



THE FUTURE OF LOCAL GOVERNMENT FINANCE

**Case studies from Romania,
Bulgaria and Macedonia**



Local Government
and Public Service
Reform Initiative

Sponsored by LGI/OSI
Editor Marjan Nikolov



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Editor, Marjan NIKOLOV



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and Public Service
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Foreword

This book is the result of a CEA research funded by the Local Government and Public Service Reform Initiative of the Open Society Institute (LGI/OSI) and managed by Marjan Nikolov, President of CEA.

CEA approached LGI/OSI with an unsolicited proposal for a cross country study on LGU borrowing with an expectation to set out lessons that can be learned by Macedonia. The overall objective of the study on local government borrowing is to accomplish an all-encompassing review that systematically captures the entirety of the fiscal decentralization processes with an emphasis on local government borrowing in each of the three transition countries: Romania, Bulgaria and Macedonia.

Macedonia is in a position to develop the legal and policy framework now, in anticipation of future development of a municipality credit market. Macedonia can learn from the Romanian and Bulgarian experience but also can learn from problems that have become clear in other countries as well. Excessive borrowing by sub-national government or debt issuance in the absence of an adequate legal framework (one that clarifies critical issues like the status of guarantees or the remedies available to lenders in the event of a municipality's non-payment) has exacerbated any national economic crisis. Also, premature borrowing, prior to a municipality establishing its creditworthiness or having identified clear investment priorities, is likely to drain local budget resources and add risk to the fiscal system. The benefit of soundly based local borrowing is large, but the risks involved with poorly prepared borrowing can be great. Stakeholders-LGU, national government, banks, and potential investors in municipal debt share an interest in ensuring that the policy issues surrounding credit market development are well understood and that an appropriate legal framework is in place before the market actually opens.

CEA wishes to express the highest gratitude to OSI/LGI Budapest for the financial and other support without which the project: LGU Borrowing in Romania, Bulgaria and Macedonia could not have been conducted, with particular thanks to Mr. George Guess, Mr. Adrian Ionescu and Ms. Marietta Kleineisel.

The Center for Economic Analyses (CEA) is a think tank of economists who share a common vision for the Republic of Macedonia as an emerging new European economy integrated into the regional and world-wide markets.

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.

November 2006, Skopje

Marjan Nikolov, MSc

COUNTRY REPORT: LOCAL GOVERNMENT BORROWING IN ROMANIA

MARJAN NIKOLOV

Center for Economic Analyses-CEA

Sponsored by:
Local Government and Public Service Reform Initiative
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It is the responsibility of other authors to cite this report when it has informed their research and publications.

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List of abbreviations

CEA	Macedonian based think tank-Center for Economic Analyses
CNVM	Romanian National Securities Commission
CSPD	Romanian think tank-Center of Studies and Programs for Development
EBRD	European Bank for Reconstruction and Development
IPP	Romanian Institute for Public Policy
ISPA	EU pre-accession instrument, Instrument for Structural Policies for Pre-Accession
LGAP	Local Government Assistance Program
LGU	Local Government Unit
LPF	Law on Local Public Finances
MPF	Ministry of Public Finances
PHARE	EU pre-accession instrument, Poland and Hungary: Assistance for Restructuring their Economies
PIT	Personal Income Tax
RON	Romanian currency
SAPARD	EU pre-accession instrument, Special Accession Program for Agriculture and Rural Development
USAID	US Agency for International Development
VAT	Value Added Tax
WB	World Bank

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Acknowledgments

CEA wishes to express highest gratitude to the OSI/LGI Budapest for the financial and other support without which this project could not have been conducted, especially to Mr. George Guess, Mr. Adrian Ionescu and Ms. Marietta Kleineisel.

CEA also wishes to thank the CSPD and its Director, Ms. Gabriela Matei for the hospitality, organizational issues and useful comments on this paper.

In spring 2006 the Parliament of Romania adopted a number of laws that will affect local governments both in the short and long term. The package of laws contained the following five drafts:

- Amendments to Law No. 215/2001 on Local Authorities
- Decentralization Law to replace Law 339/2004
- Amendments to Law No. 340/2004 on the Institution of the Prefect
- Draft Law on Local Public Finance to replace Ordinance 45/2004
- Amendments to Law No. 188/1999 on Public Employees Functions

The CEA visit to Romania took place between major changes in the legislation and this made it even more challenging to address the issues. CSPD was of great help in making clear what the changes in legislation were and how they affect the context of LGU borrowing in Romania.

Special thanks go to the people in Romania that we interviewed both for their time spent in meeting us and for sharing their experience with us.

Our beneficiaries in Macedonia: ZELS, represented by Mr. Ace Kocevski (Mayor of Veles) and Ministry of Finance, represented by Ms. Maja Parnardzieva (Head of Public Debt Department) hold a special importance for their contribution.

This report has been prepared by Marjan Nikolov, MSc (marjan@cea.org.mk). Critical review and useful comments and inputs were provided by Malgorzata Markiewitz, Economist at CEA. This document will be published on the CEA web site (<http://www.cea.org.mk>) 10 working days after submission of the final report to LGI/OSI.

1. INTRODUCTION

The overall objective of this study on local government¹ borrowing is to provide a review to capture the entirety of the fiscal decentralization processes with an emphasis on local government borrowing in each of the following three transition countries: Romania, Bulgaria and Macedonia. As part of this larger study, the main purpose of this country report is to provide an overview of the progress and issues regarding local government borrowing in Romania and to draw important lessons for Macedonia.

This study does not present a credit rating analysis nor does it cover specific aspects in detail, but rather it provides an overview of each of the building blocks of intergovernmental fiscal relations. These building blocks are the structure of the government sector, delineation of expenditure responsibilities, assignment of revenue sources, intergovernmental transfers, financial management issues, sub-national borrowing, the impact of infrastructural development on the income side of sub-national budgets and the characteristics of municipal debt. The study also considers the technical nature of the strengths and weaknesses of the decentralization process, with special emphasis on the experience gained in local government borrowing and makes recommendations for future developments.

We base our opinions not only on what was presented during interviews but by examining the available reports on Romania and the existing laws that were shown to us.

2. STRUCTURE AND SCOPE OF THE GOVERNMENT

The economic problems of Romania led to unrest and eventually to the political revolution that was a feature of Christmas 1989 (see more in Laure 2000). In March 1989, there was an open letter to the President from six retired Romanian Communist party (RCP) officials accusing him of disregard for the Constitution, economic mismanagement, and discrimination through the rural urbanization program imposed on ethnic Hungarians. The unrest spread leading to other political events taking place before Ceausescu was captured while attempting to flee. He was executed after a summary trial.

In October 1990, Prime Minister Petre Roman introduced laws to accelerate Romania's transition to a market economy. After Ceausescu's overthrow, a complete restructuring of the economy was planned, with emphasis on use of market forces and private ownership. In late 1991, a unified exchange rate was introduced and the internal convertibility of the currency, the lei, was established. In early 1993, the government announced a four-year economic reform program supported by the IMF. This plan included progressive elimination of price subsidies for staple goods and services, removal of controls on interest and exchange rates, liberalization of trade, accelerated privatization and reducing inflation.

The territorial organization of Romania was established by the Law on Local Public Administration (no. 69/1991) as a two tiered system of local government, including both counties and municipalities without a hierarchical relationship. This Law was replaced in 2001 by Law 215, which was further amended in July 2006 by Law 286. The territorial units now consist of 41 Counties (judete), 262 Towns (orase) and 2,686 Communes (comune)². A County structure consists of: Capital (municipiu

1) In this report we will use the term Local Government Unit-LGU, to designate the units of subnational government, local government, at county level, communes, municipalities and cities interchangeably. When necessary for more clear text we will stress what is the tier we are talking about.

resedinta de judet), several Municipalities³ (municipii) and all the towns, communes and villages within the county's territorial boundaries. Bucharest, the country's capital, provides a unique case as it is divided into six sectors (districts), each with its own local council and mayor, with separate budgets, under the authority of Bucharest General Council.

As for financial policies, in the beginning of the 90s the Law on the state budget⁴ was used to draft and implement Local Government Unit's (LGU) financial policies and included information about the funds allocated to the LGU throughout Romania. There were also special funds for investment purposes at local level. These were earmarked and managed by the line ministries. Then in 1994, with the Law on Local Taxes and Charges, fiscal decentralization in Romania was initiated and the own source revenues of LGU were defined. The European Charter of Local Self-Government was ratified by the Romanian Parliament in 1997.

Each line ministry responsible for providing a certain public service maintains an office in each county, headed by a director. Also, the Ministry of Public Finance has a number of tax directorates and treasury offices in each county. A Prefect is appointed by the Ministry of Administration and Interior for each county. A Prefect has the responsibility to "lead" the activities of the deconcentrated offices of the line ministries and to ensure that decisions made by local councils are in accordance with the law. Each county has an elected county council (the so called "judetean" council), presided over by the President of the County, with an executive apparatus for the public activities within the county. The central government is represented at each local council by a secretary who is appointed by the County Prefect. The secretary must countersign all decisions of the municipal council. The secretary is appointed by the Prefect following a proposal by the local council which is in turn based on the recommendation of the Mayor. The secretary has to undergo several tests before being appointed. The process by which the secretary is appointed gives decentralization in Romania a greater flavor of devolved decision making. (see figure 1) However it raises concerns about political interference in the administrative decision-making process, as local autonomy is hindered by the roles of the prefect, secretary and, in some instances, the role of the deconcentrated offices of line ministries.

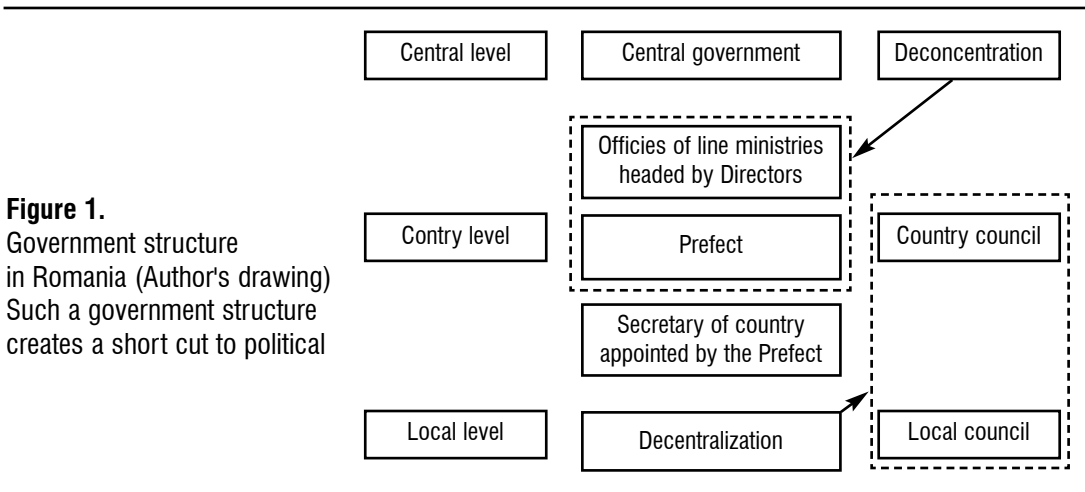


Figure 1. Government structure in Romania (Author's drawing) Such a government structure creates a short cut to political

2) These numbers are in continuous change, new LGU being accepted.
 3) Larger towns with a number of inhabitants of more than 100,000 and important economic activities
 4) A list of all laws we were able to identify in relation to the process of decentralization in Romania is in the Annex 2.

influence, replacement of office holders any time the government changes and to possible abuse of power. The adverse influence of the politics in the actions of the prefect and the political migration of staff it caused after the elections was stressed during interviews. See also Freedom House 2004: "In turn, the local governments would prefer to maintain their political connections and a loose environment, where there are no hard budgetary constraints and everything is negotiable on a case-by-case basis".

We find the complex system of deconcentration mixed with decentralization to be confusing, at least before the legislative changes planned for this year. In our opinion the current system went beyond the simple requirement for the central government to carry out central functions across country and reflected a struggle to keep power centrally. Even in the draft Amendment of the Law on local public administration (215) from 2006 Article 68 still says: "In order to exercise his range of functions appropriately, the mayor cooperates with the deconcentrated public services of ministries and of other specialized bodies of the central government". Also Article 69: "In providing such cooperation, within the law the mayor can request the prefect to support the heads of deconcentrated public services of ministries and of other specialized structures of the central public administration within the local authorities, if the mayor cannot have some functions carried out by his organisation". What "can request" means is unclear.

Also, in the amendment of the Law 215:

"It is compulsory that the mayor's orders, the local council's decisions and the county council's decisions be communicated to the prefect of the county; as well as .the decisions of the local and county council"

"The decisions of the mayor, decisions of the local council, decisions of the county council, as well as other documents issued or adopted by local government authorities shall be checked by the prefect for compliance with the law regulating activity of the local council".

With the Law on Modification and with completion of the Law on the Statute of Civil Servants, the Prefect becomes a high level civil servant. It is expected that the Prefect will be a professional person with a good education and with an appropriate length of service criteria and thus to break with the adverse effects of the past. Filling any vacant high-ranked public position must be by a national contest held by a permanent independent commission, composed of seven members who are appointed by decision of the Prime Minister. The members of the commission are appointed by rotation and have a predetermined ten and a half year mandate.

In addition a general performance appraisal of each high level civil servant must be carried out every 2 years with a view to confirming their professional knowledge and ability to fulfill the requirements of their position. Each high level civil servant also has the obligation to attend annual professional training courses on the law.

Our conclusion regarding the scope and structure of the government in Romania is that the process of decentralization was driven politically and that it tended to maintain central control. Given the two tier system, the desire for central control created a complex system with mixture of deconcentration and decentralization at same time. This mixture was particularly noticeable at the county level where the Trojan Horse of political appointees to control the local government was provided. The situation was further complicated by many new villages becoming communes with the resultant increase in the

number of LGU. This in turn reduced the possibilities for efficient management and economies of scale in the provision of services.

3. EXPENDITURE ASSIGNMENTS⁵

The assignment of responsibilities for expenditure to local governments has been included in a large number of pieces of legislation. This has made it difficult to obtain clear information on this subject. There is a lack of legislation regulating the organization and operation of local governments that presents in a clear, structured and transparent manner, the assignment of expenditure responsibilities for delivering local public services at county, commune and town level.

The Ministry of Administration and Interior, within the framework of the public administration reform process, has undertaken a general evaluation of the current legal framework applicable in this area. As a result, two documents have been drafted:

Annex 1, "Competences fulfilled by local governments at the county level in providing public services" and

Annex 2 "Competences fulfilled by local governments at the commune and town level in providing public services,"

These two annexes describe in detail the current assignment of expenditure responsibilities to the two local government tiers namely the county, and the commune and town. In case of competences shared by local governments and the central government, the roles of each are described in detail, in order to avoid any confusion. At the same time, the two documents are an important benchmark related to administrative and fiscal decentralization conditionality within the PAL 2 Program of the World Bank.

All ministries and other central public government agencies responsible for regulating areas of local public services included in the two annexes were requested to notify the Ministry of Administration and Interior about any legislative initiative designed to amend the current assignment of expenditure responsibilities to local governments.

Under the Law on Local Public Utilities (326) "municipal services" include water, wastewater, solid waste, district heating, local public transport, and maintenance of roads and parks. These services are frequently provided by enterprises (regie autonome), which are not budgetary units of the local government or by commercial companies. Other LGU services which fall outside the definition of "municipal services" are provided by budgetary units of the local government.

In terms of sustainability, we categorize some municipal services in Table 1:

5) This section benefited from the input of Gabriela Matei, Director of CSPD Romania.

Table 1. Municipal Services in terms of Self Sustainability by User Fees

Self-sustaining basis from user fees (no budget support)	Subsidized	100 % from the local budget
<ul style="list-style-type: none"> ● water, ● wastewater, ● solid waste 	<ul style="list-style-type: none"> ● district heating ● local public transport receive 	<ul style="list-style-type: none"> ● local roads ● parks

At the time of our study, Law 215 on Local Public Administration was about to be amended and supplemented by the Framework Law on Decentralization 339 (CEA studied the draft version dated February 2006). The new law is more precise in assigning competencies to the LGU as can be seen from the following extract:

"The local public administration authorities exercise, according to the law, exclusive, shared and delegated competencies:

- a) Competence - the right of a local government unit to make decisions in a certain field or regarding certain issues, as well as the responsibility associated with this right;
- b) Delegated competences - competences assigned by the central government to local governments, by law or contract, together with adequate financial resources, in order to be exercised in the name and within limits established by central government;
- c) Exclusive competences - competences assigned by law to local governments and for which they are fully responsible for implementing. Local governments have the decision-making rights and the necessary resources and means to fulfill them, in compliance with the norms, criteria, and standards established by the law;
- d) Shared competences - the competences exercised by the local governments together with other levels of public administration (county or central) with a clear separation of the financing and decision making powers."

