000 that major changes were made. The new system provides better comparative data on *gmina* finances, particularly local government debt. Nonetheless, it is still a very detailed, line-item set of reporting requirements and in and of itself will not encourage movement towards more output-oriented budgeting practices. It must also be used by the budgetary enterprises and auxiliary units of local governments.

30 Cochran, DeAngelis, Levitas, 1998. It is also unclear whether the RIOs have the financial skills to determine whether a particular borrowing will actually push a local government over the statutory debt limits in future years, since credits can be structured to postpone or substantially reduce immediate debt service payments.

31 CERA stands for the Central European Rating Agency.

32 During the 1990s, about a half-dozen Polish cities received ratings from S&P's or Moody's for hard currency bond issues. In most cases, the ratings were—strangely—equal to those of the national government.

33 Ordinance of the Ministry of Finance of August 1, 1995, concerning the specific principles of accounting and the unified chart of accounts for state and local government budgetary units and their auxiliary units, budgetary enterprises, state and local government targeted funds, as well as local governments and their units.

34 High inflation, poor information on the book values of many assets and the fact that public sector entities do not amortize their assets has made local governments very reluctant to spend the time and energy necessary to fully inventory and value their capital stock.

35 In the following we examine only the risk coefficients for assets on the balance sheets of banks.

36 There is also no adjustment of risk coefficients for rated and unrated debt instruments.

37 Information based on interviews with leading underwriters of municipal bonds and representatives of CERA and CeTO. Article 71 of the Banking Law limits the number of bonds or loans that a bank may have with a single economic agent to 25% of its own funds. Given the low level of capitalization of most Polish banks, and the size of many infrastructure investments, this limit may lead some banks to prefer underwriting bonds and purchasing some of the issue, rather than assuming responsibility for the entire loan.

38 Between 1994 and 1999 USAID invested considerable resources in helping the Polish SEC make Polish securities legislation open to municipal bonds. These efforts were on the whole remarkably successful.

39 It also created the possibility that assets related to essential public purposes could be used to satisfy the claims of bondholders.

40 Other amendments removed the requirement that bond issuers have three years of financial history, a requirement that impeded the formation of special purpose vehicles and thus blocked the development of securitized transactions.

41 The banks have argued that traditional forms of credit will be cheaper. It also seems that they have no real desire to issue revenue bonds because at the moment they regard local government general obligation bonds and bank loans as credits worth holding in their own portfolios.

42 The Polish Banking Association, CERA, CeTO and the KPWiG have requested that this fee be eliminated or reduced. There have also been claims that the charges imposed by the National Depository for Securities for the registration of dematerialized issues are too high, particularly for issues traded on the secondary market.

43 The National Environmental Fund was created on the basis of the Law For Environmental Protection of January, 1980. The regional funds were established in 1993.

44 For example, in January 1999 the rediscount rate was 15.5% while the three-month WIBOR rate was 14.8%, which is typically greater by a margin of 1%–2%.

45 The funds also subsidized investments during the 1990s by offering loans at fixed interest rates when inflation was quite high.

46 This fund was established on the basis of an agreement between the EU and the Polish government as a way to make use of the profits made from the sale of food aid provided to Poland during 1989-1990.

47 See, for example, Davis, K.J. (1988): "Municipal Development Funds and Their Intermediaries." World Bank: Washington; Laidback, J., J. Ahmad, and R. Bird (1999): "Rethinking Decentralization in Developing Countries." World Bank: Washington.

48 Unfortunately, there has been little empirical work devoted to this interesting question. A study of the allocation policies of environmental funds in two regions during the 1990s shows that in one region, loans did go disproportionately to poorer rural jurisdictions. In the other, however, grants went disproportionately to poorer jurisdictions, while lending was concentrated in richer areas. See Pozniak, 2000.

49 Ordinance No. 5/98, Banking Supervision Commission of December 2, 1998 concerning the way of calculating the solvency of banks and the risk ration requirements of specific assets and liabilities.

50 Ordinance of the Ministry of Finance of December 10, 2001, concerning the rules governing the creation of banking reserves. Dz. U. 149.1672.

51 Earmarked grants including investment grants from extra-budgetary funds.

52 Borrowing on preferential terms is treated a little differently, as an occasion that must be taken advantage of and as a way to show one's voters that you are quick on your feet.

53 Research shows also that this correlation is present when borrowing is compared to own budget revenues as opposed to total budget revenues.

54 Some 200 local governments entered into long debt agreements despite running budget surpluses in 2001. Moreover, in over 1,000 cases, the planned borrowings for the year exceeded the planned

deficits, raising questions about what the debt was to be used for. RIO officials explain this as the product of a time lag in which "income" from borrowings made in the previous year is realized in the next year. Even so, this "extra" credit should be registered in local government budgets as planned revenues and expenditure.

55 "Budget execution of Local Government in 2001 in light of the report for the *Sejm* and Senate." *Finanse Komunalne*, April, 2002.

56 As we have indicated earlier, Poland, unlike Hungary, for example, has not passed any municipal bankruptcy procedures that would allow for the orderly working out of the financial troubles of local governments.

57 It is necessary to remember that these funds are legally restricted from owning more than 5% of privately issued securities from a single issuer, and 15% of the publicly issued securities of a single issuer. They would probably be interested even in illiquid assets. But it clearly does not pay for them to initiate a transaction for extremely small sums.

58 Local governments officials often make statements like: "We can't choose the most attractive offer because the bank that offers it must also win the tender, and nobody can guarantee that."

Local Government Borrowing in Hungary

Gábor Balás
József Hegedüs

Table of Contents

Local Government Borrowing in Hungary

Gábor Balás and József Hegedüs

1. INTRODUCTION: LOCAL GOVERNMENT REFORM AND BORROWING[1]

Hungary has gone through a radical structural change since the fall of the socialist block in Central and Eastern Europe. Two basic processes dominated the transition: privatization and decentralization. Hungary's experiences offer evidence that political decentralization of the state sector can make a substantial contribution to an efficient economic adjustment during the period of transition. Local governments under fiscal pressure but enjoying broad autonomy over spending have chosen a level and a form of public service provision that resulted in huge advantages both at the macro and micro level. However, the experience has also shown that political, fiscal and administrative decentralization is a process that inevitably involves conflicts between different stakeholders. The sector ministries, the local government associations, the different types of local government (small towns, big cities and the capital, Budapest) and sectoral business groups (e.g., service providers) naturally express different interests in intergovernmental relations. The process of decentralization is not finished, and in certain areas some movement back towards centralization can even be detected.

The process of Hungarian decentralization has been burdened with several conflicts related to the typically weak and sensitive points of intergovernmental relations: fragmentation, unfunded mandates, unclear expenditure assignments, moral hazard, the nature of incentives and deficit grants, equity issues and equalization grants, etc. Badly designed instruments such as grants or laws have taken a social toll on the transition, but this has not outweighed the benefits of decentralization.

The three key elements of the process are: the democratic election of the local self-government, the provision of substantial expenditure responsibility and autonomy, and the enforcement of hard-budget constraints on the independent local budgets.

Since 1990, the law in Hungary has provided these key elements of successful decentralization. As a result, local government expenditures decreased by 10% between 1991 and 2000 in real value, while the level and scope of services provided did not decrease at the same time. However, the country was lacking in some important elements of a well-functioning system, such as a well-trained and skilled local administration, a modern accounting system, a tradition of public participation, a well-developed statistical system, a process of objective auditing, local budgetary and financial management practices, etc. But Hungary has learned a lot in the past ten to twelve years; now it is time to start the modernization of intergovernmental fiscal relations based on the experiences and the expectations of EU accession.

The 1990 Local Government Act resulted in the political collapse of the former system. A new democratic system was introduced which gave the right to every settlement, even the smallest, to set up a municipal government to manage its own affairs. The new system is a unitary government with a two-tier subnational structure, where the municipal government provides services at the settlement level, and the county government at the regional level. County governments have no right to direct municipalities, as they are self-governing units with different responsibilities. The basic rights and power of local governments are exercised by an elected council, which sets up committees with special rights and responsibilities. The directly elected mayor is the head of the office with two functions: execution of the decisions of council and delegated state tasks. The major administrative function is managed by the chief administrator (notary). The Local Government Act decrees that towns, cities, the capital and its districts as well as counties have equal rights as local governments.

After 1990 the number of local governments grew from 1,523 to 3,154 (1999), as many of the local councils separated themselves into discrete units. This was a political reaction to the forced amalgamation policy of the 1970s. The 19 counties (the middle tier) that used to be one of the strongest power centers still exist, but their responsibilities have been scaled back. The counties are now parallel authorities and unrelated to the localities. The local governments in Hungary have an average of 3,482 inhabitants, quite far from the average of 10,000 considered to be "optimal."

Nineteen percent of Hungarians live in the capital, Budapest, and the city accounts for one-third of both GDP and capital investment. The central role of the capital city has been recognized in law by defining special procedures in revenue allocation. The local governments of Budapest have joint revenues that have to be allocated between the municipality and the districts according to expenditure needs. The central government has established general guidelines for revenue division among these local governments, but has given the responsibility for setting up a revenue allocation system for the capital to the Municipality of Budapest (Balás, Hegedüs, 1999).

The government is currently discussing the future of the regions. Today there are formally seven regions with Regional Development Councils that have only limited authority. There is a four-year program for regional reform, which would lead to the creation of seven regions with elected councils. This would establish a regional structure that would be a new, locally-elected tier of government. One of the purposes for creating regions is to facilitate the channeling of EU structural funds. However, this new tier of governance would call into question the continued existence and role of the counties.

One of the weakest points in the Hungarian intergovernmental system is the lack of long-term borrowing for capital investments. The paper addresses this question of why, after twelve years of decentralization, borrowing has not become a normal way of financing capital investments. We have organized this discussion in four parts.

In the first we describe the main tendencies in borrowing, and conclude that the level of local government indebtedness is very low compared to developed countries. We discuss a serious methodological problem of having off-budget local government entities such as public works and other institutions, which operate as "private enterprises" owned entirely by the local government. Any approach that ignores this "sub-sector" could lead to a misinterpretation of the problem. The fact is that most of the data and information is structured in a way that makes it almost impossible to analyze this "grey sector" of local government borrowing. In an earlier study we stressed the importance of the off-budget activities (Hegedüs, *et al.*, 1999), and a paper produced by the World Bank (Kopányi, Hertelendi, 2000) also showed its importance. However, no real research has been done on this area.

The second part of the paper summarizes the legal environment of local government borrowing. We put a special emphasis on the "local government bankruptcy" regulation which was considered to be a path-breaking law to regulate borrowing and to stop the "moral hazard" attitude of irresponsible local governments. However, the authors do not have clear evidence on how this law has actually influenced local government behavior.

The third section investigates the demand side of the municipal credit market and tries to identify the factors explaining the low level of municipal loans. One hypothesis is that local governments are generally reluctant to borrow. But there are perhaps some understandable reasons for this attitude. One could be the political fear of indebtedness, since the public considers borrowing as a sign of financial insecurity. Furthermore, local governments are not prepared to borrow because they lack the capacity to manage debts. Within the present intergovernmental finance system, local governments have no means of prediction and cannot foresee their future revenue sources with sufficient certainty to take risks with borrowing. Paradoxically, local government borrowing is limited not only by the lack of stable resources, but also by the windfall gains from privatization that serve as a substitute for loans.

The decentralization policy of central government has a significant impact on the borrowing activity of the local governments in four ways. First, changes to regulations have set important limits to the indebtedness of local governments, and these have had the effect of ruling out certain local governments from borrowing at all. Second, the central government investment grants and other financial supports for local investment decisions tend to discourage municipal borrowing. Because of unclear eligibility criteria for access to central grants, local governments prefer to postpone borrowing. To a large extent, local government behavior depends on the grant structure. With well-structured matching grants, the conditions for access to the grants require own resources that can be provided through borrowing. Third, macroeconomic trends in Hungary caused a high inflation rate in the 1990s and also a high rate of interest due to the crowding-out effects of the central budget deficit. These factors increased the cost of borrowing significantly. Fourth, the unpredictability of the central resources, which account for more than half of local revenues, increases the risk for local governments in assuming long-term commitments.

In the fourth part of the paper we investigate the supply side of the local borrowing market. Are there any constraints from the point of view of the financial market against lending more to the local governments? Is the banking sector developed enough to serve local governments? Are the banks unwilling to lend more or are they just unable to offer advantageous financial conditions for local government borrowing? Does the lack of bond financing originate from the supply side, e.g., the lack of secondary markets for local government bonds, or from the demand side, e.g., local governments not wanting to be pioneers in this segment of the financial market?

Our research was based partly on the experiences of earlier MRI projects, and partly on small-scale empirical investigations undertaken specifically for our present purposes. We conducted three case studies on local government borrowing practices (in Szolnok, a county seat, Csepel, a district of Budapest and Gyöngyös, a medium size city). We also administered a questionnaire to obtain information about facts and attitudes towards borrowing. Thirty-eight responses were received, and although this is a small and not representative sample, the responses are illustrative of some of the problems regarding local government borrowing.[2] Additional information was gleaned from newspaper clipping services.

2. TRENDS IN LOCAL GOVERNMENT BORROWING

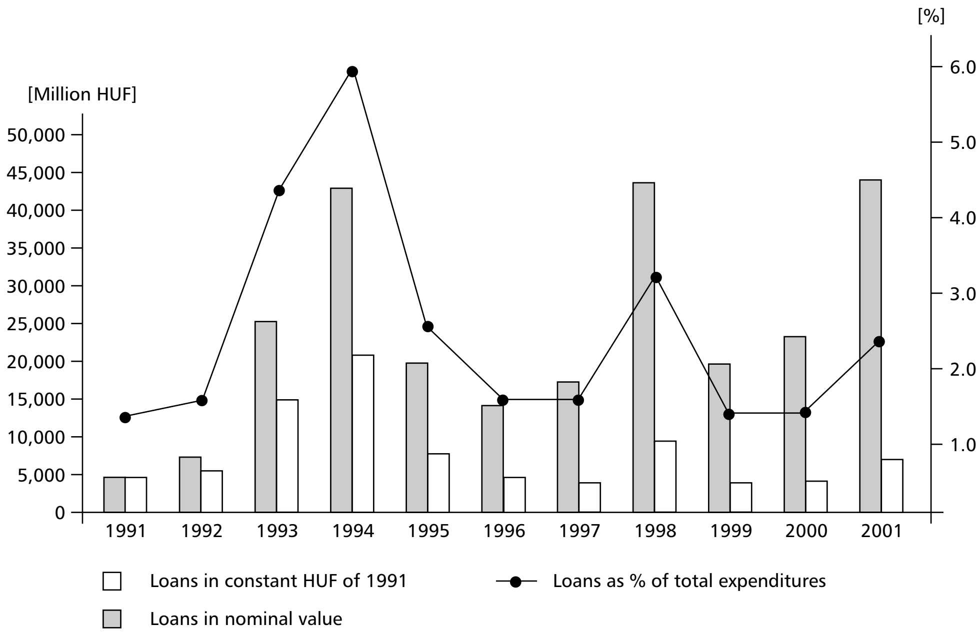
2.1 Local Government Borrowing: Flow

According to the Act on Local Self-Government of 1990 local governments are in principle free to finance their budget deficit through the capital market.

Borrowing does not play a determining role in local government finance, as Figure 3.1 shows. It reached almost 6% of total expenditures[3] in 1994, but typically it represents 1% to 3% of the total expenditures. A second observation from Figure 3.1 would be that borrowing follows a cyclical pattern: before the elections (1994, 1998, 2002) borrowing increased, but in real terms the changes are not significant.

Csepel local government was very cautious about borrowing until 2002. In that year the approaching elections generated a significant demand for investment that the budget could not accommodate. To finance it, the municipality took a loan from OTP Bank—a so-called framework loan—for one billion HUF. The contract defined the eligible purposes for which the municipality could draw the loan, and it can be drawn down until the middle of 2003. By the end of 2002 the municipality had taken only HUF 200-300 million, because of the delay in public procurement procedures. The loan was taken with a three-year grace period and a ten-year repayment term, at a fixed rate of BUBOR plus 4.5% (currently slightly more than 10%), and with interest determined on a quarterly basis. The contract lists nearly all of the municipal investments as valid purposes. Larger investments are the public utilities construction on the main road with related road construction, and construction of a main collecting pipe. Smaller projects are included as well, e.g., water wells in the outer parts of the district.

Figure 3.1
Local Government Borrowing in Nominal Value and Constant Value [Million HUF], and as a Percentage of the Total Expenditures



Source: Ministry of Finance.

A more detailed analysis of trends reveals that the municipal credit framework in Hungary evolved in two general phases. In the first phase, from 1990 to 1995, there were no formal, central rules constraining local government borrowing—no debt service limits, no reporting requirements and no separate specifications for the issuance of municipal bonds. Probably this is one of several factors explaining the decrease in local government borrowing in the second half of the 1990s.

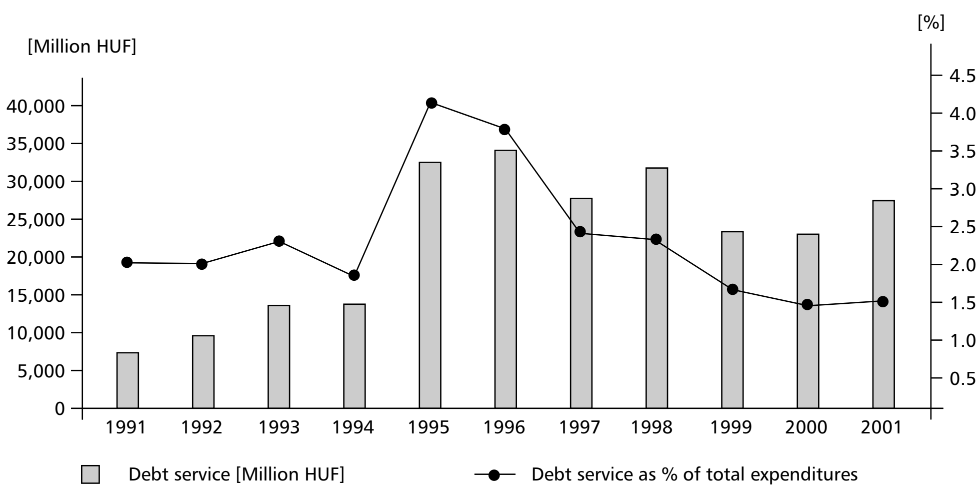
The revenue structure of local governments has changed in the last decade, and this can be observed from 1994 to 2001 (see Table 3.1) when the share of own revenues increased from 20% to 31.9%. This was accompanied by a parallel decrease in the state grants. The role of loans in the revenue resources of the local governments remained marginal from 1995 to 2001, accounting for just 2.2% to 4.4% of the total revenues. These data provide evidence of the cyclical nature of borrowing: in 1998 and 2001 borrowing increased relative to total revenues.

Table 3.1
Main Sources of Local Government Revenues in Hungary by Structure [%]

Years	1994	1995	1996	1997	1998	1999	2000	2001
Own revenues	20.0	22.2	29.9	34,0	30.0	31.9	33.5	31.9
Transfers	75.1	75.8	68.9	64.9	67.4	67.0	65.4	66.2
Loans	4.9	2.1	1.2	1,2	2.6	1.1	1.1	1.0
Total	100.0	100.0	100.0	100,0	100.0	100.0	100.0	100.0

Source: Ministry of Finance.

Figure 3.2
Local Government Debt Service Payments as Percentage of Total Expenditures [Million HUF]



Source: Ministry of Finance.

The significance of borrowing can be assessed by noting the share of interest payments and loan repayments in local government expenditures. By 1995 debt service costs had increased to 4% from 1.5% in 1991, and then decreased to 1.5% by 2001.

The data show that municipal borrowing exists, but is in a very early stage of development. However, the low averages do not necessarily mean that some local governments do not have difficulty managing their debts; rather, our case studies have indicated that the loans issued and the repayment burden are allocated very unevenly among local governments.

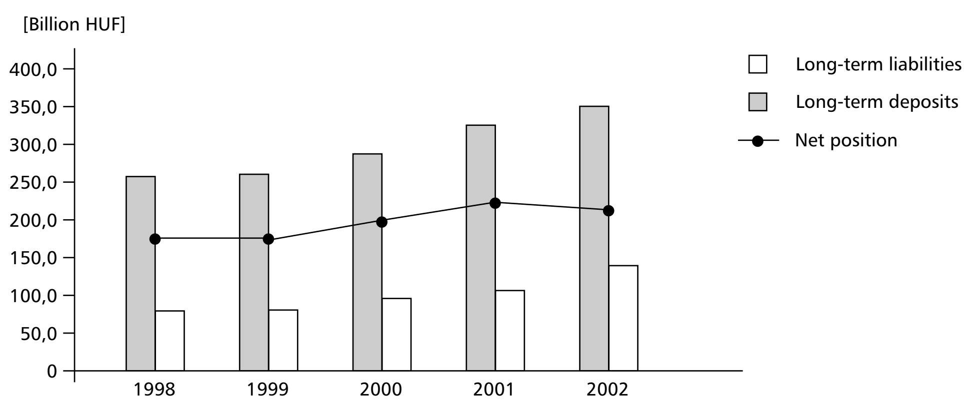
2.2 Local Government Borrowing: Stock

The Hungarian National Bank has been publishing more detailed data about the stock of local government loans since 1998. Again, these data demonstrate that despite an increase of outstanding debt in the past few years, local governments have not been utilizing the possibilities of the credit sector. The increase in debt is remarkable not only in nominal, but also in real value: the long-term liabilities of the local governments increased by 142% in real value (in 2001 prices) in the last four years.

Outstanding local government debt decreased from 1.1% of GDP in 1998 to 0.7% of GDP in 2002, which means that local governments have not contributed to an increase in the total government debt/GDP ratio. According to the EU Maastricht criteria, the maximum figure is 60%.

Figure 3.3

Net Lending Position of Local Governments in the Credit Market [Billion HUF][4] (1998–2002)



Source: Hungarian National Bank (data of 2002 is preliminary data in October).

Despite the increase in municipal borrowing, the local governments are still net depositors and there have been no significant changes in this position since the beginning of the 1990s. Compared to the total revenues of the local governments, the net position accounts for only 10%.

The structure of the local debt also shows some changes in the last years. Although banks are the most important source of the local government debt, there has been a new tendency in the last three years of local governments beginning to issue bonds in the domestic market.

Table 3.2

The Structure of Local Government Debt, in 2001 Prices [Billion HUF] (1998–2002)

	1998	1999	2000	2001	2002*
Bonds at domestic investors	0.8	0.9	3.4	4.9	7.1
Bonds at foreign investors	15.2	16.6	19.0	19.3	20.6
Loans from financial institutions	34.1	42.5	52.4	72.7	91.8
Loans from other state funds	4.2	10.1	6.1	5.4	4.7
Loans from abroad	7.2	6.4	13.1	28.0	27.8
Total amount of long-term borrowing	61.4	76.6	94.0	130.3	151.9

Source: Hungarian National Bank.

* Preliminary data in October.

The data in Table 3.2 show a rapid increase in local bond financing between 1999 and 2002 in local (domestic) bonds. Although the total bonds increased more than nine times in this period, this fact is mainly a consequence of the previous low level of municipal bond issuance. Despite the increase in local government bonds, their importance is still minor in the local credit market. In the Hungarian market, bonds are private issues. There are no public issues, and there is no secondary market for municipal bonds. These bonds are bought by financial institutions (banks, pension funds and insurance companies, etc.) and sometimes by the bank that managed the bond issue. One of the constraints to the increase of municipal bond issues is the fragmented structure of Hungarian local governments. Small local governments have much less opportunity to borrow than the larger municipalities, because they do not have real collateral and stable own revenues that are essential to their creditworthiness. Outstanding debt in the villages and smaller cities is less than 5% of their total revenues. In big cities it is 7% and in Budapest, 10% (see Table 3.12 later).

Foreign participation in the Hungarian local credit market is linked to the development of credits at the international financial institutions (e.g., the World Bank and the EBRD) and to the bond-issuing policy of the capital. As can be seen in Table 3.2 this had importance in 2001 and 2002, but there has been no recent tendency for local governments to borrow from abroad. On the eve of EU accession it is expected that the importance of foreign financing will increase.

Despite the expansion of the municipal bond market, the most important source of local borrowing is bank loans. The yearly 28% increase between 1998 and 2002 is also notable. We can see from the long-term data series that after a contraction in the mid 1990s, which was the consequence of the strict adjustment policy of the government in 1995 and possibly of the legal constraints in municipal borrowing introduced in the same year, there is a continuous expansion of bank loans.

2.3 Problems of Measurement: The Role of the Off-budget Local Government Sector

One of the general problems in cross-national comparison is that the financial indicators refer to the budget data, which do not represent the entire local government sector. Comparisons are difficult not only among countries with different institutional settings, but also within one country if the same services can be provided by both budget and off-budget institutions. In one case study (Hegedüs, 2002) the share of the off-budget activity was estimated as 12% to 16% of the total budget. In Hungary, the water sector with a yearly turnover of HUF 100–125 billion is a typical off-budget activity. This is 5% to 6% of total yearly expenditures of the local government sector.

In view of these facts, we must wonder whether the scope of borrowing is really as weak as it appears in the local government sector data, which ignores the off-budget activities of local governments.[5] The problem arises from the borrowing activity of the firms owned partly or totally by the local governments, and also from the borrowing of the firms that provide local public services in a contracting-out system, behind which the local government operates as an explicit or implicit guarantor ("lender of last resort").

Hungarian municipalities set up, took over or invested in almost 1,600 enterprises in the first decade of the democracy (See Table 3.3). Some of these originate from the obligatory conversion of previous companies of the local councils[6] into limited or joint stock companies. More than 75% are for-profit companies that provide fee-based or market services and also manufacturing and agricultural production. One-quarter are not-for-profit corporations providing public services not based on fees, e.g., social, cultural or community services (Hertelendy, Kopányi, 2000).

Table 3.3
Number of Enterprises with Municipal Shareholdings by Legal Form (January, 2000)

Limited partnerships	47
Associations	9
Public-purpose, non-profit corporations	324
Limited companies	1,067
Joint stock companies	99

Source: SAO Report 2000, in: Hertelendy, Kopányi (2000).

These companies are linked to public finance either directly (through in- and outflows to the local budget, e.g., operating and investment subsidies or guaranteed and non-guaranteed liabilities) or indirectly (through the factors affecting their operation, like setting local fees or due to concessions and contracts with the local government). The significance of these companies can be measured by the fact that their activity reached 2.6% of GDP by the end of the 1990s.

The role of the municipal enterprises is more important in local investment decisions. While local governments have spent 2.2% to 2.5% of GDP annually on infrastructure investments, municipal public service enterprises have carried out investments of an additional 1.5% of GDP. With respect to their sectoral contribution, municipal companies' investments in basic activities accounted for 30% of the total sectoral investment. In the supplementary service sector the proportion was 20%.

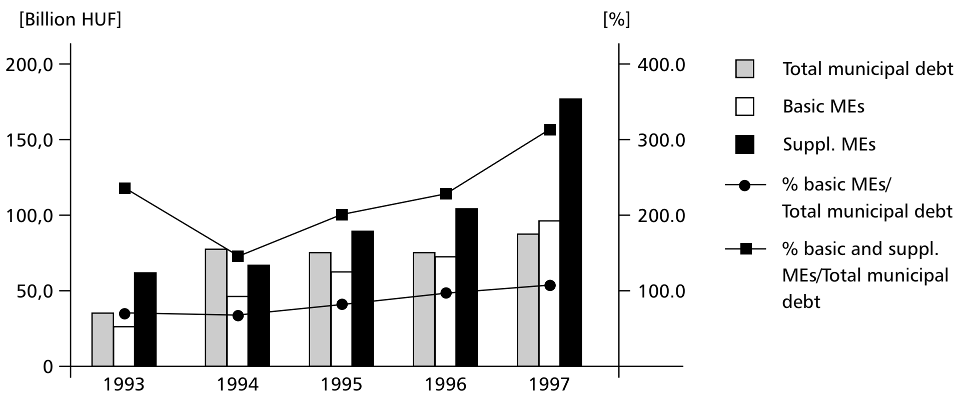
Companies in which municipalities have shares carried out investments of more than HUF 400 billion (nearly 5% of GDP). Of these, 31% was undertaken by gas and electricity companies and 38% by companies operating in other business services. Basic and supplementary public service companies invested nearly HUF 130 billion in 1997 (1.5% of GDP). Within supplementary services, telecommunication accounts for more than half of the investments. In the case of basic service companies, the distribution of investments is more even within the various sectors. District heating and the treatment of sewage and waste take up about 12% to 13% respectively, with water management and local transport accounting for 25% to 29% of the total basic service investment (Hertelendy, Kopányi 2000).

The role of municipal enterprises is also noteworthy in the field of local borrowing. Those municipal enterprises that provide basic services borrowed as much as the local governments, while all of the municipal enterprises borrowed three times more than local governments up to the end of 1997.

The World Bank projected that the local government municipal enterprises would play a larger role in local investment finance (Table 3.4). Their investment would double as a share of GDP, while local government investment would increase by 36%. What is important from the standpoint of intergovernmental fiscal relations is that the role of borrowing will continue to grow; that is, it will finance an amount of local investment equal to 2.5% of the GDP. At the 2003 level of GDP this would mean that around 80 billion in loans should be issued to local governments and 320 billion to public utilities. The real question is the users' ability to pay for the services in which investments are made.[7]

Figure 3.4

Total Municipal Enterprise Liabilities as Percentage of Municipal Debt (1993–1997)



Source: Hertelendy, Koppányi (2000).

Table 3.4

Local Investment Finance as Percentage of GDP

	Local Government		**Public Utilities**	
	1997	**2003**	**1997**	**2003**
Total investments	2.2	3.0	1.6	3.2
Investment finance: Savings (current revenue–current expenditure)	0.8	0.8	–0.3	0.2
External resources:	1.4	2.2	1.9	3.0
• EU grants	0.0	0.8	0.0	0.7
• Central grants	0.5	0.7	0.6	0.0
• Asset sales	1.6	0.2	0.0	0.0
• Borrowing	–0.7	0.5	1.3	2.0

Source: World Bank SNDP report, 2000.

The conclusion to be drawn here is that local borrowing cannot be separated from the borrowing of the municipally-owned public service companies. Their investment needs are very high and the accession to the EU will further increase the possible role of the bank sector in capital investment finance. Central government policy should be revised as well, in order to provide more incentives to borrow as occurred in the housing and education sector in 2000–2002.

3. EVOLUTION OF THE REGULATIONS

Regulation by central authorities has had a significant impact on the evolution of the municipal borrowing sector in Hungary. The central government influences the borrowing activity of the local government through legal acts and through financial incentives. Although the first involves direct control or monitoring of the local governments, this seems to have less impact than the central programs that provide an opportunity for the local governments to use loans as their own share in order to participate in central programs. On the other hand, some central investment grants provide opportunities for the local governments to avoid using market sources in the development of their services in some sectors. Issues arising from changes in the regulations are discussed in this section, while the indirect impact of the central government on municipal borrowing will be examined in further subsections.

The Act on Local Self-Government (1990/LXV) gave local governments the right to finance their operation from the credit market, with the constraint that the core assets of the local government (the property that is essential for the provision of mandatory services), the central grants and contributions, and the taxes and revenues transferred from the general government system for operating purposes cannot be used as collateral.

Regulation of local government borrowing and the eventual consequences of municipal default were implemented through three measures: the introduction of a debt-service limit for local governments in 1996, the Municipal Debt Adjustment Act (1996) and the Securities Act, which includes rules on issuance of municipal bonds (1997).

3.1 Debt-service Limit

The first direct limitations on municipal borrowing were set up in 1995, in the first amendment of the Act on the 1995 Budget of the Republic of Hungary. Although it was abolished in the same year by the Constitutional Court because of the violation of procedural rules, these limitations have been incorporated into the Act on Local Self-Governments of January 1, 1996. According to this limitation, the ceiling for annual payments by a local government resulting from debt (borrowing and associated expenses, bond issues, leasing and the provision of guarantees and surety) equals the adjusted current own revenues of a local government. Adjusted current own revenues are calculated as 70% of the local government's own revenues (from local taxes, duties, interest, fines, and other specific revenues) net of short-term commitments and liabilities (capital repayment, interest payment and lease fees) in the given year. Liquidity loans are not subject to this limitation.

Local governments contracting loans must have their budgets independently audited, which guarantees that they do not exceed the limits. In principle this procedure does not exclude situations where local governments have exceeded the limit because of revenue decrease (e.g., in local taxes). But in this case, local governments cannot take more loans.

The enforcement of the law is a different question. In 2002 there were four cases of local governments obtaining loans in spite of the fact that they were above the limits. The Ministry of the Interior, which is responsible for the local governments, learned about the cases only much later, as there is no systematic information gathered about how close local governments are to the debt limits.[8] In principle if a local government exceeds the debt limits, it has to announce a bankruptcy situation which is then published in the Official Gazette of Firms. Despite the lack of efficient enforcement, the debt limits are generally taken seriously by local governments, and this also serves the interests of the banks.

On the other hand, there is no other limitation on borrowing. There is no obligatory approval by any government body. Moreover, there has been no other control on borrowing from abroad than what has been required of private firms.[9] There is no limitation on the use of the loans, whether it is spent on investment or operation. But the local governments do need to comply, of course, with the general regulations of the financial institutions that provide credit to them.

The debt limitation by itself has been so effective that according to some experts it has excluded 50% of local governments from the market, because they do not have sufficient own revenues.[10] While this seems a strong effect, it pertains almost entirely to small municipalities that most likely could not receive credit from financial institutions without limitations. Thus, market control is as strong in this case as the regulations are. On the other hand, this limitation was not a real barrier for the larger municipalities that normally use loans for financing their investments, because they usually borrow less than would be possible according to the Act.

In our survey, 36 local governments of the 38 asked responded to the question: Up to what percentage did your municipality make use of this borrowing limit? Of the 36, 16 responded that they did not borrow this year, 9 said they had reached less than 50% of the limit and 12 were above 50%, including 2 municipalities that made maximum use of the legal possibility of borrowing. One, however, indicated that in the end they had borrowed more (133%) than the Act permits.[11] All three local governments for which the limitation made a real impact are small towns with budgets of less than HUF 3 billion and populations between 10,000 and 20,000. Among the smallest local governments there were no municipalities that borrowed this year.

In the case of Szolnok, the debt regulation would make it possible to take on much more debt than they actually did. The city has a loan of about two billion HUF and could take on an additional 1.7 billion HUF.

3.2 Municipal Debt Adjustment Act

The core change of the municipal borrowing framework in 1996 was the Municipal Debt Adjustment Act, Law XXV, in effect from about mid-1996. The law defines a debt adjustment process whose objective is to allow local governments to regain their financial health while at the same time protecting the rights of creditors. The provisions of the Municipal Debt Adjustment Act are quite sophisticated and impose a definite financial and moral cost on local governments who default on debt or other payments.

In the case of local government insolvency a debt settlement procedure is launched. When a local government or its budgetary organization has a debt which is more than 60 days overdue, the debt settlement procedure may be initiated. The initiator may be the local government itself, or its creditor, at the court. In its verdict, the court orders the launching of the debt settlement procedure and designates the financial trustee. The only obligation of the local government during the procedure is to provide the mandatory services defined in the law. It is interesting to note that these are different mandatory tasks from those defined in the Act on Local Self-Government.[12] During the procedure, the local government receives statutory grants.

The first phase of the procedure is the compromise phase, in which the local government and its creditors have to attempt to agree on the settlement of the debt, on the basis of which payments may be made. In this phase the financial trustee has the right of co-signature, without which commitment and payment may not be effected. Where no compromise is reached between the local government and its creditors, the court provides for the allocation of the marketable assets of the local government, guaranteeing that the core assets that are essential for the provision of the mandatory services will not be auctioned. Thus, the local government will still be able to perform its services after the procedure. The debts may be settled to the extent of the marketable assets. Regular personal payments, receivables covered by lien or bail and public debts are ranked first.

The support from the central budget is temporary, aimed at the payment of interest on loans taken out by the local government for the purpose of debt settlement and the fee of the trustee. Since this support is a loan, the local government is obliged to pay it back to the central government after the procedure is complete.

In the last seven years there have been only ten cases where debt settlement procedures have been completed. All of them were initiated by the local government concerned. Debts that were overdue usually financed investment projects of the local governments. This means either that the law threatening local governments with the negative consequences of the procedure has been successful in its intent, or that local governments and banks are cautious in borrowing in any case (Jókay *et al.*, 2000).

Managing the problem of municipal bankruptcy was an important policy step to increase market control on municipal borrowing. The municipal debt adjustment law made it clear that there is no implicit central guarantee behind the loans of the local governments. This law presents a message to the supply side of municipal borrowing: the risk of the local government loans is borne by the creditor itself.

3.3 Municipal Bond Regulations

Issuance and trading of local government bonds are regulated by the Act on the Capital Market, whose first version came into effect in 1997.[13] There are no significant differences in the issuance and trading of the municipal bonds other than the securities that embody a loan. Public offerings require the publication of a prospectus and bond offer announcement, both of which are subject to approval by the Supervisory Commission. The Securities Act does not regulate private placement of municipal bonds (the most common form for local governments to date). The Supervisory Commission has introduced specific regulations: (i) the minimum amount of a private issue must be HUF 5 million; (ii) investors must be specified in advance (with a letter of intent); and (iii) a brokerage firm must be employed in the transaction. In a public placement the minimum amount for a bond issue is HUF 10 million.

Issuing bonds increases the administrative cost of borrowing. The local governments have to provide more detailed information for the investors than they would in the case of bank loans. For the issuance they have to prepare a prospectus which, besides the compulsory elements, contains all relevant information essential for the investors to assess the risk of the securities. Because of infrequent municipal bond issues, there is no common practice concerning what information is needed for such an assessment. The banks or bidders have their own reporting forms that have to be used for this prospectus. All the issuers, thus the local governments too, have to publish a report every year with detailed information and send it to the Supervisory Commission. The report would indicate changes in the state of the issuer and all relevant information about the project that the bond finances.

Issuers also have to publish Extraordinary Information in all instances where important changes occurred in the project or in the local government. For example, after a local election they have to publish Extraordinary Information relating to the bonds.

While all the regulations for bond issuers are the same for local governments and other issuers, the compulsory information they are obliged to publish is slightly different from other issuers and thus is regulated in a separate appendix of the Act.

3.4 Other Important Regulations Affecting Local Government Borrowing

3.4.1 Selection of Account-keeping Bank

In most cases, local governments use the same bank for borrowing as the one in which they have their main account. It is also important to note that the local government has the right to change its account-keeping bank once a year not later than October 31. The institutions of the local government are also obliged to keep their account in the same bank.

3.4.2 Accounting Regulation

With respect to constraints on municipal borrowing on the supply side, an important factor is the assessment of the risk of lending to a local government. The problems partly arise from the accounting system of the local governments. The regulation prescribes cash-basis accounting for the local governments instead of accrual accounting (the latter being common in private enterprises), which makes the credit rating of local governments different from private firms' credit rating, creating a problem for the creditors. Cash-based budgeting is especially a problem in recording the capital expenditures. The local government budget records all the expenses in the year of the investment, rather than spreading it out over the life of the asset as is the case in accrual budgeting.

Since 1997 local governments have been obliged to produce a two-year forward budget plan attached to the yearly budget. Although it provides important information for the creditors, it also has the problems associated with cash-based budgeting, especially the problem of budgeting of capital expenses. On the other hand, the obligation to submit these budgets to the State Territorial Public Finance Office (TÁH) on a cash basis and in a structure that is different from the project view of a long-term loan, urges most of the local governments to use this type of budget in their decision-making process on capital investment, as well.[14]

3.4.3 Regulation of Asset Management

One of the main problems of local government finance is the asset management. Accounting regulations require that the assets are accounted for at face value. Consequently, most of the asset registry contains an out-dated, underestimated value of the assets, which is a problem both for local financial management and for the creditors who must assess the financial risk of a municipal loan. From 2003, a new regulation will oblige the local governments to reevaluate their assets according to real values.

3.4.4 Monitoring by the State Audit Office

Hungary's decentralized local government system requires no central approval of local budgets, but the State Audit Office regularly supervises the local governments' accounting. Although the audit concentrates on the legal aspects of the accounting, the auditors frequently point out management problems, e.g., if they identify a risk of asset-loss. The obligation of local governments to have their budget audited is an important regulation that makes the local government budget more transparent for creditors.

4. DEMAND-SIDE ANALYSIS

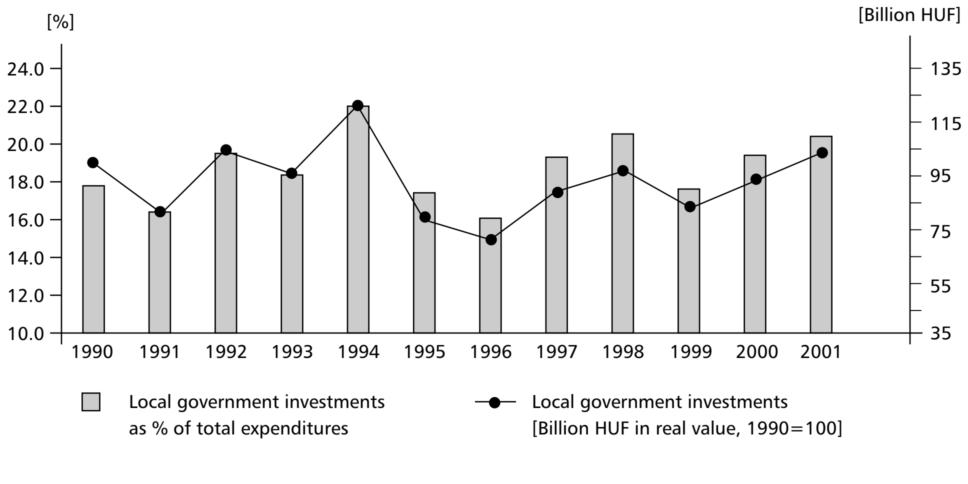
4.1 Municipal Demand for Long-term Investment Sources

In the decentralized system, municipalities identify investment priorities which do not necessarily coincide with mandatory and non-mandatory responsibilities. For instance, it is not a municipal task to build national freeways or roads bypassing the settlement. However, settlements are sometimes more interested in such investments than in investments related to mandatory responsibilities; they actually compete for such projects and are willing to sacrifice some alternatives such as building infrastructure, or providing local tax exemptions. Infrastructure development projects are typically municipal tasks. Some of these investments, such as building housing for sale and servicing plots, are short-term and tie up municipal capital only temporarily. These are the kinds of investments that could be made by the private sector, but the participation of the municipality is required due to the high risk involved (partly depending on the municipality itself), the lack of experience in and institutionalization of the cooperation between the private and public sectors as well as the underdeveloped level of the private sector.

In general, however, municipal projects are long-term investments that can be separated into two financing categories: (a) investments whose capital costs are covered from earlier government or local savings (known as *pay-as-you-go*), and (b) investments whose capital costs are financed by borrowing where—ideally—the loan is amortized throughout the life-cycle of the facility (*pay-as-you-use*). Municipalities' investment strategies have long-term budget effects, as a substantial part of public service developments is subsidized by the central government (e.g., education, social policy, etc.). Since the extent of central government subsidies is constantly changing, the higher the share of subsidies in the revenues of the municipalities, the greater the uncertainty regarding resources to finance capacities generated by the developments.

In 1990, local governments in Hungary became responsible for investments in the service areas according to their expenditure assignments. These represented huge investment needs in the areas of infrastructure and environment, especially with respect to EU accession. However, local governments also had to make up for the deferral of capital investment. Local government investments have remained quite stable in the last few years, between 15% and 20% of total expenditures. But because the local government share in the GDP has decreased, their investment share has decreased as a percentage of GDP as well.[15]

Figure 3.5
Local Government Investment in Real Value (1990=100)
and as a Percentage of Total Expenditures (1991 and 2001)



Investment needs arise from many different sources. On the eve of the transition, local governments inherited a huge number of properties, and some of the investment needs are related to the renewal of this property. Basic infrastructure investments (improvement of line infrastructure and improvement of unfilled land, e.g., for industrial parks) are typical local government needs, even though they are not related to any of their mandatory tasks. Mandatory services (typically the improvement of existing institutions) also generate investment needs that come from two sources: the development needs of local people, and the need to meet the improving standards that are set by central government regulations. The forthcoming EU accession also generates investment needs, e.g., to meet the increasing environmental standards. Last but not least, there are prestige improvements that typically arise as the election is approaching. We will now investigate these needs in more detail.

Future investment needs are related to the fact that the renewal of municipal property has been delayed and the quality of public services has deteriorated. According to reports dealing with this issue, municipal investments have for some time been much below replacement rates. Municipal assets accounted for HUF 1,800 billion in 1998 (a book-value evaluation) or HUF 6,000 billion (an experimental estimation of its market value). The replacement cost would be around 3%, which is less than investments in 1998 (HUF 279 billion).

At the beginning of the1990s, one of the main goals was to construct a basic infrastructure in the settlements, especially in the eastern part of Hungary. Despite the results, in 2000 49% of the dwellings in Hungary were not connected to any public sewage system. In the villages the percentage is 84%. The supply of piped gas is unavailable only in 25% of the households, a major improvement since1990 when the number was just below 50%. Future investments will need to fill this gap. Improvement of the road infrastructure will also be an important goal in the coming years. In the year 2000, 27% of the urban roads were not paved at all.

The improvement of solid waste collection is also among the most important goals of the local governments. In the environmental sector (water and waste management) the estimated investment needs in relation to the EU integration strategy are estimated to be HUF 1,200 to 2,000 billion, which represents 12% to 20% of GDP (in 1998).

The Local Government Act of 1990 transferred a number of important public functions to lower tiers of government. Some tasks are defined as mandatory, such as the provision of safe drinking water, kindergarten education, primary school instruction and education, basic health and social welfare needs, public lighting, maintenance of local public roads and the public cemetery and enforcement of the rights of national and ethnic minorities. The law defines the tasks of the local governments in a fairly vague way, and leaves a good deal of flexibility in service delivery. The definition of tasks in the Law on Local Self-Government allows wide room for local governments to define the quantity and the quality of the services, and even the way they are organized (contracting-out, privatization or public-private partnerships). This feature of the law and the flexible revenue structure make it possible for local governments to adjust. There are some exceptions, however, e.g., health care and fire protection services.

The right to make decisions regarding expenditures is not always welcomed by representatives of the central government, which is influenced by sectoral legislation and the supporting grants system. The sector laws redefine local government tasks. The interest of the sector policy-makers in increasing their share of the budget is an important motivation for proposed modifications to the sector laws. New standards have been set that are frequently impossible to meet under the current financial conditions of the local governments (Hegedüs, 2002). For example, local governments with over 10,000 inhabitants were obliged by law to provide housing for homeless families. However, although more than 200 towns fell into this category, only eight of them founded such institutions in 2001 because there were not enough investment sources to finance the initiative in the first years. Local governments usually adjust gradually; the missing institutions and missing levels of services are gradually matched by new investments, and with only a short delay compared to the legal requirement. Local governments usually have a few years' grace period to meet these legal standards.

As public choice literature has highlighted, the need for investment is influenced by the political cycles. In electoral years, local politicians have more incentive to "produce" tangible results and improvements than to maintain fiscal balance in the local governments. Figure 3.5 shows clearly that as an election approaches (1998, 2002), investment activity gradually increases in Hungarian local governments.

The attitude of politicians towards loans is very contradictory. The general view is that local governments should be very cautious in borrowing, because indebtedness always brings some risk and naturally limits new governments' room to maneuver. In election periods, it is normal to hear accusations that the city's successes were achieved by making the local government over-indebted. On the other hand, the government needs resources to have political success, and their attitude towards borrowing is quite positive. Their typical way of thinking is that "we will solve all problems through loans." In the case of Csepel, the financial discipline of the representatives was quite weak in the budget-making process, and because of this a district with a budget of HUF 12.5 billion had to deal with a deficit of HUF 2.5 billion in the year of the 2002 election.

Szeged, among the five biggest cities, is representative of the problem of over-indebtedness. The city has an outstanding debt of seven billion HUF, which represents 23% of the yearly revenue. Fifty percent of the debt is a short-term loan for financing the operational deficit, which caused a huge burden on the newly elected local government.[16]

Lack of predictability is one of the main constraints against long-term borrowing. Not only transfers, but also own revenues cannot be predicted properly, because of the frequent modifications of the regulations. (For instance, procedures for the local business tax have been changed every two years.) In the case of Budapest, the special equalization grant procedures add to the uncertainty, as the local taxes are redistributed among the districts and the municipality, which has the main responsibility for debt service. The transfers are defined each year by the assembly of the Municipal Government of Budapest.

4.2 Alternative Sources of Capital Investments

The main sources of financing local government investment include revenues from property (mostly the sale of assets), the grant from central government, other pass-through grants, loans and the "operating surplus." Because of changes in accounting and budgeting practices, we analyze these factors separately.

The role of loans has changed in the last decade. Figure 3.6 shows that in the years 1993 and 1994, loans covered almost 25% of the capital investments, but this share declined to 8% by 2001. The figure gives further evidence to support the earlier statement about the detectable influence of political cycles on local government borrowing and investment. In considering the possible factors that crowded out local government borrowing from 1994, we can conclude from our interviews that local governments use credit as a last resort for investments; they prefer grants, revenues from properties and the operational surplus over loans.

Figure 3.6

The Ratio of the Loans Issued to Local Government Investments (1991–2001)

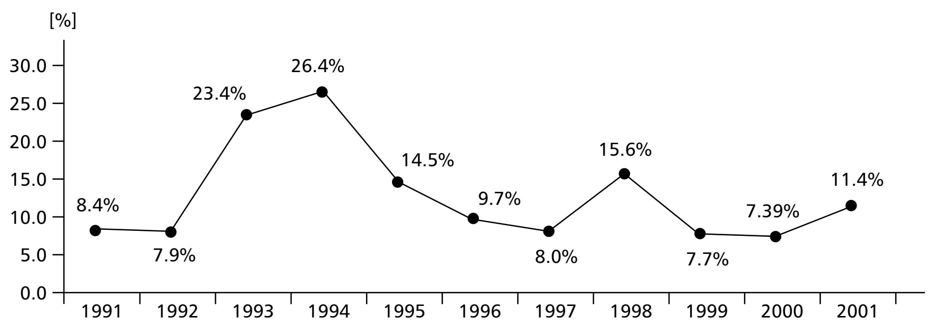


Table 3.5

The Financial Sources of Local Government Capital Investment (1994–2001) [%]

	1994	1995	1996	1997	1998	1999	2000	2001
Loans	26	14	10	8	16	8	7	11
Revenue from privatization, property, shares etc.	31	54	67	67	30	40	45	31
Capital grants to local governments	33	34	35	37	36	39	42	50
Other (operating surplus)	9	–2	–13	–12	18	13	6	7
Total investment	100	100	100	100	100	100	100	100

Source: Ministry of Finance.

In Table 3.6 we have tried to illustrate the possible role of other revenue sources in local government investments.[17] The revenue from local government assets was the main source, and in some years (especially in 1996 and 1997) it accounted for 67% of the total investments. Since 1997 its share has decreased. The second most important source is the capital grant, which accounted for 15% to 22% of the total investment, but continuously increased. The pass-through items and the operational surplus or deficit fluctuated accordingly.

4.2.1 Revenue from Property

On the basis of the Asset Transfer Law (1991), considerable assets were transferred to the local governments. These were comprised of: (i) primary assets necessary for the functioning of the local administration, basic education, health and social services, which may only be sold in a limited way; (ii) assets related to the provision of network and infrastructure public services; (iii) publicly-owned housing; and, (iv) other assets to compensate municipalities for original ownership stakes of former council companies.

It is difficult to evaluate the effect of the property transfer on the long-term capacity of local governments to finance their investments. The transferred assets could be managed by off-budget institutions (limited liability companies and foundations, etc.), which could generate revenues spent on services outside the LG budget. For example, property managed by an LG-owned company could generate revenue that could be used outside the control of the local government. On the other hand, many local governments have no capacity to manage these assets. In many cases, most of the property was sold and used to finance local government investments and, unfortunately, sometimes the operational deficit as well. Although most of the property transfer was conducted before 1995, some other additional transfers occurred during the second half of the 1990s, such as in the case of the privatization of state-owned companies. Local governments received compensation for the price of those urban lands that were used by the privatized firms. The compensation was usually paid in shares of public firms. As the privatization of gas suppliers occurred in 1996, this compensation was an additional asset that was transferred to the local governments. Finally, after some debate (and corruption scandal), local governments received additional compensation for these urban lands in 2000.

The revenue from property mainly comes from the sales of the assets. Although the scope of selling has decreased in the last years, it accounts for more than half of the revenues from property. The structure of the sales can be seen in Table 3.5.

Csepel, a district of Budapest, did not take any loans until 2002, since first of all there were no major municipal investments during the past ten years that would have required such a loan, and second, the security for minor investments was provided either from allocated subsidies or from state tenders. The Erőmű Joint Stock Company (a power plant located in Csepel) paid USD 1.5 million to the municipal development fund while the plant was being modernized, which also allowed for the financing of minor investments.

The structure of property sales shows that local governments first disposed of their shares to finance their investments, but as they gradually ran out of these assets, they moved to the sale of less liquid assets such as real estate. As mentioned earlier they received additional shares in 1997 and 2000 as compensation from the central government, and it is clear from the data that local governments immediately sold those shares or at least converted them into other financial assets.

Table 3.6

The Financial Sources of Local Government Capital Investment (1995–2001)

	1995	1996	1997	1998	1999	2000	2001
Selling physical assets [Million HUF]	43,699	42,968	51,242	51,404	60,165	76,059	81,417
As % of total revenue from sales of assets	63.0	47.5	36.1	72.4	73.3	67.2	87.9
Selling shares [Million HUF]	19,757	27,332	81,251	15,665	17,127	24,548	5,498
As % of total revenue from sales of assets	28.5	30.2	57.3	22.1	20.9	21.7	5.9
From privatization [Million HUF]	5,938	20,064	9,258	3,969	4,793	12,563	5,713
As % of total revenue from sales of assets	8.6	22.2	6.5	5.6	5.8	11.1	6.2
Total revenue from sales of assets [Million HUF]	69,394	90,364	141,751	71,038	82,085	113,170	92,628
As % of total revenue from property	87	85	84	50	50	55	50

Despite these one-time increases, the revenue from the sale of shares significantly decreased in the last few years. On the other hand, the privatization of local government firms provides less important sources for investment, and these firms are usually privatized not for revenue reasons but to increase the quality of services they provide. The only sources of further privatization revenues have been those from real estate. This entails three important problems: (i) it is limited, which could increase the demand for loans as investment sources in the near future; (ii) with the sale of real estate the local governments sell off the assets that are mostly used as collateral for their loans, so this can become a limit on future borrowing as well (e.g., in Gyöngyös the local government had to use their local tax revenues as collateral, because of the lack of valuable real estate due to previous privatization); (iii) the price of the real estate varies among the different regions of Hungary; thus, not only the quantity, but also the value of this revenue causes inequality among local governments and makes the credit ratings of local governments very different.

For the above reasons, this investment strategy of the second half of the 1990s that was based on asset sales will not be sustainable in the future to satisfy local government investment needs.

4.2.2 Capital Grants: Targeted and Addressed Subsidies

As mentioned in the previous section, the central government has a stronger impact on local government borrowing through those regulations and funds that initiate additional investments and push local governments towards municipal bonds or by crowding out the bonds from the investment finance, than by direct regulations on borrowing. We have indicated how the central government generates additional investment needs through its regulations on sectors. Here we summarize the financial incentives they apply.

Addressed and targeted subsidies increased to HUF 52.3 billion in 2000. These subsidies support municipal investments in priority areas identified by Parliament annually (clean drinking water, sewage, education and health care), although in very different forms. In the case of targeted subsidies the share of subsidy—as a percent of total investment costs—is set in each specific target area while addressed subsidies are discretionary decisions and often provide nearly 100% financing. Addressed subsidies were originally introduced to finance the continuation or completion of huge regional developments (hospitals and waste water plants) that had begun before the new decentralized municipal system. These objectives seem, however, to have been modified as addressed subsidies have been granted for new investments too, making the program economically unjustified. The volume of the two kinds of subsidy is defined by the annual budget law.

The targeted subsidy is a matching grant, where the matching rates are determined in the Law of Targeted and Addressed Subsidy approved by Parliament. The supported programs and the matching rates have changed in the last years. In 1999-2000, the priorities were building waste treatment plants and sewage networks (50% matching rate), investing in solid waste landfill (40% matching rate), buying special medical equipment (40% matching rate) and reconstructing educational buildings (50% matching rate). Recently the water sector has been the most important area for the targeted and addressed subsidy, with 47% of the grants being used in this sector.

Figure 3.7
Targeted and Addressed Subsidies [Billion HUF] (1991–1998)

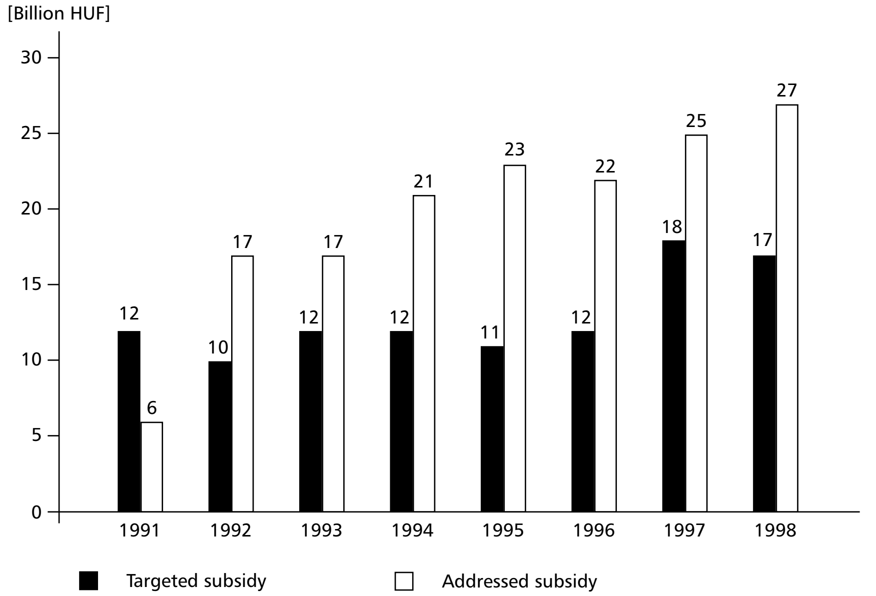
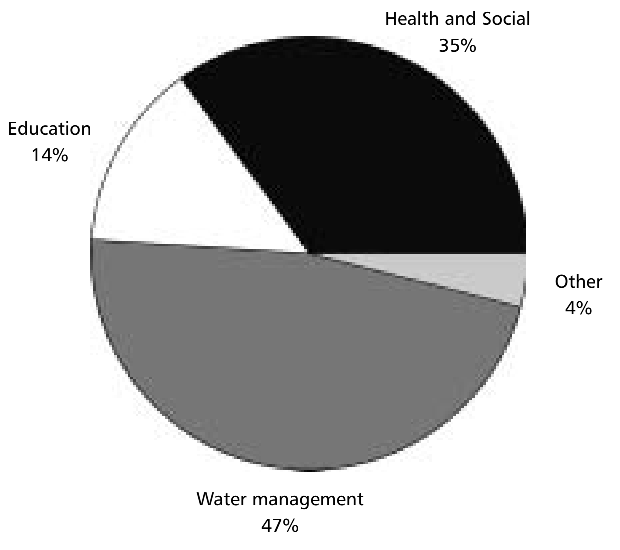


Figure 3.8
Distribution of Targeted and Addressed Subsidies among Sectors (1991–1998)



4.2.3 Sectoral Programs

Separate funds of the sectoral ministries are another source of investment financing. Since mid-1996, the grants for regional development have been distributed through the County Regional Development Councils (CDC). Three types of grants are available to municipalities through the CDC's: regional equalization grants, development subsidies and earmarked decentralization funds. Each development council sets local investment priorities, and the council manages the tendering process. The size of this grant program was HUF 14.6 billion in 1998 and HUF 16.6 billion in 2001.

The different sectoral ministries manage special programs and allocate resources according to tender procedures. One example is the housing program of the Ministry of Economics in the year 2000–2002, which launched a program for municipal rental housing investment programs. This was a grant program for local governments supporting five housing areas: the rentals sector, energy-saving renewal, rehabilitation programs, land development and the renovation of housing owned by churches.

Table 3.7

Grant Program for Local Governments and Churches (2000–2002)

Type of Program	Number of Applications	Demand for Grants	Accepted Application	Accepted Grant Request	Acceptance Rate by	Acceptance Rate by
	Number	Million HUF	Number	Million HUF	Number	Cost
Public rental sector	961	102,997	579	50,129	60%	49%
Energy-savings programs	387	1,612	355	1,553	92%	96%
Rehabilitation	4	254	2	245	50%	96%
Land development	53	3,171	26	1,546	49%	49%
Renovation by Churches	433	1,047	371	821	86%	78%
Total	1,838	109,082	1,333	54,294	73%	50%

Source: Ministry of the Interior.

The most important element in the grant program was its support of the public rental sector. The program gave an investment grant to the local governments for up to 75% of the investment costs for various purposes: social rental, cost-based rental, young family housing, homes for the elderly and pension homes. In the years 2000-2002, several hundred local governments took part in the program. The total investment amounted to HUF 50 billion, and more than 10,000 new units will be added to the rental housing stock as a result.

In 2002, Csepel municipality applied to the rental construction program of the Széchenyi Plan.[18] The own contribution of the municipality is financed through a subsidized loan scheme provided by the OTP bank. Since the costs of the project were underestimated,[19] instead of HUF 150 million of own resources, HUF 400 million had to be covered with loans. Of the total HUF 11 billion investment, the government has provided HUF 441.9 million subsidy, and the capital (Municipal Government of Budapest) has provided HUF 200 million for the right to choose 26 tenants. As part of the investment, a public utility development project is included, which was applied for in the Széchenyi Plan as well. If the city does not receive this subsidy, this investment will also have to be financed with loans. The municipality already has some loan proposals, which in the latter scenario will mean an additional HUF 100 million loan at a rate of 10%.

The success of the rental sector program is an indication of the commitment of local governments to solving the housing problems. Before launching it there were a lot of concerns in the Housing Policy Committee that local governments would not be able to participate because the majority of them would not possess the 25% own contribution necessary for participation. But the program was judged successful, as applications exceeded the grant possibilities. In all, 41% of applications were rejected, and the rejection rate was lowest in the social rental category. In the year 2000 there were no rejections, but the rejection rate increased to 52% in 2002 in the social rental category and to 63% in the cost-based category.

Table 3.8
Allocation of the Rental Program among Sub-groups
(2000–2002)

	Social	**Cost-Based**	**Elderly**	**Pension**	**Young Couple**	**Total**
Approved	73%	66%	41%	71%	44%	59%
Rejected	27%	34%	59%	29%	56%	41%
Total	100%	100%	100%	100%	100%	100%
Number	5,759	3,726	4,665	909	1,703	16,762

Source: Ministry of the Interior.

4.2.4 User Charges and Local Taxes

The Local Self-Government Act provides for a range of revenue sources to finance local government functions. The local revenues (accounting for 20% to 34% of the total revenues in the last ten years) include: five local taxes, user charges and revenues from assets and from entrepreneurial activities from the disposition of rental and commercial properties.

Local governments have the autonomy to set their own user fees and charges for public services like water, sewage, housing, district heating and garbage collection. However, they have no discretion over setting fees in education, social and health services. User charges (for water and garbage, etc.) are generally agreed upon by the board of directors of the different companies, public enterprises or mixed enterprises, where the local government is the main owner or shareholder. In the case of services given in concession to the private sector, adjustments in charges follow a procedure set by the law and are agreed on with the local government. Therefore, in principle, local governments may recover the full cost of service provision.

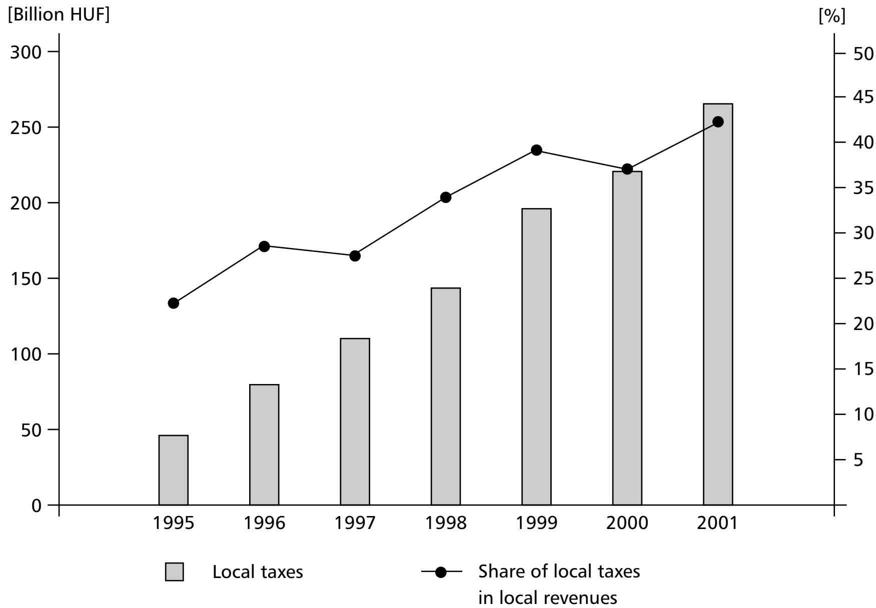
The 1990 Act on Local Taxes assigns five taxes to local governments: i) the business tax; ii) the communal tax (i.e., a poll tax and/or payroll tax); iii) the urban land tax; iv) the property tax on buildings; and v) the tourism tax. In practice, local governments must decide at their discretion and by resolution of their respective councils which of these taxes they want to levy in their jurisdictions.

The respective tax bases and the ranges for tax rates are established by the central government.

The share of local taxes in the local government budgets was around 13.4% in 2001. This is less than in the developed countries, but it is gradually increasing. In 2002 it became the most important local source of the local government sector. Unfortunately, the structure of the local taxes is unhealthy. The most important local tax is a business tax (accounting for 85% of local tax revenues). The tax base of this tax is unequally distributed among municipalities. Moreover, it is a mobile tax base and heavily depends on the business cycles of the country. As most of the local governments levy this tax with the maximum legal tax rate, there is no significant capacity to increase this source. On the other hand, it is very important for the municipal borrowing sector to increase the revenues from local sources in the municipal budget, as it provides a solid source for the repayment of the loans, thus increasing the financial rating of the local governments.

The tax capacities of local governments are significantly unequal in Hungary. This inequality has a spatial and a size dimension. The source of the inequality is the tax base of the business tax, as mentioned previously. While local taxes account for 24.4% of the revenues of the local governments in the Central Region of Hungary, this ratio is only 14.7% for the Northeastern Region (Szalai, 2002). While along the spatial dimension the central and northwestern parts of Hungary have an advantage compared to the eastern parts, the size dimension is more striking. The tax base of the business tax is concentrated in the larger jurisdictions. Most of the villages and small jurisdictions have almost no revenue from local taxes. There is a significant positive correlation between the share of local taxes in the local government revenues and the size of the local governments. On the other hand, if a large firm is established in a small village, it can raise revenues that exceed the needs of the local government to spend.

Figure 3.9
Role of Local Taxes in Local Finance (1995–2001)



Source: Ministry of Finance.

Larger firms that are settled in a small local government area make the local governments very dependent on these firms. For example, the national oil company (MOL) recognized at the end of 2002 that because of accounting mistakes they spent millions of HUF more on local taxes in the village of Algyő (the location of the oil-well) than their actual tax liability. Now they are requesting repayment from the village. The "bill," however, is as large as the yearly budget of the village.

While local taxes are the main discretionary sources of revenue for local governments, this inequality in local taxes is mirrored in the inequality of local borrowing. Most of the villages and small cities are excluded from the local credit market because of the lack of local revenues that would be the source of the debt service. This is not a minor issue, as 90% of the local governments are unable to borrow because of the lack of local revenues.

4.3 Local Attitudes and Strategies

While investment possibilities and alternative financial sources significantly influence the probability of local governments borrowing from the credit market, borrowing practices are still a matter of local politics, and the question of attitude and strategies plays an important role. While the previous factors determine how much local governments can and should borrow, the local politicians have to decide how much the local government will borrow, from whom, and what kind of loan construction will be selected.

The question of attitude toward indebtedness was revealed in the survey, as 50% of the 38 respondents answered that the attitude of the local assembly is negative toward borrowing and 15% of them explicitly refused to borrow. It is interesting that in large cities this negative attitude was even more prevalent, with six out of the ten respondents choosing this answer.

As is shown in Figure 3.11, there are different borrowing strategies among the largest municipalities (the cities with county-rights). While Salgótarján and Szeged are highly indebted, Győr is at the other end of the scale, with no long-term loans at all. The head of the financial department of Győr said that the local politicians refused to borrow despite the fact that the city would obtain a favorable credit rating and it would be a cheap source for local investments. The financial officer said there is a strong negative attitude toward borrowing that determines the local finance policy, although it is an unreasonable position to hold financially.

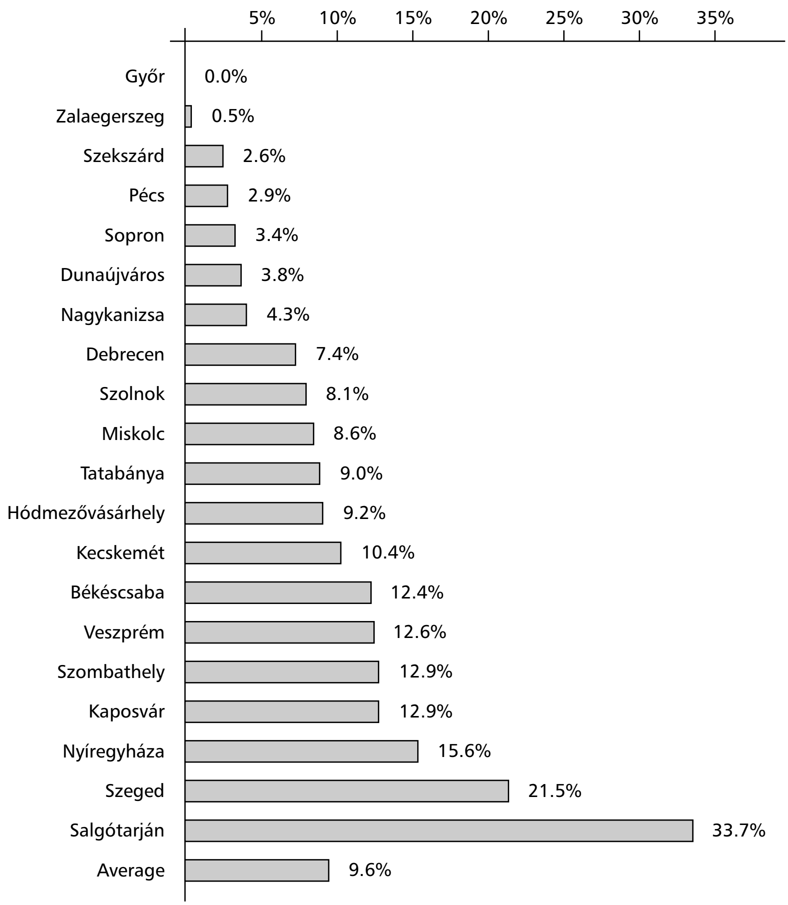
While this distribution of the scope of borrowing shows the importance of local borrowing strategies, it is important to note that there is a regional disparity in this data. At the cautious end of the scale the cities of the developed Northwestern Region are over-represented, while at the other end the centers of the less developed regions are represented much more.

Another important decision in local politics is how to select the creditor. The local governments learned in the last decade that there are positive gains from competition, and most of the local governments run a bid procedure to decide which bank will be chosen as creditor. On the other hand, the account-keeping bank is at an advantage in this procedure. In our surveys more than 60% of the local governments responded that it is an important factor in the selection of creditor.

In Szolnok, the local government usually borrows from the OTP Bank, the account-keeping bank of the city. According to the Head of the Financial Office, in those cases when the local authority offers a bid or selects another bank, they are not just interested in obtaining a better loan, but they also want to create an incentive for OTP to develop positive conditions in the future. In Gyöngyös, the banks were selected by bidding procedure except for the bond issuance of the city, which will be discussed later. In contrast, the Csepel district government of Budapest did not consider the possibility of a bidding procedure at all. They feel it is natural that the account-keeping bank should also provide the long-term loans for infrastructure investments.

The third important decision is the form of the credit. Should it be a bank loan or a bond issue? While this question seems on the surface to be a strictly financial one, it involves other factors too. The lack of bond issues in the local government credit market is not only the consequence of the underdeveloped secondary market, but is really a matter of local attitude. While some local governments have experimented with bonds, they are still not commonly used and the lack of best practices available in this field limits the spread of bond issuance.

Figure 3.10
Stock of Long-term Loans as a Percentage of the Annual Budget
in Cities with County-rights (2002)



Source: Association of Cities with County-rights.

In the case of Csepel, a bond issue was not an option. This was not for financial reasons or because of political fears. Rather, it was not regarded as a possible form of loan and therefore was not considered at all. The experience of Gyöngyös is quite the opposite and is very interesting. In November 2000, Raiffeisen Bank organized a product promotion in the city, where bond construction was professionally presented. The representative of the bank described cases where medium-size cities similar to Gyöngyös (e.g., Komárom) were successful in using a bond issue to finance their infrastructure investments. The politicians found this attractive, and thus decided to use it for financing the year's investments. In 2001, the city issued bonds valued at HUF 300 million with the cooperation of the bank, at 8.88% fixed interest for a five-year term with two years' grace period. Some other expenses came up related to the issuing: a one-time charge for organization and a sales charge at issuing, at 1% and 1.25% of the face value respectively. On top of this was the annual charge of the pay-off agent of 0.15% and an annual warranty charge of 0.5%. This bond was a private issue. That is, the city does not know who subscribed it or who possesses it. The bank was not chosen through an application process.

To summarize, there is a huge investment need at the local level that arises from the need to improve local services that suffer from delayed investments in the past, from the EU accession demands and from the lack of basic infrastructure in some parts of Hungary. On the other hand, alternative sources of funds determine how much the local government should borrow from the market. These sources are revenue from property, central investment sources, local taxes and user charges. Such revenues have not only crowded out credit from the financing of investment, but have also determined how much the local governments are able to borrow. The inequality in valuable property and further inequalities in the local tax base exclude 90% of the local governments from the credit market, mostly the small ones. The remaining 10% are the potential borrowers. The final decision on borrowing will be taken by local politicians and there is a significant fear of indebtedness among Hungarian local politicians that limits the scope of local borrowing.

5. SUPPLY SIDE: FINANCIAL INSTITUTIONS IN THE LOCAL GOVERNMENT CREDIT MARKET

The financial sector plays two roles in local government management. First, banks provide a service as the account keepers of the local governments. Second, along with other financial institutions they provide loans for the local governments. These roles are interconnected, but their relationship seems to have become less close in the last few years.

The Hungarian treasury system was introduced in 1996. There was a plan to include the local government sector in the treasury system, but this plan was abandoned because neither the local governments nor the banks (especially the National Savings Bank—OTP Bank) were interested. Beside this there were other concerns, such as the potential for hampering the independence of the local governments, etc.

5.1 The Market and Competition for Account-keeping

The market for banking services to local governments has been dominated by the OTP Bank, which had a monopoly in local government bank accounts until the end of 1991. Since the Local Government Law of 1990, local governments have been free to choose their account-keeping banks. The decision can be made only once a year, by October 31, and it takes effect from the beginning of the following fiscal year. Nevertheless, after more than ten years, OTP Bank still has the leading role in this market; in 2003 81% of the local governments still have their accounts with the OTP bank. In 1995 OTP handled banking for 95% of local governments. The second bank in terms of the number of local government accounts is the Saving Cooperatives, which is not one bank but rather several independent banks keeping the accounts of the small local governments.

The real "newcomer" in the market is the Raiffeisen Bank, which has 91 clients. They are typically cities, and represent 8% of the volume of the total budget of local governments. Raiffeisen started a local government branch in 1994. They had high expectations, as the head of the branch was recruited from the local government department of the Ministry of Finance.[20] They were quite successful in Budapest and other cities. They did not want to move to the market of small local governments because in small settlements the cost of the local unit can only be recovered if they have other financial products as well, like the small saving cooperatives.

Some local governments are pleased with their bank. For example, Csepel opened a competition for banking service only once, in 1997. The municipality never introduced a loan tender to select the account-keeping bank. The banks did not show great interest and finally OTP won again.

There is continuous competition among the banks in this market. In the beginning there was price competition, but today the quality of the services (computerized system, local cash management, local treasury and loan conditions, etc.) is an important feature. Other factors too, such as the personal connection between the bank's representative and the decision-makers at local governments[21] play a more important role in the selection. The fact that the bank can be changed once a year makes it very consumer-oriented, especially in the cities and with larger local governments. Raiffeisen has lost clients in only 5% of the cases. With smaller local governments the competition is not so severe, as the financial advantages are much smaller. The banks managing local government accounts generally provide a cash-flow credit line, and are willing to make medium-term loans for the local governments.

A typical way to get new clients is to offer a specialized loan product before the competitors, such as rehabilitation loans for condominiums, or by offering a well-designed local treasury system, water association loans, etc. In our small survey, 15% of the local governments indicated that they changed their bank in the last five years.

In terms of the market share of OTP Bank, there are no huge regional differences. There are only three counties in which OTP Bank has less than a 70% share of local governments: Komárom, Csongrád and Heves, which are located in very different parts of the country. In Budapest OTP Bank retains the market in 16 districts and the Municipal Government of Budapest, but it has lost seven districts.

Management of the local government accounts is considered to be a profitable business, provided that the local government is above a certain size. Although OTP Bank has lost some of its positions, it has kept its determining role in banking services for local governments. There are a number of factors which explain this fact. OTP Bank has the biggest network of local branches offering a wide range of financial services, and there is a perceived lack of experience of other commercial banks in handling municipal accounts and transactions.

