

STUDY TOUR TO CROATIA

VISIT TO KOPRIVNICA

VISIT TO VARAZDIN

VISIT TO PULA AND
REGION OF ISTRIA

VISIT TO HANFA

DECENTRALIZATION OUR GOAL

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The Mission of CEA is to continuously research economic development and economic policy in the Republic of Macedonia and to offer recommendations, suggestions and measures where it is deemed appropriate.

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From the editor

Dear Readers,



The challenge for Macedonia is to increase both private and public investment to support economic growth and modernize its infrastructure while maintaining a stable macro-economic environment. The LGUs and municipal companies will play a critical role in this context, as they are responsible for undertaking a substantial portion of the infrastructure investments required.

LGU investments are well below what is required to meet EU infrastructure standards over the pre-accession period. Currently, most of local infrastructure is obsolete and a large amount of effort is required for its replacement and modernization. Services such as water, sewage and solid waste systems involve large unit costs. To increase the level of such services will require considerable investments. It is evident that large part of development, replacement, and renewal of local assets will need to be financed out of LGU budgets and /or through other alternatives.

One alternative whereby the private sector undertakes to provide services of public nature is the Public Private Partnership - PPP experience. Best practices calls for each element of risk to be allocated to the party which is best equipped to manage it so that the risk can be minimized altogether. Of course that there are risks like confusing the value for money solution with the cheapest solution for investment project but setting a system in Macedonia could challenge the tariff reform, changes in the corporate structure, management and operations, improved legal framework, private sector participation and last but not least political acceptance.

The USAID BEA project indeed helped in this regards with the study tour to Croatia to bring closer to Macedonian stakeholders the Croatian experience of this PPP alternative for capital investments at subsovereign level and I hope that you will find this bulletin-issue useful in your future decision making.

Best wishes,
Marjan Nikolov, MSc
Editor



1) Thanks to the World Learning's (USAID) small grant, that CEA won in a competitive bid, the web page: <http://www.lsg-data.org.mk> is available for all those in need of data, information and indices related to the LSG. CEA is pioneer among the NGOs in hosting database with LSG data on the Internet and making it available to the larger public with no fee.



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Introduction

USAID's Business Environment Activity (BEA) within its program area that aims toward strengthening the enabling environment for doing business, addresses the process of fiscal decentralization. In this regard, special focus is placed on the municipal financing and public capital investment.

Activities of the BEA's component on Public capital investment and decentralization are aiming at increasing municipal budgets, higher rates of investments in municipalities and faster economic development in municipalities. To that aim BEA works with four pilot municipalities, providing them with training to further build on their capacities for fiscal management and successfully taking over the increased competencies. The pilot municipalities are Veles, Strumica, Struga and Bitola.

In the period of 16-20 July 2007, mayors and finance and local economic development departments' staff from the municipalities of Veles, Strumica, Bitola and Struga, joined by a USAID's BEA consultants including expert from CEA, took part in the "Financing Capital Improvements" study tour to Croatia.

The study tour was organized in order to build on the work done to date in the four pilot municipalities and to generate additional interest in the process of financing the capital projects, as a way to observe the success of implementation of the Croatian Local Governments capital improvements in Koprivnica, Varazdin, Pula and Region of Istria.

The reason behind this choice of Croatian municipalities is the similarity of challenges facing the local governments in Macedonia and Croatia as well as the fact that these Croatian cities and regions have had several years of experience with municipal bonds issuing, Public Private Partnership, and getting loans from commercial banks.

It was an intensive 5-day program, which consisted of five on-site visits, each concentrating on: issue of municipal bonds, Public Private Partnership, how to use bank

loans and finally to increase the capacity to manage resources and thus promote good governance.

The visits of three Croatian cities were intended to give the practical background from the municipal perception, combine with case studies, while the visit of Regional authorities of Istria gave a regional view in the process of implementation of the capital projects. The last on-site visit to Croatian Supervisory Agency for Financial Services (HANFA) was focusing more to the theoretical concept and legislative framework.

Croatian counterparts demonstrated strong municipal finance and budget policy and already developed public-private partnerships, relationships between local, regional and state governments, citizen participation, positive role of the media, and non-governmental organizations.

Visit to Koprivnica

First day the group visited City of Koprivnica and met with the Mayor, Mr. Zvonimir Mrcic, and other representatives of the municipal administration.

Koprivnica, a town with 33.000 inhabitants, and annual budget of 25 million EUR is the pioneer regarding the introduction of the EU models of financing to build facilities for public needs of the citizens. It is the first city in Croatia which has issued municipal bonds listed on the Zagreb stock exchange and also the first one to implement projects based on the public private partnership model.