Table 2. Framework Law on Decentralization. Competencies at Local and County Level

Exclusive Local	Exclusive County
<ul style="list-style-type: none"> a) The management of public and private domain belonging to the local government; b) The management of the local road infrastructure; c) The management of local interest cultural institutions; d) The management of local interest public health institutions; e) Urban planning; f) Water supply; g) Sewage, waste and pluvial water treatment; h) Public illumination; i) Sanitation; j) Primary social assistance services for child protection and for the elderly; 	<ul style="list-style-type: none"> a) The management of local interest airports; b) The management of public and private domain belonging to local government (county); c) The management of county interest cultural institutions; d) The management of county interest public health institutions; e) Primary and specialized social assistance services for victims of domestic violence; f) Specialized social assistance services for the elderly; g) Other competences stipulated by law.

k) Primary and specialized social assistance services for the victims of domestic violence; l) Local public transportation; m) Other competences stipulated by law.	
Shared Local with Central	Shared County with Central
a) District heating supply; b) The building of social houses as well as houses for the youth; c) State pre-university education, excepting special education; d) Public order and safety; e) The payment of the social benefits for people in need; f) The prevention and management of emergency situations at local level; g) Socio-medical assistance services for the persons with social problems; h) Primary social assistance services for disabled persons; i) Community public services for personal data records; j) The maintenance of the local road infrastructure of local interest at the level of communes; k) Other competences stipulated by law.	a) The management of the county road infrastructure; b) Special education; c) Socio-medical assistance services for the persons with social problems; d) Primary and specialized social assistance services for child protection; e) Specialized social assistance services for disabled persons; f) Community public services for personal data records; g) Other competences stipulated by law.
The local governments at the level of communes and towns exercise shared competences with local government at the county level regarding water supply if regional operators are set up, as well as other competences stipulated by law.	
Local governments exercise delegated competences by the central government regarding the payment of financial rights for disabled children and adults.	
Source: Author's adoption from the Draft Framework Law from February 2006.	

What remains is that many small communes are not able to provide the services efficiently because of the economies of scale (as pointed out during interviews). With such an assignment of expenditures, one cannot be sure of true extent of unfunded mandates at the sub-national level in Romania.

In the following tables the size and nature of LGU expenditure in Romania is illustrated.

Table 3. Proportion of Local Public Expenditure from Total Public Expenditure

	1998	1999	2000	2001	2002	2003
	10.4	11.0	11.7	18.1	18.4	19.2

Source: Budget outlook of Romania provided by one of the interviewee.

Table 4. Romanian County Expenditure as % of GDP

	2001	2002	2003	2004
	6.1	6.1	6.8	6.5
Of which: capital expenditures	0.8	0.8	0.9	0.7
Of which: wages and salaries	2.5	2.4	2.4	2.5

Source: Martinez 2005

Table 5. Wages and Salaries as % of Total Expenditure

	2001	2002	2003	2004
County council	21.5	19.1	17.2	16.5
Municipalities	40.9	39.2	34.8	38.2
Towns	53.4	50.1	46.5	50.1
Villages	64.4	57.1	51.7	54.2

Source: Adapted by author. Original Martinez 2005.

Table 6. Capital Expenditures as % of Total Expenditure

	2001	2002	2003	2004
County council	16.8	15.8	14.9	8.7
Municipalities	14.0	13.6	14.4	12.1
Towns	10.8	11.9	13.3	12.1
Villages	8.2	7.6	10.5	8.8

Source: Adapted by author. Original Martinez 2005.

The figures in the tables above, at the very least, add substance to the general claim in Romania that the current level of fragmentation at local level has a cost in terms of the loss of economies of scale (see Martinez 2005). The local public expenditures as a percentage of the total expenditures increased from 10.4% in 1998 to 19.2% in 2003 but a large part goes in wages and salaries. The percentage of wages and salaries of total expenditures is higher in the lower the tier of the government. This could be an indication of greater inefficiencies as the unit of government becomes smaller. In contrast, the following comments were also made by CSPD about the development of the expenditure system at LGU level:

- As a whole, LGU expenditures followed the trend of mandate transfer, also reflected by their evolution in the GDP throughout 1999 - 2004. New responsibilities were transferred to the LGU, thus increasing the share of local budgets in relation to the GDP and total expenditure in the public sector. These new mandates were especially in the fields of education and social welfare. Unfortunately, the new mandates were not always transferred together with the relevant sources of funding;
- Analysis of LGU expenditures by category of councils (county, city, town, and commune) shows a major difference between urban and rural communities. In the case of county and city councils a larger proportion is expended on public service or capital improvement, whereas in the case of town and rural councils a larger proportion is expended on operational and staff costs;

- As the size of LGU decreases, there is a clear trend of higher staff and social welfare expenditure, to the detriment of public services and capital improvement. This trend raises serious doubts over the capacity of LGUs, especially in rural areas, to upgrade their infrastructure;
- Arrears are difficult to assess because of the cash accounting system used. Emergency Ordinance 45/2003 introduced the first elements of accrual accounting, but this will really only start to show up in the 2006 reports.

4. STRUCTURE OF THE REVENUES

The Law on Local Taxes and Charges has no limitations on the number or level of taxes and charges that local authorities can establish. These can be set depending on the local needs and the local authority's institutional capacity.

Own source revenues

The most important own source revenues at LGU in Romania are the revenues from ownership of property. For buildings owned by physical persons, the tax is determined on the basis of a uniform nationwide schedule based on the floor area of the building. The tax is also partially based on the approximate value of the building which is estimated on the basis of several factors such as the age of the building, location, type of construction, etc. Thus the LGU has no authority to set the rates of this tax on any building owned by a physical person. In the case of a physical person, the uniform rate is 0.2 percent for buildings located in urban areas and 0.1 percent for those located in rural areas. The local councils are entitled to grant exemptions to payment of this tax. The law provides for progressively higher tax burdens to be placed on physical persons who own more than one building in the country.

For buildings owned by legal persons, the value of a building is its book value as determined from the accounting records of the company. It is interesting that in this case a local council has the discretion to set the rate between 0.5% and 1 % of the book value of the building. The tax on buildings is paid in four installments but with an option of a single payment before March 15 which brings a discount.

Table 7. Evolution of Own Revenues as % of Total Revenues 1999-2003

	1999	2000	2001	2002	2003
County	37.1	26.5	20.3	18.3	8.5
Municipalities	52.9	44.2	25.6	26.8	28.6
Towns	44.6	41.4	21.4	22.7	25.0
Communes	41	36.7	16.4	16.1	16.6

Source: IPP 2005.

The decrease in the share of own revenues as a percentage of total revenues happened because of the transfer of new responsibilities and the allocation certain grants by the central government.

Table 8. Percentage of Own Revenues

	2001	2002	2003	2004
% as of GDP	6.1	6.2	6.9	6.7

Source: Swianiewicz 2004 and Martinez 2006.

Assessing the real value of property for purpose of local taxation is a demanding task. Romania is no exception even though there is a system which tries to keep up with different types of existing buildings having regard to zones, year of construction and multiple ownership of buildings. Another challenge is the budgeting of the LGU envelope given the assumption of all property taxes will be collected in the following fiscal year but this never happens. This creates a systematic error in the amount of the budget revenues of the LGU in Romania actually collected. This could be interesting topic to explore in greater depth especially in connection with efficient tax administration and credit rating of the LGU.

Shared revenues

Quotas from the Personal Income Tax (PIT) are distributed to LGU in accordance with the Law on Local Public Finances-LPF but the percentages may change from year to year with the State Budget Law. Because of the introduction of a flat rate tax, and an expected decrease in rate of collection, in 2005 the government increased the overall revenue sharing rate to 82 % of tax collected in comparison with 63 % in 2004. The 82 % PIT is distributed as:

- 47 % to the local level where the tax is collected;
- 13 % to the county level where the LGU is located;
- 22 % to the county authorities for equalizing the local budgets of the communes, towns, municipal towns and county (county 25 % of those 22 % points) and for further distribution to local level (75 % of those 22 % points).

The share of the PIT in the Bucharest Municipal City is distributed as follows: 23.5% to the local budgets of the sectors of Bucharest, 47.5% to the own budget of Bucharest municipal city and 11% to the General Council of Bucharest Municipal City in order to equalize the local budgets of the sectors and Bucharest Municipal City

Table 9. Structure of Revenues

	2001	2002	2003
Own revenues	21.7	22.0	20.9
Shared revenues PIT and VAT	71.5	76.1	71.7

Source: Martinez 2005.

What is interesting is that the own revenues are low compared to the shared revenues thus illustrating the dependence of the LGU on the central level government. LGU also fail to show efficiency in administering own revenues and any improvement the collection rate (see more in Martinez 2005).

Capital revenues

Capital transfers are generated by sale of assets belonging to LGU. These are of an exceptional nature and provide only a small fraction of the total local revenues.

5. INTERGOVERNMENTAL TRANSFERS

The PIT and VAT transfers, as prescribed in the Emergency Ordinance on the LPF 45 from 2003, are earmarked to subsidise the price of heating, salaries of teachers and social welfare and a part which is non-earmarked for the purpose of equalization.

Earmarked transfers

A large part of the earmarked transfers goes for salaries of teachers (typically around 30 % of total local revenues). The Central Government also contributes to international projects by financing of activities and services representing medium and long term investments at local level.

Equalization fund

In the LPF, financial equalization is defined as transfer of financial resources from some incomes in the state budget to administrative-territorial units in order to ensure the necessary funds for the supply of public services, according to the law. The Law regulates the transfer between different levels of government, the role of the equalization fund and LGU borrowing. It also prescribes a mathematical formula to assess the financial capacity of the LGU so that the equalization fund can be distributed more efficiently.

The Equalization Fund is first allocated from the national to the county level and then from the county to the local level. The first allocation to the county level is in accordance with a formula with variables including the county fiscal capacity and the county land area. The second allocation to the local level is in accordance with a formula with variables again including the fiscal capacity and the land area but in this case also the population.

Our main conclusion from the interviews and the material presented to explain the equalization/transfer system is that the system is too complicated and that it has the spirit of "double counting" even though the inclusion of all the formulas gives the first impression of a very transparent system. It is not very clear why there is a need to transfer a fraction directly from the central to the local level and then another fraction to the same local level but this time via the county. Also, the power of central government to announce changes in the share and pooling of funds creates an uncertainty in the revenue flow at LGU level. Another issue may be the "quality" of the equalization system (the fiscal capacity, fiscal needs, fiscal effort, variability of poverty etc.) but this is beyond our scope of work. Interesting research in this area is the IPP 2005.

The following comments were also given by CSPD for the development of the revenue system at LGU level in Romania:

- The total revenues to the local budgets increased significantly in the period 1999-2003;
- The percentage of local taxes and fees and shared amounts of PIT from the total LGU budgets decreased, while various transfers from the state budgets increased, especially earmarked grants, and to a lesser extent the equalization grants;
- The financial autonomy of LGU to establish policies based on local taxes and fees decreased, by a gradual but obvious limitation of the LGU variation margins in setting these taxes and fees;
- There are large gaps between the general purpose revenues before equalization, especially between cities (mostly county seats) and communes. This situation is apparent if we discuss public services delivery, with big differences in volume and diversity between urban and rural areas.
- Equalization grants are mostly directed to communes (because they have low own revenues due to economic underdevelopment) and to county councils due to the gap between the mandates transferred to them (especially in social welfare) and the available financial resources (local taxes and fees and the amount from PIT which is shared out).

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- As for establishing, tracking, collecting and controlling these revenues, the principle of local autonomy (transfer of the competence for levying these taxes and fees to the LGU) has led to a significant increase in collection of revenue.

6. BORROWING PILLAR OF DECENTRALIZATION IN ROMANIA

In accordance with the LPF, the local public administration's authorities have the following competencies and responsibilities for local public finances:

- Direct contracting of domestic and external loans, in the short, medium and long terms and pursuit on maturity of the payment obligations that arise;
- Guaranteeing of domestic and external loans, in the short, medium and long terms and pursuit on maturity of the obligations for payment arising from the respective loans.

The local public authorities can contract or guarantee loans only with the approval of the Commission⁶ for Authorization of Local Loans (hereinafter referred to as the Commission). The local and county councils and the General Council of Bucharest Municipal City can decide to contract or to guarantee loans with the vote of at least half plus one of the counselors. The mayor or the president of the county, as the executive body, is responsible for the implementation of this decision.

The LPF stipulates the two instruments for borrowing that an LGU can use as being bonds and loans taken from commercial banks. It also stipulates the purpose of borrowing as financing local public investment or refinancing of the local public debt. It limits the debt destination at LGU level to infrastructure projects in the public sector and/or of public purpose.

The LPF does not allow the total annual debt which is represented by the contracted loans, bonds, financial leasing and LGU collaterals to exceed 30 % of the total current revenues in the budget of any LGU. The debt service ratio is calculated as the annual debt over the total own revenues, including PIT shares. This has been interpreted to mean that the debt service installments due in any single year should not exceed 30% of the total own revenues of the local budget.

The LPF also allows for a temporary short term financing of cash deficits from the Treasury. Starting with 2006, LGU are allowed to hold commercial banks accounts to administrate contracted loans. LGU funds in the Treasury do not yield interest.

External borrowing

LGU must have approval of the Commission if the maximum amount allowed (periodically updated) is to be exceeded. Under special circumstances, the Ministry of Public Finances-MPF can guarantee an external loan contracted by a LGU and in that case will supervise the contract procedure and the repayment of the loan.

Internal borrowing

The local or the county council that decided to contract a loan or a bond issue must present all documents regarding the loan to the Commission. Internal borrowing can be contracted and managed by local authorities without any support from the central government once it is approved by the Commission.

6) The Commission consists of representatives from LGU administration, central government and National Bank of Romania. The Commission meets monthly and analyses all requests coming from LGU, to confirm compliance with the law. More about the Commission, in the section on: Approval, monitoring and disclosure.

For short term borrowing, the cash flow deficit must not exceed 5 % of the LGU budgeted revenues including taxes, fees, contributions, other income and the allocated share from income tax. When temporary cash deficits occur, these can be covered by loans granted by the MPF from the general current account of the Treasury. The reimbursement of funds borrowed under the provisions of this article is guaranteed by the estimated income for the relevant budgetary year. In case the loan is not reimbursed by 31st of December, the MPF is authorized to execute the account of the respective administrative-territorial unit.

Guarantees

In accordance with the LPF, a local guarantee is an engagement assumed by a local public authority to pay at maturity any non-honored obligations of an economic operator or public services subordinate to them for which the public authority acts as guarantor.

The LGU must guarantee any contracted loan with its own revenues or it can use intercepts of intergovernmental transfers or use its reserve funds. Intercepts can provide a strong boost to credit market development without any implied central government guarantee or other cost to the Treasury. As such they merit particular consideration in the development of municipal credit policy and law.

In general, the following types of pledge can be used to provide a guarantee:

- Pledge of physical or monetary assets;
- Pledge of the right to operate a facility or provide a service;
- Pledge of selected revenues, such as:
 - tariffs, fares, or rentals;
 - particular taxes or special levies;
 - grants or shared taxes (intergovernmental transfers).
- Pledge of the power to set specific tax rates, utility tariffs, and other levies;
- Pledge by the executive to budget for and recommend payment of future debt service, without an explicit binding pledge that those appropriations will be made;
- Pledge to assign the payment of future intergovernmental revenue.

In the case of Romania the "special purpose transfers from the state budget" may not be pledged for the payment of municipal debt. The LPF authorizes municipalities to pledge other transfers from the central government e.g. quota and other amounts derived from particular incomes from the state budget and their "own source revenues". This is a positive reflection of autonomous control over such funds.

Almost half of all municipal bonds issued are insured by private insurance companies for timely payment of debt service. Unlike free government guarantees, private insurance does not create any incentive for inefficiency. A premium is paid for guaranty coverage because the guarantors have specialized staffs that assess the risks of municipal finances or project financing thus, the greater the risk the greater the premium charged to obtain the guaranty. Note that this is not a substitute for municipal creditworthiness as the guarantor will only guarantee debt of municipalities that it has deemed to be creditworthy (see more in USAID LGAP 2002).

Characteristics of debt

According to the definitions in Art. 2 points 3 and 4, and the provisions of Art. 3 (3) of Law No. 313/2004, financial market loans raised or guaranteed by local public administration authorities are

part of Romania's public debt, though not representing Government liabilities. Such loan-related public debt is serviced either by local budgets or by refinance loans.

The instruments of local public debt are:

- Bonds;
- Loans from commercial banks or other credit institutions;
- Supplier credits;
- Financial leasing;
- Local guarantee;

The issuing and launching of titles of value on the market can be done directly by the local public authorities or through agents or other specialized institutions.

The central government retains a legitimate interest in the integrity of municipal budgeting and financial management. One interest is to ensure that municipalities provide the basic public services expected of them, before they invest in non-core activities. A second interest is to ensure that municipalities prepare and execute balanced operating budgets.