Table 3.9

Share of the Account-keeping Market among the Banks (2003)

Banks	**Local Governments**	
	Number	**Share [%]**
OTP Bank	2,589	81
Saving Cooperatives	395	12
Raiffeisen Bank	91	3
Postbank	50	2
Erste Bank	20	1
CIB Bank	16	1
K and H	15	0
Budapest Bank	3	0
HVB Bank	5	0
Volksbank	1	0
Konzumbank	2	0
Total	3,187	100

Source: OTP Bank, Local Government Division.

5.2 The Supply of Municipal Credit

The normal type of credit is "credit with financial institutions," which accounts for 55% to 62% of total liabilities (the structure of municipal credits has been presented in Table 3.2). Two other important types are the loans by foreign banks in the form of bonds and direct loans, which accounted for 30% to 37% in the period 1998–2002. Bonds held by Hungarian residents are less than 5% of the total. Foreign loans are essentially issued to the city of Budapest. For example, after a tendering procedure in December 2002, Budapest contracted a loan of HUF 30 billion on the foreign market with 3.3% interest rate and two years' grace period, from a consortium of ABN Amro Bank, Bank Austria Creditanstalt/HVB Hungary and KBC.

Table 3.10

The Composition of Municipal Credit [Billion HUF] End of Year[22]

	1998	1999	2000	2001	2002
Bonds owned by residents	1.0	1.1	3.8	4.9	6.7
Bonds owned by foreigners	20.0	19.9	20.7	19.3	18.7
Credits with financial institutions	45.0	50.9	57.2	72.7	91.7
Credits with the government	5.5	12.1	6.7	5.4	4.4
Foreign loans	9.5	7.7	14.3	28.0	26.4
Total liabilities	81.0	91.8	102.7	130.3	148.0

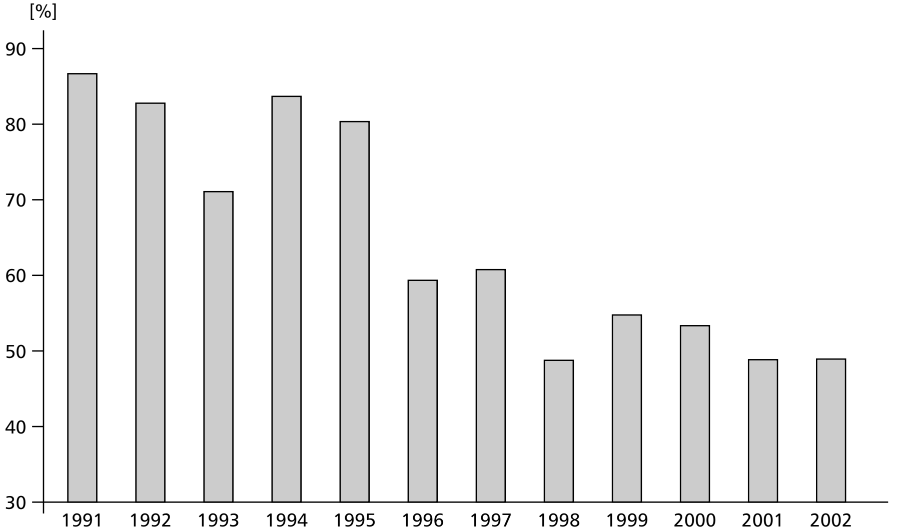
The market for the loans has been dominated by the OTP Bank, in the same way as the banking services. The competition in lending is as strong as in bank services for local governments. OTP Bank's market position has fallen from 85% to 48%, excluding loans to the water associations. The OTP Bank share is still 63.2% of the total market, which is lower than its share in bank services. (Source: OTP Bank)

Raiffeisein Bank controls around 18% of the market, and they have HUF 30 billion in outstanding loans. In lending there is tough competition among the banks, and local governments have started to turn this competition to their own advantage. The newcomers have to take more risks, and have to be more innovative in lending.

If OTP Bank manages the local government's accounts, the local government will often turn automatically to OTP Bank for a loan instead of inviting a tender from other banks as well. In the case of financial difficulties, OTP is quite flexible in finding solutions. OTP Bank argues they can offer the best conditions for local governments in terms of interest rate, the maturity of the loan and the collateral. The competitors accuse them of offering a "below-market interest rate" to out-price the competitors.

The OTP Bank in fact has the lowest cost of money, as they control the majority of household savings. On the other hand, the new banks offer risky loans (financially and legally) that would not be prudent for OTP Bank.

Figure 3.11
Estimates of the Market Share of OTP Bank Medium-term Lending Excluding Water Associations (*loan at the end of the year)



Source: NBH and OTP Bank.

Table 3.11
Size of Outstanding Loans Issued by Raiffeisen Bank [Million HUF]

	1999	2000	2001	2002
Short-term loans	1,207	1,166	1,723	3,932
Long-term loans (longer than 1 year)	5,569	5,038	10,813	13,885
Water Association loans	1,400	2,700	8,200	13,850

Source: Raiffeisen Bank.

The banks providing loans to local governments exercise financial control over the local budgets. In the case of Csepel, OTP Bank provided an advance loan for housing investment in 2001. However, the bank realized that the municipality's liquidity situation had worsened and it was regularly late with payments, despite the fact that it had financial reserves. For this reason, OTP has changed the ceiling of the frame-agreement from the HUF 900 million that was originally set in 2001, to a lower amount of HUF 200 million in 2002. Additional negotiations are needed to raise the sum to HUF 500 million in 2003.

In the case of bigger loans there is almost always a tendering procedure, which has an effect on the interest rate and the conditions of the loan. The public procurement law does not make it compulsory to announce a tender, but politicians want to make sure they are not accused of mismanagement or corruption.

The issuance of bonds by municipalities is even less developed than borrowing from commercial banks. Some of the limiting factors include the lack of regulations (until the passage of the 1996 Securities Act), the lack of a secondary market and the higher costs associated with issuing bonds. Since 1992 there have been several bond issues, none of these by counties. All but three were private placement issues. The three public issues were a HUF 100 million bond by Debrecen in 1995 and a eurobond issue by the Budapest municipality in 1998 for DM 150 million and in 2002 for HUF 30 billion in EUR.

There are two reasons why local governments use bonds. In the case of Budapest, for example, it seemed to be reasonable to issue bonds in order to increase the reputation of the capital. Budapest issued a bond in the period when the city did not really need the money. But presenting the capacity to borrow on the international financial market has enhanced the reputation of the city among potential investors. The other reason, which is particularly true for the medium-size cities, is that ordinary people view bonds differently from loans. To be indebted has a bad connotation, whereas bonds are not tied directly to the notion of indebtedness.

Small local governments cannot borrow as they do not have real collateral and own revenues. This is a direct consequence of the fragmented local government system. The villages and cities control less than 5% of their total revenues. In big cities this is 7% and in Budapest 10%.

Table 3.12

Outstanding Debt by Type of Local Government (March, 2002)

	Villages	**Cities**	**County Seats**	**Budapest**	**Total**
Total revenue [Billion HUF, in 2001]	419.5	481.5	361	527	1,789
Outstanding debt [Billion HUF, in 2001]	19	19	25	55	117
Outstanding debt/revenue	4.5%	3.9%	6.9%	10.4%	6.5%

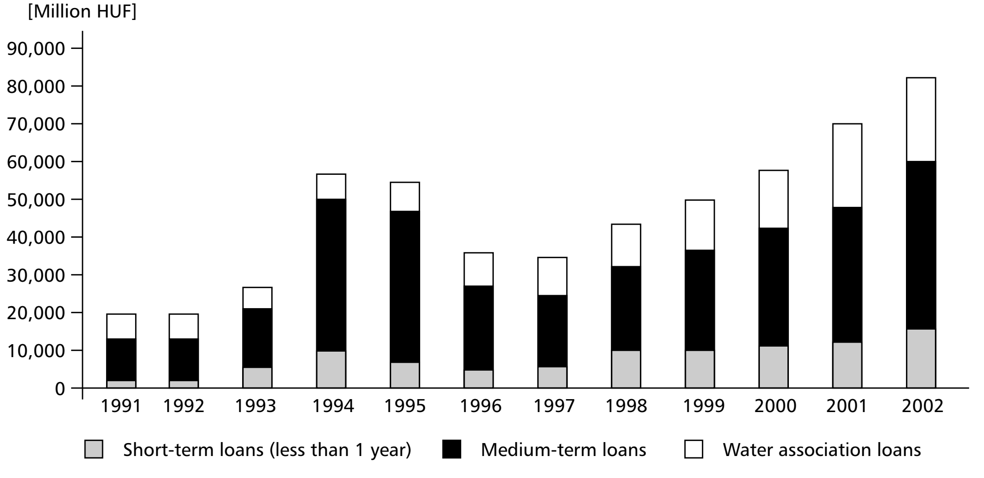
Source: GKI and TÖOSZ survey, 2002.

OTP is trying to strategically assess future changes in the local government system. The small regions would be one market possibility for them. Today small settlements can have access to loans for infrastructure investment whose catchment area extends beyond one local government. In this case a "gestor" system is used where one local government is assigned as a main contractor, but the others take on individual responsibilities for the repayment of the loan. This is not a pool system because every local government has an individual underwriting procedure and individual collateral for the loan. In principle, other local governments can offer collateral for those that do not have any, but this is very rare. There is universal liability.

There are three different kinds of credits for local governments: short-term and medium-term credit and the soft loan for water association. The next figure shows the change in the OTP Bank portfolio. There are some interesting conclusions that can be drawn on the basis of the OTP Bank data. Lending increased in 1994 and 1998, in the election years, but in the period 1999–2002 there was also a constant increase. Thus the election cycles have been broken.

Figure 3.12

The Composition of the Outstanding Loan by OTP Bank



Source: OTP Bank.

5.2.1 Subsidized Loan Programs

Several loan programs with different subsidies have been launched for the local governments, to support specific initiatives such as energy rationalization, the reconstruction of prefabricated housing stock and investment in the water sector.

Water Association loans are a special scheme used for water investments. The majority of people living in a particular area can set up an association with a foundation deed to invest in the water sector. The water association is entitled to take loans with a joint guaranty of local government. The loans are structured so that all individuals who are members of the association will take responsibility for their own share. In the case of default, the local government pays and can collect the arrears as a local tax. It means that the arrears can be applied as mortgage on the property.

Another example would be the future development of the housing program. The government announced at a conference on January 14, 2003, that the total grant amount for the public rental housing program for 2003 will be HUF 10 billion, which is approximately 50% of the amount used in 2002. This means that in order to continue the program the government should decrease the share of grants and increase the local government contribution. Local governments definitely want to continue the program. According to their plans, in 2003 approximately 6000-8000 new rental units will be built, and 800-1000 units will be bought by local governments. The share of social rent would be 40%, and of the cost-based rent 60%. For 24% of the new investment, local governments plan to take loans. The loan/value ratio would be 44%.

Local governments have been offered an opportunity to take subsidized loans for new public rental housing investment, energy-saving investment in housing estates (prefabricated housing stock) and for rehabilitation programs. The housing law of 1993 (LXXIVIII) declared that loans taken for the renewal of the public housing stock will be supported by the government. The loan (to a maximum of 50% of the total investment) will be guaranteed by the government and the interest rate will be subsidized. The conditions have been set by a government decree on housing subsidies (12/2001), which says that the loan is subsidized if local government revenues from the housing sector do not exceed the housing expenditures. The subsidy is equal to 70% of the interest rate calculated as the interest of a one-year treasury bond plus 2%. The construction of new rental housing is supported by the government as well, and the local governments are eligible for this subsidized loan.

6. CONCLUSIONS

Local government borrowing plays a limited role in the Hungarian local government finance system. The bank sector is quite open to expanding its role as a lender since local governments are generally "good debtors." But due to the fragmented structure of the local governments, only approximately 200 of the largest local governments are able to take loans, while the remaining 3000 small local governments have difficulty getting into the credit market.

The most important constraint on local government borrowing is the unpredictability of the intergovernmental financial system. On the supply side, Hungary has quite a stable banking system, which operates prudently and is open to expanding its lending activities. On the demand side, local governments have difficulty predicting future financial perspectives. On the revenue side, transfers dominate their budgets. Although these are quite stable at the macro level, for the individual governments the transfers can be substantially volatile. Thus the only possible collateral for borrowing is the own revenues and the property, representing 35% of total local government revenues.

The central sources have a significant impact on local government borrowing in the following three ways: first, these cheap sources initiate an investment decision in the sector the local government will invest in, and since they provide a cheaper source than the market sources, they crowd out borrowing as an alternative method of funding these investments. Second, the targeted subsidies are matching grants that require own sources from the local governments. Many local governments would like to benefit from a central program, but do not have the kind of resources that would create sufficient incentive for borrowing. Third, the form of the central subsidy determines the borrowing of the local governments. In case of preferential loan schemes, local governments have more incentive to increase their borrowing than in other forms of subsidies. This was clearly the case when the central government provided preferential loans for local governments to build social housing in 2002.

In our survey of local governments, 64% of respondents said that the most important incentive for borrowing is financing the own source of the initiated central investment programs. It is interesting that the small towns (with budgets less than HUF 4 billion in 2002) found it a more important factor, with 77% identifying it as the most important factor in their borrowing decision. Among the biggest towns (with budgets larger than HUF 10 billion in 2002) only 44% found it an important incentive. Among local governments that contracted loans in 2002 the number was 68%, above the average.

The main problems concerning borrowing vary across the different segments of the local government sector. Because of Hungary's extremely fragmented local government system there is a substantial part (the smallest ones that make up two-thirds of all local governments), that are unable to enter the municipal credit market. The reasons for this are: first, the lack of own sources of revenue; second, the lack of capacity to manage municipal credits; and third, the small size of their individual demand, making it unprofitable for the financial institutions to lend. With this group the solution is a higher level of cooperation among these local governments, which can be stipulated by different incentives and legal rules by the central government. Some "pooling" instrument (local government bank or state guarantee system) would also be needed for small local governments to have access to loans.

For the medium-size local governments the problems are different. Here there is a substantial need for external investment resources, but they have to pay a high-risk premium for the credits. The reasons for the premium are that their financial situations are the most unpredictable, and also that they have a capacity problem making it hard to exploit the market competition of the financial institutions. They usually have some own revenues, but these are volatile and insufficient. Their local economy depends on a few large firms (if not just one) that provide the main source of local taxes and determine the economic condition of the city. The market conditions of these firms are what determine the city's own resources. While the own revenues are thus not stable, the main funds of these local governments still come from the central government. Their financial uncertainty mainly results from the general problem of the unpredictability of the central financial regulation, and this uncertainty leads banks to ask a higher risk premium for the credit they provide to these local governments. Moreover, these cities have not had enough experience with municipal credit to be able to exploit the competition of banks. Usually the account-keeping bank provides the cheapest but still expensive credit, because this is the only one that has some insight into the financial condition of the city.

The state could help these local governments through two measures. First, the stabilization of central sources, as mentioned before, is extremely important for them. Second, central measures are needed to decrease the transaction cost of borrowing for these cities. This would mean providing training to local financial officers to increase their capacity. Also, central government could help to increase the transparency of finance of these local governments for the investors (e.g., a state rating agency). A rating and monitoring agency should be set up, private or public, or PPP form (public-private partnership). A loan guarantee scheme is needed to decrease and share in the risk of local government borrowing.

In the case of the large cities, mainly those with county rights, the difficulties are not in lack of access to the market or the competition of financial institutions, but in their current utilization of the market. They have some experience of bonds as well, and with these they usually have a better capacity to utilize market competition. While the unpredictability of central regulations causes a political fear of indebtedness, these local governments often obtain sufficient credit to meet their needs. In this part of the market, the state should help to improve the bond market, by creating a secondary market for these securities. Tax exemptions for the buyers of the local government bonds would help the sector, while the previously-mentioned improvement in the predictability of financial regulations would increase the political will to finance long-term investment from long-term external sources.

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NOTES

1 The paper draws on the research reports MRI has prepared in the last few years (in partnership with the Urban Institute, Washington, and the World Bank Institute), especially in the program of SNDP (Subnational Development Program), which was a joint effort of the World Bank and other donor agencies (USAID, British Know-How Fund, etc.) (Balás–Hegedüs, 2000, Hegedüs, 2002). We would like to thank József Kéri, Head of Financial and Strategic Department of Szolnok, Róbert Kovács, Head of Financial Department of Gyöngyös, Istvánné Halmos, Head of Financial Department of Csepel District Local Government of Budapest for the interviews and information they provided about their local government borrowing practice. Thanks should also go to László Tordi, Director, and Jánosné Potoczky, Deputy Head of the Local Government Section of OTP Bank, Ildikó Keményné Koncz, Raiffeisen Bank and Ákos Szalai (Budapest University of Economics) for the information and data they provided for us.

2 The sample of local governments is not representative of the local governments of Hungary, as only 38 of the 3,200 local governments were surveyed in a self-selection method. However, this sample could be considered as representative for the most relevant segments of the sector, as 7 of the 22 cities with county rights are represented, and 19 of the 230 other cities were surveyed in the sample.

3 We used the expenditure data for the analysis of longer trends, because the changes to the budget system in 1996 do not make the comparison of the revenues side possible.

4 The exchange rates in the period 1996–2002 [HUF].

	1996	1997	1998	1999	2000	2001	2002
1 EUR	191.15	210.93	240.98	252.8	260.04	256.68	242.97
1 USD	152.57	186.75	214.45	237.31	282.27	286.54	258.00

5 The data for this section is from Hertelendy-Kopányi (2000). The issue of the off-budget companies requires more research attention. In this project we did not have the capacity to update the data based on the tax reports of the companies.

6 Act on the Conversion of the Companies, XIII/1989.

7 SNDP Report (2000), World Bank.

8 HVG, June 2, 2003.

9 Before 2001 the National Bank of Hungary as the Foreign Exchange Authority had to approve any borrowing from abroad. Since 2001 the Hungarian Forint is fully convertible and there is no such control on the currency market.

10 Interview with Ildikó Koncz, Unicbank In: *Figyelő* (07.10.1997).

11 The legal control on local governments is rather weak in Hungary. Although they have to comply with all the regulations that any sectoral law imposes on them, there is little possibility to enforce the law on local governments.

12 The uncertainty in expenditure assignment of the local government goes beyond the limits of this study. The local government tasks are continuously redefined by the sectoral laws and regulation, which is understandable in the constantly changing world, but it can create a lot of uncertainty in the system.

13 The Act on the Issuance of Securities, on Investment Services and on the Stock-Exchange (CXI./1996) was built into the Act on Capital Markets CXX/2001 in 2001.

14 For more information on the local government budgeting system of Hungary see Hőgye *et al.* (2002).

15 We have to note that "off-budget" local government investments have not been shown in the figure.

16 HVG, January 3, 2003, p.112.

17 The table is based on the Ministry of Finance report on local government revenues and expenditures. The category "other" is the difference between the total investments and the revenue for capital investments. These are aggregate data, which means that the data do not show exactly the financing source for investment because some part of the revenues could be used for operating expenditures. However, it shows the main trends.

18 Széchenyi Plan was the name of the national development program of Hungary between 2000 and 2002.

19 Underestimation of the expenses related to the housing construction tender is a common experience among municipalities, since the decision also depends on the per-unit cost. The ministry sanctions overspending only in rare and extreme cases. It is customary that higher expenses than approved in the tender are indicated when submitting invoices.

20 It is a typical strategy for the banks entering the market to hire people from the Ministries dealing with local governments. In the case of CIB bank, the head of the department came from the Prime Minister's Office.

21 To offer a board membership is not an unusual technique to influence the bank selection.

22 In 2002, the data refer to October.

Local Government Borrowing in the Deregulated Market of the Czech Republic

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Table of Contents

Local Government Borrowing in the Deregulated Market of the Czech Republic

Vladimír Ježek, Hana Marková and Lukáš Váňa

1. INTRODUCTION: THE ROLE AND EVOLUTION OF MUNICIPALITIES AND REGIONS AFTER 1989

The post-1989 political changes in the Czech Republic were reflected in the structure of state administration and self-government. Public administration was reformed, and after a hiatus lasting many decades self-government was restored and space for the independent functioning of municipalities was created. The municipality became an independent legal and economic entity, a fundamental element of local self-government. State administration included both institutions with broad functions (the government and district authorities) and institutions with specialized functions (ministries and other central administration authorities, and decentralized authorities at the district level such as land registry offices, revenue authorities and labour offices, etc).

On January 1,1993, the splitting of Czechoslovakia resulted in the creation of an independent state, the Czech Republic (CR), with a new Constitution that secured a relatively strong constitutional anchor for local self-governing units. The whole of Chapter Seven of the Constitution of the CR is devoted to local self-government. Under the Constitution the country is divided into municipalities, considered fundamental self-governing units, and regions, defined as higher local self-governing units. In this new, "mixed model" of governance, both municipalities and regions have dual functions. On the one hand, they act within a framework of independent operations; on the other, they perform tasks delegated by the state administration.

Although the higher local self-governing units, the regions, were included in the text of the constitution of 1992, they only became functional in practice in the autumn of 2000. Their position was gradually strengthened and consolidated as responsibilities were transferred to them in 2001. In a subsequent phase of the reforms, culminating on December 31, 2002, district authorities were abolished and their functions were transferred to regional authorities and newly institutionalized "municipalities with extended operations" (a total of 205), which should ensure some administrative activities for neighbouring municipalities.

The role of municipalities is primarily defined in the Act on Communities and Municipalities (a special Act on the Capital City of Prague applies to that city). A municipality may independently issue generally binding ordinances, i.e., legal regulations that must comply with existing laws. The scope of a municipality's activity is limited only by law; thus, state bodies and regional authorities can intervene only for the purpose of protecting the law. Besides self-government, each municipality is responsible for certain aspects of public administration delegated to it by the state. Within this sphere, municipal authorities can issue by-laws such as subsidiary legal regulations. However, the state does not delegate its power to all municipalities in the same manner. Rather, there are three different levels of delegation of public administration functions to municipal authorities:

- All municipalities (6,258) execute self-government to the same extent, as well as the basic scope of operations delegated by the state;
- More than 380 municipalities receive extended areas of state-delegated responsibility or authority;
- An even greater scope of authority is delegated to 205 of these 380 municipalities.

A characteristic trait of local self-government in the Czech Republic (Czechoslovakia until the end of 1992) has been the growing number of municipalities, primarily as a result of involuntary integration. In 1989 there were 3,527 municipalities. By January 1994 the number had grown to 6,231 and at the present time there are 6,258 municipalities in the Czech Republic. The average number of inhabitants per municipality is 1,500, ranking this country among those with the lowest average population per municipality in Europe.

2. FINANCING OF LOCAL SELF-GOVERNING UNITS

2.1 The Evolution of Local Financing from 1990

The years 1990–1992 can be considered a period of transition between subsidy-based financing of municipalities and the clearly defined transfer of tax revenues as stipulated in law. At the beginning of 1993 a decisive change in the redistribution of taxes collected nation-wide occurred within the framework of a comprehensive tax reform. The law stipulated exactly what portion of the general tax revenues should go to the municipalities and the criteria for allocating these revenues among them. Municipalities then operate their budgets independently.

On January 1, 2001, an act on the budgetary designation of tax yields was adopted. The following taxes are shared with municipalities:

a) Tax yield from real estate in their territory;
b) 20.59% of revenues from the gross value added tax and and income taxes collected nationally;
c) 30% of the yield from the pre-tax income of natural entities resident in the territory of the municipality.

Each municipality receives a defined share of the overall municipal pool of nationwide gross tax yields. The allocation is based on each municipality's population and coefficients of the size category of the municipality.

An appendix to the act defines the allocations to the regions. In their first year of operation (2001) the regions were financed directly from the state budget, and with a minimum of actual revenues. Only in early 2002, following an amendment to the act, did they begin to receive specifically defined revenues from taxes collected nation-wide. Tax revenues for budgets of individual regions include 3.1% of the national gross value added tax and of income taxes.

Total expenditures of municipalities in 2000 amounted to CZK 164[1] billion, or 8.3% of GNP. In the following year expenditures grew by 19.2% to CZK 195 billion, 9.1% of GNP. However, this relatively high year-on-year growth primarily resulted from a new method of financing schools through municipal budgets.

2.2 Financing Municipal Investment Expenditures

In the year 2000 capital expenditures of municipalities amounted to CZK 56 billion (34.1% of total municipal expenditures), and in 2001, CZK 65 billion (33.4% of the total). There still remains a great demand for capital expenditures related to the development of local infrastructure. The improved community facilities and appearance of the towns and villages are clear evidence of municipal investment over the past several years; however, it is doubtful that this will be sustainable over the long term.

Since the early 1990s municipalities have developed a variety of ways of financing their investment needs. First of all, municipalities had virtually no indebtedness at the beginning of the 1990s, and could thus rely on the surplus from their operating budgets as a source of funding. Unfortunately, this source has been gradually diminishing as operating costs have been going up.

Another source of funds is the revenues from the sale of municipal property. In the first half of the 1990s, municipalities acquired substantial assets at no cost within the framework of the privatization and restitution process. This was generally property owned by them prior to 1948, as well as property they administered prior to 1989 (e.g., roads, school facilities, administrative buildings and state-owned flats in the locality). A significant asset was the equity shares in former state or local companies that were transferred gratis to municipalities within the framework of large privatization.

Because towns and municipalities were not able or willing to take care of all the property acquired in this way, part of it was and still is being sold, which adds considerable revenue to the municipal budget. Municipal (former state) flats are mostly sold to existing tenants at preferential prices, though some are excluded from this process and remain in municipal ownership. Equity shares of municipalities are also frequently sold, in many cases for significant sums. This process, termed "secondary privatization," is closely scrutinized by local citizens, especially in cases that personally affect them. But this source of funds is obviously coming to a close as most commercially interesting assets and equity shares have already been sold. Thus, municipalities must seek other sources to finance their investment needs.

Finally, municipalities are increasingly taking loans from domestic and (to a much lesser extent) foreign banks. Recourse to loans of this sort is more common than the issuance of bonds. In the first half of the 1990s banks gave preference to companies and entrepreneurs, as municipalities were not considered sufficiently transparent and trustworthy. But the situation has changed quite radically over time, as the banks have become familiar with the system of municipal management, the security of a significant part of municipal revenues and, in the vast majority of cases, responsible financial discipline. As the financial credibility of the towns and municipalities increased, the banks began to experience some difficulties with the business sector. At the present time municipalities are contracting loans from both large and small Czech banks (or banks operating in the CR) and, to a lesser extent, foreign banks. The largest number of loans has been granted by Česká spořitelna (Czech Savings Bank) and Komerční banka (Commercial Bank).

In the mid-1990s, a near boom occurred in the issuing of municipal bonds (for details, see further sections of this report). The first issue was carried out in 1992, and the largest number of issues (nine) occurred in 1994. After this, activity in this area significantly decreased and was mainly restricted to the biggest cities, since the issuing of bonds entails relatively high additional costs and is a rather lengthy process. Another factor that appears to have limited their use is the still underdeveloped Czech capital market. On the other hand, the advantage of bonds is that property is not required as collateral, and if issuers can afford to enter foreign markets they will have access to cheaper long-term money.

2.3 Structure of Revenues of Municipalities and Regions

The largest portion of municipalities' revenues comes from the allotted share of national taxes (see Table 4.1). For the regions, the share of tax revenues is roughly 20%. However, this average may differ significantly in the case of a specific town in a specific year, depending on other sources of municipal revenues such as capital income.

Municipalities have little discretion in influencing local tax revenues. Their only direct possibility is through the real estate tax. By means of an ordinance, municipalities can alter the coefficient defining the basic tax rate for some buildings and land. But this tax represents less than 5% of tax revenues of municipalities, approximately 2.5% of total revenues. Local charges, which can also be influenced by local governments, constitute a very small proportion of local revenues.

The number of inhabitants remains the decisive criterion for distribution of shared taxes among municipalities. This indicator affects up to 80% of tax revenues. From one point of view, this is a stabilizing factor ensuring a comparable revenue base for municipalities throughout the CR. From the other, it does not take into account local economic efficiency and related expenses. The classification of municipalities into size categories with significantly graded coefficients (which affect the level of tax revenues along with the number of inhabitants) also gives rise to many questions, mainly regarding the margins of the determined intervals. The entire system is relatively new and is constantly monitored by all parties concerned. Undoubtedly, it will be further modified.

Table 4.1

Structure of Revenues of Municipalities (2001)

Type of Revenue	Percentage of Total Revenues	Amount [Million CZK]
Tax and fee revenues[2] • national tax shares • real-estate tax • local and management charges • other taxes	52.8	89,900 80,900 4,500 3,800 700
Subsidies • from the state budget • from state funds	18.4	31,258 18,230 6,737
Non-tax revenues[3]	14.9	25,000
Capital revenues[4]	9.0	15,300
Other revenues[5]	4.9	8,300
Total	100.0	169,758

3. INDEBTEDNESS OF LOCAL SELF-GOVERNMENTS

3.1 Total Public Debt of the Czech Republic

The total public debt of the CR has been rising inexorably since 1996. Whereas in the middle of the 1990s it was approximately 12% of gross national product (see Table 4.2), by the end of the past decade it represented almost 15%. In terms of the Maastricht criteria this figure is by no means frightening; however, it is always necessary to keep a close eye on the trend—and the trend is not exactly satisfactory, having a permanently upward tendency.

Nevertheless, from the standpoint of municipal indebtedness, this accounts for much less than 20% of total public debt.

Table 4.2
Indebtedness of the Czech Republic [Billion CZK]

Debt	1993	1994	1995	1996	1997	1998	1999	2000	2001
Municipalities	3.4	14.3	20.3	28.3	34.4	39.0	40.0	41.0	48.3
• loans	2.5	4.9	8.7	11.6	13.5	18.0	17.6	18.4	22.6
• bonds		7.6	8.5	11.9	13.2	11.9	10.9	10.1	13.3
• other	0.9	1.8	3.1	4.8	7.7	9.1	11.5	12.5	12.4
State	158.9	157.3	154.4	155.2	173.1	194.7	228.4		
Total	162.3	171.6	174.7	183.5	207.5	233.7	268.4		

Source: Ekonom 36/2001(Ministry of Finance of the CR, World Bank).

Table 4.3
Indebtedness of the Czech Republic [% GNP]

Debt	1993	1994	1995	1996	1997	1998	1999
Municipalities	0.3	1.2	1.5	1.8	2.1	2.2	2.2
• loans	0.2	0.4	0.6	0.7	0.8	1.0	1.0
• bonds	0.0	0.6	0.6	0.8	0.8	0.7	0.6
• other	0.1	0.2	0.2	0.3	0.5	0.5	0.6
State	15.9	13.3	11.2	9.9	10.4	10.8	12.4
Total	16.2	14.5	12.6	11.7	12.4	13.0	14.6

Source: Ekonom 36/2001(Ministry of Finance of the CR, World Bank).

3.2 History and Structure of the Indebtedness of Municipalities

Table 4.2 shows clearly how the indebtedness of municipalities has been gradually growing, while in 2001 it rose by a whopping 18% in comparison with the previous year. The growth in comparison with 1994 is thus more than threefold. A positive feature of this trend is that the loans are primarily directed to infrastructure, environmental protection projects, housing construction, school buildings and the like. Looking at indebtedness more closely, we can observe a standstill in other types of loans and aid. In the case of credits, there was hardly any increment in 1998–2000, while municipal bonds even decreased significantly. Higher year-on-year indebtedness between 2000 and 2001 was roughly equal to the increase in new credits and bond issues.

Table 4.4

Indebtedness of Local Governments According to Size

Municipality Size Category According to the Number of Inhabitants	Number of Inhabitants per Size Category	Number of Inhabitants per Size Category [%]	Outstanding Debt on Dec. 31, 2001 [Thousand CZK]	Outstanding Debt on Dec. 31, 2001 in % of Total Municipal Debt	Debt per Capita [Thousand CZK]
	(1)	(2)	(3)	(4)	(5)=(3)/(1)
0–100	39,202	0.4	27,628	0.1	0.7
100–200	166,092	1.6	220,524	0.5	1.3
200–300	221,370	2.2	403,404	0.8	1.8
300–1,500	1,871,562	18.2	4,704,525	9.7	2.5
1,500–5,000	1,503,952	14.6	6,038,091	12.5	4.0
5,000–10,000	888,492	8.6	3,446,387	7.1	3.9
10,000–20,000	960,821	9.3	3,226,634	6.7	3.4
20,000–30,000	672,704	6.5	1,761,904	3.6	2.6
30,000–40,000	387,096	3.8	783,155	1.6	2.0
40,000–50,000	187,419	1.8	188,344	0.4	1.0
50,000–100,000	1,245,458	12.1	2,707,053	5.6	2.2
100,000–150,000	103,299	1.0	595,583	1.2	5.8
150,000–500,000	865,456	8.4	6,034,129	12.5	7.0
More than 500,000	1,179,920	11.5	18,206,444	37.7	15.4
Total	10,292,843	100.0	48,343,761	100.0	4.7

Source: Ministry of Finance of the CR.

Table 4.5

Evolution of the Number of Indebted Municipalities (1994–2001)

Size Category of Municipalities According to Number of Inhabitants	Number of Indebted Municipalities			
	1994	1997	1999	2001
0–100	155	80	112	52
100–200	265	214	325	249
200–300	211	214	311	275
300–1,500	823	1,237	1,585	1,636
1,500–5,000	302	443	495	516
5,000–10,000	88	128	131	125
10,000–20,000	60	65	65	68
20,000–30,000	24	28	28	27
30,000–40,000	11	10	10	11
40,000–50,000	2	6	6	4
50,000–100,000	16	16	17	17
100,000–150,000	3	2	1	1
150,000–500, 000	3	3	3	3
More than 500,000	1	1	1	1
Total	1,964	2,447	3,090	2,985

Table 4.6

Indebtedness of the Four Largest Cities Compared to Remaining Municipalities [Billion CZK]

Index	Four Largest Cities(*)				All Other Municipalities			
	1994	1997	1999	2001	1994	1997	1999	2001
Loans	1.1	0.8	4.7	8.3	3.8	12.7	12.9	14.3
Bonds	7.3	11.6	10.0	13.3	0.3	1.6	0.9	0.0
Other	0.4	1.2	1.7	2.6	1.4	6.5	9.8	9.8
Total	8.8	13.6	16.4	24.2	5.5	20.8	23.6	24.1

* Prague, Brno, Ostrava, Pilsen.

Source: Ministry of Finance of the CR.

Table 4.6 divides the total indebtedness of the municipal sector into two groups: the four largest cities and all others. Interestingly, the figures show that municipal indebtedness excluding the four largest cities has not been rising, as debt from municipal bonds has been repaid. On the other hand, other types of loans have increased, primarily in connection with the start-up of many support programs financed from the state budget and state funds. More attention to this issue is paid in the following sections.

In 2001 exactly half of the total indebtedness of municipalities resulted from borrowing by the four largest cities. The jump in indebtedness in the last year (2001) is also exclusively accounted for by them, and is fairly equally divided between credits and municipal bonds.

It goes without saying that large cities have incomparably higher investment demands. It is also true that in a way they serve a much larger territory than that belonging to them in administrative terms. When we look at the use of money borrowed by these large cities, it mainly includes projects pertaining to transport, water management and other infrastructure demands. But it is also true that part of the debt is allocated to repayment of municipal bond issues from previous years.

To conclude, these large cities, having incomparably higher investment demands, also have greater economic strength, which allows them—while keeping proper fiscal discipline—to successfully meet their obligations.

In general, larger towns have greater possibilities of acquiring external financial means. On the one hand, they can issue municipal bonds. On the other, they are favorably regarded by banks due to their extensive property and higher volume of secured future revenues. To a certain extent—in comparision with entrepreneurial subjects—this applies to all local self-governing units regardless of their size.

With small municipalities, a problem may be the size and consequent financial burden of some investment projects. It is often difficult to find financing with an economically reasonable credit level within the framework of one municipality. In this case, associations or unions of municipalities for a specific purpose allows for the pooling of finance and property, thus improving the chance of obtaining the necessary credit.

Although the banks began to view towns and municipalities as creditworthy during the 1990s, they have nevertheless become much more cautious when granting credits, because of some negative experiences over the past few years. Verification of potential debtors is much more thorough now, and requirements for information is more stringent prior to granting a credit and during the repayment period. While developing their own assessment methods, the banks have also improved their understanding of the functioning of municipalities and other non-profit organizations. The resulting procedure of credit acquisition is not entirely simple; nevertheless, it is not harmful for the sound functioning of the system.

Greater caution on the part of the banks is also connected to the privatization of the banking sector, which took place after 2000. New foreign owners introduced stricter procedures for granting credits to all clients, including municipalities and regions. This can only be seen as positive, since increased demands placed by banks upon municipalities when granting credits leads to more responsible practices by individual applicants. One of the important measures that can prevent unsound indebtedness of local self-governing units is a well-functioning banking sector. The sober view of a specialist independent of local self-government, who is directly engaged in the financing of a project, can prevent the financing of some unfeasible projects or can facilitate their change.

4. REGULATING THE DEBT OF LOCAL SELF-GOVERNING UNITS

Debt regulations for municipalities and regions are addressed in the relevant laws: the Act on Municipalities, the Act on Regions and the Act on the Capital City of Prague. The basic framework for the financial management of municipalities and regions is further elaborated in the local budget regulations. Other relevant legal stipulations are found in the Act on Bonds, defining the terms for issuing municipal bonds, and, last but not least, the Constitution of the CR and the Charter of Fundamental Rights and Freedoms.

It is important to note that both municipalities and regions are viewed as being like any other owner. Property protection is stipulated in Article 11 of the Charter of Fundamental Rights and Freedoms.[6] Under constitutional law, the provision of ownership rights has the same content and offers the same protection for all owners; there are no specific regulations applying to municipalities and regions.

The limitations on ownership rights of municipalities and regions are expressed in the Act on Municipalities, the Act on Regions and the Act on the Capital City of Prague. These texts establish limits on the right of regions and municipalities to issue guarantees for liabilities of natural and legal entities, except in specified cases where they may issue a guarantee:

- With liabilities arising from a credit contract, if financial means are intended for an investment implemented with financial support from the state budget, state funds or the National Fund;
- With liabilities arising from a credit contract, if financial means are intended for an investment in real estate owned by a municipality or region;
- With entities instituted by a municipality, region or the state, Prague or city districts;
- With entities whose level of participation either alone or together with another municipality or other municipalities, region or the state exceeds 50%;
- With housing associations in the case of municipalities.

The respective provisions of Act No. 328/1991 Coll., on bankruptcy and settlements, do not refer to municipalities and regions. That is, neither municipalities nor regions can actually go bankrupt. However, in practice there may occur cases (and such cases are known) when the property assets and financial possibilities of municipalities and regions are reduced to such an extent that they are not able to ensure fundamental services for their citizens.

The current legal regulations defining the economic management of municipalities and regions already include provisions that contribute to the prevention of excessive indebtedness. Act No. 250/2000 Coll., on fiscal rules of local budgets, contains the following stipulations:

- The annual budget must be drawn up according to an obligatory forecast balance sheet. The forecast balance sheet is an auxiliary instrument of a local self-governing unit, serving in the medium-term fiscal planning of its economic development. It is drawn up on the basis of concluded contractual relationships and accepted liabilities, normally for two to five years following the year for which the annual budget is compiled. The forecast balance sheet contains a summary of basic data on revenues and expenditures, primarily long-term liabilities and receivables, financial sources and requirements of goals implemented over the long term.
- The annual budget must be drawn up as a balanced budget. It can be approved with a surplus if the revenues of the year in question are specifically intended for use in the following years or intended for repayment of a credit principal from previous years. A deficit budget can be approved only if the deficit can be paid down using financial means from past years or a contractually secured loan, credit, returnable financial aid, or by the yield from sales of the municipality's own bonds. A positive balance in the current year is transferred for use in the next year to cover budget expenditures, or is transferred to money funds. An economic deficit is paid from the surplus from past years or is covered from returnable sources payable from the budget in subsequent years. Neither the Ministry of Finance nor anyone else may affect the level of the proposed budget deficit of a municipality or region since this decision is made exclusively by boards of representatives who operate independently.
- The budget must be drawn up on the basis of the break-down of a valid state budget (regions or municipalities can approve their budgets prior to the state budget's approval). The specific details of the financial relationship between the state budget and regions and municipalities are not required. But after the state budget has been approved, a revised budget must be approved, in which the relationships between the state budget and municipal and regional budgets set by law are integrated.

Another new regulatory instrument, internal auditing, was established by Act 320/2001 Coll., on financial control in public administration. An internal audit is an independent and unbiased check and assessment of the operations and the internal control system of a public administration body, including both regional and municipal authorities. The audit ascertains that there has been compliance with relevant legal regulations, and that the appropriate measures have been adopted and procedures set. Furthermore, it checks to see that risks relating to the operation of a public administration body are detected in time, and that adequate measures for their elimination or reduction are taken. Other issues to be examined within the framework of an internal audit are whether or not control checks provide the public administration executive body (normally understood as the district administrator, mayor or lord mayor) with reliable operating, financial and other information, and whether or not operating and financial criteria are met.[7] Finally, the audit will check whether or not the established internal control system is sufficiently effective and able to react promptly to changes in economic, legal and operating conditions. The intent is to provide sufficient security so that the adopted plans and goals of this body can be fulfilled.

On the basis of its findings, the internal audit unit submits to the public administration executive body (administrator, mayor or lord mayor) a recommendation for improving the quality of the internal control system, preventing or reducing risks and taking measures to rectify the faults detected. At the same time, this unit provides consultancy services to the public administration body.

Internal audits include in particular:

- Financial audits, to verify whether or not the data stated in financial, accounting and other statements truly describe property, the sources of its financing and its management;
- System audits, to check and assess the systems for securing revenues of public administration bodies, including debt recovery, financing of their activity and securing administration of public means;
- Performance audits, to selectively check the effectiveness, efficiency and purposefulness of operations, as well as the appropriateness and efficiency of the internal control system.

The internal audit unit is directly subordinate to the public administration executive body, which ensures its functional independence and organizational separation from top management structures.

Municipalities with fewer than 15,000 inhabitants are not required to provide an internal audit if they take other sufficient measures. In this case, they ensure continuous monitoring and assessment of the effectiveness of these measures and, at the same time, consider the establishment of an internal audit unit. If the measures taken are not sufficiently effective, municipalities are obliged to set up an internal audit unit without unnecessary delay. There have been no such cases to date.

Other legal regulations on the debt of local self-governing units are stipulated in the Act on Bonds. Furthermore, there is a compulsory annual check of economic management by an external auditor or a regional authority (formerly, a district authority). These legal controls are discussed in detail in later sections.

5. CREDITS USED BY SELF-GOVERNING UNITS

5.1 Credits in General

Local government units can use credits as a source of financing their budgets. Credits and loans are sometimes thought to be identical, but they differ in their legal status.[8] A credit might be granted on the basis of a contract pursuant to the Commercial Code. On the other hand, a loan is a legal contract defined in the Civil Code. In this case, money or another type of determined item is granted to a borrower by a lender, while the borrower pledges to repay the debt within a fixed period. In principle (legally), the loan is thus interest-free, although agreement on interest is not ruled out.

Credit can be offered on a short-term, medium-term or long-term basis. Short-term credit matures within one year or by the end of the business year, and is mainly drawn for financing current ("operating") needs of local self-governments. It is useful in bridging the time lag between income and expenses. Medium-term credits mature within ten years, and long-term in more than ten years (Markova 2000).

Short-term credit is usually granted to a local self-governing unit by the bank maintaining its budget accounts. Large towns and regions, however, do not normally hold their accounts at one bank. Instead they keep an entire portfolio of them so that they can use the most advantageous products of a specific finance company and, at the same time, cover the possible risk of a bank failure. Bank failure was not an uncommon phenomenon in the Czech Republic in the recent past.

Although there is no such legal stipulation, medium-term and long-term credits serve in practice as a source of capital for expensive long-term projects such as waste-water treatment plants and refurbishment of the housing stock. Long-term credits are primarily used for infrastructure projects where indirect return is expected—e.g., local thoroughfares.

5.2 Legal Regulations on Granting Credits to Municipalities and Regions

As mentioned above, the credit contract is defined in the Commercial Code. The creditor pledges to provide a certain amount of money to the debtor, while the debtor (in our case, a municipality or region) pledges to repay the money with interest. Both municipalities and regions can also accept credits from abroad and in foreign currencies. Since 1990 the granting and acceptance of credits and loans by municipalities and regions have been subject to approval by the municipal board of representatives.

From April 26, 1991 to December 31, 1992, another type of limit came into force under Article 9 of Act No. 172/1991 Coll. This limit applied to the transfer of certain items from the property of the Czech Republic to municipal owernship. According to this limit, the consent of three-fifths (instead of a simple majority) of all members of municipal boards was necessary for certain property transactions, including credit (loan) acceptance, credit (loan) granting, assumption of debt, alignment of debts and assumption of a guarantee if required by at least one-tenth of all municipal board members. The limitation was conditional on the request of at least one-tenth of the municipal board members, and only if such a situation occurred was it necessary to obtain the consent of a three-fifths majority of board members to accept debt.

For five months from the beginning of 2002, the amendatory Act on Municipalities set new limits on acceptance of credits and loans and the issuing of municipal bonds by municipalities. Specifically, this concerned Act No. 450/2002 Coll., which amended the Act on Municipalities, the Act on Regions and the Act on the Capital City of Prague.[9]

Pursuant to the Act on Municipalities, the following limits were established for granting credits to municipalities in the period from January to June, 2002:

- Approval by the Government was necessary for acceptance of credits from abroad. The purpose of this was to protect municipalities and regions against foreign exchange risk.
- A local self-governing unit could not accept a credit if its debt service exceeded 15% of the previous year's actual budget.

If a credit contract or other legal transaction was carried out in contradiction with these limits, it would be considered retroactively invalid from the start of the contract. This particular provision had a significant effect on the credit policy of individual finance companies towards municipalities and regions. The problem was that the law did not precisely define the term "debt service."[10] From an economic viewpoint this term is relatively unambiguous, but it is problematic in legal terms, especially in connection with the sanction of absolute invalidity.

Banks were aware of the problem from the very first days of operation of the new provisions in the Act on Municipalities, the Act on Regions and the Act on the Capital City of Prague. For this reason, many banks stopped granting credits until the situation was cleared up. Within a short time, the Ministry of Finance of the CR also realized the problem and initiated discussions on the new wording of the respective provisions of the acts. However, since the legislative process in the Czech Republic lasts several months and it was not possible to significantly speed up the process of passing the necessary amendment, a new solution had to be prepared promptly. Hence, the Ministry of Finance of the CR issued a methodological instruction for how to interpret the term "debt-servicing of last year's actual budget," which was used in all three acts.

According to this special instruction from the Ministry of Finance, debt-servicing is to be understood as "interest, instalments of principals, bills, leasing instalments, and, in the case of one-off instalments payable after an agreed term has expired, the relative part of the instalment for one year." In addition, the term "last year's actual budget" is defined as "the total attained volume of the budget for the last calendar year," i.e., all revenues of the budget of a local self-governing unit for the last year. These terms were defined in the same manner for Prague and the regions.

Since the summer of 2002, the legal regulations have not imposed these limits. Also scrapped was the condition that a municipality, region or the city of Prague must not accept credit if its debt-servicing exceeds 15% of last year's actual budget.

Nevertheless, the new legal regulation has affected the possibility of issuing guarantees by municipalities, regions and Prague. Under current legal regulation, a municipality, region or Prague must not stand surety for liabilities of natural and legal entities, except for:

- liabilities arising from credit contracts, if the funds are intended for investment carried out with financial support from the state budget, state funds or National Funds;[11]
- liabilities arising from credit contracts, if the funds are intended for investment in real estate owned by the municipality or in legal entities set up by the municipality, region or Prague, as well as legal entities in which the municipality, region or Prague possesses majority decision-making rights and housing associations.

5.3 Granting Credits to Local Self-governments

Municipal credit is considered credit with minimum risk (on the part of the creditor), for whose coverage banks[12] use municipal (regional) property as a pledge. Local self-governments mainly issue pledges for credits with immovable assets owned by a municipality or region, and also very often with future budget revenues. Third-party guarantees, pledges issued against stock (loans against securities) and various combinations of these possibilities can also be used. For banks, municipalities are welcome clients precisely due to the low risk when granting credits. In 2001 banks granted 631 credits to local governments. The most important creditors were Česká spořitelna (268 cases), Komerční banka (187 cases), Raiffeisenbank (53 cases) and Českomoravská hypoteční banka (44 cases).

To date, the regions have not played an important role in incurring debts since they have only recently been established. In the period until the end of 2001 they took a minimal volume of loans, worth the paltry sum of CZK 2.7 million! Almost the entire amount was paid back by the end of the year, while by 2002 regions recorded outstanding loans amounting to a mere CZK 0.7 million.

Credits contracted by municipalities from finance companies are primarily channelled into projects related to environmental protection, mainly construction of gas distribution lines, sewage systems, waste water treatment plants, water mains and waste sites, as well as municipal housing construction, refurbishment of primary schools, pavement repairs, etc. The terms of credit maturities are fixed within the range of two to twenty years. In most cases municipalities stand surety with their property, and to a lesser extent with their future revenues (Ministry of Finance data).

Table 4.7

Summary Data on Credits Contracted by Municipalities [Billion CZK]

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Current prices	2.5	4.9	8.7	11.6	13.2	18.0	17.6	18.4	22.6
Constant prices, 2001	4.4	7.8	12.6	15.5	16.2	20.0	19.1	19.3	22.6

Source: Ministry of Finance of the CR.

Table 4.7 shows summary data on credits contracted by municipalities between 1993 and 2001. One should bear in mind that the municipal elections in the CR took place in autumn 1994, 1998 and 2002. Another important factor is that there was a significant slump in the entire Czech economy in 1997, and the Czech government also fell in the autumn of the same year.

The growth of the sum total of incurred credits can serve for comparison with the growth of the total indebtedness in this period. The willingness of municipalities to take credits was significant until 1997, with a great increase recorded each year. It is especially interesting that only a slight growth in credits occurred in 1996 and 1997 when we recorded a real growth of 5%, compared with growth of over 20% in 1995–1996 and 1997–1998. This can be explained by so-called "packages" of strong, restrictive measures taken by the central government in reaction to the relatively deep and unexpected slump of the Czech economy after several years of boom. Connected with this was also the unwillingness of municipalities to accept more credits. Nevertheless, the following year bore witness to a new growth in accepted credits.

It is interesting to compare individual items in the year-on-year growth indexes of individual types of loans. The total growth of municipalities' indebtedness decreased in nominal terms from 121.6 in 1996–97 to 113.4 in 1997–98. Similarly, the index of year-on-year growth of accepted financial aid decreased from 160.4 in 1996–97 to

118.2 in 1997–98 as a result of saving measures taken by the central government. The index of year-on-year growth of issued municipal bonds also decreased, from 110.9 in 1996-97 to 90.2 in 1997–98. The only growth recorded in this period was in the case of credits accepted by municipalities, from 116.4 in 1996–97 to 133.3 in 1997–98.

An explanation of why the quantity of accepted credits grew in the period when the quantity of issued municipal bonds, accepted financial aid and other debts decreased, can be found in the fact that in autumn 1998 municipal elections were held and politicians tried their hardest to complete semi-finished projects. Also, it was partially a reaction to the decline of financial aid from the state or state-derived organizations.

The overall economic situation of the CR did not entirely improve in 1999 (the index of accepted credits in 1998–99 was 97.8) and since it was not an election year we can record a significant year-on-year decrease in accepted credits. On the other hand, the willingness of municipalities to accept credits grew again in 2000 and 2001 together with the economic recovery in the CR (index of 104.5 in 1999–2000 and 122.8 in 2000–2001).

These figures reveal that even without legal regulation for credit acceptance, municipalities monitor the national economic situation and naturally adapt to it, except in the period immediately preceding municipal elections.

5.4 Future Outlook

According to the preliminary version of the public finance reform prepared by the Ministry of Finance, certain limits are being planned for acceptance of credits by municipalities and regions.[13]

As regards the granting of subsidies to municipalities and regions, one idea being considered is that in the case of financial participation covered by returnable sources (credit, loans, returnable financial aid or the issue of municipal bonds) the fixed limit of debt-servicing must not be exceeded.

An effort is being made to clearly define the content of debt-servicing as the sum of all liabilities from returnable sources of a municipality or region by December 31 of the past year. Debt-servicing defined in this manner should be proportional to the volume of actual revenues attained in the last calendar year. The proportion thus derived will provide a "debt-servicing index" whose excess would mean a limitation for a municipality or region, in the sense that it would not be possible to obtain an investment subsidy from the state budget.

Also being considered is a return to the necessary three-fifths majority of all municipal or regional boards of representatives in certain cases stipulated by law. This could apply specifically to cases where a debt was accepted in excess of 50% of actual revenues of a municipality or region in the given calendar year. The proposal for the three-fifths majority decision aims at increasing the responsibility of municipal and regional board members when deciding on credits and loans that represent a large volume of financial means in comparison with the actual revenue budget, because such decisions affect municipal and regional management for a long time to come.

Another limit being considered is to clearly stipulate that local self-governments can use sources from long-term loans (credits and issues of municipal bonds) only for capital expenditures.

6. BOND ISSUING BY LOCAL SELF-GOVENMENTS

6.1 The Development of Legal Regulation for Issuing Bonds

Within a relatively short time after 1989 municipalities were given the opportunity to issue their own bonds. Legal regulation of municipal bonds was inherent in Act No. 530/1990 Coll., on bonds. After several amendments, this act is still valid today and the provisions concerning municipal bonds remain basically the same.

Rather paradoxically, municipal bonds can be issued by a bank if this bank granted a credit from the yield of sales of municipal bonds to a municipality that requested their issue and that also stands surety for the issue with its property. Such a bond was termed (and still is) a "municipal bond," although in fact it was nothing more than a different form of the municipality's standing surety for the credit granted by the bank to the municipality. The reason for the inclusion of this provision in the Act on Bonds could be the fact that in the given period banks did not have enough free financial means to grant sufficient credits to municipalities and this unusual solution offered itself as a substitute. Although this provision has been in operation since the beginning of 1991, no municipality has used it to date.

Another possibility was for a municipality to issue a municipal bond directly or, more commonly, a municipality concluded a contract on issuing municipal bonds with a specialized company or bank with whose help it subsequently issued bonds bearing the adjective "municipal." In this case, too, the municipality had to stand surety with its property.

However, there was nothing preventing municipalities from issuing bonds without the adjective "municipal" if they stood surety with, for example, their "good reputation" instead of their property. This could occur with large municipalities with a good rating, or when municipalities used another, third party as a surety. No municipality, however, has yet issued a bond in this way.

When regions were created they became excluded from issuing bonds, of course, since the Act on Bonds applied only to municipalities.

There are two phases involved when we consider the conditions for issuing bonds. The first phase was from 1990 to January 1, 2001, and this is the period we will examine in our discussion of the development of legal regulations for issuing bonds. The second phase, from 2001 to the present, will be described in the next section dealing with the current legislation on regulation and limits for issuing bonds and municipal bonds.

During this period from 1990 to 2001, each bond had to contain the name of the issuer, the name of the bond, the nominal value of the bond, an assessment of the yield, the issuer's pledge to repay the bond's nominal value within a certain term or terms, the date of the bond's issuance, as well as the details on the decision by the Ministry of Finance to permit the issue of bonds with the exception of cases where this permission was not required (solely bonds issued by the state). Each issue of bonds needed consent from the Ministry of Finance, as stated earlier. But the entire system was further strengthened by a rule requiring the approval of the Czechoslovak State Bank (the former central bank) in addition to permission from the Ministry. Permits had to meet all the necessary requirements, while the issuer had to state the purpose for the issue, its present and presumed financial situation, and to declare that it was able to secure return of the issue and how it would be materially ensured. If a natural or legal entity assumed liability for the repayment and interest, the application also had to contain data on the surety and its financial situation and, of course, the consent of the surety to assumption of the surety commitment.

Another instrument used by the Ministry of Finance to ascertain the issuer's financial situation (even more in the case of municipalities) was a rule requiring the applicant to attach to the application the most recent annual financial statement with commentary checked by an auditor. The Ministry of Finance was obliged by law to refuse a permit if the applicant did not prove its capability to ensure repayment of the requested issue; until April 1,1998, it was even obliged to do so when the considered issue was inconsistent with the national financial policy or did not comply with the needs of the financial market, which were reasons providing plenty of scope for rejection. On the other hand, the reasons for not granting a permit did have to be disclosed to applicants.

If bonds were issued without permission, the sanction imposed on the issuer was the forfeiting of all financial means acquired in this manner, to the benefit of the state budget.

The state did not stand surety for liabilities arising from the issue of municipal bonds and bonds issued by municipalities unless it explicitly assumed this liability (which did not happen).

The system for preventing bonds being issued by subjects that could have problems with their repayment was extremely comprehensive. Despite this fact, it was precisely during this period that all bonds of municipalities that could not be paid later (or paid only with great difficulty) were issued. These municipalities had to face an extremely unfavourable economic situation; one of them, also owing to this, is not even able to meet its obligations.

6.2 Current Legal Regulation on the Issuing of Bonds

At the present time, the relevant act pertaining to the issuing of bonds is Act No. 530/1990 Coll., henceforth the "Act on Bonds." Pursuant to the Act on Bonds, the issuer can only be a legal entity unless the legal entity is prohibited from issuing bonds by a special law. This also applies to municipalities and regions, since a special law does not prohibit them from issuing bonds. Thus, municipalities, regions or the city of Prague can issue bonds, while municipalities and Prague can also issue municipal bonds.

Municipal bonds are issued in accordance with Article 20 of the Act on Bonds. In line with the act, a municipal bond is understood as a bond issued by a bank if the bank grants a credit from the yield of bond sales to a municipality that applied for issuance of bonds and stands surety with its property for repayment of the bond, including its accessories. It is this form of municipal bonds which did not and does not have any real justification, nor is it used in practice. Another form of municipal bond is a bond issued by a municipality that is liable (stands surety) for the issued bond with its property. Municipal bonds cannot be issued by regions. Like municipalities, regions can issue bonds without the adjective "municipal."

To issue any bond at the present time, a municipality primarily needs the approval of the municipal or regional board of representatives. Crucial for issuance of bonds is approval of issue terms by the Securities Commission pursuant to Article 2 of Act No. 530/1992 Coll., on Bonds, as amended by later regulations. The Securities Commission (the position of the Securities Commission is defined by Act No. 15/1998 Coll., on the Securities Commission, which amends other acts) is a state institution supervising the issuance of and the market in securities and, among other things, is in charge of issuing bonds, including municipal bonds.

Issue terms for statement of bonds must contain the following compulsory requisites: data on the form of the bond issue, the term of issuing the issue, the presumed volume of the bond issue, data on persons participating in ensuring the issuance of the bond, and many other conditions. The term that must be stated concerns information on whether and by whom the financial solvency of the issuer was assessed (rating) and with what result, or that the evaluation was not carried out. The total volume of the bond issue must not be lower than a sum in CZK commensurate with the sum of EUR 200,000. The state only stands surety for bonds issued by municipalities, regions or Prague if it does not directly assume this surety, but to date there has not been such a case.

An issue of bonds can be ensured by the issuers themselves or through a person who takes care of the issue or contractually pledges for it, which is also prevalent with municipalities.

After January 1, 2001, the relatively thorough system of control for issuing bonds was abolished. Instead of being approved by the Ministry of Finance, bond issues are approved by the Securities Commission. The condition requiring approval of issues by the central bank was also abolished, the purpose of using the issue need not be stated, information about the current and presumed financial situation need not be provided, and it is no longer necessary to submit a statement of whether a municipality or region is capable of securing the return of the requested issue. The applicant need not attach to the application the most recent annual financial statement with the commentary checked by an auditor. The act also ruled out the possibility of the Ministry of Finance not granting permission for issuance of a bond if the applicant does not prove its ability to secure the return of the requested issue.

However, all these novelties are still affected by what happened during the short period between the beginning of 2002 and May 2002, which was characterized by the attempt to reduce the incurring of debts by municipalities and regions in the Czech Republic. In this period, issuing municipal bonds was conditional on the government's approval (the condition did not apply to bonds without the adjective "municipal" or to bonds issued by regions). This limit did not exist for Prague at all. It is not necessary to ponder the reasons why such a half-baked solution was chosen, nor is it necessary to create complicated structures. The amendatory act that stipulated these new terms was simply badly written, which was soon admitted by the Parliament of the CR, and within a short time the previous status was renewed. In this period, merely one municipal bond, issued by the city of Brno, was issued with the approval of the government. Nevertheless, this misconceived and imperfect solution showed that indebtedness of local self-governments had already become a generally discussed topic that would have to be tackled in an appropriate manner as soon as possible.

The only limits for issuing bonds by municipalities, Prague and regions are their internal terms, i.e., limits approved by boards of representatives, and external limits, i.e., approval of issue terms by the Securities Commission. The sole instrument the Securities Commission has for assessment of the financial situation of a municipality or region is the information about whether or not a rating was carried out and with what result. For municipalities or regions, just the information that a rating was not carried out at all is sufficient.

This all goes to confirm that at the present time in the Czech Republic there are hardly any limits for municipalities if they want to issue bonds besides approval by the Securities Commission, whose approval procedure can be qualified as being focused primarily on the formal side of the matter, while the actual capability of a municipality or region to meet its obligations remains in the background.

Neither municipalities nor regions have any legal barrier to issuing their own bonds.

6.3 Reasons for Issuing Bonds

According to the Ministry of Finance of the CR, in the period 1992–2001 a total of 23 issues of municipal bonds were carried out. The following table shows which municipalities were issuers, in which year and at what level. For a more vivid description and a better idea of the issuer, the table also includes the number of inhabitants of the municipalities (issuers). Since the authorization to issue was not acted on in all cases, the table also gives information about the real number of issues carried out. Important to our topic are the maturity term, interest rate and the purpose of using financial means attained through the issue of municipal bonds.

Table 4.8
Issues of All Municipal Bonds

Size of Municipality	1992–1993	1994–995	1996–1997	1998–1999	2000–2001	Total
Over 100,000	1	3	2	1	3	10
50,000–100,000	0	2	3	0	0	5
10,000–50,000	1	3	0	0	0	4
Below 10,000	0	3	1	0	0	4
Total	2	11	6	1	3	23

Source: Ministry of Finance of the CR.

After the initial boom in municipal bond issues in 1994–1996, a certain disillusionment followed in 1997–1998 as the economic situation worsened in the CR. Characteristic of the latest period (1999–2001) is that municipal bonds were only issued by large cities. Issuing bonds is economically advantageous when done in large volumes. To obtain smaller volumes of finance, towns and municipalities in the CR use the increasingly available credits from commercial banks.

As for municipal bond issues in past years, some towns managed to fully settle their liabilities and some handled their installments of issues by means of accepting credits from finance companies. Issuing bonds is rather expensive, especially the printing costs. Yields from bonds are capital income; therefore, towns must pay taxes on this income and furthermore regularly pay annual yields to investors. A town must secure a so-called bond manager to sell the bonds and in a way guarantee their quality, an extremely complicated and expensive process. From this viewpoint, obtaining credits is easier, regardless of the fact that issuing bonds is also a relatively time-consuming matter.

6.4 Future Outlook

Future legal regulations on the issuing of bonds by municipalities and regions should tighten up state supervision to ensure municipalities do not issue bonds that they can not repay. Two groups of questions must be confronted when dealing with the matter of regulations:

First, judging from current experience, issuing bonds does not cause big problems in general. Of all the instances when bonds were issued by municipalities, the situation of a municipality not being able to meet its obligations only occurred once, while in one additional case repayment has been extremely difficult. Both cases occurred in the period when the strictest criteria were set for issuing bonds. Approval was required by the Ministry of Finance on the basis of an expert opinion of the central bank, while the applying municipality had to prove its ability to secure return of the requested issue. Both cases involved small municipalities (up to 4,000 inhabitants). To date, issuing bonds has not resulted in any serious troubles for medium-size and large towns. Having separate criteria for different size categories of municipalities would alleviate such problems; however, this would contradict the legal order of the CR, primarily the Constitution of the CR, which asserts that identical criteria must be set for all municipalities. Because bonds are mainly issued by large municipalities, the criteria for issuing bonds should be adapted to them above all. Also, the limits should be as small as possible and should be reduced to the submission of a rating of a town or region and subsequent approval by an assigned institution.

Selection of a suitable institution is the second problem that must be tackled in the regulation of issuing activity. The question is: which state institution is best able to assess whether or not a municipality's economic situation is such that even in the future it can easily secure return of the bond issue? Basically, only the Ministry of Finance, the central bank and the Securities Commission come to mind. The Securities Commission checks that the issue terms are met, but it only focuses on the administrative side of the matter and does not have an appropriate apparatus for assessment of these questions. The mission of the central bank is somewhat different than monitoring the economic situation of individual municipalities. That leaves only one solution, namely, the Ministry of Finance should issue permits for issuing bonds by municipalities and regions despite the fact that it did not fulfill its task perfectly in the past when it also approved applications for issuing bonds for municipalities unable to repay. The Ministry possesses the necessary specialist apparatus for assessment of these matters and, crucially, it collects the necessary statistical data on the basis of which it can assess the economic conditions of a particular municipality.

At the present time, the Ministry of Finance is preparing a new act on bonds that should deal with the municipal bond issue in a new manner. According to the proposal, "municipal bonds" are redefined as all bonds issued by local self-governing units, i.e., municipalities and regions. Local self-governments are liable for their repayment, including yields, with their own property. There is an evident endeavour to renew compulsory approval by the Ministry of Finance. The applications by local governments are to include the purpose of issuing municipal bonds, fundamental data on future issue terms, economic analysis of the reasons for issuing municipal bonds and the impact on the economic and financial situation of local self-governing units, including facts essential for judging their ability to meet the obligations arising from municipal bonds. In addition, according to the proposed wording the Ministry of Finance could request other unspecified documents relating to the intention of issuing municipal bonds. However, the final version of the rules for issuing bonds is not yet known.

7. OTHER FORMS OF MUNICIPAL AND REGIONAL LOANS

As mentioned previously, apart from taking credits from finance companies or issuing their own municipal bonds, local self-governing units have other ways of borrowing money. This form of borrowing is frequently used and its importance seems to be gradually increasing. It primarily applies to towns and municipalities, with the exception of the four largest cities.

7.1 Returnable Financial Aid

In order to cover a temporary time lag between the drawing of budget expenditures and the fulfillment of budget revenues intended for their settlement, a municipality can use returnable financial aid from the state budget, a regional budget or a budget of another municipality. Such returnable financial aid is interest-free. The date of maturity depends on the specific agreement with the provider, usually ranging between one and ten years. In the past, the possibility of financial aid from district authorities was used very frequently.

This aid is mainly used by small municipalities. At times municipalities run into trouble with cash-flow management without being entirely at fault. The problem is that shared revenues from taxes collected by the state do not arrive as regularly as municipalities may need. This primarily concerns the value added tax, which became revenue of the municipalities in 1996. On the other hand, income taxes—both personal (PIT) and corporate (CIT)—are very stable.

As regards regions, pursuant to budget rules a valid approach used by this type of local self-governing unit is to access interest-free financial aid from the state budget or from the budget of another region.

7.2 Loans from State Funds and the State Budget

7.2.1 The State Environmental Fund

This fund supports the implementation of measures beneficial in areas such as water conservation, air pollution control, waste management, environmental management, natural resource conservation and utilization, technology and production. The fund is financed by charges and fines for using or polluting the natural environment as well as by subsidies from the state budget.

Support from the State Environmental Fund can also be requested by municipalities and regions (and other non-entrepreneurial bodies). A special directive determines the maximum possible percentage of direct support, i.e., subsidy or loan, for each program. In the case of a loan, the maximum possible level of the total sum is again stipulated; the debtor repays soft interest, while a several-year delay of repayment is possible. For municipalities, the soft interest rate is 1.5%, instalments may be delayed up to two years and the maturity date of loans is up to 20 years.

Another program through which the State Environmental Fund grants support pertains to energy-saving and utilization of renewable energy sources. Here, non-entrepreneurial subjects, including municipalities and regions, can obtain subsidies or soft loans. The system is the same as that described above.

In 2002 two special aid programs for flood-affected areas were also announced.

Total expenditures of the fund from 1992 to 2001 were CZK 32.52 billion. In 2001 the expenditures totalled CZK 3.70 billion, of which CZK 1.02 billion was in loans.

Between 1992 and 2001 the fund gave financial support in the implementation of:

- 972 wastewater and sewage treatment plants;
- 120 projects for mitigating flood damage (1997 and 1998 floods);
- 151 contracts to assist with purchasing drying devices;
- 3,407 all-round gas provision to municipalities and boiler plants, including other types of technology;
- 1,087 projects aimed at reducing the burden on nature and the landscape, including waste management projects.

From the beginning of the fund's activity in 1992 until the end of 2001, a total of 5,466 positive decisions of the Minister on granting support were issued, representing the sum of CZK 35.61 billion. Of this number, a total of 1,512 projects were definitively completed, including possible settlement of loan and credit repayments. In the case of 1,297 projects, implementation was finished and support conclusively awarded through approval of the final project evaluation, while the paying back of the loans continues.

7.2.2 The State Housing Development Fund

This fund is mostly financed by subsidies from the state budget and returns from granted loans. As regards loans, the fund uses its own means for covering parts of interest on credits granted by banks to legal and natural entities for repairs, modernization and restoration of prefabricated blocks of flats.

Support may be received by an owner or co-owner, a natural entity, a legal entity or an association of owners. Support is provided at the level of the difference between credit installments commensurate with the reduction of interest on credit by 3% (in some cases, 4% and 5%).

Another form of support is granting credits to municipalities to cover partial costs connected with repairs and refurbishment of flats. For this purpose, a municipality must set up a special money fund and issue rules for its use. The annual interest rate on a credit granted by the fund is 3%.

Interestingly, the fund also grants subsidies for construction of tenant flats in the ownership or co-ownership of municipalities, as well as for repairs of prefabricated blocks of flats and construction of houses with care facilities. There is also support for restoration of prefabricated housing estates administered by the Ministry of Regional Development.

Financial support for municipalities stricken by floods is also proposed.

The fund has financed 478 applications to the tune of CZK 2.999 billion under the program supporting the construction of tenant flats and technical infrastructure, which represents the construction of 8,409 residential units.

Within the framework of the program supporting construction of houses with care facilities, the fund has financed 64 applications for a total of CZK 959.5 million, which represents construction of 1,415 residential units.

This support in the form of subsidies was intended for towns and municipalities.

7.2.3 Other State Funds and Support

Through its agency for foreign investment, CzechInvest, the Ministry of Industry and Trade organizes support for municipalities and regions for the development of industrial zones, i.e., area development, technical equipment (infrastructure) and the necessary land reallotments. Support is provided in the form of subsidy for partial payment of interest on bank credits, or as returnable financial aid or direct subsidy.

Furthermore, through the Czech Energy Agency, the Ministry of Industry and Trade supports municipalities and regions in energy-saving and utilization of renewable and secondary energy sources (e.g., support for drawing up territorial energy plans and energy audits), but it offers subsidies, not loans.

Another possibility is the Housing Guarantee Program which, through the company MUFIS, supports the development of municipal infrastructure by means of long-term credits with maturity of up to 15 years with fixed interest rates. Using this credit, a municipality, town or their associations can finance in particular:

- construction and refurbishment of engineering networks (gas introduction, water mains, sewage, and electrification), including investing in land for housing construction;
- construction and refurbishment of wastewater treatment plants and facilities for solid household waste disposal;
- improvement or conversion of heating systems for municipal houses;
- construction and refurbishment of the housing stock owned by municipalities and the restoration of housing estate units;
- construction of houses with care facilities for senior and disabled citizens;
- construction and/or improvement of small thoroughfares inside housing estates and residential quarters, small transport buildings (terminals and local public transport stops, etc.);
- possibly other projects connected with the improvement of housing conditions and the environment of municipalities.

It must be emphasized, however, that the use of these credits must always result in a significantly positive effect on the residential sector in the locality. This program of financing municipal infrastructure is implemented on the basis of an agreement concluded between the Government of the Czech Republic and the US Government. Its main objective was to stimulate in our banking system the granting of long-term loans with an acceptable interest rate for the development of towns and municipalities in the Czech Republic.

Using the financial means of this credit line, 121 credits have been granted to 112 municipalities for a total sum exceeding CZK 1.4 billion, mainly to finance projects such as heating system conversions, insulation, gas introduction, construction and refurbishment of water-supply mains and sewage, wastewater treatment plants and municipal waste landfills. The vast majority of these credits were granted with a long-term maturity of 10 to 15 years.

The Ministry of Agriculture of the CR grants subsidies to cover the interest on credits for construction and technical renovation of water lines and water treatment plants, construction and renovation of sewage and wastewater purification plants. The maximum participation of the state in covering interest is set at 75% of the interest on credits with a maximum maturity term of seven years. For this purpose, it is also possible to grant non-returnable subsidies.

The Ministry of the Environment of the CR grants a subsidy for minor water-management constructions, to cover payment of the interest on credits at the level of 5% for a maximum of five years from the start of a credit not exceeding 30% of total costs. Non-returnable subsidies can be granted for this purpose too.

Table 4.9
Summary of Loans Issued to Local Self-governing Units from Budgets of Individual Departments in 2001 [Thousand CZK]

Department	Loan[14]
Ministry of Labour and Social Affairs	60.0
Ministry of the Environment[15]	100,145.5
Ministry of Regional Development	827.6
Ministry of Agriculture[16]	116,650.5
National Fund	1,626.0
General Treasury Administration[17]	864.0
State Environmental Fund	889,593.7
Total	1,109,767.3

Source: Ministry of Finance of the CR (Subsidies and loans from the state budget and state funds received by local self-governing units in 2001).

8. LOCAL SELF-GOVERNING UNITS INCAPABLE OF MEETING THEIR LIABILITIES

At the present time, there are cases of municipalities in the Czech Republic that have not been able to meet their liabilities. That is, their indebtedness has reached such a stage that they are not able to repay their liabilities at all. Unfortunately, data on the total number of these municipalities is not available.

Analyzing this situation presents many problems, one being the criterion according to which we classify a municipality as being indebted at a risk level. We can only take into account municipalities whose debt is higher than total municipal revenues. However, such an approach would not correspond with reality since the future development of the municipality will be significantly affected by a debt much smaller. Therefore, we will hold to the definition used by Ing. Luděk Tesař, who in 2000 was a specialist employee of the Ministry of Finance of the CR.

Tesař considers a municipality to be indebted at a risk level when its debt exceeds 50% of tax revenues and, at the same time (when introducing the new tax distribution), its tax revenues fall by more than 20%. According to this loosely set criterion, approximately 5.6% of municipalities in the CR were indebted at a risk level in 2000. In the same year, the number of municipalities indebted at a non-risk level was 67.3%, while 27.1% were not indebted at all. We should keep in mind that municipalities in the CR prevalently use credits for financing investments in infrastructure. In this regard, the often omitted connection between municipalities' indebtedness and their property must be pointed out. Property value greatly exceeds the current indebtedness rate. In terms of covering municipalities' liabilities, the indebtedness share in their total assets is well under 5%, which is fully satisfactory (Tesar 2002).

The study monitored the effect of change in tax revenues on municipalities' indebtedness. Table 4.10 shows that the highest number of those indebted at a risk level is among small towns and municipalities. The highest number of municipalities indebted at a risk level can be found in the category of municipalities with 300–1,500 inhabitants. As for the volume, the highest number of municipalities indebted at a risk level is in the category of municipalities with a population of 1,500–5,000. Somewhat surprising is the fact that municipalities indebted at a risk level are also to be found in the group of medium-size towns in the category of 10,000–20,000 inhabitants, which have sufficient financial means to ensure the necessary professional expertise (by having their own permanent professional staff of officials).

The data in Table 4.10 indicate that the number of municipalities that can be labelled as indebted at a risk level is not significant. A minimal number of them are not able to meet their liabilities (unfortunately, the exact figure is not available). Nor does the average debt per capita cause problems since as the average debt per capita grows according to individual size categories of municipalities, so do tax revenues from shared taxes. For a better idea of the issue of over-indebted municipalities, let us give two examples.

The first example is the municipality of Podhořany, with approximately 300 inhabitants. Revenues of its municipal budget in 2002 were CZK 1.5 million. According to the mayor, the municipality needs at least CZK 0.5 million for its annual operation. This represents expenditures that the municipality is obliged to pay by law.[18] Basically, the municipality can secure collection of municipal waste, but cannot provide public lighting.

The municipality owes a total of CZK 8 million. The major part of the debt is directed to repayment of water supply lines, roughly CZK 6 million. This debt will be repaid by the municipality in 2004—2018. Another part of the debt, which is already mature today, is the sum not yet repaid for gas introduction into the municipality. The municipality owes CZK 1.17 million (+ a contractual penalty of CZK 315,000 + distraint costs of CZK 216,000[19]), which must be paid immediately. At the present time, the municipality has hardly any property. Municipal land, the municipal office building and the building of the former nursery school do not have much value. Neither the sale of the municipal office building nor municipal land would suffice for covering the debt. The estimated value of the nursery school is approximately CZK 1.5 million, but it can be expected that the market price is much lower. At present, the municipality cannot dispose of its account since, within the framework of distraint, it has been frozen.

Table 4.10
Risk-indebted Municipalities According to the Stated Criterion (2000)

Size Category of Municipalities According to the Number of Inhabitants	Indebtedness of Municipalities in 2000 [Thousand CZK]	Average Debt per Capita [CZK]	Number of Indebted Municipalities	Number of Municipalities Indebted at a Risk Level	Number of Municipalities In the Size Group	Outstanding Debts [Thousand CZK]
0–100	31,895	814	262	11	547	8,103
100–200	290,495	1,749	649	28	1,107	89,755
200–300	410,163	1,853	531	25	900	98,832
300–1,500	4,952,109	2,644	1,968	115	2,855	669,027
1,500–5,000	5,860,988	3,898	539	38	581	894,638
5,000–10,000	3,272,230	3,685	133	10	128	411,277
10,000–20,000	3,236,427	3,368	66	7	68	610,711
20,000–30,000	1,666,015	2,477	28	0	27	0
30,000–40,000	997,746	2,578	10	0	11	0
40,000–50,000	41,789	233	5	1	4	–129,133
50,000–100,000	2,705,154	2,173	16	0	17	0
100,000–150,000	600,779	5,816	1	0	1	0
150,000–500,000	4,938,666	5,706	3	0	3	0
Over 500,000	11,948,846	10,125	1	0	1	0
CR in total	40,953,301	3,979	4,212	235	6,250	2,653,211

Source: Tesař L., Obec a finance (Municipality and Finance), January, 2002.