In June 2004, Municipality of Koprivnica has decided to raise the necessary capital for financing different types of public projects by issuing municipal bonds. The money was raised, the projects are completed and the face value or total principal amount of the bond issue will be repaid within the period of 7 years, semiannually at a fixed maturity day through fixed principal and interest payments (6,5% fixed interest rate).

According to the Securities Market Law, the Commission of Securities (HANFA's body) has approved the Prospectus published by the municipality.

Half of the money raised by bonds issue, cca.4.5 million EUR is spent for the Project of recreational center "Cerine" which is currently the most interesting project in wellness, health, sports and recreation field in Koprivnica.

About 1 million EUR is allocated to communal infrastructure reconstruction and the rest of 3.5 million EUR according to the Capital Improvement Plan, were invested to modernization of local and regional roads.

The structure of the Bond Funds is consisted of:

1. Pension Funds (the biggest buyer of bonds)
2. Investment funds
3. Commercial banks, and
4. Citizens

The construction of the new grammar school building and gym meeting the IHF (International Handball Federation) standards, is financed through a public private partnership. Several arguments in favor of PPP have been pointed out:

- Payment of the real delivery service (286 monthly installment x cca. 100.000 EUR)
- Same quality of the service delivery within 25 years
- Maintenance standard defined and provided
- Financing of the construction with no budget deficit
- Public interest protected

For this case the consortium is made up of a building contractor, a maintenance company and a bank lender. This is a typical PPP example that grammar school and sport hall are financed and constructed by a private developer and then leased to the local authority. The private developer then acts as landlord, providing housekeeping, maintenance and other non educational services.

The main differences between PPP and basic way to finance utilities from the Koprivnica's Mayor point of view could be summarizing as follows:

- Lower construction costs
- No surplus and additional works
- No delay
- No hidden defects in construction building - the risk is taking over by the private partner
- No any public finance obligations during the construction

The City of Koprivnica provides numerous advantages to local and foreign investors to start their business and invest in the entrepreneurial zones: there is no local income tax; investors are exempt from local fee for the five years of business activity. Exemption from municipal contribution is 100% and entrepreneurs obtain state and local subsidies for newly employed staff. The entrepreneurial zones have completed municipal infrastructure: gas, water, sewage, electricity, roads, telecommunication and the local government and administration facilitate prompt obtaining of necessary permissions and licenses for investors. Besides all this, Koprivnica mediates in finding suppliers, work force and business partners for new investors.

Waste water purifier system, the project worth 8 million EUR which is financed with long-term loan by the Croatian Bank for Reconstruction and Development and landfill project show that Koprivnica is very advanced regarding the sustainable development. It is also the first city in Croatia that is developing Local Agenda 21, a document which will determine sustainable development of the entire region.

Visit to Varazdin

Second day the Macedonian delegation had an opportunity to meet with the Mayor of Varazdin, Dr. Ivan Cehok.

Varazdin has 50.000 inhabitants, located in North-Western part of the Croatia and the size of the municipal budget is cca. 35 million EUR.

Mayor Cehok, mentioned that the main goal of the local government in Varazdin is creation of the modern education system in compliance with the European standards. The second goal, but not less important, is to develop stable investment possibilities for regional and foreign investors. Thus the city has two entrepreneurial zones, Jal-kovec (zone for small business in which Local Government has invested cca. 2.5 million EUR) and Free Zone Varazdin.

Macedonian delegation had an opportunity to learn about how the city and municipalities in Varazdin County promote a healthy business environment, stimulate local enterprises and attract outside investors with the goal of improving conditions for sustainable economic growth.

One of the instruments for attracting the new investments is institution of Free Zones, which in the Republic of Croatia operate on the same way as in many others developed as well as emerging national economies.

Macedonian group visited the Free Zone Varazdin, one of the youngest and the biggest Croatian export oriented green-field investment, covering 62 ha. It has been established in 2005 within an industrial area in order to improve business conditions for the companies which are already active in it and, what is the most important, to ensure attractive conditions for new investors. In addition to tax



and other privileges which are given by state and local government, this Zone offers many other advantages, like advanced infrastructure, skilled workers, good outsourcing facilities, etc.

The main portion of the infrastructure arrangement of the Free Zone comes from the Municipal Budget. The legal status of the company manage the Free Zone is a Ltd. Company founded by the Region of Varazdin, City of Varazdin and City of Trnovec, and two public entities as well.

Since 2005 eleven domestic and international companies have invested in the Free Zone Varazdin 100 million EUR, created about 3.000 new jobs, and will exceed 500 million EUR export per year, contributing with 6% in total Croatian export.