In respect to the overseeing of municipal credit, the central government has two critical concerns in ensuring compliance with legally mandated procedures. One concern is to limit the consolidated public sector's outstanding debt to comply with international benchmarks and thus to preserve the government's ability to borrow abroad in order to build a solid base for the national economy and future participation in the European Union. The second concern is to guard against imprudent borrowing that could threaten the integrity of the overall public finance system and so to put pressure on the national government to deliver costly bailouts.

i. Maturity

The maturity of a debt instrument should be no longer than and matched to the economic life of the asset it is financing. Ideally, amortizing the liability on one side of the balance sheet is matched by the depreciation of the asset financed on the other. In Romania short term loans used to cover possible liquidity issues are under the competency of the State Treasury.

ii. Interest

Although the provisions of the LPF do not expressly authorize debt which bears interest, the provisions imply that such debt may be issued. The bank regulations and the contractual provisions of any loan prevail.

iii. Debt Service

The debt limitation formula is an incentive for structuring substantially equal debt service installments and thus to avoid the dangers of deferring larger or balloon installments of principal to the end of the loan term.

iv. Foreign Currency

As a rule, municipalities should be discouraged from assuming foreign currency risk. The LPF provides that debt denominated in a foreign currency is subject to the approval of the Commission.

Additionally, Annex 1 to Government Decision 978, October 4, 2001(II) requires approval by the Commission of municipal guaranties of loans denominated in foreign currency.

The MPF report on government domestic debt in Romania from February 2006 says: "the increase of domestic public government debt is made under a strict observance of the ceiling of domestic public indebtedness, approved by Parliament. Thus for 2006 a domestic public indebtedness ceiling of RON 9.600 million was approved. The domestic credits contracted directly or guaranteed by the state and local authorities represented 0.25% of this ceiling at the end of February 2006".

In Romania at the end of February 2006, the outstanding domestic credits guaranteed by the state amounts RON 2,139 million. The debt contracted by local authorities under state guarantee to finance investment projects under the SAPARD program amounts RON 87.2 million which is 4 % of the outstanding domestic credits guaranteed by the state.

Approval, monitoring and disclosure

The Commission⁷ has been established by Governmental Decision No. 158 of March 3, 2005 (OG No. 220/March 16, 2005) to consider and advise local public administration authorities on borrowing and issuance of loan guaranties. The Commission consists of nine members, of which four are MPF representatives, including the Commission Chair, two are Ministry of Administration and Interior representatives, and three are representatives of the local public administration associative structures. The Commission reviews, based on the documentation provided by applicant:

- the loan amount to evaluate compliance with Romania's annual public indebtedness ceiling;
- the timing of any securities issue in relation to the schedule of MPF issues in order to avoid unnecessary competition in attracting capital market loans;

By the 15th of every month, local government borrowers, including the guarantor administrative units, must report on the status of outstanding borrowing for the previous month. Such reports must be structured as required by MPF-developed norms. Norms and procedures for authorizing local government borrowing or loan guaranteeing are illustrated in the Annex 4.

Borrowings and guaranties by a local public administration authority must be entered in the local public debt register and local government guarantee register, as applicable, of the respective authority.

In accordance with the LPF, the Local Public Debt Register (LPDR) is an official paper which presents, in chronological order, the position of the directly contracted local public debt. The LPDR has two components namely the sub-register of the local domestic public debt and the sub-register of the local external public debt. The LPDR will include information which specifies the total sum of debt of the local authorities, together with details of the debts and other information concerning the LPDR required by the methodological norms issued by the MPF. The total value of guaranties issued by the local authority is written in the registry of local guaranties of this authority and it is reported annually in its financial statements.

In accordance with the LPF a Local Guaranties Register (LGR) is an official paper which presents, in chronological order, the position of the local guaranties granted by the local authorities. The LGR has two components namely the sub-register of the local domestic guaranties and the sub-register of the local external guaranties. The LGR will include information which specifies the total sum of guaranties of the local authorities, together with details of the guaranties and other information concerning the LGR required by the methodological norms issued by the MPF.

7) Before that there was a Commission but only for external borrowing authorization.

Financial distress and insolvency

Before the amendments to the LPF were adopted, the law provided that, in the event of default in the payment of short-term debt or a violation of the limit in the amount of short-term debt that may be issued, the Court of Accounts must request the municipality to submit a recovery plan. The LPF contains a chapter (Chapter VI, articles 74 and 75) on financial distress and insolvency of LGU. A special law for implementation of these provisions is being drafted. Starting with 2007, situations of fiscal distress and insolvency in LGUs will be regulated and observed more thoroughly.

In the LPF there is a list of definitions which includes a definition of insolvency but not of financial distress. However later in the text financial distress is defined as non-payment of liquid and matured debts, older than 90 days, registered at the end of a quarter of the financial year, and which exceed 30% of the total budget of that quarter. The definition also includes non-payment of salaries as foreseen in the budget of income and expenditure for a period longer than 90 days.

In accordance with the LPF, the definition of insolvency is:

"A situation in which a debtor finds himself when his goods have a lower value than the totality of his obligations that need to be satisfied with those goods"

Our comment on this definition of insolvency is that not only goods can satisfy the liabilities but also the expected future proceeds of these goods and because solvency should be defined in net present value terms.

The syndic judge, through the decision to opening an insolvency procedure, will appoint an administrator who undertakes all prerogatives of the main credit release authority of the administrative territorial unit which is the subject of the insolvency. Within 30 working days from the administrator appointment, he/she elaborates, together with the territorial structure of the Audit Court, a Plan of Insolvency Recovery.

If the insolvency is found to have ceased, the syndic judge, at the administrator's proposal, will pronounce the closure of the insolvency proceedings in the administrative- territorial unit. The administrative-territorial unit remains in the financial crisis situation, while the main credit release authority and the local council regain their prerogatives and start applying the Plan of Financial Recovery in order to release the administrative- territorial unit from its financial crisis situation.

The opening and closing of the insolvency proceedings are registered by the main credit release authority within 5 days from declaration of the insolvency. The registration is made in the Local Register of the Administrative-territorial Unit which is administered by the general directorates of public finances of the counties and by the Bucharest Municipal City in the case of Bucharest. The opening and closing of insolvency procedures must be communicated monthly to the MPF in order to record them in the National Register of Insolvency for the administrative- territorial units.

In a financial crisis, the main credit release authority has to draw up the Plan of Financial Recovery. The plan will be elaborated by the main credit release authority, together with the general directorate of public finances of the county or of the Bucharest Municipal City and the territorial bodies of the Audit Court, within 30 days from the day the financial crisis is declared by the deliberative authority. The control of executing and fulfilling the measures set out in the Plan of Financial Recovery lies with the territorial structures of the Audit Court.

Table 10. Characteristics of Financial Distress and Insolvency at LGU Level

<p>Financial distress</p>	<p>Insolvency is a situation in which a debtor finds himself when his own goods have a lower value than the totality of his obligations that should be satisfied with those goods</p>
<p>Conditions</p>	
<ul style="list-style-type: none"> ● non-payment of liquid and matured debts, older than 90 days, registered at the end of a quarter of the financial year and which exceed 30% of the total budget of that quarter; ● non-payment of salaries, foreseen in the budget of income and expenditure for a period longer than 90 days. 	<p>If the LGU is unable to pay the matured debts exceeding 50% of its budget for a period of 120 consecutive days</p>
<p>Initiation</p>	
<p>Declaration by the deliberative authority</p>	<p>Any creditor or group of creditors having one or more true, liquid and matured debts to be claimed from an administrative-territorial unit, with a value above 50% of its budget, for a period of 120 consecutive days, can file, with the Court of Law in the territory in which the unit is located, an application for the opening of proceedings of insolvency against that administrative-territorial unit.</p>
<p>Plan</p>	
<p>The main credit release authority to draw up the Plan of Financial Recovery.</p> <p>The control of executing and fulfilling the measures set out in the Plan of Financial Recovery lies with the territorial structures of the Audit Court.</p> <p>The Plan includes:</p> <ul style="list-style-type: none"> ● economic-financial analysis of the administrative-territorial unit ● measures for maintaining the essential public services by the local public administration's authorities throughout the period for which the Plan of Financial Recovery is in force; 	<p>The administrator will administrate the insolvency recovering procedure of the administrative-territorial unit.</p> <p>The Plan includes:</p> <ul style="list-style-type: none"> ● measures for re-establishing the financial viability of the administrative- territorial unit; ● measures for further fulfilling the essential services of the administrative- territorial unit throughout its insolvency; ● negotiated measures and the schedule for paying the debts to the creditors in order of the debt seniority.

<ul style="list-style-type: none"> ● measures for increasing the realisation of own income, as well as for attracting other income; ● measures for decrease in expenditure; ● economic-financial and budgetary planning until recovery; ● establishing the tasks for fulfilling the provisions within the Plan of Financial Recovery 	
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7. FINANCIAL MANAGEMENT ISSUES

In Romania there is a single Treasury system, so that, in principle, the government knows at all times the aggregate amount of resources available in the Treasury. This means that, although individual local governments maintain records of their own finances, their accounts are actually under the control of the central government (local governments can hold accounts in commercial banks for the EU grants received for infrastructure/development projects). This can constrain local fiscal flexibility. The Audit Court at the central level is responsible for control of local community's expenditures.

Public institutions are obliged to transmit their budget to the territorial unit of the Treasury. The executive authorities and the presidents of the county councils are obliged to publish on the Internet site of the public institutions and/ or to post in a public place the budget draft, the approved budget, the budget execution, its development, the budget rectification and final accounts. This information must be updated at least once a quarter.

In accordance with the LPF, the main credit release authorities of the local budgets shall draw up, annually, a public investment program, in accordance with the functional classification and to include both financial and non financial information.

The financial information must include the total value of the project, engagement credits, budget credits, the financing graph by source and by year correlated with the execution graph, the cost-benefit analysis and the operating and maintenance costs after commissioning.

In Romania, the LPF introduces a solidarity principle as: "by means of local budgetary policies, administrative-territorial units and physical persons found to be in extremely difficult situations can be assisted by allocating sums from the reserve fund constituted within the local budget".

The budgetary reserve fund at the disposal of the local and county councils comprises 5% of the total expenditure. The reserve fund is used on the proposal of the main credit release authority, based on a decision of the council, to finance certain urgent or unexpected costs that come up during the budgetary year. The reserve fund can also be used for the removal of the effects of certain natural calamities and for granting assistance to the administrative- territorial units in cases of extreme difficulty.

In accordance with the LPF, in order to cover the financial risks deriving from the guarantee assured by the administrative-territorial unit for the loans contracted by the economic operators and the public services found in local subordination, a risk fund is constituted separate from the local budget. The risk fund is kept a separate account, opened at the territorial units of the Treasury to provide for local guarantees to domestic loans and for guarantees to external loans.

The most transparent means of financial management at local level is to separate the capital budget from the current budget. The current budget's surpluses can be used to repay loans used for investment i.e. for capital needs. In accordance with the LPF the Operational Section is a compulsory main part of a local budget which comprises the income for covering the current expenditure needed to carry out the duties and competencies established by the law and to cover the current expenses;

Development section is a complementary part of a local budget which comprises the income for covering capital expenditure. Capital expenditure will be in accordance with the established development policies, at national, county, zone or local level and be based on programs and projects. The zone level means the territory of two or more neighboring administrative-territorial units on which an action or a program has been agreed by the local communities. These articles from the LPF are not yet implemented, and are not clearly defined. They will be enacted in 2008, when methodological norms will be issued.

The programmatic budgeting is prescribed thus moving toward performance budgeting as opposed to the input based budgeting. In accordance with the LPF, a Program is an activity or a coherent assembly of activities that refer to the same main credit release authority which has been designated to achieve an objective or a defined set of objectives and for which there are established program indicators for evaluating the results to be obtained, within the limits of the approved financing.

Following the commitment of the Government in 2001 to move from cash to accrual accounting (as per the Strategic development plan for public financial management Reform 2005-2007):

- A strategy for the move to accrual accounting was developed for SAPARD⁸ and ISPA funds to provide working models based on the accrual accounting principles;
- Cash methodology is being developed for PHARE transactions together with norms for accounting on an accrual basis that need to be approved by the Ministry;
- New accounting methodology based on accrual has been developed to apply to all public entities at central, regional and local government level. The reporting system became operational in January 2006. Communes now have double entry accounting systems which also started in January 2006.

8. BONDS

In accordance with the LPF, bonds are defined as titles of credit, on the middle and long term, issued on the authority of a local public administration, with reimbursement guaranteed by the income of the administrative-territorial units, and goods belonging to the private property of the administrative-territorial units.

In 1998 the USAID funded project managed by the Urban Institute, made a training needs assessment for the banks in Romania. They collected information from the five largest banks that have expressed an interest in lending to municipalities and regii. These banks included Bancorex, Romanian Commercial Bank, Romanian Development Bank, Bancoop, and Savings Bank.

Since then, two Romanian banks, the Romanian Commercial Bank and the Romanian Development Bank have been the underwriters to most of the LGU bonds issued in Romania. Major investors have been the banks, investment funds, companies and insurance companies. Pension funds are not involved in investment so far. At first it was the LGU that initiated the issuance of bonds although later the banks have also become initiators.

8) Three pre-accession instruments have been financed by the European Community to assist the applicant countries of Central and Eastern Europe with their pre-accession preparations:

- **Phare** program that provides support for institution building, investment to strengthen the regulatory infrastructure needed to ensure compliance with the *acquis communautaire* and investment in economic and social cohesion,
- **SAPARD**, which provides aid for agricultural and rural development; and
- **ISPA**, which finances infrastructure projects in the fields of environment and transport.

The LGU worked with independent consulting companies that assisted in:

1. Analyzing the indebtedness capacity of the LGU and recommending the amount of money that can be borrowed;
2. Analyzing other alternatives such as treasury bonds, credits, external borrowing;
3. Suggesting the optimal timing for bond issuance, the nominal value of the bonds and the maturity rate;
4. Negotiating the interest rate;
5. Estimating the macroeconomic trends and interest rates in the capital market;
6. Analyzing the budgetary flow of LGU and making mid term forecasts.

According to the Urban Institute report of 1998, apart from the perceived wisdom that the issuance of bonds is more complicated than contracting a loan, in Romania the bond market is considered to be less politicized and more transparent than the bank market. In fact the procedure for issuing bonds is less complicated than getting a bank loan and the interest rate in the capital market has been lower than in the banking sector. However, the LGU loan market has become a competitive one and LGU now prefer loans to bonds. Some consulting agencies have become involved in offering consulting services related to LGU borrowing. The interest rate on a loan is calculated based on the BUBOR which is the rate at which the banks in Romania borrow among themselves. The margin between the interest on a loan and BUBOR is in the range 0.5 % to 2 % per annum. The banks also charge a facility commission of not more than 1 % and an administration fee of 0.01 % of the outstanding loan. The bank charges a commission in case of reimbursement ahead of schedule.

In case of issuing bonds, there are additional costs for the external consultant, the stock exchange etc. These additional bond costs are outside the 25 % debt limit (only the coupon and the final payment are included in the 25 % debt limit). The Romanian Commercial Bank

In Romania in the event of a default on a municipal bond issue, the present law leaves bondholders to pursue remedies on individual basis since the legal framework does not permit bondholders to act in an organized and effective manner to enforce their rights, and to create a contractually based role of bondholder representative. The legal framework in future should permit bondholders to act in an organized and effective manner to enforce their rights.

The first municipal bonds were issued in 2001 and from the very beginning the LGU found financing through bond issues attractive. In the first year 7% of new domestic debt was in the form of bonds (two issues). In 2002, the proportion of bond issues increased to 35% (eight issues). In 2006 Bucharest issued bonds denominated in Euro.

Table 11. The Profile of Romanian Municipal Bond Features, 2004

Number	9 issues at year end 2004
Value	Average: ROL 39.68 billion, or about \$1.42 million
	Range: ROL 5 billion-ROL 150 billion, or \$0.17-\$5.34 million
Maturities	Generally two to three years, although Deva has 4+ years, and Oradea has 6+ years
Fees	Range: ROL 100,000-ROL 2 million, or \$3-\$60
Coupons	Range: four to 12
Rates	Generally $[(BUBID + BUBOR)/2] + 1\% - 3\%$.
	Most rates are set on a trimester basis.

Source: CSPD from MPF, CNVM.

According to Fitch, in the period 1999-2002, local public debt increased from 35% to 38% of total public debt and has stabilized at about 11% of GDP. The main overseas lenders to Romania are the EBRD and the EIB while in the domestic market the principal players are Banca Comerciala Romana, Banca Romana de Dezvoltare and BankPost. In 2002 local branches of international commercial banks (such as ABN AMRO and Raiffeisen Bank) were also becoming active providers of funding to Romanian municipalities. In view of the latest regulations, which permit municipalities to open accounts in commercial banks for loan transactions, the number of lenders is expected to increase.