The second example is a small town with approximately 3,500 inhabitants, located in an attractive skiing resort (Rokytnice nad Jizerou). Municipal budget revenues in 2001 were CZK 43 million. The town's total debt in 2002 was CZK 417 million. In 1994 the town acquired CZK 120 million from an issue of municipal bonds. The acquired funds were used for a wastewater treatment plant, reconstruction of the upper square and the lower square.

On November 20, 1996, the municipal councilors were notified that the town did not have one crown left; therefore, it had to borrow money for repayment of the coupon from the bond issue. At that moment, the town virtually collapsed. In November 1996 it did not even have money for repayment of the coupon in the sum of CZK 14,400,000. In 1998 a commercial bank requested that the town pay its liabilities of CZK 70 million; however, the town could only pay less than CZK 14 million. Thus, the town owed CZK 57 million for 1998, and it attempted to negotiate with the commercial bank. After one year of fruitless negotiations, the debt was transferred to Konsolidační banka Praha, s.p.ú (Consolidation Bank Prague). The town tried to reach an agreement on a long-term installment calendar, but negotiations were unsuccessful. Konsolidační banka Praha annnounced that an auction would be carried out.[20] According to available information, the auction of municipal property brought in approximately CZK 70 million.

The respective provisions of Act No. 328/1991 Coll., on bankruptcy and settlements, do not apply to municipalities and regions; i.e., neither municipalities nor regions can actually go bankrupt. However, in practice, the property assets and financial possibilities of municipalities (the same may occur in the case of regions) could be reduced to such an extent that they would not be able to provide fundamental services to their citizens. Consequently, the state began to feel some pressure to deal with the situation. Hence, the Acts on Municipalities, Regions and the Capital City of Prague unambiguously stipulate that the state does not stand surety for financial management and liabilities of a municipality, region or Prague, unless the state assumes this liability contractually. The situation of the municipalities affected remains unresolved.

9. THE IMPORTANCE OF ECONOMIC CHECKS, AUDITING AND RATING

9.1 Economic Checks and Auditing

The first version of the Act on Municipalities of 1990 already stipulated their annual duty to verify the results of their economic management for the past calendar year. Municipalities could decide themselves whether to have the check carried out by a district authority or by an independent auditor.

In the early 1990s, auditors or audit companies had to familiarize themselves with differing conditions in towns and municipalities since there was virtually no one specializing in non-profit organizations.

The vast majority of municipalities in the CR had their economic management audited by district authorities (free of charge). Only large cities were willing to pay for auditors.

Since the beginning of 2003 municipalities with a population of at least 5,000 must have their economic management checked by auditors. In territorially divided statutory towns, economic management of wards and districts is checked by municipal councils of these towns. Municipalities with fewer than 5,000 inhabitants can still choose between regional authorities or auditors to check their economic management for the past calendar year.

Furthermore, stricter sanctions have been introduced, and revenue authorities are entitled to impose fairly substantial penalties for non-fulfillment of this duty.

As for regions, at the beginning of 2001 they were required to have their economic management for the past calendar year checked by an auditor or the Ministry of Finance. The amendatory act valid from the beginning of 2003 changed this so that only auditors may perform the check. The capital, Prague, can still choose between an auditor or the Ministry of Finance.

At the beginning of 2002 the Ministry of Finance of the CR issued a special regulation on auditing the economic management of local self-governing units and voluntary unions of municipalities. It defines the subject in detail, including the content and terms of the check.

The conclusion of the report on the results of an audit must state that:

- No faults were ascertained; or
- Faults were ascertained but violation of fiscal discipline was not ascertained, nor incompleteness, non-evidence or incorrectness in conducting accounting; or
- Some of the following faults were ascertained:
  - violation of fiscal discipline;
  - incompleteness, non-evidence or incorrectness in conducting accounting;
  - alteration of records and documents inconsistent with the legal regulation;
  - violation of competencies and duties of authorities of local self-governing units and voluntary unions of municipalities stipulated in special regulations;
  - faults ascertained during previous auditing were not removed; or
  - conditions for auditing were not created.

The regulation guaranties a comparable level of economic checks, independent of whether or not they are performed by a regional authority or an auditor.

The amendatory Act on Municipalities is essential in the sense that a large number of towns will have to request audit companies to check the results of their economic management. It will mean a certain financial burden for them and a rather different way of cooperating. On the other hand, there will be more work for audit companies since there are 260 towns with populations over 5,000 in the Czech Republic. As for regional authorities, the number of potential "clients" (i.e., municipalities with less than 5,000 inhabitants) will be approximately 6,000.

Since the beginning of 2002 another law with a direct effect on this issue has been in operation—the Act on Financial Checks in Public Administration. This issue was dealt with in detail in Section 6.

9.2 Rating

Unlike auditing the results of economic management, rating is not imposed upon municipalities by law; i.e., it is not compulsory. Basically, it provides an independent, comprehensive assessment of a subject's ability to meet its obligations. It is a comprehensive description of all known risks. This service is generally used abroad, and Czech towns are making increased use of it. Several well-known agencies have been operating worldwide for a long time, among them Standard&Poor's, Moody's and Fitch. The Czech Rating Agency has established itself on the Czech market. In 1998—2002 this agency carried out ratings of approximately 30 Czech towns, with good short-term and long-term rating and stable outlook.

Of course, rating is most often used when someone wants to borrow money, either directly through a bank credit or through a bond issue. For instance, when Prague decided to issue municipal bonds on a foreign market, rating from an established global agency was necessary.

Successful rating of the examined subject has two main benefits. On the one hand, it provides potential creditors—purchasers of bonds or credit grantors—with the detailed information they have no time to ascertain themselves. The set mark rating the level of one's ability to meet short-term or long-term obligations then serves as a recommendation for whether or not to establish a business relationship with the given subject and, if so, under what conditions. Thus, rating significantly affects the value of money the subject in question is borrowing. During the rating procedure, it is also possible to order subsequent continuous monitoring.

Rating is not only useful in obtaining the cheapest possible external financial means. For towns and municipalities, it is also suitable when applying for various subsidies and loans from the state budget and state funds. Recently, Czech municipalities began using this manner of evaluation as another advantage when negotiating the entry of foreign investors to their territory. Information in rating records is comprehensive and can serve as one of the many factors to be considered during investors' complicated decision-making on the selection of the most suitable locality for implementation of their intentions.

It must be added that rating services are not free; in the case of major foreign agencies, the minimum sums required amount to hundreds of thousands of Czech crowns. For municipalities this cost is decisive; however, there are situations when rating is necessary and useful.

10. STANDING SURETY FOR THIRD-PARTY LIABILITIES

The issue of local self-governments' standing surety is interesting for two reasons. First, legal regulation on standing surety affects the real possibility of a local self-governing unit incurring debt, i.e., accepting a credit, accepting a loan or issuing municipal bonds. The other, no less important, reason to pay attention to this question is the fact that in the past municipalities supported local entrepreneurs by means of standing surety for their accepted credits. For example, there were cases when a municipality stood surety for a liability of a private company that introduced a gas system for the municipality. In such cases the municipality secured the credit or loan either with its property or its future revenues. It was precisely this standing surety for third-party liabilities that led to the growth of indebtedness in (mainly small) municipalities. However, we do not have at hand exact data on the level of such liabilities.

The situation was dealt with by the World Bank in its report of 2000. Point 5.28 of this report states: "On the other hand, municipalities themselves[21] granted loans and stood surety for local companies with the aim to support local development activities. Although these financial activities of municipalities in the Czech Republic are subject to the approval of municipal boards of representatives, the procedures are unclear,[22] and the lack of monitoring and supervising mechanisms provides scope for soft fiscal limits and also brings moral risks, which are signs of high fiscal risk."

10.1 Legal Regulation and Practice

Limits for standing surety are almost identical for municipalities, regions and Prague. They must not stand surety for liabilities of natural and legal entities, apart from the case of exceptions specified in detail by law.

The first exception concerns liabilities arising from credit contracts, if the financial means are intended for investment implemented with financial support from the state budget, state funds or the National Fund. This formulation not only includes construction of a new flat, residential or family house, but also many other cases where a certain type of investment is supported by the state from the state budget, by the state through state funds set up by it (e.g., the State Environmental Fund and the State Housing Development Fund) or where investment will be implemented using money from the

European Communities. A practical example is investments in construction of industrial zones pursuant to a special law on investment incentives. Another practical example is gas introduction in a municipality for which the municipality can obtain state financial support (from the State Environmental Fund), but since the municipality itself does not possess the necessary financial resources, it stands surety for the liabilities of the natural or legal entity implementing this investment.

The second exception from the rule that a municipality must not stand surety for the liabilities of natural and legal entities concerns liabilities arising from a credit contract if the financial means are intended for investment in real estate owned by the municipality. This exception was set in order to minimize the risk of a municipality suffering a loss since, in the case of an unsuccessful investment project, the municipality keeps the actual investment in its own real estate. In practice, this exception is to allow for cases when a municipality rents a certain real estate or part of it provided that the tenant valorizes it. Thus, the tenant can take a credit that will all be invested in the municipal real estate, adding value to the municipal property. If a natural or legal entity does not fulfill its debt towards the creditor (as a rule, a bank), the municipality has to stand surety. However, the municipality's loss in this case will be smaller since the unpaid debt will be invested in its property.

The third exception concerns legal entities set up by a municipality, region or the state. Mainly this relates to contributory organizations[23] set up by a municipality or region, or state contributory organizations.[24]

The fourth exception again concerns merely legal entities established[25] or created[26] by a municipality itself or together with another municipality (municipalities), together with an optional region (i.e., not only the region in the territory where the municipality is located) or the state. At the same time the condition must be met that requires higher than 50% share of one or more municipalities, or together with one or more regions, alternatively the state. This ensures that a local self-governing unit can stand surety for the liabilities of a legal entity it "controls" itself or together with another local self-governing unit or the state. The assumption here is that if local self-governing units have a majority share in such a legal entity, they also control its functioning.

The last exception concerns housing associations. A local self-governing unit can stand surety for the liabilities of housing associations, including those in which it is not a member. This exception is to allow municipalities to stand surety in an area as specific as association housing and, above all, it should prevent barriers being placed against association housing construction with state support.

All this shows that by means of significant restrictions, the current legal regulation in operation since July 31, 2002 has tackled the problem of a local self-governing unit standing surety for a third party. In the case that the third party does not fulfill its obligations, the duty is transferred to the guarantor. These cases have only concerned municipalities (there is no known case involving regions during their short history).

Thus, municipalities' debts grew due to their assuming the debts (liabilities) of someone else. In particular, this problem occurred with small municipalities without a sufficient legal and economic background.[27]

Throughout the 1990s there were no limits on local self-governing units' standing surety for third-party liabilities. Just as today, municipalities could stand surety for their own liabilities entirely according to their own deliberation, without any limits. Most frequently, municipalities stood surety with their property or future revenues.

The new regulation limiting local self-governing units' standing surety for third-party liabilities needs a certain time for definitive assessment. The working material relating to public finance reform that is to be prepared by the Ministry of Finance of the CR does not indicate that this legal regulation should change in the near future. Hence, we assume that the limits on standing surety will remain in their present form.

We must stress that statistics on local self-governing units' standing surety for third-party liabilities do not exist at the present time.

11. MAIN ISSUES IN LOCAL SELF-GOVERNMENT BORROWING: CONCLUSIONS AND RECOMMENDATIONS

11.1 Main Issues

As a result of the totally different method of financing and dividing competencies between the state and local administration, there was no experience with borrowing prior to 1990. There was no need for borrowing given the subsidy system of granting sources.

However, the original system caused extreme investment debt, mainly pertaining to local infrastructure. Therefore, from the very beginning of the 1990s citizens and, subsequently, elected representatives applied great pressure aimed at removing this debt as quickly as possible in order to continue with the essential work of repairing local thoroughfares, constructing wastewater treatment plants, providing gas and sewage for more municipalities, repairing school and theatre buildings, sports grounds and so on. Naturally, municipal budgets were not sufficient to carry out all these tasks, irrespective of the fact that since the early 1990s their volume was gradually growing.

As a result of all this, a necessary discussion was launched in municipalities— first about whether to borrow money, and then later, how much. In most municipalities the prevailing opinion was that it was sensible to use financing other than one's own revenues for infrastructure investment projects that should serve for many decades. However, at the beginning of the 1990s the big problem was that banks did not have cheap long-term money available. Thus, municipalities were forced to borrow for a short term at relatively high interest rates. This situation has gradually improved.

Another issue is how big a debt to incur. Only over time did banks draw up their own systems for assessing the creditworthiness of individual towns and municipalities, i.e., their ability to repay all liabilities. In the early 1990s, rating as a form of assessing municipalities' creditworthiness hardly existed, and analyses on the part of municipalities was impeded by the lack of affordable, high-quality specialists, especially in the case of smaller municipalities. In addition, banks did not require such information very much, or did not take it into account when setting credit terms.

Connected with this is another issue: the requirements of banks for security of money borrowed. Initially, in practically all cases municipalities were required to provide surety in the form of pledging some municipal immovable asset. Most in demand, of course, were commercial buildings with a definite market value; however, there are not a vast number of such buildings in municipal ownership. It was also possible to stand surety with negotiable shares, but municipalities have gradually rid themselves of these shares over time. At present, standing surety with future revenues is accepted, but only after the financial situation and behaviour of the potential debtor has been checked in detail.

In the Czech Republic there are a lot of municipalities with few inhabitants, and consequently with a relatively small annual budget. Despite this, they are obliged to execute all self-governing functions pursuant to valid laws, without exception. Naturally they face major problems with the financing of necessary investments, primarily of an infrastructure nature. Many projects are not only beyond the financial means of the municipalities, but it is also difficult to borrow for them from a well-established finance company.

There is minimal room for maneuver when it comes to autonomy over municipal revenues. In other words, in the case of regular, repeatable revenues, municipalities have virtually no possibility of reacting to fluctuations or additional requirements for expenditures through a significant increase in their income. One possibility is to sell municipal property, which has occurred on a large scale and is still occurring. However, this significant source of municipal revenues is finite and will gradually play a diminished role. Another possibility is to exert great effort to obtain investment subsidies from the state budget or some of the funds set up by the state. This is also happening, but it is not an entirely systemic approach and is subject to discussion at the present time, especially in connection with the strengthening of the regions' role in the entire system.

The only other path open to municipalities is to incur debt. Basically, the issue is that municipalities have a high ratio of capital costs against total expenditures, and not only in recent years. Operating costs have been gradually rising while total revenues have not been increasing significantly. Irregular capital revenues have been gradually exhausted while the necessity of investments has not decreased. This is very evident in the data provided in this report.

A major difficulty pertaining to Czech municipalities incurring debts is the frequently changed rules for redistribution of taxes collected by the state. The amendatory Act of

1996 had a directly negative financial impact on many municipalities, while an even more fundamental change was introduced in 2001. The issue is that if a municipality wants to borrow for a large investment project, it needs a stable outlook on its financial situation for the period covering the repayment of the entire financial liability. If in the meantime the conditions of the revenue side significantly change, problems with repayment of credit or its interest may occur. At the same time, municipalities have few other possibilities besides selling something or borrowing money.

A more thorough examination of the various forms of lending reveals that a big problem in the early 1990s was the lack of banks' confidence in municipalities. For them, municipalities were not sufficiently transparent since their budget and accounting systems differ from those of entrepreneurs, to which banks are accustomed.[28] Nor is municipal property a simple matter to deal with, especially not its market evaluation or its writing off. On the other hand, municipalities certainly possess the advantage of having a large proportion of guaranteed revenues (real estate tax, shared state taxes and local charges) that are not dependent on any specific business plan.

As regards bonds, these were initially a completely new product for municipalities; their representatives and municipal officials had no experience of them after many years of living in a totally different system. Therefore, some municipalities issued municipal bonds without having the necessary expertise. If a municipality wanted to issue a municipal bond, there was always a bank (throughout the 1990s, the main banking institutions in the Czech Republic were owned by the state) willing to provide the necessary administrative backing to municipalities issuing municipal bonds. State supervision in the area of issuing municipal bonds failed too. Issuing municipal bonds is a demanding matter and in order to be able to enter this process, a municipality needs a reliable long-term forecast of its financial management.

The example of issuing municipal bonds underscores the importance of the professionalization of officials within the local authorities. The privatization of the banking sector has also been a major factor, leading to greater awareness when providing the necessary professional background.

Since the early 1990s two contradictory tendencies have been at work. On the one hand there has been a reduction of the control functions of the state when municipal bonds are issued. We described earlier the strong powers of the Ministry of Finance and the former central bank, but this permission system gradually weakened and was finally fully abolished. On the other hand, the phenomenon developed that small and medium-size municipalities with up to 50,000 inhabitants ceased issuing municipal bonds. At the present time, only the largest cities in the Czech Republic issue bonds. We can assume that regions will also issue bonds in the future; nevertheless, this process can be only expected after their competencies and related revenues have stabilized.

It is precisely in this matter of municipal bonds that we find confirmation of local self-governing units' natural ability to learn and to gain experience. Therefore, any future regulation function of the state should not assume responsibility for local self-governing units, but rather should be set up in a way that prevents the worst excesses.

On the other hand, we have provided some evidence that legal actions or other legislative measure on the part of the state to limit municipalities borrowing money have thus far been minimal. It is quite an interesting phenomenon that Czech municipalities have little room for maneuver in influencing their own revenues but, at the same time, are sufficiently free to acquire external financial sources in the form of loans, credits or municipal bonds.

11.2 Conclusions and Recommendations

If one thing is certain, it is the ineffectiveness of either exclusively following the path of legal restriction, or of leaving unlimited scope for local self-governing units' running into debt. The solution is a suitable combination of legal limits on local self-governing units' indebtedness on the one hand and a responsible approach on the part of elected municipal and regional authorities on the other.

One of the important factors that appear to prevent excessive indebtedness of municipalities and regions is for them to have greater room to affect the revenue side of budgets. At present, they have only minimal possibilities to increase their tax revenues. Regions do not have this possibility at all. In other words, we believe that a method of controlling the growth of local self-governing units' indebtedness would be to reinforce their financial autonomy precisely by granting them the possibility of affecting their tax revenues. All this, of course, must occur in compliance with the total tax burden of citizens and companies.

Hand in hand with the enhancement of municipalities' tax autonomy and the introduction of partial autonomy of regions, the motivation component of redistributed taxes should be increased. The linkage between tax payers and their local self-governing unit should be significantly strengthened using such tax revenues. In this kind of system a citizen can expect to know what will happen to his or her taxes. As tax-payers, they would also become more interested in the operation of local self-government and in the control of the spending. If excessive indebtedness of a local self-governing unit were also to mean an increased tax burden on its citizens, we may expect the development of stronger pressure upon elected authorities aimed at preventing "unnecessary" debt. This "political" component need not be overestimated or considered the sole and most suitable self-regulating element. On the other hand, this important element is almost overlooked in the Czech Republic, even though it is considered one of the foundation stones of local democracy. It is beyond the scope of our report, however, to make precise recommendations on possible changes in the local tax system.

To summarize, we believe that local self-governing units need greater autonomy to affect their tax revenues, and that some form of suitable linkage needs to exist between tax-payers and their local self-governing units.

Another reason for the growing indebtedness of local self-governing units in the Czech Republic was the change in the rules governing municipalities' financing. As for regions, which are relatively new, their rules of financing have changed every year. This is understandable and also correct in our opinion, since they have been gradually assuming more and more new competencies. The change in the financing rules for municipalities can also be seen as justified, as it was necessary to seek an optimum model for their financing. However, the sudden changes without a long transition period in municipal financing have definitely had a detrimental impact on municipalities. As a result, the financial planning of municipalities and regions has lost its information value and justification since the methods of their financing have frequently changed without a long transition period. All changes in the financing of local self-governing units are certainly closely monitored by banking institutions as well, since for them standing surety with future revenues is not an entirely convincing guarantee.

Our second conclusion, therefore, is the requirement for as stable as possible a system of financing of local self-governing units, without any abrupt changes. If changes are to be made to the system, a transition period of several years is necessary to allow local self-governing units to adapt their financial plans to the future system.

Another positive measure leading to higher efficiency and thus also to abatement of municipalities' running into debt is the association of small municipalities for joint investment projects. At present, municipalities can cooperate for the purpose of executing independent operations. Such cooperation is primarily carried out on the basis of a contract concluded with the aim of fulfilling a specific task, on the basis of a contract on the creation of a voluntary union of municipalities, or by means of establishing joint-stock companies or limited liability companies. This confirms that municipalities have an entire spectrum of cooperation possibilities. In addition it allows for professional assessment of the possibilities for individual municipalities to participate in such projects. Small and also medium-size municipalities frequently use these cooperation possibilities in practice.

The third conclusion, then, is the significant value of maximum cooperation between small municipalities in joint investment projects.

One of the many factors preventing municipalities from excessive indebtedness is the internal fiscal discipline of local self-governing units. This includes the creation of responsible budget outlooks that municipalities and regions must draw up for the period of between two and five years. In the case of expensive projects, it is also suitable to use the services of experts whose expertise, however, is often very expensive. As an alternative, small municipalities can also use the services of the banking institutions holding their accounts. Thorough financial control is of great importance. The level of indebtedness of local self-governing units is affected by high-quality annual audits that should provide them with sufficient information about their economic situation.

Another factor preventing local self-governing units from incurring excessive debt is thorough external and internal control when planning investment projects, using either their own or external financial experts who can choose the optimum method of financing the investment project.

Last but not least, legal regulation of municipal and regional debts is important. But when setting rules to limit the incurring of debt, it is essential to learn from the imperfect, non-systemic attempts from past years that had to be promptly rectified, and which in no way contributed to the stability and trustworthiness of the system. When setting criteria it must be borne in mind how sensitive this whole area is; therefore, all economic terms used in the legal rules must be clearly defined in advance. When determining limiting measures, rather than having unachievable criteria there should be a process for obtaining permission from competent institutions (in this case, most probably the Ministry of Finance of the CR) after exceeding a certain limit. When defining legal criteria, it is necessary to acknowledge that a generic legal rule cannot react to all the possibilities of individual local self-governing units, which differ from case to case.

As regards credits and loans, we assume that a legal limit on debt-servicing could be set at 15% of total municipal revenues. This figure is unofficially recognized by banks as a kind of limit up to which they grant credits to municipalities without any major problems. We believe it is possible to support the proposed definition of debt-servicing as described in Section 6. A sanction for exceeding this limit would be the impossibility of being granted an investment subsidy from the state budget and insistence upon prior approval of each credit or loan by the Ministry of Finance.

Despite certain failures in the past, we believe that issuance of municipal bonds should be preceded by approval from the Ministry of Finance. As for the future, we feel it is advisable that municipal bonds should be issued only by large towns and regions. This way, the state administration will encounter few significant problems in assessing individual applications, both in terms of the factual content and of future impacts on economic management.

Last but not least, the excessive running up of debts should be precluded by means of a suitably set system of legal regulations.

To conclude, the indebtedness of local self-governing units in the Czech Republic, despite occasional alarms in the media, is by no means critical. Nevertheless, certain preventive measures as outlined above should be introduced.

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NOTES

1 The study gives data in Czech crowns (CZK). For better understanding of the text, we state the exchange rate of CZK against EUR and USD as of March 11, 2003.

1 EUR	31.50 CZK
1 USD	30.00 CZK

2 Tax revenues of municipalities consist of: national tax shares, real-estate tax, local and management charges, and payments pertaining to environmental protection.

3 They include revenues from organizational sections of municipalities and taxes from contributory organizations set up by municipalities, estate lease revenues, revenues from financial assets, revenues from interest and other non-tax revenues.

4 Primarily yields from fixed assets. Capital revenues have shown a decreasing trend for two years, mainly due to the fact that revenues from shares for which municipalities used to sell voting rights have been basically implemented in significantly lower values.

5 These revenues are formed by transfers from economic activity funds, donations, etc.

6 The Charter of Fundamental Rights and Freedoms is part of the constitutional order in the CR.

7 The main objectives of financial control are to check compliance with legal regulations and measures

adopted by public administration bodies within the scope of these regulations during management of public means for securing the set tasks by these bodies; securing protection of public means against risks; discrepancies or other faults primarily caused by violation of legal regulations, uneconomical, unsuitable and inefficient management of public means or criminal activity; due and reliable informing of public administration executive bodies about management of public means, operations carried out and their conclusive accounting, aimed at efficient regulation of the operation of public administration bodies in accordance with tasks set, and the economical, efficient and purposeful execution of public administration.

8 However, apart from the formal distinction made in the current section, in the rest of the chapter we use the terms loans and credits to describe any sort of borrowing from banking and non-banking institutions.

9 As a specific entity, Prague has its own Act. The capital can be considered a hybrid between a municipality and a region.

10 The problem also lay in the term "last year's actual budget." The text of the respective legal norm did not clearly define if it concerned last year's revenues or last year's expenditures.

11 The National Fund is the sum total of financial means entrusted by the European Communities to the Czech Republic for implementation of joint programs in the CR and money pledged to be provided for implementation of these programs by other foreign sources, the state budget, budgets of local self-governments and other public sources and private sources unless use of these financial means for the determined purpose is proved. Through the National Fund, the Ministry of Finance of the CR coordinates management of financial flows and adherence to the procedures defining implementation of joint programs of the Czech Republic and the European Communities.

12 Credits to local self-governing units in the CR are mainly granted by banks (see Table 3.12).

13 It merely concerns an outline from which we can only imagine the direction the deliberations of the responsible officials at the Ministry of Finance will take in the future.

14 It concerns loans in the form of returnable financial aid.

15 Loans were directed to construction or refurbishment of sewage and wastewater treatment plants in individual municipalities.

16 The largest volume of this sum was represented by loans for support of construction and technical refurbishment of water lines, as well as sewage systems and wastewater treatment plants.

17 Revenues and expenditures of the state budget having a general nature and not being in the scope of power of a certain chapter's administrator, or expenditures of the state budget whose level for individual chapters is not known for the respective year at the time the Act on the state budget was passed, form the chapter of General Treasury Administration. The decision on inclusion of other expenditures in the chapter of General Treasury Administration can be taken by the Government at the time of preparation of the draft state budget, or by the Assembly of Deputies at the time of its passing. The chapter General Treasury Administration also includes the government budget reserve. The administrator of the chapter General Treasury Administration is the Ministry of Finance of the CR.

18 For example, contributions for pupils. If a municipality does not have its own school, it must pay part of the expenses per pupil (at the contractual level) to the municipality whose school the child attends (in this specific case, CZK 3,800 pupil/year).

19 At the present time, the municipality's property is under distraint.

[20] Information from www.mesto-rokytnice.cz/tastupiteltsvo/zapisy/20020710.shtml.

[21] Regions did not exist at that time. Nor at present do we see similar tendencies with regions.

[22] We believe that the procedures are clear and there is no need to harbour doubts about them.

[23] Legal entities that can be set up by a local self-governing unit (municipality or region) for activities within its competence are usually non-profit-making and their scope, structure and complexity require an independent legal personality (e.g., kindergartens, primary and secondary schools).

[24] State contributory organizations are legal entities and manage state property. They are set up and/or controlled by central authorities.

[25] In particular, trading companies are established. Local self-governing units can only be partners in joint-stock companies or limited companies. Furthermore, local self-governing units can be founders of public-benefit organizations.

[26] Pursuant to the Act on municipalities, "unions of municipalities" are created.

[27] No statistics exist about these facts; information only concerns individual cases. We may presume that in general these phenomena do not significantly affect the total indebtedness level of local self-governing units in the CR.

[28] At the present time, the Ministry of Finance of the CR is trying to make the accounting systems of local governments similar to that used in private enterprises, with the assumption, however, that these two systems cannot be absolutely identical.

From Deregulation to Regulation and Stabilization in Slovakia

Jaroslav Kling
Viktor Nižňanský

Table of Contents

From Deregulation to Regulation and Stabilization in Slovakia

Jaroslav Kling and Viktor Nižňanský

1. INTRODUCTION

1.1 Major Developments in Public Administration

Changes to public administration in Slovakia began immediately after the fall of the communist regime at the end of 1989. Local self-government was re-established with the approval of Municipal Law 369/1990, and a dual model of public administration comprised of state administration and territorial self-government was implemented. The state administration was represented by 38 districts (*okresy*) and 121 sub-districts (*obvody*). The regional level (*kraje*) was abolished, and only one tier of territorial self-government was created: the municipalities. After years of forced amalgamation of "municipalities,"[1] the beginning of the 1990s saw a rapid growth in their number. When the Municipal Property Law was approved and municipalities took over a portion of formerly state-owned property in 1991, the conditions for the operation of territorial self-government were established. At that point, public administration reform came to a stop for the next five years.

In 1996 further reforms were introduced as the central government reorganized the administrative and territorial units of state organization. The elections of 1998 were a breaking point for the reform of public administration. The winning parties claimed support for decentralization and in 1999 appointed a plenipotentiary for the reform and decentralization of public administration. In 2001, under the strong influence of governing political parties, 79 districts (*okres*) were established of varying size ranging from 13,000 to 163,000 thousand inhabitants. At the same time the subdistrict level was abolished and a new, higher tier consisting of eight regions (*kraj*) was created, territorially identical to the state administration regional level. A range of responsibilities was to be transferred from the local state administration to territorial self-governments.

After the elections of 2002, the government claimed to have completed the process of decentralization, not only of responsibilities and mandate but also fiscal decentralization.

A new plenipotentiary was appointed to coordinate the implementation of the reform. The political parties recognized that the state administrations (ministries) could not easily accomplish this task and a cross-ministerial body would need to be established to coordinate the steps of individual ministries.

1.2 Organization of Public Administration

Since January 1, 2002, the establishment of a regional tier of territorial administration has completed the recent stage of local government reforms. Today, both the state administration and territorial self-government consist of two tiers (Table 5.1). The latest plans of governing political parties are to abolish the district level of state administration by 2004, leaving only networks of specialized state administration as the lowest tier of state administration.

Table 5.1

The Organization of Public Administration in Slovakia

		Number of Units	**Population**		**Average Territory [km²]**
			Average	**Range**	
Local self-government	Municipalities	2,883	1,874	2–447,345	17
	Self-governmental regions*	8	675,318	551,441–87,483	6,129
Local state administration	Districts	79	68,387	12,597–163,419	621
	Regions	8	675,318	551,441–787,483	6,129

Note: figures as of December 31, 2000.
* data aggregated for the territory as of December 31, 2000.

Source: Statistical Office of the SR.

1.3 Basic Political Mechanisms

The main political principle involved in running the state administration is the prerogative to make appointments. After the parliamentary elections the winning political parties appoint the chairpersons of the state administration bodies in order to secure commitment to their political directions. On the other hand, the driving political principle in territorial self-government is the election. Every mayor/chairperson of the self-governing regions as well as every councilor in the municipal and regional councils is elected in direct elections. As such, these elected officials are accountable to the citizens of the particular municipality or region.

1.4 Distribution of Responsibilities

With the changes implemented in 2001, the responsibility for delivery of public services has shifted towards territorial self-government. Prior to 2001, municipalities did not have much responsibility for public services, while the state administration took care of such services as healthcare, education, social assistance, culture, etc.[2] The process of decentralization is not yet complete, but the local governments have assumed a very large portion of the responsibilities of the former district offices.

2. THE FINANCIAL SITUATION OF LOCAL SELF-GOVERNMENTS

2.1 Financial Mechanisms

2.1.1 Basic Legal Framework

The fiscal context in which municipalities must carry out their obligations is defined by three major laws. The Constitution of the Slovak Republic stipulates that they fund themselves from own resources as well as from state subsidies. Further regulations are included in special laws. The Municipal Law (369/1990) defines the revenues of municipalities in more detail as well as the essentials of the municipal budget process. The Law on Budgetary Rules (303/1995) provides the most detailed description of the financial operation of municipalities, their revenues and expenditures. It also stipulates the limitations on municipal borrowing, the measures to be taken when a municipality runs into financial problems and the nature of its financial relations with others.

2.1.2 Regulations on the Structure of Municipal Revenues

The funding requirements of municipalities are obtained primarily from own revenues, state subsidies and other sources. Major sources of municipal revenues are:

a) The share of state taxes. The revenue from state taxes (e.g., personal income tax, corporate tax and road tax) is distributed to the municipalities in compliance with the given rules. The revenues from income tax and road tax are distributed according to the size of population of the municipality. The distribution of corporate tax revenues reflects the locality of the corporation. Sixty percent is distributed proportionally by population, and forty percent according to the constituency of the taxpayer. The overall portion of state taxes to be received by the municipalities is defined annually by the state budget (except for the share of road tax revenues which is set at a stable 40% level);

b) Revenues from local taxes and local fees. Real-estate tax is an exclusively municipal tax. It is calculated as a multiple of the rate for individual types of real estate set by the Ministry of Finance. The multiple changes according to the number of inhabitants of a particular municipality or the importance of the municipality (whether district, regional seat or spa). A wide variety of local fees are collected: for owning a dog, selling alcohol and tobacco products, operating entertainment and slot machines, making sales from dispensing machines, driving a car into the historical center of a city, lodging, advertisements, entrance fees, spa and recreation fees, fee for using an apartment for something other than housing, fee for public property use, air pollution fee, waste disposal and other fees;

c) Other minor sources of revenue such as income from municipal property, administrative fees and received dontations;

d) Transfers and other subsidies from the state budget. Subsidies to municipalities for the provision of services belong under this category. Until 1995, all municipalities up to 5,000 inhabitants were eligible for this subsidy. The subsidy was given according to the quality of soil in the territory defined by the Ministry of Agriculture of the SR and the size of the municipality. Since 1996 the size limit has dropped to 3,000 inhabitants. Further subsidies are: subsidies for local public transportation in Bratislava, Košice, Prešov, Žilina and Banská Bystrica; subsidies to finish the construction of a housing complex; subsidies for regional development; other specific transfers and subsidies provided by individual sections of the state budget. In 2002 a new, decentralization subsidy was introduced to cover the costs of transferred responsibilities. This subsidy is based on the financial norms calculated for the given service.

e) Funds distributed within the system of horizontal equalization—this provision has been incorporated in principle into the law since 2001. However, at the time of writing, the system has not been legally elaborated or implemented.

f) Subsidies from state funds.[3] This category mainly consists of the transfers from the State Environmental Fund for construction of technical infrastructure facilities (sewage, wastewater treatment facilities, etc.), the state fund Pro Slovakia for funding cultural activities, the State Water Management Fund mainly for supporting the construction of water supply systems, and the State Fund for Housing Development for housing construction.

g) Received credits and revenues from municipal bonds.

Municipalities can also use joint funds of several municipalities or other economic entities, funds of the European Union and international associations and the sources of extra-budgetary financial funds. Municipalities can provide returnable financial assistance to municipal companies as well as private companies.

2.2 The Financial Situation of the Municipalities[4]

In terms of the distribution of public funds, Slovakia is one the most centralized countries in Europe. Local governments in Slovakia allocated only 7.4% of total public budget expenditures in 2001. Despite preparing deficit budgets, municipalities end each budgetary year in a surplus position (Table 5.2).

Table 5.2
Public Budgets and GDP[5]

	1994	1995	1996	1997	1998	1999	2000	2001
Local budget revenues [SKK bill.]	20.1	22.2	25.4	28.8	28.9	27.3	33.7	32.7
Local budget expenditures [SKK bill.]	19.1	18.9	23.2	26.6	27.4	26.1	31.2	30.6
State budget expenditures [SKK bill.]	162.0	171.4	191.9	192.8	199.5	234.9	241.1	249.7
GDP in current prices [SKK bill.]	466	546	606	686	751	815	887	965
Revenues of local budgets/GDP	4.3%	4.1%	4.2%	4.2%	3.8%	3.4%	3.8%	3.4%
Expenditures of local budgets/GDP	4.1%	3.5%	3.8%	3.9%	3.4%	3.2%	3.5%	3.2%

Source: State financial statements, Statistical Office of the SR.

2.2.1 Municipal Revenues

Municipalities are fairly dependent on the central government financially. Every year, the state budget contributes about one-third of the total revenues of the municipal budgets. This contribution is approved along with the state budget. Each year municipalities actively lobby the government and the parliament to increase their allocation from the state budget. Their share in state tax revenues depends on a decision of parliament each year; the only stable and predictable revenue they receive is the share of road tax. Since the state budget is often approved as late as the end of the year, municipalities have no certainty about what funds they will receive from the state budget until the very last moment of the year. This obviously creates problems for approval of municipal budgets.

When municipalities took over areas of governance and provision of services from local state administrations in 2001, the respective funds were transferred to municipalities in the form of the so-called decentralization subsidy. But according to the municipalities these funds are not sufficient to provide the required services and they call for full-scale fiscal decentralization as a remedy. The devolution of tasks and responsibilities without proper fiscal decentralization has brought about risks in the area of municipal indebtedness (to be discussed further in section 3.5).

Starting in 1993, tax revenues have accounted for the largest portion of revenues to local budgets. They reached their maximum in 1993, accounting for 52.2% of total revenues, and since then the share has persisted at around 40% of total revenues of local budgets.

Table 5.3

Development of Local Budget Revenues in 1996–2001 [Million SKK]

	1996	1997	1998	1999	2000	2001
1. Tax revenues	10,163.1	10,569.4	11,402.2	11,608.5	12,799.2	13,992.1
Personal income tax	4,656.0	5,284.2	5,459.2	5,875.1	6,440.2	6,888.5
Corporate tax	1,200.4	786.3	1,357.9	980.0	1,226.7	1,515.4
Real-estate tax	2,861.0	3,124.1	3,199.5	3,352.6	3,606.2	3,689.5
Road tax	425.7	411.7	450.6	515.4	629.1	959.3
Local fees	960.7	866.8	840.7	866.9	885.1	939.4
Other tax revenues	58.4	96.3	94.3	18.4	12.0	0.0
2. Non-tax revenues	8,992.6	10,294.8	10,646.6	9,116.6	10,691.6	10,924.8
3. Grants (subsidies)	3,608.7	5,026.3	3,784.6	3,362.3	3,739.4	4,773.3
Current	1,377.4	2,155.9	1,950.0	1,859.6	1,843.7	2,134.4
Capital	2,231.3	2,870.4	1,834.6	1,502.6	1,895.7	2,639.0
4. Credits received	2,565.7	2,733.2	2,942.7	3,162.9	6,302.8	2,730.5
5. Other revenues	93.8	161.9	96.5	93.4	124.3	297.1
Revenues total	25,423.9	28,785.5	28,872.6	27,343.5	33,657.4	32,717.8

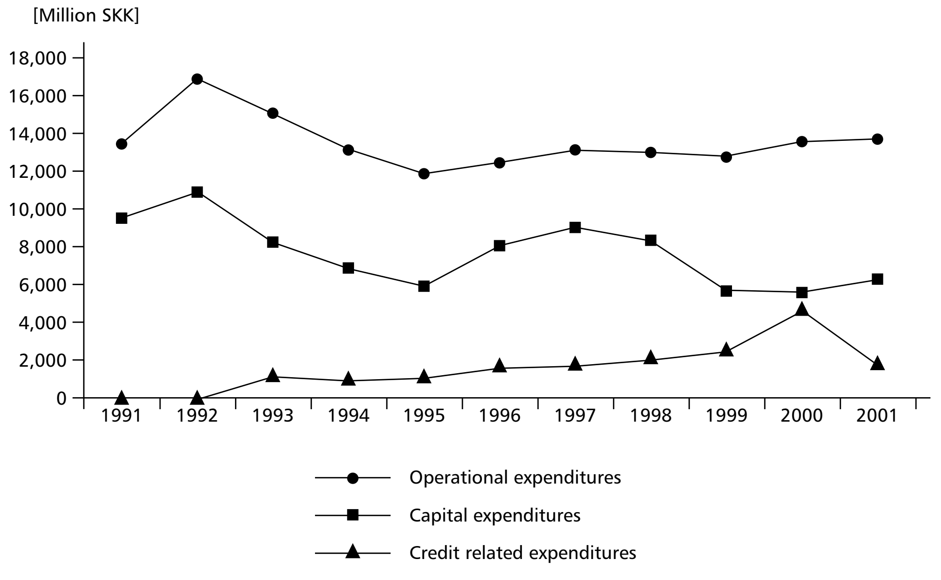
Source: Berčík 1999, State Financial Statement 1997, 1998, 1999, 2000 and 2001.

2.2.2 Municipal Expenditures

The development of municipal expenditures indicates a relatively stable ratio of operational and capital expenditures. On average, capital expenditures account for about 30% of total expenditures. The periodic increase in capital expenditures every four years suggests the influence of the municipal election cycle on the investment activities of local governments (Kling et al. 2002). Higher investment activity before elections is not unexpected—elected representatives will try to increase their chances of being re-elected.

Separating operational and capital expenditures and expenditures related to municipal debt[6] over the period since 1990 reveals that debt-related expenditures increased gradually up until 2000 (Figure 5.1). The sudden increase in 2000 occurred because Bratislava's bonds were due in that year. A comparison of 2001 with 1999 in the figure reveals a small decrease in debt-related expenditures, suggesting an improvement in the debt behavior of local governments in the most recent years.

Figure 5.1
Development of Local Budget Expenditures [Million SKK] (1991—2000)



Source: Berčík 1999, State financial statement 1997—2001; note: figures in constant prices of 1995 calculated through the gross domestic product price deflators as published by the Statistical Office of the SR 2002.

The highest expenditures were reached in 2001 in the category of administration of municipalities; the operation of municipal offices and costs of elected local representatives accounted for 34% of local expenditures. In comparison to previous years the share of these expenditures increased by over 10%. Expenditures for housing and construction accounted for the second largest portion of total expenditures.

Other significant groups of expenditures in 2001 were transportation and local economy expenditures. Transportation includes such services as local public transportation, and construction and maintenance of local roads. Services under local economy mainly include public lighting, funeral services and public utility services. The next highest expenditure was for the protection of the environment. This group consists of such services as public green care, cleaning and winter maintenance of local roads, and waste management.

3. LOCAL GOVERNMENT BORROWING

3.1 General Regulations and Practices of Local Borrowing

Municipalities in Slovakia can use returnable financial sources to fulfill their tasks. Until 2001, regulations on the conditions, limitations and use of such sources did not exist. The increasing indebtedness of municipalities and the critical financial situation of some big cities led to a legislative action to prevent further financial troubles of local governments.

The basic provisions on local government borrowing are specified in the Municipal Law, under which crucial power in the use of returnable funds is put into the hands of the municipal council. If the municipality wants to use such funds, any credit acceptance or bond issue must be approved by the councilors. Originally the Municipal Law included the obligation to publish an intention to use returnable funds for at least 15 days prior to its approval in the municipal council. Today, such a provision is not included in the law. More detailed regulations on local government borrowing can be found in the Law on Budgetary Rules (303/1995), which defines the rules for municipal budgeting, the proper behavior of municipalities when engaging in indebtedness as well as actions to be taken when a municipality cannot deal with its liabilities.

3.1.1 Basic Fiscal Environment

The fiscal year of municipalities is identical with the calendar year. Municipalities operate according to their budget which is approved in the municipal council. It is comprised of two parts, the operating (current) and the capital budgets. The current revenues include all revenues except those from the sale of the capital assets, real estate and intangible assets, revenues from the use of financial assets of the municipality, revenues from capital grants and transfers and revenues from the sale of property shares. These are revenues of the capital budget. Current expenditures are the costs related to salaries, services and consumables, etc. Capital expenditures consist mainly of expenditures on procurement and appreciation of fixed and intangible assets, and expenditures on the creation of tangible and emergency reserves.

The current budget must be balanced, but it can show a surplus if some revenues of the current budget in the given year are to cover the principal of received credits, loans, returnable financial assistance and the nominal value of issued bonds, expenditures of the capital budget, or if they are to be used in the coming years.

The capital budget can be drawn up to show a deficit only if the deficit can be covered by funds from previous years or by returnable financial sources covered by the current budget in the following years. In exceptional situations where the autonomy of a municipality is endangered, the municipality with council approval can use funds from the capital budget to cover current expenditures, except for wages and salaries, up to 25% of budgeted capital revenues for the given year.

Municipalities have an obligation to report to the Ministry of Finance on their economic performance, the budget and the financial statement.

3.1.2 Limitations on Borrowing

Municipalities can use returnable financial sources to cover capital expenditures only (Act on Budgetary Rules, No. 303/1996, art. 29a). These sources can also be used to bridge the time difference between revenues and expenditures of the current budget within a fiscal year. Such a debt must be settled from the revenues of the current budget by the end of the budgetary year. Municipalities can only take on such credit obligations when their fulfillment does not negatively influence the balance of the current budget in the following years. A municipality cannot take over the guarantee for the credit provided to a physical entity (entrepreneur) or legal entity of which it is not a founder or establisher.

Municipalities (as well as regional self-governments) are allowed to receive credits totaling more than SKK 75 million in one budgetary year only upon written approval from the Ministry of Finance. This limit applies to all size categories of municipalities. The total does not include credits that do not increase the overall debt, or returnable sources coming from state support programs such as the housing support program. The ministry is supposed to issue written approval or refusal not later than 30 days after receiving the request. Failure to issue the decision is considered approval of the credit. The ministry must issue the written approval when the municipality fulfills the criteria regarding the ratio of debt versus current revenues. Municipalities as well as regional self-governments can use returnable sources of financing only if:

a) overall debt by the end of the budgetary year does not exceed 60% of real current revenues for the previous budgetary year, and

b) total annual installments for returnable sources including interest do not exceed 25% of real current revenues for the previous budgetary year.

Total annual installments do not include one-shot premature repayment of returnable sources of financing. A municipality is obliged to report the receipt of returnable sources of financing in the given year to the Ministry of Finance by January 31 of the following year. The rules on ratio of debt versus current revenues will be used for the first time in 2005. By then only the provisions on ministerial approval of the credits exceeding SKK 75 million will be effective.

If the government of the Slovak Republic approves a special program for debt regulation of public administration, the ministry should proceed in line with this program when approving the credits. It is expected that the ministry will discuss such a program with the representatives of the territorial self-government associations.

3.1.3 Reactions to Excessive Indebtedness

The amendment to the Law on Budgetary Rules of 2001 also elaborated the procedures to be followed when the debt of municipalities exceeds a bearable level. These provisions were a reaction to cases where some municipalities basically defaulted and even had to auction off their own office premises to address the claims of lenders. This amendment introduced such terms as "recovery regime" and "forced administration" in local self-government.

3.1.3.1 Recovery Regime

A municipality is obliged to introduce a recovery regime if it did not pay a recognized liability by 60 days after the due date and if the total of overdue liabilities exceeds 15% of real current revenues of the municipality in the previous budgetary year. Within seven days after such conditions are met the mayor of a given municipality must prepare measures leading to the introduction of a recovery regime, including a proposed recovery budget. The proposed measures and budget must be submitted to the municipal council meeting within 15 days.

During the recovery regime, a municipality can use its financial funds only in compliance with the recovery budget. Every use of financial funds of the municipality must have written approval in advance from the chief auditor of the municipality. The mayor must present monthly reports to the municipal council meeting on the fulfillment of the recovery regime, including fulfillment of the recovery budget. The chief auditor is obliged to present to the municipal council a written report on the proposal of the recovery regime, the recovery budget and on every report on fulfillment of the recovery regime and budget.

The municipality must immediately report its adoption of a recovery regime to the Ministry of Finance. Within seven days after the 90 days of recovery regime implementation, the municipality must inform the ministry about its fulfillment of the recovery regime including the recovery budget and the state of municipal liabilities, together with the statement of the chief auditor. If the municipality is able to demonstrate that by adopting a recovery regime its performance improved and its overdue liabilities decreased, the ministry can agree to extend the recovery regime for a specified time.

3.1.3.2 Forced Administration

If the conditions for the introduction of a recovery regime were fulfilled but the municipality did not introduce it, or if the recovery regime did not lead to improvement after 120 days of its implementation, the ministry has the authority to introduce a forced administration on the municipality. This decision can be based upon the report from the mayor, the creditor or the state institution.

The mayor must discuss the notice with the municipal council and send it to the ministry within 15 days of the end of the 120 days of recovery regime implementation. Before the introduction of forced administration, the ministry verifies the facts in the notice and the reasons for not paying the liability. The municipality must fully cooperate in this process of verification. The decision on forced administration also includes the identification of an administrator to oversee the forced administration. The Ministry of Finance appoints the administrator after agreement with the Ministry of the Interior. The administrator is selected from the staff of the regional or district office. He or she must have a university education and at least ten years of experience in financing, can not be the mayor or member of the self-governing body of the municipality, and can not be personally close to the mayor, members of the municipal bodies or municipal employees. An appeal of this decision will not mean postponement of the forced administration.

The decision on forced administration will also be communicated to the local tax office and relevant regional or district office. Within seven days after the decision is delivered, the municipality is obliged to open a separate, forced-administration bank account and transfer to this account all funds left in all accounts of the municipality except for those that must be kept in separate accounts (state budget funds and funds coming from the European Union). During the forced administration all revenues coming to the municipality go to this forced-administration account except for the funds to be kept separately. The municipality can use the funds in all its accounts only after the written approval of the administrator, who has an obligation to find out about the economic situation of municipality. In doing so the administrator has full authorization to go through all necessary bills and books of the given municipality. Based upon his or her findings, the administrator can request the municipality to adopt a special program of economic performance consolidation, including organizational and personnel measures. The administrator has the right to participate and have an advisory vote in the municipal council and its committee meetings, where the municipal budget, performance and property are on agenda. The opinion of the administrator must complement any reports presented to the municipal council meeting regarding municipal budget, economic performance and property.

Within seven days after delivery of the decision to introduce a forced administration, the municipality must communicate the situation to all banks where it has accounts, to the regional self-government and to creditors.

Within thirty days of the decision, the municipality is obliged to prepare and approve a crisis budget for the period until the end of budgetary year. The crisis budget must include necessary expenditures (e.g., liabilities stemming from the legal obligations of municipalities, expenditures on delivery of services and the delegated state administration functions). If the forced administration is not over by the end of that budget year, the municipality must prepare and approve a crisis budget for the following budgetary year by December 31 of the regular year. When preparing the crisis budget the municipality is not obliged to divide the budget into current and capital budgets. If the municipality does not approve a crisis budget by 30 days after the decision on forced administration, then the municipality will operate on the basis of a crisis budget prepared by the administrator.

The ministry can make a decision to cancel the forced administration based on the proposal of the administration or on a request from the municipality.

3.2 Scale of Local Indebtedness

An elemental problem in analyzing local indebtedness is the definition of debt. Should the debt of municipalities include all liabilities? Should it consist of all obligations to banks, providers of loans, owners of municipal bonds and suppliers of goods and services? Should we separate the operational debt (liabilities to suppliers of goods and services) and investment debt (bank loans, municipal bonds and loans from state funds)?

Another problem is the identification of local indebtedness. The municipalities in Slovakia have an obligation to submit their municipal budget, financial statements and other accounting reports such as balance sheets or reviews of assets and liabilities to the Ministry of Finance of the SR. These reports provide the only comprehensive basis for the analysis of local indebtedness. While municipal financial statements give data on annual revenues from returnable sources of financing and annual expenditures to settle the debt, the balance sheet and review of assets and liabilities give data on the accumulated liabilities of municipalities.

There are two major groups of municipalities in Slovakia in terms of accounting. The municipalities under 3,000 inhabitants are considered small municipalities and do not have to use a double accounting system. These municipalities do not submit balance sheets to the ministry. They submit only the annual review of assets and liabilities. The municipalities over 3,000 inhabitants use the double accounting system and submit the full balance sheet. In 2000 there were only 224 municipalities over 3,000 inhabitants (out of 2,883). The structured information on local indebtedness[7] is available only for these municipalities (from their balance sheets). The overall indebtedness of the entire municipal sector is provided in the state financial statement, which also contains information on public sector debt, including the debt of local governments. This indebtedness is calculated from the accepted returnable financial assistance (from other public sector organizations, e.g., state funds), the issued bonds, the long-term promissory notes and bank assistance and loans of municipalities over 3,000 inhabitants and from the accepted returnable financial assistance and the balance of non-repaid credits of municipalities under 3,000 inhabitants. At the end of the following section we provide a review of local indebtedness as calculated from the balance sheets and annual reviews of assets and liabilities as well as the alternative calculation of local indebtedness and total indebtedness of municipalities.

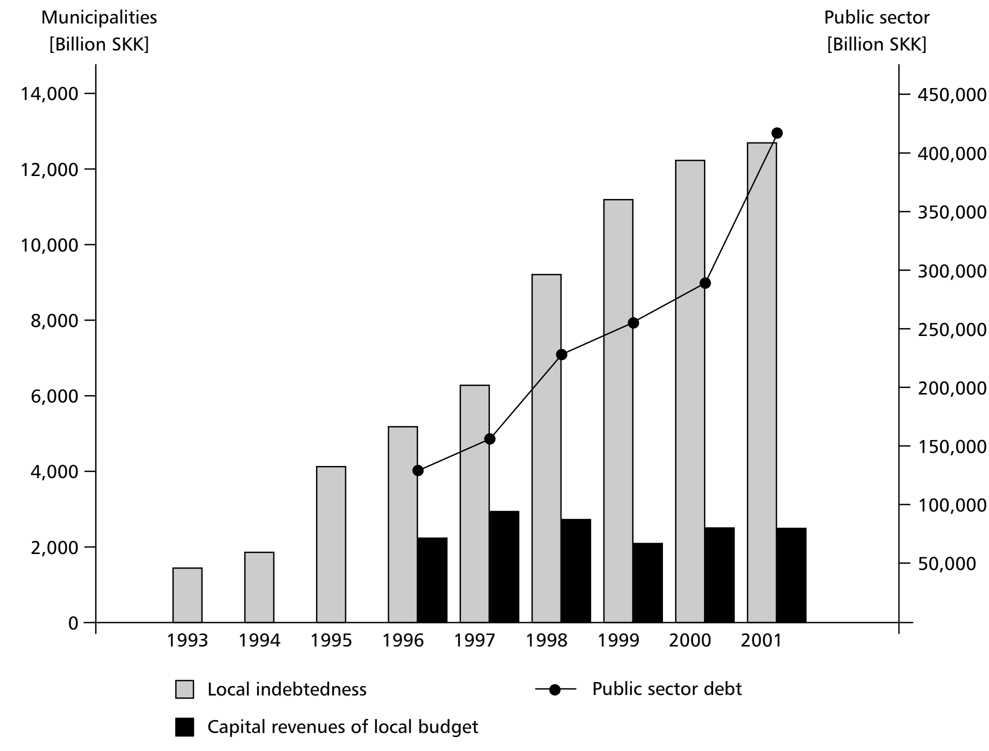
3.2.1 Local Indebtedness

Municipalities have been forced to look for credit financing in the form of loans and municipal bonds because of their acute need to finance their investment projects (mostly construction of infrastructure) while at the same time facing a continuous shortage of funds coming from tax and non-tax revenues. The indebtedness of municipalities is growing annually (Figure 5.2).

In 2001, the accumulated indebtedness of local self-governments in Slovakia reached SKK 12,724 billion (state financial statement 2001). This accounted for 3.05% of the public sector debt by the end of year. The largest indebtedness was recorded by the largest cities (Table 5.4).

The regional seat cities accounted for 68% of total municipal debt in 2001. At the same time these cities are the largest cities in Slovakia. The debt per citizen in this group was SKK 7,414 in 2000, compared to SKK 668 in municipalities under 3,000 inhabitants. In municipalities over 3,000 inhabitants, every citizen "owed" SKK 3,681 SKK (taken from the balance sheets of municipalities and the annual review of municipal assets and liabilities in 2001). The debt per person was highest in Bratislava, where every citizen was burdened with a municipal debt of SKK 11,381 in 2000. Košice and Banská Bystrica follow with above SKK 8,000 of debt per person. The rest of the regional seat cities lag far behind with a more favorable debt situation (between SKK 1,000 and SKK 3,000 per person). Košice and Banská Bystrica fell into such a critical debt situation that they basically cross-defaulted and needed to initiate a recovery regime. Bratislava, due to its size and capacity as the capital city, can deal with this debt.

Figure 5.2
Public Sector Indebtedness [Billion SKK]



Notes: Capital revenues of local budgets do not include capital grants and transfers.
Figures for the entire period of 1993–2001 are available only for local indebtedness.

Source: State financial statements 1996–2001.

Table 5.4
Indebtedness of the Regional (*kraj*) Seat Cities [Million SKK]

	Population as of Dec. 31, 2000	1996	1997	1998	1999	2000	2001	Debt per Citizen (2000)
Bratislava	447,345	1,764.4	1,756.4	2,247.0	3,884.6	5,091.2	4,581.0	11.4
Trnava	69,681	65.2	84.5	143.9	119.6	76.5	70.9	1.1
Trenčín	59,094	0.0	136.6	161.3	151.3	147.6	138.3	2.5
Nitra	87,575	66.4	83.8	144.6	108.5	112.0	174.2	1.3
Žilina	86,679	441.5	395.3	339.8	334.9	227.1	396.6	2.6
Banská Bystrica*	84,000	259.5	520.3	596.7	630.7	689.3	592.2	8.2
Prešov	94,058	84.0	164.0	198.2	235.9	281.6	257.3	3.0
Košice**	242,080	331.3	793.8	1,178.1	1,362.1	2,052.6	2,210.1	8.5
Regional seats total	1,170,512	3,012.4	3,934.6	5,009.7	6,827.6	8,677.9	8,420.5	7.4

Note: * the indebtedness reported by the city (1.2 billion SKK in 2001) differs from the indebtedness reported by Datacentrum by about half. This fact only confirms the unavailability of sound aggregated data on indebtedness in Slovakia.

** the indebtedness reported by the city (1.8 billion SKK in 1998) differs from the indebtedness reported by Datacentrum.

Source: Datacentrum 2003, Statistical Office of the SR 2001; calculations: authors.

Table 5.5 shows that small municipalities up to 500 inhabitants and those with 4,001–5,000 inhabitants are the least active in loan-taking. In 2000, credit revenues accounted for over a quarter of total revenues in municipalities over 5,001 inhabitants. The majority of this debt was created by the cities mentioned above. In municipalities over 100,001 inhabitants, credit revenues accounted for as much as 48.6% of total revenues of local budgets.

In 1998 an analysis of the financing of cities was undertaken (see Figure 5.3), in which the authors analyzed 34 selected cities of different size categories and locations. In the period from 1993 to 1996, loans accounted for about 6.8% to 11.0% of overall revenues of the selected cities. The analysis showed that the volume of credits per capita increases with the increasing size of the city. As the volume of received credits grew annually the debt-related expenditures grew as well. In 1993 they accounted for only 3.8% of total expenditures while in 1996 it was already as much as 10.1%. The debt-related expenditures were differentiated among individual cities according to their financial policy. In the cities, which experienced parallel growth of the current (operational) expenditures, the capacity to use external financial sources was significantly reduced.

Table 5.5
Received Credits* per Capita [SKK]

	1995	1996	1997	2000	% of Total Revenues per Capita in 2000
to 500	63	106	71	67	1.3
501–1,000	139	174	183	101	2.2
1,001–2,000	178	203	198	84	1.9
2,001–23,000	243	335	272	139	3.3
3,001–4,000	134	308	229	179	4.1
4,001–5,000	55	130	186	62	1.3
over 5,001	368	695	764	2,020	26.5
• 5,001–10,000				316	6.9
• 10,001–20,000				481	9.5
• 20,001–50,000				277	5.7
• 50,001–100,000				487	7.9
• over 100,001				7,881	48.6

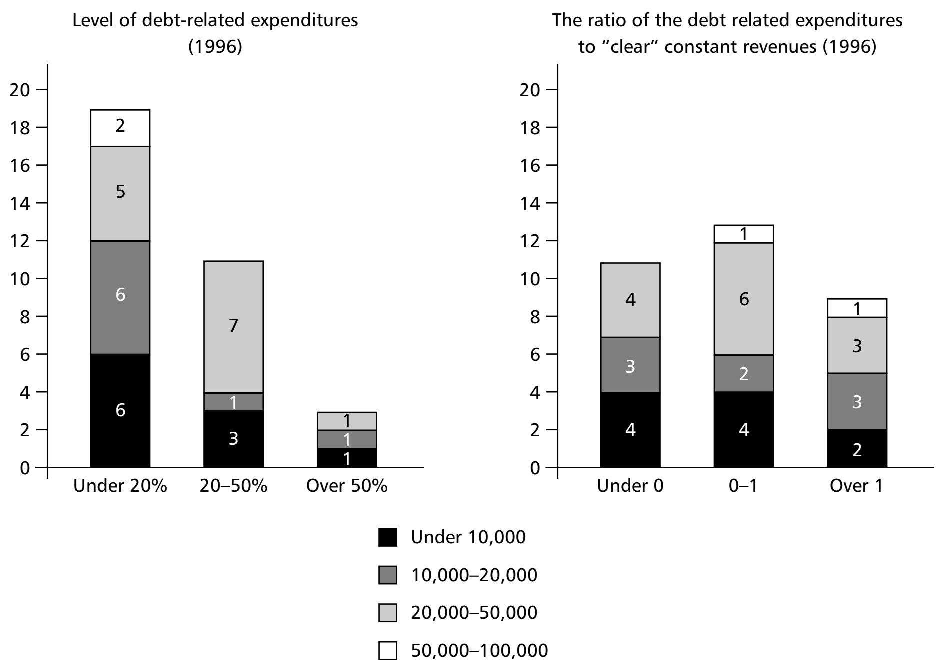
Note: * including municipal bonds.
Data for 1998 and 1999 were not available.

Source: Berčík 1999, Ministry of Finance of the SR 2001

According to the authors, the acceptable level of the debt-related expenditures might be 20% of constant revenues, which consist of local taxes and fees, the share in the state tax revenues and the revenues from municipal property use (not sales). In 1996, the 20% limit was not exceeded in 19 cities. The cities that exceeded this limit decreased their chances to receive a larger volume of external sources for financing development projects, since the councilors approved the growth of operational expenditures instead.

The level of debt-related expenditures, however, does not reflect the need to fulfill the tasks of self-government. Therefore, the constant revenues must be cleared of operational expenditures. The ratio of the debt-related expenditures and "clear" constant revenues is the local indebtedness, or the capacity to pay out the unsettled debts. If the ratio reaches a value lower than 1.0, the municipality is not able to pay the debt-related expenditures. If the ratio exceeds a value of 1.0, the municipality can pay credits and related interests.

Figure 5.3
Indebtedness of Selected Cities



Source: Nižňanský, V. (1998). Financie miest (Financing of the Cities). M.E.S.A. 10, Bratislava.

Of the 34 cities analyzed only nine had the capacity to accept further returnable external sources of financing for the development programs. A large portion of the municipalities—eleven—have absolutely no capacity in their budget for new loans unless they gain some revenues from the sale of municipal property. The remaining cities might be able to pay back further loans only if they reduce their current expenditures.

If the credit burden on municipalities increased only moderately from 1996 to 1999, the volume of received credits almost doubled in 2000 as compared to 1999 (Table 5.6). In 2001 the dependency of local self-governments on the credits decreased. Until 1999, revenues from credits and municipal bonds accounted permanently for about

10% of total revenues of local budgets. This portion has risen since 1999. It reached 18.7% in 2000, mainly due to the loan provided by the Deutche Bank Luxemburg S.A. to Bratislava in the amount of SKK 4.7 billion.

Table 5.6
Credit Financing of Municipalities [Million SKK]

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Total revenues	20,966	20,072	22,236	25,424	28,786	28,873	27,344	33,657	32,718
Received credits*	1,004	927	3,231	2,566	2,733	2,943	3,163	6,303	2,731
% of total revenues	4.8	4.6	14.5	10.1	9.5	10.2	11.6	18.7	8.3

Note: * including municipal bonds.

Source: State financial statement 1993–2001.

Comparing the received credits in 1993-2000 (Table 5.6) and expenditures related to debt[8] in this period (Table 5.7), we see that debt-related expenditures exceeded revenues from received credits and issued municipal bonds only in 1994 and 1999.

Table 5.7
Debt-related Expenditures of Local Budgets

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Debt service [Million SKK]	664.4	928.4	1,136.4	1,795.1	2,015.7	2,515.9	3,195.8	6,258.4	2,717.6
% of total expenditures	3.4	4.9	6.0	7.8	7.6	9.2	12.3	19.8	8.9
% of operational expenditures	5.2	7.2	8.8	12.2	12.1	14.2	16.8	25.8	12.4

Source: Berčík 1999, State financial statement 1997–2001.

Until 1995 the expenditures related to debt did not exceed 10% of the overall expenditures of municipalities. After a slight increase to 16.8% in 1999, expenditures further increased to 25.8% in 2000 and then dropped back to 12.4% in 2001. As illustrated in Tables 5.9 and 15.10, developments in the use of credits suggest that Bratislava's behavior has played a leading role in the overall development of local indebtedness. Both in 1995 and 2000, when Bratislava issued municipal bonds, there occurred a sudden increase in the significance of credits in the local budgets (credits accounted for 14.5% of total revenues in 1995 and 18.7% in 2000). Bratislava, as the capital and the largest city in Slovakia with a budget turnover exceeding SKK 5 billion,[9] has the largest capacity for taking credits. Since the Bratislava bonds issued in 2000 are due in 2003, we may expect a significant increase in credit-related expenditures as well as an increase in the volume of credits taken.

The ratio of debt and credit-related expenditures varies according to the size of municipality. In 2000, the largest payments per capita for debt settlement were spent in municipalities over 100,001 (Table 5.8). Bratislava's municipal bonds, due in 2000, accounted for the majority of these expenditures. In a contrary fashion, the lowest expenditures were achieved in the smallest municipalities, which did not take on as much debt as the larger ones. Partly, this is because small municipalities do not have a suitable property base that can be used as collateral for bank loans.

Table 5.8

Debt-related Expenditures per Capita in 2000 [SKK]

	Debt Service	% of Total Expenditures
to 500	102.6	2.3
501–1,000	211.6	5.2
1,001–2,000	128.4	3.2
2,001–3,000	284.1	7.4
3,001–4,000	262.1	6.4
4,001–5,000	208.2	4.6
5,001–10,000	421.7	9.8
10,001–20,000	781.8	16.4
20,001–50,000	544.9	12.0
50,001–100,000	1,232.9	21.0
over 100,000	6,071.3	39.0

Source: Ministry of Finance of the SR 2001.

An alternative way of calculating local indebtedness can be formulated as follows. The balance sheet of the municipality also provides the figures on short- and long-term liabilities, bank assistance and loans. The annual review of assets and liabilities provides information on unpaid invoices and other liabilities (e.g., tax liabilities). The sum of these figures could represent the real picture of local indebtedness, since it also includes arrears in payments such as liabilities to suppliers of goods and services, liabilities to employees or liabilities to the tax office, etc. (Table 5.9). The content of columns A to H in Table 5.9 is elaborated in the chart beneath.

Table 5.9

Alternative Calculation of Local Indebtedness [Million SKK]

Year	Municipalities above 3,000 Inhabitants				Municipalities under 3,000 Inhabitants				Total Alternative Indebtedness	Published Indebtedness
	A	B	C	D	E	F	G	H		
1996*	35.7	2,903.3	3,272.4	1,831.7	71.9	298.9	685.0	667.5	9,766.3	5,286.5
1997	83.1	3,683.0	3,934.3	2,323.0	89.5	403.5	853.7	746.5	12,116.7	7,005.3
1998	57.4	4,697.2	4,861.9	3,407.6	41.0	552.8	1,094.7	459.1	15,171.6	8,450.4
1999	263.3	5,625.5	4,500.6	4,386.9	69.7	501.8	1,140.8	733.3	17,221.8	10,590.2
2000	203.3	3,459.7	5,150.9	8,354.6	66.9	497.3	1,083.1	549.5	19,365.3	12,260.6
2001	176.3	2,826.7	3,726.6	9,265.4	53.9	453.7	1,356.8	717.2	18,576.7	12,724.0

Notes: Based upon balance sheets of municipalities over 3,000 inhabitants and the annual review of assets and liabilities of municipalities under 3,000 inhabitants.

Figures as of December 31.

* as of January 1, 1997.

Total alternative indebtedness is calculated as sum of A, B, C, D, E, F, G, and H.

Source: Datacentrum 2002; calculations: authors.

Municipalities above 3,000 people	A—Accepted returnable assistance	**Loans from special state funds**
	B—Long-term liabilities	• **Issued bonds**; • Liabilities from rental; • Long-term accepted advance payments (to customers); • **Long-term promissory notes**; other long-term liabilities
	C—Short-term liabilities	• Liabilities from trade (debt to suppliers of goods and services); liabilities to partners and associations; • Liabilities to employees; • Liabilities to mandatory insurance funds (health, welfare, illness, employment); • Tax liabilities; • Liabilities of budgetary organizations to their founder; other short-term liabilities
	D—Bank assistance and loans	• **Long-term bank loans**; • **Regular bank loans** (short-term up to one year loans and discount loans); • **Accepted financial assistance** (short-term up to one year municipal bonds and loans from other entities than banks)
Municipalities under 3,000 people	E—Accepted returnable assistance	**Loans from special state funds**
	F—Unpaid invoices	By the end of year (listed in the book of invoices)
	G—Unpaid credits	**Long-term and short-term loans**
	H—Other liabilities	Short-term liabilities from trade (such as complaints); tax liabilities; other liabilities (as listed in the book of liabilities)

Notes: Based upon the balance sheets of municipalities over 3,000 inhabitants and the annual review of assets and liabilities of municipalities under 3,000 inhabitants.

The items included in the published municipal indebtedness are in bold.

The limitations on the scale of local indebtedness as stipulated in the Law on Budgetary Rules will become effective on January 1, 2005. The law gives the municipalities time to settle their debt by this date. Even today, we can model the situation in the past if these limits had been in effect (Table 5.10).

Table 5.10
Model of Local Governments' Indebtedness Limits

Year	Debt as of Dec. 31 [Million SKK]	Real Current Revenues for the Previous Year [Million SKK]	Annual Debt Installments in the Given Year [Million SKK]	Overall Debt as% of Current Revenues (Legal Limit–60%)	Debt Service as% of Current Revenues (Legal Limit–25%)
1996	5,215.000	17,404.100	1,795.100	30.0	10.3
1997	6,311.000	20,926.000	2,015.700	30.2	9.6
1998	9,240.000	22,825.700	2,515.900	40.5	11.0
1999	11,223.000	24,249.592	3,195.800	46.3	13.2
2000	12,261.000	23,715.524	6,258.400	51.7	26.4
2001	12,724.000	29,151.149	2,717.563	43.6	9.3
2002	12,878.000*	27,405.630	2,320.400**	47.0	8.5
Municipalities over 100,000 inhabitants (Bratislava and Košice)					
2000	7,143.793	6,315.218	3,989.393	113.1	63.2
2001	6,791.010	9,589.238	531.891	70.8	5.5

Notes: * debt of local governments as of June 30, 2002.
** as budgeted in municipal budgets for 2002.

Source: State financial statements 1995–2001, financial statements of Bratislava and Košice 2001, Ministry of Finance of the SR 2000 and 2001; calculation: authors.

The influence of Bratislava's debt behavior mentioned earlier can also be seen here. The 25% limit of annual installments in real current revenues was exceeded only in 2000, when the ratio of overall debt in real current revenues reached its maximum for a seven-year period. In terms of legal limits on municipal indebtedness, the situation in Slovakia is not critical yet. The preliminary figures for 2002 suggest that the indebtedness of local governments is increasing its influence on the local budgets. The budgeted figure for annual installments indicates that the debt behavior of municipalities becomes more prudent and provides a lower threat to their fiscal balance. An optimistic evaluation of the debt situation of Slovak municipalities is further supported by the fact that the two largest cities basically account for the majority of indebtedness problems in the municipal sector as a whole. If the legal limits had been effective in 2000, these two municipalities (mainly Bratislava) would have huge problems in fulfilling them.

3.2.2 Bank Loans

Ever since they were created, municipalities have balanced their lack of funding for development projects with bank loans. Yet in 1991, they took credits totaling SKK 404 million. Available financial reports of aggregated data do not allow for the full reconstruction of the structure of municipal credit financing due to the inconsistency of the state financial statements over last decade (Table 5.11).

Table 5.11
The Role of Bank Loans in Municipal Revenues [Million SKK]

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Revenues total	20,966	20,072	22,236	25,424	28,786	28,873	27,344	33,657	32,718
Received credits*	1,004	927	3,231	2,566	2,733	2,943	3,163	6,303	2,731
Of which bank loans	n. a.	886	1,173	n. a.	2,259	2,865	2,910	5,968	2,710
Bank loans as % of total revenues	n. a.	4.4	5.3	n. a.	7.8	9.9	10.6	17.7	8.3

Note: * including municipal bonds

Source: State financial statements, 1993–2001.

Similarly, the available aggregated data does not provide any insight into the use of bank loans. Research has not been done on this issue in Slovakia, and it would be necessary to compile data from all municipalities in order to find out the exact use of the sources gained from bank loans.

3.2.3 Municipal Bonds

Issues of municipal bonds are regulated by a special Law on Bonds (no. 530/1990). Municipal bonds can be issued by:

a) the banks, using revenues from the bonds’ sale to provide a municipal loan to self-governed regions or municipalities that have asked for the issue and that use real estate as their guarantee;

b) the municipalities, which guarantee the issues with their entire property;
c) self-governed regions, which guarantee the issue with their entire property.

If the bonds are issued by a municipality or self-governed region, the bank can take over the guarantee for the issue. The supervision of municipal bonds issues is put under the jurisdiction of a supervisory body for the financial and capital market, the Office for Financial Markets.

Slovak municipalities have used municipal bonds to finance their investment activities since 1993. There has been a total of 37 issues in Slovakia since 1990, and these were traded in the public market of the Bratislava stock exchange (Burza cenných papierov Bratislava). The files of this stock exchange were used as the primary source for the analysis of municipal bonds that follows (Table 5.12). The capital city, Bratislava, has issued municipal bonds twice since 1990. Both issues were in YENs and were traded in the foreign markets.

Table 5.12
Municipal Bonds in Slovakia since 1990

Domestic Market [SKK]	Foreign Markets
2,365,880,000	1995—US$ 80 million (SKK 2.37 billion), coupon 4.1%, 5-year maturity, in YENs
	2000—US$ 100 million (SKK 4.74 billion), coupon 4%, 3-year maturity, in YENs

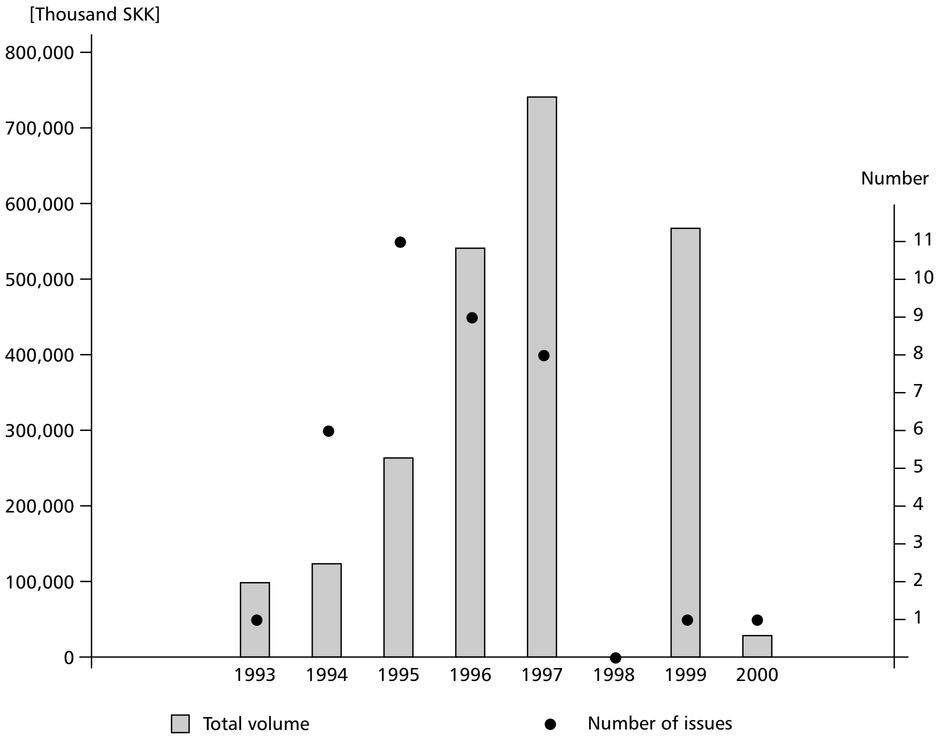
Source: Bratislava stock exchange (www.bcpb.sk), authors.

Overall, 28 cities have issued municipal bonds so far in Slovakia, for a total volume of SKK 2.366 billion.[10] All these issues were realized in Slovak crowns. The development of the issues in individual years is presented in Figure 5.4.

The highest number of issues can be seen in 1995, but this does not correspond to the highest volume. In 1995 bonds totaling SKK 265 million were issued, while in 1997 the volume reached SKK 742.5 million. The group from 1995 primarily consisted of seven cities under 20,000 inhabitants and only one city of more than 40,000. The group of cities was similar in the following year, but unlike 1995 it was cities over 40,000 inhabitants that accounted for the majority of issues (seven), while cities over 80,000 accounted for five. In 1997, one city accounted for the majority of the volume of bond issues; Banská Bystrica issued two issues of municipal bonds totaling SKK 500 million. In 1999, the second largest city made the largest issue of municipal bonds by volume, SKK 560.88 million. In 1998 no municipal bonds were issued in Slovakia, partly because this was a parliamentary election year, but primarily because of municipal elections. The municipalities were probably more concerned about preparing for the election.

As for the size categories of the issuers, a clear pattern does not exist. Only the municipalities with the status of city have issued bonds; more precisely, cities over 5,000 inhabitants. Municipal bonds are an attractive means of finance for the mid-size cities. This category (10,000–40,000 inhabitants) accounts for half of the cities issuing bonds. By volume, however, municipalities with more than 80,000 inhabitants account for the largest portion of the total volume of issued municipal bonds (Table 5.13).

Figure 5.4
Development of Municipal Bond Issues in Slovakia [Thousand SKK]



Source: Bratislava stock exchange (www.bcpb.sk), calculations and figure: authors.