In terms of financing capital projects the City of Varazdin prefers loans than PPP or bonds issue, and it was argued by the fact that according to their analysis the ratio between bank loan and PPP is usually 1:3.5.

Another argument as a response to our question why do they get into debt using the loans instead of PPP or bonds was that in many cases the City appears as a guarantor to its budget users (schools) or to the public companies founded by the City when they take a loan from commercial banks. In such cases the level of public debt of the municipality is not increased and the City can still borrow till the level of 20% of the current operational revenues.

This year the City issued a guarantee of 4.5 million Euro bank loan drawn by eight primary schools that will be investing in rehabilitation of their facilities to enable one-shift education for all the pupils.

At present the city is implementing several investment projects. Technological Park Varazdin initiated in 2003 in cooperation with Ministry of Education and Economy, and World Bank as well, provides services to 31 companies, mostly in ICT sector.

The contract for construction of the new sport hall has been signed recently and for this purpose the City in cooperation with the Central Government will pay 10 million EUR each from its own budget.

Visit to Pula and Region of Istria

Third and fourth day Macedonian delegation has been hosted by the City of Pula and its Mayor, Mr. Boris Miletic. At the same time the delegation has visited the Region of Istria and met with its Vice President, Mr. Sergio Bencich.

Over 205 000 people or 4.65% of the nation's population live here and the Region has the second highest GDP in the country after Zagreb. The size of the Pula's budget is set to 40 million EUR while the Istria one is positioned to 32 million EUR.

Pula's Mayor introduced the recently completed project in public transport. The needs of the local community and a fast development of economy, especially of tourism as one of the strongholds of the development of the Istrian Region, affect the need for a quality traffic infrastructure. For this reason, big efforts are being invested in public transportation and interregional connection. Therefore, the City of Pula this year through its Public Transport Company has invested in purchasing of 22 new buses. The whole investment was realized by EBRD loan of 5 million EUR.

In terms of borrowing, Pula did the same way like the City of Varazdin, so the Public Transport Company is debtor and the City has issued a guarantee. While for financing of the other public utilities such as building of swimming pool and construction of the parking space, last year the City was willing to establish Public Private Partnership.

One of priority projects in the segment of infrastructure projects in the area of Pula and the Istrian Region, as it was stated, is certainly the project of introducing natural gas. It was elaborated in short that following the construction of pipeline infrastructure (network and plants), economy and households will be able to use cheaper fuel. "The Project of Installation of Gas System in the Istrian Region" is designed so that the Istrian Region should become a single gas distribution area with the objective of enabling the gas use for every potential user in the area. The value of the total project is estimated to 28.5 million EUR. So far about 80% of total population of Pula is covered by the distributive pipelines.

The long-term programme of encouraging business zones in the Istrian Region is directed towards the creation of a more favourable entrepreneurial infrastructure, on the basis of the research of the entrepreneurs' needs and the manifested interest for lasting solutions of the issues related to business areas.

The organizer and the leader of the work related to the performance of the programme is IDA Ltd - the Istrian Development Agency which represents an essential agent of the Istrian economic development and serves as development coordinator of the Regional Operational Programme of the Region of Istria. The founders of IDA are the Region of Istria and nine Istrian cities.

In order to support local and regional economy, a Credit Line "Entrepreneur 2" was created on the basis of the Agreement on Business Collaboration signed by the Region of Istria, the Ministry for Crafts, Small and Medium Enterprise, and the five commercial banks. The total credit fund is 17.5 million EUR and it will be used for encouraging small and medium enterprise.

Mayor was talking about the Adriatic Euro Region and regional cooperation, and was presenting the opportunities of using IPA funds in the implementation of Pula's projects in the field of waste water treatment, and protection of cultural

and historical heritage as well as how EU accession impacts local and regional governments and the local economy.

During the visit to the Region of Istria Hall, the Vice President, Mr. Bencich, gave an overview of the economic profile of the Region of Istria. According to economic indicators, the leading activities are processing industry, tourism, and trade. Great attention is being given to agriculture and the production of ecologic food, the wine and olive growing.

Significant efforts were made to develop the tourist infrastructure and to accentuate its importance. In combination with the natural beauties, rich history and cultural heritage, investments paid off and resulted in highly developed competitive service all along the western coast. Istria was and still is the most important tourist destination in Croatia. Area is the most visited tourist region with 27% of all visitors and 35% of time spent in all of Croatia.