For loans other than those from the Treasury, LGU were permitted to open accounts with commercial banks since 1 January 2004. This is a positive development since establishes a bank-client relationship between banks and municipalities, with the banking sector becoming more familiar with the financial affairs of LGU.

9. CONCLUSION

After the initial early start to the process of decentralization with the drafting the Law on Local Public Administration and the Law on Local Elections in 1991 in Romania, the process has been slow with heavy central government and political influence rather than rapid decentralization. It took a couple of years to institutionalize local autonomy by means of the Law on Local Taxes and Charges 1994 and the European Charter which was ratified in 1997.

New changes in legislation took place in 2006 but have yet to be implemented. There are high expectations for transparency, professionalism and less political voluntarism. The main difficulty with the institutional framework has been its changeability, arising from the high number of regulations affecting it and the frequency with which legislation has been amended, replaced or abolished. Another issue has been the limited involvement of local government officials in the legislative process, especially in decisions over revenue and expenditure. With the changes in the Law 215 this should be changed and the LGU should be consulted in a timely manner about any change in legislation.

It seems that the problems related to the decentralization process in Romania are well identified and the changes in the legislation in 2006 are considered to be a major step forward. These changes include the adoption of the Framework Law on Decentralization, the new LPF and Law 215. Implementation has yet to begin and so the benefits cannot yet be assessed.

With the Framework Law on Decentralization, the competencies are now clearly assigned to local and county level. However, the inefficiency in providing services as a consequence of the fragmented territorial structure remains a problem especially for the smaller LGU. There is the lack of strong relationship with the business community for many reasons such as the low rate of return of projects, the presence of subsidies and political sensitivity. Strengthening this relationship with its different instruments (PPP for example) might improve the situation by ensuring more efficient spending of public money in providing services.

There was an attempt at recentralization during the period of 2001 to 2004 in terms of control and intervention at local level from the central level. There was confusion in sharing responsibilities especially in the health and social sectors. The result was a lower level of investment and underdevelopment of the borrowing market at LGU level because of lower demand for capital caused by uncertainty. At LGU level, property rights and ownership are not yet clear.

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The LGU revenue system experiences systematic error. The deferred payments not collected in the previous fiscal year are actually counted as planned revenues for the next fiscal year. Another problem is the dependency on central government transfers mostly due to low efficiency in administering own revenues and a failure to improve the collection rate although since the LGU have become responsible for collection, the rate has increased to about 80%-85%.

The intergovernmental transfer, even though in one respect transparent (formulas in the legislation and detailed explanations), remains complicated and creates uncertainty due to possible changes in percentages each year by the central government. This creates difficulties in fiscal planning for the lower level governments. Allocation of equalization funds often becomes a political negotiation rather than the result of a transparent effort to differentiate between local needs. During development of the equalization system the WB wanted to remove the counties from the system of redistribution as they are exercising too many discretionary rights. The WB preferred a central level system in accordance with a formula but the Romanian government wanted to retain the system. The compromise reached was to use devolved units i.e. the Prefects. Further discussion with the WB related this issue is envisaged for 2007.

As for borrowing, best practice is followed in relation to the definition of borrowing, debt limits and institutions. The debt limitation was increased to 30 % from 20% with the Emergency Ordinance 425 of own revenues. A "Financial Crisis" is clearly distinguished from "Insolvency", there are insolvency procedures prescribed in the LPF and what now remains is to see how the legislation will work in practice.

In relation to the guarantees from own revenues of LGU, the WB would like to resolve the situation concerning shared revenues. The definition of PIT is unclear as to whether it is a shared or an own revenue and this creates confusion.⁹ There is a twinning program of the EU to prepare a separate Law on Public Debt and the LGU which will deal with LGU insolvency rather than this issue simply being a part of the LPF. It is WB opinion that in case of insolvency, the Treasury should not give loans because of the moral hazard (classical bail out). In contrast domestic experts think that these loans are the last resort to fix possible problems and should remain.

Starting in 1999 and after 7 years of practice the system of borrowing at LGU level has developed significantly with loans and bonds being issued. There still are some issues to be resolved such as permitting bondholders to act in an organized and effective manner to enforce their rights. The loans were mainly used for infrastructure projects (water, sewage, roads, land fields etc)

Before 1998, 17 loans were provided by the EBRD mostly for water rehabilitation. These loans had government guarantees (60 % from the EBRD, 20 % from the county council and 20 % from the central government). LGU borrowing was allowed in 1999 but the banking sector lacked knowledge of LGU finances, the LGU didn't have accounts at the banks, the legal system was unpredictable and changing and the collateral system was weak. Municipal services loans are provided from the WB to the MPF in Romania. It is interesting that the WB now is preparing a policy note on LGU Financing. It should cover the topics of: decentralization, LGU financing processes and EU funds, access of LGU to the banks, financial market structure etc.

The bank's loan market started to be operational in 2001. It started from a low base and has increased about 400 fold by 2005. The proportion of capital investment financed from borrowing is

9) The unclear definition of PIT is very similar to the Macedonian situation described in the Macedonian country report.

about 85 % and mostly in public services. There is no borrowing experience for operational spending. Also, 10 banks signed a memorandum of interest with the Ministry of Administration and Interior to lend to the LGU. The largest Romanian bank (25 % of the total banking sector assets) is also the largest investor in the LGU loan market. The final result of these developments is lower spread in interest charged. The purpose of the loans was to provide services in water supply and transportation. Maturities varied from 1 to 10 years with variable interest rates.

In case of taking a loan from a bank, an LGU has to organize a tender and to have at least 5 banks making offers with information on interest rates, fees, maturities and commissions. The credit analysis is done by the banks. After the tender procedure is done the LGU provide financial statements, contracts with construction companies etc to the banks. For their own credit analyses, the banks look at LGU: revenues, own revenues, actual versus planned revenues i.e. the fiscal effort (80 % is considered sufficient) and own taxes over total revenues i.e. the level of dependency (40 % is considered sufficient). Other information and data banks examine include the relationship and political proliferation of the Mayor versus Council, managerial skills of mayors etc. The banks develop their own procedures for credit analyses of LGU. Banks are not interested in the intergovernmental transfers as these are considered as certain.

In 2005 the city of Bucharest issued Euro Bonds with the rating agency being S&P. The problem is that the proceeds are idle in a bank account and waiting for the fruitless debate on what they should be spent to end. Such an experience shows that Euro Bonds are a political instrument rather than an instrument to raise capital for investment.

Some LGU are listed at the stock exchange (13 or 14 of them). EBRD and IFC are enhancing the financial collateralized debt obligation in order to create special purpose vehicles to issue bonds and to help the process. There are also special guaranties from these financial institutions.

The possibility of LGU borrowing in Romania has served as an incentive for improved cost recovery through user charges even though subsidies remain especially for the heating and gas supply. For example, the joint initiative between the PHARE and the EBRD and EBI developed an application form for the SAMTID funds to be used for regional projects. LGU that had access to the SAMTID funds were forced to increase their tariffs and this was stated in the contracts. The willingness to pay was high but subsidies to the poor stratum of the population were introduced.

There are big differences in financing the LGU. The large LGU were financed mostly by the ISPA and WB but small and medium LGU gained nothing. The general wisdom in Romania is that the large LGU are afraid to borrow and the small LGU are not informed.

Currently sub-national governments have not used borrowing to pay for current expenditures. There is no type of regional development fund, no sub-national banks, bureau for development etc. There were some initiatives in this regard but these were not successful.

Annex 1. Field visit in Romania

A number of factors limit the extent of this report. One being the short time allocated to conduct a reasonable number of interviews during the stay in Romania (list of individuals interviewed follows). It was not possible to observe in any depth the challenges faced by all levels of governments and stakeholders on a daily basis and was also not possible to base analysis here on a detailed local financial data. Thus, much of the report relies on the information obtained in the interviews and a review of legal documents and existing studies.

Table 12. List of people interviewed in Romania

Interviewee	Position	Contact
Sorin Teodoru	Consultant at the World Bank	steodoru@worldbank.org
Radu Dorcioman	Ministry of Administration and Interior Affairs	radu.dorcioman@yahoo.com
Valentin Ionescu	Legal expert at CSPD	vionescu1961@yahoo.com
Victor Giosan	State Secretary at the Romanian General Secretariat	vgiosan@yahoo.co.uk
Cassandra Bischoff	Decentralization team at the World Bank	cbischoff@worldbank.org
Gabriela Matei	Director of CSPD	gabriela.matei@cspd.ro
Adrian Oprica	The BRD Bank	adrian.oprica@brd.ro

Annex 2. Relevant legislation in Romania

1. Constitution (1991 revised in 2003)
2. Framework Law on decentralization (339/2006)
3. Law on local public administration (69/1991 replaced in 2001 by Law no. 215 and now in 2006 by Law no. 286)
4. Law on local public finance 189 from 1998/2003/2006
5. Law on civil servants
6. Law on local elections (no. 70/1991)
7. Law 340 on the prefects
8. Law 188 on the statute of civil servants
9. Law 326 on local public utilities
10. Law on state budget (annual)
11. Law on local taxes and charges (1994) amended in 2002
12. Law on fiscal code (no 571/2003)
13. Emergency Ordinance from 2002 that establish maximum limits for taxes and charges related to buildings, lands, automobiles and construction permits.
14. Law on public domain that classifies the private domain that can be used as guarantee.
15. Law on municipal services 326 from 2001
16. Law on public debt 81/1999
17. Order no. 219 (2000) regarding calculation of the debt services
18. Order no.7 (2001) that decides who is excepted from LGU bonds transaction
19. Order no. 1631 (1999) regarding the obligation of the local public authorities to send information about LGU borrowing
20. Order No. 7, 2001 grants tax exemption to municipal bonds held by natural persons.
21. Law on patrimony for securing municipal debt with a mortgage on municipal property in the private domain.

- 22. The Law regarding securities and stock exchanges (No. 52/1994) provides that municipal securities are exempt from the disclosure requirements established by the National Securities Commission ("NSC").
- 23. Government Ordinance No. 35/30.01.2000 removes the restrictions of municipalities to deposit funds in banks for operations in "hard currency"
- 24. Prudential investment guidelines for private pension funds
- 25. Law on concessions (no.219/1998), setting the general framework for concessions at the local government level
- 26. Government Ordinance 92/2003 regarding the fiscal procedure code
- 27. Law 522/2002 on local taxes and duties
- 28. Annex 1, "Competences fulfilled by local governments at the county level in providing public services"
- 29. Annex 2 "Competences fulfilled by local governments at the commune and town level in providing public services"

Annex 3. Applications to the Commission to authorize borrowing

**ANNEX 1.1.
APPLICATION
for Borrowing Authorization*1)**

- 1. Applicant name
- 2. Address in full, telephone/fax
- 3. Duly delegated persons
- 4. Loan destination
- 5. Local public administration authority approval
- 6. Borrower
- 7. Financier name
- 8. Conditions of the loan authorization for which is sought:

Loan amount (in such currency as denominated in contract)	Annual interest rate	Term of Loan		Level and timelines for payments in principal, interest and fees
		Grace period	Repayment period	

Date
.....

Signature
(Primary Spending Agency)

*1) To be filled in by local public administration authority if authorization of borrowing on the basis of local public administration guarantee or state guarantee is sought, or if a subsidiary loan is provided to the administrative unit.

**ANNEX 1.2.
STATEMENT**

I, the undersigned, lawful representative of county/city, as primary spending agency, state herein and am liable for this statement that the county/city has the following outstanding domestic and/or foreign loans or loan guarantees:

Lender	Loan amount (currency as denominated in contract)	Loan destination	Borrower	Guarantor	Loan duration		Annual payable in principal	Annual interest rate	Fees
					Grace period	Repayment period			

This Statement is part of the documentation required to authorize loan-taking/guaranteeing in the amount of and I am liable, in conformity with Art. 27 of Law No. 313/2004 and Art. 70 of Government Emergency Ordinance No. 45/2003 on local public finance, as amended and made into Law No. 108/2004, for any inaccurate data supplied.

Date
.....

Signature and seal

**ANNEX 1.3.
APPLICATION
for Loan Guarantee Authorization *2)**

1. Applicant name
2. Address in full, telephone/fax
3. Duly delegated persons
4. Loan destination
5. Local public administration authority approval
6. Financier name
7. Conditions of the loan for which authorization is sought:

Loan amount (in such currency as denominated in contract)	Annual interest rate	Term of Loan		Level and timelines for payments in principal, interest and fees
		Grace period	Repayment period	

Date
.....

Signature
(Primary Spending Agency)

*2) To be filled in by the local public administration authority, if authorization is sought of borrowing by an economic agent or a public service coordinated by local authority, and also if a subsidiary loan guarantee is provided by the administrative unit.

**ANNEX 1.4.
APPLICATION**

for Authorization of Local Public Administration Borrowing by Securities Issues

1. Applicant/issuer name
2. Address in full, telephone/fax
3. Duly delegated persons
4. Finance destination
5. Local Public Administration authority approval
6. Information on securities issue:
 - type of securities
 - form of securities
 - issue size
 - nominal value
 - selling price
 - interest rate
 - coupon yield
 - maturity date
 - issue guarantee
 - size of finance expected to be mobilized
 - type of securities offer
 - if sale is mediated, name of intermediation company/syndicate (lead-manager)
 - period of implementation
 - further details

Date
.....

Signature
(Primary Spending Agency/Authority)

Annex 4. Norms and procedures for authorizing local government borrowing

A. Borrowing by Administrative Units

Domestic borrowing by administrative units means:

- domestic state-guaranteed borrowing by administrative units;
- domestic loans taken and guaranteed by administrative units;
- borrowing from State Treasury general account availabilities to bridge temporary revenue-expenditure gaps in local budgets.

Foreign borrowing by administrative units means:

- foreign loans taken by the State for on-lending to administrative units;
- foreign loans taken by administrative units themselves with State guarantees;
- foreign loans taken and guaranteed by administrative units themselves.

A local public administration authority applying to the Commission to authorize borrowing shall have attached to its borrowing authorization application (see Annex 3) the following documents:

- a) statement by primary spending agency/authority, which is liable therefore, that the investment project engineering and economic documentation was advised by the relevant Romanian authorities;

b) local public administration authority decision to borrow, to specify loan amount and its financier, the local budgeted servicing of the loan-related public debt, for the period of the loan, payment of any taxes and charges associated with investment project implementation, which decision was made in compliance with Government Emergency Ordinance No. 45/2003 Art. 57 (2);

c) local public administration authority decision on approving the engineering-economic documentation, engineering and economic indicators of the investment project of local interest and its funding sources;

d) decision on set-up of local council, county council of General Bucharest City Council, as applicable, and the list of authorized signatures;

e) local budget as approved for current year and as projected for the period of the loan authorization for which is being sought, to include own revenue and expenditure by MFP-approved budget classification, including local public debt servicing expenditure incurred by the loan;

f) the administrative unit's local budget annual accounts for 2 years before the year when loan-taking authorization is sought, and the quarter-year accounts for the current year;

g) the draft loan contract (agreement) sent by financier, to include: loan amount, loan currency, grace period, repayment period, rate of fees and other loan costs;

h) primary spending agency's statement for which it is liable of the status of other loans taken and/or guaranteed by the administrative unit, attached as Annex No. 1.2;

i) an estimate of the local public debt servicing during the period of the loan authorization of which is being requested, to include payments in principal, interest, fees and other related costs, broken down by domestic and foreign loan taken and/or guaranteed by the respective administrative unit, and the loan the contracting of which is subject to authorization;

j) any other documents the Commission may request to review the application for authorization of borrowing.

B. Borrowing Guaranteed by Administrative Units

Borrowing guaranteed by administrative units means domestic borrowing by economic agents or public services coordinated by administrative units, with such administrative units providing guarantees therefore.

Foreign borrowing guaranteed by administrative units means:

- foreign borrowing by the state for on-lending to economic agents or public services coordinated by administrative units, with such administrative units providing guarantees therefore;
- foreign borrowing by economic agents or public services coordinated by administrative units, with such administrative units providing guarantees therefore.

A local public administration authority applying to the Commission to authorize loan guaranteeing under the statutory provisions in force shall have attached to the application for loan guarantee authorization (see Annex 5) the following documents:

a) statement by primary spending agency/authority, which is liable therefore, that the investment project engineering and economic documentation was advised by the relevant Romanian authorities;

b) local public administration authority decision to guarantee the loan, to specify the amount of the loan and financier, which decision was made in compliance with Art. 57(2) of Government Emergency Ordinance No. 45/2003;

c) local public administration authority decision on approving the engineering-economic documentation, engineering and economic indicators of the investment project of local interest and its funding sources;

- d) decision on establishment of local council, county council of General Bucharest City Council, as applicable, and the list of authorized signatures;
- e) charter of the economic agent or public service coordinated by the administrative unit which is to guarantee such agent's or public service's borrowing;
- f) decision of the Board of Directors or any other executive body of the economic agent or public service coordinated by the administrative unit on approving investment and borrowing, to specify loan amount and financier, local budgeted servicing of the loan-related public debt, for the period of the loan, payment of any taxes and charges associated with investment project implementation;
- g) local budget as approved for current year and as projected for the period of the loan the authorization of guarantee for which is being sought, to include own revenue and expenditure by MFP-approved budget classification, including local public debt servicing expenditure incurred by the loan;
- h) the administrative unit's local budget annual accounts for 2 years before the year when loan guaranteeing authorization is sought, and the quarter-year accounts for the current year;
- i) the draft loan contract (agreement) sent by financier, to include: loan amount, loan currency, grace period, repayment period, rate of fees and other loan costs;
- j) primary spending agency's statement, it is liable therefore, of the status of other loans taken and/or guaranteed by the administrative unit, attached as (see Annex 5);
- k) an estimate of the local public debt servicing during the period of the loan authorization of guarantee for which is being requested, to include payments in principal, interest, fees and other related costs, broken down by domestic and foreign loan taken and/or guaranteed by the respective administrative units, and the loan guarantee of which is subject to authorization;
- l) any other documents the Commission may request to review the application for loan-guarantee authorization.