The coupon of the bonds varies between 10% and 20% per annum. Only the ten-year bonds have a 10% coupon. The bonds with the 10% coupon have another common feature. In all cases the nominal value of one bond is SKK 100,000. The volume of these "cheapest" bonds is fairly high, around SKK 100 million, except for one issue that reached SKK 37.5 million, mainly stemming from the size of the issuing city. At the other end of the scale we can find bonds with a 19% or 20% coupon. The maturity of these bonds is only three and four years respectively.

Table 5.13
Municipal Bonds by Population of Municipality [SKK]

Size Category	Number of Issues	Number of Cities	Total Volume
to 9,999	5	5	80,000,000
10,000–19,999	8	7	190,000,000
20,000–39,999	8	7	252,500,000
40,000–79,999	4	4	205,000,000
80,000–99,999	9	4	1,042,500,000
over 100,000	3	1	595,880,000
Total	37	28	2,365,880,000

Source: Bratislava stock exchange (www.bcpb.sk), calculations: authors.

Table 5.14
Municipal Bonds by Maturity in Years

Maturity	Number of Issues	Number of Cities	Total Volume
2	1	1	15,000,000
3	4	3	85,000,000
4	8	7	155,000,000
5	18	17	1,655,880,000
6	2	2	140,000,000
10	4	4	315,000,000

Source: Bratislava stock exchange (www.bcpb.sk), calculations: authors.

Municipalities use this source of funds for several purposes: housing construction, road construction, street lighting, water and sewage infrastructure, sport facilities (including commercial ones such as winter sports centers), city hall renovation and health care facilities.

At least one clear trend can be noted. The bonds with the longest maturity, ten years, are used to fund housing construction, i.e., apartments. Municipal bonds are also used to finance construction of technical infrastructure such as water supply, gas distribution and sewage systems. Even though municipalities have invested money in their construction, the infrastructure is not owned by them. Water supply lines belong to the state utility company, which is in the process of free-of-charge privatization in favor of municipalities. The gas pipelines have had a similar history. However, the state gas company was privatized into the hands of foreign investors. The municipalities were reimbursed for their investments, with the reimbursement of 2002 exceeding four billion SKK.

3.3 Types of Local Borrowing

Although bank loans and municipal bonds are the most typical forms of local borrowing in Slovakia, further types of municipal borrowing exist:

- financing from special state funds;
- arrears in payments to suppliers of goods and services;
- arrears in payments to the tax office, insurance system and other mandatory payments.

While the financing from special state funds is included in the published indebtedness of municipalities, the arrears are not. If these types of borrowing were counted in the indebtedness of towns and villages, the figure would increase significantly (see Table 5.13). The available data, however, does not allow all the arrears to be specified.

3.3.1 Financing from Special State Funds

Special state funds played a role in the financing of investment activities in Slovakia until 2001. They operated as part of the public sector, with a special budgetary section in the state budget. There were 12 special state funds, of which four provided significant funding for municipalities:

- the State Environmental Fund for environmental construction such as sewage systems and waste water treatment facilities;
- the state fund Pro Slovakia for cultural activities;
- the State Water Management Fund for the construction of water supply systems;
- the State Fund for Housing Development, for both housing construction and the maintenance and repair of existing housing.

This funding consisted primarily of subsidies, as well as loans. The key players in funding the investment activities of municipalities were the State Environmental Fund and the State Fund for Housing Development. In 2002, the state funds were included under the organizational structure and budget of the respective ministry, with the exception of the State Fund for Housing Development.

3.3.1.1 The State Environmental Fund

This fund had been established in 1991 to provide funding for protection of water, air, landscape and nature, and for waste management. Starting in 2002 it was included under the organizational structure of the Ministry for the Environment. The main activities that can be financed through its funding are: activities towards fulfillment of the goals of the state environmental policy; procurement of physical planning documents and other environmental documentation; support for research and development; prevention of and response to ecological catastrophes; environmental monitoring; protection of endangered species; and establishment and maintenance of public parks in municipalities. The returnable funding can be provided as loans, with a maximum interest rate of 8% per annum.

Table 5.15
Municipal Borrowing from the State Environmental Fund

Year	2000	2001
Number of municipalities supported*	38	36
Total loans [SKK]	201,976,813	210,662,439
• sewage and water treatment facility	132,584,213	98,799,451
• water supply system	12,000,000	20,900,000
• landfill	51,392,600	34,067,388
• other	6,000,000	56,895,600

Note: * including one association of municipalities.

Source: Ministry for the Environment of the SR (www.lifeenv.gov.sk).

The distribution of use of the loans is provided in the Table 5.15. The municipalities used loans to construct brand new facilities, to finance certain phases of construction, and to reconstruct or improve existing facilities. The item “other” consists of investments in municipal heating systems, either for their reconstruction or adaptation to a more ecologically sound operation.

3.3.1.2 The State Fund for Housing Development

This fund was established in 1996 to support a variety of housing projects: the construction of apartment houses, family houses or their finishing; the construction of accommodation for citizens in need of assistance (i.e., disabled people); the upgrading of insulation to prevent the loss of heat; the renovation of apartments, apartment houses or family houses; the repair of structural problems in apartment houses; and the completion of social care facilities and other facilities for technical services that had been initiated during the socialist era as part of the construction of housing complexes. The interest rate for these funds changes with the change in the discount rate of the National Bank of the Slovak Republic, and the maturity of the loans varies between 10 and 30 years.

Table 5.16
Supports for which Municipalities Can Apply (Effective January 1, 2003)

	Maximum support	Maturity [Year]	Interest Rate [%]
Targeted-purpose support			
Construction and purchase of apartment	40% of OC, maximum 6,400 SKK/m^2	20	6.5
Construction of social services facility	60% of OC, maximum 3,500 SKK/m^2	20	6.5
Insulation of apartment	80% of OC, maximum 1,800 SKK/m^2	10	4.9
Changes in finished construction	80% of OC, maximum 2,900 SKK/m^2	10	6.5
Removal of static shortcomings	80% of OC	20	4.9
Complex housing construction project (KBV)	80% of OC	10	6.5
Programs			
Program for construction of rental housing	80% of OC, maximum 700,000 SKK/apartment	30	3.3
Program for construction of social services facility	60% of OC, maximum 3,500 SKK/m^2	20	4.9
Program to enable greater mobility of the working force	80% of OC, maximum 700,000 SKK/apartment	30	3.3
Program for apartment house renewal			
• insulation	80% of OC, maximum 1,800 SKK/m^2	20	3.3
• changes in finished construction	80% of OC, maximum 2,900 SKK/m^2	20	3.3
• removal of static shortcomings	80% of OC	20	3.3

Note: OC—the budgeted costs of construction.

Source: State Fund for Housing Development, www.sfrb.sk.

Of the various programs offered by the fund, the support for construction of rental houses has had the greatest significance for municipalities. In 2000 applications for this funding began to increase, and municipalities can apply for support from other programs as well (Table 5.16).

The volume of loans provided to municipalities from the State Fund for Housing Development totaled over SKK 2.5 billion in 2002 (see Table 5.17).

Table 5.17

Returnable Support to Municipalities

Year	2000	2001	2002	2003*
Number of contracts	n. a.	137	257	n. a.
Loans total [Million SKK]	161.10**	1,534.37	2,577.67	150

Notes: * budget for 2003: the support for construction of rental housing
In 2002 the total volume of loans to municipalities corresponded to the volume of loans provided in the support program for construction of rental housing.

Source: State Fund for Housing Development (www.sfrb.sk);
** State financial statement 2000

The support to municipalities for the construction of rental housing should decrease dramatically in the 2003 budget.

3.3.2 Bank Loans to Local Municipalities

In Slovakia the banking system consists of 20 banks, all of which provide bank loans. Only six, however, have special credit products for municipalities (Table 5.18). The table contains information on five banks, while the sixth (Prvá komunálna banka) is discussed in more detail in later sections of the chapter.

All but one of the banks in Slovakia provide loans to municipalities with no special requirements in terms of rating. The conditions of the banks are fairly similar, requiring the municipalities to provide:

- documents showing the economic and financial situation of the municipality;
- the municipal budget;
- statistical and accounting files;
- approval of the municipal council to take a credit;
- documents proving further sources of financing of the intended project;
- the business plan for the project;
- proof of ability to repay the credit;
- a rating prepared by the Slovak auditing company.

Table 5.18

Special Credit Programs for Municipalities Offered by Slovak Banks

Bank Product	**Maturity of Loan**	**Interest Rate [%]**	**Volume Min.–Max.**	**Use of the Loan/Type of Loan**	**Special Conditions**
VÚB Communal credit	4–15 years	9–13	SKK 300,000–up to 60% of collateral	Investments in real estate used for publicly helpful purposes	No
Tatrabanka Communal financing	n.a.	n.a.	n.a.	Short-term financing of operational needs Long-term financing of publicly helpful projects and development investments	No
Ľudová banka Communal credit	4–30 years	9.15–10.2	SKK 100,000–up to 70% of collateral	Mortgage-type loan Investment in real estate used for: • municipal rental housing • housing as part of social care for citizens • buildings for cultural events—community centers, cinemas and theaters, etc.	No
Unibanka Communal credit	4–30 years	n.a. fixed for 1 or 5 years	SKK 1.5 million–up to 70% of collateral		• rating from Slovak auditing company is required • co-financing of the project must be indicated
Instrobanka Communal credit	4–20 years	n.a.	n.a.	Publicly helpful purpose	No

Source: Banks, authors.

The banks also have requirements for how the credit is to be guaranteed. Collateral must be provided in every case, and it cannot be under pledge to a third party. Municipalities are permitted to use as collateral:

- real estate owned by the municipality, including plots of land, storage and production space, administrative buildings and technology (all appraised by the bank);
- securities (shares, state bonds and other securities).

Further securing of the credit is also required, in some combination of the following possibilities:

- insurance on real estate against damage and destruction, with benefits bound in favor of the creditor;
- receivables assigned to the creditor (for existing and future contracts);
- binding of the time deposit account to the creditor;
- promissory note;
- bank guarantee, company guarantee;
- notary note;
- further guarantees based upon the creditworthiness of the debtor and the type of credit operation.

3.3.2.1 The Municipal Bank

Prvá komunálna banka (First Communal Bank) was established by several municipalities as a specialized bank for the municipal sector in 1993. In 1996 the bank obtained a universal banking license allowing it to operate as a regular commercial bank. Currently, 367 municipalities have a 19.62% share in the bank. Of these, the city of Žilina owns the largest share, 2% of total shares. There are four more municipalities having a stake higher than one percent: Bratislava-Petržalka (1.32%), Bratislava-Nové Mesto (1.2%), Prievidza (1.02%) and Skalica (1.01%). The majority stakeholder in the bank is Dexia Kommunalkredit Holding with a 78.4% stake. This group took over the bank in 2000 as part of its strategy to become the key bank for the municipal sector in Central and Eastern Europe.

During its ten-year history the bank focused on the municipal financing sector, as well as the retail and corporate sectors. After the entry of the Dexia Group, PKB decreased its activities in the corporate sector and focused primarily on the municipal sector and utilities. According to the bank, the municipal sector is less risky to do business with than corporations. The overall volume of credit funds provided to municipalities is around 3.5 billion Sk. Of this total, about one percent of the loans have repayment problems. Starting in 2000, the bank decreased the volume of credits provided to the private sector and increased its credit involvement in the municipal sector. In the course of the last five years over 75% of all credit funds provided to municipalities[11] has come from the bank. In 2001 the bank provided 289 municipal loans and credits. The volume of loans to municipalities and utilities totaled 1.1 billion Sk in 2001, and PKB accounted for 83.5% of all municipal credit funds in that year. In the most recent years the bank restructured the debt portfolio of two of the three most indebted cities in Slovakia, Banská Bystrica and Košice. Despite the fact that PKB was not the first bank serving these cities, it offered a solution to their "cross-default" financial situation and now the cities are recovering.

Further areas of service to the municipal sector are deposits and consultancy in municipal and project financing. PKB accounts for about 40% to 50% of total municipal deposits in the Slovak banking sector. About 65% of Slovak municipalities use PKB as the first or only bank.

The bank also engages in the financing of environmental and investment projects supported by special state funds or pre-accession funds (PHARE). The bank is an administrator for the financial funds of the State Environmental Fund and the State Fund for Housing Development. In 2001 and 2002 the bank organized several seminars and conferences on project financing for utilities and environmental projects. Additional activities of the bank include:

- mobilization of sources and funds of municipalities;
- municipal bonds issues;
- funding of activities directed to renewal of municipalities;
- separate care of the municipal financial funds;
- depository activity for the forest-owners' associations;
- leasing and consultancy.

The bank offers the following products to municipalities:

a) Current accounts—with low minimum deposit and privileged interest rates;
b) Housing development fund accounts and road fund accounts—these accounts have similar conditions as a current account, with a more favorable interest rate. The following resources can be transferred to the housing development fund account, for the construction of infrastructure:
    - revenues from municipal apartments and the sale of facilities;
    - revenues from the sale of ongoing construction of facilities;
    - revenues from the sale of non-residential premises or plots of land connected with the transfer of apartments to the ownership of residents;
    - sanctions for non-legitimate use of resources provided from a fund;
    - repayment of loans;
    - contributions and donations of legal entities and individuals;
    - the annual allocation from the town (municipal) budget.

The road fund account is intended for the construction, repairs and maintenance of local communications and other related expenses. The following resources can be transferred to the road fund account, along with other resources as long as they are used for the same purpose:

- revenues from the road tax;
- the annual contribution from the municipal budget.

c) Credits for towns and villages—the PKB provides:
   - short-term loans with a maturity of up to one year;
   - mid-term loans, up to five years;
   - long-term loans, up to twenty years.

The projects that can be financed are:

- gas distribution;
- sewage;
- waste water treatment plants;
- water supply;
- landfills;
- reconstruction or construction of local roads;
- purchase of measuring and regulating devices;
- schools and school facilities;
- reconstruction and purchase of real estate;
- residential apartments, etc.

After receiving a loan application the bank assesses the credibility of a town or village and its ability to repay the principle and interest. PKB has elaborated a system for creditability assessment and capability to repay a loan while setting up the maximum possible loan for the specific size of the municipality.

The loan must be guaranteed with any one or a combination of the following: financial collateral, real estate, tangible assets, securities or bank guarantee.The collateral must account for a minimum of 130% of the provided loan. The municipality draws the loan through a special account with zero interest and commission. The loan can be repaid through regular equal monthly installments (annuity system) or through regular installments of principal with interest rate repaid monthly. The floating interest rate on the loan depends on the refinancing costs of the bank. If a municipality wants to get a loan from PKB it must have a current account with this bank and the municipality must deposit its annual tax revenues from the state budget to this account during the period of loan.

Since 2001 the bank has provided three special credit programs for municipalities:

- PKB-Prvý municipálny úver (First Municipal Loan)—a ten-year credit provided as a revolving line of credit to finance the investment needs of municipalities or to refinance existing liabilities from investment activities. Every village and town has a credit limit (maximum credit) as assessed by PKB. This credit line has several advantages: it can be obtained quickly; the bank manages the process of drawing or repaying the credit according to the financial needs and abilities of the municipality; and, the municipality does not have to guarantee the loan with municipal real estate, as a promissory note from the municipality is sufficient.
- PKB-Superlinka (Superlink)—a one-year bank overdraft credit. Municipalities can use the funds in their current account up to the set debt. This credit is targeted at municipalities that want to manage their finance effectively and flexibly and also manage their short-term liabilities. The only guarantee for this credit is the creditability of the municipality.
- PKB-Klasik (Classic)—a long-term investment credit with a 15–20 year maturity to finance bigger projects in the areas of ecology, infrastructure and housing. The conditions are tailor-made for each project. It can also be used for the construction of rental housing where the municipality can get a bonus of up to 6% of the interest rate from the State Fund for Housing Development after special conditions are met.

d) Bank guarantees, and discount and acceptance of their promissory notes.

3.3.3 Municipal Rating

Municipal rating emerged in Slovakia in 2001, after a decade of municipal sector operation. In this year two local rating agencies were constituted: CRA Rating Agency, a Moody's Investors Service affiliate, and Slovak Rating Agency (SRA) as the rating agency with no affiliation to any major international rating agency. Until 2001, Bratislava was the only Slovak municipality that was considered to have a rating. However, this was not actually a rating of Bratislava as a municipality. Rather, it was for the purpose of receiving a foreign credit in the middle of the 1990s—the rating was awarded for the issue of a municipal bond arranged by a Japanese bank. The first municipality that obtained a "true" rating was the city of Spišská Nová Ves in April 2001.

The municipal sector is not the only client of rating agencies located in Slovakia. They provide ratings for regional self-governments, industrial companies, banks, investment funds, bond issues as well as individual investment projects. While the CRA Rating Agency was the first one to be established in Slovakia, the Slovak Rating Agency has a lead in the number of municipalities that have been assessed (twelve, while the CRA has completed eight). In the municipal sector both agencies provide credit ratings—an assessment of creditability and of the entity's ability to pay the liabilities on time and in full scale. They provide short-term and long-term, public and non-public ratings; ratings of creditability in local and foreign currency (SRA); and local and international ratings (CRA).

A review of awarded ratings indicates that mid-size as well as large municipalities use ratings. Five of the eight regional seat cities (Bratislava, Žilina and Banská Bystrica are the exceptions) have been provided with ratings. Some municipalities that were evaluated can offer a positive example of how sound financial behavior leads to a good reputation and creditability (e.g., Nitra and Trnava). On the other hand, rating agencies also evaluated municipalities with serious financial problems, such as Košice and Nové Zámky. So far only the administrative centers of districts have taken steps to receive a rating, with the exception of Nováky and the municipality of Bratislava-Rača (a section of Bratislava with the status of local government).

There has been no research on what motivates municipalities to get a rating, but it can be assumed that this activity has something to do with "image." The cohort of rated municipalities includes three of the four cities that participated in the USAID-funded project, "Strategic Plan for Local Economic Development." The Statement on Rating for the participating cities (Trnava, Humenné and Prešov) includes a comment on their participation in the project. The rating agency considered it a positive feature contributing to a better rating. The cohort also includes seven municipalities that used municipal bonds for their investment activities in the past (Prešov, Košice, Ružomberok, Komárno, Nitra, Nové Zámky and Trenčín). With the exception of Nové Zámky and Košice, all received a favorable rating.

In total, the ratings of municipalities in Slovakia are not bad. It may suggest that municipalities with financial problems are reluctant to have some agency going through their books. Such municipalities might be afraid of facing the true picture of their financing, and even more so if it were a public rating. On the other hand the results support the opinion that the overall situation of the municipal sector in the area of indebtedness is strongly influenced by the "misbehavior" of selected municipalities.

3.4 Local Policies on Borrowing and Debt Management

The worst cases of municipal financial problems emerged after the local elections of 1998. The problems of Banská Bystrica and later on Košice stemmed from the financial misbehavior of the previous city administration. This included acceptance of unfavorable interest on credits, acceptance of unfavorable maturity and the underestimation of or failure to consider at all the financial feasibility and returns of the project. The misbehavior can also be attributed to the populist way of managing city finances for the sake of reelection.

The central government addressed these problems by setting up some limits on borrowing and by specifying what should be done if a municipality is not able to clear its liabilities. The reaction of the municipalities was extremely negative from the beginning. Municipalities considered the limits on borrowing as an attack on their autonomy. With local governments that are less experienced, and where the elected representatives may not fully understand the nature and role of local government, a certain level of control seems necessary. The following case studies show why.

3.4.1 Case Studies of Municipalities in Severe Financial Situations

- *Dolná Lehota*

Dolná Lehota is a village with 739 citizens. In the 1990s it took a credit for the construction of a waste water treatment facility, and in the next four years the municipality paid about SKK 10 million. The inability of the municipality repay this credit resulted in distress sales where it lost some of its facilities for only a portion of their real value, and all other property was collateralized. Even the mayor's chair bears a stamp "under the distraint of debtor." The situation would not be so bad if the waste water facility at least served its purpose. However, not all the people in the village are connected to this facility, so the environmental problem still exists and the municipality faces a severe financial situation.

By coincidence, the first Slovak astronaut was born in this village. When he was in orbit, many state authorities visited the village and promised state help but none arrived. The municipality did not get into these difficulties through its own negligence. Its credits were from banks that went bankrupt, and in this situation loans are repayable immediately (or as agreed with the assignee of the estate of the bank). The mayor has been asking for state assistance, arguing that if the state helps citizens in the case of bankruptcy of a bank, it should also help the affected municipalities.[12] Moreover, the state should provide assistance if the municipality used the money for a necessary purpose, not just an image investment such as the renewal of a municipal center or for cultural events as happened elsewhere (Pravda, June 2002). The municipality's debt reached SKK 25 million as of June 2002.

- *Pohorelá*

The mountain village of Pohorelá is the home of 2,677 people. Excessive debt caused the municipality to undergo a forced administration, but the village has no means of covering its debt as all its property was sold in the process. The local government even has to rent the premises of its municipal office. All revenues coming from the state budget go to debt repayment, and the municipality operates solely on the revenues from local fees.

The "debt story" began in 1993 with the loan of SKK 4.2 million to construct the infrastructure for cable television. The current mayor has judged this investment as "an unreasonably expensive, populist act without a necessary purpose" (Pravda, July 2002). Moreover, a part of the municipality cannot use the cable due to technical problems. With the taking of this loan, the financial pressure on the municipality had only just started. Soon it needed money for a waste water treatment facility, a sewage system, and in 1992 a funeral house was started (the mayor does not foresee its completion in the near future).

The overall debt of SKK 8 million was not particularly high, but in ten years not much of it was cleared. Despite the fact that the municipality repaid SKK 6 million in 2001, the overall liabilities of the municipality amounted to SKK 7.89 million in April 2002.

- *Banská Bystrica*

Banská Bystrica, a regional seat, has more than 83,000 inhabitants. By the end of 1998 the liabilities of Banská Bystrica exceeded SKK 1.2 billion. In 1999, the city was paying for a total of seven loans (one from 1995 and six from 1998). These credits were due at different times, with the last installment due in 2006. In 1998 the city did not pay the coupon from some municipal bonds totaling SKK 42 million. These bonds are due in 2006 in the amount of SKK 1.064 billion. The funds gained from the loans were not used for projects with a short-term return, despite the fact that they were short-term loans (five-year, two-year and even one-year). For example, the city received about SKK 500 million from bonds for housing construction, a further SKK 150 million for housing construction, and SKK 100 million for the "development of the city," which in fact was for reconstruction work to improve the look of the city.

In 1999 the situation of the city was close to cross-default. It also did not fulfill its obligations to the suppliers of goods and services. In 1999 several companies (suppliers of construction works and public lighting) initiated an execution of debt. In March, the executor froze the city's bank accounts (except for the social fund account). The city had to draw up a list of property available for sale, which included 22 items amounting to more than SKK 200 million. Based upon this list the court stopped the execution and reopened the accounts. The list included real estate as well as shares in the Banka Slovakia.

In July 1999 the municipal council approved a short-term revolving loan of SKK 5 million at 24% interest from Banka Slovakia (in which the city is a shareholder), to stabilize municipal finance. This loan was to be used to cover installments of other outstanding loans. In November of that year the city accepted another short-term loan from

Dopravná Banka, amounting to SKK 16 million at a 22% interest rate. This loan was to cover the penalty interest for one particular budgetary organization of the city. The settlement of this penalty was a requirement of the bank in order to assist in restructuring the debt portfolio of the city organization. This loan was due in September 2000.

One can consider 1999 as a year of desperate searching for a solution to the debt situation of the city. The overdue liabilities reached almost SKK 100 million by the middle of 1999. The municipal budget for 2000 could be calculated neither with expenditures for the municipal bonds coupon (almost SKK 70 million) nor with the creation of funds for repayment of the principal (SKK 40 million).

The investment activities prior to 1998 may have improved the look of the city, but it was the new mayor and municipal council that solved the ensuing financial problems. In 2000 PKB (Prvá komunálna banka) stepped in. By that time the bank was not the largest creditor of the city. The bank prepared a recovery plan for the local government, which included taking over the debts owing to the other bank and the provision of a long-term loan of almost SKK 600 million to restructure the remaining debt. This loan was provided for 15 years with a floating interest rate exceeding the basic interest rate in the state by three percent (11% in total in 2001). The agreement between the city and the bank also included a provision that the bank controls the financial activities of the city and all municipal property management.

This solution is in fact one of the best ways to educate local governments in sound financial management. The only shortcoming is that the municipality almost cross-defaulted before such management was introduced. The response of the mayor on the question of legal limitations on borrowing was to criticize the central government's intervention into the "autonomy of local governments" (Obecné noviny 39/2001). On the other hand, the same mayor criticized his predecessor for unreasonable financial and investment activities. In the same interview the mayor praised the introduction of forced administration into law. His opinion about this basically confirms the fact that municipalities expect the state to resolve the financial problems of cross-defaulted municipalities. The idea of municipal autonomy vanishes when the municipality gets into problems, as is seen again in the following case study.

- *Košice*

Košice is the second largest city in Slovakia totaling almost 240,000 people. In 1998 its debt was almost SKK 1.8 billion. The city councilors attributed this debt to excessive investment activities of the city hall that had been initiated by the mayor in the period before 1998, mainly the massive reconstruction of the main square in the city (Trend, March 1998). The mayor in question, who is today the president of Slovakia, argues he is not responsible for it. He blames the legislative environment, mainly the existence of special laws on Bratislava and Košice, which oblige these cities to finance services that should be, in his opinion, financed by the state (e.g., road management, firefighters, etc.). He also points to the bi-level nature of local government in the city, which makes administration costly. A third problem, he claims, is that the city councilors in Košice caused obstructions in the approval of the city's bonds issue in 1997. Their delays caused the failure of this issue in 1998, resulting in the need to search for other sources of financing the debt (Pravda, May 2002).

In 2000 the city's debt exceeded SKK 2 billion, mainly due to unfavorable credits accepted by the previous city management to cover the investment activities to improve the look of the city. The new management had to struggle with a cross-default threat just like the situation in Banská Bystrica. The central government was seen as the only option for help, despite the city's poor credit policy in the past when it accepted high interest on credits. As in the case of Banská Bystrica, the PKB offered a hand, with similar conditions. PKB also required cutting the debt by a billion, which the city decided could be achieved by selling the city forests. The expectation of revenues of over SKK 3.5 billion was gradually reduced to SKK 1 billion. But there was little interest in buying the forests and the state was the only possible buyer. When local politicians initiated negotiations on this, other municipalities protested because they would like to get such assistance as well. The liberal governmental officials did not want to accept such a solution either. When the government finally decided not to buy the forests, other solutions were sought.

In the beginning of 2002 the central government approved a 15-year loan of SKK 580 million at 5% interest, secured by city property valued at SKK 650 million. The loan is to be used for repayment of selected overdue debts and this is the first time that central government has offered an interbudgetary loan. Many voices warned that this could set a precedent for the future, but there have not yet been any other examples like this.

At the same time, the city had to elaborate a plan to clean up the municipal finances and also a plan to redeem the government loan using financial sources from the sale or rent of the city forest. After these conditions were met PKB agreed to assist in restructuring the city debt. In August 2002 three banks provided a syndicated loan of SKK 700 million. The loan is due in 15 years with an interest rate of almost 11%. PKB plays the leading role in the consortium of three banks. The loan was secured with municipal property valued at 130% of the loan. The use of municipal property and the financial operation of the city must be under the supervision of the board of creditors. When all the tranches are in the city accounts and the revenues for the forests are in the municipal budget, the debt situation of Košice should be stabilized.

3.5 Future Threats to Local Government Financing

The municipal debt was for the most part created by 2000. The municipalities were not responsible for the delivery of many services at that time. In 2002 the process of decentralization entered its second stage, and many powers were transferred to the municipalities (see introduction). This phase of decentralization has raised new problems for local governments, as financial decentralization has lagged behind the transfer of powers. The present government will need to address this discrepancy and proceed with fiscal decentralization. The current system of financing the local governments mainly through revenues from centrally collected taxes does not reflect their increased responsibilities.

The financing of the transferred powers is currently organized through a so-called decentralization subsidy, which is insufficient to guarantee the adequate operation of facilities such as schools, hospitals, etc. At the same time the law discourages local governments from the more efficient delivery of these services, since funds that are saved in one area cannot be transferred to cover another area or service.

A further potential threat for the municipalities is the fact that the property being transferred to local governments bears not only operational but also capital costs. The buildings are in very poor physical condition. There have been no renovations or investments in their renewal for many years. The most critical situations were often addressed in an ad hoc manner without addressing the underlying structural and technical problems of the facilities. Local governments, the new owners of this property, will have to deal with these costs using own resources (only the operational debt of transferred facilities is settled as of the date of transfer).

After the transfer, the operational debt from services such as education, healthcare and social services will have to be covered with the funding sources of local governments. However, they do not have much power to make major changes to the system in order to lower the deficit provision of such services as education and healthcare. These systems must be restructured by the central government. Until then the municipalities will have to cope with the operational debt being created.

In the framework of potential threats to local government finances there is one crucial threat influencing them all, and this is the tax reform in Slovakia. The central government has announced a reform of direct and indirect taxes to ease up the tax system and accelerate economic development. The tax reform has become a priority of the government and has shifted fiscal decentralization to a lower priority. This fact together with a shortage of sound financial management in municipalities is the biggest potential threat to the future fiscal operation of local governments and to their continued existence as well.

4. CONCLUSIONS AND POLICY RECOMMENDATIONS

4.1 Conclusions

Local Financing

The financial status of local budgets is healthier than the financial situation of the public sector as a whole. In total, local budgets have been permanently in surplus throughout the last decade. Major sources of local budget revenues are the share in revenues from state taxes, real-estate tax, local fees, municipal property ownership and enterprise revenues, transfers from public budgets and loans. The decentralization of public administration does not address the issue of fiscal decentralization, which leaves local governments in a risky financial situation.

Regulations on Local Borrowing

In 2001 the central government addressed the issue of increasing municipal debt and amended the Law on Budgetary Rules. The amendment introduced limits on the size of local indebtedness as a percentage of their current revenues. It further stipulates the process to be followed when a municipality cannot pay its liabilities, including such measures as the recovery regime and forced administration. Although these measures are not systemic ones and local governments criticize them a lot (mainly the borrowing limits), they are nevertheless relevant in the environment of immature local governments in terms of sound financial and investment behavior.

The Scale of Local Indebtedness

In Slovakia the municipal debt is defined as the sum of unpaid credits and municipal bonds and the financial assistance from special state funds. But this formula is complicated by differentiated accounting and reporting systems for municipalities under and above 3,000 inhabitants. In line with this definition the municipal debt was SKK 12.7 billion in 2001, which accounted for 3.05% of total public sector debt. The majority of this debt is created by the largest cities. The regional seat cities accounted for 68% of total municipal debt in 2001. In municipalities under 3,000 inhabitants the overall debt per capita was SKK 668. In municipalities over 3,000 inhabitants, every citizen "owed" SKK 3,681. The debt per citizen culminated in Bratislava, where every citizen was "burdened" with a municipal debt of SKK 11,381 in 2000. Košice and Banská Bystrica follow with more than SKK 8,000 of debt per citizen. Debt service accounts for about 12% of total local expenditures with maximums in the largest cities.

If short-term and other liabilities were included, the overall local government debt would jump to a level one-third higher than the official number. On the other hand, when looking at the development of such debt we can see a decreasing trend since 2000, suggesting the improved ability of municipalities to clear their short-term liabilities. Taken together with the slow-down of the official indebtedness of municipalities, this suggests that municipalities are improving their debt behavior.

Municipal bonds

Slovak municipalities have used municipal bonds to finance their investment activities since 1993. Since 1990 there has been a total of 37 issues in 28 cities in Slovakia. The municipal bonds in these issues were traded in the public market of the Bratislava stock exchange.

Financing from Special State Funds

Until 2001 there were 12 special state funds, of which the State Environmental Fund, the fund Pro Slovakia, the State Water Management Fund and the State Fund for Housing Development were the most significant. Their funding consisted of subsidies as well as loans.

In 2000 and 2001 the State Environmental Fund provided loans of SKK 200 million to municipalities each year. The loans were primarily used for the construction or reconstruction of sewage systems and waste water treatment facilities. In 2001 and 2002 the State Fund for Housing Development provided very favorable loans of SKK 1.5 billion and SKK 2.6 billion respectively. The primary purpose of these funds was to support the construction of rental housing. This type of state support should be decreased in the following years and shifted to the commercial banks.

Bank Lending to Municipalities

Major banks in Slovakia offer special products for municipalities (credit and deposit products). The requirements of the banks for securing the credits are very similar. Basically, a municipality needs collateral that exceeds the credit value. In 1993 the municipalities established a special bank for the municipal sector—Prvá komunálna banka. Since 1996 it has operated as a universal commercial bank with a special focus on the municipal sector and utilities. The municipalities are almost a 20% stakeholder in this bank. The majority belongs to the Dexia Kommunalkredit Holding—a European leader in municipal sector banking.

Municipal Rating

Municipal rating in Slovakia is quite new. There was neither a rated municipality nor a rating agency until 2001 when two local rating agencies were constituted in Slovakia:

CRA Rating Agency, a Moody's Investors Service affiliate and Slovak Rating Agency (SRA) as the rating agency with no affiliation to a major international rating agency. Overall 20 municipalities have been rated since then. It is mostly larger cities that are involved in the rating process, both financially sound and financially troubled.

Debt Management

The financial and investment malpractice of local governments resulted in several cases of "cross-default." In some small municipalities that were unable to pay their liabilities, the creditors initiated the execution of municipal property. In such cases the local government basically cannot fulfill its tasks since all available funds must go to the settlement of the debt. On the other hand there are municipalities that got into a severe financial situation due to excessive and unfavorably structured debt and still can deal with it. This is mostly the case with large cities such as Banská Bystrica and Košice, which were described earlier. They, of course, could not deal with it by themselves. With the assistance of the municipal bank (PKB), and in the case of Košice with the further assistance of central government, they restructured their debt portfolio and introduced sound financial and investment management.

Potential Threats to Local Financing

As the decentralization of public administration proceeds, there are two major threats. First, fiscal decentralization did not accompany the decentralization of powers. The decentralization of powers established conditions that do not motivate municipalities to operate more efficiently. Second, the transferred property carries with it not just operational debt (which is continually created) but also a so-called technological debt. The buildings have not been renovated or maintained properly for years, and they will require major investments that will come solely from the local budgets. Indirectly, there is also one background threat to local financing. This is the tax reform announced and prioritized by the government. This may deflect attention away from fiscal decentralization and consequently lead to its non-realization.

4.2 Recommendations

Recommendations to Central Government

Meaningful financial planning by municipalities cannot occur when the funding from the state budget to local governments is unstable and unpredictable. Without strict rules surrounding the state's contribution, local budgets and investment plans are often prepared under stress. Therefore, we recommend strengthening and stabilizing the financial circumstances of local governments.

With the ongoing decentralization of powers from the state administration to territorial governments, financial decentralization should be implemented as an important step in increasing the economic independence of local governments.

New regulations on the limits to local borrowing seem satisfactory, but their impact should be carefully reviewed after they come into effect in 2005.

Recommendations to Local Governments

When deciding on the use of returnable sources of funding, the municipality should fairly assess its capability to pay the debt back. If the loan can be repaid by the financed project itself, the municipality should provide an analysis demonstrating that the returns from the project can cover both the operational costs and the repayment of the loan (interest plus principal). Predictions for future revenues from the project should be conservative. The costs should be presented in full, including depreciation as well as operational costs after the project is finished, to avoid hidden subsidies from other expenditure items of the local budget or a potential decrease in the operational effectiveness of the project in the future. When the investment is not returnable directly, the loan must be refinanced through current revenues. Finally, if the project is not profitable the municipality has even more reasons to accurately assess its debt capacity.

The debt capacity should be calculated as the difference between current revenues and current expenditures, installments of actual liabilities and future liabilities stemming from the present investment activities and guarantees taken over by the municipality. This calculation is more precise than the ratio of debt service in the current revenues of municipalities since the latter does not consider current expenditures.

We recommend that local governments use their capabilities and potentials more effectively through the development of sound economic, financial and budgetary policies. Therefore, they should:

a) improve budgeting;
b) implement standard techniques of "company calculations;"
c) improve their multi-year financial planning; and
d) with regard to a severe financial situation and limited sources, they should:
   - limit their activities primarily to delivery of public services and focus on only a limited number of investment projects after a thorough analysis of their effectiveness and return;
   - shift gradually towards multi-year strategic financial planning;
   - use tax revenues primarily to finance delivery of public services not investment projects;
   - abandon the idea of swift improvement of technical and social infrastructure and clearly define priorities for the coming years;
   - not reduce investments dramatically, as they have multiplication effects;

- consider consequent operational costs of the intended facility and their impact on the municipal budget prior to investing in such a project;
- invest in measures leading towards improvement of the organizational, economic and technical effectiveness of municipal tasks delivery, including the enhancement of the skills and capacities of staff.

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www.pkb.sk—webpage of Prvá komunálna banka.

NOTES

1 In state socialism municipalities did not exist as they are defined today. There were, however, settlement units that can be referred to as today's municipalities.

2 For more detailed information on distribution of powers in Slovakia by 2001 see Horváth 2000, Kling *et al.* 2002.

3 Most of the state funds were incorporated in 2001 under the respective ministries, but the roles and provisions of the subsidies (grants) remain basically the same.

4 For a more detailed account see Kling *et al.*, 2002.

5 USD1=SKK33.20 (1993); USD1=SKK31.43 (1994); USD1=SKK29.57 (1995); USD1=SKK31.90 (1996); USD1=SKK34.78 (1997); USD1=SKK36.91 (1998); USD1=SKK42.27 (1999); USD1=SKK47.39 (2000); USD1=SKK49.27 (2001); USD1= SKK40.04 (2002) (www.nbs.sk).

6 Debt-related expenditures comprised of credit interest, principal payments and fees for credit administration.

7 Structured in terms of dividing banks loans, municipal bonds and other types of liabilities.

8 Debt-related expenditures = debt service.

9 In 2001, revenues reached SKK 2.85 billion and expenditures reached SKK 2.77 billion; in 2002 revenues were SKK 6.08 billion and expenditures were SKK 5.24 billion; in 2003 the draft budget proposes revenues and expenditures being even, SKK 9.8 billion.

10 Plus Bratislava, two issues totaling SKK 7.11 billion.

11 This figure excludes the credit funds for Bratislava, which used foreign markets. If these funds are included in the calculation, PKB accounts for about 60% of all credit funds to municipalities.

12 In Slovakia, the state repays a certain amount of the citizen's savings in a bankrupt bank (up to a certain multiple of minimum monthly wages). This provision does not apply to legal entities. In the process of "stabilization" of the bank sector when many banks bankrupted, many municipalities lost part of their savings deposited in such banks (for example Bratislava lost about SKK 350 million deposited in the account in Slovenska kreditna banka that filed for bankruptcy in 2001).

Local Government Borrowing: Regulations and Practices in Estonia

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Table of Contents

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1. INTRODUCTION

Estonia has adopted an autonomous model of local government (LG) from the very beginning. Thus, the central legislation may prescribe various functions to the LG but only a few obligatory standards, structures and procedures apply. The central legislation has established a framework that every LG should adapt to its own needs and capacity.

The size and capacity of Estonian LG units are so varied that it is almost impossible to speak about universal practices. Even strictly regulated areas like borrowing, which requires a great deal of precision and comparability, are enormously diversified. But this variability, which could cause difficulties for research, also has its positive dimension: the operation of LGs in Estonia can offer a variety of potential solutions for problems, thus helping to meet the practical and very pragmatic needs of LGs.

2. LOCAL GOVERNMENT IN ESTONIA

Estonia today has a one-tier local government with 241 units—39 towns and 203 rural municipalities. They are all covered by the same regulations, despite the fact that their size and real capacity are rather different.

There are also 15 county governments, which are the general administrative agencies representing the state interests on the regional level and supervising the actions of LG units.

State authorities only supervise the legality of LG actions.

Local governments cannot delegate their functions as prescribed by law to the upper tier of (county) government. On the other hand, municipalities may delegate their functions to the lower level and may found municipal districts. Usually these subgovernments are established in larger cities (e.g., Tallinn) but also in spatially larger municipalities, with several centers having sub-units to better represent the interests of the remote areas. Municipalities may found voluntary associations with the aim of mutual cooperation in service delivery and in representing the interests of local governments at the county and state levels.

There are six general legal acts regulating local government, including two acts regulating their finances. Their functions are prescribed unambiguously by the Local Government Organization Act (LGOA) and cannot be negotiated with state authorities.

Table 6.1

Mean Population and Number of Municipalities (2003)

Number of Inhabitants	Number of Municipalities	Proportion of Municipalities	Proportion of the Whole Population in Municipalities within the Population Range [%]
–999	27	11	1
1,000–1,999	98	40	10
2,000–4,999	72	30	16
5,000–9,999	30	12	14
1,000–49,999	11	4	17
50,000–9,999	1	0	5
>100,000	2	1	35

Table 6.2

Distribution of Responsibilities Between Central Government and Local Governments

	State Government	Local Government
Defense	Entire responsibility	
Justice/Internal safety	Entire responsibility	
Foreign/Economic relations	Entire responsibility	
Education and culture	All universities and research institutions; teachers' training; preparation of textbooks and methodological materials; some investment grants	Construction, operation and maintenance of primary and secondary schools, kindergartens etc. Salaries and social security of teachers in primary and secondary schools. Sports facilities, houses of culture and community centers, vocational, hobby and sport schools

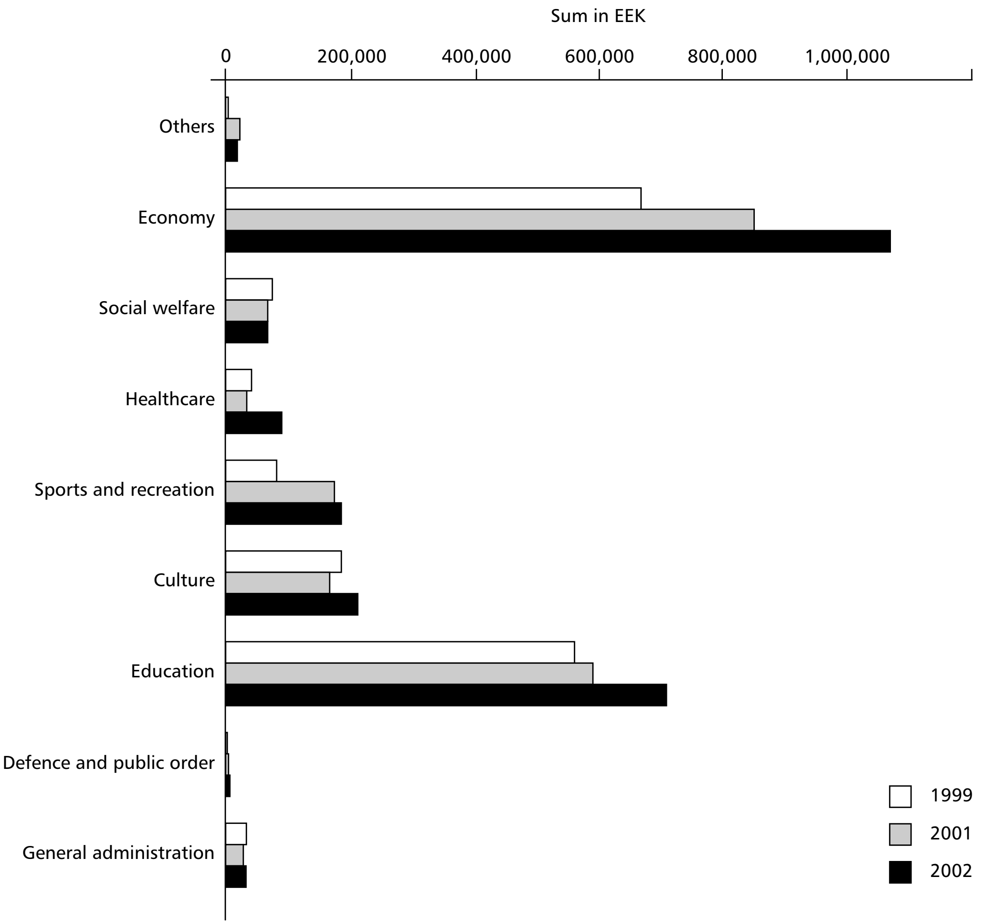
Health	Research institutes, special services hospitals and tertiary hospitals (there is a national health fund which covers individual medical expenses)	Capital investment and maintenance of municipal hospitals and polyclinics
Roads	Construction of national highways, maintenance of state highways and other roads linking cities and villages	Maintenance of local networks and town streets
Public Transportation	Intercity buses by state enterprise, airports, railway subsidy and subsidy for local transportation	Local public transport
Fire protection	All fire protection services and emergency services	All fire protection services and emergency services
Culture	National library and museums	Local libraries, cultural centers and museums
Police service	National police	Participation in criminal prevention
Sanitation		Garbage collection and street cleaning
Water and sewage	Some investment grants	Operation and capital expenditures
Public utilities	Electricity and gas provided by state enterprises	District heating
Housing		Housing maintenance and communal services
Social welfare	Unemployment benefits, pensions for elderly and disabled persons, benefits to families with children	Care for elderly, home visits and other social services. Subsistence benefit for low-income persons and other social benefits.
Environment	Responsibility for national environment issues	Local environment issues

Even when it is obvious that a local government is unable to fulfill its responsibilities, it has no right to delegate them to the upper tier; neither is the central government responsible for assuring the provision of a certain level of service to citizens in that local government unit.

On the other hand, the central government has no means of forcing the local government to implement its functions. This has become a tacit agreement between LGs and the state. The central government does not control the ways the money from the state budget is used and does not pay attention to the failure of LG units to perform their functions appropriately.

As is demonstrated in Figure 6.1, the economy accounts for the major portion of LG expenditures, primarily for the financing of the water supply, sewage or heating. Capital repair expenses are mostly connected with repairs of the existing schools and kindergartens (to replace windows, heating and ventilation systems).

Figure 6.1
Local Government Investments and Capital Repairs (1998–2000)



3. FINANCING OF LOCAL GOVERNMENT FUNCTIONS

3.1 Structure of Revenues

From the beginning of 1994 local governments have received the main part of their revenues from taxes. There are state taxes (personal income tax and land tax) and local taxes.

3.1.1 State Taxes

Personal income tax forms the largest proportion of LG revenues. According to the Income Tax Law, 44% of personal income tax goes to the state budget and 56% to the budget of the LG where the person is registered. Personal income tax is levied on all permanent residents of the LG. The Tax Board holds the only authentic information about the precise number of taxpayers.

Land tax is the second most important tax in LGs' revenue structure. Along with the local taxes, the land tax comprises that part of LG revenues over which they have a considerable amount of discretion. As the LGs may set their own tax rates in the framework of the centrally set limits (from 0.1% to 2.5% of the assessed value of the land per year) and because 100% of land tax is transferred back to the LG budget, this tax has all the prerequisites the local tax must have. However, the absence of tax collecting capacity as well as major possibilities for tax evasion may be reasons why this tax still is a state tax.

3.1.2 Local Taxes

According to the Law on Local Taxes the LG may impose eight taxes on its territory:

- *Poll tax*—paid by the citizens of the municipality aged 18—65 according to the rate established by the municipal council, though rarely implemented in spite of theoretical benefits because it is not connected to any kind of revenue source;
- *Sales tax*—applied to the enterprises and to self-employed persons registered in the territory of the municipality, with the tax rate established by the municipal council, but not to exceed 1% of the sale price of the goods or services;
- *Boat tax*—applies to boats, motorboats and yachts with a length of less than 12 meters. The tax rate is established by the municipal council;

- *Advertising tax*—the most widely used local tax, applying to advertisements located within the LG's territory and producing approximately 30% of local tax revenues or 0.3% of total local revenues;
- *Tax on closing the streets*—used only in towns, and imposed on those who require the closing of all or parts of public streets, parks and other public areas for repair works, demonstrations, processions and other events;
- *Tax on motor vehicles*—generates the main part of local tax revenues (approx. 60%) but only 0.5% of total local government revenues;
- *Tax on keeping animals*—implemented only in towns;
- *Entertainment tax*—imposed on the owners of amusement businesses and organizers of amusement events, and levied on the sold tickets. It has remained only a declaration in the Law on Local Taxes, and has never been imposed by any municipality.

Despite the ineffectiveness of local taxes, the Ministry of Finance is insisting on their more intensive use. During negotiations over the support fund, as well as on investments from central government, the absence of sufficient local tax revenues is sometimes used as the argument for refusal. We are of the opinion that this is used, however, as a bureaucratic device in situations where there are no real arguments to be offered.

3.1.3 Grants

According to the State Budget Act, transfers to LG can be of two different kinds:

- Unconditional grants through the equalization fund;
- Single-purpose allocations (conditional grants).

The size and distribution of the grant fund among LGs in the draft state budget is determined by agreement between the authorized representatives of LG associations and the central government. If those parties cannot reach an agreement, the central government itself will decide the size of the grant fund and its distribution in the draft state budget.

3.1.3.1 Unconditional Grants

The purpose of this grant is to supplement and equalize the revenues of LGs coming from different revenue bases. General grants are provided for regions with specific geographic conditions (remote areas, islands, etc.). If LGs had total financial autonomy (i.e., the revenues were formed only from their own incomes), they would not be able to offer all the public services to which citizens are entitled under the laws, even if the income tax were paid 100% into their own budgets. The distribution of the support fund is based on the equalization of revenues and the calculated expenditure needs.

3.1.3.2 Conditional Transfers

There are various types of conditional grants depending on the purpose for which the grant is targeted. The strategy of the government is to decrease the number of conditional transfers. LGs share the same viewpoint on this, as they would like to see a decrease in conditional and an increase in unconditional transfers.

3.1.3.2.1 National Investment Program

In 1995 the National Investment Program (NIP) was launched. LGs were granted investment supports by central government, with resources being allocated only to investments that exceeded 0.1 million kroons (or EUR 6,391). LGs' own financing had to be not less than 10%, although the latter requirement was often ignored in practice.

Resources for LGs' investments are allocated from the budgets of ministries, primarily the Ministry of Education, the Ministry of Culture and the Ministry of Social Affairs. According to the new system, the LG is required to submit its application for investment support to the county governor, who then creates a list of investment needs in order of their priorities. The county government then submits the list of investments to the relevant ministry, where the inclusion of projects for the NIP is decided. A ministry must submit its application to the Ministry of Finance for inclusion of a project in the NIP. Also within this system, the members of Parliament can always include new investments via political lobby, thus increasing the total amount of NIP grant by adding extra projects. But often ministries have changed the list of priorities without approval or consultation with county government or LG regional unions. This is the negative side-effect of the centralization of financing in the framework of NIP.

When deciding about allocations, the first priority is given to investments for projects that are already in the building process. Some LGs keep this principle in mind when applying to the new investment program. They ask for smaller amounts of money than are actually needed to finalize the first investment application. After the LG receives the grant, they claim the following year that they need supplementary money to finish the project.

For the preparation of the state budget of 2001, ministries and other institutions were asked to submit a four-year investment plan. The aim of long-term planning of investments and resources of the NIP was to ensure consistent financing of investments and efficient and prudent use of resources.

3.1.3.3 Other Transfers

LGs also get grants from the state budget through the budgets of ministries. These transfers partly cover the costs of LGs in implementing state functions or policies, and they are frequently conditional. In these cases the transfers are expressed in the budget of the ministry. The sectoral structure of these transfers is illustrated by Table 6.3.

Table 6.3
Conditional Grants by Ministry (2002)

	Ministry (Function)	Role of Expenditure Item in LG Budget [%]
1.	Education	1.6
2.	Defence	0.0
3.	Environment	0.3
4.	Culture	1.1
5.	Economy	0.1
6.	Agriculture	0.1
7.	Finance	0.1
8.	Internal Affairs	0.7
9.	Social	0.7
10.	Transportation & Communication	0.1
	Total	4.8

3.1.3.4 Allocations from Foreign Aid Programs

All LGs can apply directly for aid from the various local and foreign funds and programs. Of the local funds the most important are the Centre of Environmental Investments and the Agency of Estonian Regional Development. The problem with applying for foreign aid is the difficulty of the process for LGs. All foreign aid programs have very strict requirements and LGs do not have the knowledge or experience to fulfill them. They are not familiar with how to prepare the project documentation, and are unable to carry out the necessary analysis or to obtain co-financing, which is quite often required. The different LG associations could help with this, but so far their activity has been quite low. The Cooperation Assembly of Local Governments Associations and the Association of Local Governments have not applied for aid at all; some bigger towns and municipalities have applied directly. There has been some cooperation with the Danish, Finnish, Swedish and Dutch Association of Local Governments, but in these cases the foreign partners have been the applicants.

There are also some programs that require that applications be made through the ministries. This presents possibilities for local governments because the ministries will help to prepare the documentation and also help with co-financing through local aid programs.

3.1.4 User Charges

There are almost no services provided directly by LGs as authorities. Exceptions are certain legal services offered by the town secretary (e.g., business licenses, verification of documents and issue of sales, and hunting and fishing licenses (permissions)). Most services are provided by organizations subordinate to the local authorities. These include childcare and education, health and social care, maintenance of public parks and support of sports and cultural institutions (sports schools, theatres, culture houses, etc.). LGs are quite autonomous in establishing user charges for services. Usually services with charges are not provided by public organizations. Exceptions are payment for food at schools and kindergartens and penalties in libraries. The official strategy is to prevent public organizations having their own revenues which could cause fraud and other complications. Presumably that is the reason LGs are not subject to VAT.

Table 6.4
The Structure of LG Revenues (2002)

		Role of Exp. Item in LG Budget [%]
1.	Personal income tax	34
2.	Landtax	3
3.	Revenues from economic activities and property	0.6
4.	Transfers from other LGs	17
5.	Equalization fund	1.5
6.	General block-grant	12
7.	Earmarked grants from ministries	15
8.	State budget investment grant	1.5
9.	Funds and agencies	2
10.	Surplus	1
11.	Taken loans	4

Many of the other services at the local level, particularly infrastructure and public utility services, are provided by the private sector: either by companies with LG shares, foundations, NGOs or private companies. Inhabitants of an LG unit should pay the full price for these services, although payments for communal services would be partly subsidized for low-income persons. Besides, almost all social services that are provided by public organizations on a general basis are paralleled by non-public organizations (schools, special education for children, sport, health, social care, etc.).

The overall structure of LG revenues is presented in Table 6.4.

3.2 The Role of Local Revenue in Capital Investments

LGs should have a substantial revenue basis for large investments on its territory. Differences in the revenue basis of communities can be overcome by other sources of investment funds. Ministerial investments are obviously targeted to the equalization of the revenue basis of the smallest local communities (more than half of the population lives in communities with fewer than 2000 inhabitants). At the same time larger communities rely on loans and foundations for funding.

The share of self-financing is the first indicator that credit institutions consider in assessing loan applications. The income base also determines the possible loan burden that a local government is allowed to carry pursuant to law. Further, the income base determines the extent of financial obligations that a municipality is capable of assuming without issuing its obligations.

4. LOCAL GOVERNMENT BORROWING

4.1 Limitations to Municipal Capital Spending and Borrowing

4.1.1 Borrowing Practices from 1991 to 1993

The borrowing policy of Estonian LGs dates back to the year 1992. With the restoration of LGs starting at the beginning of 1990, the monetary functions were also changed. In 1991 the budgets of LGs were separated from the budgets of county councils. As a result the budgets of LGs became independent and had to be balanced.

The LGs did not have systematic loan practices because of the following:

- Legal acts were missing which would have provided the regulations;
- The half-prepared investments that were transferred with the functions and responsibilities were covered from the state budget;

Table 6.5

Sources of Investments in Local Communities of Different Sizes (2002)

Local Government Group as per Number of Inhabitants	Own Income	Loans	Government of the Republic Reserve	Transfers 1999	Investments via Ministries	Funds, Foundations etc.	Other	Total
Rural municipalities < 1,500	27.4	9.9	0.5	0.4	49.4	11.6	0.6	100
Rural municipalities 1,500–3,000	50.9	7.4	0.5	0.0	30.7	9.9	0.6	100
Rural municipalities > 3,000	56.7	6.1	0.0	3.9	30.4	2.8	0.1	100
Towns < 10,000	26.8	15.0	0.5	0.5	36.7	20.4	0.0	100
Towns > 10,000	52.9	6.6	0.1	1.3	24.7	3.9	10.4	100
Tallinn	99.7	0.0	0.0	0.0	0.3	0.0	0.0	100

- The monetary policy was incomplete—the banking sector was in the process of development;
- The rapidly growing inflation also produced uncertainty in the financial actions of LG;
- Lack of foreign experience.

As the Republic of Estonia developed, it also established its own financial goals. The priority was to establish a new monetary system with its own currency and on June 20, 1992, Estonia's own currency, the kroon, was introduced. Until that day Estonia was dependent on the Russian finance system, which in those days was characterized by rapidly growing inflation.

The borrowing of LGs has been regulated since the beginning of 1993 when the Local Government Organization Act and The Rural Municipality and City Budgets Act were accepted by Parliament. Until 1993 the budget law in force was the one adopted during the final years of Soviet rule. The law provided that loans were LG revenues and other loans could be taken to cover the necessary costs.

During this period LGs were not active on the capital market and the loan portfolios consisted mainly of loans from the state. There were no limits set for the loans, and the size of LG budgets and their ability to administer the loans were not considered. The Local Government Organization Act (LGOA) provides general rules for the operation of LG, that have remained essentially unchanged until now. Development plans as basic documents for planning the activities of LG serve as the legal basis for taking loans to LG. The conclusion of the borrowing contract requires both that it be based on the development plan, and that it has received a decision from the city council.

According to the Local Government Organization Act the LG development plan (DP) is "the document that contains the analysis of economic and social processes and the situation in the environment. [The document contains] the long term plan of actions and priorities for future development." The plan must cover a period of at least three years, and if the LG unit has financial or other obligations for a longer period, then the DP must cover the whole of this period.

According to the law the DP must be the basis for the composition of the LG budget, for applications for investments, including investments funded from external sources, and for taking loans and issuing obligations. In practice the role of the DP as a management tool is far from being effective.

The LGOA also set the principle that LGs are prohibited from giving or guaranteeing loans, but in the budget law of Soviet Estonia the guaranteeing of loans was permitted. The reason for prohibiting the giving of loans is to avoid situations in which LGs as organizations established for public services start taking risks in investing or in gaining additional resources that in unfavourable circumstances might lead LGs into financial difficulties. On the other hand LGs may offer study loans to their employees from their budgets.

4.1.2 Developments in Borrowing between 1994 and 1997

The State Budget Act came into force in 1994, giving LG the opportunity to apply for short-term loans from the state budget in case of insufficient revenues. The loans had to be repaid by the end of the budgetary year. The applications for the short-term loans were examined in the Ministry of Finance and the law provided for granting the loan from the state budget according to the resolution of the minister.

In the Rural Municipality and City Budgets Act, which was passed at the beginning of 1994, the first steps were taken to define the budgetary limits for borrowing. The law stipulated that rural areas and towns could take loans on condition that the amount taken and interests paid would not exceed 20% of the accepted budget revenues from which the amounts borrowed in any budgetary year were to be deducted. When the guarantor was the state, then that amount could be exceeded. The act permitted LGs to take short-term loans for covering their current expenditures, but long-term loans could be taken only for investments or for re-financing existing loans. However, no legal definitions of short-term or long-loan were provided. The act also stated that loans of LG could not be guaranteed by LG real estate. The above restriction comes from the property law which provides that LGs are not allowed to mortgage real estate. On the other hand, using movable property as a guarantee was allowed until 1998. Budgetary incomes of LG most often served as assurance of loans.

It should be stressed that during this period the approval of the Ministry of Finance for borrowing was not obligatory, nor was it necessary to present a duplicate of the loan contract to the supervisory authority (i.e., the Ministry of Finance or county government). In addition, there were no specific sanction mechanisms for resolving the cases of exceeded limits of borrowing. Administrative supervision over LG borrowing was exercised by county councils, which had the right to challenge actions of LG (including the decision to borrow) and require harmonization with the legal acts and regulations. Unfortunately, this mechanism has not been very effective in controlling LG borrowing.

In 1994, Estonia ratified the European Charter of Local Governments. Point 8 of Article 9 provides that LG shall have access to national capital markets under defined circumstances for taking loans for capital investments. Accordingly, Estonian LGs have the right to borrow from domestic and international capital markets and in addition are allowed to use any financial instrument with loan characteristics.

In 1995 the Law on Taking Foreign Loans for the Republic of Estonia and Ensuring State Guarantee of Foreign Contracts came into force. The law defined the norms for second-hand loans, i.e., for giving loans to the final user. Until then the use of foreign loans and the terms of usage of such loans were examined case by case. The procedure for usage was fixed by the contracts signed by the state and the user of the loan.

In 1996 the earmarked Reserve Fund for Property Reform was established, based on resources coming from privatization. LGs could apply for the loan with low interest rates or support, to solve problems which had arisen from property reform (e.g., for renovating heating systems).

In the mid-1990s many programs and foundations were set up in the public interest. In addition to transfers they could give loans to the LGs based on the warranties defined in the statutes.

4.1.3 New Controls on Borrowing: 1998 to 2002

To manage the general debt of the public sector (state organizations, LGs and other public organizations) and to ensure the solvency of LGs, new restrictions were worked out for the arrangement of LG borrowing. The limits were based on the allowed amount of deficit in the GNP. With amendments to the Rural Municipality and City Budgets Act, limits were established for the annual servicing of the debt, in addition to the total amount of the borrowed sum. The definition for the annual servicing of the debt remained generally unchanged, but a 20% limit was established, replacing the income of the previous budgetary year by the income of the budgetary year when the loan was taken.

In borrowing or issuing bonds the following scheme was applied: the total of all unpaid loans, bond issues and other liabilities proceeding from them, together with loans to be taken and bonds to be issued, must not exceed 75% of the planned budgetary revenues (net or own revenues) in the current year. Conditional grants from central government are excluded from the total. "Other liabilities coming from the loans and obligations" refers to loan interests on the entire sum until the end of the borrowing period. This amendment introduced the principle that the county government must be informed of decisions about taking loans and concluding loan contracts. In addition, the loan contract had to be presented to the Ministry of Finance. There are still problems with the application of this principle.

In the period 1997 to 1999, a regulation of the Bank of Estonia was in force which obligated credit institutions to apply for written approval from the Ministry of Finance before concluding loan contracts with LGs. The written approval had to indicate that the Ministry had no objections to the borrowing of the specific LG. After a conflict between the capital city, Tallinn, and the Ministry of Finance over permission to take a loan, the city appealed the case to the Chancellor of Justice whose decision was that the obligation to seek government approval is contrary to Estonian law.

Until the Law on Taking Foreign Loans for the Republic of Estonia and Ensuring State Guarantee of Foreign Contracts was implemented, every case of borrowing from foreign countries was examined separately. Under the provisions of this law, application can be made for a state guarantee for enterprises owned by the state or municipalities, in cases where the guarantee is creditworthy enough to obtain a loan from a foreign creditor, but the creditors are not willing to give loans without the guarantee of the Republic of Estonia. In practice this article has not been in the case of municipal foreign loans.

The possibility of getting short-term loans from the state budget was ruled out with the amendment of the State Budget Law in 1999, and then reinstated again in 2002 in a new, more extensive form, i.e., the municipalities can now obtain loans from the state budget to fulfill public functions.

At the end of the 1990s the Ministry of Finance faced difficulties in getting back the second-hand loans. As a solution, a principle was included in the State Budget Law that if a local government was indebted to the state, the state could withhold grants given to the municipality and erase the debt with that. So far that principle has not been used.

4.1.4 Regulations in Force until 2003

The borrowing of Estonian LGs is today regulated by the European Charter of Local Governments, The Local Government Organization Act, The Rural Municipality and City Budgets Act, the Law on the State Budget and the Law on Taking Foreign Loans for the Republic of Estonia and Ensuring State Guarantee to Foreign Contracts.

Municipalities can take loans or issue bonds under following conditions:

- The total repayment cost of loans, interest and obligations may not exceed 20% of planned budget revenues during any budget year;
- The total of all unpaid loans, bond issues and other liabilities arising from them together with loans to be taken and bonds to be issued may not exceed 75% of the planned budgetary revenues in the current year (excluding conditional grants from the central government);
- These restrictions do not apply to short-term loans taken by municipalities to cover current costs (e.g., for holiday pay in May or June, when all budget revenues have not yet been received). Such loans must be returned by the end of the budget year;
- The restrictions also do not apply to loans having state guarantees that are given to foreign loans when creditors demand them, or if the state guarantee derives from the law. The state may give a guarantee up to 15% of the budgetary income of the current year;
- Loans will be taken or bonds issued for investments outlined in the development plan of municipalities;
- Borrowing and assuming other financial obligations is the exceptional right of the municipal council;
- The municipality or town government must present a copy of the loan contract or bond issue to the Ministry of Finance within 30 days after concluding the contract, to ensure that it is within the range of the legally defined loan limit.

4.1.5 New Principles Applied since 2003

Beginning in 2003 new principles for managing LG borrowing were established. The limits that are currently applied to LG borrowing and the issuing of bonds (in practice also for leases and capital rent) were set in the Local Government Organization Act. With the amendments in the law, limits were established on all kinds of short-term and long-term loans. The purpose was to obtain stricter control over the financial activities of LGs because different financial instruments (like rotating bonds, factoring, etc.) have been used by LGs to get around the established limits.

Likewise, the book value of interest on the gross loan commitment will no longer be considered, and only interest payable during the upcoming period will count. These amendments were necessary because the previous method of accounting clogged the long-term borrowing, where the amount of interest may have been equal to the amount lent.

The third essential amendment will lower the limit of the gross borrowed sum from 75% to 60% of total funds required. Lowering of the limit arises from rearrangements in the structure of the LG support fund from which single-purpose grants for things like teachers' salaries were covered. With an increase in their own revenues, municipalities can borrow more even when the limit remains the same.

Since there were no sanctions for punishing LGs that surpassed the set limits, the amendment will make it possible to deduct the amount owed from the support funds destined for the specific local government. The central government also has the right to stop the transfer of the equalization fund if the LG fails to submit a copy of the loan contracted.

4.2 Sources of Borrowing

4.2.1 Borrowing from Local Financial Institutions

LGs can use the following as debt instruments:

- Ordinary loans pegged to EEK or to a foreign currency, mostly EURO;
- Bonds issued and bought by both local banks and insurance companies and international financial institutions;
- Lease or capital lease, mostly from local companies specializing in leasing and being subsidiaries of local banks.

In reality, LGs are not concerned about whether to borrow through loans or bond issues. Practice shows that they take loans from the institutions offering more favorable (cheaper) conditions.

4.2.2 Loans Based on Sources from the State Budget

4.2.2.1 Loans Allocated from the State Budget

The State Budget Law of 1994 permitted short-term loans to LGs in case of temporary shortages of revenues. This was used mostly from 1994 to 1996, but the practice differed somewhat from the provisions in the law, and included such arrangements as:

- Short-term loans from special sources in the state budget or in the state government reserve fund for financing reconstruction work and for covering the debts in the same field. The loan had to be paid off by the end of the same budgetary year;
- Long-term loans from the state government reserve fund to resolve problems that occurred because of the property reform (e.g., for moving out of a building that had been given back to the pre-soviet owner and for purchasing new housing). The term of the loans was mostly two to four years;
- Short-term loans that were not paid off on time and were redrafted as long-term loans (for example, repayment time for some loans allocated in 1998 was extended until 2005) or were turned into non-returnable aid.

Loans were mostly given in response to applications filed by the specific LG, consolidated applications made by associations of LGs, or by virtue of so-called political will. The law states that: “The Ministry of Finance examines the loan applications together with the representatives of the municipality(ies), agreeing on the amount of the loan, loan guarantees, interest rate and the term. Short-term loans are given by decision of the Minister of Finance who is in charge of the cash reserve.” In most cases the state government decided upon the loans, authorizing the Minister of Finance to conclude the loan contract as in the regulation. The extension of the loan period was generally based on the application of the LG or the ministers who found that due to a complicated economic situation it was appropriate to extend the borrowing contracts.

In general the interest rates of state budget loans were several percent lower than for loans from commercial banks. As the state government had absolute freedom to make decisions, the rate depended on political will and in some cases could be as low as 0%.

4.2.2.1.1 Loans from the Earmarked Property Reform Reserve Fund

The general aim of the Property Reform Reserve Fund was to allocate resources for the costs related to moving out of the buildings which had illegally been taken away from people during the Soviet era, costs related to the taking over of state assets by municipalities, etc. The activities of the Fund are now complete.

Applications first had to be filed at the county government, which forwarded it with its opinion to the Ministry of Finance. If a local government was applying for the loan, the municipal council's decision and also data about existing loans had to be presented.

Fund regulations stated that in addition to the grant (returnable money) the resources could be allocated as loans, but the interest could not be lower than the bank interest that would be received when the funds were deposited.

4.2.2.1.2 Loans from the Energy-saving Program

The state budget includes resources for financing a program whose intent is to create energy savings. The program is administered from within the Ministry of Economic Affairs, and a special unit of the Ministry makes decisions on the financing of primarily environmental projects.The Ministry of Economic Affairs holds a competition to choose the projects, or decisions are based on expert assessments. Applications for financing of the selected projects are submitted to the Ministry of Finance and the latter allocates the resources to the Ministry of Economic Affairs. The Ministry of Economic Affairs can decide whether the loan will be on favorable terms (which according to current regulations cannot exceed five years) and the loan will be executed without interest or with annual interest up to 5%. The Ministry of Economic Affairs concludes the contract with the applicant.

4.2.2.1.3 Loans from the Security Fund of the Estonian Regional Development Agency

In the years 1997 to 2001 a security fund for special economic situations was available at the Estonian Regional Development Agency. LGs could apply for resources from that fund in case of financial difficulty. LGs presented their applications to the council of the Agency through county governments. The council made their decision based on the seriousness of the situation and by estimating the achievable objectives through the implementation of the appropriate measures—grant or loan. The council had full authority in determining the interest rate and the duration of the loan contract.

4.2.2.1.4 Loans with State Guarantee

LGs or municipal enterprises can apply for state guarantees for their loans if the collateral is creditworthy enough to get a loan from a foreign bank, from another non-residential legal person or from an international organization, and when the organization refuses to give a loan without the guarantee of the Republic of Estonia.

To get the state guarantee for a loan, LGs or enterprises owned by LGs file applications to the Ministry of Finance. The application must describe the exact purpose of the loan, what the material and non-material obligations are, how resources will be found to repay the loan and to co-financing it. The Ministry of Finance will assess the conditions of the applied loan and the LG's or enterprise's ability to meet interest payments based on the feasibility of the loan project and the financial status of the borrower. The Ministry of Finance also verifies that the loan conforms to the legally set limits.

The Ministry of Finance may reject the application if it deems the project to be not worthwhile or to have adverse results, or if the loan applicant has not enough resources to fulfill the obligations arising from the loan. In that case the loan applicant has the right to resubmit the application. If the Ministry of Finance agrees to give the state guarantee, it presents the corresponding documents to the state government for authorization to conclude the guarantee contract and issue the guarantee letter. A fee is established for covering the guarantee risk and administrative costs.

The procedure described above remains a theoretical possibility, since the state government has not ever given a guarantee to the loans of LGs even though they have applied for it many times, but one was given to the LG-owned enterprise, Tallinna Vesi (Tallinn Water) in 1996.

4.2.2.2 Second-hand Loans by the State

Between1992 and 1994, the Ministry of Finance lent money received from international organizations to LGs using contracts for second-hand loans. In 1992, when the Republic of Estonia was preparing to take the first foreign loans (from the World Bank and the EBRD), the banks recommended using second-hand loan schemes for directing the money to the required economic sector. The second-hand loan schemes required repayment of the loans to the state by the lenders after the projects financed by the loan were completed. Likewise, the banks recommended adding a margin to the interest when the state used second-hand loans. The margin was to cover the costs of bank transfers and loan administration.

During the years 1992–1999, the Ministry of Finance had second-hand loan resources from 12 foreign loans, totalling 2.7 billion kroons covered by 381 contracts. The LGs were involved mainly with the four biggest foreign loans: the black oil loan from the World Bank (a part of the rehabilitation loan), the energy loan from the World Bank, the energy loan from the EBRD and the heating loan from the European Union.

The second-hand energy loans and black oil loans have involved several different processes:

- The Ministry of Finance concluded the contract with LGs and gave the loan;
- The LGs gave the second-hand loan directly to an enterprise (e.g., a municipal heating enterprise);
- The Ministry of Finance concluded the contract directly with a heating enterprise (with LG as an intermediary). The responsibility for paying back the loan lies with the LG or with the enterprise, depending on details of the contract;
- The Ministry of Finance concluded the contract directly with the heating enterprise and gave the loan money to them;

- There are also situations when LGs concluded the contracts but did not get the loan.

Table 6.6
Second-hand Loans from the State (2002)

Loan	Borrowed Amount [EEK]	Receivers		Debtors	Total Amount of Debt [EEK] (Without Interest)	Including Sums Unlikely to be Repaid (Without Interest)
Black oil loan from the World Bank	92,374,240	County Governments	15	29	43,680,478	36,816,000
		LGs	60			
		Heating companies	121			
Energy loan from World Bank	487,891,462	LGs	39	17	475,000,000	7,663,940
Energy loan from EBRD	355,676,110	LGs	56	10	222,000,000	22,940,896
Loan for small boiler-houses from the EU	72,779,615	LGs	57	17	29,203,508	
		Municipal enterprises	47			

In Table 6.6, LGs who have refused for different reasons to pay off a loan are represented in the columns "debtor" and "unlikely repaid sums." The interests and fines for delay are not shown here because the amounts are disputable according to each contract. Residual loans are not presented in this table either.

4.2.2.2.1 Black Oil Loan from the World Bank

The purpose of taking the black oil loan from the World Bank was to disconnect the Estonian heating business from the Russian energy system. With this loan, black oil was bought and immediately distributed between counties. The amounts and the recipients were announced later. The state did not conclude the contract directly with LGs or heating enterprises, but through county governments (at this time counties were the upper-tier of LG). The Ministry of Finance as the representative of the state was in contractual relations with the county governments. The latter should have concluded contracts with the municipalities and heating institutions located in their territory, but in most cases this did not happen.

Many problems have occurred with black oil loans:

- Some county governors took the resources as non-repayable aid and refused to sign the contracts;
- In some cases written contracts were not concluded and people are denying their debt or, even if they admit it, are refusing to repay;
- Contracts were concluded with LGs that have not received money or black oil themselves;
- The delivery of black oil was not possible to prove afterwards, because the documents were not available;
- There was no correct calculation on contract provisions until the end of the 1990s (a thorough record of the amount and to whom it was given is missing, as well as a complete account of repaid sums);
- Many heating companies which had received black oil have been liquidated or have gone bankrupt;
- The contracts were not concluded in a consistent way and may be interpreted differently;
- After the reforms of 1994, the counties were transformed into state agencies and according to the law one state agency (ministry) cannot reclaim a loan from another.

Forty-four recipients of black oil loans have completed their repayments. There are still 28 debtors with contracts who are refusing to pay and 17 without contracts. New contracts have been concluded with 13 LGs.

4.2.2.2.2 Energy Loans from the EBRD and the European Union

The purpose of the loans from the EBRD and the EU was to allocate resources for reconstructing small boiler houses operating on local fuel. This was based on the notion that as heating consumption was increasing and black oil difficult to obtain, it was necessary to find alternative energy sources.

The Energy Office arranged a competition for projects to rebuild the boiler houses to start operating on wood pulp and turf. The Minister of Finance concluded the contracts mainly with LGs, but in some rare cases contracts were concluded with a heating enterprise (if the latter was a business association). LGs gave second-hand loans to these municipal or private sector heating enterprises.

A number of problems occurred with repayment of these loans:

- Switching the boiler houses to burn local fuel was a failure because:
  - This form of heating was ultimately more expensive and the local citizens were not able to pay for it (they preferred heating with electricity);

   – The economic forecasts proved to be false, as the consumption of heat decreased;
   – The boiler houses were uneconomical and their administration too expensive for LGs, so they are now not operating.
- Some LGs are refusing to pay off loans for failed investments, since central government planned the whole initiative and caused the failure;
- Some of the heating enterprises have gone bankrupt;
- Many of the heating enterprises have become privatized and cannot pay off the loan because of their difficult economic situation;
- Some LGs have transferred the loan to the heating enterprises and are saying that it is not their business any more to repay it, claiming the responsibility rests with the Ministry of Finance to retrieve the money from the user of the loan.

4.2.2.2.3 Administration of Second-hand Foreign Loans

Repayment of the second-hand energy loans has been fraught with problems, as described above, and this situation is typical of the problems in administering second-hand foreign loans in general. Some LGs refuse to pay, others are late or irregular with their payments, and some simply file application with the Ministry of Finance to cancel the foreign borrowed loans, to exempt interest payments or to extend the repayment schedule.

For many LGs the funds from the second-hand loans have exceeded the loan limit set by law. In the early 1990s, although there were no loan limits, some LGs obtained loans that exceeded their budgets many times. It is surprising that this occurred, as the ability of LGs to administer the loan must have been considered. The guilty parties in this are both the LGs (for assuming the state would cancel the loans) and also the representatives of the state who were not particularly interested in the ability of LGs to administer the loan in the future. The Ministry of Finance is in a difficult situation now because in concluding new loan contracts with LGs, laws can be violated.

The Ministry of Finance has not gone to court on this issue because there is a very weak legal basis for doing so. First of all there is no legal definition of second-hand loans in Estonian acts. They are mentioned only in the Law on Taking Foreign Loans for the Republic of Estonia and Ensuring State Guarantee to Foreign Contracts, but a definition is not found there either. Thus, there was no legal basis for concluding second-hand loan contracts between the Republic of Estonia (represented by the Minister of Finance) and county governors or enterprises. Instead, the contracts were made under civil law between two persons. The problem is that the Minister of Finance is not an independent person under the law, but has legal capacity based on orders of the Ministry. As a result, the Minister of Finance did not actually have the authority to conclude loan contracts or to give loans. Moreover, the state government has not authorized the Minister of Finance to conclude second-hand loan contracts by decree.

If the contracts for second-hand loans were declared illegal in court, LGs who are currently administering their loans properly might discontinue paying. In the worst-case scenario they might even demand compensation for loss from the state. This explains why to date there has been no legal action regarding the LGs that have failed to repay their loans. Despite these problems, the Republic of Estonia has been repaying foreign loans on time and in the amounts demanded. The EU loan for small boiler houses has been finally paid off and the last payment of the EBRD energy loan will be made in the year 2003.