Vice President has mentioned that previous decades in the construction of gross infrastructure in Istria will remain



Participants at the study tour in Croatia on Public Private Partnership - PPP at subsovereign level

marked by common and large investments in water supply systems. Waterworks of Butoniga I phase, nominal capacity 1000 l/s drinking water as one of the largest and most important interventions in the history of Istrian peninsula which has started in 1995 and was financed by the World Bank loan of 27 million US\$ plus the central Government credit of 17.5 million EUR. In the meantime the Central Government credit is fully written off by the Government according to the new Water Law.

Such investments enabled the construction of the water supply network, resulted in a high level of water supply network in Istria today amounting to above 95%.

The participants also visited the Regional Water Supply Enterprise "Butoniga". They were familiarized with future plans after the completion of the strategic capital construction of water supply capacities; the necessary step needs to be the long-term investment in the protection of sources of drinking water. The construction of the system of public drainage in the Istrian peninsula is planned. Due to the configuration of the territory and the predominantly Karst soil structure, makes the project of water protection more demanding and the total estimated amount of the project is determined on 145 million EUR. It will be realized through several sources of financing such as: Regional and

Local budgets, Local Self Contribution - special charge established by the Region of Istria, State Water Fund and IPA funds.

Visit to HANFA

Fifth and last day of the field visits was reserved for HANFA, Zagreb - Croatian Financial Services Supervisory Agency.

Macedonian officials were presented with a general overview of the Croatian legislative system in the context of local government bonds issuance and fulfillment of their responsibilities, as well as interaction among city, region and state governments taking into account the role of different stakeholders. First, the Local Government needs to have a prior agreement of the Government of Croatia (for example in 2007 the permitted level of total public debt for all municipalities, determined by the Government, is limited to 50 million EUR). Then, the City Council adopts a decision for bonds issue. The City is responsible to publish a prospectus, and, finally, HANFA is controlling the content of the prospectus.

The total amount of the municipal borrowing / loans in the course of the fiscal year can not be more than 20% of the total revenue that has been realized of the current operational budget of the municipality for the previous fiscal year.

Regulatory framework for borrowing and PPP

The Croatian Law on Budget provides local government (which is consisted of two tiers: 1. region, and 2. cities and municipalities) to borrow and to issue securities. Compared to Macedonian regulations, municipal borrowing is provided through the Law on Financing Local Government, while issuance of securities is provided in the Law on Securities.

Regarding the amount of the annual debt, Croatian local governments are allowed to amount up to 20% of the overall revenues in the current operational budget of the municipality in the preceding fiscal year, which is similar to Macedonian provisions.

According to the Croatian Securities Market Law, the issuer shall publish a prospectus (public offering) or deliver to potential investors a prospectus of issues of the securities (private offering). In addition to an invitation to subscribe securities, the prospectus shall obligatorily contain complete, accurate and objective information of the property and obligations, profit or loss, financial position and prospects of the issuer, the purpose of raising funds, risk factors and the rights contained in the securities to which the prospectus pertains, on the basis of which a potential investor can make an objective assessment of the prospects and risks of the investments and make a decision about the investment.



Before publishing the prospectus or delivering it to potential investors, the issuer shall file an application with the Commission of Securities (HANFA's body) for approval of the prospectus. The issuer shall include the prospectus, the decision of issuance of securities and other prescribed documentation with the application.

Through its decision, the Commission shall confirm that the prospectus contains all the data prescribed by law and that it can be published.

The issuer and persons who were determined to have used the prospectus for the covering up or false presentation of important facts shall be held completely liable for the fullness and truthfulness of the data contained in the prospectus.

As for the public private partnership, there is no special law in Croatia that regulates PPPs, but the Croatian Government has endorsed "Directions for exercising contractual forms of public private partnerships" in September 2006. Within these Directions, the basic definitions are given, the forms of PPPs are defined, the act of selection of private partner is prescribed, the elements of the PPP contract are provided, and other relevant issues are provided. In the case of Macedonia, PPPs will be regulated with the new draft Law on concessions and other forms of PPPs, in a special part of that Law. With this part, similarly like with Directions in Croatia, the forms of PPPs are defined, the objectives, the content of the contract, the risk etc.

What are the arguments PRO PPP?

(Croatian local government experience)

PPP provide benefits by allocating the responsibilities to the party - either public or private - that is best positioned to control the activity that will produce the desired result. With PPP, this is accomplished by specifying the roles, risks and rewards contractually, so as to provide incentives for maximum performance and the flexibility necessary to achieve the desired results.