C. Local Borrowing by Issuance of Securities

Local public administration authorities may borrow by issuing securities in compliance with the legislation on the treatment of securities. Securities may be issued and launched by local public administration authorities themselves or through agencies of other specialist institutions. A local public administration authority shall submit to Commission Secretariat an application for authorization of borrowing by a securities issue (see Annex 3).

The issue prospectus shall basically provide information on:

- total value of the securities issue and the project financed;
- terms and characteristics of securities (type, form, currency they are denominated in, nominal value, issue value, annual interest rate, maturity, coupon frequency);
- terms and conditions of the securities issue (offer procedures, conditions and ways of selling securities, payment agencies, the securities issue governing law).

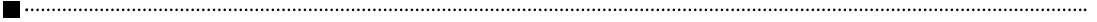
Further Dispositions:

Within 10 days of effectiveness of a borrowing and/or loan guaranteeing contract/agreement, the local public administration authority shall convey to the Ministry of Public Finance copies of each primary document confirming, as applicable:

- loan-taking/loan-guaranteeing;
- the additional act to the loan/guarantee contract/agreement, if amended with due respect for contractual provisions.

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COUNTRY REPORT: LOCAL GOVERNMENT BORROWING IN BULGARIA

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Sponsored by:
Local Government and Public Service Reform Initiative
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Budapest, Hungary

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List of abbreviations

CEA	Center for Economic Analyses (Macedonian think tank)
ZELS	Association of the units of local self-government of the Republic of Macedonia
FDWG	Fiscal Decentralization Working Group
NAMRB	National Association of Municipalities in Bulgaria
GDP	Gross Domestic Product
PIT	Personal Income Tax
CIT	Corporate Income Tax
MDA	Municipal Debt Act
DCA	Development Credit Authority
EBRD	European Bank for Reconstruction and Development
WB	World Bank
JBIC	Japan Bank for International Cooperation
CFS	Commission for Financial Supervision
BGN	Bulgarian currency - Lev

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1. INTRODUCTION

The following case study describes the development of the local self-government in Bulgaria with special attention paid to issues of debt. Firstly, the study gives an overview of the regulatory changes and legislative actions to set up the system of intergovernmental relations. Then, the structure of local governments is described with attention paid to the election of the representative bodies. Basic information on the responsibilities for expenditure and revenue assignment is presented in the subsequent chapters. As the grants and transfers from the state budget comprise a substantial amount of the revenue for a local government, the next section sets out the rules by which such funding is provided. Next, an overview of the legislation on local government borrowing is presented and the results for the local budget financing are discussed. In the last section, the unresolved issues and institutional obstacles to debt market developments are set out. Based on this, some recommendations which are potentially applicable for Macedonia are formulated.

This report is based on an extensive review of existing legislation and documents such as reports, analyses and research studies. Additionally, during the field visit to Sofia (27-28 September 2006) the main issues were clarified and discussed with the policy makers and researchers dealing with the issues of municipal debt.

2. BACKGROUND

The decentralization process started with adoption of a new Constitution in 1991, which defined Bulgaria as country with local self-government. At the same time the Local Self-government and Local Administration Act was adopted. Since then this regulation has undergone numerous amendments.

Subsequently additional regulations were adopted to shape the system of local self government. These were:

- The Administrative Division Act,
- The Local Election Act (1995) and
- The Municipal Budget Act (1998).

In 1995 the government adopted a concept for administrative-territorial reform, but it was not implemented due to the economic crisis of 1996-1997.

A major institutional step forward was establishment of the National Association of Municipalities in late 1996. In 1998 the Law on Administrative Division was amended stipulating the replacement of the 9 regions that previously existed with 28 new regions by the end of that year. This reform was followed by approval of the Regional Development Act in 1999.

The regime of municipal ownership was set up by the Law on Municipal Property specifying the competences of each municipal authority in relation to municipal property. The rules for revenue collection were determined by the Law on the Local Taxes and Charges (1997).

In order to build consensus on the key issues confronting local government, the Local Government Forum was organized in 2001. The following problems were identified (Manual, 2005):

- permanent deficits,
- a non-transparent and unstable system of transfers
- a backlog in municipal investment.

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In order to provide solutions to these problems, a Fiscal Decentralization Working Group (FDWG) was established in March 2002 by a resolution of the Council of Ministers. This group included broad local government representation, officials from central ministries and from local government organizations. It was mandated to make proposals for fiscal decentralization and to identify the requirements for implementation of the program. The FDWG provided leadership for meaningful reforms. The first result of its work was the Concept for Fiscal Decentralization (adopted in June 2002), which identified the following objectives and principles for decentralization (Case study, 2005):

- (1) Clarify the responsibility for the assignment of expenditure at municipal level;
- (2) Identify the responsibilities for the financing of state expenditure delegated to the municipalities;
- (3) Identify the responsibilities for the financing of the municipal expenditure;
- (4) Improve the legal environment for the development and implementation of municipal budgets.

Along with the Concept, a Fiscal Decentralization Program for 2002-2005 was adopted. Building on the Concept, the program defined the legislative targets for enactment in the current year and the policies for subsequent years. The specific steps, tasks, deadlines and the institution responsible for implementation were identified.

FDWG organized itself into 3 task groups to work on the specific legislative changes that were required. As a result of these efforts, at the beginning of year 2003 fiscal decentralization reform was carried out. The main change brought about by this reform is the division of the public services provided by the municipalities into mandated and local option services. Fundamental changes in the inter-governmental transfers system were carried out as a result of this division of the services in particular by the introduction of two new types of subsidies, the general complementary subsidy (for financing mandated services) and the general adjustment subsidy (for financing local option activities). Another accomplishment of the reform is that the local governments were given powers to set the rates of local fees.

All local government related laws mentioned above were updated in compliance with the changes introduced by the fiscal decentralization reform.

A second working group was established in 2003 and dealt with development of the municipal credit market (Municipal Borrowing Working Group). A draft of the legislation was developed and submitted to the Ministry of Finance in early 2004. This legislation was approved by Parliament in April 2005 and became effective on 1 June 2005 as the Municipal Debt Act which provided a comprehensive legal framework for municipal borrowing.

The third working group was established by the order of June 2004 of the Cabinet of Ministers, with the task to develop and propose a permanent system for monitoring and evaluation of the fiscal decentralization process. The group approved two documents (Assessment, 2004):

- (1) Permanent System of Indicators for Monitoring and Evaluation of Fiscal Decentralization
- (2) Report on the Development of Fiscal Decentralization in 2003.

After the Parliamentary elections in June 2005, the new government continued the policy of decentralization. The FDWG was replaced by the National Council for Decentralization which was made up of representatives from all stakeholders. In October 2005, the government signed the agreement on cooperation with the National Association of Municipalities in Bulgaria (the only countrywide representative body for the municipalities). The Council of Ministers and NAMRB jointly elaborated and adopt-

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ed (June 2006) a Decentralization Strategy for 2006-2015 and a Program for its implementation in the period 2006-2009. Thus, for the second time since 2002 there has been a mid-term decentralization reform agenda.

Having EU accession in mind, municipalities were delegated functions on internal audit. In the first half of 2006, three new acts on this issue were adopted:

- Public Sector Internal Audit Act,
- Public Sector Financial Management and Control Act,
- State Financial Inspection Act.

3. STRUCTURE OF GOVERNMENT

The Constitution provides for two main levels of local government namely the municipality and the region. Bulgaria is now divided into 28 regions and 264 municipalities. The municipalities represent local self-government, while the regions are deconcentrated administrations of central government. City districts and mayoralities are municipal subdivisions below the municipal level. Due to EU accession, a new tier of government (NUTS II) represented by the six planning regions has been established. This level of the local government has the potential to develop regional development policy. Experts still argue that two out of six defined regions do not correspond to the EU standards from the point of view of the number of habitants (CED, 2006), and so consensus still has to be reached.

Proposals for new borders for the NUTS II regions were made recently by the Ministry of Regional Development and Public Works but these need to be approved by Eurostat in order to become valid.

The region (oblast) represents the national government at provincial level, and harmonizes national and local interests. The Governor of a region is appointed by the Council of Ministers. He is responsible for governing the region and is assisted by a regional administration. Region administrations have neither the legal power nor the financial resource to carry out public investments. Their activities concentrate on the preparation of development strategies.

The municipality is the basic administrative territorial unit in which local self-government is carried out. The body of local self-government in the municipality is the Municipal Council, which is elected by popular vote and has a mandate of four years. The Municipal Council comprises of the elected councillors, the number of which depends on the population registered in the Municipality. The Mayor is the executive arm of the municipality. He is elected by the population for a four-year term of office. The municipality has an independent budget and its own property. The rights and obligations of the local authorities are defined in the Local Self-Government Act (LSGA).

4. EXPENDITURE RESPONSIBILITIES

The scope of local services is regulated in the LSGA. Article 55 sets forth the financing responsibilities of the municipal budgets as:

1. Operational costs and wage costs including social security contributions, for the health, social, educational and cultural activities supported by the municipality;
2. Public utilities; Construction, extension, reconstruction, maintenance, and operating repair of municipal property, and the acquisition costs for municipal property;
3. Joint initiatives with other municipalities;

4. Costs of the Municipal Council and the municipal administration;
5. Administrative and technical services for the community where these are free of charge;
6. Town planning and cadastral records;
7. Redemption of loans;
8. Environmental protection activities;
9. Capital investments in economic activities.

Over the last few years a reduction of the share of municipal expenditures in relation to GDP and to the consolidated budget expenditures was observed (Table 1). The information presented in the table illustrates the fall in municipal spending since 1999 and a trend towards centralization in the provision of public services. As observed by Research Triangle Institute "these trends run contrary to the very essence of fiscal decentralization". Two examples illustrate the tendency towards centralization:

- transfer of social assistance to the Ministry of Labour in 2003
- transfer of municipal hospitals to the National Health Insurance Fund.

Table 1: Basic Data on Municipal Expenditure

	1998	1999	2000	2001	2002	2003	2004	2005
Municipal expenditure/ GDP	7.4	7.8	7.5	6.7	7.4	6.5	6.3	6.5
Municipal expenditure/ consolidated budget expenditure	19.2	19.3	17.9	16.6	18.8	15.9	15.7	16.4
Municipal investments/ GDP	0.9	0.7	0.6	0.7	0.8	0.9	0.8	1.2
Municipal investments/Municipal expenditure	12.8	9.3	7.9	10.2	10.8	13.2	13.0	19.1
Municipal investments/ public investments	35.1	23.2	15.6	10.0	16.0	17.7	16.9	n.a.

Source: Ministry of Finance, data for municipal investments/public investments - Nenkova.
 Note: capital expenditures are represented as category of 'capital and state reserve gain' thus starting from 2001 they may be overestimated. Another source (Nenkova) provides the following figures for capital investments in municipal expenditures: 2001 - 6.5%, 2002 - 8.6%, 2003 - 11%, 2004 - 11%.

Significant responsibilities for the provision of services have been assigned to municipalities without the transfer of matching resources. As a result two thirds of the municipalities have arrears in local activities (Assessment, 2004). The highest arrears occur in the case of local activities, but there are also arrears in the case of delegated activities. Due to limited availability of funds, current expenditure has taken precedence over capital outlays. Investments have remained small both in size and as a share of total expenditure.

Based on the Concept, the assignment of responsibility for expenditure between the state and municipal levels was clarified. The FDWG developed costing standards to determine the minimum funding levels for mandated services in four sectors: education, health, culture and social welfare (Mid-course, 2003). These funding levels are negotiated based on the previous expenditure pattern and not on analysis of the spending needs necessary to reach some specified level of services. The assignment of budget is revised every year before the State Budget Act for the following year is enacted. In regard to local services, spending is driven by the availability of funds not by the estimate of needs. The FDWG decided that the labour cost of municipal administration will be included in the mandated cost standards while the maintenance support costs were assigned as local expenses.

There are some weaknesses in the existing costing standard for the mandated services. Firstly historical data is used and the transfer for financing mandatory services is negotiated based on the pre-

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vious expenditure pattern. The second weakness is the capital costs of mandated services. At present, these are not included in the funding of mandated services and the government provides separate specified capital investment subsidies, which are usually insufficient. As a result, municipalities have no funds to finance capital investments and so the level of investment has declined steadily (Mid-course, 2003). As at September 2006, the costing standards for mandated services still do not provide for capital expenditures.

Certain activities have mixed financing. These include kindergartens and nursery homes. The operating costs of such an establishment are financed from a municipality's own revenues, whereas the salary and social expenditures are financed from government transfers (Current status, UNDP).

State delegated activities are funded from shared revenues collected under the PIT Law. When the proceeds from PIT in a particular municipality are lower than the costs of its delegated activities, the municipality receives a top up subsidy from the state. Local activities are financed from the municipality's own revenues plus the equalization subsidy.

5. REVENUE ASSIGNMENT

All potential revenue sources are defined in the Local Self-government Act (Article 53). The main categories are:

1. Municipality's own revenues
2. Share in state taxes
3. Transfers and grants from the central budget

A municipality's own revenues include local taxes, charges and other local levies established by law such as (Drumeva):

- Tax on real estate;
- Inheritance tax
- Tax on donations;
- Tax on vehicles;
- Proceeds from granting of concessions
- Local charges on household waste
- Charges for technical and administrative services
- Charges for security and protection of agricultural property
- Charges for use of kindergartens, nurseries, social care institutions etc.

The locally sourced revenues also include the revenues from the renting of municipal property.

The most important characteristic of the local revenue system is the lack of power of municipalities to set either the tax base or the tax rates. As a result, local taxes are local in name only, although the proceeds are spent in line with the decisions of the municipal council (Mid course, 2003). The attempt to grant greater local control over taxation was blocked by the Constitutional Court. Therefore, constitutional changes are necessary regarding the taxation rights of municipalities.

Until very recently municipalities did not play any role in tax collection, as all of the local taxes were collected by the Regional Tax Offices (Mid course, 2003). Pursuant to the amendments to the Local Taxes and Charges Act, the municipalities took over the collection of tax revenues. In 2005 some of

the municipalities were given the right to collect local taxes and charges as a pilot program. The results of this program were positive and since 1 January 2006 local taxes and charges have been collected exclusively by the municipal administrations. Despite some concerns about the administrative capacity of local government, it seems that revenue collection has increased since the municipalities took over this task.

Lack of power to set taxes has some important consequences. Firstly, the share of local taxes in municipal revenues has decreased since the beginning of the reforms in 2003 (Table 2) and revenues are derived mainly through transfers from the central budget. Secondly, due to the low contribution made by local taxes, local fees outweigh local tax receipts (Mid course, 2003).

Table 2: Basic Data on Municipal Revenues

	2003	2004 - projected	2005 - draft
Local taxes/ total tax revenues	1.9	1.7	1.4
Local taxes/ municipal revenues	9.1	9.6	8.4

Source: Assessment, 2004

The lack of power to set taxes has led to the level of local taxes being frozen. A good example is the property tax, which accounts for one-third of the municipal tax revenues. The rates and base of the property tax have remained at the levels set in 1999 (Assessment, 2004). It is only in 2006 that the official value of real estate has been raised by 20-30%, leading to an expected growth in municipal property income of 18% (State Budget Act 2006).

The municipal council has the right to set the price for every service provided by the municipality, with the amount of these fees having to be set within the range stipulated in the Local Taxes and Charges Acts. An amendment to this regulation, effective from 1 January 2003, has given the municipalities the authority to set the amount of fees, the methodology for determining the fee schedules, the definition of exemptions and the collection procedures (Mid course, 2003). The Municipal Councils now may raise the fees to a degree that allows them to cover the full costs of the relevant service. Due to these legislative amendments, the revenues raised by the municipalities from their own sources have increased significantly. The garbage collection charge accounts for the highest relative share and importance in local budgets.

In 2002, road tax was introduced as a new source of revenue to local government, with the purpose of financing road repairs. The road tax was actually a surcharge placed on the vehicle tax, but because of its purpose it was treated as a separate levy. In 2004 the revenue from road tax was replaced with a one-off transfer of the amount equal to the road tax revenues reported for 2003. This action has strongly increased the municipal budget dependence on central transfers (Assessment, 2004).