4.2.2.3 Long-term Bank Loans

In Estonia LGs started to procure loans independently from the capital market in 1993-1994. Usually the loans are long-term investment loans for infrastructure projects. As co-financing is required by the National Investment Program, PHARE and by foreign creditors, LGs usually receive co-financing through loans because of the lack of resources. The foreign institutions most active in giving loans to LGs have been the Nordic Environmental Investment Fund (NEFCO) and the Swedish National Development Bank of Industry and Technology (NUTEC). The European Bank of Reconstruction and Development (EBRD) and the European Investment Bank (EIB) have given less to Estonian LGs, because for them the loan-taking ability of Estonian LGs is too small.

4.2.2.4 Lump-sum Long-term Loans for Investments or Refinancing of Existing Loans

LGs in Estonia take loans for investments foreseen in the development plan and for re-financing of an existing loan. The banks use the following criteria to assess whether to give loans to LGs:

- The application must be based on the development plan and the investments to be financed must be in accordance with the plan;
- Existing loans and other liabilities must also be within the legal limits (in many cases the banks find the LGs creditworthy even though the limits are exceeded);
- Size of the budget (the percentage of own revenues in the budget), fulfilment of the budget (forecast compared to actual income from taxes) and the possibility of additional budget revenues;
- Forecasts concerning employers situated in the LGs' territory (existence of only one big employer in the LGs);
- Structure of the population (percentage of unemployed and population not studying).

The banks consider LGs to be low-risk clients, and therefore they do not thoroughly investigate the feasibility or costs of the project. As one of their conditions banks may ask LGs to keep their assets only in their bank.

Contracts are concluded as follows:

- The contract is usually for up to 5-6 years (the national credit institutions are not willing as a rule to give loans for a longer period);
- The interest on the loan is based on the EURIBOR with added margin (in 2000 it was 6%, in 2002 it decreased to 3%);
- In taking loans LGs will be given one year of payment relief in paying back the principal of the loan, but the interest must be paid right away;
- The contract identifies a period when LGs can receive the loan (usually one month).
- The penalty for delayed payments is usually 0.1% per day;
- In situations where the LGs cannot fulfill the obligations, the bank may freeze the LG's account in that bank and firstly fulfill its own demands;
- LGs may be obligated to harmonize loans taken from third parties with the bank if they exceed, for example, some specific percentage of the residual of obligations;
- LGs have to inform the bank if enforcement procedures have been initiated with regard to the requirement which exceeds a specific sum;
- LGs must present the approved budget, amendments to the budget and additional budgets. If the bank requires it, the budget report has to be presented.

4.2.2.5 Bullet Loans

During the last few years a new product, called the bullet loan, has come to the market and it has been used mostly by bigger cities. The purpose of the bullet loan is to increase the flexibility and decrease the bureaucracy involved in taking loans, and also to increase the speed since loans are essential financial instruments required at any moment in time. In administering the loans, repayment relief can be obtained for some years.

The general principles of the bullet loan are:

- The contract will normally be concluded for three years and the maximum amount of the loan will be fixed in the contract;
- When the size of the budget increases the loan limit also increases;
- LGs may take loans any time within the range of set loan limits without another contract being necessary;
- The principal of the loan will be paid off after the loan period set in the contract is over;
- Interest paid is based on the borrowed amount.

But there are drawbacks to bullet loans, especially at the LG level. If the loan is concluded for three years, i.e., for the election period, the party in power can fulfill all the promises made in the election period by postponing the payments for their promises, leaving the financial burden to be dealt with by the parties to be elected. Moreover, linking the loan limit to the increase in the budget that may occur in the so-called good times can leave the LGs in serious difficulty when they must deal with an increased loan burden during an economic downturn. In addition, the municipal council may lose control over the LGs in that kind of borrowing scheme.

4.2.2.6 Overdrafts

Overdrafts may be considered short-term loans, i.e., loans that do not extend beyond the current year, and they can be used in the event of a shortage in revenues for financing current costs. There is no single approach to short-term loans in the legal acts: according to accounting practices, the short-term loan is an obligation that does not exceed one year, but for budget purposes it is a loan that will be paid off by the end of the budget year, otherwise it automatically becomes a long-term loan. Thus the different acts treat short-term loans differently.

The principles for concluding overdraft contracts are:

- The contract will be concluded for one year and the LG will be given a fixed sum;
- LGs may take credit at any time;
- Interest is usually higher than in the case of long-term loans;
- Interest is calculated from the credit taken on that day and the bank takes the payable interest from the LGs account on the last day of the month.

4.2.2.7 Bond Issues

In the mid-1990s many LGs, especially in towns, started to issue bonds. The first LG to go to the international capital market with its bonds was the capital city, Tallinn, in 1996. On the one hand this shows trust in the Estonian LGs, but in reality Tallinn has remained the only LG to do this. The loans of other Estonian LGs would be too small to attract serious financial investors. Similarly, local banks are not interested in issues under ten million kroons.

Bigger LGs prefer issues with a shorter time period. This may be because of the need for flexibility and maneuvering. If the issue is for a half-year or less, the LG may use re-financing, i.e., a new bond issue to repay the old one. The precondition is that new interest rates may be negotiated with the new issue. In addition, the amount of loan can be increased or decreased without delay. General bonds with fixed interest rates and low liquidity are mainly issued.

There are many circumstances that explain the low liquidity of bonds:

- Low quantity of single issues;
- Lack of information at the start of issuing bonds and lack of information afterwards that could trigger bargaining with those bonds;
- Short validation of bonds, though the investors are willing to keep the bonds themselves until the deadline;
- The condition of local banks that if they take responsibility for organizing the issuing of bonds, the LGs must keep their resources in that bank.

4.2.2.8 Capital Leases

The second half of the 1990s saw a quick development of the capital lease market within Estonian financial markets. Several banks established special subsidiaries specializing in rendering capital lease services. One reason for incorporation of independent companies is the possibilities arising from the value-added tax. While in the beginning the focus was just on the lease of movable properties, now real estate is also being leased. The capital lease is essentially just a form of lending. The peculiarity of this kind of lending is that the loan security is not represented by the budget of LGs, but by property which is delivered to LGs only after repayment of the loan. Thus, this kind of lending enables the avoidance of restrictions on borrowing established by law, at least in the case of movable property and newly constructed real estate. Moreover, capital lease payments are not reflected in the budget reports submitted to the Ministry of Finance. An operating lease offers even better possibilities in this context, as the LG does not have to buy out the thing. Instead, the thing is used as long as is necessary and thereafter the lease contract is terminated either according to its term or ahead of time. Estonian LGs use both capital and operating leases in the case of movable property, particularly vehicles. Real estate leases are less frequent.

4.2.3 Borrowing from Foreign Credit Organizations

According to Estonian laws LGs have the right and freedom to take loans from the domestic and international credit markets by taking on the currency risks themselves:

- Unlike domestic banks, foreign financial institutions normally want to see profitability studies and expert assessments of reconstruction work;
- As a rule the approval of the Ministry of Finance is required and if the Ministry is against taking the loan it may not be given;
- The loan period may exceed ten years and the interest is equal to the EURIBOR;

- The loan amounts will be transferred in several phases according to the duration and extent of the project;
- The loan schedule may be drawn up very flexibly and it is possible to get relief on the interest payment for several years;
- The loan is strictly a single-purpose loan and the usage of the loan resources will be monitored.

4.3 Loan-taking by Local Governments—Practical Aspects

Estonian LGs took their first loan in 1992, and year after year loan-taking has increased. In 1993, borrowing by LGs increased rapidly for many reasons:

- LGs realized that it is difficult to make investments without borrowing;
- Foreign loans became more frequent;
- Local banks became active and were interested in lending to LGs whom they regarded as secure partners;
- Different funds emerged as loan resources;
- The economy was improving.

Though good prospects for lending to LGs emerged, credit organizations proved to be the most active lenders at first. Most of the loans were targeted at infrastructure, energy, water and sewage pipes, recycling, etc. These cases also included foreign loans that were more profitable than loans offered in the domestic market (e.g., the loans given to the energy sector to purchase heating equipment, reconstruct local heating systems, draft development plans concerning the economy of heating, etc.). The loans were given at very low or no interest rate. They were strictly single-purpose and could not be used for LGs' operating costs.

The loans by the state were offered on favorable conditions, where the repayment consisted of only the basic payment without interest (e.g., loans for environmental investments from the Environment Fund).

Increasingly, LGs required loans for reconstruction projects in the educational, cultural or social domains, but the earmarked loans could not be used for these projects. To cover such expenditures, the LGs turned to the credit organizations such as commercial banks or funds through which loans were taken or bonds issued. Most popular was the issuing of bonds through the Compensation Fund.The LGs became more and more active in taking loans, and today it could be said that there is virtually no LG that has taken no loans. The sums vary, but every LG has taken a loan.

In the following section, the mechanisms for borrowing by LGs are described.

4.3.1 Determining the Need for a Loan

A continuous need for loans exists for LGs. As a rule, those needs are targeted to the reconstruction of premises (to improve thermal insulation), water and sewage systems, electricity mains, etc. These projects must be based on a development plan that is connected with the loan strategy and investment plan. The investments set in the plans serve as basis for taking loans, and are prioritized in the plans.

Loans can be divided into different kinds. The most common way to cover the investment needs of a project is through state funding—the National Investment Program—and the rest is covered by LGs' own contributions (mainly loans). This is a common scheme for investment in the education sector, because the National Investment Program has mostly supported improvement in this sector.

There is hardly an LG in Estonia, the buildings of which do not need renovation. But the funds given to LGs for investments are inadequate compared to their substantial investment needs, so borrowing becomes a necessity for LGs.

4.3.2 Negotiations with the Credit Organizations

When the decision to borrow has been taken, the LGs start to negotiate with the credit organizations—banks or foundations. For the negotiations, the credit organizations need background information, certified by several documents to be submitted concerning the LG's economic situation:

- A report about fulfillment of the previous year's budget (or more than one year);
- Comments of the auditing commission about fulfilling the budget;
- Comments of the auditor on the proposals;
- An accepted budget;
- A balance sheet;
- Information about previously taken loans;
- Application for investment, presenting reasons.

In addition, the credit organizations are able to request additional documents or information. The need for additional information depends on how well the LG's application conforms to the legally set loan terms.

If the LG has borrowed a lot, then a higher risk occurs when taking a new loan. The credit organization is definitely interested that its client—LG—would not exceed the legally set limits. The negotiations concentrate mainly on the capacity of the LG to fulfill the finally signed contract.

4.3.3 Taking of a Loan

If there is an agreement about taking the loan, then negotiations will commence about loan conditions with the credit organization. When the contract is signed, the credit organization will transfer the agreed amount of money to the LG's account in bulk or in several portions according to the agreement.

4.3.4 Repayment of Loans—Fulfilling the Contracts

There are several LGs that have problems with loan repayments, largely stemming from improperly planned budgets. In the main, the error is in overestimating the budgetary resources in the following years. Other possible mistakes include inaccuracies in the estimation of:

- The profitability of the investment;
- The solvency of the consumers;
- The economic situation.

Credit solvency and overall loan policy are improving. There are fewer LGs who have exceeded the legally set loan limits. This is because the LGs are administrating their budgets better, but also the state has interfered more seriously with the problem of exceeding the legally set loan limits, which have been amended in law. In addition, they have cooperated with the credit organizations.

Improvements in LG loan activity bring about an increased perception of reliability of LGs in the eyes of credit organizations. Increased trust means better loan conditions and that enables LGs to make more investments.

4.4 Actions of the Ministry of Finance in Collecting Loan Contracts

According to the law, the LGs are obligated to present a copy of the loan contract to the Ministry of Finance during the next five workdays (earlier it was 30 days) after concluding the contract. If the LG fails to do this, the transfers from the support fund may be withheld.

The Ministry of Finance handles the copies in the following way:

- It reviews the contract and checks for compliance with the law and whether the loan conforms to the limitations;
- Based on the monthly budget report, it checks the LG borrowing case and if the loan contract is not available in the Ministry of Finance, sends a reminder;

- In the event of a breach of the law, the Ministry of Finance sends a note to the LG (although this has not been used in practice).

4.5 Case Studies

The following are examples of particular cases where some Estonian LGs incurred payment difficulties. Vormsi rural municipality was the first to announce its payment difficulties and to declare itself bankrupt in 1997. In 1999, Kallaste, Tõrva, Paldiski and Püssi expanded the list. The list is presented in the final part of the report. See Appendix 6.1.

4.5.1 Tõrva City

Tõrva is a remarkable example of the corruption existing in many LGs. On September 23, 1999, the Council of Tõrva City, located in the South of Estonia in Valga County, adopted a resolution pursuant to which the city was permanently insolvent, as the deficit of the city's budget of 13 million kroons (EUR 830,851) amounted to 4 million kroons (EUR 255,646), which the city could not recoup even with a negative supplementary budget. Of the debts, 1.4 million (EUR 89,476) were constituted by outstanding invoices and a debt to the Tax Board, and 1.5 million kroons (EUR 95,864) were outstanding for renovation of the city's historic inn. A lot of money was tied up by state debts. This difficult situation faced by the city occurred upon acceptance of documents and assets from the former city mayor.

Tõrva's difficulties began in 1997, as the renovation of the historic inn was begun. The building, situated on the central square and one of the symbols of the city, is subject to heritage conservation. The initial budget for repairs amounted to 8 million kroons (EUR 511,293) and was finally increased to 9.5 million kroons (EUR 607,160). The city invested 1.5 millions (EUR 95,867) in the renovation of the inn and 2 million kroons (EUR 127,823) were received from the government. 4.5 million kroons (EUR 287,602) originated from the advance payments of lessees. The economic situation of the city was further aggravated by the cost of improvements to Vanamõisa beach for 700,000 kroons (EUR 44,738), and for bringing street lighting up to the European standard at a cost of 1.2 millions (EUR 76,693).

At the beginning of 1998, the Financial Department of the Valga County Government controlled the use of specific-purpose appropriations by Tõrva City Government. It was discovered that not all the invoices were paid out of the 700,000 kroons (EUR 44,738) appropriated by the Ministry of Environment in 1997. The state's money (484,887 kroons) was not there either, as it had been spent for other purposes. The money had been allocated specifically for the construction of a sewage system, wastewater treatment plant and water intake for Tõrva. The city was not allowed to cover any other expenses with it. By March 30, 1998, the money was recovered somehow and the environmental debts were paid. The budget for the year 1998 should have presented the expenditure of 484,887 kroons (EUR 30,989), but it did not.

Due to bankruptcy, the city gave up several planned repairs. Although the street lighting was preserved, only half of the lamps were lighted. Further efforts were made to minimize the office expenses of the institutions managed by the city, almost to the level of zero expenses. Existing pencils were used to write on existing paper, but nothing was bought in addition.

Tõrva did not ask for money from the state, but tried to manage the situation by itself, by passing a negative supplementary budget and cutting down on all kinds of expenses (e.g,. by laying off employees in the city government and institutions managed by it).

4.5.2 Paldiski City

Paldiski is a sad example of the demise of a city that was first looted by the Russian Army, and then gradually allowed to collapse by the Government of the Republic and through the subsequent failures in the management of the city.

Estonian inhabitants were removed from Paldiski in 1940. When the Russian Army left, the city had enormous military structures but lacked most of its population. The infrastructure of the city was in a state of absolute deterioration and was haunted by the storage of radioactive waste. The initial plan for reviving the city was based on placing the Consolidated Training Centre of Defence Forces in the huge military complex situated in the city (the so-called Pentagon). Under the plan, the boiler-house and the utility network routes of the city were to be repaired using loans from the European Bank of Reconstruction and Development, totalling 19 million kroons (EUR 1,214,321). However, the Government of the Republic and the Riigikogu "forgot" to transfer these loans to the city when it became an independent local government. According to an evaluation by Swedish experts, the need for investments to restore the living environment in the city to a minimum level amounted to 380 million kroons (EUR 24,286,426).

Several campaigns were initiated with the hope of restoring and re-populating the city. Attempts were made to attract enterprises that would offer work to the population, as the former employers had left. Much hope was placed on the construction of a port complex.

But unfortunately, the city government's attempts to establish new enterprises were marred by greed. Media frequently accused city authorities of corruption and transactions detrimental to the city. At the same time, the city mayor repeatedly failed to fulfill the city's tax liabilities to the state, claiming lack of resources (no personal income tax or social tax were paid), so that the debt to the Tax Board grew to 3.5 million kroons. The city promised to settle the debt by the summer of 1999, and when it was still not paid at the time, the accounts of the city were frozen on September 16, 1999.

Paldiski's tax debt increased to almost 10 million kroons within four years. Further, according to a court judgment, the city owed 1.7 million kroons to a private company. As for current invoices, the city still owes 1.5 million kroons. The mayor of Paldiski who generated the tax liabilities is still an influential person in the City Council, besides being engaged in real estate (the city's real-estate transactions deprived it of considerable potential revenues). The current chairwoman of the Council sent petitions to the Prime Minister, the Minister of Finance, the Minister of Regional Affairs and the Harju County Governor, applying for 5.6 million kroons in order to balance the budget of the city. On October17, 2000, the Government of the Republic decided to allocate 3.3 million kroons as non-refundable aid to Paldiski from the off-budget Ownership Reform Reserve Fund to cover expenses relating to the municipalization of state assets and expenses incurred in organizing the process. With this action, the state partially satisfied the application of Paldiski for appropriation of additional resources for the purpose of balancing the budget.

4.5.3 Püssi City

On August 28,1996, the Püssi City Government (with a budget of 9.3 million kroons) organized an issue of bonds through Eesti Maapank, for 6 million kroons at an annual interest of 14%. The due date for redemption was August 15, 2002. On December 12, 1997, the issue was sold to the Compensation Fund in the course of a repurchase transaction. The bonds issue was organized with a view to buying a boiler-house for the city. In addition, a loan was obtained from the Environmental Fund for 750,000 kroons at 10%, and the term for repayment was December 2003. By assuming these large loan obligations, the city violated the Rural Municipality and City Budgets Act due to an inexpedient loan allocated by the Estonian Environmental Fund.

The purchase of the boiler-house was motivated by the desire to become independent of the heating services provided by AS Repo Vabrikud, which was the largest employer in the city. The option to make the purchase was selected on the basis of research carried out by OÜ EnPro Inseneribüroo, and it turned out to be the worst possible decision. Further, even though the Ministry of Economic Affairs had concerns about the expediency of buying the boiler-house, the project went ahead based on the justification that the city would save a lot of money and achieve independence in fulfilling its responsibility for heating.

The first financial difficulties occurred as soon as the heating period of 1996 began, as the old debt to AS Repo Vabrikud was still outstanding while the city also faced new expenses related to the project and also its payment of bond interests. At the same time, the debts to Kohtla-Järve city, Lüganuse rural area and Kiviőli city relating to education continued to grow.

Although the city managed meet the the payment schedule for the bonds until November 1998, within the first months of independent heat production debts relating to fuel were already growing. To ensure that public utility services would not rise in price for the population and to be able to claim that the purchase of the boiler-house was reasonable in all respects, the City Council established 236.00 EEK/MWh as the selling price of heat for dwellings (to match the price previously offered by AS Repo Vabrikud). But by February 1997 the actual cost was 241.00 EEK/MWh . By summer the price had risen further to 751.00 EEK/MWh, but the inhabitants were still charged 236.00 EEK/MWh, which in reality meant that the city subsidized and continues to subsidize the whole dwelling fund with the difference in prices.

On September 21, 2001, the city was faced with the following expenses to be paid from its annual budget of 13.2 million kroons:

- 6 million kroons—the bonds issue (redemption from the Compensation Fund on August 15, 2002);
- 3 million kroons—bond interest;
- 200,410.00 kroons—fine for delay arising from outstanding interest;
- 750,000.00 kroons—loan from the Environmental Fund for purchase of the boiler-house;
- 480,000.00 kroons—interest on the loan made from the Environmental Fund;
- 2.1 million kroons (approximately) for outstanding invoices including a debt of 2 million to a fuel supplier, plus interest in the same amount;
- 2.3 million kroons—debt to neighbouring LGs for education.

Thus, the total debt of the city amounted to 14,830,410.00 kroons.

At the end of 2001 the court ordered Pussi city to pay 1.5 million kroons to the Compensation Fund. When the city government refused to pay, an executive procedure was carried out and the executor seized the accounts of the city. The city government then decided to stop the provision of heating and hot water. At the end of 2002, the Compensation Fund was liquidated and the claim of 6 million kroons was handed over to the Ministry of Finance. In 2003, the state government allocated 100 thousand kroons to Pussi city to pay back a debt to neighbouring LGs for education services provided to children from Pussi.

4.6 Actions of the Ministry of Finance when Limits are Exceeded

The State Budget Law provides that if the LG has exceeded the limits on borrowing set by law, then the State Government has the right to decrease the transfers made to the LG from the support fund by the amount that exceeded the limits. This threat is only theoretical, however, and has never been applied.

In these cases, the Ministry of Finance would:

- Notify the parties about the decrease in transfers from the support fund to the LG, with an explanatory letter to be supplied;
- Transfer the retained amounts to the reserve for administrating foreign loans.

Paragraph 9 of Article 4 in the State Budget Law provides that if the LG has not fulfilled its obligations set by contract towards the state, the State Government has the right not to transfer grants to that LG in the amount of the unfulfilled obligations and by that to erase the unfulfilled obligations. This procedure is regulated by a decree of the state government.

In its reporting on the state budget, the Ministry of Finance considers the obligations of LGs or other public organizations fulfilled towards the state in the amount not paid to the LG.

4.7 Statistical Analysis of LGs' Management of Borrowing

Systematic data concerning LGs' borrowing have been available in Estonia since 1995. The tables and figures below show Estonian LGs' borrowing activities from 1996 to 2002.

Figures 6.2 and 6.3 show that in 1996 and 1999 a drastic rise in loan-taking occurred. The reason for this is that elections of municipal councils were held in these years. The preliminary summary of year 2002 shows clearly that there is a direct link between the election year and the increase in the amount of loans (total loans were nearly one billion and repaid loans slightly over EEK 600 million). As the restrictions on borrowing are quite soft, the municipal leaders have broad opportunities to realize their political promises and so-called "buy votes."

Figure 6.2
LGs' Annual Loans and Repayment Including Interest (1996–2001)

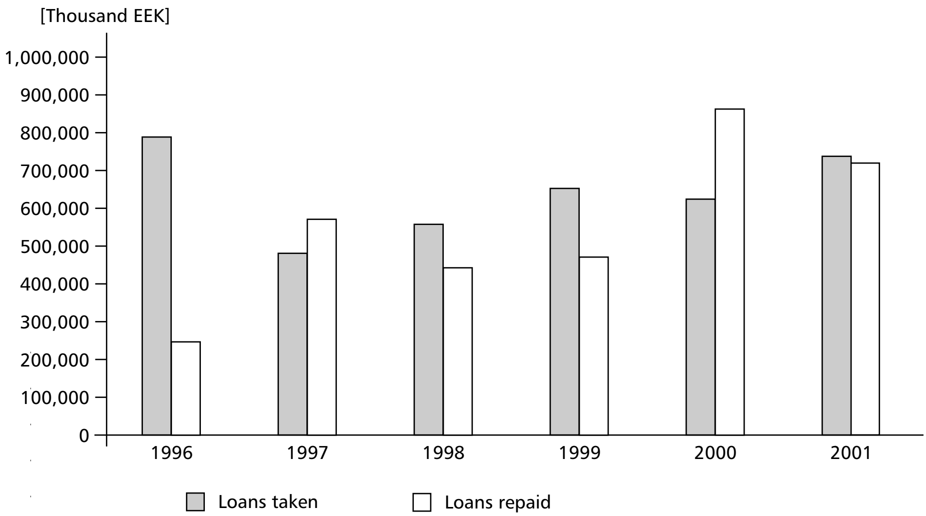


Figure 6.3
The Structure of Local Government Debt (1996–2001)

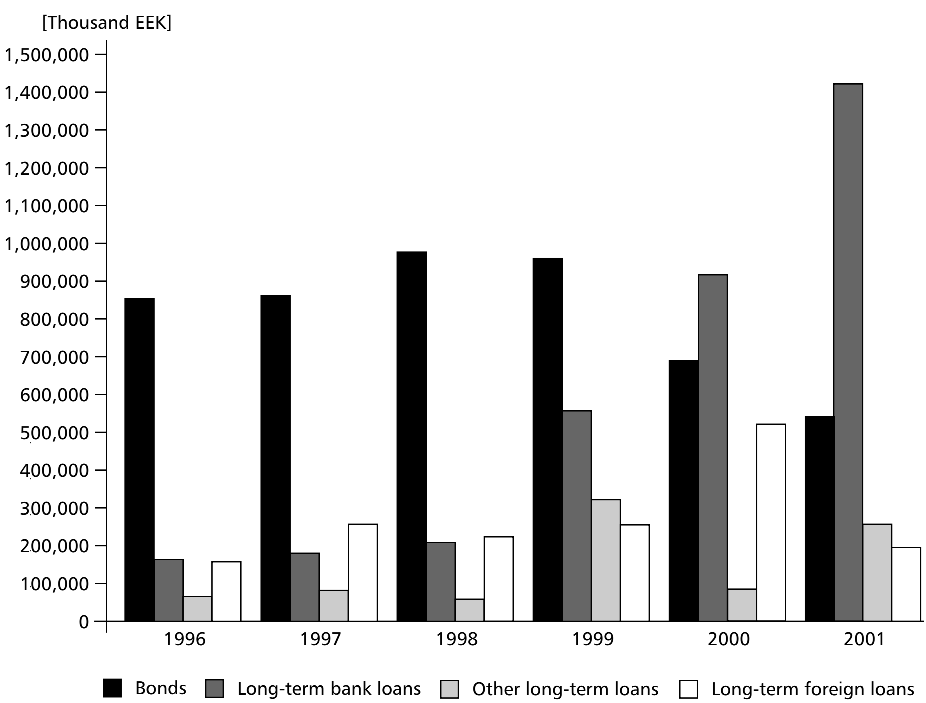


Table 6.7
Structure of Debt (1996–2001) [Thousand EEK]

	1996	1997	1998
Net revenue of LG budgets	4,015,926	4,999,455	5,569,195
Total debt (loan instruments)	1,234,337	1,382,972	1,469,381
Including principal sum	1,053,296	1,178,322	1,358,369
Including interest	181,041	204,650	111,012
Calculated average burden of loan debt of LGs	30.74%	27.66%	26.38%
	1999	**2000**	**2001**
Net revenue of LG budgets	5,948,849	6,551,533	7,900,338
Total debt (loan instruments)	2,088,365	2,265,841	2,474,602
• principal sum	1,961,439	1,882,570	2,068,445
• interest	126,926	383,271	406,158
Calculated average burden of loan debt of LGs	35.11%	34.58%	31.32%

Table 6.7 shows that LGs tend to increase their debt burden in the years of municipal elections. If the revenue base rises more rapidly than the total debt in absolute sums, the situation is not considered so dramatic and a warning is not necessary.

4.8 Reasons for Failure of Local Government Management of Borrowing

These legal restrictions are not able to regulate borrowing appropriately and do not assure that a municipality will not go bankrupt. There are several weak points in the legislation. Firstly, the limits of LGs' loans are not strictly defined. The total amount of loans may actually be larger than 60% of revenues of the budget year because the requirement of the 60% (from revenues) does not include loans with state guarantees and short-term loans. The total amount of a municipality's loans could therefore exceed the entire budget income of a current year. Table 6.8 shows an example of this.

The law does not regulate what kind of measures can be taken with municipalities experiencing payment difficulties. A local government cannot go bankrupt according to the Bankruptcy Law of the Republic of Estonia. But according to the Law on Taking Foreign Loans for the Republic of Estonia and Ensuring State Guarantee to Foreign Contracts, the guarantor (the government) has the right to demand compensation for loss of the guarantee, and if these are not compensated, the state may initiate bankruptcy procedures.

Table 6.8
Total Loans of Municipalities Compared with Planned Revenues

Municipality	County	Planned Revenues for 1998 [Thousands EEK]	Total Loans and Interest [Thousands EEK]	Total Loans from Planned Revenues [%]
Kehra city	Harju	10,706.50	19,975.202	186.57
Võnnu	Tartu	4,156.70	7,209.463	173.44
Võhma city	Viljandi	6,247.60	8,690.069	139.09
Orava	Põlva	3,201.90	3,717.111	116.09
Oru	Lääne	3,093.90	3,213.463	103.86
Türi city	Järva	21,116.50	20,472.987	96.95
Haapsalu city	Lääne	52,334.60	48,943.191	93.52
Taebla	Lääne	8,919.20	8,335.410	93.45
Räpina city	Põlva	11,484.60	10,585.345	92.17
Jõelähtme	Harju	22,036.90	19,318.335	87.66
Püssi city	Ida-Viru	12,831.30	10,790.000	84.09
Maardu city	Harju	55,568.00	45,919.912	82.64
Kullamaa	Lääne	5,052.50	4,040.669	79.97
Mooste	Põlva	5,387.70	4,289.188	79.61

Even though Estonian laws do not provide for LGs to give guarantees to enterprises with LG shares, the laws do not forbid subsidizing them.

The obligation to inform the Ministry of Finance about a loan or issuing of bonds has been interpreted by financial institutions (banks) as a reliable though silent guarantee to the loans of LGs. Therefore, the banks have set a "special price" for municipal loans. Although it is not said in law that the state gives a guarantee to LG loans, financial institutions have taken for granted that when an LG arrives in financial difficulties, the state will help it out.

The following table (Table 6.9) shows the LGs with the most serious problems, where the limits have been substantially exceeded. In addition to ignoring the restrictions, many LGs do not inform the Ministry of Finance upon taking financial obligations. The established rules thus appear to be ineffective. Many meetings have recently been held in the Ministry of Finance to discuss the problems and possible solutions.

Table 6.9
Local Government Loans [Thousand EEK] (2001–2003)

Municipality	Revenues in 2000	Debt Including Interest	Debt as % of Revenues	Required Debt Service as % of Revenues		
				2001	2002	2003
Kehra city	15,633.2	13,319.8	**85.20**	**18.82**	**18.82**	**19.02**
Keila city	68,502.4	37,702.0	55.04	**37.85**	3.55	3.34
Keila parish	14,360.4	10,727.0	**74.70**	13.00	14.79	16.52
Paldiski city	20,082.0	13,632.1	67.88	**17.41**	15.86	14.48
Kärdla city	1, 098.9	12,904.6	**75.47**	**18.82**	11.63	11.63
Avinurme	9,171.8	5,926.8	64.62	9.50	8.60	8.11
Püssi city	13,438.6	8,243.0	61.34	13.29	**46.34**	1.70
Haapsalu city	71,742.8	58 ,408.0	**81.41**	6.42	9.36	8.67
Ridala	12,354.6	7,944.0	64.30	11.93	10.87	10.20
Pärnu city	232,084.8	194,174.8	**83.67**	**38.07**	14.06	13.72
Pőlva city	33,114.8	22,472.5	67.86	4.45	10.00	9.69
Räpina city	14,252.4	8,920.3	62.59	7.98	7.69	7.69
Kuressaare c.	74,607.0	44,436.3	59.56	5.26	12.85	11.83
Mőisaküla	6,318.4	6,353.0	**100.55**	13.77	13.91	15.17
Viljandi city	97,339.2	75,911.3	**77.99**	6.73	10.41	10.47
Vőhma city	7,939.5	12,642.0	**159.23**	**17.22**	**18.65**	**18.49**

Note: Values higher than allowed by present legal regulations are marked with bold font.

No correlation has been established between a local govvernment's size and its problems related to loan policy. Some have exceeded the legally set loan limits and many are approaching that line. There are also LGs that have not yet begun to reduce the capital amount of the loans because of continuous refinancing, on each occasion to a lower interest rate.

Currently, no possibilities exist to receive a more favorable loan and the LGs will have to start to pay back the basic amount. But this is difficult when such discipline has not become a habit because of the continuous refinancing of the loan. A target has now been set, to achieve a balanced budget at all levels of government (both state and local government budgets) and to prevent the critical financial situations that can occur when LGs take on obligations beyond their capabilities.

The standards established by law are not a good indicator of the actual situation where LG debt is concerned. The repayment of most foreign loans may start several years later. But at the same time, for most LGs, 75% of their own yearly revenues is too small an amount to make important investments.

4.9 Devices for Control

Supervision and control over the economic and financial activities of LGs are basically regulated by ten acts. This legal control is exercised as follows:

- The County Governor monitors utilization of funds and investments delivered by the central government and the EU, grants and foreign aid;
- The legal chancellor verifies that local regulations conform to laws;
- The State Audit Office supervises the funds and investments delivered by the central government, and also the loans guaranteed by central government;
- An Audit Commission named by the LG council monitors utilization of funds and investments drafted by central government and the EU, grants and other foreign aid, usage of municipal funds, correspondence of LG functions to LG decisions and regulations and settlement of financial and accounting principles of LG institutions;
- Internal control, found within only some LGs, exercises controls similar to the Audit Commission's.

4.9.1 The Audit Commission

In LGs the Council is the higher authority of control and evaluation of the work of LG organizations. The working regulations (operating procedures) of LG councils is determined by the LGOA. The LG council forms an audit commission to control LG actions until the next elections. The commission must consist at least of three members, and only the members of the LG council can be members of the audit commission.

The composition of the commission is political. The governing coalition as well as the opposition must be represented among the members. Some of the LGs traditionally elect the head of the audit commission from the opposition.

According to the LGOA the functions of the audit commission are to control:

- The compliance of LG actions to the legal acts and decrees;
- The collection and registration of revenues at a fixed date;
- The accordance of costs with what was in the approved LG budget;
- The correctness of accounting of LGs' organizations, agencies and enterprises;

- The purposeful utilization of LG assets by LG organizations;
- The implementation of contracts that are made by LGs.

Written reports about the mistakes or shortcomings that are identified have to be presented to the municipal government with proposals for their elimination. The municipal government has to provide a response to the report and present it with the decree to the LG council.

Estonian legislation includes a requirement of follow-up control for the local budget. According to the LGOA, the audit committee must present an overview about its work to the municipal council before budget authorization. The commission also has to present its comments and proposals. According to this regulation the audit commission carries out the follow-up control. But the external audit—the final step in the audit process—should be presented prior to the approval of the budget for the last year.

The obligation to conduct an a priori audit is not prescribed by Estonian legislation. At the same time it does not exclude that possibility either. According to the LGOA, the audit commission will report to the municipal government in written form about the discovered shortcomings and its proposals for eliminating these shortcomings. The municipal government will develop its response during the ten days after the audit report was received and will present it together with the file to the municipal council. In this way the audit commission can audit some activity before its start, and both the municipal government and council must take the shortcomings pointed out into consideration.

4.9.2 Internal Control of the LG

The law does not impose any additional obligations for internal control on the LG. An internal control unit or staff position exists only in some LGs (the largest). In most, the internal control is carried out by an audit commission of the Council.

4.9.3 Legal Supervision by the County Governor

Governors are the representatives of central government on a regional level. They have the duty and right to supervise whether an LG has followed legal norms in the implementation of budget. If a county governor discovers that a legal act adopted by an LG does not correspond to the superior legal act, he or she makes a proposal for dealing with the problem within 15 days. If the LG refuses, the county governor should apply to the administrative court.

Usually the request of a county governor has enough moral force to change the decision even in cases where the law has not been formally violated. There have been cases when after the protest of the county governor, unjustified expenses have been compensated by the person concerned (for instance, for a training course in Morocco).

If the county governor establishes that illegal or inappropriate management of state assets has occurred, all documents about the case must be presented to the State Audit.

4.9.4 The Role of the State Audit in Supervising the LG

The State Audit is an independent budget organization for the supervision of appropriate utilization and management of state assets. It can control the use of these assets and also of enterprises where the state holds more than half of the shares. This organization can also control the appropriate utilization of government grants and subsidies.

5. STATE RESPONSE TO SOLVENCY PROBLEMS

Regulating the borrowing activities of LGs is connected with regulating the financial crisis situations or "bankruptcy" of LGs.

As was mentioned earlier, the law does not regulate what kind of measures can be taken to deal with municipalities with payment difficulties. An LG cannot go bankrupt according to the Bankruptcy Law of the Republic of Estonia. But at the same time, in some cases, LGs have found themselves in critical financial situations. However, because of the absence of mechanisms for regulating the whole situation, the central government has dealt with all these cases separately. The interference of central government has therefore offered one-time solutions.

LGs facing solvency problems usually file petitions together with explanatory memoranda to the Minister of Finance, the Minister of Internal Affairs as well as the Minister of Regional Affairs. The answer is unambiguous, as a rule—the state does not grant any loans to LGs to manage difficult situations. This position is supported by the statement that lending by the state is regulated by the State Budget Act and the Law on Taking Foreign Loans for the Republic of Estonia and Ensuring State Guarantee to Foreign Contracts.

Pursuant to section 38 of the State Budget Act, the state may take long-term loans for the purpose of balancing revenue and expenses in the state budget, and short-term loans for the purpose of ensuring the stability of cash-servicing. The State Budget Act does not provide for borrowing for any other purposes. Further, sub-section 29 (3) of the State Budget Act stipulates that a Ministry and any state agency within that area of government may not give loans, provide guarantees or use the amounts received from the state budget for the purpose of lending. This position is also justified by the fact that the State Budget Act does not provide for lending on the part of the state at all.

The state has very limited means to help LGs in case of financial difficulties. Until 2002, it could use resources from the Compensation Fund for Special Economic Situations under the Estonian Regional Development Agency. The resources of non-budgetary ownership reform reserve funds are in principle used for other purposes. As central government can only allocate non-returnable financial aid from its reserve funds (law does not permit the giving of loans from central government reserves), the minister of cabinet considers the decision of allocation thoroughly.

By the second supplementary budget in 1997, resources from the Compensation Fund for Special Economic Situations in the amount of 45 million kroons (EUR 2,876,024) were allocated to the Estonian Regional Development Agency. The primary aim of this fund is to promote activities designed to prevent economic crisis situations and to mitigate the consequences of special economic situations.

A regulation on LG insolvency is now being drafted in the Ministry of Finance. In the draft, procedures for insolvency are under the management of the courts. Generally, the principles are quite similar to those in the private sector, but due to the status of LGs some specific rules are introduced. First, LGs facing insolvency should not take on new obligations to increase revenues, and they are obligated to follow crisis budget principles and meet the claims of debtors. LGs operate under the direct and full supervision of the county governors.

6. POLICY PROPOSALS FOR THE ESTONIAN BORROWING PROCESS

Having considered the advantages and also the numerous deficiencies of the existing system of borrowing in Estonia, we would propose a new vision for how to improve the basic as well as the technical aspects of borrowing. Our views are somewhat different from the diagnosis and remedies proposed by the government.

6.1 Organization and Functions of LGs

The basis of all the financial problems in Estonian LGs is the division of functions among the tiers. The idea of revising governance structures that were adopted in the 1993 LGOA concerned first of all the abolition of the second tier of LG. Hence, two substantially different sets of functions of governance—community and regional functions—were not clearly defined and assigned to local and/or state regional institutions. Regional functions of government, except for the abstract task of balancing, were not assigned to the county government. Regional functions cannot be carried out by the municipalities either. This paradox was solved theoretically through the idea of the development of inter-municipality cooperation. This cooperation has not transpired, however.

The issue of allocation of functions is an important precondition for the healthy development of the local borrowing market, but since it goes beyond the scope of this report, it is not discussed in detail here.

6.2 Borrowing and Regulating of Bancruptcy

To improve the existing situation three alternatives could be implemented.

In the first alternative, the LGs would take loans, first of all, from commercial banks. Then:

- When calculating the suitable limits we must definitely take into account the fact that teachers' salaries that were given to LG budgets from 2001 will considerably increase revenues;
- An ex ante control mechanism must be established, i.e., that LGs will present their loan applications to the Ministry of Finance for approval before concluding the contracts. On the one hand, this will assure that the Ministry of Finance will know about all the financial obligations and can discover at an early stage if some LG has broken rules. Then suitable measures can be taken to prevent the LG from concluding the contract. On the other hand, this restriction contradicts the policy that gives LGs as much freedom as possible, i.e., to decentralize the system. Besides, the Constitution states that LGs are independent units that have their own budgets.

In the second alternative, if ex ante control mechanisms are not applied we should establish consequences for those who intentionally break the limits and or present wrong data:

- Stemming from administrative reform, only general principles of borrowing will be prescribed by law and the government will be given a right to establish the limits, presenting and processing loan applications and the rules for registering bond issues;
- Integration of the databases of LG loans of commercial banks with databases of the Ministry of Finance should be considered to improve follow-up control;
- The Rural Municipality and City Budgets Act should prescribe that the state does not guarantee LG loans. Probably after that, financial institutions will assess more carefully LGs' ability to pay back the loan and interests, and the amount of other loans it has.

In the third alternative the LGs would not have access to the loan market of commercial banks, or only restricted access, and all the borrowing would take place through the Treasury which would:

- Establish the total sum of loans of the public sector every year in a state budget;
- Create a loans committee in the Ministry of Finance that would evaluate the LGs' loan applications;
- Establish in a law or in another juridical act the criteria for assessing the loan applications and also the rules for processing these applications.

Against the third alternative one could use a legal argument about the correspondence of the suggested principles with Article 9, Clause 8 of the European Charter of Local Governments, which states: "Local authorities have an access to the national capital market within the law if they want to take a loan for capital investments."

In the view of our research group, the first alternative is the easiest to implement because half of it is already written in the LGOA. The only item that should be added is the sanctions that will (not only theoretically) be imposed if the law is not followed.

6.3 Government Grants

From the point of view of the borrowing market, the most important recommendation is that the general amount of government grants must become much more stable and should be determined for several years forward. Government must take more risks in ensuring a level of financing that reflects its own forecasts. Simultaneously, intensive training in forecast capacity at the level of individual communes should be organized.

6.4 Investments

The system of municipal investments ought to be adjusted for the requirements that enable LGs to receive resources from the structural funds of the EU. Different public channels, through which external investment resources could be obtained, should be integrated. It should be possible to consider the resources of LGs as well as support grants of the state as co-financing funds when making application to the structural funds of the EU. The Ministry of Internal Affairs has also suggested that resources should be allocated from the state budget in accordance with the project-principle for the whole period of an investment project.

6.5 Reporting and Controlling

In most LGs, the audit commission of the Council is the only unit that carries out the function of internal control. The work of the audit commission should become more regular and clearly scheduled. This would enable it to control all budget units during a certain period. In smaller communities the internal control could be jointly contracted out to regional development centers.

Information that is legally obligatory should be separated from information essential for analysis, and attention needs to be given to collecting data for the latter purpose. Developing the analytic capacity of the Ministry of Finance does not require an increase in personnel. The analysis could be contracted out. LG unions could be the contractor in the event that their capacity is increased with the change of their status and roles. It is also important to discuss the results of analyses with the LG financial managers with the aim of unifying the practices of financial management in LGs.

APPENDIX

Cases of Local Government Insolvency

LG unit	Year	Amount EEK/ measure	Source	Remarks
Vormsi rural area	1997	550,000 (340,000)/ support	County government support fund (state budget)	Initially 550,000 kroons was transferred, but then it was discovered that the municipality did not use the resources as agreed.
Kallaste city	2000	1,250,000/ loan until 2005	Estonian Regional Development Agency assurance fund for special situations	Kallaste owed Hansacapital company, and the court decided to seize the accounts of the municipality. The contract was extended with the company.
Narva-Jõesuu city	2000	1,500,000/ returnable support 2002 (without interest)	Earmarked reserve fund of property reform	
Paldiski city	2000	1,500,000/ loan until 2005 (3% annual interest) 3,371,600/ nonreturnable support	Estonian Regional Development Agency assurance fund for special situations Earmarked reserve fund of property reform	The transfer decree stated that the money was for municipalization of the state assets.
Tootsi rural area	2000	927,697/ nonreturnable support	Estonian Regional Development Agency assurance fund for special situations	
Püssi city	2001	The city had very big debts (17 million kroons in a total budget of 15 million kroons). In 2001, the court required Püssi city to pay 1.5 million kroons to Hüvitusfond (unpaid interest). Hüvitusfond started the executive procedure and the executor seized all the city accounts, thus ensuring the payment of 1.5 million kroons to the Hüvitusfond. In 2002, Püssi city bonds were redeemed. As the Hüvitusfond has finished the operation, the claim has been handed over to Ministry of Finance, which wants to go to court again. In 2003, the state government allocated 100 thousand kroons to Pussi to pay back debt to neighbouring LGs.		

Bond Issues and Bank Loans —New Mechanisms to Support Local Development in Romania

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Table of Contents

Bond Issues and Bank Loans —New Mechanisms to Support Local Development in Romania

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1. INTRODUCTION

The restructuring process in public administration was initiated immediately after the removal of the Romanian communist regime in December 1989. Upon the adoption of a law on local public administration (Law no. 69/1991, replaced in 2001 by Law no. 215), and a law on local elections and articles (nos.119 and 120 of the new Constitution) in 1991, the necessary legal framework for a real public administration reform process was established.

Romania is divided into counties (*județe*), towns (*oraşe*) and communes (*comune*), whose boundaries are established by law. A county structure consists of a capital (*municipiu reşedință de județ*),[1] several municipalities (*municipii*) and all the towns and communes within the county's territorial boundaries. Certain towns are classified as municipalities. Although there are no legal regulations in terms of public administration institutions or policies to distinguish towns from municipalities, the main existing criteria are: territorial size, number of inhabitants, historical background and socio-cultural importance (the term *municipality* will be used in the report to name the specific administrative territorial units). Bucharest Municipality is a unique case as it has subdivisions (sectors) that are each able to designate district councils and mayors. Romania is divided into 42 counties (including Bucharest Municipality), 262 towns and 2,686 communes.

The public administration institutions through which local autonomy is implemented in the local communities are the local councils as deliberative authorities and the mayoralties as executive authorities. County councils with deliberative prerogatives, and the president of the county council as the executive authority, are the representatives of county government. There is one further administrative institution at the county level, the Prefecture, which mainly supervises the legality of local governments' actions. The prefect is the representative of the government at the county level.

According to Law no. 70/1992 regarding local elections, local and county councils are to be elected on the basis of the party list system through direct suffrage, while mayors are to be elected on the basis of a uninominal system in two rounds. The local councils, the county councils, the mayors and the General Council of Bucharest Municipality are elected by universal, equal, direct and freely expressed suffrage. The last local elections were held in June 2000.

There is no subordination between the prefect and local authorities, nor is there subordination between the county public administration and the local one, according to the Law on Public Administration (2001). In reality, in both cases there are different aspects that make the insubordination principle more a *desideratum* than an obligation for the functioning of the local administration. For instance, prefects have the responsibility to supervise the legality of normative acts issued by local authorities within the counties they are appointed in. At the same time, they can take legal action against local authorities if they consider that the normative acts are illegal. Domestic and international analysts have expressed concern about political interference in the administrative decision-making process, which was reported in a significant number of localities all around Romania.

A more clear "dependency" is the one regarding the relation between the president of the county council and the rest of the local authorities within the county. The "dependency" is mainly related to the constitution and distribution of local budgets. The president of the county council is responsible for the distribution of the equalization funds to the local communities within the county.[2]

Once the major pieces of legislation regarding the functioning of the public administration were adopted, the most problematic task was to assist local authorities to understand their new financial responsibilities and—even more important—the complete reversal in their relationship with the central authorities, compared to what they had been accustomed to as "tutors."

With all the provisions of the law on local public finances, for example, it becomes easy to understand why local authorities have complained more frequently about the equalization funds (percentage and criteria) than about legislation allowing them to try other financial tools (borrowings, credits, etc.). An unfriendly local economic environment is the main reason why they have tended to seek an increase in central government transfers. But the old culture of dependency still exists, and this may also play a role. People need more time to adapt to the new trends and realities.

Ultimately, local implementers are more likely to make use of the new legislation on financial self-autonomy and other means of supplementing local revenues if some of the following elements exist: the confidence to try other mechanisms than state transfers, experience, a strong relationship with the business community, good communication between the executive and legislative branches at the local level, and assistance from the central government in following the correct procedures.

It is quite clear that new practices such as local borrowing were initially regarded as "extravagant" by mayors and local authorities at their first mandate. More experienced local authorities, on the other hand, saw them as very positive. It is new practices that will lead to transformation, and Romanian local authorities can adapt. However, extensive exposure to those local authorities who have succeeded (both within the country and abroad) will undoubtedly assist the process.

2. LOCAL GOVERNMENT FINANCING MECHANISMS

The local public administration in Romania includes two levels of government: a local level (communes, towns and municipalities) and a county level. Each has distinctive own revenues and competencies (expenditures) according to the adopted legislation and reform strategies.

Local public administration in Romania manages approximately 4% of GDP (2002). During the first years after 1990, the annual Law on the State Budget was used as the basis for drafting and implementing local administration finance policies. The provisions of the law seemed to reflect a high degree of centralization of the decision-making process and insufficient budgetary predictability for the local level, although the situation has considerably improved over time. The State Budget Law is adopted annually and includes information about the equalization funds allocated to the counties. A preliminary assessment of spending occurs midway through the year, and normally, additional funds are wired to the local communities at that time.

During the annual drafting of the State Budget Law, an intense discussion takes place concerning the so-called "special funds." These are earmarked funds meant to assist local communities with investment projects they are unable to completely finance themselves. These funds are managed by the ministries, and are established through a Decree issued either by the Romanian Government or the Parliament. They must be established and collected for a specific project with a concrete goal, and implemented within a certain time frame. Special funds come from special taxes paid by the direct beneficiaries. In 2002 the main special funds were: the Fund for Health and Social Insurance, the Special Fund for Developing the Energy System and the Special Fund for Public Roads. The criteria for distribution of the funds are decided by the ministries. The Special Fund for Public Roads, for example, is managed by the Ministry for Transportation, an institution often criticized for having an insufficiently transparent implementation process.

Administrative reform has continued since 1991, passing a significant crossroad in 1997–98; analysts agree that at a certain point the process even accelerated, in the sense that key financial policies changing the structure of public finance and fiscal relations between central and local authorities were implemented.

Fiscal decentralization was initiated along with the adoption of the Law on Local Taxes and Charges (1994). The law clearly stipulates that local taxes and charges form the local communities' own revenues; their rates are decided, collected and controlled by local governments. Thus, the property tax became the main source of own revenues of local communities in Romania. During 2002 the law was amended to facilitate the increase of local government own revenues.

The Law on Local Public Finances was issued in 1998 and the role of local budgets became more important at this time. The law regulates the transfers between different levels of the government, the equalization funds' role, as well as local government borrowing. A mathematical formula for assessing the financial capacity of the local governments was established in order to help the central government correctly distribute the equalization funds. The equalization of the local budgets happens in two ways: from the national level to the county level, and from the county level to the municipalities, towns and communes within one county. Although stipulated in the law on local public finances, the indicators as well as the place of the financial capacity formula in the whole equalization process are annually revised in the context of drafting the State Budget Law.

The Law on Local Public Finances also includes an appendix on the budgetary classification that must be followed by the local administration while administrating the budgetary revenues and expenditures. The adoption of the law changed the whole approach to public financing, as local communities after 1998 were given a share of the income tax collected in their community. Earmarked transfers allocated to autonomous enterprises or to public services and investments were eliminated. An equalization system that aimed to correct expenditure and fiscal capacity disparities among counties/local communities was also elaborated.

The key aim of the law was to strengthen local fiscal autonomy while clarifying and expanding local control over revenues and the formation of local budgets. Although the establishment of an equalization system has been an important step towards local financial autonomy, there are still problems that are mainly related to transparency in the allocation process and to political interference in the financial decentralization process at different levels. For example, the allocation of equalization funds often becomes a political negotiation open to influence rather than the result of an objective and transparent effort to fairly differentiate between local needs. The criteria for the distribution of funds to the local level are modified annually while adopting the State Budget Law. But the key role in allocating the funds to mayoralties belongs to the president of the county council, and there have been frequent accusations of political membership being a factor in the county council president's relation with the local authorities in the process of allocating the transfers (a very hot topic in Romania but obviously not the central theme of the current report). It should also be mentioned that consultations are part of the funds' allocation process.

In the same way that consultations (correctly speaking, negotiations) between the central authorities and the representatives of the counties should be genuine and fair, the president of the county council should also consult with the mayors in the county, listening to their needs before allocating the funds. How often this happens would be another very interesting area to research, keeping in mind the very personal nature of the relationships between public authorities in Romania.

The positive contribution of the 1994 Law on Local Taxes and Charges is unquestionable, but real progress also occurred when the Law on Local Public Finances was elaborated in 1998. It was in this year that the approach changed, and local budgets were addressed as part of a larger, comprehensive, unitary policy for local budgeting. Through the creation of a unique, articulated legal framework, the old individual resolutions approach turned into an articulated vision on local public finances in Romania. Improvements to complement this process became easier to introduce after 1998, although some have still been difficult to implement.

2.1 The Structure of the Revenues of Local Public Administration in Romania

Local public administration revenues include own revenues, transfers from the state budget and internal and external borrowings.

2.1.1 Own Revenues

In Romania the percentage of own revenues within local budgets' revenues increased during the last several years, mainly as a result of the changes in legislation allowing the decentralization of several sources of revenues. In 1995 own revenues formed 28% of the revenues of local budgets at the national level. The percentage decreased during 1996 (22.61%) and 1997 (18.95%), and increased again in 1998 (24.73%) as a result of the new Law on Local Public Finances. In 1999 the consequences of the new law became quite visible as own revenues reached 44.58% (a quota of the income tax being decentralized). During 2000 there was a slight decrease to 36.28% (see Figure 7.1).

The distribution of local revenues according to different types of local government units shows that the municipalities collect the highest percentage of revenues of all the local government units (see Figure 7.2). The main reason is that the local economic environment plays a significant role in the formation of the local revenues, and the municipalities have the most developed business environment of all other types of local community in Romania.

Own revenues include current revenues (fiscal and non-fiscal), capital revenues and earmarked revenues.

Figure 7.1
Local Government Units' Own and Shared Revenues as a Percentage of the Total Revenues of the Local Budgets

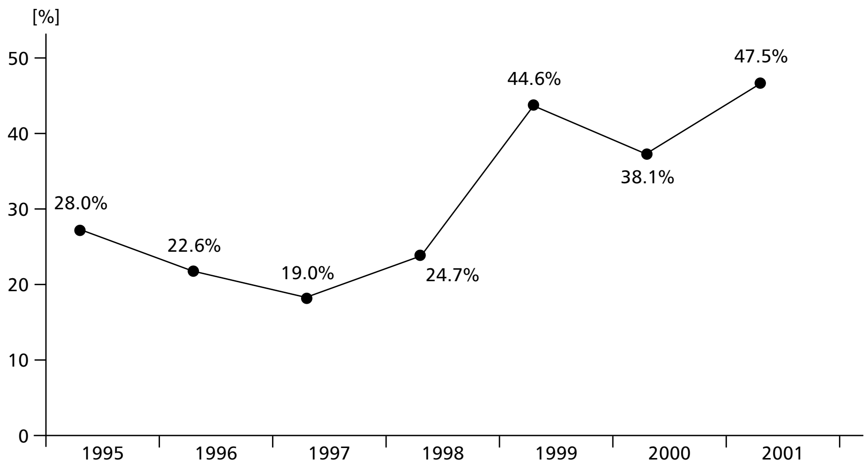
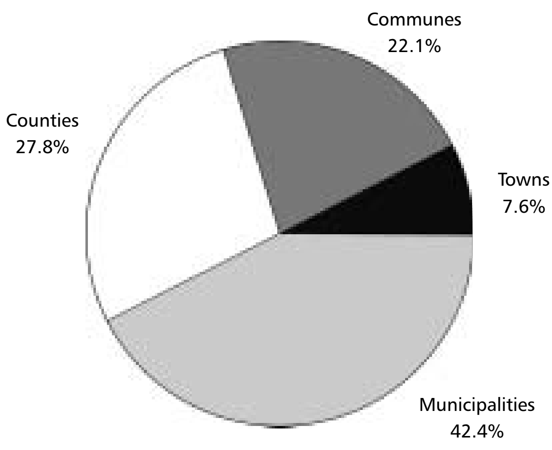


Figure 7.2
Distribution of Local Revenues According to Type of Local Government Unit (2001)



2.1.1.1 Current Fiscal Revenues

These are the taxes and charges collected at the local level, such as the property tax. Non-fiscal revenues come from the profit of private and autonomous enterprises, as well as from public institutions. It resembles the corporate income tax, except that in Romania it is not a tax and is considered a non-fiscal revenue of the local budget.

According to the legislation, own revenues are under the control and audit of the local authorities, who are responsible for establishing the taxes and charges of the local communities and also their levels. The Audit Court is the institution at the central level responsible for control of local communities' expenditures.

Local public authorities are directly involved in the establishment and collection of taxes and charges, and they can conduct their own fiscal policy depending on the status of local economic development, local needs and their own institutional capacity. The Law on Local Taxes and Charges of 1994 had no limitation on the number or level of taxes and charges that local authorities could establish. In 2002, however, after many local authorities succeeded in increasing their local taxes by over 50%, the central government issued an Emergency Ordinance that established some maximum limits for main local taxes and charges (the ones regarding buildings, lands, automobiles and the issuing of construction authorizations). There are small variations between municipalities' local tax rates with respect to the main taxes (e.g., property tax) but the funds raised from the local taxes also depend on the capacity and inventiveness of local authorities in establishing new taxes. The following are just two examples of taxes established by local authorities:

- The tax on questions—Sibiu. According to a decision of the local council in Sibiu, a tourist who gets lost while hiking has to pay 10,000 lei for every question he addresses to the members of the rescue team;
- The tax on interviews—Vrancea. The mayor of Țâmboiești commune (Vrancea County) decided that for each interview with local authorities, there should be a charge of 400,000 lei, generating funds that will help the local budget;

2.1.1.2 Capital Revenues

These are generated by the sale of assets belonging to the local government. They are rather exceptional revenues representing only a small fraction of the total local revenues.

2.1.1.3 Earmarked Revenues

These include special taxes[3] that can be established in order to finance the provision of public services. They represent an optional choice for local communities, not all of which access this type of revenue (under current circumstances, they are not substantial).

Quotas from personal income tax are a shared tax representing one important financial resource for local budgets. It is distributed to local public administrations according to the Law on Local Public Finances, but the percentages may change every year in accordance with the new provisions of the State Budget Law. For instance in 2002 the personal income tax was shared between the levels of government as follows:

- 37.5% remained at the local level after the tax was collected;
- 10% was allocated to the county level;
- 15% was transferred to county authorities that further distribute it to local communities within the county, according to the criteria provided by law for the respective year;
- 37.5% belonged to the State budget.

2.1.2 Transfers from the State Budget

These revenues include:

- Grants and quotas from shared taxes
- Earmarked transfers

2.1.2.1 Grants from Shared Taxes

These consist of transfers from the personal income tax (the quota that remains at the state level) and from the Value Added Tax (VAT). These funds can be:

- non-earmarked and used by local authorities to fund any kind of expenditure;
- earmarked to cover such things as subsidies for the price of the heat distributed to population, for the salaries of teachers in primary and secondary schools, and for social welfare. In this case local authorities do not decide their level or their destination.

2.1.2.2 Earmarked Transfers

These transfers are the government's contribution to the projects of international organizations. The government is required to contribute to the financing of activities and services representing medium and long-term investments in local communities.

2.1.3 Internal and External Borrowings

Local government borrowing is the most innovative of the tools for increasing investment revenues of local public administrations in Romania. Several regulations regarding borrowing were introduced by the new Law on Local Public Finances in 1998, enabling two instruments of borrowing: loans from commercial banks and bond issues. The Romanian experience with internal local borrowing will be explored in the following section.

Local government units also have access to external borrowing. When contracting external loans, the local communities must have the approval of a Commission mandated to authorize and approve the loans (consisting of representatives of the local public administration, the Government and the National Bank of Romania) when a certain amount will be exceeded. This maximum amount is periodically updated. The members of the Commission meet monthly and they assess all requests coming from local government units. The Ministry of Finance can guarantee an external loan contracted by a local government unit. In this case, the Ministry will supervise the contract procedure as well as the repayment of the loan. We do not include details about the external loans of local government units here, as the specific procedures and institutions involved require separate research.

2.2 The Structure of Expenditures of the Local Public Administration in Romania

In actual practice, central authorities in Romania have a tendency to maintain control over the level and structure of local administration expenditures. A study of the Partners for Local Development Foundation (2002, p.15) shows that there are at least two explanations for this tendency: the concern for macroeconomic stability and the fact that central government still plays an important role in financing the decentralized responsibilities. Local public administrative units continue to act as agents of the government when dealing with some public services. Central authorities may have transferred the management of public services to the local level and provided some of the financial resources, but local authorities are still not able to make important decisions regarding the quality of those services. For instance, the responsibility for teachers' salaries was transferred to the local communities along with the financial resources, but the local authorities still cannot decide the number of teachers in a school or the number of schools their community needs. These decisions are made at the county department of education, a decentralized government institution.

In 2001 local public expenditure as a proportion of total public expenditure reached 36.4%, while in 2002 it represented 35%.

2.3 Forms of Funding for Local Capital Investments

Until 1998 investments at the local level were financed through earmarked transfers (for utilities such as water and gas, waste removal, heating units, roads and bridges, housing, etc.). These transfers were eliminated with the Law on Local Public Finances, when investments became financed either through own revenues or borrowings.

Although the transfer of responsibilities regarding investment financing is a positive step towards real local autonomy, problems occurred after the adoption of the law. Many local communities had insufficient financial resources to support investments, unlike the central government, which could continue at full capacity. Because of this, they generally did not get involved in investment projects until the new financial instruments were created. In 2000, capital expenditures constituted 19.7% and in 2001 13.2% of total local government expenditures.

During 2001 the percentage of all types of capital expenditure of local communities decreased due to a weak synchronization between the transfer of fiscal resources and the delegation of responsibilities to the local level. At the same time, the newly delegated social assistance projects required such a large share of the local budget that local authorities could not afford to invest in development programs.

Capital expenditure for local development can be financed through:

- Own revenues (local communities elaborate their own fiscal policies, according to the provisions in the law);
- Grants based on two criteria: the contribution of the local public administration to the creation of public resources and the level of expenditures for public services;
- Internal and foreign resources (credits, bond issues, grants and non-reimbursable borrowings).

Municipalities finance the largest portion of capital expenditures (47.4%) and towns the lowest (8.9% in 2000).

Reform of the local public finance system is definitely moving ahead and will reach a new stage as local public authority representatives (the Local Authorities Federation in Romania) more strongly promote their needs and are successful in achieving changes. The experience of the first few years of implementation of the Law on Public Finances has already led central government to consider modifications to the law in 2003, in response to both the reality of implementation and the advocacy of the Local Authorities Federation. What public authorities are mainly seeking is increased financial autonomy as well as a better match between fiscal decentralization and the assignment of responsibilities.

Recommendations:

- The fiscal decentralization process should be accelerated in order to allow stability and predictability in the local budgeting process;
- The local communities' budgets should be created on a multi-annual basis to better contract and manage long-term investments.

3. LOCAL GOVERNMENT BORROWING IN ROMANIA

3.1 General Regulations and Practices of Local Borrowing

As local borrowing is still at an incipient stage in Romania, we have room for further detailing of the relation between current regulations and the institutions' ability to respond to market needs. Several relevant examples will help to illustrate the situation.

From all last years' statements, it appears that the future high-priority policy issue in Romania will be the establishment of a local government credit market. With a delay of more than ten years, Romania is now ready to follow its neighboring countries such as Poland, Hungary and the Czech Republic, whose strong economic and political will back in the 1990s favored significant local development over the years. The following factors are part of the background that must be considered for improving the legal framework for municipal credit market development in Romania:

- A greater effort is needed to match available resources with assigned responsibilities, e.g., for disabled and handicapped support, child protection and capital expenditures for schools. Over the past decade local communities have faced an increasing burden when undertaking the capital investments necessary to provide local services at appropriate standards.
- The central government has limited resources available for capital investments. Its need to ensure macroeconomic stability directly affects the transfers and grants coming from the State budget. Central authorities' strategy for encouraging the development of local borrowing consists more in a re-evaluation of the legislation than in the allocation of grants for local capital investments.
- Accession to the European Union (EU) will require a massive investment in environmental cleaning, much of it in landfills, incinerators, water treatment plants and other facilities at the local level. As in other countries aspiring to join the EU, the Romanian public sector will have to contribute significantly to this effort, helping to meet the twenty-five percent (25%) country match required for obtaining EU preaccession grants. Developing the ability to leverage local investment resources through access to private debt financing will be a precondition for local government units to contribute their share to the local public services' undertaking.

The fact that there have been so few practices in the area of local government borrowing indicates that while the responsibility primarily belongs to the local authorities, their success has also depended on central government assistance. One of the main conclusions of the present chapter is that the current legal framework governing local government borrowing needs substantial improvement. Local authorities associations have already drafted concrete proposals that would improve the legislation, equipping them with more appropriate tools to successfully contract borrowings. Central government, in its turn, is analyzing the possibility of amending the legislation to deal with institutional implications both at the central level (the role of Treasury, the banks, etc.) and the local level.

In this legislative review process, we must keep in mind that certain enthusiastic local authorities did decide to contract borrowings, despite the risks and the financial and legislative instability. These examples lead us to believe that commitment is a very important factor. It is still hard to speak about wide-spread local borrowing practices in Romania, but those few examples provide an idea of what would be the minimum conditions necessary when deciding to contract loans. Local practices in Romania indicate that legislation is only one very important factor that needs to be in place. A local authority's commitment and long-term strategy, predictability of revenues and future years' spending, and local authorities' will to help the community grow (thus its willingness to borrow the necessary funds to invest in development projects) are only a few conditions that also need to be fulfilled.

3.1.1 The Legal Framework Regarding Local Government Borrowing

With the adoption of the Law on Local Public Finances in 1998 establishing the basic principles regarding municipal borrowing in Romania, the local government units could contract loans and issue bonds. The first loans were contracted in 1999 after the adoption of methods for implementation. 2001 was the year when the local communities issued the first bonds. Other aspects regarding local government borrowing are stipulated in the Law on Public Debt (no. 81/1999) as well as in various other normative acts like Orders issued by the Ministry of Public Finances such as:

- Order no. 291 (2000) regarding the calculation of the debt service;
- Order no. 7 (2001) that decides who is excepted from municipal bonds taxation;
- Order no. 1631 (1999) regarding the obligation of the local public authorities to send information about local government borrowings.

All this intense legislative activity demonstrates visible progress that required constant improvement to legislation.

The provisions of the Law on Local Public Finances apply to loans and bond issue procedures. It is the responsibility of the local and/or county council to approve internal or external medium and long-term borrowings that concern their particular community. According to the legislation, the mayor or the president of a county council, as executive authorities of the local communities at each of the two levels, are responsible for the implementation of this decision. In practice, the mayor's and/or the county council president's initiative of issuing bonds is often easily approved by the local/county councils, as the final responsibility belongs to the executive level. No doubt the personality of the mayor or county council president and his previous managerial experience are other important factors that have an impact on the deliberative process.

The law stipulates two main instruments that local government units can use in borrowing (bonds and loans from commercial banks). The borrowing destination is clearly regulated by law: the funds coming from a loan or a bond issue can only be used to finance local public investments or the refinancing of the local public debt. Local public authorities in Romania regard such funds as one important source of financing of their development projects, keeping the rest (the state transfers, local taxes and charges) for daily operational costs.

The Law on Local Public Finances also allows a temporary financing of cash deficits through short-term borrowed cash from the available funds in the State Treasury (Art.53, [1]). Whenever these situations occur, the contractor (the local community) has to deposit the money at the Treasury. No deposits in commercial banks are allowed. Today this is one of the most important topics for negotiation between central and local government. In the context of a banking system that is still not sufficiently stable in Romania, central government sees too high a risk in local communities depositing their funds at the commercial banks. On the other side, local communities demand more autonomy and expect to be treated as mature enough to distinguish between risky and safe banks. Besides, the interest on deposits at a bank is considered to be an important, useful and additional source of income that the Treasury is not, by law, able to provide. When new negotiations between local and central government were conducted in February 2003, the local authorities reiterated their request, emphasizing again that they were aware of the risks but also that the gains were important for their development projects, and the central government was less able to finance these. The central government has remained cautious, no change being accepted so far.

The internal borrowings can be contracted and managed by local authorities independently, as no support from the central government is required. For each internal borrowing the Ministry of Finances need only be notified by the local or county council that decided to contract the loan or bond issue. The topic of notification is discussed later in the report.

Central government has a legitimate interest in seeing that local communities do reach a balance between excessive debt and their own financial resources. Most countries accomplish this through a debt limitation. The Law on Local Public Finances in Romania stipulates that the "annual debts representing the due installments deriving from contracted loans … shall not exceed twenty percent (20%) of the total current revenues of the local budgets …." (Article 51 [1]). This debt limitation has been interpreted to mean that the overall local debt in any single year shall not exceed twenty percent (20%) of the total current revenues of the local budget. Governmental Order no. 219/2000 specifies that the calculation of the debt service with a variable interest rate shall be based on the initial interest rate. At the same time, Governmental Order no. 219/ 2000 also addresses the issue of calculation of the debt service within the debt limitation that is guaranteed by a municipality. The Order says that the entire local government guaranteed debt service shall be subject to the debt limitation.

This provision is unnecessarily conservative. For instance, in the case of the proposed fifteen-year loans offered by the European Bank for Reconstruction and Development (EBRD) to local communities (without a sovereign guaranty), the local government has to provide guarantees that the debt will be reimbursed. In order to secure this guarantee, the municipality will be required to create a "reserve fund" that is equal to the amount of the annual debt service of the loan. In such a case, when the debt has been fully reimbursed during the year, it seems unnecessary to include such a guarantee for the debt limitation. Additionally, as a result of current restrictions on commercial bank deposits, such funds would remain uninvested for fifteen years, substantially increasing the cost of financing. Furthermore, there are no executory procedures in place that the creditor can use in order to access such funds from the Treasury.

The Law on Local Public Finances stipulates that long and medium-term loans may be authorized only if their purpose is to finance public investments of local interest or to refinance the local public debt (Article 48 [1]). This provision limits the municipal debt destination to infrastructure projects that are included in the "public domain" and sets an appropriate "public purpose" standard for all local government credits.

Also, the Law on Local Public Finances stipulates that short-term Treasury loans for cash flow deficit financing shall not exceed five percent (5%) of a local government's budgeted revenues (Article 53 [2], [1]). Additionally, the law stipulates that such loans shall not exceed the amount that the local government is able to cover during the respective fiscal year.

As we have emphasized in the report, revisions to the legal framework regarding local government borrowing are currently under debate, and many of the above-mentioned issues are now being extensively discussed among the main actors involved.

Recommendations:

- The Law on Local Public Finances allows no exceptions to the maximum amounts set forth, should any local community plan to access more. Consideration should be given to a more flexible framework. It could be stipulated that if certain criteria are accomplished (i.e., the own local revenue base can support a greater amount of the debt, or creditworthiness indicators are better compared to the maximum level registered by local government units of the same category), the debt limitation might be exceeded. Such a procedure for exception would allow: i) additional financing for more creditworthy municipalities, ii) financing of investments that have a positive net impact on cash flow, e.g., energy conservation projects;

- The Law on Local Public Finances should include clearer regulations regarding the calculation of the debt limit;
- Local government units should be allowed to make deposits at commercial banks. A step forward would also be the decision of the central government to permit local communities to collect interest on the deposits in the State Treasury;
- Consideration should also be given to the possibility of eliminating the restriction on short-term debt for the financing of "temporary cash deficits." Local communities' arguments in favor of financing public investment projects with short-term debt should be more carefully analyzed. For example, they might need this either in anticipation of a long-term debt to be issued later, or to finance some preliminary costs of a public short-term investment project.

3.1.2 Monitoring and Database Regarding Local Government Debt

The Law on Local Public Finances stipulates that "a municipality may contract loans only after the Ministry of Finance is informed about the intention" (Article 48 [6]). The law does not state when the Ministry of Finances should be notified, nor what the standard form of notification should be.

Local government units are required to book all their debts and store the information in their annual accounting report (Article 52 [1]). The registry book must include "details of such debt" and any other information required by the Ministry of Finances (Article 52 [2]). On the same matter, the Ministry of Finances has issued Order no. 1631/1999 providing details on precisely what information should be included in the public registry.

Legal provisions regarding data collection on local government borrowing are thus in place. In practice, however, the Ministry of Finances has no national database. Therefore, no nation-wide, clear view of the extent of the local public debt is available to the public. Also, no detailed data about the local government units that contracted loans is centralized. The role of the Ministry of Finances is crucial in providing current, updated nation-wide information about the local authorities' experiences and capacity in our area of interest. A fluent exchange of information between the central authorities and local communities also needs to be in place, with both parties transparently sharing information. Central authorities would benefit greatly from up-to-date knowledge of local financial capacity, and could better determine the most appropriate financial development policies. These, in turn, would bring more advantages to the local communities and would increase cooperation between the two levels.

As the legal provisions require, it is the primary role of the local authorities to inform central government on their situation regarding the local debt. But in interviews with central government representatives while developing this report, it became clear that the representatives of the Ministry of Finances do not see the task of updating a national database as part of their role. One explanation could be that they are not sufficiently aware of their role in ascertaining a clear, overall picture of local borrowing in Romania, or of the value in having a local perspective on how the municipal borrowing system should be regulated. On the other hand, the local authorities perceive notifying and informing central government about their local debt and borrowing as an interference of central government in their local autonomy and in the local decision-making process.

Sensitive to EU recommendations, central government has often overreacted, acting with excessive caution in demanding information or notification from the local government. Obviously, the concept of local self-governance is perceived very differently by the many public authorities at different levels in Romania.

There is no sufficient monitoring of the municipal debt process. According to the current legislation, neither the local government unit nor the lender should notify the Ministry of Finances in case of a default. Consideration should be given to requiring a default notification in a public register to be stored at the Ministry of Finances and, of course, open to the public.

Closely linked to effective economic development and efficient use of public resources is the improvement of municipal budgeting and financial reporting practices. Preparation of local budgets and financial reporting are two important and intricately connected parts of local fiscal management. In Romania, both processes are subject to strict national regulations. Information from the local level plays a crucial role in the drafting of the State budget. A budget is line-itemed in order to clearly indicate the inputs (the financial resources) as well as the appropriate level of expenditures that need to be realistically planned. Local government fiscal information is based on the chart of accounts for budgetary (public) organizations. It is up to each local authority to describe in detail the local financial report according to the information that it needs internally. All this detailed information should be integrated into the legal requirements and limitations.

Budgeting and financial reporting are more than just a set of procedural rules for spending public money; they could have a very important impact on local development. A well-structured budget may be used as a tool when implementing policies that are in accordance with local needs, and reporting might serve as an instrument to provide feedback on outcomes of the policies. A sectorial or program-type approach promotes allocative efficiency, i.e., allocation of resources from lesser to higher priority sectors or programs. The application of performance indicators or output indicators is closely linked to operational efficiency, providing information about the cost-efficiency of the service provider units.

In short, local budgeting and reporting procedures in Romania currently entail the following problems: (i) lack of strategic vision in the context of the budgeting preparation process, (ii) lack of regional and sectorial perspective, (iii) current reporting standards that do not allow credit analysis, and (iv) limited access to comparative information on municipal finances and service delivery. The main problems mentioned above are interconnected. In the absence of a clear strategy regarding the delivery of services, output (performance) criteria will not have been identified, and there can be no measurable service goals and standards if performance indicators are lacking.

Most of these problems cannot be solved by simply introducing new regulations. Innovative approaches and methods should be disseminated to professionals and local practitioners. One possible option is to replace the current organization-oriented, input-based budgeting methods with output-oriented programs and budgeting mechanisms. An important step in this direction might be to develop and introduce key service delivery indicators, ensuring that these are included in both the budget plans and the annual reports, and that information on outputs is fed back to the budget of the subsequent year.

Finally, another problematic area is the publicity for and public accessibility to the fiscal data of local government units. Information on the local municipal budgets and the budgets of municipally owned service providers, including balance sheets and property registration data, is centralized by the local offices of the Ministry of Finances. Although the government annually collects several hundreds of expenditure and revenue variables for fiscal monitoring purposes, this information is kept confidential at the national level. Only the Ministry of Finances has access to detailed fiscal data from local government units. The existing data-synthesized charts, although very important, are insufficient for any elaborated analyses on matters regarding communities' financial capacities.

There is no legal obligation for the Ministry of Finances to transparently communicate the local governments' debt. The only requirement refers to the local governments whose budget has to be published in a local newspaper so that all citizens can read it. It also should be noted that the requirement refers to the estimated budget and not to the executed budget.

Emphasizing the importance of publicity and accessibility to information regarding local public debt, our recommendations are:

Recommendations:

- A special department should be established under the supervision of the Ministry of Finances, whose responsibility will be to build and constantly update the database regarding local government borrowing. We would recommend that the Ministry of Finances require a Notice that contains the same detailed information as is included in the local government units' public registry.
- Careful consideration should be given to the information to be reported, to ensure that all relevant information about the debt is included. In addition to the information required through the Order, to be contained in the local government units' public registry, a certification of compliance with the debt limitation should also be solicited. Additionally, notification by both a lender and

a borrower should, upon default of payment, be an obligation. Such information should be accessible to the public.

- This current inventory could also be annually updated, with special attention being regularly paid to improving local government units' debt reporting practices. Moreover, it could also be maintained as a public registry open to prospective lenders in order to assist them when underwriting the local government credits.
- Should any default on a local government credit occur, both the local community and the lender should be asked by law to notify the Ministry of Finances over a certain period of time (e.g., in ten days).

3.1.3 Regulations Regarding Insolvency

As complex as it is, and even though it has been revised almost annually during the last few years, the legal framework in Romania has no provisions to regulate municipal insolvency situations. The Law on Local Public Finances does have some remedial procedures that relate solely to short-term loans owed in the Treasury.