The primary benefits of using PPP include:

- Public buildings would not be built at all if it was not for private finance - the public money was simply not available;
- This allows the local government to get new public buildings without raising taxes;
- PPP leads to a dramatic increase in the quality of public services;
- Performance-related penalties that are now built into PPP contracts will ensure a continuing improvement in standards, far in advance of anything that could be achieved in the public sector;
- The local government is increasing its reputation

through delivering better public services;

- PPP is a fast, effective - and in the short term at least - cheap way of getting new facilities built;
- Project cost savings;
- Substitution of private resources and personnel for constrained public resources; and
- Access to new sources of private capital.

What are the arguments CONS PPP?

(Croatian local government experience)

- Critics argue that taxpayers will pay the bill for PPP. Whether the local government is aware that there is a limit on how far taxes can be raised?
- The local government is just mortgaging the future - and the long-run cost of paying the private sector is more than it would cost the public sector to build facilities itself;
- According to a survey the rent for PPP project in the school service will exceed 25 million EUR (Case of Koprivnica grammar school, comparing to construction cost that is 15 million EUR);
- In some cases, the initial cost of the project has been paid back within five to ten years, leaving 15 - 20 years of pure profit from the construction;
- There is also evidence that some early PPP projects in the region have not been up to standard;
- Concern about the extension of the private sector into new areas like schools and sport halls which have traditionally been publicly run;
- Private companies have been accused of cutting "corners" in order to maximise profits.

The future of direct funding of public facilities

(Croatian local government experience)

- It is important to keep PPP in perspective but the majority of public works are still directly funded by the local government;
- The local government has not written off the public sector altogether;
- There are some areas where public-private schemes may ultimately prove unsuitable (water supply, sewage, etc.);
- It is gearing up for a massive increase in private involvement in public services in the years ahead and local authorities are increasingly being steered towards PPP;
- But the local government is hoping that the current

school building programme as well as construction of four sport halls in Croatia will demonstrate to sceptics that it is the only way to restore the country's weakly public services.

Issues raised by the participants regarding municipal bonds

- Local governments have a responsibility to provide services for the needs of their citizens. But oftentimes there is not enough money in a Municipality's general or daily operating fund to pay for those needs.
- Issuing bonds is different and best compared to taking a loan. Instead of sharing ownership and regardless of what earnings are, there is a promise to make fixed interest payments and to pay back the borrowed amount on a fixed date.
- The issuer of a municipal bond receives a cash payment at the time of issuance in exchange for a promise to repay the investors who provide the cash payment (the bond holder) over time. Repayment periods can be to 20, 25 or 30 years, or even longer.
- All money raised by a bond sale to be spent on one-time capital projects within three to five years of issuance (according to Capital Improvement Plan adopted by the City Council).

- Because of the special tax-exempt status of most municipal bonds, investors usually accept lower interest payments than on other types of borrowing (assuming comparable risk). This makes the issuance of bonds an attractive source of financing to many municipal entities, as the borrowing rate available in the open market is frequently lower than what is available through other borrowing channels.

Potential Risk

- The risk of a municipal bond is a measure of how likely the issuer is to make all payments, on time and in full, as promised in the agreement between the issuer and bond holder.
- If the issuer is unable to meet its financial obligations, it may fail to make scheduled interest payments and/or be unable to repay the principal upon maturity. To assist in the evaluation of an issuer's creditworthiness, ratings agencies such as Standard & Poor's, Fitch and Moody's Investors Service analyze a bond issuer's ability to meet its debt obligations.
- The interest rate of most municipal bonds is paid at a fixed rate. The rate does not change over the life of the bond. If interest rates in the marketplace rise, the bond you own will be paying a lower yield relative to the yield offered by newly issued bonds.



STATEMENTS:

Aleksandar Sahov, Chief of Party:

"The idea to organize this study tour and my expectations were that it would help pilot municipalities broaden their understanding of alternative municipal financing and thus accordingly improve their performance" - said Mr. Aleksandar Sahov, the Chief of Party of the Business Environment Activity. "After completing the study tour, from the participants' evaluations I can see that the overall impression is that it was a very insightful experience in terms of acquiring new knowledge. "

Gjorgji Josifov, BEA's consultant who has actively participated in the implementation of the study tour:

"We had a valuable chance to see a mix of public / entrepreneurial - oriented approach in the public development sector. We saw that problems can be reduced, simplified or completely solved if more finance / business practices are applied in the public sector" - said BEA's consultant Mr. Gjorgji Josifov. "Another significant aspect of our stay was that the Croatian officials provided a variety of views and experiences on the subjects elaborated during the tour. During these five days I think that municipal staff got familiar with many new concepts of financing capital needs. On the whole, I feel that visiting Croatian municipalities and Region of Istria, and HANFA has been a very enlightening and useful experience from many different aspects and that it really met our expectations" - he added.