Municipalities are also eligible to receive a share of the taxes collected by the state. Until 2002 this right referred to PIT (Personal Income Tax) and to CIT (Corporate Income Tax). In 2002 the legislation on income taxes was revised and the corporate income tax was eliminated as a municipal revenue source and replaced by the full amount of the proceeds from PIT. The reason was that there were large variances in revenues between municipalities. In the State Budget Act for 2003, PIT was allocated to finance the state portion of the mandated services.

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This is a substantial change as previously the share of the PIT allotted to local government was defined each year in the State Budget Act (Epstein, 2000). Despite this arbitrary solution the share has remained quite stable at 50% of PIT revenues.

In the administrative sense, municipalities have the right to keep the PIT revenues collected on their territory. Out of 264 municipalities only 17 do not keep the total amount of collected PIT. These 17 are mainly big municipalities like Sofia and the other large cities.

Municipalities may also receive revenues from the sale of municipal property. Proceeds from such sales under Municipal Budget Act are registered as local revenues, whereas proceeds from sales under the Act on the Privatization of State-Owned and Municipal Enterprises are placed in an off-budget municipal fund and may be used for investment or for paying off the debts of municipal enterprises (Current status, UNDP).

From 2006 the municipalities were assigned a new competence with the right given to mayors to suspend illegal construction and to impose penalties. Until then, municipal bodies were engaged only in the identification of violations and submitting the information to the Directorate for National Construction Supervision (CED, 2006).

Due to the recently introduced changes, municipal revenues are expected to grow by 18% as envisaged with the State Budget Act 2006. There are two reasons for this namely the expected tax collection rate and the increase in property tax revenues. However, local governments still remain highly dependant on transfers from the central budget.

Another category of local revenues are transfers and grants which are discussed in detail in next section.

6. INTERGOVERNMENTAL FINANCIAL TRANSFERS

Major reforms in this field were introduced in 2003. The purpose was to change the system of inter-governmental transfers, to rationalize the system of subsidies for capital investments and to stimulate debt financing in order to provide the possibility of taking advantage of EU funds. In the new system of intergovernmental transfers the funding was adjusted in line with service requirements. All municipal responsibilities were divided into mandatory i.e. those delegated by the central government, and those provided optionally by the local governments.

The FDWG has developed costing standards for the mandated services that set the level of transfer going to each municipality. The government has agreed on the mechanism for setting operating cost parameters annually and to fund the operating costs of mandated responsibilities. All these changes were included in the Municipal Budget Act that sets the minimum expenditure standards to be financed by transfers for mandated services, establishes the size of equalizing transfer and distinguishes between current and capital expenditures. It also established a budgetary section for debt and prohibits debt to balance current budgets.

There are 3 types of government subsidies:

1. General complementary subsidy (for financing government-delegated activities)
2. General adjustment subsidy (for financing local activities)
3. Tied subsidy for investment

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The purpose of the general complementary subsidy is to supplement PIT revenues in the financing of the delegated activities.

The second type of subsidy, often called the equalization subsidy, is granted to those municipalities whose revenues from local taxes per capita during the previous year were below the national average. The MBA sets a mandatory minimum of the equalization subsidy at not less than 10% of the self generated revenue reported by all municipalities during the previous year (Nenkova).

The third type is investment subsidy. Up to 2002 the central government distributed investment subsidies at its discretion and in the absence of appropriate rules. Moreover, the local capital expenses were capped at a certain percentage of the municipality's self generated revenues (the limit in 1999 was 10% of such revenues, in 2000 it was 5% and in 2002 up to 25% of projected revenues from local taxes and non-tax sources) (Nenkova). Only in 2003 State Budget Act were the caps on using self generated resources for capital investment purposes lifted.

The capital subsidy comprises two elements. The first includes funds for national investment projects as determined by the state government. These funds are determined on an ad hoc basis every year and channelled through the different line ministries and central agencies. The second includes funds for local projects. These funds are determined on the basis of population, area and the number of populated settlements. These funds may be used for financing both delegated and local activities and distribution is decided by municipal council. Typically, the ad hoc subsidies amount to more than the target capital subsidy allocated under the formula.

Investment activity of local governments was further undermined by the practice of allowing the targeted investment subsidies to be transformed into a general subsidy at the end of the year (Epstein, 2000). There was also the risk that an investment started by a local government might not get financed in subsequent budget years.

The formula for distribution of dedicated (capital) subsidy does not take into account the inter-municipal disparities in investment funding capability (Nenkova). There is a great disparity across the municipalities in their capacity to fund investment. The crucial issue related to capital subsidies is how to find sources to match EU grants for regional development investments starting in 2007 as co-financing is a principal requirement for use of structural funds. Given the EU requirement for matching funds, the level of transfers has to rise substantially.

Central government target subsidies for capital expenditures increased from 75 million BGN in 1999 to 123 million BGN in 2002 and 116 million BGN in 2003.

7. REGULATIONS ON BORROWING

Local government revenues increased by transfers from the state budget are insufficient to finance the necessary investments. Given the financial constraint at the central government level, the only possibility was to allow borrowing at local level. In order to avoid the financial consequences of excessive borrowing, some legal constraints had to be set. Municipalities had the general power to borrow under the annual Municipal Budget Act as well as under the Local Self-Government and Local Administration Acts, but there were many gaps in the existing regulations and so the new law was prepared. The Municipal Debt Act (MDA) was approved by Parliament in April 2005 and became effective on 1 June 2005. The MDA provides a comprehensive legal framework for municipal borrowing thus completing the existing regulations.

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In line with the Local Self-Government Act, a municipal council has the competence to make decisions on bank borrowing, interest free lending and municipal bond issues under terms and procedures provided by the Act (art.21). A municipality may use bank loans, as well as interest free loans from the central budget under terms and conditions provided by the government (art.52). Additionally, a municipality has the right to issue bonds. The borrowing purpose is limited as a municipality has no right to borrow for costs of a general nature such as paying wages or running current expenses. The interest on loans obtained by a municipality is funded from its current budget (art.52, p.6).

The rules on local borrowing were further specified in the Municipal Debt Act.

Municipal debt shall be incurred only by a resolution of a Municipal Council.

Municipal debt comprises (art.3):

- Issues of municipal securities;
- Debt incurred by municipal loan contracts;
- Debt of municipal-owned enterprises;
- Municipal guarantees that have become due;
- Interest free loans extended by the central government budget, including those to co-finance programmes by the EU;
- Obligations under commercial credit and arising from financial leases for a period exceeding two years.

The current liabilities of a municipality to suppliers of goods and providers of services shall not be counted as municipal debt.

The distinction has been made between short term and long term debt according to its purpose. Short-term debt may be incurred in order to finance current expenditures but has to be redeemed before the end of budget year (art.5). Long-term debt may be incurred to finance investment projects, refinance existing debt, to prevent and mitigate the effects of force majeure and to meet payments made under municipal guarantees that have become due.

It is not allowed to secure municipal debt by means of pledge or mortgage of any items constituting public municipal property (art.8).

Municipalities may incur debt in foreign currencies without any additional approval.

The mayor shall prepare an annual report on the state of the municipal debt, which will be an integral part of the report on the implementation of the municipal budget (art.9). These annual reports shall be transmitted to the Minister of Finance or the National Audit Office (art.18). The MDA stipulates that a Central Municipal Debt Register shall be established at the Ministry of Finance, with individual records for each municipality.

Creation of the debt register is the task of the municipal debt department. This register has already been developed and pilot testing has been implemented in nine municipalities. According to plans the register should start operating at the beginning of 2007. The central register will comprise three elements: a sub-register for local governments bonds, a sub-register for loans given to municipalities and a sub-register on guarantees.

The MDA sets specific limits on debts. The annual amount of payments on the debt during each particular year may not exceed 25% of the sum of revenues from a municipality's own sources and

the equalizing grant under the last audited report on the implementation of the municipality budget (art.12), and the nominal value of the municipal guarantees issued may not exceed 5% of the same amount. The annual amount of payments on the debt comprise the principal, interest, charges, commission fees and other payments due on the debt incurred by the municipality. If the payments exceed the above mentioned amounts then the municipality has no right to incur new debt or guarantees. The operation register will allow monitoring of these precautionary limits.

The MDA does not contain limits on the size of the outstanding debt. However, municipal debt is the part of government debt, the upper limit of which is stipulated by Law on Government Debt (LGD):

"The outstanding portion of the consolidated government debt at year-end as a ratio of the projected gross domestic product may not exceed 60 per cent (art.10). In the event of any risk of non-compliance with the requirement under Article 10, the Council of Ministers may require some restrictions on the issuance of municipal debt and social security funds debt in the State Budget Law for the respective year".

Within the meaning of this Law, the consolidated government debt shall be the face value of the government debt, the debt of the municipalities and the debts of the social security funds. Within two months from the coming into effect of this Law, the municipalities and the social security funds shall inform the Ministry of Finance of their outstanding debt and the guarantees already issued by them.

The Minister of Finance must prepare an annual report on the state of the government debt, which must then be considered by the Council of Ministers and submitted to the National Assembly as an integral part of the government budget performance report for the year (art.15).

The Government Debt Directorate at the Ministry of Finance is responsible for reporting on general government debt. Every month the information on municipal debt (aggregate figure) is collected and published. Once a year municipalities provide the Directorate with declarations on their planned debt issue. Based on this, the ratio of debt to GDP is monitored. Data on the arrears and debts of public utilities are not collected.

There are no explicit guarantees of the municipal debt provided by government and does not constitute a liability of the government, except in cases where a government guarantee has been issued according to the appropriate procedure (art.30).

By law, the official information on the consolidated government and government guaranteed debt shall be published on a monthly basis by the Ministry of Finance in the Official Bulletin and on the Internet (art.38).

Besides these regulations, the Financial Regulatory Commission has established guidelines and procedures for the public offering of municipal bonds.

One of the weaknesses of the existing law is the lack of regulations concerning the default and the MDA does not deal with such situation. However the ordinance "Law on Municipalities in Financial Distress" has been prepared by a governmental working group. Based on this ordinance the government has supported 14 municipalities which have accrued substantial arrears. These municipalities have developed rehabilitation programs and the Ministry of Finance monitors the implementation of these programs.

8. FINANCING OF THE LOCAL GOVERNMENT DEBT

No explosion of municipal borrowing is under way and Bulgaria had the chance to develop the legal and policy framework before any development of the debt market. Creditworthiness of municipalities is undermined by accrued arrears in the local activities although the monitoring of such liabilities is questionable.

Table 3: Basic Debt Statistics, End of Period Data

	2002	2003	2004	2005*
Consolidated state debt (million Euro)	8793.9	8148.7	7557.8	6625.9
Municipal debt (million Euro)	22	33.8	46.6	83.5
Consolidated state debt (% GDP)	53.2	46.1	38.9	31.3
Municipal debt (% GDP)	0.1	0.2	0.2	0.4

Source: Ministry of Finance

Note: * end of November

There are numerous limitations on the development of municipal debt, which are now analyzed within the framework proposed by Leigland.

From the demand side:

1. Lack of a system of legal and procedural protection of investor rights. The Law on Local Government Debt has been adopted only recently;
2. Lack of an active secondary market and transactions are still rare. Therefore the chances to sell investments before maturity remain very limited;
3. Municipal bonds are backed primarily by tax revenues. However, the ability of local taxes to generate strong and consistent revenues is currently limited;
4. Lack of institutions familiar with bond issues, which could play the role of underwriters;
5. Lack of information regarding investment risks. The Bulgarian market only now has developed a disclosure system for the issuers;
6. Lack of financial intermediaries willing to provide assistance in interpreting information. Thus basic judgements about the credit quality of municipal bonds are difficult to make;
7. Municipal borrowing was limited due to the unstable financial standing of the banking system. The banking crisis of 1996-1997 was followed by the introduction of the currency board from 1 July 1997.

From the commercial banks' perspective the following constraints on local financing were identified (Case study, 2005):

1. Perception of municipalities as not being creditworthy due to their financial weakness and lack of financial knowledge. It was stressed that the growth in self generated revenues is a precondition for this perception to change (Mid-course, 2003);
2. Budgets rely heavily on state transfers and thus the volume of predictable income that can be used for debt repayment is limited;
3. Availability of collateral. Banks have required physical property as collateral to secure municipal debt but privatization has reduced this asset base. Banks have not accepted municipal revenues as a source of collateral;

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4. Municipalities have sought to finance investment projects and loans that were too large for the size of local budgets;
 5. Lack of well prepared projects submitted to the banks, and so credit analysis was not possible;
 6. Lack of belief by the banks that incumbents will honour the debt obligations undertaken by their predecessors in office;
 7. Preference among bankers to finance revenue-generating projects rather than infrastructure projects.

From the supply side:

1. The borrowing costs were relatively high and determined mainly by the macroeconomic developments. However, the costs of securities issuance are minimal making bonds an affordable financing alternative for creditworthy municipalities with the regular brokerage fee being around 0.5% of the value of bonds sold (Strategy, 2004);
2. Short-term debt amortization. Relatively high risks and underdevelopment of the market did not allow extension of maturities;
3. Assistance for small borrowers is limited. The Development Credit Authority Guarantee mechanism is the only credit enhancement mechanism which is functioning in regard to the municipal credit market (USD 20 million guarantee fund). Through the DCA, USAID provides guarantees on behalf of potential borrowers to United Bulgarian Bank for 50% of the principal loan amount that is due. The portfolio comprises 13 municipal projects successfully financed under the DCA;
4. Lack of any form of responsible self-regulation with a focus on the disclosure of information.

These limitations are counterbalanced by the high liquidity of the financial institutions such as commercial banks and the pension funds. These investors are looking for good investment opportunities. Therefore the potential available supply of capital does not pose a constraint on the enlargement of municipality credit market activity (Strategy, 2004). A tax stimulus is in place under the Taxation of the Income of Natural Persons Act effective January 1, 1998. Under this Act, interest paid on state securities is not liable to tax when acquired by natural person (the interpretation of the tax authorities is this provision also applies to interest paid on municipal securities) (Epstein, 2000).

The primary source of municipal debt is the provision of loans by the banking sector (Table 4). However, only few commercial banks have municipalities as clients. In order to receive loan from a particular bank, a municipality has to be a client of that bank and in most cases to move all its accounts to the bank extending the loan. Banks recognize that few municipalities have budgets that reliably generate the operating surpluses needed to service debt. Banking credits are used to cover temporary cash deficits. Long-term lending is still rare (Strategy, 2004). There are also international institutions providing loans to the municipalities. For example, Sofia received loans from international institutions (EBRD, WB, JBIC, Council of Europe Development Bank). At the end of 2005 banking credit from domestic and foreign sources comprises 52.9% of the municipal debt.

Table 4: Municipal Debt

	2004	2005*	2004	2005*
	thousands BGN		Structure	
Domestic	52318.8	110027.5	57.4	67.3
Securities	10179.6	29459.3	11.2	18.0
Loans from banks and other financial institutes	26244.8	61144.8	28.8	37.4
Loans from central government	2764	4093.3	3.0	2.5
Loans from extra-budgetary funds	6276.7	8363.6	6.9	5.1
Other	6853.7	6966.5	7.5	4.3
External	38813.3	53348.4	42.6	32.7
Loans from banks and other financial institutes	18863	25299.2	20.7	15.5
State guaranteed	19950.3	28049.2	21.9	17.2
Total	91132.1	163375.9	100	100

Source: Ministry of Finance, State Debt, December 2005

Note: * end of November

Some banks prefer to finance municipalities through bonds rather than credits due to their higher liquidity, the possibility to use bonds as collateral by investor, and the lack of pledge requirements as is the case with loans. On the other hand public issue of bonds requires more information to be disclosed publicly than in the case of a bank loan.

Bonds comprise 18% of municipal debt at the end of 2005. To date Bulgarian municipalities have completed 10 bond issues with diverse structures (Table 5). Several municipalities have been unsuccessful in issuing bonds (Strategy, 2004).

The law does not prevent borrowing in foreign currencies. However, the issues in foreign currencies, namely Euro, are rather uncommon (Table 5).

Two issues of municipal bonds have been rated by international agencies namely: the Issue by Sofia in 1999 rated by Standard and Poor and the 2000 Varna Issue rated by Moody. There are also domestic rating agencies in Bulgaria, but lack of transparency regarding their methodologies and their short history limits their credibility as a source of information for the financial community (Strategy, 2004).

There are institutions in place to regulate the issuing of bonds. Since 2003, the issuance of municipal bonds has been regulated by Ordinance 2/2003. Up to June 2004 no public or private offering was made under these new requirements. Municipal debt (bonds and credits) is regulated and supervised by the Commission for Financial Supervision (CFS) and the National Bank of Bulgaria. The public offering of bonds is supervised by the CFS.