Laws and procedures need to be drafted soon to allow better management of local government insolvency and to clarify its rights. The regulations should also stipulate which policies need to be in place in order to assist a local community in regaining a stable financial status. The central government, the local government units themselves, or the local government units' creditors should be able to initiate such procedures. The definition of local government insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged should be also very clearly stated. When interviewed about the policies regarding the medium/long term insolvency, most respondents have agreed that, if insolvency regulations were to be adopted, the remedial procedures should primarily fall under the responsibility of the local authorities. Central government should have a limited role, more in the sense of assisting the local community.

In cases involving the incapacity of local communities to reimburse bond issues, the law stipulates that each creditor of the municipal bonds should individually try to recover the money. Probably not a unique case, the Romanian experience has shown that it is in a way unrealistic to imagine that each municipal creditor will manage to collect individually what is owed. The legal framework should be amended to provide the creditors with more appropriate tools to act in an efficient and organized manner, nominating a person to legally represent their interests.

Closely linked with insolvency is the creditworthiness of the local government units. Neither laws nor regulations require creditworthiness analyses or evaluations. Since the banks were not very active in contracting borrowings to municipalities, such analyses were conducted on a very casual basis. Only a few municipalities undertook such analysis, for their own financial management purposes exclusively.

As yet there are no local rating agencies offering such analyses. Also, no international rating agency has provided a rating to a Romanian local government unit. Some years ago the city of Sinaia tried to contract such a rating. The Mayor of Sinaia planned to issue bonds on the European market, but at that time this was possible only after the approval of the Ministry of Public Finances. Despite the favorable perception of Romania in the Europe financial markets, the approval was not granted. As was already mentioned, it is very important to have a mutually beneficial relation between local and central government when it comes to contracting a borrowing.

Banks are involved in undertaking credit analysis as part of their internal rules since they have become more and more interested (but still cautious) in working with the local government units. In most cases such rules are of little use to a local government, but more to commercial companies, given the fact that they are the most important clients of the commercial banks.

Recommendations:

- There is no clear legal regulation on local government insolvency. Law and procedures should be developed for managing an insolvent municipality, its relationships and rights with regard to creditors. The definition of local government insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged, should be very clearly elaborated;
- As the local government borrowing market develops, the independent rating agencies should be more active since their involvement will contribute to further development of the local credit market in Romania;
- A set of policies to assist a municipality in regaining a stable financial position should be drafted. Depending on the rules that are adopted, such procedures could be initiated by the central government, the local government unit itself, or, eventually, the local communities' creditors;
- The regulations regarding bond issues' creditors should be more clearly defined, so that they would act in a more efficient manner while trying to recover their debt.

3.1.4 Guarantees for Local Government Borrowing

The largest source of local revenues is still represented by transferred central governmental funds. This can easily be seen when the existing overall financial resources and estimations regarding the local communities' near future financial capacity are analyzed. A number of countries use legislatively authorized "intercepts" of such intergovernmental transfers to enhance the ability of local governments to provide safety for their borrowings. Such intercepts can provide a strong incentive to the credit market without any implied central government guarantee or additional "costs" of the Treasury. Own revenues thus represent the most frequently used form of guarantee in local government borrowing.

The Law on Local Public Finances stipulates that a local community has to guarantee any contracted loan with *own revenues*, except when the ultimate use of the loan could also be financed through earmarked transfers from the State budget (Article 48(3)). The Law on Local Public Finances authorizes municipalities to pledge other transfers from the central government, e.g., quota and other amounts derived from certain incomes of the State budget.

Although the Law on Local Public Finances does not include any provision related to securing municipal debt through *physical property*, the general principles of Romanian legislation would not prohibit securing municipal debt with a mortgage on local government property in the private domain. Although this may involve a decrease in collateral, it is a way of securing loans that bank lenders are familiar with, and it could have a role in the initial stages of bank lending to local communities. However, the Law on the Public Domain, which will classify the "private domain" property that is eligible to be used as guarantee, has not yet been fully implemented by the government. This has adversely affected the ability of local communities to use physical property as a guarantee. A shift away from physical guarantees to general obligation and revenue-secured debt may be a significant precondition for the sustainable development of a local government credit market.

The current legal framework has a foreclosure procedure that further decreases the value of physical property as guarantee. An amendment that became effective in January 2001 expedited the process of enforcement over movable assets (no. 99/1999). However, the foreclosure procedure for immovable or real property remains a time-consuming process.

Another form of guarantee is the *reserve fund*. This is a financing device that sets aside an amount of funds, usually from the borrowing total. It is held separate from the other funds of the local government and is available only for debt payments when the local community is unable to make the payments. In such a case, the municipality is required to replenish the reserve fund within a well-specified period of time. This device enhances the security on a debt instrument by providing a source of funding for debt service payments in the case of cash flow disruptions that would otherwise result in a payment default on the debt. The Law on Local Public Finances has no provisions to allow or to prohibit such a security device. As we have already mentioned, certain local government guarantee programs require the municipal guarantor to create a reserve fund equal to the guaranteed annual debt service. But unless such funds were permitted to be held in interest-bearing accounts, the guaranteeing municipality would pay a substantial negative arbitrage cost in addition to such reserve funds.

The Law on Local Public Finances expressly states that the central government can guarantee the internal loans, if conditions such as financial capacity of local government units are fulfilled.

The Law on Local Public Finances also stipulates that the "government may offer guarantees to external municipal 'loans' in accordance with the terms of the Law on Public Debt" (Article 55). The Law on Public Debt authorizes the government to offer guarantees on debt issued in the domestic currency (Article 27). Despite all efforts to amend the Law on Local Public Finances in such way that the central government would guarantee the domestic debt, it was not changed. Discussions created nothing but confusion. Since the Law on Local Public Finances does not prohibit such a guarantee, and the Law on Public Debt clearly speaks about such a guarantee, it becomes the Ministry of Finances' role to further debate the issue and identify the appropriate solution, harmonizing the provisions.

Private guarantees or insurance on municipal debt have been widely used to reduce creditors' risk and enhance the municipality's creditworthiness. Private insurance companies insured almost half of all municipal bonds that have been issued so far for the one-time payment of debt service. Unlike free government guarantees, private insurance does not create "perverse" efficiency incentives. A premium is paid for guarantee coverage. A guarantor has well-trained staff to assess financial risk, or a project's financing stability. The greater the risk, the bigger the premium that will be charged to obtain the guarantee. However, this is not a substitute for local governments' creditworthiness, as the guarantors will only guarantee the debt of communities considered to be creditworthy.

Normally, lending banks in Romania get similar insurance from companies guaranteeing the loan reimbursements. Further documentation regarding the possibility of developing this option for local government debt transactions is necessary.

Recommendations:

- Currently, most financial institutions require real estate guarantees and just a few allow local authorities to guarantee the loan with their annual own revenues. Many local authorities in Romania do not have a clear understanding of what is private or public property of the local government. Only a Governmental Decree for each and every locality can establish the nature of property in this regard. Under these circumstances, the procedures should be simplified and decentralized to the level of the local councils;
- A shift away from physical guarantees to general obligation and revenue- secured debt is recommended as a significant precondition for sustained development of a local government credit market;
- Through specific banking mechanisms, the commercial banks should be encouraged to accept collateral forms of guarantee from the local public authorities;

- Local communities should be allowed to deposit the money coming from the local budget reserve fund at commercial banks, thus offering a supplementary guarantee.

3.1.5 The Role of Central Government in the Local Borrowing Process

Even in a decentralized public finance system, the central government retains a legitimate interest in the integrity of municipal budgeting and financial management. The first priority of a local government unit should be to provide the best local services to the community. A second fundamental priority is to prepare and execute balanced operating budgets. The central government has one critical objective in ensuring compliance with legally mandated procedures, and that is to limit the consolidated public sector's outstanding debt to comply with the international agreements, to preserve the government's ability to borrow from abroad, and most importantly, to build a solid base for the national economy and future participation in the European Union.

It is very important to protect the local government (and the central government indirectly) from imprudent loans that could threaten the safety of the overall public finance system and put pressure on the national government to deliver costly bailouts.

Still, under existing circumstances, it is not advisable that the Ministry of Finances be authorized to exercise prior restraint on municipal debt issuance. The Law on Local Public Finances suggests a careful approach by not requiring the Ministry of Finances' approval for any municipal debt unless it is an external debt. As already mentioned, the Ministry of Finances has repealed a prior order that required approval of local government bond issues. A statutory debt limitation is used to decide a maximum "limit" on the debt that a local community can issue.

The heart of the rationale for private capital market development is the confidence that the self-interest of banks and other financial institutions will motivate them to assess the capacity of the borrowers in reimbursing their debts. To duplicate this function requires a sophisticated institutional capacity that the Ministry of Finances or another appropriate agency should develop. Even when this institutional capacity exists, there is little reason to believe that the monitoring agency will do a better job in assessing credit risks than the lenders or the rating agencies (or, for that matter, the communities themselves). Moreover, central government review and approval of local government credits can easily imply the idea of an implicit guarantee, with municipal bondholders or lenders likely to hold the oversight agency responsible for any payment default.

The role of the central government in the new financial environment (in which more and more local communities are seeking other means through which to supplement their local revenues) is currently the subject of debate. Successful local authorities (experienced and financially independent) would expect no assistance from the central government other than channeling the necessary information from top to bottom and vice versa. The ones whose experience is only now being consolidated claim more substantial support from the central authorities, whose involvement they feel will bring more confidence that they ultimately will not fail.

3.2 The Scale of Local Indebtedness

As previously mentioned, the local public authorities will not have access to any type of borrowing if the total annual debt (consisting of interest on existing loans, and other interest and commissions including loans that are still to be contracted) exceeds 20% of current revenues. The percentage will not change, should the size of the local government unit or financial capacity vary. Some local authorities in Romania are advocating for the Ministry of Finances to amend the legislation so that a city that is financially stable can borrow beyond the current limitation.

The debt service ratio is calculated as follows:

$$\text{Debt service ratio} = \frac{\text{The annual debt}}{\text{Total current revenues}}$$

Periodical estimations on debt service ratio are needed as it can vary from one year to another. With regular estimations not only will the central government be constantly aware of the size of the debt, but also the most financially successful, self-developed local communities will have more initiative and incentive to grow.

According to the Law on Local Public Finances, local communities can contract short, medium and long-term loans. But in reality they can now contract medium and long-term loans only. As noted earlier, if local government units plan to contract short-term loans, they can only access funds from the State Treasury with the purpose of refinancing the cash flow.

Today, there is no centralized data available that would show the geographic distribution of the local debt. The existing information, however, suggests that in Romania it is the cities and big towns that have so far contracted the most numerous and also most consistent (in terms of the borrowed amount) borrowings. No county council has accessed the internal market of loans or issued bonds for supplementing its own budget so far.

Macroeconomic development has an important impact on the Romanian credit market and on the scale of local indebtedness. Until now, the effect of fluctuations in macroeconomic indicators on local borrowings could not be comprehensively estimated.

The practice of local government borrowing is still in its early stages and there is not sufficient data to allow correlations. At the same time, it is obvious that the development of local borrowing, in its turn, also directly influences macroeconomic growth and/or stability. It is in fact a dual process and the policy-makers need to be aware of how the correlations are inter-related.

In theory it is suggested that an increase in the inflation rate will cause a decrease in the lending rate. Information from the Romanian case shows an upward trend in the inflation rate as well as a parallel downward trend in the interest rate. This might encourage the local authorities to access local borrowing because crediting will be stimulated.

Other factors that are involved in the decision-making process regarding the size of a loan or a bond issue to be contracted are:

- the estimate of revenues and expenditures of a local government unit;
- the estimate of the resources that will be available after covering the operational expenditures;
- the net debt per capita;
- the experience of the local community in managing public debt;
- the available resources to allow the development and the maintenance of the project for which a loan is to be contracted;
- the consideration of analyses regarding major economic and political aspects (especially in Romania where the legal framework is unstable and frequently amended);
- the willingness to accept risk.

As for the supervision of the local borrowing process, the central government has two reasons for concern other than compliance of local communities with the law:

- The need to carefully monitor and limit the public debt in order to comply with international standards, while allowing the government to contract loans from international organizations. These practices will create the ground for a more rapid but also professional EU integration process. The consolidated national public deficit includes the deficits of all local budgets. In this sense, the public debt in Romania (which includes the national and subnational debt) has fluctuated as follows:
  - 1997—27.7% of GDP
  - 1998—28.0%
  - 1999—26.67%
  - 2000—29.3%

  These figures are far under the limit of 60% recommended by the EU.
- Risky borrowings of local communities may affect the integrity of the public finance system, forcing the central government to undertake "expensive" actions.

A consolidated financial environment, in which central government assists local public authorities financially unable to deal with reimbursement of loans, will strengthen arguments concerning the need to carry out legislation revision. It is true that in the early stages of development, central authorities in Romania had to become closely involved with the different local communities, assessing their needs and assisting with the necessary processes in constructing a loan. Such experiences, no matter how difficult, have a value and importance that must be considered when framing arguments for changing the law. Future weaknesses could be avoided if recommendations were made based on prior experiences. Of particular value would be recommendations regarding a better consultation process between different levels of government, and ones concerning non-partisan assistance from central government to the local communities.

Also, since these practices (loans, bond issues) are so new in Romania, borrowers with insufficient financial capacity among the local communities will naturally have a direct effect on the confidence of potential new clients. It is imperative that all interested parties have free access to information, learning from others' experiences while carefully assessing their financial capacity, and also being assisted by more experienced central government experts whenever necessary.

Recommendations:

- The annual State Budget Law should include information about the local internal public debt. Currently it only includes information about the total internal and external public debt;
- Policies regarding local government borrowing should be periodically correlated with the existing macroeconomic situation;
- The consultation process between different levels of government should become permanent in order to improve practices and avoid future failures in the local government borrowing process.

3.3 The Debate on Establishing an Investment Bank for Local Communities in Romania

Romania has no specialized institution in charge of managing or facilitating the local government borrowing process. At times there have been discussions about creating an Investment Bank for Local Communities (IBLC), following the examples of different Western European municipal banks. In evaluating the possibility of establishing a bank whose clients would only be the local authorities, the central government has analyzed the factors that will directly have an impact. Financial fluctuations are obviously a main factor, as Romanian internal resources are insufficient for financing such a project. The cost of capitalization (a serious potential burden for the local authorities still not financially stabilized) was the second major concern that has been deeply analyzed. The experience of other countries when capitalizing their Local Authorities Bank was studied, and the Romanian Government and local authorities are currently accumulating and analyzing all the information gathered. Finally, the criteria for contracting loans were discussed, since preferential loans could easily undermine the credibility of the whole initiative.

The idea of establishing an Investment Bank for Local Communities was generated by the many problems that local authorities faced in the local government borrowing process. No doubt the idea arose as a compromise between local and central authorities. The local communities' suggestion was that financial operations would no longer be managed exclusively by the Treasury, since the responsiveness of banks was perceived as being more rapid and therefore more helpful. To fully explore the possibility of establishing an IBLC, central government has had consultations with a number of foreign experts. The Dutch and Danish experiences in this area are only two of a number that were closely researched. Of these two, the Dutch one is seen as inappropriate for Romania at the present time, mainly because the chief responsibility in the capitalization process there belongs to the Ministry of Finances. The Danish example is still being carefully assessed, with some analysts expressing concern that in this model the local authorities may expose themselves to too high risks in the process of becoming shareholders. The analysis is continuing with other questions still not fully answered, including the steps in the process towards a proper capitalization, as well as the role of the bank in relation to the rest of the state institutions.

The arguments in favor of establishing the bank focus on the following: the deposit risk attenuation, a lower interest rate, and the possibility of contributing to the capitalization of the bank. Another aspect that will stimulate local communities' interest in contracting local government borrowings is related to the guarantees. In these new circumstances, the local communities could provide a guarantee only with their current revenues. At the same time, the bank could better represent the specific interests of the local communities and could provide consultancy services that the commercial banks are not delivering today.

An important matter that should be regulated is the relation between the capitalization process and the possibility of contracting a loan. The latter should not be directly dependent on the local administration's capacity to capitalize. Political interference, which was perceived by many international analysts as being a dangerous characteristic of the developing Romanian democracy, should be avoided. If not, small local communities and public authorities that have limited access to banking information will be disadvantaged.

There are clearly both advantages and risks involved. Still, it is the general opinion that the IBLC should not remain the unique source of available funds that local communities can access when borrowing. The current commercial banking community should also be strengthened, as their services should continue to serve the local communities' needs. Local public authorities have been positive about the project of creating the bank. In fact, 92.6% of local authorities questioned in a survey conducted by the Institute for Public Policy in Romania in July 2002[4] were in favor of the project of establishing the bank. There was an 80% response rate to the questionnaire.

For successful development of the local authorities, it is imperative that the future IBCL act with transparency and professionalism at all times, respecting the principles of trust and mutual cooperation between all parties. The temptation to subjectively allocate preferential loans is a very sensitive, problematic area in the Romanian banking community. However, the bank will grow as a solid and credible institution only if no preferential loans are approved on the basis of political interference, or because of clientelistic relations between the mayor and the bank delegate. The procedures, methodology, obligations and rights related to loans should be well explained and widely communicated through all media channels in Romania.

Recommendations:

- The study of the feasibility of establishing the IBLC should continue to analyze all options;
- The decision about establishing the IBLC should not be taken without consultation with all actors involved;
- If the IBLC is established, local communities' access to other commercial banks should not be limited.

3.4 Bond Issues: Specific Considerations

The specific nature of the bond issue process requires a closer look at several other important aspects, such as the profile of the underwriters and the role of the financial consultant.

Two Romanian banks have been the underwriters for most of the bonds issued in Romania in 2001 and 2002: the Romanian Commercial Bank and the Romanian Development Bank—Societe Generale Group. The major investors are the banks, the investment funds and the companies (shipyards, oil companies) and, to a lesser extent, the insurance companies. No pension fund has invested in municipal bonds so far. Also, just a few of the underwriters originate from the town or city the bonds were issued in. From this perspective it is clear that the citizens are not necessarily directly connected to the bond issue.

At first, the joint bond issue projects of local communities and banks were mostly initiated by the local communities. But in time the banks also became initiators, approaching other local authorities more frequently as they began to "enjoy" operating locally. Interviews with bank representatives, whose opinions have relevance to the report, showed that the two banks were very interested in this new type of partnership. Although concerned with the local authorities' financial solvency and their capacity to meet the reimbursement deadlines, the banks admitted that these partnerships were and would continue to be an important part of the future development of Romania.

With some other new banks struggling to enter the market, the two banks identified became flexible and more receptive to local solicitations. Their role changed over time from that of a typically rigid loan provider to more of a partner providing consultancy services and dealing with each situation in a flexible manner. According to the local authorities that were also interviewed, this improved the whole loans and bond issuing process.

The new role of the banks in the entire local financial development and decentralization process in Romania raises new questions about relations among the three partners: the bank, the local community and central government, and the Ministry of Public Finances. The role of this last institution, in particular, is constantly questioned.

The competition between the two banks that is very visible these days will undoubtedly increase the quality of their services, which will reach a larger number of local communities and increase the attractiveness of the two financial mechanisms (bond issuing and bank loans) to local communities.

The consultant's role becomes very important in the issuing of bonds. In addition to developing specific knowledge and staff within the local government units, most local authorities that issued bonds worked with an independent consultancy company. The consultants assist local authorities through the entire process of municipal borrowing by:

- analyzing the indebtedness capacity of local government units and recommending the amount of money to be borrowed;
- analyzing other alternatives on the market: Treasury bonds, borrowing credits, external borrowing, etc;
- suggesting the optimum moment for a bond issue, the nominal value of the bonds and the maturity rate;
- negotiating the interest rate;
- estimating the macroeconomic trends and interest rates on the banking and capital market;
- analyzing the budgetary flow of local government units and making predictions for the following years, etc.

The bond market is less politicized and more transparent than the bank market in Romania. Also, the procedure for issuing bonds is less complicated than for contracting banking loans, the bureaucracy being considerably reduced in the case of bond issues. Another element that makes bond issues more attractive than other financial instruments is the fact that the interest rate is lower because of competition among the economic agents (most of the bond issues in Romania were oversubscribed).

The bond issue is becoming a popular instrument used by local communities in Romania in their efforts to better support local investments. Still, the procedure is not sufficiently regulated and further legislative steps need to be taken in order to facilitate an easier access to the bond market. In addition, the incomplete consolidation of this practice undermines its perception as a trust-worthy mechanism for improving the local revenues.

Recommendations:

- The Law on Local Public Finances should include a distinct section regulating bond issue procedures;
- Legal provisions regarding bond issues should be correlated with the legislation regarding public debt and guarantees;
- Specific expertise should be further developed within the local public administration institutions; one suggestion might be the establishment of a department specializing in loans and bond issues within the economic department of the local public authority.

3.5 Local Policies on Borrowing and Debt Management

3.5.1 The Attitude of Local Government Units towards Borrowing

Local government units accessed internal borrowing for the first time in 1999. That year and the next, most loans were small and their role was to co-finance local investment projects. Focşani (an important city in eastern Romania) was the first local community to contract a loan from a commercial bank. This was a loan of 25 billion lei (approx. USD 192,000 at the currency rate of that time), contracted for financing the expansion of Moldova Market Place. At that time funds were borrowed for the purpose of supplementing existing but insufficient local revenues. Local authorities in Romania, still dependent on centrally allocated resources, are interested in exploiting other means of increasing their local resources. However, they are not necessarily equipped to better finance their development initiatives.

During 1999–2000, just a few local government units borrowed funds to supplement their own revenues. State budget transfers and local taxes and charges are optimum for covering the operational costs, while investment projects require additional financial support. The local authorities were cautious about taking risks, as fiscal decentralization was in its early stages and the local revenues still lacked predictability and stability. On the other hand, local government borrowing was also a novelty for the rest of the partners involved, such as the banks. The banks were greatly concerned that they would not receive a guarantee; insolvency was not clearly defined in the legislation and the local communities were forbidden to make deposits at commercial banks. Still, even in that quite risky environment, two solid banks decided to get involved (the Romanian

Commercial Bank and the Romanian Bank for Development), becoming an active part of the local government borrowing process during its first stage in Romania.

In 2001, the first two local government units to issue bonds were Predeal and Mangalia, two small tourist towns (mountain and summer resorts). Eight other local communities followed them in 2002 and the popularity of the bond issues has grown every year. The success stories immediately became an inspiration for the rest. Individual, direct consultations among the mayors have clarified questions about whether to take "such risks" or not, a question that became prevalent among the local authorities. Although not fully understood in its complexity, the mechanism of the bond issue is certainly a question to reflect upon for many of the local managers who are committed to developing the local community through attracting additional financial resources.

In July 2002,[5] a survey of the Institute for Public Policy showed that 60.7% of the local authorities questioned answered "yes" to the question: "Are you planning to initiate a bond issue during the following months?" In practice the number might turn out to be lower, but it at least it indicates that local authorities in Romania were aware of how important it is to explore other means of supplementing local revenues and that issuing bonds could be one possible solution. A local community needs to know that risk is involved (many types of risks, sometimes almost uncontrollable), but it also requires a realistic evaluation of the local financial capacity at that moment and in the near future. At the same time, it requires vision as much as it involves pragmatism and strong support from the final beneficiary of the project: the local community.

As the existing centralized data show, 12 local communities (including big cities) contracted loans during the period of October–December, 2001. The total value of the contracted loans was 934,000 million lei (approximately USD 350,000). Two of them chose a bond issue (Predeal and Mangalia), and the remaining ten contracted loans from commercial banks. The clearest proof that the mechanisms are slowly becoming understood and assimilated by the local beneficiaries consists in the higher number of loans contracted from commercial banks or bond issues in 2002. Eight of these were bond issues to be reimbursed in 2007,[6] and 30 were bank loans.

As the data in Table 7.1 below shows, the funds raised through the bond issues progressively increased while the interest rate decreased (see Figure 7.8). This situation may reflect the banks' increasing confidence in the system, as more local government units engaged in bond issue activity. Table 7.1 also shows that most of the municipalities that issued bonds were in Transylvania. The only exceptions are Bacău (Moldova) and Mangalia (Dobrogea).

The data presented in Table 7.1 as well as other macroeconomic trends (e.g., the estimated inflation decrease) show that the bond market will not only be more attractive to the local communities but also more accessible.

Table 7.1
Bond Issues in Romania (2001 and 2002)

Municipality	Number of Inhabitants	Year of the Bond Issue	Number of Issued Bonds	Total Funds Gained	Interest Rate [%]
Alba Iulia (Alba county)	71,848	2002	160,000	16 billion lei (484,848.48 USD)	32
Bacău (Bacău county)	208,643	2002	350,000	35 billion lei (1,060,606.06 USD)	26
Breaza (Prahova county)	18,768	2002	15,000	3 billion lei (90,909.09 USD)	28.3
Cluj-Napoca (Cluj county)	332,941	2002	250,000	25 billion lei (714,285.71 USD)	34.28
Mangalia (Constanța county)	43,974 (summer resort)	2001	100,000	10 billion lei (312,500.00 USD)	36
1st bond issue by Predeal municipality (Braşov county)	6,646 (winter resort)	2001	50,000	5 billion lei (156,250.00 USD)	37
2nd bond issue by Predeal municipality (Braşov county)	6,646 (winter resort)	2002	75,000	7,5 billion lei (214,285.71 USD)	25
Sebeş (Alba county)	29,483	2002	10,000	10 billion lei (285,714.28 USD)	23
Tîrgu Mureş (Mureş county)	164,132	2002	20,000	20 billion lei (571,428.57 USD)	23
Zalău (Sălaj county)	70,497	2002	100,000	10 billion lei (285,714.28 USD)	35

Source: The data was collected directly from the local authorities, no centralized data-base being available.

3.5.2 Local Government Units' Attitude towards Bank Credits vs. Bond Issues

The analysis of neighboring developed markets, in which it was expected that bank loans would predominate over bond issues, shows that each country's experience differs according to many factors. These include the local financial capacity and the solidity of the banks, the confidence of the local managers and their partnership with the local business community. In any case, in Romania, the two municipal bond issues successfully carried out in the fall of 2001 indicate that the capital markets were waiting for real financial investment instruments resulting in lower borrowing costs for the local community than could have been achieved through bank lending.

Since the adoption of the Law on Local Public Finances, more local government units have contracted loans from commercial banks than have issued bonds. One possible explanation could be related to the broader dissemination and completeness of information regarding the loans procedures, while the mechanisms for bond issues remain vaguely understood. Also, steps towards contracting loans were more easily understood by the local communities while the comprehensive mechanism for issuing bonds continued to cause reluctance among some local actors. The promotion of best practices, helpful in this respect, became a preoccupation only recently.

Nevertheless, many of the local authorities have been commenting in the last few years on the possibility of supplementing their local revenues through bond issues. The main reasons they have cited are as follows:

- the interest rate was lower in the capital market than in the banking sector;
- the procedure for issuing bonds is less complicated than the one for contracting bank loans, as the bureaucracy is considerably reduced in the case of bond issues;
- best practices in the area of bond issues were constantly promoted through central and local media.

Regarding capital spending, it should be noted that most is financed through internal or external borrowings. The Law on Local Public Finances, as has been repeated frequently in the report, does not allow local communities to use the loan funds for their operational expenditures. The experience of Romania so far has shown that the areas more financeable through borrowing are the public utilities (water, street maintenance and waste disposal), and the construction or improvement of tourist facilities or market places. Various other projects could be financed through this mechanism as local communities continue to grow.

In the cases of both contracted loans and bond issues, a key element contributing to the success of the borrowing process is the political commitment of the local public authorities. The community will benefit if the mayor and the local councilors have the same understanding of the local public interest and the correlated investment priorities. In the communities in which the mayor and the local councilors have different perspectives on local development and where political disputes frequently occur, investment initiatives and the borrowing process might be affected.

If we are to consider a typology of the local communities that have accessed local government borrowings, most of them are medium-size municipalities whose economy is well developed. Also, many of them are tourist areas in which local authorities collaborate closely with the local business community. At the same time, small towns obviously lack these advantages and the number of their contracted loans remains small. Big cities, in turn, have become more attracted to external borrowings because these bring more substantial revenues.

We cannot discuss practices in managing insolvency of local government units yet, as there has been no case of bankruptcy or liquidation of local governments. This is partially explained by the fact that legal provisions regarding the debt level (20% of total currant revenues) offer protection by not allowing the local communities to borrow beyond their financial capacity. On the other hand, although the practice of local borrowing is still in its early stages, it is expected that this type of problem will occur along with the development of local borrowing.

In the end, the acceptance of new mechanisms for supplementing local revenues depends directly on how informed the local authorities are about the whole process and its obligations. It is encouraging that the attitude of local authorities towards borrowing has slowly evolved, from mistrust and fear of risk during the first two years after the adoption of the Law on Local Public Finances, to a more positive perception of local government borrowing by the beginning of 2002. Although there are currently more contracted loans than bond issues, information from the field indicates that the popularity of the latter is constantly growing among the local communities.

Recommendations:

- Best practices in the domain of bond issues and loans contracted from commercial banks should be further promoted, so that local communities in Romania will place more trust in these financial instruments that are crucial for local development;
- Local communities should diversify their investment objectives, public utilities being the main target so far;
- Local public authorities should increase their effort to improve relations with the local business community, the main creditors of the bond issues;
- In order to reduce risk in local investments, thus encouraging more involvement, local authorities should diversify their financial instruments. Our recommendation is to use the bond issue or commercial bank loans for co-financing investment projects.

4. CONCLUSIONS

Contracting loans from banks or partnering with citizens and companies in the borrowing process were not common practices in Romania. It took a while for these practices to be understood, but eventually they became part of daily life in many local communities. Eager to help in developing their communities, local authorities have faced more and more severe budget constraints. In the first years after 1989, drafting policies to address community development was rather exceptional, with many local authorities struggling to adapt to the new circumstances. But step by step, local communities began to implement development projects, first with assistance and then independently and proactively. During this process they became very receptive to other means through which to supplement their local revenues. The more demanding they became, the more development-oriented they were, the bigger the pressure on the central government to create the necessary tools for local communities to increase their revenues.

In a big country like Romania, it is hard to generalize about attitudes and experiences. The largest communities, run by former well-trained managers, have quickly become financially stable. They have also become more demanding, seeking access to funds that will help them grow further. A significant number of local authorities, however, have continued to rely on assistance from the central government and to request State budget transfers in order to meet their needs. It is important for such communities to be widely exposed to the experiences of neighboring localities, to be helped (of course) but also trained in how to replace the centrally transferred funds with money they have raised themselves. Risk management and planning based on a good sense of future needs are part of the challenge, but also good management skills. And, as we know from life, not everybody succeeds.

Local government borrowing is one of the most recent (and therefore still insufficiently explored) means through which local communities in Romania are aiming to raise additional funds for their development projects. Soon after the 1990s, learning that resources from the central budget would become limited, local communities started to explore other less traditional means. The first "temptation" was to increase and diversify the local taxes. As a new method, increasing taxes or inventing new ones was closest to the traditional means of financing local needs. It was when approaching the less traditional financial tools that some local authorities became quite reluctant. It was almost ridiculous how far some local authorities were willing to go to increase their local funds to finance their development projects. Examples of local authorities imposing taxes on questions or interviews were earlier mentioned in this report. Despite the very questionable legality of such approaches, they serve well to demonstrate the more and more serious need for extra State budget funds to cover the development projects. The State transfers will remain crucial for the operational costs of the local communities.

While other post-communist countries have made borrowing a normal means of channeling additional funds into their local communities, Romania has looked at this option rather cautiously. We have to admit that it is a tendency of the system to adopt a protective stance towards change, leading to resistance on the part of public institutions and authorities towards risk that comes with the new. Through the eyes of many, a secure and predictable financial system was revolutionized by these two not-so-secure mechanisms through which to raise more funds.

Why are the local authorities still cautious when approaching the banks or, even more, when issuing bonds? How difficult is it for some of the local communities to assimilate free market practices, e.g., approaching a commercial bank for a loan? Besides the legal framework, there are other obstacles that have had a direct impact on the relatively few local authorities that tried to contract a loan or issue bonds. Some of these barriers are related to the insufficient experience and initiative of many local authorities in Romania. Public servants are generally not sufficiently trained in preparing and conducting the necessary documentation (e.g., in drafting a business plan). Also, local authorities are still inexperienced in building medium and long-term strategies that could provide them with a trajectory of finances and investments for three to five years. It is only recently that the central government established the Institute for Public Administration, whose main role is to train locally and centrally elected officials as well as public servants. Training topics vary from human resources management to public relations to EU accession requirements.

Many of the local authorities that were approached during our investigations explained the difficulty, if not the near-impossibility, of multi-year budget predictability. Still dependent on yearly budgeting, local communities that felt ready to contract ambitious development projects would need to advocate strenuously to convince the central government to adopt such a profoundly new budgeting philosophy. Very concerned with the financial discrepancies between local communities, central government finds it safer to supervise the financial process at the local level on an annual basis. A continuous concern in analyzing the central government's role in relation to the local communities has been the different (sometimes extremely different) level of development of communities from distinct areas of the country. In an environment of increasing competition for additional funds to finance development projects, it is very hard these days to underestimate the importance and the implications of concepts such as subsidiarity, solidarity, etc. There are many values that Romania has only recently learned about, and many questions still to be answered, as it decides its future development priorities.

As a direct consequence of local financial growth and of the frequent exposure of many local authorities to their counterparts' experience, the contracting of loans and bond issues have slowly but surely become integrated into the Romanian market. There are no statistics available to indicate how developed the first local communities participating in these practices were. Economic development (both in terms of local revenues and a well-developed business community) was obviously a key criterion. In reality, these well-developed local communities not only proved that borrowing can work, but they were the ones whose advocacy led to improving the legal framework, thus enhancing the ease of future experiences.

Certainly these several years of experience were not enough to create perfect legislation, and local authorities reunited in a Local Authorities Federation of Romania are still lobbying for future amendments. A multi-level working group including representatives of the Ministry of Finances, Ministry of Public Administration and local authorities has analyzed the possibility of amending the legislation. Amendments that would make possible local access to other sources of funds are only one part of a more comprehensive reform of local public administration that is currently being implemented.

The main legislation regulating our topic of interest should be also correlated with all complementary legal provisions. Local budgets need to become predictable to facilitate planning for the reimbursement to a bank or to be able to compensate the community for borrowed contributions. In this sense, it is imperative that the fiscal decentralization process continues. More financial resources should be transferred to the local communities so they can exercise real local autonomy in designing and implementing the necessary policies. A more realistic correlation between fiscal decentralization and the assignment of responsibilities is also very important. Local authorities should not only be allocated resources and mandated responsibilities, but they should also be entitled to make decisions about how the local public services are administered and therefore how the money is locally spent.

To ensure the future growth of Romanian local communities, the local finances must be strengthened and local authorities equipped with the necessary legislative tools. Local authorities must also have at least a minimum exposure to the examples of others who have previously borrowed from the population or contracted a loan. When familiarizing the local authorities with new means through which to supplement their revenues, it is important to emphasize the necessity of having confidence in the project, and of accepting responsibility for it. Parallel with this entire comprehensive process, all other processes that the central government uses to financially help the local communities must be completely transparent. The criteria, methods and processes for distributing the Ministers' "special funds" must be applied in a fair and transparent way. All this is essential for good relations between central and local authorities. In the same context, it is also very important to raise awareness about the long-term threat to the consolidation of institutions posed by political interference in administrative decision-making at any level.

The two financial instruments largely debated in this report—loans from commercial banks and bond issues—seem to be less exposed to political interference, although certain individual cases suggest it is not impossible to influence banks' transactions in Romania, to give but one example.

It is obvious that the local community cannot and should not be separated from the central government, since there are continuous and mutual interconnections. In terms of development, a stable, predictable macroeconomic development and the growing number of both foreign and domestic investors will directly influence the confidence of local authorities in the idea of issuing bonds (as an example) to finance a development project.

The ultimate goal of public administration reform should be the building of strong, powerful, independent local communities with solid budgets and capable of providing high quality services to the citizens. These can be achieved only if the necessary responsibilities and instruments are available (local government borrowing being one of them). When the necessary tools are in place, it is expected that local communities in Romania will take charge of all local matters, designing and implementing policies that will further stimulate local development.

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NOTES

1 The capital is the biggest municipality within the county and the headquarters of all county public institutions.

2 Equalization funds are non-earmarked funds allocated from the state budget to local communities in order to conduct a horizontal and vertical equalization of budgetary revenues.

[3] Special taxes are collected with a specific purpose and the revenues are spent according to their initial destination.

[4] Institute for Public Policy (2002), Practical Guide to Local Budgets. How Local Communities Supplement Own Revenues, Bucharest, page 47.

[5] Institute for Public Policy (2002), Practical Guide to Local Budgets. How Local Communities Supplement Own Revenues, Bucharest, page 40.

[6] Two more local communities issued municipal bonds (one, from Bacău municipality, was for 1 million USD) in December 2002.

Local Government Borrowing in Russia: Difficult Paths of Economic Transformation

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Table of Contents

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1. INTRODUCTION

1.1 The Last Decade of Decentralization

Like Russia's economic reform, the reform of municipal finances in Russia has a history of more than ten years. For municipal governments, these reforms meant great changes in the local budget revenue and spending conditions, the development of new budgeting procedures and the development of local governments' ability to meet the challenges of federal and regional policy.

The formation of the Russian democratic state took place from 1990 to 1993. The process was completed with the adoption of the Constitution of the Russian Federation, which declares that Russia is a federal state and establishes the jurisdiction and powers of the federal bodies of state administration and the various bodies within the Russian Federation. These bodies are referred to in the Constitution as "subjects of the federation," and include all the ethno-national territories and administrative bodies. The Constitution provides an exhaustive list of matters under the jurisdiction of the Russian Federation and of those falling under the joint jurisdiction of the Federation and its subnational bodies or "subjects." With respect to other matters, the subjects hold state power to the full extent.

The Constitution guarantees local self-government and contains a separate article on it. Concerning fiscal authority, Article 132 says that the "local self-government bodies shall independently manage municipal property, form, adopt and implement the local budgets [and] introduce local taxes and dues...." The same Article says that "local self-government bodies" may be vested with certain state powers and for this purpose an appropriate law must be passed. The transfer of powers must be accompanied by the transfer of necessary material and financial resources for their implementation.

The adoption of the Russian Constitution had a significant effect on the development of local self-government. A new level of governance not included in the system of state administration was established by the fundamental law of the Russian Federation. But there were many cases where state powers were transferred to the municipal level without the necessary resources.

The first step in reforming inter-budgetary relations and in developing the fiscal independence of regions was made in 1994. Until then, the amount of financial aid from the federal budget was determined separately for each region or subject of the Russian Federation and the amounts and forms of financial aid were used as an instrument of political pressure. But uniform federal tax retention quotas were established for all Russian regions in 1994, increasing their political independence from the federal center. The Regional Financial Support Fund has been part of the federal budget since 1995. The resources accumulated in that fund are now distributed among regions in accordance with a uniform procedure, which is becoming more formalized and objective from year to year. The relationships between Russian regional and municipal governments are developing in the same direction. Until recently, however, the shares of federal taxes transferred to budgets of other levels were established each year by the law on the federal budget and laws on regional budgets.

The next important milestone on the way to decentralization was the adoption of the Federal Law "On the General Principles of Local Self-Government in the Russian Federation" in 1995. Two years later the Federal Law "On the Financial Bases of Local Self-Government" was passed, establishing the minimum shares of federal taxes that must be transferred to budgets of municipalities. This made municipal government revenues more stable and predictable.

The Budgetary Code of the Russian Federation became effective at the beginning of 2000. This document has much significance for Russian public finance law. It lays legal bases for the budgetary system, establishes general principles of budgetary legislation, determines the legal status of subjects of budgetary relations and divides their powers.

Unfortunately, despite an obvious evolution of Russia's budgetary legislation towards greater fiscal independence of subjects of the Russian Federation and municipalities, significant vertical imbalances between revenue collection and spending powers of state administration bodies of various levels still remain in place. A significant part of the budgetary need of Russia's subnational governments is covered through financial aid from the budgets of higher levels.

Simultaneously with the introduction of these changes in legislation, which were aimed at the division of powers in the budgetary sphere and increasing the fiscal autonomy of subnational bodies, a number of legislative acts aimed at the protection of various groups within the population have been adopted during the last ten years. Such laws allow groups of citizens to buy certain services at reduced rates. Most frequently, the services are those provided by municipal governments, but the procedure for compensating the expenses involved is not described clearly or is not specified at all. In practice, this only shifts such costs to the municipal governments. With respect to municipal finances, the most "burdensome" law for Russia's municipal governments was the Law on Veterans passed in 1995. The federal center has applied Article 132 of the Constitution to the part concerning vesting certain state powers in local self-government bodies. However, the obligation to provide municipal governments with the necessary material and financial resources for their implementation is not entirely fulfilled. As a result, regional and municipal governments can not use their revenues at their own discretion because they have to spend their funds on financing federal obligations.

Russia's tax system has been developing during these years, with the main goal of reforms being reduction of the tax burden on the Russian economy. The tax reform has led to significant changes in the structure of regional and municipal government revenues.

The processes described above collide with each other, however, and have contradictory and divergent impacts on the financial position of regional and municipal governments.

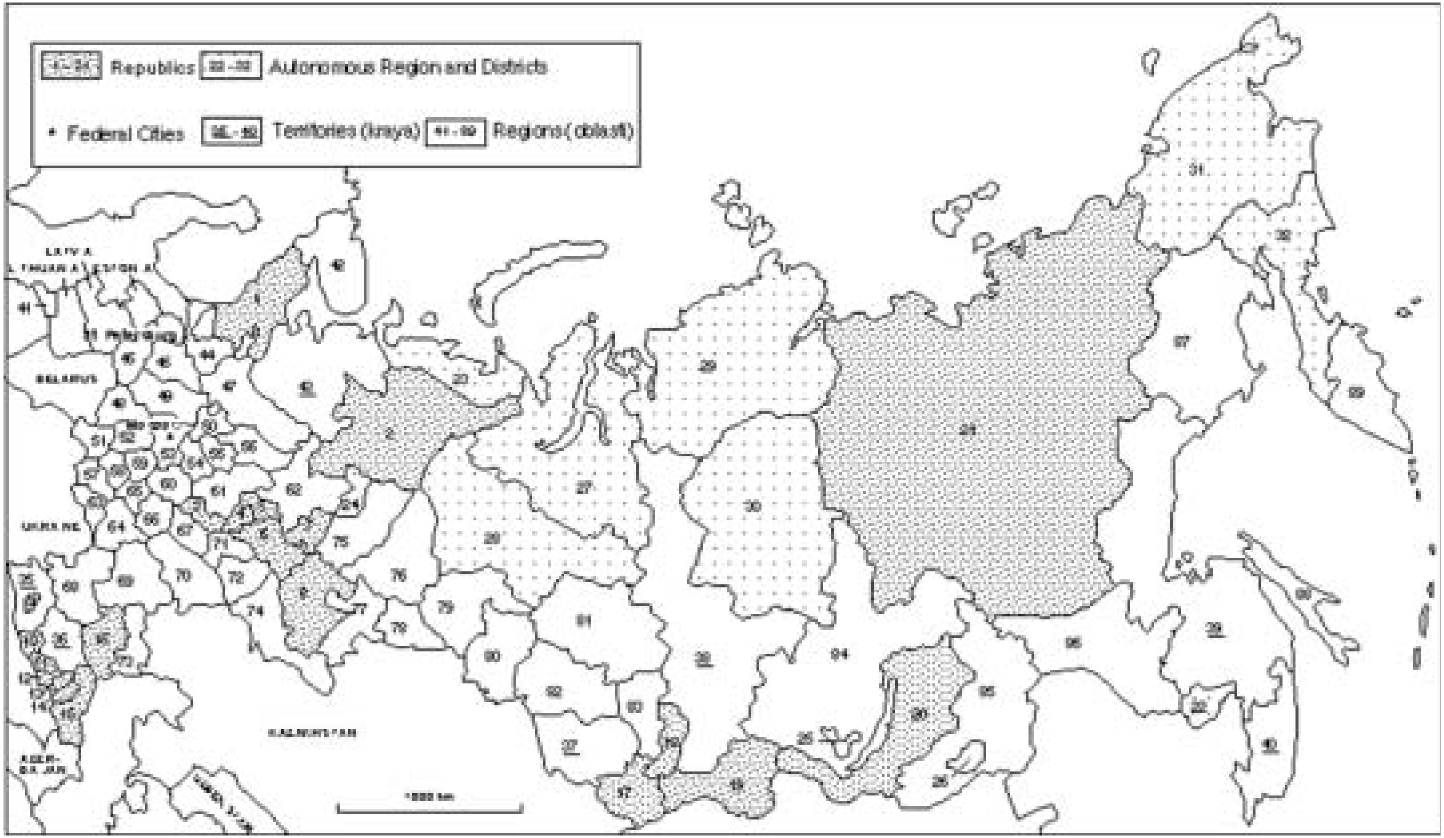
1.2 Administrative and Territorial Structure of the Russian Federation

Russia's 1993 Constitution established three levels of power in the Russian Federation. They are the federal level, the level of subjects of the Russian Federation and the municipal level. The Russian Federation consists of 11 republics, 6 *krajs* (territories), 59 *oblasts* (regions), 2 cities of federal significance—Moscow and St. Petersburg—10 autonomous *okrugs* (districts) and one autonomous *oblast* (the Jewish Autonomous Oblasts)—89 subjects of the Russian Federation in all.

In Soviet Russia, the autonomous oblast and autonomous okrugs were part of the krajs (territories) and fell within their administrative jurisdiction. At present, in accordance with Russia's current Constitution, all subjects of the Russian Federation have equal rights. Republics within the Russian Federation have their own Constitutions and legislation. Krajs, oblasts, cities of federal significance and the autonomous oblast and the autonomous okrugs have their own charters and legislation.

Russia's Budgetary Code also provides for a three-level budget system, but in reality the situation is more complex. There are remaining elements of subordination between territories and their autonomous districts. Sometimes problems arise during the distribution of revenues between territorial budgets and budgets of autonomous districts within respective territories. In some cases, such conflicts become open and develop into a confrontation between particular areas, as in the case of the Krasnoyarsk Territory and the Taimyr Autonomous District.

Figure 8.1
Subjects of the Russian Federation



Source: Map by Billie Bielckus, SIPRI. http://editors.sipri.se/pubs/pressre/ptiia.html.

According to the 1993 Russian Constitution, the Russian Federation consists of 89 "subjects of the federation," 32 ethno-national territories and 57 administrative entities.

Ethno-national territories

Republics

1. Karelia
2. Komi
3. Mordovia
4. Chuvashia
5. Mariy El
6. Tatarstan
7. Udmurtia
8. Bashkortostan
9. Adygueya
10. Karachaevo-Cherkessia
11. Kabardino-Balkaria
12. Northern Ossetia
13. Ingushetia
14. Chechnya
15. Dagestan
16. Kahmykia
17. Gomiy Altay
18. Khakassia
19. Tuva
20. Buryatia
21. Yakut-Sakha

*Autonomous Region**

22. Yevreysk (Blagoveshchensk)

Autonomous Districts

23. Nenets
24. Komi-Pemyak
25. Ust-Ordyn Buryat
26. Aguin Buryat
27. Yamalo-Nenets
28. Khanty-Mansi
29. Taymyr
30. Evenki
31. Chukotka
32. Koryaki

Administrative Entities

Federal Cities

33. Moscow
34. St. Petersburg

Territories (kraj)
(numbers undelined on map)

35. Krasnodar
36. Stavropol
37. Altay (Bamaul)
38. Krasnoyarsk
39. Khabarovsk
40. Primorskiy (Vladivostok)

*Regions (oblast)**

41. Kaliningrad
42. Murmansk
43. Archangelsk
44. Leningrad (St. Petercburg)
45. Pskov
46. Novgorod
47. Vologda
48. Smolensk
49. Kalinin
50. Yaroslavl
51. Bryansk
52. Kaluga
53. Moscow
54. Vladimir
55 Ivanovo
56. Kostroma
57. Kursk
58. Orel
59. Tura
60. Ryazan
61. Nizhniy Novgorod
62. Kirov
63. Belgorod
64. Voronezh
65. Lipetsk
66. Tambov
67. Penza
68. Rostov
69. Volgograd
70. Saratov
71. Ulyanovsk
72. Samara
73. Astrakhan
74. Orenburg
75. Pern
76. Sverdlovsk (Yekaterinburg)
77. Chelyabinsk
78. Kurgan
79. Tyumen
80. Omsk
81. Tomsk
82. Novosibirsk
83. Kemerovo
84. Irkutsk
85. Chita
86. Amur (Blagoveshchensk)
87. Magadan
88. Kamchatka (Petropavlovsk)
89. Sakhalin (Yuzhno-Sakhalinsk)

* where the name of the region is not that of the capital city, the city is given in parentheses.

Another flaw exists in the current legislation regulating local self-government in Russia. The Federal Law "On the General Principles of Organization of Local Self-Government in the Russian Federation" establishes equality in the legal status of all municipalities. But in practice, local self-government in the Russian Federation has two levels. In some municipalities such as a district and a city, there may be smaller self-governing units having the same status of "municipal formation." In practice, the division of responsibilities for the provision of services to the population deviates from the provisions of the law in such municipalities, frequently resulting in friction over tax revenue distribution.

According to the State Statistics Committee of the Russian Federation (Goskomstat), there are 12,261 municipalities in Russia. Most are rural (9,325 or 76%) and these may consist of several settlements each. The second largest group is administrative districts (1,440 or 12% of the total number of municipalities). There are also 591 cities, 524 urban-type settlements and 214 rural settlements that are independent municipalities.

The least-populated district is the Aleutsky District of the Kamchatka region, with only 500 people. The ten most populated districts, those with a population of 170,000 to 260,000, are located in European Russia in the Moscow and Leningrad Regions. There are 11 cities with a population larger than a million people, 21 with between 500,000 and 1,000,000 and 131 with a population of 100,000 to 500,000 people in Russia.

1.3 Local Government Financial Mechanisms

Currently, the Budgetary Code determines that expenditures to be financed jointly from the federal budget, budgets of the subjects of the Russian Federation and budgets of municipalities include:

- State-supported construction and construction materials industries, gas and water-supply, agriculture, road and water transport, the Metro, telecommunications, road construction and maintenance (the nuclear power industry is not included);
- law-enforcement activities;
- fire-protection activities;
- research and development work ensuring scientific and technical progress;
- social security measures;
- environmental protection, protection and sustainability of natural resources, hydrometeorological service operation;
- prevention and alleviation of emergency situations and natural disaster consequences on a regional scale;
- market infrastructure development;
- development of federal and nationality relations;

- operation of the election commissions of the subjects of the Russian Federation;
- activities in the media sector;
- other expenditures.

Local budgets are used exclusively to finance the following activities:

- municipal property formation and management;
- organization, support and development of educational, health, cultural, physical culture and sports organizations, institutions and enterprises, the mass media and other institutions and organizations in municipal ownership or under the jurisdiction of local self-government bodies;
- support of municipal law-enforcement bodies;
- management, support and development of municipal utilities service complexes;
- municipal road building and maintenance of roads of municipal significance;
- improvement and planting of greenery in the municipalities;
- household and domestic waste removal and treatment (with the exception of radioactive waste);
- maintenance of cemeteries under the jurisdiction of municipal bodies;
- provision of transportation services to the population and to institutions in municipal ownership or under the jurisdiction of local self-government bodies;
- fire safety measures;
- environmental protection in the territory of municipalities;
- implementation of municipal governments' purpose-oriented programs;
- servicing and repayment of the municipal debt;
- purpose-oriented subsidies to the population;
- maintenance of the municipal archives;
- municipal elections and local referendums;
- other expenditures.

The above list is rather impressive. In addition, primary and secondary education, health, housing and utility services, and most of the social security programs must be financed from local budgets. The municipal government bears full responsibility for the development of the housing and utilities services and the public and communal service sectors within their boundaries.

In present-day Russia the share of municipal government spending in Russia's consolidated budget is rather high; this data can be seen in Table 8.1.

However, receiving such a significant share from the Russian Federation consolidated budget does not mean that municipal governments have much budget autonomy. For the municipal governments, the problem lies not so much in the amount of revenue available, but rather in the practical impossibility of making independent spending decisions.

Table 8.1
The Role of Local Budgets in Russian Public Finance

Year	Local Budget Spending as % of Consolidated Budget Spending	Local Budget Revenues as % of GDP
1995	37.6	7.3
1997	31.7	10.9
1998	29.8	8.7
1999	27.5	6.8
2001	26.7	6.2

Source: Ministry of Finance (Minfin) of the Russian Federation and the Russian Federation State Statistics Committee (Goskomstat).

The reduction of the municipalities' share in Russia's consolidated budget that took place during the last few years reflects a centralization trend in which the federal budget's share in the Russian Federation consolidated budget increased, and Russia's regional administrations began to assume certain municipal spending functions. In terms of the data in Table 8.1, it should be pointed out that according to the Russian Federation State Statistics Committee (Goskomstat), Russia's GDP in 2001 was 72% of what it was in 1992, while municipal government revenues declined 37% during the same period. Compared to 1990 this was a 50% reduction, according to our estimates.

Annual municipal budget revenue growth (reduction) rates for the period from 1996 through 2001 are shown in Table 8.2.

Table 8.2
Municipal Budget Revenue Growth (Reduction) Rates
[in Constant Prices] (1996–2001)

Year	1997	1998	1999	2000	2001
Municipal budget revenue growth rates (chain rates)	112.2	74.2	84.4	100.1	104.8
Municipal budget revenue growth rates (compared to the 1996 base year)	112.2	83.1	70.1	70.2	73.5

Source: Ministry of Finance (Minfin) of the Russian Federation, the Russian Federation State Statistics Committee (Goskomstat). For local budget revenue comparison purposes, GDP deflators for respective years were applied. The 2001 figures are estimated.

Russian municipal government revenues have declined 26% over the last five years. The reduction that took place in 1998 was associated with Russia's systemic financial crisis, which resulted in a decline in tax revenues. The 1999 reduction was caused mostly by the shift of regional revenue centers in the direction of regional budgets. The 2002 growth of local budget revenues was approximately equal to Russia's GDP growth, which amounted to 5%.

Significant changes occurred after 1998 in how Russia's budget was apportioned. The role of the federal budget increased. While in the 1990s it amounted to 12% to 14% of Russia's GDP (with the exception of 1992), in 2000 and 2001, when the situation changed, the federal budget grew from 16% to 17.5% of GDP. We can point to three factors behind such growth. First, tax revenues were redistributed in favor of the federal center. Second, the favorable situation on the primary fuel market resulted in an increase in tax revenues of the federal budget after 1998. Third, there was an increase in federal tax collectability after Russia's financial crisis, while the practice of tax claim off-sets with the federal budget and tax payments in a non-monetary form was discarded.

At the same time, the spending powers of different levels of government have been changed over the last few years (e.g., since 2000 some social benefits have been financed from the federal budget). This clarifies some of the decline in local spending to GDP ratio.

The structure of municipal budget revenues for the last six years is shown in Table 8.3.

Table 8.3

Municipal Budget Revenue Structure [%] (1996–2001)

Revenues / Year	1996	1997	1998	1999	2000	2001
Tax revenues, including:	59.8	60.5	63.8	69.7	68.2	61.5
VAT revenues	7.1	7.5	7.9	6.8	5.3	0
Profit tax revenues	11.5	9.3	9.1	14.6	13.5	16.7
Income tax revenues	17.0	18.2	18.4	16.6	16.8	21.1
Property tax revenues	9.2	8.9	10.0	7.8	6.2	6.7
Sales tax revenues	—	—	0.0	2.8	2.9	2.8
Local tax revenues (except tax on individual persons' property, but including land tax)	Not available	Not available	11.2	13.4	14.9	5.1
Non-tax local own revenues	2.4	2.2	3.7	3.6	3.5	4.3
Non-repayable transfers	37.8	37.3	32.5	26.7	28.3	34.2
Share of municipal governments' own revenues in their total revenues	Not available	Not available	24.9	27.6	27.5	18.9

Source: Ministry of Finance (Minfin) of the Russian Federation.

It should be noted that Russia's tax and budgetary legislation reform is not yet complete, with tax legislation being reformed especially actively. This explains the unstable condition of the municipal budget revenue structure during the last six years. The ratio between tax revenues and financial aid from budgets of higher levels is one of the key figures characterizing the structure of local budgets. We have already noted the growth of tax revenues and the reduction in the share of non-repayable transfers in the structure of municipal government budgets from 1996 to 1999. But in 1999, as a result of the tax system reform, the evident trend towards an increase in local budget revenues reversed.

As Table 8.3 shows, the major municipal revenue-earner during the entire period under review was the personal income tax. According to Russia's tax code this is a federal tax, and for this reason the obligatory income tax revenue distribution proportions are established annually by a law on the budget. In 2001, for instance, of the federal 13% income tax revenues, 1% went to the federal budget and 12% to regional budgets. But in 2002, 100% was transferred to regional budgets.

Corporate taxes (on the profits of organizations) are the second-largest revenue-earner for municipal governments. As with income taxes, the distribution proportions for profit tax revenue are determined by agreement with the regions. Municipalities "negotiate" their share of taxes with the regions. From 1997 to 2001, the minimum share that was transferred to local budgets was 5% of the profit tax rate. After the introduction of Chapter 25 of Russia's Tax Code on January 1, 2002, the minimum share of the profit tax transferred to local budgets decreased to 2%. As these examples illustrate, local budget revenues from the main tax revenue sources change significantly from year to year and cannot be forecasted with sufficient reliability.

For our present purposes, we may assume that municipal governments' own revenues include total revenues from the property, sales and local tax revenues, including land tax revenues, and non-tax revenues. It should be pointed out that sales and enterprise property tax revenues of local budgets may exceed the shares established by law. From 1998 to 2000, governments' own revenues accounted for 25% to 27.5% of their total revenues but decreased sharply in 2001 as a result of the abolition of some turnover taxes, the highest of which was the tax on the housing and utilities service sector. That tax had to be abolished in order to improve the structure of Russia's tax system as a whole, but there was no compensation to municipal budgets for the loss of that revenue.

As part of the continuing reform to the tax system, Part I of the Tax Code of the Russian Federation, which defines the general principles of taxation and tax collection, came into effect on January 1, 1999. The separate chapters of Part II, which regulate particular taxes, have been introduced one by one. Russia's tax code distributes tax revenues between three levels of power and forbids introducing taxes other than those envisaged in the code.

During the introduction of local taxes, the local self-government bodies can establish tax rates only within the limits established by the tax code. One of the local taxes is the personal property tax, whose rate depends on the type of property. If it is valued at more than 500,000 rubles, the tax limit according to federal law is 0.3%–2%. The land tax depends on the type of land used, its quality and placement. Federal legislation lays out the average land tax rates (annual payments per unit of land) for each region and the municipal self-governments can establish the specific tax rates for each territory based on the given average rate.

The Tax Code of the Russian Federation also establishes the tax bases, tax periods, maximum rates and calculation procedures pertaining to regional and local taxes.

2. LEGISLATION REGULATING MUNICIPAL BORROWING

2.1 The Concept of Debt and Forms of Debt Instruments

The evolution of legislation regulating government and municipal borrowing will be described in the section on the development of the municipal securities market. This section gives an account of the legislative regulations and requirements that are currently in effect.

At present, the Budgetary Code is Russia's main law regulating legal relationships in the area of government and municipal finances, including government and municipal borrowing.

This law defines municipal debt as the aggregate of obligations of a municipal formation and establishes that municipal debt must be fully and unconditionally secured by all the municipal property comprising the municipal treasury. The Budgetary Code says that the maturity of a municipal formation's debt instruments must not exceed ten years. Municipal debt is managed by an authorized body of local self-government. Obligations of a municipal formation that arise as a result of municipal securities issuance must be denominated and repaid in the currency of the Russian Federation. Russian legislation forbids municipalities to issue securities that create foreign debt.

Debt instruments of a municipality may include:

- loan agreements and contracts;
- borrowing by way of issuance of municipal securities;
- agreements and contracts for municipalities to receive budgetary loans and credits from other-level budgets within the Russian Federation;
- agreements on the provision of municipal guarantees.

The law forbids municipalities to use any other form of debt instrument.

Municipal debt includes the following:

- the nominal amount of principal debt on municipal securities;
- the nominal amount of principal debt under loans received by a municipal formation;
- the principal amount of debt under budgetary loans and credits received by municipalities from budgets of other levels;
- total liabilities under guarantees provided by a municipal formation.

In Russia, because municipal finances are accounted for on a cash basis, local governments' obligations are reported only when they are fulfilled. This leads to a situation in which local governments may have unfulfilled liabilities for services already received, which are not shown on their balance sheets. Such liabilities are called accounts payable. The Budgetary Code does not include payables in the government and municipal debt. In Russia the total amount of payables of local administrations is very large, but this fact is not reported in their budget execution reports. In 2000, local state administrations and local self-governments began to show the amount and structure of their payables in their budget execution reports, but payables are still excluded from debt calculations and debt servicing expenditures.

2.2 Current Capital Expenditures and Purposes of Borrowing

Depending on their economic purpose, budgetary expenditures are subdivided into current and capital expenditures. Russian legislation allows a development budget to be established within a local budget, including in it all or part of the capital expenditures, but this is not obligatory. Usually, the local government submits budgets for consideration to the respective representative authorities not only as functional and departmental documents, but also as economic ones. For this reason, the amounts of capital expenditures are known to all the participants in the budgetary process and interested parties. Nevertheless, budget execution reports are prepared as functional documents and therefore they present all capital investment expenditures by functional categories (e.g., capital expenditures on new school construction are shown in the "Education" section, and library construction in the "Culture" section).

The Budgetary Code says that current spending of subnational budgets must not exceed their revenues. Consequently, a budget deficit may arise only as a result of capital investment. Another provision of the code stipulates that domestic borrowing may be used for spending on capital investments or on debt refinancing of budget deficits, within the established limits on the redemption of government and municipal debt. A separate Budgetary Code article is dedicated to debt restructuring. The restructuring is construed as replacement, based on agreement, of certain government or municipal debt instruments by other instruments with different debt servicing and repayment terms. Debt restructuring may be carried out together with a partial write-off (reduction) of the principal amount of debt.

2.3 Budget Deficits and Sources of Funding to Finance Them

The budget deficit of a subject of the Russian Federation must not exceed 15% of its revenues, excluding financial aid from the federal budget. But a local budget deficit is subject to tighter regulation, and must not exceed 10% of its financial aid from the federal budget and from the budget of the respective subject of the Russian Federation.

If the annual budget includes revenues from the sale of property, the maximum budget deficit may exceed the above limit, though only by the amount of property sales revenues.

Representative authorities must approve the sources of funds for financing the budget deficit for each financial year, according to the category of borrowed funds. These may include the following internal sources:

- municipal borrowing carried out through municipal securities issues made on behalf of municipalities;
- loans from lending institutions;
- budgetary loans and credits received from budgets of other levels of the budget system of the Russian Federation;
- revenues from the sale of municipal property;
- change in the local governments' budgetary account balances.

2.4 Government and Municipal Debt Limitations

The Budgetary Code establishes that government and municipal borrowing, as well as the provision of government and municipal guarantees to other borrowers, must be approved by the relevant representative authority.

The maximum amount of debt servicing expenditures of a subject of the Russian Federation or a municipal body must not exceed 15% of the total expenditures of the respective budget.

The total amount of public debt of a subject of the Russian Federation or a municipal body must not exceed budget revenues, with the exception of financial aid provided from the budgets of other levels of the Russian Federation budget system.

To control these ratios, the budget execution report must be sent to the Ministry of Finance, and may be checked by the latter if a reason arises. If the ratios are exceeded new securities issues will not be approved by the Ministry of Finance. Furthermore, the Ministry may temporarily take over the execution of a territorial budget.

2.5 Shortcomings of the Existing System of Restrictions

The system of quantitative and qualitative restrictions on municipal borrowing established by the Budgetary Code has certain drawbacks and contradictions:

Restrictions on the total amount of debt. Obviously, the amount of debt by itself can hardly have any impact on the borrower's creditworthiness, which depends on the debt structure (its maturity, currency, interest rates, possibility or impossibility of advanced repayment claims, etc.). All other conditions being equal, the risk of default on short-term debt denominated in hard-currency and with 50% interest per annum, which amounts to only 30% of budget revenues, is much higher than the risk of default on a ruble-denominated loan comparable to total budget revenues, but raised for a term of ten years at 10% per annum. The restriction on the total amount of debt is worded rather unclearly. It is not clear, for example, which year or years can be included in reporting municipal revenues. Finally, this restriction impedes municipal administrations wishing to assume reasonable risks associated with the implementation of large investment projects.

Restrictions on the budget deficit. Investment projects in the public infrastructure sector, which are financed by regional and municipal administrations with borrowed funds, are often very large. Moreover, one important condition of effective implementation of such projects is the fast introduction of infrastructure facilities. Consequently, such tight restrictions on the total amount of borrowing at a given time within a fiscal year may have a negative impact on the efficiency of the investment policy implemented by municipal administrations.

But this restriction does not apply to guarantees provided by subjects of the Russian Federation and municipal administrations with respect to third party obligations. According to the Budgetary Code, municipal guarantees are a type of debt instrument and, as such, are included in the total government (municipal) debt. But for all that, guarantees are not a source of funds for financing budget deficits because it is assumed that debt instruments are issued to finance the expenditures of the end borrower rather than administrative expenses. However, in some cases administrations may use guarantees as the administration's deferred payment or bank loan repayment.[1] In this case, the absence of quantitative restrictions on guarantees provided by a subject of the Russian Federation (municipal administration) during the year may be a loophole enabling increased borrowing.

Restrictions on the use of borrowed funds. Despite the requirement that current spending must be financed only with budget revenues (there is an indirect ban on the use of borrowed funds for that purpose), local administrations frequently use borrowed funds for making wage payments and financing routine repairs and other non-capital expenditures. Frequently, they are compelled to do this because of insufficiently considered actions of the federal authorities. For instance, in order to implement a federal resolution of November 6, 2001 on raising wages of employees on the government payroll, municipal administrations sharply reduced allocations for capital construction and used the released funds to pay the wages. Current municipal borrowing practices provide many other examples of violations of both quantitative and qualitative restrictions contained in the Budgetary Code.

In addition, there are many common municipal borrowing practices that are problematic even if they do not violate the Budgetary Code. Such practices include:

- *The absence of a uniform debt management strategy.* Most Russian cities do not develop long-term financial plans (and thus violate the unclear requirement of the Budgetary Code) and have no long-term borrowing strategy. It is difficult to blame them for that under current conditions because their revenues (as defined by the Budgetary Code) are small, while inter-budgetary relations in Russia are unstable.
- *Inadequate debt structure.* One result of the absence of a municipal borrowing strategy is an inadequate municipal debt structure. At present, short-term borrowing accounts for too large a part of municipal debt. Moreover, borrowing is inconsistent with the capital construction programs implemented, which only increases the risks involved.
- *The absence of borrowing efficiency assessment criteria.* Another peculiarity of the budget process in Russia is the absence of criteria for assessing the efficiency of the use of budgetary resources. The same applies to the use of borrowed funds.

2.6 Recognition of Budgetary Borrowings and Expenditures for Government and Municipal Debt Servicing and Repayment

Borrowed funds and other liabilities are recognized in the budget as sources for financing the deficit, and all debt-servicing expenditures are recognized as spending on government and municipal debt servicing. Revenues from government or municipal securities placement which exceed the nominal amount of the issue, the coupon income accrued and revenues received in the event of the repurchase of securities at prices lower than the placement price are all credited to the government and municipal debt-servicing expenditures account for the current year. Repayment of the principal amount of government or municipal debt is recognized as a source of deficit financing, causing a reduction in budget deficit financing sources.

Obligations on securities, guaranteed with government or municipal property in accordance with the terms of the issue, can be fulfilled by way of transfer of such property to the securities' owners. In this event, the debt will be reduced by the principal amount repaid in such manner.

2.7 Debt Books

Russia's Budgetary code obligates all government and local self-government bodies that make borrowings to keep debt books, and this information must be provided to the body responsible for keeping the state debt book of the particular subject of the Russian Federation.

Russia's Budgetary Code establishes that the minimum amount of information to be included in the debt book with respect to each type of borrowing is:

- the total debt of a subject of the Russian Federation (guarantees included);
- the date of borrowing;
- the means of securing the performance of obligations;
- information about the fulfillment of specified obligations in full or in part.

The law allows representative authorities to make decisions on the inclusion of additional information in the debt books. The content of the information entered, its entry methods, the arrangement and other registration-procedure elements differ significantly from region to region and from city to city.

The most typical structure of the standard document includes three or four obligatory sections. The first section is general, describing the nature and structure of debt of a region or city and specifying the body responsible for keeping the debt book. The second section is dedicated to the procedures for the book-keeping and entry-making. In this section, the content of information entered and the entry-making procedures are described, and additional analytical information is provided. The third part describes the procedures for the provision of information contained in the debt book to other interested parties, and the procedure for reporting out. The fourth and final part contains provisions concerning responsibility, control and supervision, etc.

The debt book information may be accumulated and stored in electronic form, on hard copy or using both methods. In the Republic of Mari El and the Vologda Region, only the electronic form of debt book-keeping is used. In the Bryansk Region and St. Petersburg, only hard copies are used. The debt book of the Irkutsk Region is a strict accounting form (hard copy).

Levels of transparency and availability of the information contained in the debt books also vary. Access to the information is provided to:

- regional executive bodies of the state administration and local self-governments, and territorial bodies of federal bodies of state administration in accordance with their debt management authority;
- creditors of subjects of the Russian Federation and municipalities;
- law-enforcement agencies and other organizations in cases provided for by the current legislation.

The procedure for receiving information from the debt book is also regulated. As a rule, information is provided upon receipt of a written request specifying the reasons. Few regions and municipalities have a standard-form debt book conforming to the Budgetary Code of the Russian Federation. Some municipal administrations classify debt instruments in the most general way, subdividing the entries between two groups of debt, such as “direct borrowing” and “government guarantees.” Some debt books contain such entries as “other debt instruments,” but do not explain their exact type.

Moreover, some subjects of the Russian Federation and municipal administrations do not strictly observe the mandatory requirements of the Budgetary Code concerning information on debt. Information about the purposes of borrowing is especially difficult to find. Though the code forbids municipalities to engage in foreign borrowing, debt books of some municipal administrations contain sections reserved for information about the currencies of obligations that result from international contracts and agreements. The analytical sections of the debt books are hardly a strong point. Some contain information about the maximum amount of debt established by a law on the budget of a subject of the Russian Federation or by a legal act of a municipal government for the respective fiscal year. Other restrictions may also be established. They may include the maximum amount of borrowed funds that can be used for budget deficit financing in the current fiscal year, the maximum spending on the state debt services in the current fiscal year or the maximum total amount of government guarantees.

Russia has not yet developed recognized rules for keeping debt books. They will be worked out sooner or later on the basis of acquired experience and in accordance with the principles of best practice.

2.8 Government and Municipal Guarantee Provisions

Since guarantees provided by subjects of the Russian Federation and municipal administrations reduce investors’ risks, they are an effective instrument for attracting capital. Under usual conditions they do not increase spending. However, they require that the law on the budget provide for special allocations to the extent of possible fulfillment of obligations under the guarantees provided. The effectiveness of this instrument, as well as the possibility of using the allotted funds for other purposes, makes it very popular among financially stable regions and cities. For this reason, guarantees now account for more than half of the total debt of some regions.

In the early 1990s, the procedure for the provision of guarantees was in complete disorder, resulting in serious financial problems for many regions and cities. Consequently, the Budgetary Code established a detailed procedure for the provision of government and municipal guarantees. The guarantee is construed as a method of securing civil-law obligations by virtue of which the guarantor undertakes to answer for the performance of the person to whom the state or municipal guarantee was provided, in fulfilling the obligations to third persons in full or in part.

Government and municipal guarantees must be provided in writing, and failure to comply with this requirement renders it invalid (void).

The guarantee must contain information about the guarantor and the name of the body issuing the guarantee on behalf of the specified guarantor. It must also specify the extent of obligations under the guarantee. The term of the guarantee is determined by the maturity of obligations covered by the guarantee.

As a rule, guarantees are provided on a competitive basis. The guarantor under government or municipal guarantee bears secondary liability, additional to the debtor's obligation whose fulfillment is guaranteed by the guarantor. The guarantor's obligation to a third person under the government or municipal guarantee is limited to the payment of the amount of obligation for which the guarantee was issued. A guarantor who has fulfilled the obligations of the principal has the right to demand the reimbursement of payment made to a third person under the government or municipal guarantee, in full and in accordance with the procedure described by the Civil Code of the Russian Federation.

Payments under government or municipal guarantees must be recognized as loans provided and must be included in the budgetary expenditures. If payments made by the guarantor in that capacity do not cause the emergence of the guarantor's claims to the debtor who failed to fulfill his obligation, the payments made under government and municipal guarantees must be recognized as deficit financing sources in the budget.

Decisions to levy execution on the third person's securities on behalf of municipalities are made by the local authorities responsible for the management of municipal debt.

Securities issued by third persons and guaranteed by the Russian Federation, a subject of the Russian Federation or a municipal formation (government or municipal guarantee) are not regarded as government or municipal securities.

Government guarantees of subjects of the Russian Federation and municipal guarantees are provided to subjects of the Russian Federation, municipalities and other legal persons to ensure the fulfillment of their obligations to third persons. The agreement on the provision of the government or municipal guarantee must specify the obligation whose performance is secured by the guarantee.

The list of guarantees provided to particular subjects of the Russian Federation, municipalities or other legal persons for any amount exceeding 0.01% of the spending of the respective budget must be approved by a law (decision) on the budget for the next fiscal year. The total amount of guarantees provided is included in the total debt of the respective subject of the Russian Federation or municipal formation as particular kinds of debt instruments. If the principal under the guarantee fulfills his obligations to a third person, the debt of a subject of the Russian Federation or the municipal debt is reduced by the respective amount, while entries to that effect are made in the budget execution report.

An appropriate finance-management body keeps records of all the guarantees issued, the fulfillment of obligations by the principals and payments made in accordance with the guarantees. Based on that information, a detailed report on the guarantees is issued.

Government guarantees are provided by an appropriate executive body of the state administration. Municipal guarantees are provided by an authorized local self-government body. In the event of government or municipal guarantee provision, an appropriate financial body must perform due diligence procedures with respect to the principal under the guarantee. The representative authority may also order the accounting body of the subject of the Russian Federation or municipality to carry out an audit on the principal under the government or municipal guarantee.

Russian legislation restricts the guarantee-provision rights of those regions and municipalities that receive equalization grants. The amount of guarantees provided by such regions and municipalities must not exceed 5% of their spending.

2.9 Measures to Prevent Municipalities' Failure to Fulfill their Obligations

The law requires that the state fiscal authorities supervise the execution of subnational budgets and implement measures aimed at preventing their default. If a municipality that is capable of servicing and repaying its debt has violated at least one of the budget-deficit or debt-amount restrictions established by law, it will be forbidden to assume new obligations until it brings its budget into conformity with statutory requirements. The only exception is borrowing (assumption of new obligations) carried out for the purposes of municipal debt restructuring and repayment.

If a municipality is unable to service and repay its debt, the fiscal agency of the Russian Federation may implement the following measures:

- order the performance of an audit of the local budget;
- place the local budget under the control of the body responsible for the execution of the budget of the respective subject of the Russian Federation;
- implement other measures as outlined in the budgetary legislation of the Russian Federation.

Some observers, however, believe that removing local control over the execution of the budget contradicts the Constitution of the Russian Federation.

3. MUNICIPAL BORROWING POLICY

3.1 Local Budget Deficit Financing

Sources of funds for financing deficits of local budgets, which are permitted by Russian legislation, are described in Section 2 of this chapter. Here we shall analyze the contribution of each of these sources to financing the aggregate budget deficit of Russia's municipalities.

The aggregate local budget deficit in the period from 1996 to 2001 and the structure of its financing are shown in Table 8.4.

Table 8.4
Aggregate Local Budget Deficit
[in trillion rubles until 1997, in billion rubles thereafter]

Budget Item / Year	1996	1997	1998	1999	2000	2001
Total revenues	218.1	269.3	239.9	324.2	480.6	588.5
Total spending	223.5	283.0	243.1	323.8	483.0	576.5
Budget deficit/surplus	–5.4	–13.7	–3.2	0.4	–2.4	–15.2
Financing sources						
Change in budget balance	2.2	2.8	0.4	–5.2	–10.9	2.7
Securities	0.4	0.0	–0.3	–0.3	0.007	–0.06
Budgetary loans	0.0	0.0	–0.5	2.9	9.7	7.9
Bank loans	Not available	Not available	Not available	Not available	–0.00	1.7
Sale of property	Not available	Not available	Not available	Not available	1.4	2.0
Other sources	Not available	Not available	Not available	Not available	2.3	0.7

Source: Ministry of Finance (Minfin) of the Russian Federation.

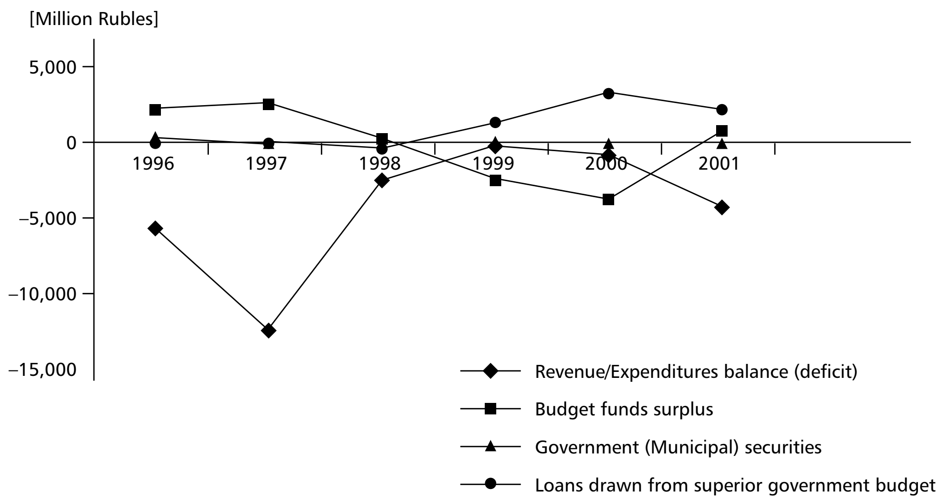
Data obtained from the Russian Federation Ministry of Finance for 1996 to 1999 do not give a clear understanding of sources of funds for local budget deficit financing during that period. However, the table shows that securities issues have never played a significant role in budget deficit financing.