Table 5: Municipal Bond Issues

	Svishtov	Sofia	Varna	Sliven	Dupniza	Dobrich	Varna	Shoumen	Svilengrad	S. Zagora
Issued in	1999	1999	2000	2002	2003	2004	2004	2005	2005	2005
Total value BGN	0.37 million	50 million EUR	3 million	3 million BGN	1.3 million BGN	2.6 million	3 million EUR	4 million BGN	2 million BGN	5 million BGN
Purpose	n.a.	Restructuring of the urban infrastructure	Street lighting (energy efficiency cost saving) and cultural and educational facilities - in the proportion 50/50	Bus station (1.85 million BGN), building covered pedestrian bridge (850 ths. BGN) building citrus fruits market (150 ths. BGN) and flower market (150 ths BGN)	Financing of infrastructure projects	Streets network upgrade	Modernization of urban road infrastructure	Rehabilitation of the road network	Financing of key infrastructure projects	Rehabilitation of the road network, opera house remodelling
Type	n.a.	Interest-bearing, free transferable	Interest-bearing, freely transferable	Interest-bearing, freely transferable	Interest-bearing,	n.a.	n.a.	n.a.	n.a.	n.a.
Interest rate	5.6%	9.75% on annual basis	9% paid semi-annually	9% on annual basis	9%	n.a.	n.a.	n.a.	n.a.	n.a.
Grace period	n.a.	None	n.a.	1 year	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Maturity	7 years	3 years	3 years	4 years	4 years	5 years	3 years	5 years	5 years	10 years
Repayment schedule	Coupon payment on a semi-annual basis	The coupon payment shall be made on an annual basis	1 million per year	Principal repaid in three equal instalments/ the coupon on a semi-annual basis	Coupon payment on an annual basis	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Strategy (2004); Gumpel P.E. (2006)

Another source of deficit financing is by loan from the budget (2.5% of municipal debt in the end of 2005). In the past, the government provided credits to municipalities, which were spent to finance current expenditure. This was possible as the purpose of loan was not regulated by law. Under the amended Municipal Budget Act, from the beginning of 2004, municipalities have access to interest-free loans from the central budget in order to pre-finance costs for approved projects under programs co-financed by the EU, until such costs are reimbursed (Nenkova).

In the past the borrowing activity was constrained by the ceiling placed by the central government on capital investments. The State Budget Act limited the amount of local government investments to the amount authorized in the investment grant. Beyond this level with its targeted subsidy, local governments were limited to additional investment spending of only 10% of self generated revenue as defined by the Ministry of Finance. This investment spending limit was reduced to 5% in the 2000 budget. (Epstein, 2000). In practice this was another borrowing limit, although the local governments have not spent to the full amount of the limit.

The growth in debt is necessary to remove the infrastructure investment gap. One analysis conducted by the World Bank provided an estimate of the financial requirements needed by Bulgaria to meet the environmental standards for EU accession (World Bank). The results were presented in brackets. The lower estimate for municipalities to upgrade environmental infrastructure amounted to over BGN 1,000 million per year in capital costs and the higher was BGN 1,800 million annually. It means that current investment expenditures need to double.

Besides banks, another financing source for the municipalities is Foundation for Local Government Reform which provides short term credits (up to 1 year). In 2004 a revolving fund was established in order to finance municipal projects such as small infrastructure projects and the pre-assessment and preparation costs for investment proposals. Financing is provided for small projects (5-30 thousand BGN) at interest rates below the market rate. The borrowing period is set at less than 12 months as public tender procedures are required for longer debt periods. Until now there were no problems with repayment of these loans. In the market for long term borrowing, the commercial banks are very active providing credits at very competitive prices which are below the price of bond issues.

9. LESSONS LEARNT FROM BULGARIAN EXPERIENCE

The level of fiscal decentralization measured by local expenditures is still very low. There is no financial autonomy at the local level as self generated revenues remain lower than those allocated from central government sources. Local authorities do not control the scope and sources of their self generated revenues and are dependent on the resources allocated by central government. Local Authorities also need to get authorization on spending. Central government controls more than 80% of local budget revenues without bearing the responsibility for providing public services to local residents.

The fiscal decentralization reforms accelerated significantly when the formal institutional body (FDWG) was created. The FDWG comprised of representatives of all stakeholders from the municipal leadership to key central ministries. The comprehensive plan of reform was prepared and its implementation was constantly monitored and adjusted when necessary. Thus, the fiscal decentralization program was kept on track. The members of FDWG had access to reliable and up to date data on municipal finance. Continuity of leadership has accompanied the reform process.

This institutional solution allowed reforms to proceed, together with the solving of different problems according to the priorities assigned. Within a relatively short period of time the system of transfers has been changed and a comprehensive legislative framework of municipal debt has been set up.

As the law on local debt was implemented only in mid-2005, it is too early to evaluate how it works in practice, although some observations can be made. The monitoring system is not in operation, so complete information on municipal borrowing is not yet available. The current regulations do not deal with insolvency issues, which is a significant weakness. Despite this the regulatory framework is in place to allow the secure development of the municipal debt market.

There are some unresolved issues. The most important is a change in the constitution necessary to authorize municipalities to unilaterally set local taxes and fees. This constitutional limitation on local discretion to set taxes has resulted in low proportion of self generated revenues in municipal budgets. For now municipal revenues come mainly from shared taxes and transfers, making municipalities highly dependent on centralized funding. Thus, there is no room for a municipality to have an inde-

pendent investment policy. This is highly important as in 2007 Bulgaria joins the EU and accession will require massive investments in environmental repair and improvement. There is also a need to co-finance such investments with domestic funds.

During the last two years the need for constitutional change has become understood and the amendment is expected to be made by the end of 2006. The amendment will give municipalities the right to determine the size of local taxes within limits defined by law (CED, 2006). It is planned that along with increased powers of taxation, municipalities will be charged with new responsibilities such as providing professional schools and specialized medical and social establishments.

EU membership will create new investment opportunities with the price of having to provide co-financing for the projects. In response to this, the Ministry of Regional Development and Public Works is drafting a new ordinance for the creation of a Local Development Fund in December 2006. It is planned that the state budget will not provide more than 40% of the resources of this fund while the remainder will come from a syndicated loan managed by the EBRD (CED, 2006).

It is necessary to set a more transparent and predictable system of transfers. At present delegated expenditure responsibilities are not sufficiently secured against revenues and thus municipalities are more distributors of funds than independent policy makers.

The remaining weakness is the unclear mechanism for determination of subsidies needed to cover municipalities' investment costs. The existing law provides an option to transform dedicated subsidies into all purpose subsidies which then could be used to cover current expenditures. Municipal investment expenditures are considered to be of low priority. The lack of stable rules for the amount of capital subsidy does not allow the municipalities to plan their investment programs (CED, 2006). The strong dependence of municipalities on centralized funding restricts their ability to formulate and implement independent local policy (CED, 2006). The municipal budget should be divided into current and capital and the possibility to carry forward expenditures from one year to another should be considered.

In general, there has been strong leadership shown in the process. Despite this, the level of decentralization is low, as municipalities are still largely centrally financed. Expected constitutional changes should improve this situation, but strong cooperation between central government and municipalities remains a necessity. Further progress in decentralization could be measured by the financial autonomy granted to the local governments. Today such autonomy is very limited.

Anex 1. Field visit to Bulgaria

List of people interviewed during the filed visit to Bulgaria (27-28 September, 2006)

Interviewee	Position
Valentina Grozdanova	Director of the Local Governments Directorate at the Ministry of Finance
Ljudmila Bojanova	Head of Sector Analyses Division, Government Debt Directorate at the Ministry of Finance
Zdravko Sechkov	Financial Director at the Foundation for Local Government Reform
Emil Kaltchev	Senior researcher at the Center for Economic Development

Anex 2. Legislation related to LGU borrowing in Bulgaria

A number of laws that affect municipal finance have been adopted:

1. Constitution of the Republic of Bulgaria, Official Gazette, 1991
2. Ratification of the European Charter on Local Self-government, 1995
3. Local Self-government and Local Administration Act, Off. G. No. 77/1991 and amendments
4. Law on Local Elections, Off. G. No 66/1995 and amendments
5. Law on the Local Taxes and Charges, Off. G. No. 117/1997 and amendments
6. Law on Administration, Off. G. No. 130/1998 and amendments
7. Law on Civil Servant, Off. G. No. 67/1999 and amendments
8. Municipal Property Act, Off. G. No. 44/1996 and amendments
9. Law on Municipal Budgets, Off. G. No. 33/1998 and amendments
10. Law on the Administrative and Territorial Division of the Republic of Bulgaria, Off. G. No. 63/1995 and amendments
11. Regional Development Act, 1999
12. Municipal Debt Act, Promulgated, SG No. 34/19.04.2005 (effective 1.06.2005)
13. Corporate Income Tax Act and Natural Persons Income Tax Act, 2002 - the corporate income tax was eliminated as a municipal revenue source and was replaced with the full amount proceeds from PIT.
14. Monitoring and evaluation system, adopted by FDWG in September 2002 - the proposed amendment to the Constitution was submitted in 2003 in order to expand the taxation authorities of the municipalities.
15. The formation of the regions as new administrative and territorial unit act (promulg. SG, No. 65 of 1987, amend., No. 45 of 1989)
16. Law on the government debt, (Issued by the 39th National Assembly on 17 September 2002; published in the State Gazette, issue 93 of 1 October 2002)

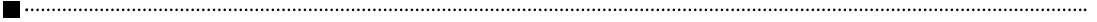
Annex 3: Local governments in Bulgaria

Thousands of BGN	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue and grants	1,027,493.1	1,087,820.5	1,122,423.6	1,364,828.8	1,489,534.1	1,422,107.6	823,500.9	935,053.5
Tax revenue	858,351.8	848,029.9	864,538.5	1,020,320.4	1,082,910.2	933,381.5	224,659.1	245,529.4
Profit tax	266,711.6	251,495.3	245,518.9	393,338.2	394,979.3	----	----	----
Income tax	508,497.7	507,349.9	524,177.2	522,114.8	520,376.0	724,059.9	----	----
Excise and fuel duties	101.1	22.8	30.2	33.1	28.5	15.5	4.2	1.9
Other taxes	83,041.4	89,161.9	94,812.2	104,834.3	167,526.4	209,306.1	224,654.9	245,527.5
Non-tax revenue	169,024.1	239,505.9	257,628.6	337,000.6	396,163.6	480,852.1	591,202.8	679,210.2
Grants	117.2	248.7	256.5	7,507.8	10,460.3	7,874.0	7,639.0	10,314.0
Transfers from central government (net)	617,701.0	737,678.0	832,555.9	640,856.7	870,719.6	755,725.5	1,590,111.4	1,663,644.1
Transfers without Income tax							866,051.5	939,584.2
Total expenditure	1,658,716.0	1,864,094.8	2,005,339.6	1,990,101.1	2,391,577.6	2,243,815.5	2,382,465.8	2,738,673.4
Current	1,446,785.8	1,690,971.4	1,847,382.8	1,787,162.7	2,132,942.8	1,946,699.0	2,071,586.8	2,214,724.7
Compensation of employees	692,642.4	821,280.4	782,813.3	667,750.5	785,013.6	845,891.8	922,944.1	947,697.0
Maintenance and operating	592,300.6	706,763.4	770,049.1	661,845.5	796,985.5	880,948.6	1,039,331.0	1,140,761.3
Subsidies	65,798.2	24,337.1	22,977.5	159,526.2	184,642.8	201,653.7	90,324.4	105,440.7
to non-financial enterprises	65,798.2	24,337.1	22,977.5	23,943.5	25,809.9	36,046.9	38,858.8	43,125.7
for health care and medical assistance				135,582.7	158,832.9	165,606.8	51,465.6	62,315.0
Interests	1,200.9	571.3	10,042.1	10,157.1	10,581.5	2,433.4	4,020.1	5,760.1
Social expenditures, scholarships	94,843.7	138,019.2	261,500.8	287,883.4	355,719.4	15,771.5	14,967.2	15,065.6
Capital and state reserve gain	211,930.2	173,123.4	157,956.8	202,938.4	258,634.8	297,116.5	310,879.0	523,948.8
Deficit	-13,521.9	-38,596.3	-50,360.1	15,584.4	-31,323.9	-65,982.4	31,146.5	-139,975.8

Source: Ministry of Finance

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COUNTRY REPORT: LOCAL GOVERNMENT BORROWING IN MACEDONIA

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Local Government and Public Service Reform Initiative
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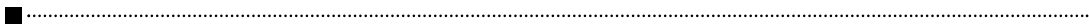
BIS	Bank for International Settlements
CAPEX	Capital Expenditure
CB	Central Bank
CE	Communal Enterprise
CEA	Macedonian based think tank-Center for Economic Analyses
GFS	Government Finance Statistics
CIA	Central Intelligence Agency
CSPD	Romanian think tank-Center of Studies and Programs for Development
DWG	Decentralization Working Group
EBRD	European Bank for Reconstruction and Development
GSU	Georgia State University
IMF	International Monetary Fund
IPP	Romanian Institute for Public Policy
IPA	Instrument for Pre-Accession Assistance
LGAP	Local Government Assistance Program
LGU	Local Government Unit
LFLGU	Law on Financing LGU
MCI	Municipality Composite Indicator
NUTS	Nomenclature of Territorial Units for Statistics
OFA	Ohrid Framework Agreement
OG	Official Gazette
PFI	Private Finance Initiative
PHARE	EU pre-accession instrument, Poland and Hungary: Assistance for Restructuring their Economies
PIT	Personal Income Tax
PPP	Public Private Partnership
PRO	Public Revenue Office
SAPARD	EU pre-accession instrument, Special Accession Program for Agriculture and Rural Development
UNDP	United Nations Development Program
USAID	US Agency for International Development
VAT	Value Added Tax
ZELS	Association of Macedonian LGU
WB	World Bank

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1. INTRODUCTION

The overall objective of this study on local government¹ borrowing is to accomplish an all-encompassing review that systematically captures the entirety of the fiscal decentralization processes with an emphasis to the local government borrowing in each of the three transition countries: Romania, Bulgaria and Macedonia. As part of this larger study, the main purpose of this country report is to provide an overview of the progress in the process of decentralization after July 2005 when the process started and an overview of issues with the local government borrowing in Macedonia.

This study is neither a credit rating analysis nor does it cover specific aspects of local government borrowing in detail. Rather the study provides an overview of each of the building blocks of intergovernmental fiscal relations (structure of the government sector, delineation of responsibilities for expenditure, assignment of revenue sources, intergovernmental transfers, financial management issues, subnational borrowing legislation, infrastructure and the financing side of the subnational budget and the municipal debt characteristics). The study also considers the technical nature of the strengths and weaknesses of the decentralization process, with a special emphasis on experiences in local government borrowing and recommendations for further development.

Macedonia is in a position to develop the legal and policy framework first, in anticipation of the future development of a municipality credit market. Macedonia can learn from the experience in Romania and Bulgaria² and from the risks that have become clear in other countries. Excessive borrowing by sub-national government or debt issuance in the absence of an adequate legal framework (one that clarifies critical issues like the status of guarantees and the remedies available to lenders in the event of a municipality's non-payment) has exacerbated national economic crises. Premature borrowing, before a municipality has established its creditworthiness and identified clear investment priorities, is likely to drain local budget resources and to add risk to the fiscal system. The potential benefit of soundly based local borrowing is great, but the risks involved in badly prepared borrowing also are large. Stakeholders (LGU, national government, banks, and potential investors in municipal debt) share an interest in ensuring that the policy issues surrounding credit market development are well understood and that an appropriate legal framework is in place before the market actually opens.

We believe that by reviewing the process of decentralization one year after it started (1st of July 2005) we can gain important insights for the future borrowing at LGU level. Thus, the study opens with review of the process of decentralization in Macedonia, followed by consideration of the many aspects of LGU borrowing. Useful information and data are presented in the annexes especially the insolvency matrix in annex 4 and the strategic analysis of LGU borrowing presented in annex 5. Annex 5 contains three two-dimensional matrices that served as a base for collating information obtained in the course of our field trips and for developing this country report (originally developed by the GSU; more in UNDP 2005). The three matrices in Annex 5 are labeled as Tables 25, 26 and 27.

- Table 25 (The Assessment Matrix): Identifies the current state of borrowing and maps policy areas within the realms of borrowing and local government reform that present the current key policy issues and obstacles for the further development of borrowing.

1) In this report we will use the Local Government Unit-LGU, subnational government, local government, county level, communes, municipalities and cities interchangeably. When necessary for more clear text we will stress what is the tier we are talking about.

2) Basic data about these countries are illustrated in the Annex 1.

- Table 26 (The Reform Initiatives Matrix): Identifies and maps recent or ongoing initiatives pursued by the national government, subnational governments and their associations, as well as other donor agencies and stakeholders within the realms of borrowing and local government reform that are aimed at addressing and resolving the obstacles and challenges noted in the Assessment Matrix.
- Table 27 (The Reform Priorities Matrix): Within the same dimensions as the previous two matrices, the Reform Priorities Matrix identifies priorities for further action in areas that are either currently underserved in the policy discussion on borrowing or areas where a fresh perspective may stimulate new policy thinking.