The main contributors to budget financing are budgetary loans provided to municipalities from budgets of subjects of the Russian Federation. In 2000, budgetary loans to municipal governments were so large that, despite an aggregate municipal budget deficit of 2.4 billion rubles, municipal governments' budgetary account balances increased by the end of the year to 10.9 billion rubles.

Table 8.4 and Figure 8.2 also show that in 2000 municipal bond issuance exceeded municipal bond redemption by 7.8 billion rubles, while in 2001 redemption exceeded issuance by 59 million rubles. Also, the total amount of loan contracts concluded in 2001 was 1.7 billion rubles, while in the previous year this source of funds played no role at all (305,000 rubles for all the municipal governments in Russia).

Figure 8.2 shows that after the 1998 crisis, municipal governments spent more funds on securities redemption than they raised through securities issuance. The amount of budgetary loans that municipal governments received from budgets of a higher level has been growing since 1999.

Figure 8.2
Deficit Financing Sources



As of the end of 2002, the aggregate municipal debt in Russia amounted to 12.9 billion rubles (Moscow and St. Petersburg excluded), according to preliminary data from the Ministry of Finance of the Russian Federation. In 2000, 9.7 billion rubles was provided in loans to municipal governments from budgets of a higher level. This means that budgetary loan-taking was the main factor behind an increase in municipal debt during that year.

In 2001, the aggregate municipal debt grew by 8.8 billion rubles, to 21.7 from 12.9 billion rubles. During that year, municipal budgets received 7.9 billion rubles in budgetary loans from regional budgets. Thus, it was budgetary loans that accounted for the entire growth of municipal debt in 2001.

On the other hand, we should remember that budgetary loans amounted to an insignificant part of municipal spending. As a rule, budgetary loans amount to not more than 2% of budgetary spending.

Figure 8.3 offers an overview of the role of budgetary loans in the budgets of municipal governments. That figure and some of the later ones are "boxplot diagrams" and are constructed in the following way. For any random variable such as the amount of budgetary loans of a city, we can construct percentage points at 0%, 25%, 50%, 75%, 100%. For example, 25% of all cases (cities) with the lowest values lay between 0% and 25% percentage points.

The box on a boxplot diagram marks the segment between 25 and 75 percentage points of a variable distribution. Thus it covers 50% of all cases "in the middle." The horizontal line within the box shows the median value.

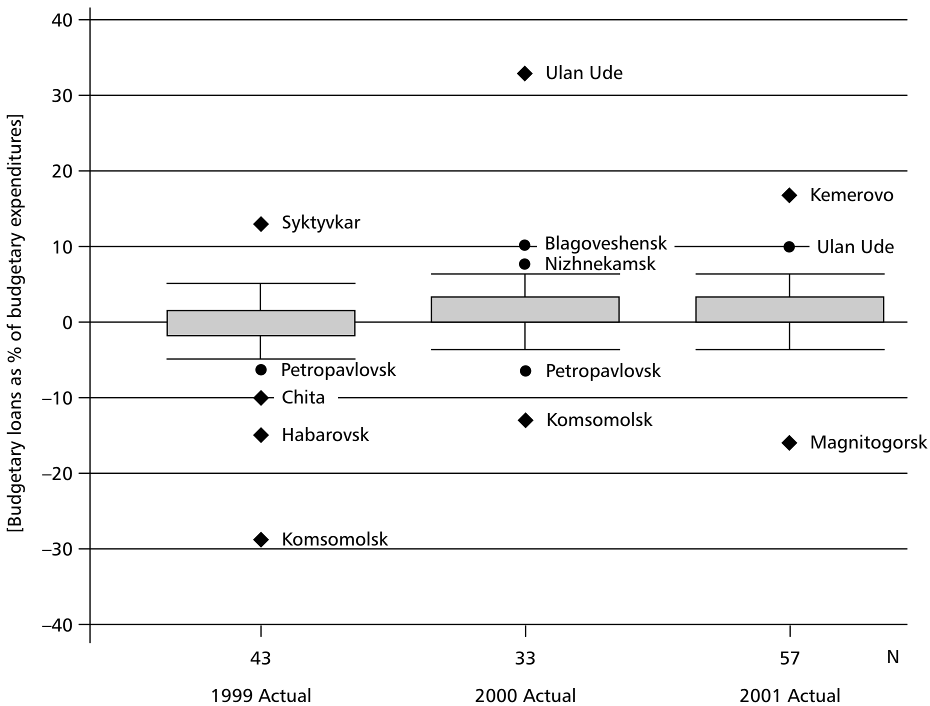
The lines above and below (whiskers) restrict the area of all used values of a particular indicator between 0 and 100 percentage points, with the exception of "extreme" points which, in our case, include those cities that spent significantly larger portions of their budgets on taking or returning budgetary loans, such as Syktyvkar, Ulan-Ude, Kemerovo, Blagoveshensk, or Komsomolsk, Habarovsk and Magnotogorsk.

Figure 8.3 and similar figures that follow are based on a sample of 79 Russian cities whose population varies from 140,000 to 1,398,000. The majority of cities of that size are included and these represent various geographical regions, which assures that the figure is more or less representative for mid- and large-size Russian cities. Moscow and St. Petersburg are not presented here. They are huge and have regional status, so including their data would somewhat distort our illustration of municipal policies in Russia.

Figure 8.3 shows that a significant portion of municipal governments successfully repaid the loans raised in the time period under review (half of them in 1999).

Budgetary loans and credits are the cheapest source of funds for budget deficit financing and closing the revenue-spending gap for regional and municipal budgets. They may be either interest-bearing or interest-free, and are provided for terms no longer than six months on the condition of their repayment in the same financial year. Budgetary loans are provided to close temporary budget gaps or as an advance provision of financial aid to a budget of a lower level. Quite frequently, budgetary loans are extended to the next financial year. In this case, they are accounted for as sources of funds for budget deficit financing. Budgetary credits may be provided not only to local governments, but also to other legal entities, including, in particular, state-owned and municipal enterprises. Russia's Budgetary Code imposes no limits on the term of budgetary credits. Budgetary credit is always interest-bearing, but the interest rate is always lower than the bank interest rate. The bodies providing budgetary loans and credits often require the use of property or other assets as loan security.

Figure 8.3
Budgetary Loans as Percent of Budgetary Expenditures (1999–2001)



The use of budgetary loans and credits also leads to tighter control over budget execution by the borrower from the body providing funds. We can regard the growing role of budgetary loans in local budget deficit financing as a sign of curtailment of municipal governments' budgetary autonomy.

Bank loans still remain a cheaper source of funds than securities issue for regional and municipal administrations. Bank loans are not only cheaper, but can be received more quickly and involve lower organizational costs. For this reason, in 2001 municipal and regional administrations were able to reduce their outstanding bonded debt by refinancing it partially through bank loans.

The exemption of municipal administrations and subjects of the Russian Federation from the securities registration tax, which now amounts to 0.8% of the nominal value of the registered issue, can make this method of financing a budget deficit more attractive for subfederal authorities. However, even with the reduction of organizational costs, securities issuance may remain less attractive than taking bank loans.

It should also be pointed out that the share of funds raised for budget deficit financing through the sale of municipal property remains significant: 10% in 2000 and 13% in 2001. Usually, this is less than 1% of budgetary expenditures. However, we were unable to analyze whether the sale of municipal property is merely part of the planned restructuring of municipal assets or is caused by the unavailability of other sources of funds for budget deficit financing.

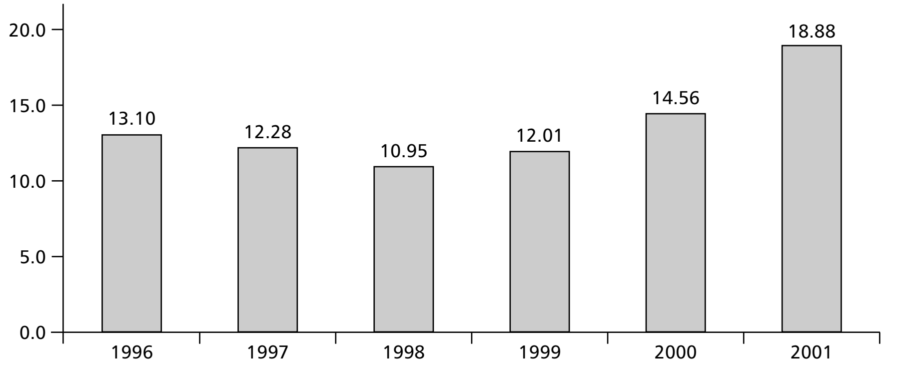
3.2 Capital Investment Financed by Local Governments

The share of expenditures on capital construction in subnational budgets varied from 11% in 1998 to 18.9% in 2001. Regional consolidated budget data is shown in Figure 8.4. For our purposes, the consolidated budget is understood as a budget of the subject of the Russian Federation consolidated with budgets of all municipalities located in its territory. After a deep decline in investment in 1998, capital expenditures from regional consolidated budgets increased slowly from 11% to 19%. It is interesting that in the period between 1996 and 2001, regional consolidated budget expenditures increased by 8% in comparable prices.

During the last six years, the share of spending on the construction of new facilities (about 60% of all capital spending), capital repairs (over 20%) and equipment purchases (below 20%), has hardly changed at all, despite serious financial problems in 1998-1999 caused by Russia's financial crisis.

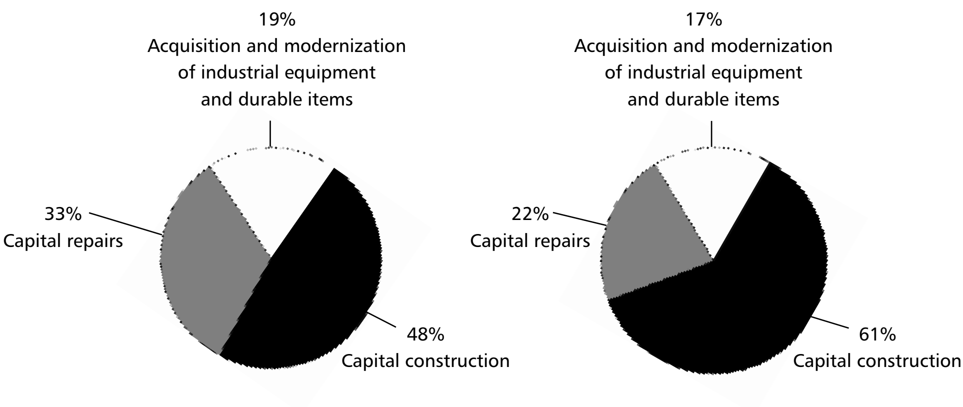
In 2000, capital expenditures of Russia's municipalities accounted, on average, for 13.6% of their total spending. The figure grew to 14.9% in 2001. For purposes of comparison, the Russian regions' capital expenditures amounted to 15.1% and 22.0% in 2000 and 2001, respectively.

Figure 8.4
Proportion of Capital Expenditures in Total Consolidated Regional Budget



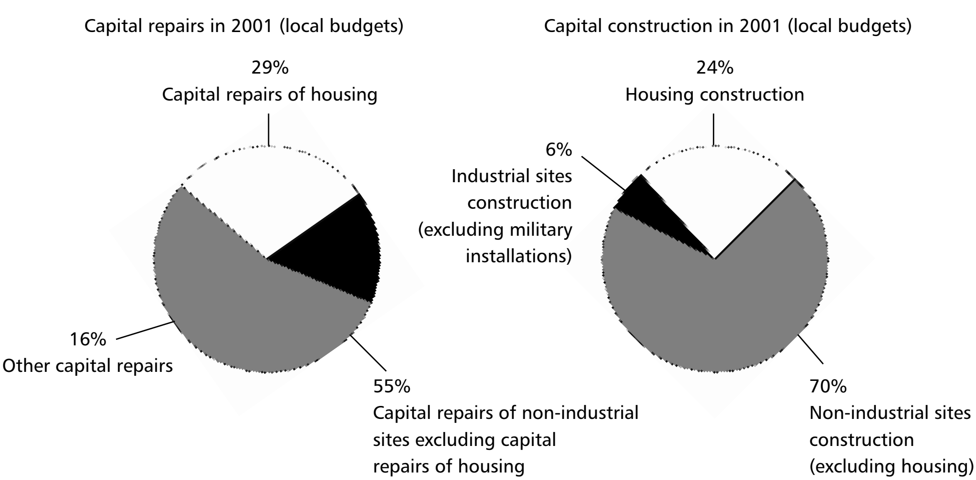
It is interesting to analyze municipalities' budget execution reports to see the distribution of capital investment by spending items, such as equipment and durables purchases, capital construction and capital repairs. The data for all municipalities in Russia for 2000 and 2001 are given in Figure 8.5.

Figure 8.5
Capital Investments in 2000 (left) and 2001 (right) (Local Budgets)



About half of the capital spending of municipalities is used for construction of new facilities, while the respective share for Russian regions is just over two-thirds. It is interesting that, despite the rather difficult financial position faced by the majority of cities, their spending on new construction is nearly twice as large as their capital repairs spending. Results of our analysis of spending in these two categories are shown in Figure 8.6.

Figure 8.6



In 2000, funding from the municipal budgets was primarily used for construction of non-industrial facilities such as schools, health and social institutions, etc. Municipal housing construction accounted for about 25% of capital construction, while production facility construction for less than 10%.

Half of the municipal budgets' allotments for capital construction are used to finance capital repairs in the non-production sector. One-third of funds are used to finance repairs of municipal housing, while 20% is used to finance repairs of municipal production facilities.

Interviews with heads of municipalities make it clear that cities attach much importance to modernization of the material and technical basis of educational and health institutions and resource-related programs. These expenditures are used to finance computer purchases for schools, measuring instruments for the heating and water-supply systems and other resource-saving equipment.

It would be appropriate to analyze which facilities are financed from the "construction of production facilities" item and which are financed from the "other capital repairs" item. Such analysis will show whether and how much municipalities invest in commercial projects. However, it seems that the greatest part of funds is used to finance construction of engineering infrastructure facilities. A general analysis of the budgetary data shows that, for Russia as a whole, the proportions of various types of capital investment spending are quite reasonable. An analysis of a representative sample of cities would be required to reach more definite conclusions.

It should be added that sometimes municipal property construction is supported by federal block grants. In such cases the work is funded either jointly or by the federal budget. The scale of this phenomenon is hardly calculable.

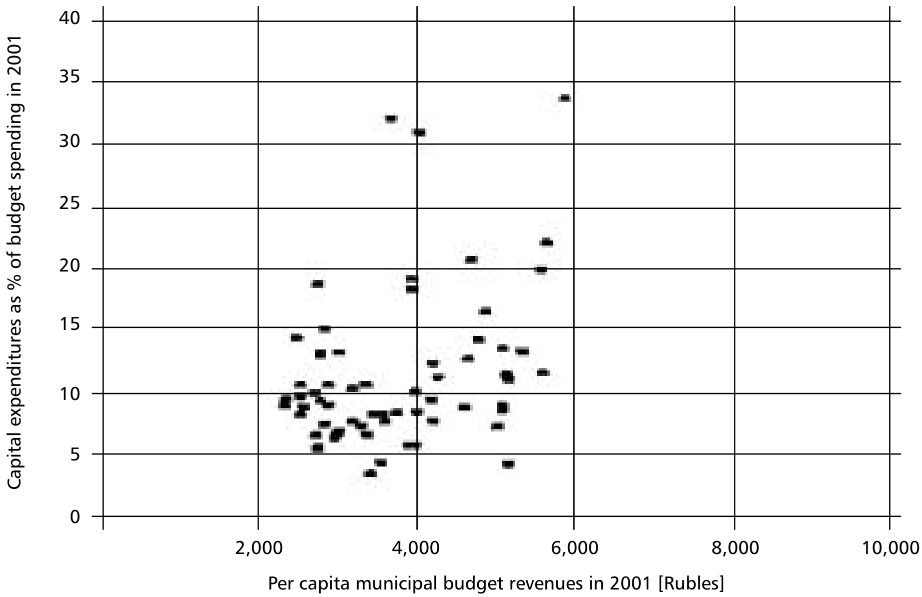
3.3 Relationship between Capital Investments and Affluence of Budgets

Based on the budget execution data from 79 Russian cities, we shall analyze capital investment as a share of municipalities' total spending in 1999 through 2002.

There is a strong statistical dependence between the budget adequacy and municipalities' spending on capital investment purposes. In fact, these indicators are nearly proportional: the coefficients of correlation between per capita income and per capita investment are not smaller than 0.85 in each of the periods under review (they are significant at the 0.95 level; all correlations to be mentioned are also significant at the same level).

One pronounced trend in 2000 and 2001 was that more wealthy municipalities spent a large percentage of their funds on capital investment. This can be seen clearly in Figure 8.7 below, which shows that the correlation between the shares of investment spending and budget affluence amounted to 0.44 in 2000 and 0.33 in 2001 (0.24 in 1999).

Figure 8.7
Scatterplot: Share of Capital Spending vs. Per-capita Municipal Revenues (2001)



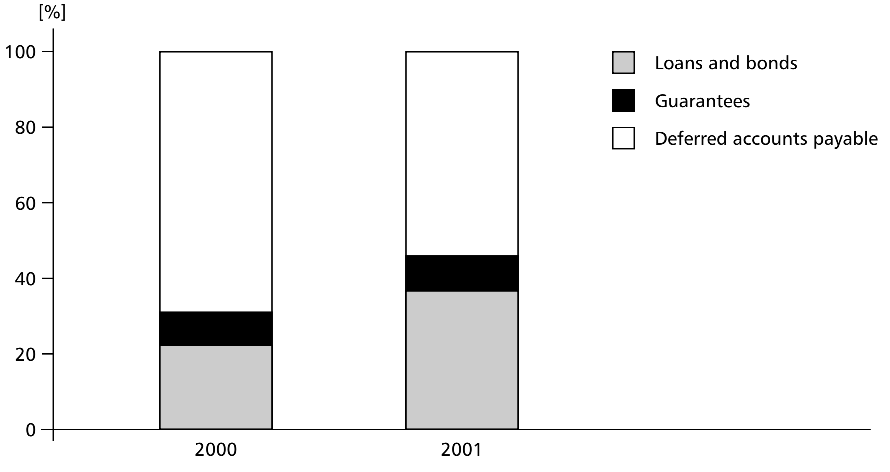
Our analysis allows us to conclude that the larger the municipal budget per capita, the greater the share of budgetary funds spent on capital investment purposes. This trend, which was barely visible in 1999, became evident in 2000 and 2001.

3.4 Amount and Structure of Local Budgets' Debt

To analyze the debt burden on the municipal level, we used the following three indicators: the amount of the municipal debt, the amount of the municipal debt including guarantees provided, and the amount of the municipal debt including overdue payables. The last indicator cannot be counted as municipal debt according to the Budgetary Code of the Russian Federation. At the same time, based on economic sense, the overdue liabilities can be regarded as municipal debt because they are in fact a form of crediting the municipal budget at the expense of enterprises' funds (wage debts in the housing and utilities service sector) or employees on the municipal government payroll (delayed salaries).

The structure of debt at the municipal level is shown in Figure 8.8. Overdue payables are taken into account.

Figure 8.8
Structure of Municipal Debt



In 2000, overdue municipal payables accounted for about 68% of the total municipal debt. The loans and bonds accounted for 23%, while guarantees provided accounted for 9%. In 2001, the share of overdue payables decreased sharply, to 52%. At the same time, the share of loans amounted to 36%, while the share of guarantees accounted for 12%.

A calculation of debt-revenues balance was made for each subject of the Russian Federation. The calculation was made using data for the municipal level of subjects of the Russian Federation. To characterize the debt burden on the budget, we calculated the debt-revenues ratio using the three above-mentioned debt indicators. Municipal debts were registered in 28 subjects of the Russian Federation in 2000, and 27 in 2001.The largest debt was registered in the Republic of Buryatia, where it accounted for 69% of budget revenues in 2000 and 46% in 2001. With guarantees and overdue payables taken into account, municipal debt in Buryatia accounted for 88% and 123% of budget revenues, respectively. In 2001, the figures for Buryatia amounted to 46% for general debt, 50% with guarantees taken into account, and 88% if overdue payables are taken into account.

Russia's Primorsky Kraj was the second Russian region ranked according to the amount of municipal debt in 2000 and 2001. There, the debt to revenues ratio amounted to 56% in 2000, while the debt plus guarantees to revenues and the debt plus overdue payables to revenues ratio amounted to 56% and 72%, respectively. The figures for 2001 were 21%, 21% and 25%, respectively.

For Russia as a whole, the ratio between the municipal debt and municipal government revenues amounted 3% in 2000 and 4% in 2001. With guarantees taken into account, these ratios were 4% in 2000 and 5% in 2001. Taking into account overdue payables, different figures are produced: 12% for 2000 and 10% for 2001.

Thus, the recent years revealed a trend towards municipal debt growth with a simultaneous reduction of overdue payables, which shows that a process of conversion of overdue payables into municipalities' debt is now underway. The total amount of debt with respect to guarantees and overdue payables has decreased.

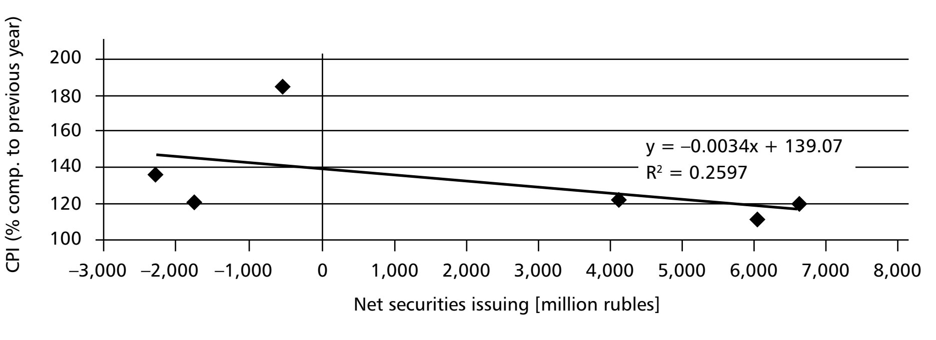
An analysis of the relationship between a municipal formation's debt and municipal budget revenues has shown that there is practically no statistical relationship between budget revenues and various types of municipal debt.

3.5 The Impact of the Macroeconomic Situation on Municipal Borrowing

We carried out a time analysis of the relationship between net budgetary loans and net outstanding municipal bonds (funds raised less repayment), based on the consumer price index. For the purposes of our analysis, we took the 1996-2001 series of net amounts of outstanding securities (securities placement less redemption) and net budgetary loans from budgets of higher levels (funds raising less repayment), as well as the inflation data. The results of our analysis of the relationship between inflation and net securities issuing are shown in Figure 8.9.

Figure 8.9

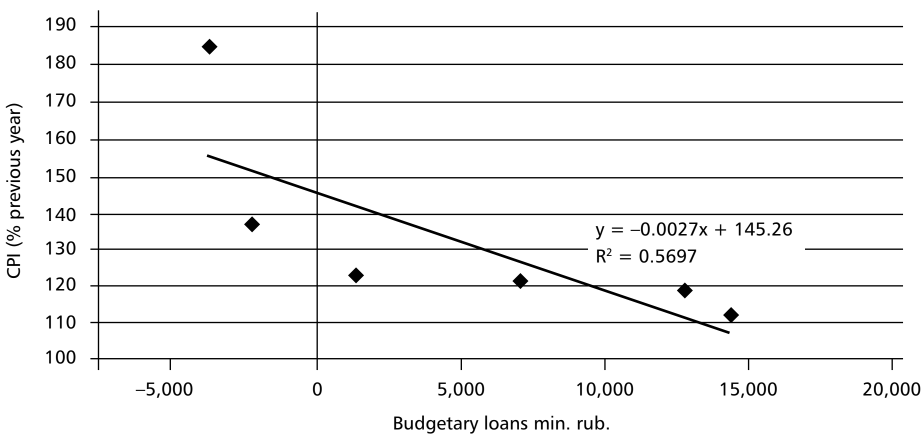
Relationship between Net Securities Issuing and Inflation (1996–2001)



As the figure shows, there is a weak negative relationship between the net amount of securities issuing and the rate of inflation. The figure also gives the coefficients for a linear regression model that shows the relationship between the Consumer Price Index (CPI) and the net amount of outstanding municipal bonds. All the coefficients of the model proved to be significant. Moreover, the model determination coefficient equals 0.25, which means that inflation has a very slight impact on the net amount of outstanding securities.

The relationship between net budgetary loans and inflation is shown in Figure 8.10.

Figure 8.10
Net Budgetary Loans—Inflation Relationship



A similar regression model developed for this particular case shows that the determination coefficient is close to 0.57, which means that the inflation factor has a rather strong impact on the amount of budgetary loans.

In both analyzed cases, the linear model slope ratio amounts to approximately 0.003. This means that inflation's impact on the amounts of municipal borrowing is rather weak when both net municipal securities issuance and net budgetary loan raising from budgets of higher levels are concerned.

Owing to a sufficiently long sequence of data characterizing municipal borrowing, a cross section analysis of macroeconomic parameters' impact was carried out for the period of 2000 through 2001. Similar results are achieved during a cross-section analysis of the 2000 and 2001 data. We analyzed the relationship between the total municipal debt in the subject of the Russian Federation and the rate of inflation in that region. The coefficient of correlation between the two indicators amounted to about –0.05 in

2001 and –0.03 in 2000. Moreover, Russia's 2001 inflation amounted to 118% of the previous year's inflation. The inflation rates varied from 115% in the Vologda region to 128% in the Ulyanovsk Region.

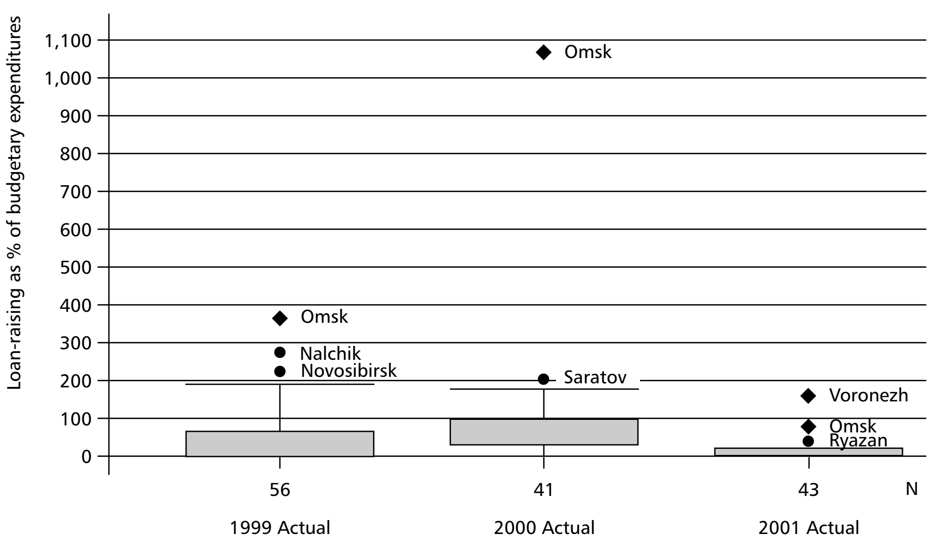
Thus, we can conclude that inflation has a slight negative impact on the amounts of current borrowing by a municipal formation. At the same time, there is practically no relationship between the total amount of debt and inflation.

Such behavior can be explained by the fact that an increase in inflation leads to an increase in economic activities and consequently in budget revenue growth, which slightly reduces the need for borrowed funds. Since most budgetary loans are short-term loans, inflation's maximum impact is on the amount of short-term borrowing.

3.6 Trends in Use of Borrowed Funds

On the basis of a statistical analysis of data from 79 Russian municipal governments from 1999 to 2001 and research into the spending directions of their borrowed funds, we can make a number of observations. In 1999 and 2000 municipal government borrowing amounted to about 5% of spending. In 2001, municipal governments borrowed much less, about 1% to 2% of their spending. One can also consider the ratio against capital spending, illustrated in Figure 8.11.

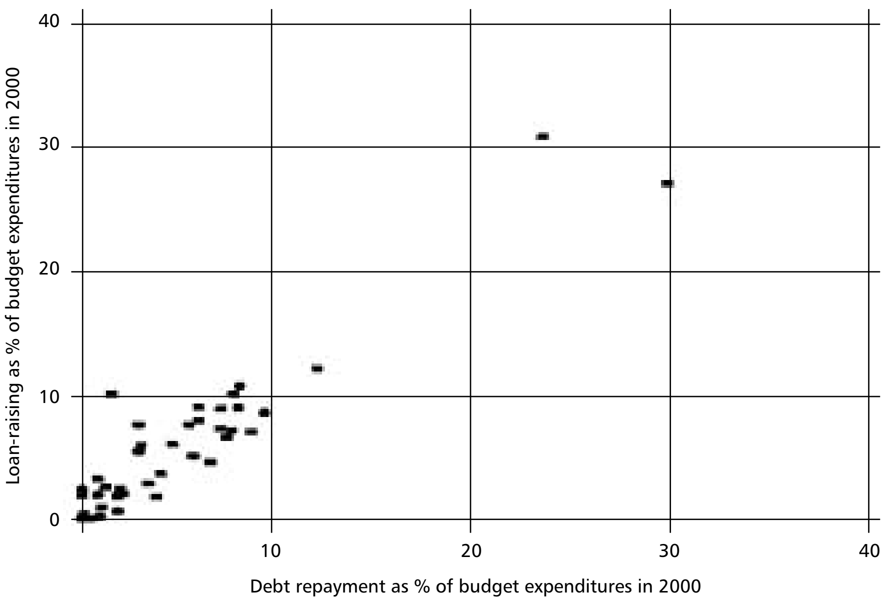
Figure 8.11
Loan-raising as a Percentage of Capital Expenditures (1999–2001)



This figure shows that municipal borrowing is usually no more than the capital expenditures (except for some outliers). Median value is about 50%. And again, borrowings as a ratio to capital spending in 2001 were considerably lower than in the years 1999–2000.

The main observation with respect to municipal government borrowing during that period is that in 1999 and 2000 a significant amount of borrowed funds was used to repay municipal debts, i.e., for the purposes of municipal debt refinancing. Accordingly, the correlation coefficients were 0.94 and 0.93, respectively. The correlation between loan raising and debt repayment was significant in 2000 and 2001, although there was much less municipal borrowing in 2001, as we have already mentioned.

Figure 8.12
Scatterplot: Share of Loan-raising vs. Share of Debt Repayment (2000)

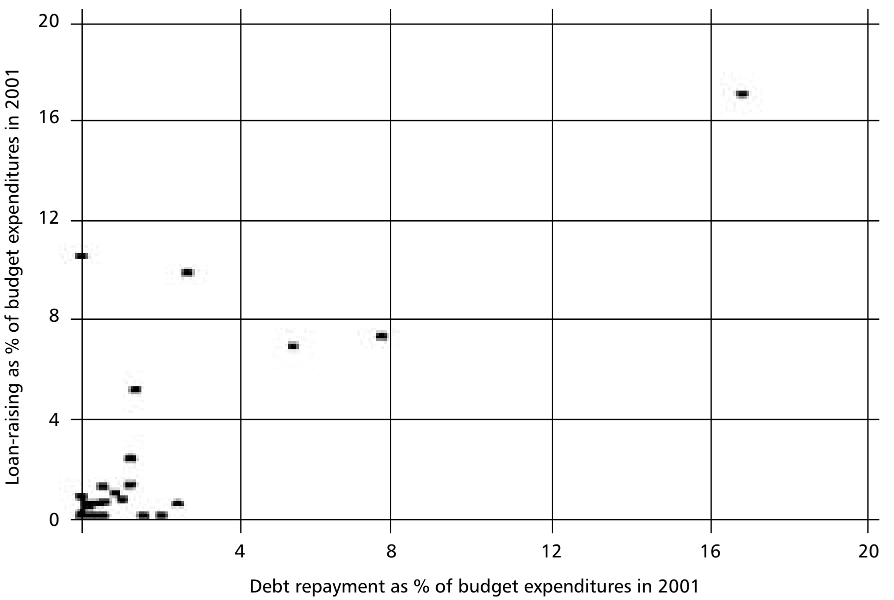


Overall, no statistical relationship between investment spending and municipal borrowing is to be observed. For instance, many municipal governments ended 1999 with a budget surplus and therefore financed their capital investments as current expenditures. Moreover, in some cases capital investment spending financed from current income was accompanied by an increase in municipal governments' bank accounts, i.e., in their savings.

In 2000, a trend emerged towards use of loans to finance capital investments (correlation: 0.46). When adjusted (taken as% of budgetary spending), there is no statistical relationship between these two values. This means that the correlation occurred because of a small number of municipal governments whose large capital investment was accompanied by raising large loans.

Figure 8.13

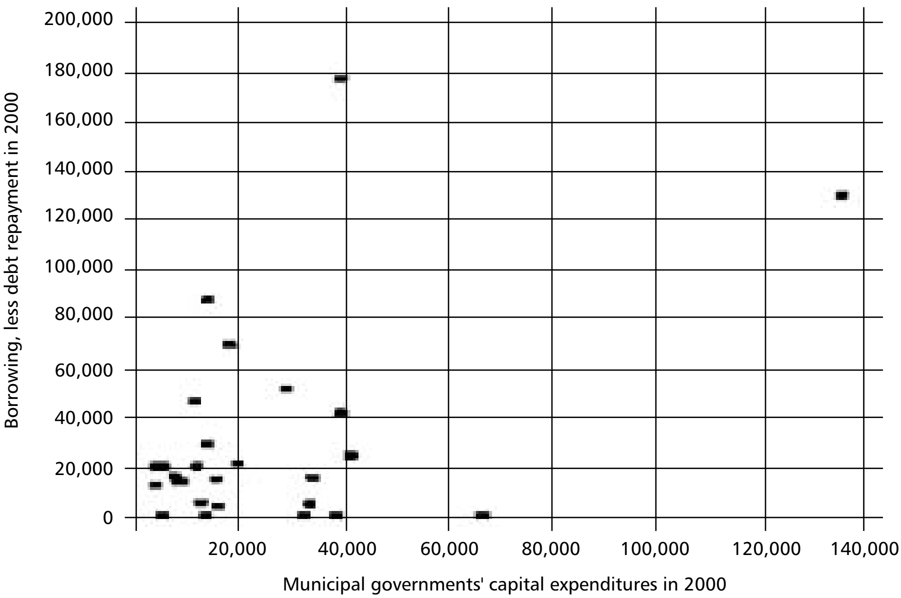
Scatterplot: Share of Loan-raising vs. Share of Debt Repayment (2001)



Two conclusions can be drawn on the basis of Figure 8.12:

1) No statistical relationship between capital investment and borrowing by Russian municipal governments has been revealed.
2) During the post-crisis period, the greatest part of municipal borrowing was used for debt refinancing, but this trend was not as pronounced in 2001 as in 1999 and 2000. In addition, the total volume of borrowing was significantly smaller in 2001.

Figure 8.14
Scatterplot: Borrowing Less Debt Repayment vs. Capital Expenditures (2000)



3.7 Conclusions

Municipal borrowing primarily comprises loans and credits from the budgets of other levels and to a lesser extent bank credits. Zero-interest loans are obtained for funding budget gaps and temporary financial shortfalls occurring as emergencies. However, if loans are not repaid over the year they are reflected in the budget report and contribute to increasing the municipal debt.

The municipal debt total by the end of 2001 was 21.7 billion rubles. This makes up 3.5% of local budget expenditures, with budget loans and credits accounting for 80% of this amount.

The proportion of long-term and short-term budget credits has not yet been assessed, and the rest of the municipal debt consists mostly of bank credits.

Municipalities do not usually draw bank credits for financing budget gaps. These funds are used for refinancing old outstanding debts and, to some extent, for capital construction.

The analysis of data from 79 cities shows that these cities allocate an average of 12% of their expenditures to capital investment. In addition, a lot of municipal facilities are built with direct funding from regional budgets.

Local budget deficits amounted to 0.5% and 2.4% of local government expenditures in 2000 and 2001 respectively.

Municipalities' debt total in 2001 (21.7 billion rubles), debt augmentation in 2001 (8.8 billion rubles), local budget deficits (15 billion rubles) and capital investments (92.8 billion rubles) in the same year shows that in extremis borrowing may finance no more than 12% of expenditures for capital investment. The remaining 88% of expenditures is funded by municipalities on a pay-as-you-go basis.

4. MUNICIPAL SECURITIES

Municipalities attract very few loans from the securities market, as was shown in the previous section. In 2001 the volume of repayment exceeded that of borrowing. At present, securities amount to less than 1% of the municipal borrowing total. One can assume, however, that in the near future municipalities will more actively use them as a source of funds. Bank loans are indeed more competitive than bonds, but banks are interested in short-term lending, while most infrastructure investment implies long-term borrowing.

4.1 Development of Legislation Regulating Municipal Borrowing

During the ten years of Russia's economic reform, the municipal bond market grew rather rapidly if somewhat unevenly. In the early 1990s, municipal borrowing was carried out according to old Soviet practices based on Soviet principles of budgetary finance. In case of a shortage of funds, municipal governments borrowed from the budget of a higher level. These borrowings had to be repaid by the end of the same financial year. Two laws passed in the first half of the 1990s established a rather liberal regime of borrowing by subjects of the Russian Federation. One was the now-abrogated Law on the Bases of Budgetary Rights and Rights for the Formation and Use of Extra-Budgetary Funds (1993), while the other was the Law on the Bases of Organization of Local Self-Government in the Russian Federation (1995). Article 42 of the latter law says that in accordance with legislation of the Russian Federation, local self-government bodies have the right to float municipal loans and hold lotteries, provide and receive loans and establish municipal banks and other financial and lending institutions. However, the law determines neither the upper borrowing limit nor the purposes of borrowing.

In the mid-90s many regions and municipalities actively borrowed by means of municipal and regional bonds and bank credits. The absence of borrowing limits and borrowing aim restrictions for regional and municipal governments had negative consequences: municipal governments actively borrowed funds to finance their current needs on extremely unfavorable terms and without having a loan repayment plan. For this reason, the federal center introduced some restrictions soon after.

According to the applicable law in effect at that time, transactions with state bonds were not taxed. "Provisions on Issue and Circulation of Municipal Securities in Stock Markets in the RSFSR" defined state debt obligations as "any securities certifying a borrowing relationship involving the state authority as a debtor." Therefore, it was beneficial to attribute the status of state securities to the issue of regional and municipal securities, and the applicable law at that time allowed doing so. The act of the Federal Securities Commission of May 5, 1995 preserved state status only for securities of the subjects of the Russian Federation. That very decision sharply decreased municipalities' incentive to issue new securities.

In 1995, extremely profitable and seemingly risk-free federal state securities also came into existence. This financial tool had been accumulating most of the surplus financial resources in the country for three and a half years.

Bills of exchange issued by regional and municipal governments became widespread in 1995 and 1996. These proved to be a very convenient instrument for implementing various mutual off-set plans. Bill issues do not need not to be registered. Bills of exchange exist only in documentary form, and they can be used for settlements with suppliers and creditors, bypassing the banks. This made it possible for their users to fulfill obligations and simultaneously accumulate debts within the budgets of various levels. Many privatization plans were implemented using regional and municipal governments' bills of exchange. After all, under conditions of an acute cash shortage (the Central Bank of the Russian Federation ceased to provide loans to Russia's Ministry of Finance in 1995) and flourishing non-monetary settlements, bills of exchange were a convenient money substitute. However, the issue of regional and municipal bills of exchange and their circulation and repayment procedures were insufficiently regulated. The existing practice of advanced payment of regional and municipal bills of exchange provided significant financial benefits to bill holders.

In 1997, the Federal Law "On the Note and Bill of Exchange" prohibited regional and municipal administrations from assuming "note and bill of exchange liabilities."

4.2 Government and Municipal Securities Issue Procedures

Procedures for the issuance of government and municipal securities, the circulation of securities, the assumption and performance of obligations arising from the securities issue and the disclosure of information by securities issuers are regulated by the Federal Law of the Russian Federation "On the Specifics of the Issuance and Circulation of the Government and Municipal Securities." The issuance procedure consists of several phases.

1) To issue securities, a local government must approve a municipal regulatory document entitled General Terms and Conditions of the Issuance and Circulation of Municipal Securities. The General Terms and Conditions must specify the following:
    - the types of securities;
    - the form of securities issuance;
    - the maturity of the type of securities concerned (short, long or medium-term securities);
    - security denomination currency;
    - specifics of the fulfillment of obligations, which provide for the right to use property instead of cash for redemption purposes;
    - restrictions, if any, on the circulation of securities and the categories of securities holders who may own or hold these securities.
    - in accordance with the General Terms and Conditions, the issuer (the municipal government in the case of a municipal formation) must adopt a regulatory document specifying the conditions of the government and municipal securities issue and circulation, including the following:
        – the types of securities;
        – the shortest and longest maturities of that type of government or municipal securities; different securities issues may have different maturities;
        – the nominal value of each government or municipal security in the issue;
        – the procedure for the government or municipal securities placement;
        – the procedure for the execution of rights attached to securities;
        – the yield or the procedure for its calculation;
        – other significant conditions of the issue, which are important from the viewpoint of the emergence, fulfillment or termination of obligations on government or municipal securities.

    The terms and conditions of the securities issuance by subjects of the Russian Federation and municipal administrations must also contain the following information:
    - the borrower's budget for the year of the government or municipal securities issue with a breakdown into the current and development (capital) budgets;
    - the borrower's total outstanding debt as of the time of the government or municipal securities issue;
    - information about the execution of the borrower's budget for the last three fiscal years.

2) The Terms and Conditions of the Government and Municipal Securities Issue are subject to state registration. Russia has a uniform government and municipal loan registration system. Subjects of the Russian Federation and municipalities register the loans they float in the Ministry of Finance of the Russian Federation, and each issue of government or municipal securities is assigned a state registration number.
   The Ministry of Finance may refuse to register the Terms and Conditions of the Issue if the issuer violates the borrowing limits established by representative and executive authorities of subjects of the Russian Federation and local self-government bodies.
   In the event of denial of state registration of the Terms and Conditions of the Securities Issue, the issuer has the right to appeal against it in court.
3) Upon the registration of the Terms and Conditions of the Issue by the Ministry of Finance, the issuer must make the issuance decision. The decision must conform to the General Terms and Conditions of the Issue.
4) The terms and conditions specified in the securities issuance decision must be published in the media or disclosed in some other way by the issuer not later than two working days prior to the beginning of placement.
   Government or municipal securities issuers must register information relating to obligations under each securities issue. This information includes the total amount of obligations on issued securities and their maturities.
   Government and municipal securities issuers must prepare annual reports on the results of securities issues, approve it by a legal document and submit to the Ministry of Finance of the Russian Federation not later than May 1 of the year following the reporting year in accordance with the established procedure.
   The report on the results of securities issue must contain the following information:
   a) the total obligations of a subject of the Russian Federation or municipal formation, which emerged as a result of the securities issue, denominated in a foreign currency or rubles as of the end of the reporting year;
   b) overdue debt, including principal and interest, which must be shown separately;
   c) liabilities due in the future (with specification of principal repayments and interest payments);
   d) the source of funds for budget deficit financing, which must be approved by a law (decision) on the budget (nominal figures);
   e) the total amounts of securities issuance and redemption at par, with a breakdown by each type of security;
   f) the amount of funds raised through the securities issuance in the reporting

year (compared to the similar amount for the previous fiscal year);

g) the debt servicing expenditures of a subject of the Russian Federation or a municipal formation (separately for each type of debt instrument, compared to the similar figure for the previous fiscal year);

h) the amount of borrowing made through the securities issue as a source of financing a budget deficit of a respective level in the reporting year and the total budget deficit;

i) measures aimed at debt restructuring, debt servicing expenditure optimization, borrowing procedure improvement and securities market infrastructure development, which were implemented by the securities issuer in the reporting year.

4.3 Information Disclosure on Securities Issue

According to the Federal Law of the Russian Federation "On the Specifics of Government and Municipal Securities Issue and Circulation," information about government and municipal securities must be available to all interested parties.

In addition, executive bodies of the subjects of the Russian Federation and local self-government bodies must publish quarterly reports on the execution of their budgets and submit reports on the fulfillment of obligations that have emerged as a result of the securities issue to the Ministry of Finance of the Russian Federation.

In early 2001, Russia's Ministry of Finance introduced additional disclosure standards applying to government and municipal securities. The document requires that securities issuers put the above information on their Internet servers, and submit it to the General Securities Underwriter and/or dealers on the government (municipal) securities market for further information provision to the interested parties.

4.4 Regional and Municipal Bond Market: Phases of Development

4.4.1 Market Origination

In its development, the subfederal and municipal bond market passed through four qualitatively different phases, including the following: the formation phase (1992–1996), the growth phase (1997 to August 17, 1998), the crisis phase (August 17, 1998 to December 31, 1998) and the post-crisis phase (1999 to the present).

For the first time, governments of subjects of the Russian Federation and the municipal governments tried to raise funds through bond issuance in the early 1990s.

The first regional bonds were issued in the Habarovsk Kraj in March 1992. In 1992 and 1993, the issue of bonds and other debt was of an experimental nature. The bonds were placed and circulated in isolated regional markets with inadequate infrastructure. During that period, the total issue of subfederal and municipal securities (bills of exchange excluded) amounted to only 1.2% of the respective regional budget deficits. The main factors impeding the development of the municipal bond market was Russia's hyperinflation and the absence of an adequate regulatory base.

In 1992, Russia's Ministry of Finance registered five subfederal and municipal bond issues worth 5.6 million rubles (with adjustment for the ruble denomination), while in 1993 there were eight issues worth 9.3 million rubles.

Table 8.5

Subfederal and Municipal Bond Issues in 1992–1996

Year	Bond Issues			Nominal Issue Amount		
	Number	Growth on the Previous Year [%]	Weight	Million Rubles	Growth on the Previous Year [%]	Weight
1992	5		3.27	5.6		0.03
1993	8	160	5.23	9.3	166.1	0.05
1994	28	350	18.3	2,701.0	29,043.0	13.49
1995	73	260.7	47.71	6,516.0	241.2	32.54
1996	39	53.4	25.49	10,789.0	165.6	53.89
Total	153		100.00			100.00

Source: Finansy i Kredit Magazine, No. 7, 2002.

In 1994, the executive bodies of state administration began to use debt issuance more widely, as an alternative to bank lending as a source of borrowed funds. During that year, Russia's Ministry of Finance registered 28 subfederal and municipal bond issues worth 2,701 million rubles. In 1995 it registered 73 issues worth 6,516 million rubles, and in 1996, 39 issues worth 10,789 million rubles. In some regions the share of the budget deficit of subjects of the Russian Federation and municipalities, which was financed through the issue of bonds, grew to 50% in 1995 and 1996.

From 1992 to 1996, bond issues were characterized by the following distinctive features:

1) Securities issuers provided no high-quality issue prospectuses. Government authorities had no reliable information about the financial and economic position of their territories and the actual need for financial resources. As a result,

the greatest part of the bonded debt issued during that period was aimed at bridging temporary budget gaps and increasing local budget revenues. A small part of the funds raised was used to finance housing construction and public welfare programs.

2) When selecting agents for servicing subfederal and municipal loans, executive bodies of subjects of the Russian Federation and municipal bodies practiced a sort of protectionism for regional and local financial institutions. Custody and settlement risks were so high that the most important investor in the region or municipality had no possibility of showing any significant presence in the market.
3) There were no generally-accepted, common guarantee mechanisms for bond repayment. Quite frequently, the debt-servicing amounts were not even shown as a separate spending item in the regional or local budget.
4) A significant portion of subfederal and municipal bonds was used as an instrument of tax payments to the regional budget, which only increased the outflow of real financial resources from the region.

4.4.2 The Development Phase

Russia's macroeconomic situation changed significantly in 1997. During that period, Russia's GDP grew, inflation and real interest rates decreased, and the reliability of the trading system as a whole and the professional adequacy of exchanges increased. In addition, the attitude of Russian and foreign investors to Russian government securities improved and credit ratings were assigned to them. The growing investment needs of Russian financial and industrial groups revealed the inadequate capacity of the Russian securities market. Unsatisfied demand for securities amounted to dozens of billions of rubles.

The total number of registered subfederal and municipal bond issues grew more than eightfold in 1997 compared to 1996 (from 39 to 313), while the total amount issued grew more than 2.7 times, from 10,789 to 29,488 million rubles. Nevertheless, only six billion rubles were taken from the bond market for the purpose of covering the substantial budget deficit.

In all, as of January 1, 1998, the Ministry of Finance of the Russian Federation registered 466 prospectuses of bond issues by the executive bodies of subjects of the Russian Federation and municipalities for a total amount of 49,508.8 million rubles at par. This means that 67.2% of the total number of subfederal and municipal bond issues made between 1992 and 1997 was registered in 1997. The bond issuance activities of executive bodies of subjects of the Russian Federation and municipalities reached their peak in that year.

The intensive growth of the subfederal and municipal bond market in 1997 can be explained by a number of factors, including the following:

- a significant reduction of federal government securities yields;
- a ban on the issue of bills of exchange by the bodies of state administration of subjects of the Russian Federation and municipal governments imposed by the Federal Law "On the Note and the Bill of Exchange" passed in March 1997;
- changes in the legislation of the Russian Federation, requiring registration of securities issues and assignment of state registration numbers to them;
- the aggressive behavior of certain issuers on the securities market. For instance, the Moscow city government represented by its Committee for Municipal Loans was a large borrower on the securities market in 1997.
- the large number of agribond issues—201 issues in all.

One feature of Russia's subfederal and municipal bond market in 1997 was a significant share of no-purpose borrowing in the total amount of borrowing. Most of the bonds issued during that period were short-term or medium-term discount bonds (57%).

The situation on the securities market worsened in late 1997. Interest rates grew and became unstable, while the maturities of the bond issues increased. As a result, pressure on budgets of subjects of the Russian Federation and municipalities increased, while issue planning and loan management became more difficult.

However, Russia's subfederal and municipal governments continued to issue debt securities rather actively until May 1998. In January through May, Russia's Ministry of Finance registered 59 subfederal and municipal bond issues worth 14,122.5 million rubles. But compared to 1997 the average monthly securities issue volume decreased, to 1,606.45 million rubles (2,025.4 million rubles in 1998). That period was also characterized by a more rapid concentration of trading in municipal bonds on trading floors located in Moscow and St. Petersburg. Cities placed their bonds only on the regional financial markets.

In May of 1998, industrial production began to decline and borrowing conditions worsened as a result. From June to August, 1998, 24 regional and municipal bond issues worth 7,918.56 million rubles were registered in Russia. The capacity of the financial market decreased significantly as a result of a sharp increase in foreign capital outflow from Russia and the continuous withdrawal of funds from the securities market by non-resident investors with their subsequent conversion into hard currency. The first cases of subfederal and municipal government defaults on debt obligations were also registered on the market during that time. The issuers' failure to fulfill their agribond and energy bond obligations was explained not only by the worsening of Russia's macroeconomic conditions, but also by the "administrative factor," which is the issuers' reluctance to repay their liabilities.

From January to August, 1998, seven municipalities registered their internal bonded debt floats worth 378.95 million rubles, or 2.95% of the total amount of the outstanding municipal debt, while Moscow and the Moscow Region registered four external bond issues. The total amount of Eurobond issues as of the date of their state registration, calculated according to the exchange rate quoted by the Central Bank of the Russian Federation for that date, accounted for 41.6% of the total debt issued, while their weight in the total number of bond issues amounted to 4.8%.

Regional and local governments grew more active on the securities market from 1992 to 1998, with the total of internal subfederal and municipal bond issues amounting to 71,549.96 million rubles at par.

But despite a rapid development of the subfederal and municipal bond market during that period, it still accounted for a rather moderate share of Russia's securities market. In 1997, for instance, subfederal and municipal bonds accounted for an insignificant 6.6% of all outstanding bonds issued in Russia. To a great extent, that was explained by a faster growth of the GKO/OFZ market and the introduction of new types of government securities, including those targeted at small investors in general and ordinary Russians in particular. The institute of underwriting was not yet formed during that period.

4.4.3 The Crisis Phase

Russia's August 17, 1998 crisis caused a mass sell-off of securities by bond holders at dumping prices. The volume of securities issuance decreased sharply, too. In September through December, 1998, only one municipal bond issue was registered in Russia. It was registered by the Yaroslavl Mayor's Office.

During the crisis, only Moscow and St. Petersburg continued to service their debt, but even Moscow sometimes delayed payments and repaid part of its liabilities in a non-monetary form (provision of tax exemptions and debt conversion in newly-issued securities) on agreement with investors. Moreover, only St. Petersburg managed to maintain its secondary securities market during the crisis. St. Petersburg also managed to place new bond issues, although investors bought only 10% to 15% of each issue, while the issuer rejected the most aggressive bids. Cases of mass defaults on the subfederal and municipal bond market revealed a number of major problems faced by the market at that time and even at present.

In addition to political and national risks, the main impediment to raising funds was the absence of institutional mechanisms for protecting the rights of creditors financing executive bodies of subjects of the Russian Federation and municipal governments. In the event of refusal to fulfill bond redemption obligations by regional and local governments, it was impossible to enforce court decisions made in favor of creditors. The only known precedent was in 2002, when an administration building, which was the property of the Nakhodka Mayor's Office, was seized in accordance with a court decision.

Furthermore, there is no procedure for enforcing the precedence of payment of creditors' interest in the event of default, and there are no mechanisms of control over the use of funds in accordance with the stated borrowing purposes or over the management of reserve funds. Nor is there a system for monitoring investment project implementation and the assessment of risks involved. As a result, the formation of a secondary subfederal and municipal bond market needed for attracting commercial banks' funds and portfolio investment is impossible.

In spite of all this, Russia's subfederal and municipal bond market was one of the few financial market segments that remained active under the conditions of Russia's financial crisis in the second half of 1998, although to a lesser extent.

4.4.4 The Post-Crisis Phase (1999 to the Present)

The paying capacity of regional governments has increased significantly during the last two or three years. Assets of regional and municipal governments are growing rapidly. According to the Bank of Russia, regional and local government bank deposits amounted to 52.2 billion rubles as of November 1, 2000, while their liabilities to the banking system amounted to 21.4 billion rubles. The regional governments' outstanding debt has also decreased significantly.

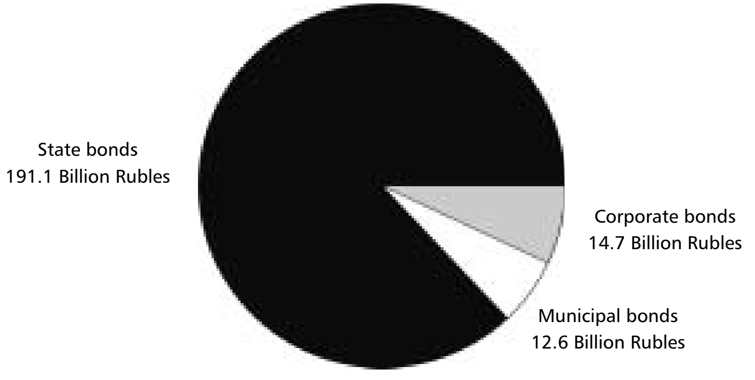
In addition, the numbers of subfederal and municipal bond issues returned to their 1994 level. Regional budget surpluses led to the reduction of the subfederal and municipal bond market by more than 5 billion rubles. A change in the debt structure in favor of bank loans also contributed to this reduction.

Despite the fact that the subfederal and municipal bond market is shrinking, new issuers have emerged while the best-known borrowers of the past are leaving it. In 2001, an excessive supply of fixed-income securities was characteristic of the bond market. The increase in investment seen in 2001 was due to an improvement in Russia's macroeconomic conditions. High international oil prices, political stability in Russia, moderate government borrowing on the domestic market and the subsequent excessive liquidity of Russian banks prompted investment in securities.

In the years since the crisis, yields on the Russian securities market have returned to their pre-crisis levels. Recently, the yields in various segments of the Russian securities market have decreased significantly, including GKO/OFZ yields, regional bond yields (especially yields on bonds issued by Moscow and St. Petersburg), municipal bond yields and yields on corporate bonds, a market segment that is growing again.

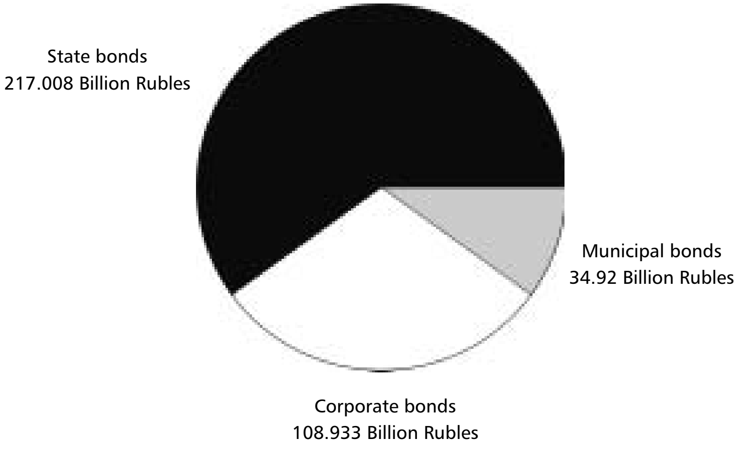
Figures 8.15 and 8.16 illustrate the change in the structure of domestic borrowing from 2001 to 2002, as follows: the share of municipal bonds and corporate securities increased, while the share of government securities shrank.

Figure 8.15
Distribution of the Bond Market (May 2001)



Source: Bankovskoye Delo. #8, 2002.

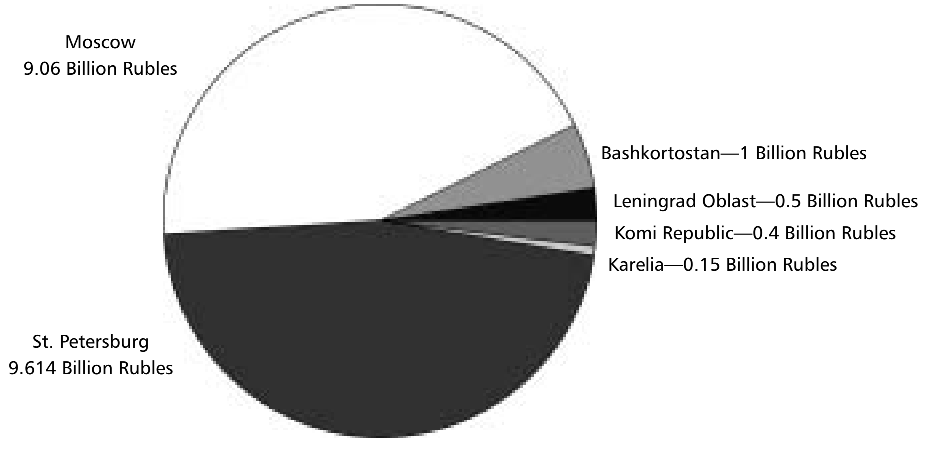
Figure 8.16
Distribution of the Bond Market (December 2002)



Source: Cbonds.Ru. #1, 2003.

Moscow and St. Petersburg accounted for the two largest shares of the municipal bond market, which amounted to about 9 billion rubles each. Moreover, Moscow's and St. Petersburg's shares significantly increased from 2001 to early 2002.

Figure 8.17
Distribution of the Bond Market by Issuers



Source: Bankovskoye Delo. #8, 2002

St. Petersburg's share of the market grew from 3 billion rubles at the start of 2001 to almost 10 billion rubles at the year's end. As of the start of 2001, Moscow's outstanding bonds included only its eighth issue of bonds worth 560 million rubles. However, having had its borrowing program approved, Moscow successfully placed eleven more issues worth 10 billion rubles, two of which are already redeemed. Moscow's municipal bond turnover on the secondary market has also increased significantly.

4.5 Bonded Debt Types

The bonded debt issued by regional and municipal governments can be subdivided by type into the following: bonds similar to federal government short-term bonds (GKOs and OFZs) issued to finance a budget deficit, agribonds, "energy" bonds, savings bonds and Eurobonds.

4.5.1 Bonds Similar to Federal Government Short-term Bonds (GKOs and OFZs)

Mechanisms for the issuance and placement of most of these bonds, as well as the secondary market organization, are similar to GKO and OFZ issue and circulation mechanisms. Bonds of this type are registered securities issued in a non-documentary form. They are placed in series (tranches) by auction or on exchanges. Such bonds have been issued by Moscow, St. Petersburg and other Russian regions in both documentary and non-documentary forms.

Table 8.6

Moscow's and St. Petersburg's Municipal Bond Issues (1992–1996)

Securities Issuer	Issued Amount [Billion Rubles]	Daily Turnover [Billion Rubles]	Daily Turnover as a Percentage of Total Issue
Ministry of Finance (Minfin) of the Russian Federation (GKOs and OFZs)	360,000	4,000	1.11
St. Petersburg city administration	3,000	33	1.1
Moscow city government	2,000	0.755	0.04

Source: Rynok–Tsennye Bumagi Magazine, No. 4, 1998.

4.5.2 Bond Issues for Financing Purpose-Oriented Investment Programs

Subjects of the Russian Federation and local self-government bodies also float purpose-oriented loans in order to finance investment projects in the manufacturing and other sectors.

The most common are housing loans. Housing bonds are issued in small tranches. They confirm that their holders have invested a certain amount of funds to finance construction of a particular housing project. In most cases, such securities are interest-bearing. They are redeemed within several years with housing or with cash. Their redemption is guaranteed by the total amount of new housing built under contract with the administration of subjects of the Russian Federation and by other property and budgetary funds. The interest accrued is paid on the redemption date.

Housing bonds were issued by administrations of the Nizhni Novgorod Region, the Krasnoyarsk Territory and other Russian regions and territories. Most frequently, they were issued by municipalities within subjects of the Russian Federation such as Samara, Omsk, Yaroslavl, Dubna and others.

After Russia's August 1998 crisis, Moscow was the only city that registered a securities issue to finance projects implemented in accordance with Moscow's investment program.

4.5.3 Agribonds and "Energy" Bonds

Agribonds were issued in 1996 by subjects of the Russian Federation against commodity credit provided by the federal government in the amount of 1996-denominated rubles. They were also an attempt to change the existing agri-industrial complex support practices through the conversion of its debt to the Ministry of Finance of the Russian Federation into securities to be sold on the stock market, with the raised funds being transferred to the Fund for Soft Lending to Agribusinesses.

"Energy" bonds of two other subjects of the Russian Federation, the Primorsky and Habarovsk Territories, are similar by origin. These securities are instruments for the restructuring of Russia's debt to the federal government in the fuel and energy complex, into loans provided against the guarantees of territorial governments. "Energy" bonds were fixed-income securities issued in a non-documentary form.

4.5.4 Savings Bonds

Savings bonds are targeted at a particular category of investors—the population of the region that issues them. These securities are coupon bonds issued in a documentary form. Coupon income is paid annually or quarterly. Though savings bonds were successfully issued by Moscow, St. Petersburg, the Astrakhan Region and some other Russian regions, they are hardly a widespread instrument.

4.5.5 Foreign Borrowing

International financial markets attracted Russian securities issuers, including subjects of the Russian Federation, because of a significant demand for debt instruments, longer maturities and the relative cheapness of funds (before the August 1998 crisis) compared to the Russian market. Another factor behind entering international markets was the desire to create a favorable investment image for Russia.

However, few Russian regions will be able to work on the Eurobond market even if it remains attractive to them. Since Russia's capacity to absorb investment is limited, the federal government, when entering the international financial market, would be affected by competition from regional governments. In addition, their borrowing increases

Russia's aggregate foreign debt. The timeliness of repayment of foreign debt liabilities by subjects of the Russian Federation also affects Russia's credit rating and, consequently, the cost of servicing its foreign debt.

Until 2000, Russian legislation imposed no restrictions on local self-government bodies' right to borrow in foreign countries, although no municipal formation managed to use that right. When the Budgetary Code of the Russian Federation came into effect, however, municipalities lost the opportunity altogether.

Table 8.7
Weightings of Various Types of Bonds Issued (1996 and 1997)

	Issue				Nominal Issue Amount			
	Number of issues		% of the Total Number		Billion Rubles		% of the Total Issue Amount	
	1996	1997	1996	1997	1996	1997	1996	1997
GKO-type bonds	34	97	87.2	31.3	10,582.3	16,780.9	98.1	69.04
Agribonds	—	201	—	64.8	—	7,233	—	29.76
Housing bonds	5	8	12.8	2.6	207	151.1	1.9	0.62
Other bonds	—	4	—	1.3	—	140	—	0.58
Total	39	310	100.0	100.0	10,789.3	24,305	100	100.00

Source: Rynok–Tsennye Bumagi Magazine, No. 4, 1998.

4.6 Underwriting

When the first subnational and municipal securities were issued, their placement was made either by appropriate departments of local administrations or governments, or municipal organizations established specially for the purpose. That was possible because municipal securities issued in early 1990s were intended only for a limited number of investors and were never distributed outside the issuer's region. As the municipal bond market grew, securities placement began to require professionalism and the function was thus transferred to professional underwriters. Under current conditions, securities underwriters and secondary-market agents must have a thorough knowledge of the financial market. To work out and successfully implement a detailed plan of the issue, it is necessary to have a thorough knowledge of the market infrastructure and legal aspects of the issue registration. In addition, it is necessary to assess demand for securities, attract attention of potential investors, minimize debt-servicing costs and, finally, ensure liquidity of the secondary market. Dealing with so wide a range of tasks requires professionalism. For this reason, large investment companies based in Moscow and other large cities play an important role in municipal bond distributions. They consult local administrations on all matters relating to the securities issue.

During the last few years, local administrations have been appointing their agents for securities placement, servicing and redemption on a competitive basis. Such agents are charged with the entire scope of work, including the following:

- development of the securities placement and circulation plan;
- preparation of all documents needed for the registration of an issue, as well as its registration;
- organization of municipal bond placements, including preparation, agreement and conclusion of agreements with all major participants in municipal bond placements;
- organization of municipal bond circulation on the secondary market;
- securities servicing and redemption;
- informational support of municipal bond issues.

Table 8.8

Municipal Bonds Underwriters' Rating

	Underwriter	**Volume of Issues [Million Rubles]**	**Number of Issuers**	**Number of Issues**	**Location of Issue (#)**
1	AVK Investment Company	4,520	1	13	Saint-Petersburg (13)
2	RosBank	1,625	3	7	Ufa, Bashkortostan, Moscow (5)
3–4	Zenit Bank	1,475	2	6	Ufa, Moscow (5)
3–4	Trust and Investment Bank	1,475	2	6	Ufa, Moscow (5)
5	Bank of Moscow	1,425	1	5	Moscow (5)
6	Web-invest Bank	1,000	3	3	Komi Republic, Tver Oblast, Moscow
7	Citibank	800	1	3	Moscow (3)
8	Uralsib Bank	550	2	3	Ufa, Bashkortostan (2)
9–12	MDM-Bank	300	1	1	Moscow
9–12	NOMOS-Bank	300	1	1	Moscow
9–12	ING Bank	300	1	1	Moscow
9–12	AMRO Bank	300	1	1	Moscow

Note: The table does not list nine underwriters whose volume of issue was below 250 million rubles.
Source: Cbonds.ru

Participants in such tenders may include only the holders of appropriate licenses for professional activities on the securities markets. Additional requirements for the financial position, qualification and business reputation of participants in such tenders may be set, too. This particular service sector is now growing rapidly.

4.7 Credit Ratings, Rating Agencies and the National Credit-rating Scale

The main component of the debt securities analysis is an evaluation of the issuer's creditworthiness and capability of repaying obligations. The evaluation provides what is known as a credit rating, which performs a specific and limited function: it describes credit risk.

The practice of credit rating is not yet sufficiently developed in Russia. In the pre-crisis period, Russia's regions and some cities, anxious to enter international capital markets, were very much interested in receiving credit ratings. But at present, when the consequences of the 1998 crisis are already alleviated, Russian regions continue to implement a very conservative borrowing policy. As a result, they show little interest in credit ratings, including both international and domestic ones.

The main factor behind Russian regions' indifference to credit ratings is the absence of real benefits from their assignment. The assignment of a credit rating implies that the borrower's financial position is better monitored and the borrower's debt instruments have been thoroughly described. In addition, investment possibilities in the region concerned are made known. But the main factor behind the wide use of credit ratings in international practices is the desire to attract the funds of insurance companies and pension funds. The fact is that Western pension funds and insurance companies are allowed to buy only investment-grade securities. In many countries, there exist regulations requiring that obligatory provisions should be increased for investing in securities issued by borrowers with low credit ratings. Russia's low national risk rating makes it impossible for even the most reliable Russian securities issuers to count on getting an investment-grade rating.

Another reason for getting an international credit rating is to make a Eurobond issue, because Eurobond issues are impossible without a credit rating. However, this reason is irrelevant for a significant part of Russia's regional and municipal administrations. The Budgetary Code of the Russian Federation forbids new foreign borrowing by regional administrations, be they through Eurobond issues or loans from foreign banks.

For these reasons Russian regions can now regard the acquisition of international credit ratings only as an advertising measure, useful either for attracting funds for their foreign debt refinancing or for improving the region's investment profile. Thus, Russian regions now have hardly any reason to have international credit ratings, unless they received them in the past.

Similar factors are behind Russian regions' indifference to the acquisition of Russian credit ratings. But in this case there are additional negative factors, including the absence of Russian rating agencies with significant reputations and the absence of investors, other than banks, who are interested in an independent evaluation of risks of securities issuers. At the same time, bank lending to Russia's regions is in no way dependent on any domestic or international ratings. Such creditors rely more on their informal relationships with regional administrations than on evaluations of their creditworthiness, though of course such practices are unscrupulous. Thus, investors' indifference to the independent risk assessment is the main impediment to further development of rating agencies and a factor limiting reputation-building possibilities for them. The low standing of any credit ratings that have been assigned by Russian agencies reduces demand for them from the borrowers. Moreover, loan provision to a region usually involves evaluation of the borrower's paying capacity by the creditor's internal analytical division.

Finally, violations of spending and reporting procedures by regional administrations may also be a factor behind their reluctance to receive credit ratings. Since rating assignment procedures require that such information be revealed, it may mean trouble for certain regional administration officials. One consequence of the effective absence of demand for domestic credit ratings in Russia is that the agencies will voluntarily assign credit ratings at their own expense as an agency advertising measure, or sometimes the rating is requested and financed by international financial institutions whose goals include development of the Russian financial market infrastructure.

S&P international and Russian credit ratings for Russia, the Russian regions and local administrations are presented in Table 8.9.

The issuance of regional and municipal securities is expected to increase in Russia as Russia's economic situation improves. The regions and cities are very much in need of funds for investing in their economies. Moreover, the regional administrations' need for investment resources will increase as the Russian economy stabilizes. It will be impossible to meet these needs using only bank loans. On the other hand, as the Russian economy stabilizes, new securities market participants will be emerging in Russia. They will create demand on fixed-income instruments issued by regional and municipal administrations.

Additional grounds for this conclusion are provided by another indicator, the relationship between loans of all types raised by regional administrations and their consolidated revenues. According to the Ministry of Finance of the Russian Federation, as of January 1, 2001, the total (foreign and domestic) consolidated debt of subjects of the Russian Federation amounted to 97,911 billion rubles, while their domestic debt amounted to 68.1 billion rubles, of which non-market forms of borrowing (guarantees and sureties) accounted for 31.4 billion rubles. At the same time, the consolidated regional budget revenues amounted to 1.032 trillion rubles. It is obvious that at present the ruble part of the market-sector debt of subjects of the Russian

Table 8.9
International (S&P) and Russian Credit Ratings

International Credit Rating			
Securities Issuer	**Date of Assignment (Last Upgrading/ Downgrading)**	**Foreign Currency/Outlook**	**Local Currency/ Outlook**
Russia's Sovereign Credit Rating			
Russian Federation	February 22, 2002	B+/Positive	B+/Positive
International Credit Ratings of Russia's Regional and Local Governments			
Republic of Bashkortostan	November 13, 2002	B/Positive	—/—
Irkutsk Region	October 3, 2001	CCC+/Positive	—/—
Moscow	February 22, 2002	B+/Positive	—/—
Nizhni Novgorod Region	September 6, 1999	Credit rating withdrawn	
Rostov Region	July 31, 2000	Credit rating withdrawn	
Samara Region	November 13, 2001	B/Positive	—/—
St. Petersburg	February 22, 2002	B+/Positive	B/Positive
Sverdlovsk Region	August 23, 2001	CCC+/Positive	CCC+/Positive
Republic of Tatarstan	October 9, 2001	CCC+/Positive	—/—
Khanty-Mansi Autonomous District	March 7, 2002	B+/Stable	—/—
Yamal-Nenets Autonomous District	May 8, 2001	CCC+/Positive	—/—
Russian Credit Ratings			
Securities issuer	Date of assignment (last upgrading / downgrading)	Issuer's Rating	
Russia's Sovereign Credit Rating			
Russian Federation	February 22, 2002	ru AA+	
Russia's Regional and Local Governments' Credit Ratings			
Khanty-Mansi Autonomous Region	March 7, 2002	ru AA	
Cherepovets	January 28, 2002	ru BB	

Federation (36.7 billion rubles) is quite insignificant, compared to their budget revenues. Even such coarse estimates testify to a significant potential capacity of the regional debt market.

This will eventually make it necessary for regional and local administrations to receive credit ratings. As a result, Russia's regional and local administrations will become the largest group of Russian credit agencies' clients.

International rating agencies actively began to expand their activities in Russia in the mid-1990s, when they began to assign credit ratings to Russian banks, industrial enterprises and subjects of the Russian Federation. Subjects of the Russian Federation have credit ratings from Moody's, Standard & Poor's and Fitch IBCA. A number of Russian rating agencies were also established at that time (e.g., EA Ratings, the AK&M rating center, the Interfax Rating Agency, EXPERT RA and the MFK-Renaissance Rating Agency).

On December 9, 2002, the AK&M information and analysis agency and the Expert RA rating agency announced the establishment of the Expert RA-AK&M rating consortium. The consortium's purpose is the assignment of credit ratings to subjects of the Russian Federation and municipalities, and it plans to use a proprietary technique developed by AK&M and Expert RA specialists in early October, 2002.

The relatively short time that has passed since the beginning of the development of market-economy institutions in Russia is hardly sufficient for Russian rating agencies to establish a reputation. No matter how high its specialists' analytical skills are, any Russian agency is going to lose when compared to a large international agency. To change this situation, strategic partnership (affiliation) mechanisms can be employed. Such partnerships can make it possible for a Russian rating agency to hold the reputation of its international strategic partner by guaranteeing uniformity of practice in certain essential areas such as credit-risk assessment techniques and procedures, and business ethics standards.

One example of such a relationship is the affiliation agreement between the Euro-Asian Rating Service (EA Ratings) and Standard & Poor's, concluded in August 1998. The agreement provides for a joint marketing policy of the two agencies, uniform business ethics standards, uniform techniques and procedures, division of functions (Standard & Poor's is responsible for the international, and EA Ratings for the domestic ratings), the procedure for the use of Standard & Poor's "brand" by EA Ratings and the approaches of EA Ratings' integration into Standard & Poor's international structure.

One important attribute of a rating agency is its own rating scale, which is the main element distinguishing it from any information agency. It is the rating scale and the corresponding definitions for each category that allow an agency to assign ratings, as distinguished from ranks, which are frequently mistaken for ratings.

The national scale allows greater differentiation and more precise comparison of risks associated with different securities issuers and their debt in the country concerned.

The national scale is especially important when, as a result of a high national risk and other factors, borrowers' international credit ratings are low and the application of the international scale cannot provide sufficient differentiation of risk levels. It is also important in situations when domestic borrowers and investors dominate the country's financial markets. In addition, the national rating scale provides a greater range of domestic credit ratings. For example, Standard & Poor's international ratings have stayed within the D -CCC+ range during the last two years, but the national rating scale can provide a greater range of creditworthiness levels

On December 6, 2002, Russia received the highest rating in her history from Standard & Poor's international rating agency: BB for foreign currency obligations and BB+ for obligations in the national currency. The letter rating is the highest in the high-risk category. It is only one grade below the investment grade rating BBB-, which already allows conservative foreign investors, such as pension funds, to invest on the Russian securities market. Moody's international rating agency has also announced that it can upgrade Russia's credit rating by two grades, i.e., to its highest rating in the risk group. At present, Russia has Moody's Ba3 rating, which is three grades below the investment-grade rating group. Upgrading Russia's rating by two grades to Ba1 will raise Russia's rating to a level higher than it was from 1996 to 1998.

For Russian securities issuers, the costs of receiving a domestic credit rating are significantly lower than the costs of receiving an international rating.

Standard & Poor's Russian credit-rating scale, which was developed to meet the needs of borrowers, guarantors, sureties, business partners, financial intermediaries and investors operating on the Russian financial market, is a tool for evaluating creditworthiness of Russian borrowers under conditions of Russia's financial market. Based on the national credit-rating scale, credit ratings may be assigned to both borrowers and their debt. Standard & Poor's credit-rating scale for Russia uses Standard & Poor's traditional symbols with the prefix "ru" to denote Russia and to specify that these ratings are intended solely for Russia. The national and international rating criteria are similar.

However, certain national risk factors are less significant when Standard & Poor's national scale for Russia is applied. When such risks will affect all Russian borrowers equally, they are practically disregarded by Standard & Poor's national scale for Russia. Russia's national risk is taken into account only in the context of the Russian market and to the extent of its impact on a particular borrower, which differs from the impact on other Russian borrowers. As a result, Standard & Poor's Russian national ratings can not be directly compared to their international ratings or to ratings assigned in accordance with some other national scale.

Standard & Poor's national ratings for Russia are a current evaluation of the general creditworthiness of a securities issuer, guarantor, surety or business partner, as well as the assessment of their ability and willingness to fulfill their obligations in full and in due time as they mature, as compared to other Russian borrowers.

4.8 Regional and Municipal Borrowing Prospects

Many of the subjects of the Russian Federation and municipalities are continuously in need of funds for financing their economic and social programs. With a growing concentration of revenues at the federal level, the amount of funds left at the disposal of subjects of the Russian Federation and municipalities is decreasing. The funds they retain are sufficient only for wage payments to employees on the government payroll and for the minimum needed to maintain the social and cultural facilities and the utilities and housing sectors in their areas. Since the accident rate in the utilities, housing and social and cultural sectors has increased significantly, the problem of renovation of the obsolete infrastructure in these sectors (whose depreciation amounts to 80%) has become especially acute during the last few years. For this reason, the regional and municipal governments will have to look for additional sources of finance in the years to come, and their return to the bond market is only a matter of time. Other factors promoting such a return include the following:

- investors' interest in new securities market instruments, which has arisen because of an acute shortage of financial market instruments under conditions of high liquidity in the banking system;
- a sharp reduction in interest rates, which on the one hand makes borrowing more attractive for regional and local governments, and on the other compels investors to look for new, more lucrative investment opportunities and instruments;
- current conditions making it possible to borrow funds for longer terms: while before the crisis, investors were reluctant to invest for time periods longer than twelve months, now they show interest in longer-term investments of from three to five years (recent issues have typically been for multi-years periods, while the maturity of issues in 1997 or 1998 was normally for only a few months—see Table 8.10);
- the rather inactive behavior of the federal government on the securities market, which creates favorable conditions for subfederal and municipal securities placement;
- large new borrowings, possible due to the relatively small liabilities of most of the subjects of the Russian Federation and municipalities;
- the establishment of a uniform subfederal and municipal bond trading system in Moscow and St. Petersburg, which helps attract more investors through increasing market liquidity and reducing interest on such bonds;
- significant bank account balances, which form an investment potential.

Based on the above, we can conclude that the revival of the subfederal and municipal bond market is likely to begin in the near future. It will be accompanied by a significant growth in the number of subjects of the Russian Federation and municipalities using market mechanisms for the purpose of raising funds.

Table 8.10
Municipal Bond Maturities (1997–2002)

Year of Issue	1997	1998	1999	2000	2001	2002
Median	1 year	1 year	1 year	2 years	2.5 years	2 years
Maximum	25 years	10 years	5 years	5 years	5 years	9 years
Minimum	3 months	6 months	2 months	3 months	1 year	2 months

Source: Ministry of Finance of the Russian Federation.

In October 2002, St. Petersburg issued bonds with a nine year maturity and an annual yield of 19.34%. The placement of that issue was more successful than the seven year maturity issued in September. The Cbonds consulting company based in St. Petersburg assumes that successful distribution of that issue was possible because banks possessed idle resources. Nevertheless, analysts tend to consider this maturity term too long for the present bond market in Russia. Only St. Petersburg can succeed in the distribution of such issues because of its exclusive credit history and financial standing. Overall, a maturity of five years seems to be a real investment horizon.

In 2002 there was a significant increase in the volume of regional and municipal bonds at the end of the year. Both economic and technical reasons can explain this. Regional and municipal authorities, on having registered their bond issue in the current year, would try to execute the placement of at least the first tranche before the end of the respective year.

There are 23 bond issues planned for 2003 by municipal and regional governments. This number includes three issues by Moscow city, one by St Petersburg and two by other, non-metropolitan cities (Volgograd and Ufa). The remaining 17 issues are planned at the regional level.

Although the potential debt of regional administrations and local self-government bodies may be rather large (up to US$30 billion), the actual capacity of the subfederal bond market that can be achieved in the future is much smaller. According to expert estimates, the maximum capacity of that market can be estimated at 100 to 200 billion rubles (Eurobonds included).

5. CONCLUSIONS

Nearly all subjects of the Russian Federation and a significant part of Russia's municipalities have substantial borrowing experience. During the last ten years, the regional and municipal administrations have used various debt instruments for their borrowing purposes, including ruble-denominated bonds, bills of exchange, ruble- and foreign-currency denominated bank loans, guarantees and sureties, and budgetary loans from budgets of higher levels. Moscow, St. Petersburg and Nizhni Novgorod have issued Eurobonds.

During the years of Russia's radical economic reforms, the subfederal and municipal debt market passed through various phases of development. The most rapid growth in the debt market was from 1992 to 1998. At this time, Russia's regional and municipal governments were actively operating on the capital market where they raised both ruble and hard-currency amounts. Russia's systemic financial and banking crises and a 70% devaluation of the national currency caused numerous defaults on the regional and municipal levels. Some regions have not yet repaid their debts accumulated in the pre-crisis period.

In the post-crisis period, regional and local administrations' activity on Russia's financial markets has been sluggish, in large part due to the tightening of Russia's budgetary legislation through the restrictive provisions of the Budgetary Code, and the negative borrowing experience and lost confidence in Russia's debt markets. At present, only a few subjects of the Russian Federation are actively operating on the debt market. They include Moscow, St. Petersburg and the Republic of Bashkortostan. Lately the number of non-metropolitan cities borrowing money on the bond market has shrunk to only two, Ufa and Volgograd. The gross increase in the bond market has been achieved by market expansion in Moscow and especially St. Petersburg. Provincial cities are reluctant to choose bonds as a financial tool. Furthermore, there are few examples of recurring bond issues among provincial cities, one exception being Volgograd.

Russian regions' and municipalities' experience in borrowing may serve as a lesson. The following widespread mistakes in borrowing practices should be noted:

- The Budgetary Code's regulations on the debt management policy of Russia's regions and municipalities were frequently violated. Many municipalities failed to keep properly organized debt books, and the information contained in them is unavailable to the public. The restriction on the total amount of debt is frequently violated. Moreover, the federal and regional governments apply no sanctions to violators. Without sanctions, municipal administrations are hardly working hard to eliminate such violations.
- Most Russian cities do not have any borrowing strategy, which results in the absence of medium-term (three- to five-year) borrowing plans. The same can be said about Russia's regional governments.
- One result of the absence of a municipal borrowing strategy is an inadequate municipal debt structure. Debt instruments are inconsistent with the respective investment programs. In most cases, short-term debt to a small group of creditors accounts for the greatest part of municipal debt. Such debt needs continuous refinancing. This situation has occurred due to difficulties in obtaining long money rather than bad management.

- Regional and municipal administrations often use borrowed funds to finance commercial projects which business people regard as too risky. Such use of borrowed and, more generally, budgetary funds can seldom be justified. Apart from debt refinancing, the greatest part of budgetary funds is used for wage payments, current repairs and other non-capital spending purposes. This contradicts an indirect requirement contained in the Budgetary Code.
- Most regional and local administrations have no criteria (indicators) with which to assess the efficiency of borrowed funds. For this reason, irrespective of the results achieved, there is really no objective information available to local or municipal officials, or to deputies of the local legislative assemblies and taxpayers, that would make it possible to assess borrowing purposes, strategy and quality of management of borrowed funds.

But there are a number of positive factors that make it possible to hope for favorable developments in municipal borrowing in Russia. These factors include the following:

- Even under the conditions of Russia's financial crisis, a number of regional and municipal administrations managed to maintain their favorable credit history, continuing to service and issue debt. Such borrowers include Moscow and St. Petersburg. These borrowers managed to create a rather liquid market for their bonds, which made debt management significantly easier for them.
- Regional and municipal administrations are in need of funds to finance their investment projects, and for their part, investors are interested in further growth in the securities market. At present, Russian commercial banks have to keep huge amounts of funds in their correspondent accounts in the Central Bank because of the inadequate condition and liquidity of Russia's securities markets. Since the federal government securities market is small and slow-growing, the present situation is favorable for the development of the subfederal and municipal bond market.
- Efforts of Russia's monetary authorities and especially its Central Bank reduce inflation and interest rates. This makes bank loans more attractive to regional and municipal administrations than securities.
- Macroeconomic stabilization makes it possible for securities issuers to switch from short-term borrowing to medium- and long-term borrowing that is already comparable to investment cycles and, in some cases, with the life cycles of the new facilities introduced into operation. Bank loan terms will also increase, as macroeconomic stabilization allows for longer terms. One-year bank loans have become usual, three-year terms are less frequent though widespread in the corporate sector, and St. Petersburg has placed securities with seven- and nine-year maturities!

6. RECOMMENDATIONS

In this current phase, it is possible to formulate a number of recommendations addressed to municipal administrations. The implementation of the following recommendations could help promote further development of the system of municipal borrowing.

Municipal administrations must plan their debt management policy in a way that ties it to their fiscal and investment policy:

- Short-term borrowing should be used for financing temporary budget gaps, and long-term borrowing for financing investments (first of all, in infrastructure development and housing construction projects).
- Local administrations should not use borrowed funds for financing projects that fall outside their jurisdiction and commercial projects.
- Optimal debt structure and management of risks associated with debt are essential.
- Special attention should be given to the commitments of local administrations. They should be more careful in furnishing guarantees.

The same recommendation is elaborated in more detail below.

In planning for debt management, municipal administrations must clearly formulate their debt policy objectives and prepare long-term plans (minimum five years) for the repayment of their obligation and for raising new funds. Since the borrowing plan must very much conform to the financial investment plan, while the servicing and repayment is financed from the current budget revenues (and, possibly, through debt refinancing), the debt management plan must agree with the investment and fiscal plans. Administrations must realize that borrowing funds can open the possibility of increasing other spending such as, for instance, wage payments.

The debt management plan must include not only unconditional obligations (bank loans, bonded loans and bills of exchange), but also conditional obligations (guarantees and commitments of government and municipal enterprises).

The debt management strategy must be based on an analysis of the prospective debt structure with a breakdown by type of debt, debt-holders' structure and the repayment schedule for the near future (at least for the term of the debt with the most distant maturity).

The debt strategy must be based on an analysis of the main debt plan targets' sensitivity to changes in interest rates on borrowed funds, amount of budget revenues and budget deficit. Municipalities that to a great extent depend on one or several taxpayer enterprises must analyze their debt plan's sensitivity to prices for the products of those enterprises (oil, gas, mineral raw materials and metals). If such enterprises are exporters, the sensitivity analysis may be based on the international prices for the respective goods and the ruble/dollar rate. Quite often, large taxpayer enterprises in the extracting industry are parts of vertically integrated companies. In this case, an analysis of the sensitivity of budget revenues to changes in the parent company's profit consolidation policy may be performed (application of the "transfer prices" which are lower than fair-value prices in the oil sector has a significant impact on municipal administrations' revenues).

Financial resources borrowed for terms shorter than twelve months must be used exclusively for financing the revenue-expenditure gap. Such borrowing must be reduced to a minimum through effective budget revenue and expenditure management. It is not recommended to finance long-term investment projects (with terms longer than twelve months) through short-term debt issuance. Such practices involve significant risks of debt refinancing at an unaffordable cost.

Long-term borrowing may be used for investment in social infrastructure, housing construction and, in some cases, for refinancing debt in order to optimize its structure. Long-term borrowing must be the basis of municipal administrations' debt management strategy.

The practice of financing current spending, commercial projects and financial investments with long-term debt involves unacceptably high risks. With respect to financial investments, however, it is reasonable to invest temporarily free funds in reliable financial market instruments such as government securities. In some cases, municipal administrations' participation in commercial projects may be justified. The same may apply to cooperation with large companies and banks who may be interested in local administrations' participation in certain projects because their participation may reduce political risks and, probably, provide opportunities for the use of the so-called "administrative resource."

Debt structure is especially important because it determines the main risks associated with borrowing. The general requirements for a sound debt structure are as follows:

- Long-term debt must form the basis of municipal administrations' debt;
- The structure of debt must ensure the most even distribution of annual interest payments and principal repayment;
- If debt-servicing payments will peak at a certain time, administrations must provide for the accumulation of financial reserves. The funds accumulated in the reserve funds should be temporarily invested in the most reliable financial instruments, such as government securities;
- The structure of the municipal administrations' debt must be diversified as much as possible by type of debt instrument and creditor;
- Priority treatment of some debt instruments compared to others is permitted only if it is provided for in the terms and conditions of borrowing.

Conditional obligations of local administrations must be distinguished by:

- Guarantees and sureties issued by the administration;
- Debt instruments issued by enterprises and organizations fully or partly owned

by local administrations and for whose obligations the owner will carry secondary liability in the event of their bankruptcy though the owner's fault in accordance with legislation of the Russian Federation.

It follows from this that municipal administrations must monitor the financial positions of its subsidiary enterprises in order to know the amount of debt arising in connection with such enterprises.

Guarantees and sureties must not be used as a deferred payment instrument in cases when administrations know in advance that there are going to be events causing this debt instrument to become an unconditional obligation.

Preferably, local administrations should provide guarantees and sureties to borrowers who raise funds to finance construction of infrastructure facilities in order to help them enter capital markets and reduce borrowing costs. Provision of guarantees to commercial enterprises operating in a competitive environment (manufacturing, trade, agricultural and financial services) is undesirable.

Provision of guarantees of performance of third parties' obligations can be recommended only in cases when municipal administration has the resources to take a greater debt burden and in the following cases:

- When a guarantee is a precondition for the provision of funds by an investor;
- When the administration's guarantee reduces borrowing costs significantly.

Local administrations must provide guarantees and sureties on a compensatory basis. In such cases, administrations receive compensation for risks borne in connection with the guarantee issued, while the borrower has to make a reasonable decision about whether to apply or not apply for a guarantee.

Local administrations must have clear guarantee and sureties provision criteria approved by appropriate documents. Such criteria should include spheres of activity, purposes of borrowing and levels of paying capacity of enterprises that are appropriate to the purpose.

Reserves for the guarantees issued must be created to the extent of the risk of the principal's probable default (in accordance with the principle applied by financial institutions) rather than for the full amount of obligations whose performance is guaranteed in the following year.

NOTE

[1] In this case, the administration knows in advance that the end borrower will never fulfill its obligations.

PART III.

Comparing International Experiences: Emerging Markets of Local Borrowing?

Pawel Swianiewicz

Table of Contents

Comparing International Experience: Emerging Markets for Local Borrowing?

Paweł Swianiewicz

Local government borrowing is still a relatively new phenomenon in Central and Eastern Europe. With few exceptions, cities and communities were not allowed to borrow before 1990, nor did they have any communal property separate from state-owned property that could be used as collateral. In some countries this situation continued beyond 1990. Hungary, where local borrowing has been a real (or at least legally possible) option since the economic reforms of the 1980s, is perhaps the only significant exception to this.

The new possibility of using credit instruments came during a very difficult period. First, the beginning of 1990s was very difficult from the macroeconomic point of view. A rapidly decreasing GDP made public revenues unpredictable, and a high inflation rate pushed up the interest rate. Second, the banking sector was very weak, and banks themselves were trying to learn how to behave in a market environment. Understanding the nature of local governments and their financial needs was also quite low on the list of priorities of banking specialists. Third, the institutional setting for local government finance was far from stable. One needed to wait for basic stabilization of institutional rules before even thinking about borrowing, especially for multi-year periods. Fourth, new local administrators and politicians had to learn how to operate in market conditions. They usually had very little experience in management in general, and in financial planning in particular. In countries where the turn-over of local elites was lower the situation was not much better—on the contrary, old habits from the planned, command economy provided an important barrier to learning how to use credit instruments. All of these problems have been mentioned in the individual country reports and will also be discussed later in this chapter.

But there was one more—to a large extent psychological—factor which should be drawn to attention. In some of the countries, new local governments found that they had inherited a high budget deficit from the previous communist administration. The deficit was not related to bank credits but to unpaid invoices or other financial obligations that could not be covered by current revenues. Without having any statistical data describing the extent of this phenomenon, we do know it has been quite widespread. In 1994 there was a competition announced for memoirs of mayors and councilors in the Czech Republic, Poland and Slovakia (Surażska 1995). One of winners, mayor Zbigniew Grzesiak from Mińsk Mazowiecki in Poland, wrote the following:

> In his report presented during the first meeting of the city council, the departing mayor presented a very optimist picture of local finances. However, after summing up revenues and liabilities I realized that our arrears were over 1 billion of [old] Polish zloty [about USD 100,000—P.S.], the execution of revenues was close to 35% of the plan...the bank account was empty and new revenues were just being spent on wages and salaries (actually, they were not even sufficient for this purpose). I made a decision to stop all investments and to cover only a minimal level of operating expenditures.

This phenomenon was by no means limited only to Poland. One of the Slovak mayors wrote:

> When I learned about our financial situation I immediately understood why I had no counter-candidates in the mayoralty election. I realized it when I received the first bank account statement. I was scared to learn that our account was empty. But that was just the beginning. I then realized that we were indebted for over 300,000 Slovak koruna [about US 10,000—P.S.]. It was the beginning of the year and it was quite probable that our revenues would be immediately taken by the bank. We would not even have been able to pay salaries (Malikova, Bucek 1996).

Coping with such a deficit was often a first test for new local authorities. This task was especially complicated because of the macroeconomic situation and lack of experience of the new elites, mentioned earlier. The fact that most local governments successfully solved their problems is really impressive. But one can risk a claim that this experience influenced new mayors' and administrators' approach to financial planning. It contributed to the development of defensive budget planning and resistance to any form of borrowing, and this reluctance became an important aspect of the administrative culture. In Poland it took several years to change this attitude.

So what is the current picture of local government borrowing in the countries of Central and Eastern Europe?

Before turning to the more detailed picture we should make one explanatory comment. A common characteristic of decentralization reform in CEE countries has been a strengthening of the lowest (municipal)[1] tier and a weakening (if not the abolition) of the upper tiers (county, regional). Consequently, local borrowing is mostly an activity of the municipal tier. In Poland the borrowing of county and regional governments is minimal, although still growing. These are very new tiers of self-government, created in 1999. But even more importantly they account for only a small fraction of total municipal spending, their investment spending is even lower, and their revenues are highly dependent on transfers from the central government. The same observation is even truer for Slovakia and the Czech Republic, where regional governments are even younger. In Estonia the municipality is the only tier of self-government. In Hungary the role of counties is extremely limited, and so is their significance on the capital market. The role of counties in the provision of services is much more important in Romania; however, Romanian counties have also remained inactive on the borrowing market. The picture is much more complicated in Russia, where the scale of the country is different and territorial organization is difficult to compare with the rest of the countries analyzed.

1. BORROWING REGULATIONS

The present picture of borrowing regulations in the seven countries examined in the book is summarized in Table 9.1.

The overview presented in Table 9.1 offers only a snap-shot of a fast-changing situation. In many countries regulations on local borrowing have been changed several times during the last decade and are still far from being stable. Central governments responsible for these regulations have been in a learning phase. Central officials may not have understood the conditions for development of a debt market, but as they have learned, through both the good and bad examples of local government borrowing, the regulations have also been fine-tuned.

One can distinguish among several dimensions of regulations, which are presented in the table and analyzed briefly below:

- For what purposes can local governments borrow?
- What is the limit on the level of debt?
- What other conditions do local governments need to follow? What is the supervision over local borrowing?
- How are potential insolvency situations regulated?

1.1 Borrowing for What?

In most of the countries analyzed it is legally required that the sole purpose for long-term borrowing (i.e., with a maturity period longer than one year) must be capital spending. This is in line with the classical "golden rule" of the balanced budget, discussed in Chapter 1, and applies to Estonia, Slovakia, Romania and Russia. Short-term borrowing is permitted for the easing of temporary cash-flow problems, but usually such loans must be paid during the same budgetary year. In some countries (e.g., Romania) such

Table 9.1
Summary of Borrowing Regulations

	Czech Rep.	Estonia	Hungary	Poland	Romania	Russia	Slovakia
For capital or operating purposes?	Both	Long-term for investments only, but no separation of capital budget.	Both	Both	Long-term for investments only, but no separation of capital budget.	Long-term for investments only, but no separation of capital budget	For investments only.
Limit of overall debt	No limit	60% of net revenues (without state earmarked grants)	No limit	60% of total revenues,	20% of current revenues; short-term: 5%	Annual budget revenues	No limits, but from 2005—60% of current revenues; state-supported loans not included
Limit of debt service	No limit	20% of net revenues	Adjusted current own revenues net of short-term commitments and liabilities	15% of total revenues	No limit	15% of total expenditures	No limits, but from 2005—25% of revenues; state-support loans not included
Sanctions for not respecting	Not applicable (no limits defined)	Since 2003—possibility of holding state fund transfers	Effectively no	Effectively no, but ex-ante control of Regional Audit Offices	No sanctions defined	No sanctions defined	Not applicable (no limits defined)

Any other conditions	Forecast balance sheet for 2–5 years; internal audit; guarantees by local govt. prohibited, with some exceptions	Presentation of development plan; guarantees by local govt. prohibited	"Core properties" cannot be used as collateral	Limits applying when public debt exceeds 50% GDP		Maturity not exceeding ten years. Limitation of the budget deficit	Ministry of Finance ex-ante approval of credits over US 2 million is required
Comments	Limits were introduced for short periods only—in part of 2002 debt servicing no larger than 15% of budget revenues	Debt of municipal companies not included in the limits	Debt of municipal companies not included in the limits (unless formal L.G. guarantees exist)	Debt of municipal companies is not included in the limits (unless formal L.G. guarantees exist)	All types of borrowing—only since 1999		Guarantees by local governments prohibited

short-term returnable support is provided by the State Treasury, while in others local governments need to rely on commercial banks.

However, it should be noted that in most CEE countries, current and capital budgets are not strictly separated from each other (Slovakia provides a positive exception to this rule). As fiscal federalism theory argues (Musgrave, 1959; Mikesel, 1982), this makes effective implementation of the "golden rule" doubtful (see Chapter 1). Even if current practice does not provide many examples of local governments wanting to use loans to cover operating costs, it may become an issue in the future. But the "golden rule" is broken from time to time, and current examples of this are given in Chapter 8 (Russia) which notes frequent cases of "using borrowed funds for making wage payments and financing routine repairs and other non-capital expenditures." To large extent this is due to insufficient supervision of local finance, but the lack of clear separation of capital and current budgets definitely contributes to difficulties in establishing such a supervision system.

But there is another group of countries—the Czech Republic, Hungary and Poland—in which the law does not limit the purpose for borrowing. Local governments can legally borrow not only to finance their investments, but also to cover needs related to their operational spending. The clear intention in these countries is certainly that investments remain the main purpose of taking bank credits or issuing municipal bonds, and in practice most borrowing is for local capital investments. (Exceptions to this are discussed in the country reports.) In this chapter, therefore, we will focus on local government borrowing as a potential source of capital investments.

We should remember, however, that in addition to the different forms of loans and credits as well as bond issues in Central and Eastern European countries, there is also one more form of local government indebtedness—namely, arrears in payments (of salaries, of social benefit payments, of user charges for utility services). Although it is not the main focus of this book, we briefly discuss the issue in section 2.2 of this chapter.[2]

1.2 Limitations on the Local Debt Level

In most of the countries limits are set on the overall level of debt and/or debt service, with two significant exceptions: the Czech Republic and Slovakia (but in the latter case they will be introduced in 2005).

In the remaining cases, the most typical limitation is a set proportion of annual debt service[3] in total (or current) revenues of the local budget. In some cases, loans which are guaranteed by the state are treated differently and do not count in the total debt limit.

In Poland and Estonia the level of local government debt is additionally limited by the overall proportion of accumulated debt to total budget revenues (in Poland) or to budget revenues excluding state grants (Estonia).

One more macroeconomic limitation exists in Poland, where the overall level of public debt cannot exceed 60% of GDP. This regulation has been written into the Constitution and is repeated in the Law on Public Finance. If public debt is larger than 50% of GDP, certain additional barriers to taking new loans apply. The constitutional limit does not distinguish between central and local debt, and in practice it may happen that fiscal policy of the central government would impose limitations on local borrowing even if local government behaviour is very prudent and their level of debt is low. It should be added that the Polish method of debt calculation is stricter than that applied in EU countries. The main difference is related to the treatment of guarantees granted by local governments to other creditors.

There is one more important issue related to the debt level. In several countries, public utility companies (even if owned by local governments) are separate legal entities, and their credits do not count toward the limits set for local governments. In practice, however, the local government guarantees these loans and its intervention is required in case of difficulties in repayment. If the guarantee is a formal one, then the credit is taken into account in determining the position of the local government against the legal limit of local debt.[4] But more typically, such a credit is not formally connected with the local budget, although the guarantee exists indirectly both in the consciousness of the bank offering resources and through ownership rights of the communal property. This issue was extensively discussed in the chapters on Hungary and Poland. Similar problems also occur in some other countries of Central and Eastern Europe such as Serbia (Meekel, 2003), but also in West-European countries such as Germany.[5]

In spite of this last issue, limitations on the level of local debt in the countries analyzed could be arranged on a scale where the rules imposed in Poland are the strictest, while those in the Czech Republic are the most liberal.

1.3 Supervision over Local Borrowing

Strict formal rules on the debt level do not necessarily ensure the expected result. The most typical limit operates as a proportion of total current budget revenues, excluding grants. But this requires sound projections of future revenues, and if there is no external control on such prognosis, there is sometimes a temptation to engage in "creative accounting" (or rather "creative financial planning") that will allow for higher credits. In some cases, limits do exist and yet nothing happens because they are not observed in practice.

Implementation of the adopted rules seems to be a weak point in most of the analyzed countries. A recent regulation in Estonia allows for the withholding of state grants as a punishment for local policy leading to excessive indebtedness. But it remains a theoretical option that has not protected against several cases of debt levels higher than formally allowed by law. Given these circumstances, it is not surprising that some specialists argue for the introduction of ex-ante control to monitor whether legal limits are followed.

In some countries the absence of a reporting system and of good information impedes the effective execution of adopted rules and limits. In Romania the approval of a special Committee is required for external borrowing (from foreign banks), but other borrowing is just reported to the Ministry of Finance and this function is poorly performed. The central information on local borrowing is incomplete and not very reliable.

In Poland projections of future revenues and debt service are checked by Regional Audit Offices (RIO). Their qualifications to analyze creditworthiness are often questioned, but at least "creative accounting" involving unrealistically inflated estimates is not possible. In practice, however, even this regulation does not prevent individual cases of local debt that is higher than allowed by law (though one has to admit these cases are not numerous). If such a situation continues for a long time, and attempts to improve the fiscal position are unconvincing, a procedure for imposing a state commissioner to administer the municipality for a limited time may be initiated.

As noted above, in Russia there have been cases of using borrowed funds in ways that are counter to law. The poor supervision and execution of existing legal regulations may be related to this situation to a large extent.

1.4 Regulation of Insolvency Situations

In some of the analyzed countries there are special regulations on debt-problem situations. The most comprehensive and most interesting is probably the system in Hungary, where a special Debt Adjustment Act regulates situations in which the debt is more than 60 days overdue. The first stage of the procedure is an attempt at agreement with a creditor. If this proves to be unsuccessful, the court may decide on the auctioning of marketable assets, but so called "core properties" of the local government are exempted. The state budget may provide temporary support in order to pay interest on local loans, but this support is given as a loan, not a grant. In the last seven years the Debt Adjustment Act procedures have been initiated in about 16 cases.

In Slovakia as well, liability not paid within 60 days is a threshold initiating a special action. An additional requirement here is that overdue liabilities exceed 15% of current local revenues. Slovak law requires the preparation of a "recovery regime." If such a regime is not introduced by local government itself, or if its implementation does not lead to improvement in the situation within 120 days, the central government may appoint an administrator. In practice, problems with payments arose in both small municipalities and big cities, but the latter cases were more frequently discussed. The second largest Slovak city, Košice, was supported by a loan of almost US$20 million from the central government, and many observers were afraid that this might set a precedent for demands from other local governments. Another major city that has faced severe difficulty is Banská Bystrica, but in this case recovery was possible through the implementation of an agreement with banks involving dramatic cut-backs and without extraordinary support from the state.

In the Czech Republic local governments cannot go bankrupt, but during the last few years there have been cases of the auctioning of local government property. There have also been cases where local governments have had serious difficulties with repayment of their liabilities. Two were related to problems with serving bond issues (one of them, Rokytnice nad Jizerou, failed to repay its bonds). Both occurred during the period when approval from the Ministry of Finance was formally required, which suggests that direct, administrative control of central regulation over local borrowing is not always an efficient means of regulation.

Regulations on debt service difficulties in Estonia are not very clear, either. In practice, municipalities often apply for state support, but lending from the state budget is not legal (it was permitted only in 1994–1996). However, central government may support local governments indirectly through the Regional Development Agency or through the ownership reserve fund, and there are cases of such support noted in Chapter 6. A newly drafted law provides a role for the court in management of the finances of a local government having problems with serving its debt.

In Russia, federal authorities have several measures for intervening if a municipality is unable to serve its debt. The fiscal agency of the Russian Federation can order an audit or even take over control of the execution of the local budget. The latter remains doubtful, however, since some observers claim it is in contradiction with the Constitution of the Russian Federation.

Poland does not have special legal procedures for insolvency situations, but in practice there have not been many occasions to call for such regulations, since debt service has usually been timely.

1.5 Borrowing Regulations—Typology

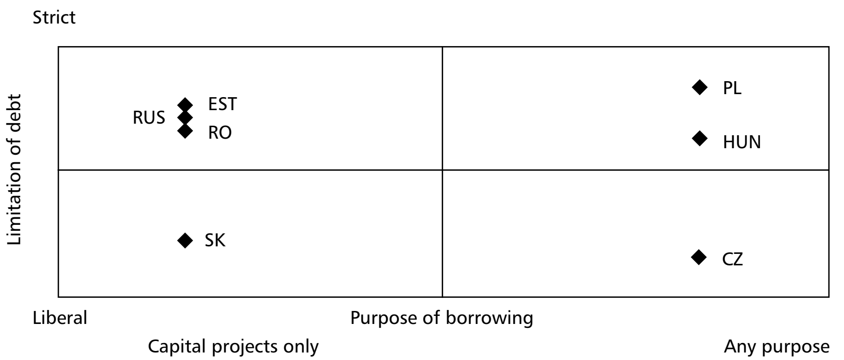
Figure 9.1 provides a very simple typology of borrowing regulations in CEE countries. With some simplifications the analyzed countries can be grouped in the following categories:

- borrowing allowed for any purpose with no limits on the level of local debt—Czech Republic;
- borrowing for capital projects only and (currently) no limits on the level of local debt—Slovakia;

- borrowing allowed for any purpose and defined limits on the level of debt—Hungary, Poland;
- borrowing allowed for capital projects only and defined limits on the level of debt—Estonia, Romania, Russia.

The figure also illustrates the strictness of borrowing limits (the least liberal being Poland). It should be stressed that the figure illustrates formal regulations only, and says nothing about the execution of rules (as described in sections 1.3 and 1.4), or about the real role of borrowing in the practice of local governments, which is discussed below.

Figure 9.1
Classification of Local Borrowing Regulations



2. THE PRACTICE OF LOCAL BORROWING

Generally speaking, the level of local debt in relation to GDP is very low in the analyzed countries (for details see Table 9.2). It is below 2% of GDP in Hungary, Poland and Slovakia and just above this threshold in the Czech Republic and Estonia. Romania provides the only exception to this rule, but Romanian local debt consists primarily of arrears in payments, not of bank credits or bond issues. The ratio of local indebtedness to GDP is still considerably lower in most CEE countries than is typical in Western Europe (See Figure 9.2).

In most cases local debt is also negligible in comparison with the debt of the central government—in Hungary, Poland and Slovakia the local debt constitutes no more than 2% to 4% of the total public debt (i.e., much less than the average in EU countries—see

Chapter 1). The share of local debt in total public debt is significantly higher in the Czech Republic, at 18% (and this figure puts it close to the top in the ranking of EU countries)—and much higher in Estonia and Romania (around 45%).

These figures indicate that the potential macroeconomic consequences of local debt are minimal and we may disregard them in our analysis. For that reason we focus in the next sections on microeconomic consequences for individual communities.

Table 9.2

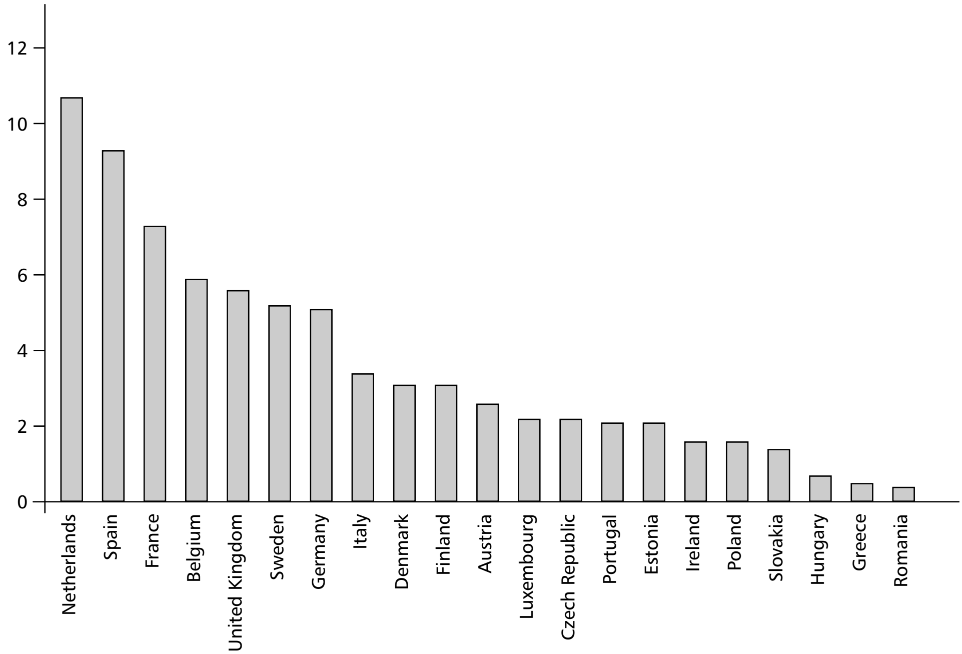
Size of Local Government Spending and Local Government Debt (2001)

	Czech Rep.	Estonia	Hungary	Poland	Romania	Russia	Slovakia
Local expenditures as % of GDP	8.3	10.0	11.2	10.6	4.1	6.4	3.2
Local investments as % of GDP	0.9	1.9	2.6	1.5	0.8	0.71	0.9
Local investments as % of public investments		49.5	40.1	58.3 (*)	20.3	21.9 (*)	
Public debt as % of GDP	14.6	4.5	41.2	41.9	31.2		43.3
Local debt as % of public debt	17.5 (**)	43.8	1.7	3.6	1.4	0.25	3.05
Local debt as % of GDP	2.2	2.1	0.7	1.6	0.4		1.32
Local debt as % of local revenues	29	18.3	6.3	15.4	1.98	4.0 (10 including arrears)	38.9
Local debt service as % of local revenues		6.6	1.4	1.1	0.7	0.28	8.9

* 2000

** 1999

Figure 9.2
Local Government Indebtedness as % of GDP
(EU Countries—2000, CEE countries—2001)



Source: For EU countries: Local Finance in the Fifteen..., 2002.

2.1 The Development of the Borrowing Market

It is difficult to find an example of a well-established and mature communal credit market in Central and Eastern Europe. In all the analyzed countries, both legal regulations and the actual behaviour of the most important actors (local governments and banks) are far from becoming stabilized. Markets are still developing, so it is difficult to talk about a mature market in any country, but we can perhaps distinguish between markets in their infancy (Romania and Russia) and markets in the "teen-age" stage (Hungary and Poland). For different reasons the remaining three countries could be placed somewhere in the middle. In the cases of Slovakia and Estonia the main reason for such a classification is the frequency and depth of changes in the legal environment. With the Czech Republic and Slovakia the reason is the relatively minor role of local government investments (below 1% of GDP, while in Poland and Estonia it is above 1.5% and in Hungary over 2%). In Estonia another reason is the low level of borrowed resources in financing local government investments (this issue is discussed further in section 2.3).

Finally, in the Czech Republic there is only a very small proportion of revenues that local governments can directly influence, such as local taxes.

As was noted in the introductory section, the use of credit instruments in the countries of Central and Eastern Europe was very rare at the beginning of the1990s. But in some countries it has gradually became more and more frequent over last decade. This has clearly been the case in Poland, Slovakia, the Czech Republic and Estonia. The most recent data on the level of local debt and debt service are included in Table 9.2. We have mentioned previously some psychological reasons for the reluctance to borrow at the beginning of the 1990s, but several other factors also contributed to the change in local governments' attitude and practice, including the following:

- macroeconomic stabilization (decrease in the inflation rate and growth of GDP which lowered interest costs and gave local governments a greater amount of certainty in their future revenue projections);
- strengthening of the national banking systems;
- increasing financial management skills among local government staff;
- advice (or sometimes even pressure) from international financial institutions and donor organizations (the role of the World Bank and USAID was probably the most important in most of the countries, but in Romania it was the EBRD);
- relative exhaustion of possibilities to finance investments through revenues from sales of assets and property, the most valuable pieces of which have already been sold off (this investment strategy was obviously unsustainable over time).

These factors influenced both the supply and demand sides of the borrowing market.

In Slovakia the level of debt expressed as a proportion of total local government revenues has been on a clear increasing slope, rising from 2.5% in 1991 and just over 5% in 1993 to over 30% in the most recent two years. The level of debt service has also been increasing, with the exception of 2001 when it decreased compared to 2000 (but this change was mostly related to the service of one big loan by the city of Bratislava). The level of new credits taken was below 5% of total revenues in 1993–94, and then it increased to over 10% in the period from 1995 to 2000 (with a decrease to 8.3% in 2001—the lowest level since 1994).

A gradually increasing number of indebted local governments is also noticeable in the Czech Republic. Between 1993 and 1998 local government credits increased by almost five times (in constant prices), and since then have stabilized. The present debt level has reached almost 30% of total local revenues, while in 1993 it was below 5%.

In Poland, it was very unusual for local governments to take loans in the first half of the 1990s. In 1992 only 2% of rural and about 5% of urban local governments decided to take a loan—and this low number includes not only commercial but also preferential loans taken from environmental protection funds. In 1994 the proportion of municipalities taking commercial loans increased to over 10%. In 2000 it was almost 40% of rural and 60% of urban local governments, and almost 90% in the case of big cities. On average, the level of debt in 1995 was around 5.6% of local revenues, but in 1998 it was already 9.5% and in 2001 slightly exceeded 14%. But the situation among individual local governments was very much diversified and in the case of several municipalities (especially in certain big cities) debt levels were over 30% or even 40% of total revenues in 2001.

In Estonia local borrowing started in 1993. The market gradually expanded, and currently there is no local government that has not taken a loan. The development of the borrowing market was especially radical in the first half of the 1990s and stabilized in the second half of the decade. (The accumulated debt expressed as percentage of local revenues was even slightly higher in 1996—26%, than in 2001—18.3%, but the ratio of debt service to revenues increased from 4.8% in 1996 to 6.6% in 2001).

Hungary, where local borrowing developed relatively early, is an exceptional case as it has decreased during last few years. Both in absolute terms and as a proportion of local revenues, new local loans reached their highest level in 1994. In 1999 the total local government debt was just 40% of the 1995 level, while the debt service ratio decreased from over 7% of revenues in 1997 to 3% in 2001. The debt level in 2001 was at a moderate level of over 6% of local government revenues, but it varies greatly among local governments.

In Romania local borrowing began only in 1999, and we can observe a slow but constant increase in the scale of borrowing since then. It 1999 there was just one local government that used credit financing. A clear increase was evident in 2000–2001, with two bond issues in 2001 and eight in 2002, and a slowly growing number of bank credits.

In Russia, fluctuations in the emerging local borrowing market show a significant correlation with macroeconomic changes, and especially with phases of the 1998 financial crisis.

Another interesting observation related to trends in local borrowing concerns the influence of elections. In the Czech, Estonian and Hungarian chapters, it was reported that borrowing has usually expanded immediately before local elections (e.g., in Hungary in 1994 and 1998 and in Estonia in 1996 and 1999, with preliminary data showing the same for 2002). This suggests that young local democracies in Central and Eastern Europe are vulnerable to the well known "electoral cycle," which has been described in Western Europe and America at the central government level (Tufte 1978), but also on a local level (see for example Mouritzen 1989). Shortly before elections local politicians try to increase budget spending, and the increase of capital expenditures is especially welcomed by their potential electorates. At the same time it is too risky to increase local fees or taxes (even assuming that local councilors do have the discretion to make such a decision). Consequently, taking loans for which repayment will not be a problem until after the election seems an ideal solution.

Interestingly enough, the chapter on Poland suggests the opposite phenomenon. There, local politicians are extremely careful in their borrowing policies in the period shortly before the next elections, because accusations of excessive indebtedness are considered extremely serious and can ruin the reputation of a candidate.[6]

2.2 Borrowing—How and From Whom?

Earlier in this section we identified three major sources of local debt—borrowing for investments, borrowing for operating expenses and unpaid invoices. Here, taking into account the source of borrowed money, we can describe the most typical forms of debt:

- intergovernmental loans (provided by central or other higher tiers of the public budget, usually, although not always, interest free, and sometimes with a real chance of being transformed into non-returnable aid);
- loans from special governmental programs administered by sector ministries or by state off-budget funds; environmental protection funds are among the most typical in several countries (Poland, the Czech Republic and Slovakia). They offer both grants (which are not the focus of analysis in this volume) and loans—usually with preferential interest rates (lower than commercial);
- commercial bank credits—taken both in local and foreign banks;
- issues of municipal bonds;
- arrears in payments (such as unpaid invoices or salaries).

Each of the sources listed plays a different role in the countries analyzed. We discuss all five forms of indebtedness below, but it is important to note that not all of them can be identified with the development of the borrowing market in the sense intended by fiscal federalism theory and the "golden rule of balanced budgeting." It is obvious that arrears in payments are nothing more than an indicator of unhealthy fiscal relations. But because omitting them in the presentation of data on local indebtedness might lead to false conclusions (on the creditworthiness of local governments, for example), arrears will be included as well. Also, intergovernmental loans are not usually considered helpful in the development of a proper borrowing market. In many countries they are a hidden form of subsidization of local governments by central or regional state administration. But again, their influence on local indebtedness in some countries is too big to simply skip them in a discussion of borrowing practices.

2.2.1 Intergovernmental Loans

This has been perhaps the most significant funding source in Russia, especially during 2000 and 2001 when loans from other tiers of government constituted well over two-thirds of borrowed resources (arrears in payments excluded). This source is similarly important in some other countries of the region, such as Ukraine, where loans from rayons (counties) to siolo (village) are very common but rarely repaid.

In the countries analyzed in this volume (other than Russia), intergovernmental loans either do not exist, as in Poland, or play only a marginal role, as in Slovakia, Estonia or Hungary. As was mentioned in section 1.4, recent state support for the severely indebted city of Košice in Slovakia (the second largest city in the country) was the first ever case of such an intervention, and caused serious questions to be raised by many observers. In Estonia, lending central government funds to localities is not allowed, but sometimes it is done indirectly through state-controlled agencies.

2.2.2 Loans from State Funds and other Governmental Programs

Housing and environmental protection, especially water management, are the most common sectors covered by subsidized loans programs. The role of preferential loans in shaping the size and structure of local government investments seems to be most significant in three countries: Poland, the Czech Republic and Slovakia. In these countries support has been offered either as grants or preferential loans from state funds aimed at environmental protection and housing development. This has been especially important in Poland, where investment sectors supported by national and regional environmental protection funds have played a dominant role in the structure of all municipal investment projects for a long time. The role of the housing fund in Poland was much more limited. The chapter on Poland also noted an important educational role of state funds; being the first to accept applications for returnable resources, they helped local governments to learn application procedures, basic creditworthiness analysis etc. This prepared the ground for a boom in commercial borrowing at the end of 1990s. The environmental funds were of greater importance in the Czech Republic and Slovakia, too, although in Slovakia in recent years, the state policy on support for housing development has temporarily reversed this emphasis.

In Hungary both the housing and water sectors have been included in programs offered by the Hungarian government.

In Estonia preferential environmental loans have been offered through central government channels for energy-saving programs. A unique aspect of the Estonian case has been a program of loans from the reserve fund for property reform. This program was intended to support the reprivatization process, which included moving out of several properties being used by local governments.

Sectoral programs of subsidized loans are absent in Romania and Russia.

2.2.3 Municipal Bonds

The fashion for financing investments through the issuing of municipal bonds arrived in Central and Eastern Europe together with American advisers working for USAID or the World Bank. The role of bond issues varies from one country to another, but in general they seem to be less important than financing through classic bank credits (data on the relative importance of different sources of borrowing are presented in the table below).

Two more general issues influencing development of local bond markets in Central and Eastern Europe should be mentioned:

- opposite to the situation in the United States, in the CEE countries there are typically no tax exemptions related to purchase of bonds issued by local governments. This seriously restricts the interest of individual citizens in this type of investment;
- the future development of the bond market may be stimulated by the pension reform (currently introduced in several countries of the region) which leads to the creation of well-capitalized pension funds. Such funds may soon become significant investors in municipal bonds.

In the Czech Republic the first issue took place in Ostrava in 1992, and there were altogether 23 issues by the end of 2001. The boom for bond issues was in 1994–1996 with 16 issues during these three years, followed by a decreasing trend later on. In 1995 debt in the form of bonds was 1.5 times higher than commercial credits, while in 1999 the proportion was almost exactly the opposite. Since 1998 Prague and Brno (the two largest Czech cities) have been the only local governments to take new issues. In general, bonds were used mostly in big cities (ten issues in five cities of over 100,000 citizens), but there were also a few issues in relatively small towns (four in towns with a population of 3,000–5,000). According to the Czech authors, two factors contributed to the decrease in the popularity of bonds in the second half of the 1990s: first, the general economic problems of 1997–1998 had an influence, and second, small and mid-size towns realized that small issues are too expensive since they cannot take advantage of economy of scale.

The picture in Slovakia is quite similar. There have been 37 issues in 28 cities since 1993. The most intense activity was from1995 to1997, with 27 issues during these three years. In 1996 over half of local debt was in the form of bonds, while in 2001 this proportion decreased to about one-eighth. As might be expected, big cities have been the most active, and rural villages are not present on the market at all. But there was also a considerable number of issues in small towns—five in those with populations below 10,000, and seven in the 10,000–20,000 cohort. Several bonds are traded on the public market in Slovakia, and there were two issues on international markets—both by Bratislava, the capital city.

Table 9.3
The Structure of Local Government Debt (2001) [%]

<table>
<tr><th></th><th>Czech Rep.</th><th>Estonia</th><th>Hungary</th><th>Poland</th><th>Slovakia</th></tr>
<tr><td>Unpaid invoices and other arrears</td><td rowspan="2">25.7</td><td>NA</td><td>NA</td><td>5.9</td><td>26.4</td></tr>
<tr><td>Intergovernmental budgetary loans</td><td>0.1</td><td>0.0</td><td>0.0</td><td>exceptional</td></tr>
<tr><td>Loans from special funds</td><td rowspan="2">46.8</td><td>12.9</td><td>3.1</td><td rowspan="2">79.8</td><td>1.2</td></tr>
<tr><td>Commercial credits</td><td>65.3</td><td>78.7</td><td>60.0</td></tr>
<tr><td>Bonds</td><td>27.5</td><td>21.7</td><td>18.2</td><td>13.7</td><td>12.0</td></tr>
</table>

In Hungary most issues were on the international market, but the role of the domestic market seems to be increasing. In 1998, debt to domestic investors was just 5% of total bonds, while in 2002 it was 25%. The role of bonds has been limited, accounting for only one-sixth of local debt in 2001, down from 25% in 1998. Unlike the Slovak model, Hungarian local bonds are exclusively private issues, with no secondary market for municipal bonds.

In Poland the role of bonds is still very limited, but it has been the most dynamically growing part of the borrowing sector during the last few years. As in Hungary (and the opposite of Slovakia), most of the issues were private, bought by banks which in 2001 held 72% of municipal bonds. For the banks this was a more comfortable way of lending money, and consequently cheaper for local authorities. The only public issue was organized by Ostrów Wielkopolski, and another was announced in 2003 by Rybnik. Bond issues really started in 1996, with 11 issues, and by the end of 2001 there were almost 200. The real boom came in 2000 when the number of issues grew to 46 from 20 in 1999. In 2001 alone there were over 70. Most of the issues were in big cities, but there were also relatively numerous small issues. Almost 100 of these had a value of less than PLN 5 million (approximately USD 1.3 million) and many were in small towns or even rural local governments. But the value of small issues was less than 10% of the total volume of Polish municipal bonds. The smallest issue of all was undertaken by the town of Proszowice and had a value of less than USD 200,000. On the other hand, the largest issues were organized by Kraków city, whose two issues were larger than USD

30 million each. In 2001 bond issues were organized in over 20% of big cities (cities of county status), 8% of other cities and less than 1% of rural local governments. But in absolute numbers, the number of local governments issuing bonds in 2001 was almost identical among big cities and among rural gminy (between 10 and 15 in both cases). Since competition between banks lowered the issuance fees to almost zero, costs were not prohibitively high even for very small amounts. A very high proportion of bonds has been channelled into transport investments (roads and the purchase of busses and trams)—the only major sector of local capital spending that had no chance for preferential loans or for substantial grants from the central government (Deroń 2001).

In Estonia, too, bond issues have been organized mostly by large and medium-size towns. This is explained by the fact that neither investors nor banks are usually interested in issues below 10 million kroons (about USD 750,000). The capital city of Tallinn was the first to turn to the international market in 1996. Unfortunately, available data do not allow us to give the precise number of issues or of local governments that decided on this course of action. A specific feature in Estonia is that bonds were the major form of borrowing in the second half of 1990s (more than two-thirds of the total debt in 1996-1998). But the role of bonds has significantly decreased in recent years, and bank credits now amount to almost three times more than bond-debt.

In Romania there were no issues until the end of 2000, but we know that there were two issues in 2001 and eight in 2002. The size of the local governments involved varied from 6,000 (Predeal) to over 300,000 citizens (Cluj). The issues were relatively small—between 150 and 1,000 thousand USD. Here also, banks were the underwriters and main investors for most local government bonds. The increasing interest in bonds is evidenced by the fact that in a recent survey (2002), over 60% of local governments admitted they were considering plans to issue bonds in the near future. But bank credits remain more popular, since banking procedures are better known to local governments and also because a special EBRD credit line for Romanian municipalities has stimulated interest in such borrowing. The municipalities involved claim that bonds allow for lower interest rates and—surprisingly—that the procedures are easier than for bank credits. If this information is confirmed and disseminated, we may expect a boom in bonds on the quickly changing local borrowing market in Romania.

In Russia the first issues were organized in 1992. They were very numerous in 1995 and 1996, and booming in 1997 and the beginning of 1998. The financial crisis of 1998 was a reason for cases of default in municipal bonds and the decline of the market for a short time. But since 1999 it has been possible to detect a dynamic growth again. In 2001 municipal bonds constituted around 6% of all bonds in Russia, but at the end of 2002 the proportion raised to 10%. The two biggest cities—Moscow and St. Petersburg—have a dominant position; both issued bonds of about 10 billion rubles (over USD 300 million). But during the last four years 11 other cities have also organized issues (e.g., Volgograd, Nizhnyj Novgorod, Ufa and Yuzhno-Sakhalinsk).

It is difficult to summarize the development of the municipal bonds market because of significant variation among the countries analyzed, but the following issues should perhaps be stressed:

- There are two models of development. In Hungary, Poland, Romania and Russia the market has been gradually growing (with a break in 1997–98 in Russia due to the financial crisis), while in the Czech Republic, Slovakia and Estonia disillusionment with bonds brought a decrease in their importance after the boom in the mid-nineties;
- Except for the brief boom in certain countries mentioned in the previous section, bonds remain much less important than traditional bank credits;
- Big cities are the most active in the bond market, although in several countries small local governments try issues as well;
- Big cities are also often active on the international market and they apply for ratings from well-known international agencies (some examples of received ratings are cited in Chapter 1);
- Local rating agencies have been created in some countries, in addition to the activity of international ones. This has been the case in the Czech Republic, Slovakia and Poland (the Polish one—CERA— has been recently bought by Fitch);
- In most of the countries (except Slovakia) private issues that are usually bought by an underwriting bank are dominant. In many cases a bond is simply a specific form of bank credit, denoted that way for bureaucratic reasons.

2.2.4 Commercial Bank Credits

As mentioned above, commercial bank credits remain the main source of borrowing in most of the countries analyzed.

In several countries (Poland, Romania and Slovakia) discussions took place on the creation of a special bank that would specialize in lending resources to local governments. Typically this would be a communal bank, i.e., partially or totally owned by local governments. But for various reasons little came from this idea. In Poland, the government's clear declaration that it would not support such a bank was probably of decisive importance. In Romania, also, in spite of the wide "moral support" of over 90% of local governments and in spite of careful preparation and research based on studies of the Dutch and Danish experiences, the idea has not yet materialized.

The communal bank, Prvá komunálna banka, was eventually established in Slovakia only in 1993. It was established by several municipalities, but presently local governments have only 20% of its shares.

The lack of a state or municipal bank formally specializing in serving local governments does not mean that in practice there are no "general purpose" banks that focus particularly on the local market. The Slovak Prvá komunálna banka clearly has a dominant position on the market—in 2000 it held 75% and in 2001 83% of credits for municipalities.

But the dominance of one or two major banks is not necessarily less prevalent in countries in which there are no municipal banks. In Hungary, the OTP bank has an 81% share in local governments' account keeping (2003 data), but one should note this is a decrease from 95% in 1995. The OTP also has a dominant position in lending resources (currently over 60% of all credits), again a decrease from over 80% in the first half of the 1990s. Raiffeisenbank is a strong newcomer and the main reason for the gradually decreasing dominance of OTP.

There is no clear domination by one bank in the Czech Republic, but there are three that definitely have the strongest position on the market: Česká spořitelna, Komerční banka and Raiffeisenbank (the same bank that has recently been so active in Hungary). Compared to the situation a few years ago, Czech banks now appear to have a better understanding of municipalities, but they also check their creditworthiness more carefully. Privatization of the banking sector after 2000 has definitely contributed to this change

There is no similar domination of one or even two or three banks in Poland. The Bank of Environmental Protection (BOŚ) is the most active in channelling loans from environmental protection funds, but most of the major commercial banks are very active on the local market. According to a survey of over 300 urban governments in 1998,[7] the distribution of main bank accounts of local governments was far from being monopolized. The largest share was held by Bank Zachodni WBK—15%, followed by Pekao—13%, PKO BP—11% and BPH-PBK—9%.[8] The market appears even more diversified if we take into account rural communities, which often keep their accounts in small, local Co-operative Banks.[9] This variation also reflects the competition in the market of banks lending money to local governments. According to Kopańska (1999), at the end of 1998 none of banks had more than a 20% share in credits for local governments. The situation is similar for the market in municipal bonds—there is no strong domination of one underwriting bank, although a few banks are the most active. According to analysis conducted by FITCH, PKO BP has organized slightly over half of all municipal issues, but most of them were relatively small. If we take into consideration the value of issues, the leader is Pekao, which has been involved in issues worth over one-third of all municipal bonds in Poland (data including issues till the end of 2001). But by the end of 2000, altogether 20 banks were involved in communal issues (Deroń 2001).

In general, in spite of isolated insolvency cases, local governments are considered by most banks to be among the most attractive and desired clients. Sometimes their approach is even too liberal—they assume there will be state support in case of difficulties in debt service, so they apply less demanding criteria than they do with private investors. This may contribute to the crowding out of private investments.

2.2.5 Arrears in Payments

This area is often in the shadows, since hardly any precise data is available even on the local level. It is not difficult to find municipalities in Ukraine or other former Soviet Republics in which data on arrears are not closely monitored by the local executive board, which does not have exact and up-to-date information from municipal utility enterprises or individual departments in the city administration. Nevertheless, we know that in some countries this is a very significant (sometimes most significant) type of local debt. Among the countries analyzed in this volume, arrears in Russia constitute over half of the local accumulated debt, and in Romania the figure is also high (although we do not have precise data on arrears in "local Romania"). This is also a considerable problem in some other countries of the region. For example in Bulgaria, Sofia remains the only local government without payment arrears (Swianiewicz 2002). In Ukraine local government arrears peaked at 6.4% of GDP at the end of 1998, and were reduced to "only" 0.8% of GDP at the end of 2001. In other countries such as Hungary, the Czech Republic, Poland and Estonia, the phenomenon is much less important, although sometimes not totally unimportant. Our research team has calculated that in Slovakia local government arrears are equal to almost one-quarter of the total debt. There are also significant arrears in some Estonian cities. In 1999 in the city of Tőrva, of the 4 million Estonian crown debt (over USD 300,000), around 1.4 million was in unpaid invoices. As reported in the chapter on Poland, the total of delayed or unpaid invoices has recently grown as well, although as a national average it is still around 5% of the total debt of local governments, very different from countries in which this category is the main component of the debt portfolio.

2.3 The Role of Borrowing in Financing Local Investments

How important is borrowing as a source of local government investments? Although it is next to impossible to give a very precise answer, we have tried to offer an estimate. The results are presented in Table 9.4, but we need to stress that some calculations are based on simplified assumptions. For example, in Poland we assume that all credits taken in 2001 for more than one year have been utilized for capital projects.

In the Czech Republic, Slovakia, Hungary and Poland the role of borrowing has risen significantly, to over 40% of the value of total capital spending. The proportion in these four countries is now quite similar to numbers identified for several countries of Western Europe (compare with Table 1.1). Poland has seen a clear, gradual increase throughout the last years, while in the remaining three countries over the same period local borrowing has been relatively stable. In Hungary, the role of borrowing is especially high in public utility companies (almost 70% of their investment spending, against just over 20% in investments financed from local government budgets directly).

Table 9.4

The Structure of Local Investment Financing (2001) [%]

	Czech Rep.	Estonia	Hungary* (2003)	Poland	Slovakia
Current own revenues		63.4	17	40.8	
Sale of property			3	0.6	
Central government grants		17.6	12	7.4	
Grants from off-budget funds		5.3		2.1	
EU and other grants		2.5**	25	5.8	
Subsidized loans	1.7	11.2	42	36.4	19
Commercial bank credits	34.6				30
Municipal bonds	10.6			6.9	

* Local governments plus municipal utility companies.

** Most foreign grants are not visible in Estonian local government budgets and are not included in this table.

The level of borrowing in Estonia is much lower, at just over 11% of investment spending. It is even less significant in Romania and Russia unless we include arrears in payments in the calculations, but precise data for that are not available.

For what purposes is borrowed money normally used? We have already said that the vast majority is directed at capital investments, but how are these investments structured? Is the structure the same as the general structure of all capital projects financed by local governments, or are there specific differences in the use of borrowed resources?

As the authors have indicated throughout this book, there are usually several national programs offering grants or subsidized loans for different sectors. It is not surprising, however, that commercial credits or bond issues are often directed disproportionately at those sectors that are considered important locally, but which cannot count on extensive support from other sources. In Poland, for example, the sector structure of projects financed through commercial borrowing differs substantially from the structure of all local capital investments. In particular, road construction and bus/tram purchase projects are over-represented as purposes for borrowing, while sectors for which alternative cheap means of financing are available (mainly environmental protection—i.e., projects like solid waste and waste water treatment, as well as municipal housing) are under-represented. Similarly, in the Czech Republic and Slovakia the availability of cheap loans or grants for housing and environmental protection often causes commercial borrowing to be targeted at other sectors. In the Czech Republic, of 23 bond issues only six were totally or partially targeted for environmental protection or housing projects.

Characteristically, credits are sometimes taken for projects serving general community development rather than the narrowly defined compulsory functions of local government. The development of a cable network in Slovakia, Czech shopping center projects and Romanian hotels, tourist development and general upgrading of cities are good examples of this phenomenon.

2.4 Local Borrowing Practices —Variation among Local Governments

There is also no uniformity in the pattern of local borrowing within the individual countries analyzed. Local governments are highly diversified in their size, affluence, political colour, etc., and so is their approach to using credit instruments.

The first striking similarity is that in several countries borrowing is mostly the business of large local authorities. It is not particularly surprising that extremely small Czech, Slovak or Hungarian villages are not very active in this field, but the domination of the biggest cities on the capital market is sometimes surprising.

In the Czech Republic half of the total local debt is in the four largest cities (Praha, Brno, Ostrava and Pilsen). It is still the highest if we calculate the debt per capita (in general the index is significantly, positively correlated with the size of municipality). At the same time, these four cities contain less than 20% of the Czech population.

The concentration is perhaps even larger in Slovakia, where two-thirds of the debt is in the three largest cities (Bratislava, Košice and Banská Bistrica). In local governments with populations below 3,000 the average debt per capita is SKK 668 (about USD15); in local governments over 3,000 it is more than five times larger (SKK 3,681 or almost USD 80). At the same time (2000) in Bratislava it was SKK 11,400 (USD 240) per capita, and in Košice or Banská Bistrica, over SKK 8,000 (USD 180) per capita.

A similar but not as strong a relation between size and borrowing is observed in Hungary. Small villages usually do not enter the borrowing market—they are too small to have sufficient creditworthiness, they lack the capacity to manage credits, and their demand is too small to be profitable for financial institutions. Larger cities, county seats and especially Budapest, are the most active on the credit instruments market. In 2002 the approximate outstanding debt per capita was around USD 20 in Hungarian villages, USD 25 in small towns, USD 50 in county seats and around USD 120 in Budapest. But because rural budgets are also very low, the ratio of accumulated debt to annual budget revenues is higher than in small towns (4.5% and 3.9% respectively in 2002). In 2002 the average debt in county seats was 6.9% of annual budget revenues, while in Budapest it was over 10%.

Poland is not different in this respect. In 2001 borrowing covered about 59% of investment expenditures in cities with county status, but less than 35% in other municipal governments. The difference was even larger in bond issues, which covered almost 13% of the investment spending of big cities, but just over 3% in the remaining municipalities. In 2001 two-thirds of rural governments took credits (either commercial or preferential), compared to 95% of cities with county status. In December 2001 accumulated debt was lower than 0.5% of budget revenues in 12% of rural governments, 4% of small towns, but in none of the mid-size or big cities. The average per capita debt in local governments with populations below 10,000 was around USD 45 by the end of 2001, while in cities of 50,000–100,000 it was around USD 70 and in cities over 100,000 around USD 95.

Similar observations can be made about Romania. According to the country report (Chapter 7) none of the rural communes, around 3% of small towns and almost 40% of larger cities (called "municipalities") have ever issued bonds or borrowed money from a bank.

In Russia, as mentioned above, the borrowing market is dominated by the two largest cities— Moscow and St Petersburg.

Estonia is a slightly different case. The basic difference between small and big local governments is the high proportion of central government grants in the former group and the much smaller share of such grants in bigger cities. In 2002 state grants provided altogether 49% of investment spending in rural governments with fewer than 1,500 citizens. At the same time in towns over 10,000 the proportion was below 25%. On the other side of the same coin, bigger local governments rely on their own operational surplus to much larger extent. But differences between small and big municipalities in the use of credit instruments are almost non-existent. More than 90% of governments borrowed money in 2001, regardless of which source cohort we consider, and the proportion of borrowed funds in financing investment spending has been similar as well.

Table 9.5 summarizes the relationship between the size of local government and per capita indebtedness.

But the observation that big cities use credits more often in the analyzed countries does not mean that larger governments are more vulnerable to problems related to excessive indebtedness. It is true that debt-service problems were noticed in Košice and

Banská Bistrica—two of the largest Slovak cities. But usually big cities have higher fiscal capacity and the problems are more typical of small governments. According to the Czech report, in 2000 as many as 27% of municipalities were not indebted at all (small villages dominated in this group). At the same time around 3% were indebted at the risk level. Among the smallest villages (fewer than 1,500 inhabitants) the proportion of risky indebtedness was similar to the national average. On the other hand only one of 64 cities was in this sort of troublesome situation. The proportion of risk-indebtedness was the highest among municipalities with populations of 50,000-20,000 (almost 10% of governments are within this size cohort). These mid-size local governments are big enough to use debt instruments, but not big enough to have a strong economic base, nor sufficient skills to manage the debt.

Table 9.5

Debt Per Capita and Size of Municipal Government (2001) [in approx. USD]

<table>
<tr><th>Population</th><th>Czech Republic</th><th>Hungary*</th><th>Poland</th><th>Slovakia</th></tr>
<tr><td>Up to 5,000</td><td>70</td><td>18</td><td>45</td><td>15</td></tr>
<tr><td>5,000–10,000</td><td>95</td><td rowspan="2">25</td><td>45</td><td rowspan="3">80</td></tr>
<tr><td>10,000–50,000</td><td>70</td><td>55</td></tr>
<tr><td>50,000–100,000</td><td>60</td><td>45</td><td>70</td></tr>
<tr><td>Over 100,000</td><td>305</td><td>110</td><td>95</td><td>220</td></tr>
</table>

* For Hungary data are based on the following categories: rural governments, small towns, county capitals and Budapest. For comparison reasons, these four categories have been approximated to population-size groups.

In Poland, as well, cases of excessive indebtedness (larger than the legal limit of 60% of local revenues) have occurred only among small towns and rural governments, although the average level of indebtedness is higher among big local governments.

Popular opinion holds that it is often poverty that pushes local governments to borrow money. They do not have sufficient resources, so they take credits to cover their costs. But this simple explanation does not find confirmation in empirical data. In Poland the debt of local governments with revenues per capita higher than 125% of the national average is more than twice as big as those with revenues lower than 80% of the national average. The high indebtedness of big cities in the Czech Republic or Slovakia is also a confirmation of the above-average credit activity of the most affluent local governments. The Romanian report also calls attention to the fact that relatively well-off local governments are more active on the borrowing market.

There are at least two explanations for this. First, more affluent municipalities have a better chance to successfully apply for credit at a bank. Second— and perhaps more important—taking loans is more often related to the existence of a long-term investment strategy than to the necessity to close the "budget gap."

3. GENERAL CONCLUSIONS AND PRACTICAL LESSONS

In the first chapter of the book, several theoretical arguments were presented for the advantage of using credit instruments to finance local investment spending. But which of these arguments is considered the most important in the countries of Central and Eastern Europe? The answer to this question is not obvious. When asked why they borrow money, most local officials or administrators give a very simple but not very helpful answer: "Because our own resources are too scarce to finance all the necessary investment projects." The next question, logically, is: "Why do you think it is better to borrow funds now and then suffer for several years trying to find the resources necessary for debt principal and interest service, rather than wait until you are able to collect sufficient own resources to implement the project on pay-as-you-go basis?" This question remains not only unanswered, but usually even unasked.

Does this mean that all the theoretical arguments presented in Chapter 1 are irrelevant in this part of Europe? Quite the opposite—I am convinced that most of them are especially valid in this region. But at the same time most of them are neither known nor discussed by local politicians.

The inter-generational and geographical equity arguments seem to be especially important in young democracies, where citizens are still learning about the relationship between contributing to and benefiting from public budgets.

Benefiting from accelerated local development and reducing excessive operational costs are both especially relevant in the context of filling the gap in long-term delays of development programs and dealing with the considerable depreciation of assets inherited from the previous system.

Making the investment cycle shorter appears very relevant when we are reminded of the long-lasting, over-scaled and badly-managed investments of the socialist period.

Last but not least, borrowing may well become the linchpin in making use of pre-accession and structural funds made available by European Union regional policies. This is especially true of programs such as SAPARD, where it is usually necessary to spend the whole required amount first, and then wait for eventual reimbursement of the agreed proportion of costs. In some of the analysed countries the same will soon apply to access to EU Structural Funds.

We should also remember that in many cases, local governments are responsible for the bulk of public investments in their respective countries. *All these points support* *the claim that daring but prudent borrowing policies are not only recommended to local governments in Central and Eastern Europe—they are essential.* They also suggest that the rationale for using debt instruments has not yet been the subject of sufficient reflection among local politicians and administrators in the region.

Table 9.6
Local Government Borrowing—Summary of Regulations and Practice

	Regulations		Practice		
	Purpose of Borrowing	**Limitations on Debt**	**Dominant Form of Borrowing**	**Local Debt as % of Local Revenues**	**The Role of Debt in Financing of Local Investments**
Russia	capital spending	moderate-strict	arrears, intergovernmental loans	around 4	<10%
Romania	capital spending	moderate-strict	arrears	around 2	<10%
Estonia	capital spending	moderate-strict	bank credits, bonds	almost 20	around 12%
Slovakia	capital spending	liberal	bank credits	almost 40	> 40%
Czech Rep.	any	liberal	bank credits	around 30	> 40%
Hungary	any	moderate-strict	bank credits	around 6	> 40%
Poland	any	strict	bank credits	around 15	> 40%

A summary of regulations and practice in local borrowing is briefly summarized in Table 9.6. We can see that the position of individual countries is highly diversified, but bank credits and bond issues have gradually became a significant financial resource for development projects in several countries (Poland, Hungary, the Czech Republic and Slovakia). In some other countries (Russia, Romania, and to a much lesser extent Estonia), borrowing has remained a marginal source of resources, used by innovators rather than by typical local governments. In spite of the initial boom for bonds (in the Czech Republic, Slovakia and Estonia) and in spite of external conditions for bond issues being sometimes more favourable (Poland), bank credits have remained the main source of capital. This puts Central and East European countries closer to the European than the American model of financing for local investments. Also, in spite of several discussions on the issue, most lending is offered by "general purpose" banks rather than by special institutions established to finance local government projects. The degree of competition among banks varies from one country to another, but usually one or two banks have a dominant position on the market.

What *practical recommendations* flow from the analysis presented in this volume? They may be summarized as follows:

- *First of all it must be repeated that there are several sound arguments for the wider use of borrowing to finance local government investments. And in countries where this method has not yet become popular, the case for investigating this option more thoroughly is especially strong*. Arguments supporting this claim are introduced at the beginning of the current section. In addition, however, there are practical manuals available in most countries (often prepared in conjunction with foreign donor programs, especially those sponsored by USAID or the World Bank) that provide guidance on how to calculate a safe level of debt, and how to initiate investment programs utilizing credit instruments in a way that avoids the trap of excessive indebtedness.
- One may discuss to what extent local government borrowing should be supervised, but there is no doubt it should be *monitored. It requires complete, precise and up-to-date information* both on the aggregate size and structure of local indebtedness and on the position of individual municipalities. In practice, however, we have experienced enormous problems in obtaining comparable data. The difficulty concerns not only comparisons between countries, but even the availability of reliable information within individual countries. In Romania, Russia or even in Estonia certain important information is missing in official statistics. In Russia, data on arrears in payments is not counted as part of the debt, which makes information on local debt incomplete and often misleading. Similarly, the authors of the Slovak report discovered that official reports do not include all sources of debt and they needed to make a special effort to estimate (for example) the amount in unpaid invoices and other parts of debt that are normally "invisible." In Poland and Hungary, official data on local debt do not include the borrowing of local utility companies, for which local governments act as an explicit or implicit guarantor. In Hungary in 1997, utility companies spent 1.5% of GDP on investments (about three-quarters of what local governments budget themselves). In recent years the balance has been even more in favor of utility investments. In Poland such precise estimations are not possible at all. In both cases utility companies' debt does not count against the limit of local government debt or debt service. Improving the information base is necessary to properly assess and monitor both the macro- and microeconomic consequences of taking loans by local governments.
- Another issue closely related to the availability of information is *transparency and public access to data on local borrowing. Public finance is public, so it cannot be confidential*. This means that information on city borrowing policies and practices should be available to the general public. It is not always the case. In

some countries the access to information on local borrowing is strictly limited (see, for example, the Russian report).

- In discussing the development of local borrowing one cannot ignore the *wider context—the stability of public finance, the predictability of local revenues, the condition of the banking system, etc*. In particular, the health of the local financial system is a precondition of special importance. Opposite to what might be expected, the development of a local capital market does not depend mainly on how severe the legal regulations on borrowing are. Poland is one of the countries with the strictest regulations, but also with the most developed and relatively healthy local government operation on a credit market. It is also very telling that Polish municipalities are both more courageous and more prudent in their loan policies than county or regional governments. This may be directly related to the system of local revenues, which is relatively autonomous, with room for local discretion in the case of municipalities, and with less stable revenues strongly dominated by state grants in the case of counties or regions;
- Even in unitary states (all of the countries analyzed in this volume except for the Russian Federation) *local governments should have a considerable amount of fiscal autonomy and their borrowing policies should not be subordinated to the debt incurred by the central government*. Such a danger is now very real in Poland, where the total public debt is noticeably close to the constitutional limit of 60% of GDP, but with a very modest contribution of local governments to this problem. But because the limit is not divided in any way among tiers of government, local government borrowing power may soon be seriously limited because of the central budget debt made to cover social expenses. It is true that such a separation of debt limits is not common in European countries either at the moment—it has been discussed in Germany, but not introduced in the end. Nevertheless, it is still worth discussing in Poland, which has a constitutional limit on the public debt, as well as in other countries in which borrowing regulations are included in "regular" laws.
- There is one more important precondition for the local borrowing market that is related to fiscal autonomy—namely, *control of local government over its revenues*. If local budgets are dominated by conditional grants (as, for example, regions or counties in Poland) or by other revenues that the local council has no discretion to influence (as for example in the Czech Republic) then development of rational borrowing policies is much more difficult.
- The development of a healthy local borrowing market also requires the *liquidation of substantial arrears in payments*, such as those now existing in Romania, Russia or several other countries not analyzed in this volume (e.g., Bulgaria, Ukraine, etc.). Although our discussion on arrears focused on local borrowing because in some cases arrears seriously influence the real indebtedness level,

this is not an acceptable way of financing local investments. The precondition for effectively coping with this problem is usually a general improvement in macroeconomic indicators, but also a reform of the way local governments are financed. Such reforms should make the allocation of revenues to local governments more transparent and more predictable, but should also impose "hard budget constraints" and support budget discipline. This item is another case where borrowing cannot be discussed outside of the wider context—which is formally beyond the scope of analysis in this volume.

- Another *form of local indebtedness that plays an important role in several countries, but which we must not recommend, is a system of intergovernmental loans*. In several countries this turns out to be a way of invisibly subsidizing some local governments. And even though it is a loan, this form does not promote the effective use of borrowed resources. There are no elements of market competition for resources, and usually no tools that typically support control over the feasibility of the financed projects. In turn, intergovernmental loans tend to soften hard budget constraint and hamper budget discipline.
- Turning to *regulations on local borrowing—these must be predictable, which first of all requires stability*. This is not always the case in the countries analyzed in this volume. The lengthy sections describing legal changes during the last decade in Estonia or the Czech Republic provide good examples of this phenomenon.
- It seems that the *"golden rule of the balanced budget" should be applied in Central and Eastern Europe* as well. That means that borrowing for capital spending should be allowed or even encouraged, but the use of credit resources to finance operating expenditures should be strictly prohibited. Perhaps an exception could be made for some amount of short-term loans (repaid within the same budget year) to ease cash-flow problems. The "golden rule" is formally followed in some but not all of the analyzed countries (e.g., not in Poland or the Czech Republic). In practice, borrowing for operating needs is not frequent but it does happen, and—as the Polish example of financing the teachers' salary increase in 2000 suggests—it may quickly proliferate under unfavourable conditions.
- Moreover, as fiscal federalism theory suggests, *effective implementation of the "golden rule" requires a clear separation of capital and operating budgets*, which is very rare in Central and East European financial regulations. The separation of capital budgets would not only support monitoring and control of local borrowing, but it would also make investment programs more transparent and easier to prepare. The last issue, however, goes beyond the scope of analysis presented in this volume.
- But when rules regulating local government borrowing are discussed, the first precondition is that *the rules agreed upon are also really observed in practice*. In the country reports we find numerous examples of rules which are perhaps fine

in print, but they are not followed and in practice there are no sanctions for ignoring them. Examples are the use of borrowed money for current spending in countries where it is forbidden, the surpassing of legal limits of indebtedness etc. This means an effective system of supervision is necessary, and this requirement is not at all in contradiction with the recommendation to increase local fiscal autonomy.

- Turning to the *practice of borrowing on a local level, there is still a demand for developing the expertise of the local staff*. Effective usage of borrowing tools requires sophisticated skills that are not everywhere available, especially (but not only) in smaller local governments. Obviously training needs differ from one country to another, as well as among individual cities, but access to relevant courses is required in each of countries of the region.
- In practice *most of the local governments are prudent in their borrowing policies, but there are some exceptions to this rule (discussed in the country reports) and they call for the existence of clear external regulations.* As stated before, such regulations should be transparent, stable and non-discriminating. In the country reports we find at least three arguments calling for external regulations on borrowing:
  - In several chapters the authors noted that banks usually see local governments as "easier" or more reliable customers than private businesses. This also strengthens the case for external regulation of the market.
  - Another argument supporting external regulations arises from observations about the electoral cycle in local borrowing. Local governments are especially inclined to borrow in the period directly before elections. The intention is to strengthen the position of the ruling group in the coming election, but an additional danger is that service of the new debt too often becomes the problem of the new authorities. Elected for a new term, they had little to do with taking the credit. The influence of the electoral cycle on spending and credit-taking has been noticed in Estonia, Hungary and Czech Republic.
  - There are examples of local governments whose indebtedness is irrationally high and where borrowed funds were misused or mismanaged, although it should be stressed these examples are not numerous. It is to be expected that the Czech report, written by authors working for SMOR (which represents local governments at the national level), calls for administrative control over the issuing of bonds. Currently the legal environment for local borrowing in the Czech Republic is probably the most deregulated among the analysed countries. One may wish to discuss the logic of the Czech authors' suggestion to increase control over bonds while leaving the bank credits market deregulated, but more important is the observation that representatives of an association of local governments see important arguments for imposing some form of control over local borrowing.

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NOTES

1 For simplicity I use the term "municipality" to describe all local governments of the lowest level, even though in some countries such as Romania this term is reserved for a more limited group within the basic tier of local governments.

2 Reasons for including this issue are explained in the final section of Chapter 1.

3 By annual debt service we mean annual interest plus principal repayment on outstanding debt.

4 Strictly speaking, guarantees are taken into account only in some of the analyzed countries. But in others (e.g., Poland), formal guarantees granted by local governments are treated in the same way as loans taken by the local budget.

5 See Farber 2002. For more details see Chapter 1.

6 This observation on Poland had been made on the basis of the 1998 local elections. However, recent data show that before the 2002 elections, the behaviour of Polish local politicians was closer to the classical model—i.e., the borrowing has rapidly increased.

7 Data based on a survey conducted for BPH bank by the Gdańsk Institute for Market Economics (see Swianiewicz, Dziemianowicz 1999).

8 Actually, Bank Zachodni and WBK as well as BPH and PBK were separate banks when the survey was conducted. They merged in 2000, as part of the consolidation of the banking system. I present accumulated data for these pairs of banks to show that consolidation has not resulted in a dramatic decrease of competition in the local government market.

9 According to Libura (1998), in 1997 in the representative sample of all local governments, 46% were keeping main accounts in Cooperative Banks, 9% in Bank Zachodni-WBK, 8% in BPH-PBK and 7% in PKO.

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Index

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