2. STRUCTURE AND SCOPE OF THE GOVERNMENT

The process of decentralisation requires not only that the Government has the political commitment but also has the capacity for the coordination and sequencing of the process. The Decentralisation Working Group (DWG) was established by the government to monitor progress towards decentralization. The DWG and its Sub-Groups did not succeed fully in achieving their aims of monitoring the process of decentralisation, identifying and solving problems, managing risks and dealing with the weak capacity of local governments.

The evolution of decentralization in Macedonia has been a mixture of political inefficiency and ethnic disputes. Three periods can be identified in the process of decentralization.

The first of these periods was one of centralization between 1991-1995 which left the municipalities without competencies and without an efficient system of financing. The GDP declined continuously until 1996 when the unemployment level reached 32 %. During this period, the government was focused on achieving macroeconomic stabilization and on privatization.

During the second period 1995-2001, macroeconomic stabilization was achieved but the overall economic performance was rather poor with an average annual growth rate of around 2 %. During this period, for the first time after independence, a new Law on LSG was adopted in 1995 and a new Law on Territorial Organization was adopted in 1996. Both laws were products of a highly ethnically and politically motivated process.

Contrary to the widely accepted "wisdom" held by donors that the Ohrid Framework Agreement (OFA) brought about the process of decentralization in Macedonia, the process of decentralization in fact started after Macedonia signed the European Charter in 1996 and ratified it in 1997. The process was backed up by two important documents namely the Government Program of 1999 and the Government Strategy for Reforming the Public Administration also of 1999. As a result of these two initiatives, a Working Team within the Ministry of LGU was established in March 1999 to start the process of decentralization. .

In 1999, the Kosovo conflict further complicated ethnic tensions in Macedonia leading to an armed interethnic conflict in 2001. The crisis in Macedonia ended with the signing of the OFA in 2001. The OFA called for constitutional changes as well as the adoption of a new Law on LSG (adopted in 2002) and thus the decentralization initiatives of 1999 gained a new momentum. One consequence of the politically-driven process (rather than a fiscal decentralization process motivated by a desire to improve economic efficiency) was the reverse sequencing of decentralization, with revenue decentralization preceding a loosely defined assignment of expenditure.

Essentially the decentralization of particular functions has been delegated to line ministries, which have used every opportunity to slow down the process, as they had no incentives to "give up their turf" to the municipalities.

The speed of decentralization reforms greatly accelerated during 2004, as the Ministry of LGU moved forward with a number of initiatives and intensified its contacts with the Association of LGU (known by its Macedonian acronym ZELS). The Program of 1999 set out the activities for the implementation of the decentralization process in the period 2004-2007 and was adopted by the Government in November 2004. These activities are related to the transfer of competencies, employees, equipment and property from the central to the local level and to capacity building in the municipalities to enable them to successfully take over the devolved competencies.

2.1. Legal framework

What the legal framework in Macedonia defines as decentralization is in fact devolution, i.e. that elected local officials are given power and resources to make decisions about the provision of public services.

Functional decentralization, i.e. the devolution of competencies, is left to the sectoral laws in Macedonia while the fiscal decentralization framework, including the inter-governmental transfers, is defined in the Law on Financing LGU (LFLGU).

2.2. Territorial organisation

With the Law on Territorial Organization being adopted in 2004, the local governments in Macedonia were restructured into 84 municipalities (15 of which have less than 5,000 inhabitants) and with the City of Skopje as a special unit. Many of the LGU, after one year, are facing the fact that they do not have the capacity to provide the necessary and expected services to their citizens. This is generally caused by a lack of economy of scale due to their limited size or by limitations in their capacity because of under-investment, low regional development, etc.

3. ASSIGNMENT OF COMPETENCES

The Law on LGU regulates the competencies of the local governments. A wide range of responsibilities are listed in the provisions of Article 22 of the Law. The role of local governments and the central government are well defined.

3.1. Subsidiarity principle

The European Charter for Local Self-Government includes among its provisions the subsidiarity principle in Paragraph 3 of Article 4:

"Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy."

Basically the provision of services should be exercised at the lowest possible level of government that is capable of providing them efficiently. This principle results in a situation where, as far as possible, the area which benefits from a government service coincides with the territorial boundaries of the level of government which provides the service.

Relying on this principle, it can generally be concluded that three types of functions are best performed by the Central Government:

1. Provision of public goods and benefits that benefit entire country
2. Income redistribution by social policies
3. Activities that involve spill-over or externalities between local governments

The income redistribution programmes cannot be provided effectively by the local governments because:

- 1) Differences between local governments cannot be addressed;
- 2) Wealthy households and companies have the incentive to move away from an area where the local government attempts to undertake income redistribution;
- 3) Local governments may produce inefficient levels in certain public services if these activities involve spill-over effects into neighbouring local government areas.

This means that there basically are two dimensions of the subsidiarity principle which are relevant to Macedonia:

- 1) The size of the local governments;
- 2) The competences assigned to the local governments.

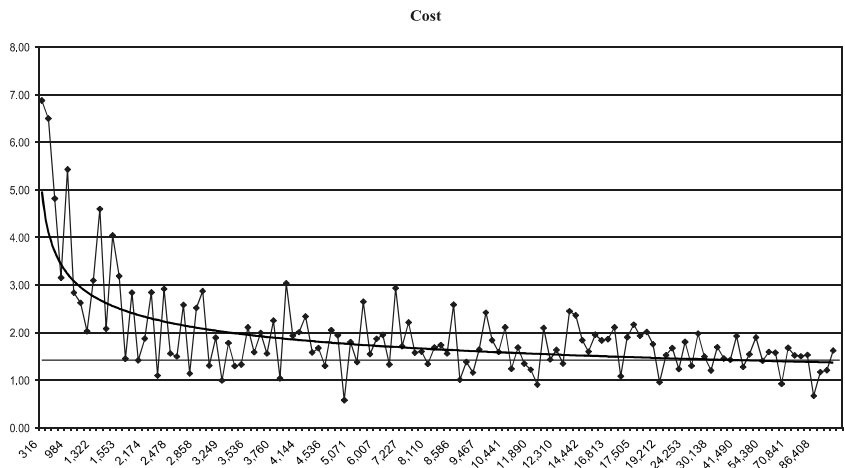
Conducting an analysis of the optimal minimum size of local governments is a difficult task because one has to measure the output of all services and their benefits. Empirical analyses show that the minimum size for an effective municipality might be between 5,000-8,000 citizens.

In analyzing the economies of scale in the administrative costs of local governments (CEA bulletin 2004 covering 123 local governments at that time), a composite index is calculated from three variables:

1. Number of employees in the administration per inhabitant;
2. Salaries as a percentage of total expenditures;
3. Total municipal budget expenditure per inhabitant.

The calculated administrative cost composite index for each of the 123 local governments in Macedonia is illustrated in the next figure.

Figure 1.
Economies of scale
of administrative
costs at LGU
in Macedonia



Overall the figure shows that the greater the number of citizens in a local authority area implies lower average administrative costs. More specifically, the figure illustrates the increasing economies of scale of up to 4,000-6,000 inhabitants. Furthermore, the figure shows that the optimal minimal size of local government in Macedonia is around 6,000 inhabitants if the criterion is the cost of providing administrative services.

3.2. Competences assigned and expenditure arrangements

Monitoring of the process of decentralisation is conducted by the DWG, which has operated through ten thematic Sub-Groups. The Sub-Groups have established Action Plans which set out the risks identified related to the competences that have been transferred to the local level. The general conclusion is there is a lack of financial resources for the reassigned competencies. For this reason assessment and cost analysis must be carried out before any further transfers are made.

One risk identified was the transfer of too little finance from central to local government to provide the assigned service. This situation could be improved by using the "principle of neutrality of earmarked transfer" i.e. that the central government transfers funding to the local government at the same level that it had previously cost the central government to provide the service. An example of this problem can be seen in the case of the Ministry of Education and Science where the transfers to local government in 2005 were less than it had spent in the previous fiscal year in providing the now assigned services

3.3. Deconcentration and Decentralisation

The Government adopted the Detailed Plan for Transfer of Competences and Resources in April 2005 in which administrative decentralisation was planned in terms of transfer of institutions, assets, employees and documentation. In the Plan, the deconcentrated units of the line ministries were to be transferred to the local level.

This, together with the new legislation provided an efficient legal framework for the process of decentralization. However problems with transfer of staff and resources still remain. These problems were identified by the Sub-Groups of DWG.

3.4. Overall assessment

Macedonia is no exception in making the mistake of defining the assignments and not calculating the costs of conducting the competencies assigned to the lower level of government. This is not so bad provided the central government identifies the under-funding during implementation and then makes the right decisions to deal with the problems. So far central government does not appear to have made sufficient effort to resolve the disparity between expenditure and revenue. Therefore, local governments are forced either to provide services of lower quality or to build up further arrears which in the long run lead to further under-investment in capital projects.

One interesting example is the Municipality of Veles where an analysis of the school system was undertaken which resulted in some schools being closed. This is positive because the local government was thinking in terms of improved efficiency.

Given the fact that some LGU in Macedonia are too weak to provide the assigned competencies to its citizens, it is worthwhile to consider the possibility of an asymmetric assignment of functional responsibilities. This should be based on firm analysis which in turn would require a strengthening of the analytical capacity within the Ministry of Finance and Ministry of LGU.

It is difficult to judge whether or not local governments in Macedonia provide a sufficient quality of service given the environment in which they operate and the short period of review to date.

The financing of services provided by local governments should follow a function, i.e. for each assigned responsibility there must be revenue assigned as well. If this rule is not followed, then the level of revenue transfer from central to local government should increase. In order to establish the exact current status within the system there must be a strong central ability to monitor and evaluate the process of decentralization. For that purpose and in accordance with the LFLGU, a Commission for Monitoring of the Development of the System for Financing has been established.

Given the discussion above and considering the report of the Commission, one gets the impression that the report contains little information on the problems encountered and lacks a sufficiently in-depth analysis of different aspects including:

1. Fiscal gap (needs assessment and fiscal capacity calculation) in providing local services for competencies that have been transferred
2. The problems with collection of own revenues by local governments (taxpayers' record transfer, development and distribution of tax returns system, etc).
3. Current status and measures to improve the situation regarding arrears
4. Whether earmarked grants are in line with the transferred competencies
5. The tendency to discuss problems at DWG-level without information being transferred to lower levels afterwards.
6. Financial management issues related to local governments appear to have been addressed.
7. In dealing with the legal framework it appears that a list of problems identified and options for their resolution is required.
8. To clarify the VAT transfer as a source of stable financing for local government.
9. The results that have been brought about by the Law on Local Self-Government through the implementation of fiscal decentralization. The main points being the criteria that were taken into account and the measurable indicators that were monitored and, in general, how the assessment of a "good result" was made.
10. The report itself is not fully up-to-date given that it only covers the period up to December 2005. It was adopted June 2006.

4. OWN REVENUES

The major change brought about by the new legislation was the assignment of property-related tax administration to the local level. Moreover, it is not only the revenue from these taxes that is assigned to local governments but the powers to determine the rate for these taxes and to collect them. By utilizing the possibility of inter-municipal cooperation, local governments can contract joint tax administration or one local government can contract out the tax administration to another local government.

Reportedly, the Public Revenue Office (PRO) has used low-quality data from the cadastre system for property taxes and lacks a good statistical information system. Moreover, these revenues were not directly distributed to the local governments where they were collected but rather transferred into the

treasury system and then distributed among local governments in accordance with a formula within the so-called "cap system". Clearly, there were no proper incentives for higher collection rates so that the system can provide a sustainable and predictable revenue stream.

Table 1. Size of LGU Revenues

	Total revenues as % of GDP
Bulgaria 2005	6.2
Romania 2003	6.9
Macedonia 2004	2.4

Source: Author's Calculation

4.1. Structure - types of own revenues

The sources of financing in accordance with the LFLGU identifies both own and shared sources of financing.

Own Source Revenues:

1. Own Source Revenues

- a. Local taxes (property tax, transfer of property tax, inheritance tax and gift tax)
- b. Local fees (communal fees, administrative fees)
- c. Local charges (construction land charges, communal activity charges, spatial planning charges)
- d. Revenues from property (rents, interests, capital revenues from property sale)
- e. Donations
- f. Fines
- g. Self contributions

2. Donations (a contract between the donor and the mayor following approval by the municipal council)

3. Self contributions (a municipal council decision defines all related variables)

Shared revenues:

4. Personal Income Tax (PIT) revenues

- a. 3% of PIT collections from salaries are allocated to the local government where the employee resides. The employer is responsible for paying the PIT on behalf of the employee. The transfer goes through the treasury system automatically, leaving no room for discretionary decisions by the central government.
- b. 100 % PIT collected from artisan activities.

An issue is that the wording of the LFLGU is such that it defines the PIT and VAT transfers³ as own revenues of local governments. However:

1. The transfers from VAT and PIT generally are not enough to cover the fiscal gap arising from the provision of transferred competencies

3) More on the VAT transfers see in the section of inter-governmental transfers.

-
2. The central government sees the VAT as an unconditional transfer for equalisation purposes even though it is defined in the LFLGU as an own revenue for local governments. In contrast ZELS views VAT as a kind of unconditional transfer with the comment that central government should introduce a new equalisation transfer

4.2. Sufficiency

Common wisdom is that the total revenues of local governments should be enough to cover the provision of services to citizens and to pay for capital investments. In Macedonia, it is difficult to judge if the current system is sufficiently well established to provide that given that no comprehensive analysis has been done on costs of providing local services including possible capital needs. Indicative in this regard are four main issues:

- The centralised system until 2005 has led to under-investment by local government and it should be realised that there will be high capital requirements and demand in near and distant future
- The requirements stemming from EU-related legislation on environmental protection, quality and standards of services, etc.
- The issue of viable size of local governments
- Expected increase in public awareness and expectation

These four issues alone should be sufficient to alert the central Government that the current system of revenues (own and transfers from the central level) is likely to be insufficient in the mid and longer terms. This is a further compelling argument for the building of a strong analytical unit within the Ministry of Finance and Ministry of LGU to develop and utilise an extensive data system.

4.3. Principles for own revenues

The system of own revenues is now analyzed and some principles are set out:

1. Local government should be allowed to set tax rates.
2. The tax base should be relatively immobile.
3. The taxes raised should be borne primarily by local residents.

The above three principles relate to property taxes and, given that the Law on Property Tax allows local governments to set tax rates so it can be said that a degree of fiscal autonomy has been secured.

4. The tax yield should be adequate to meet local public spending requirements.

In Macedonia, the share of own revenue in relation to the total revenue is low and thus there is high level of fiscal dependency (transfers over total revenues).

5. The tax yield should be able to grow in response to increases in spending requirements without altering tax rates.

The need for changes in the tax base and rates can be a result of inflation, growth of the national economy, population growth or income changes of the population. In Macedonia, the exemptions for business-related property taxes should be abolished. The central Government should provide other measures to attract businesses without causing a lower level of tax base for the local governments.

6. The tax yield should be predictable and not prone to substantial variations from year to year.

The property taxes are easily predictable.

7. The tax should be easy (not overly costly) to administer fairly.

In theory, property taxes are easy to administer once a proper system for registration and monitoring is established.

8. The tax should be considered fair by taxpayers.

One criterion is whether wealthier taxpayers pay more than poor taxpayers, i.e. equity judged on the basis of ability to pay. An alternative criterion focuses on whether those taxpayers who derive greater benefits from public services pay more than persons receiving lower levels of benefits. These two criteria can lead to conflicting conclusions regarding the equity of a local tax instrument. However, it is too early to debate the fairness of the tax system in Macedonia.

4.4. Local administration of transferred revenue tasks

The first initiatives taken by the local level to establish its own system of property tax illustrates the initial, not so positive approach to development of the system. Some local governments announced the start of their own revenue collection and addressed the taxpayer with the following:

1. An announcement in the old-fashioned way informing citizens that if they do not comply then the penalty provisions will become operational
2. No explanation to the citizens how the system would operate
3. No information provided to the citizens
4. Use of outdated data in the system (old title of ownership of the asset)
5. Immediately reaction by Central Government as to what local governments can and cannot do
6. Traditional expectations that everything should be regulated (tendency for overregulation)

Shortcomings observed in the Law on Property Tax are the self-assessment of the value by the owner, the lack of a well developed database of taxpayers and of a sound system of monitoring.

4.5. Overall assessment

The overall assessment is that the property tax system in Macedonia is performing poorly and is in serious need of improvement.

Box 1. Bringing services closer to the citizens or not: Case study on tax administration in LGU Aerodrom.

The LGUs in Macedonia administer property taxes and have the authority to set the tax rate.

Current situation and procedure for a taxpayer to register new property (Interview with an accountant from Skopje).

There is an office in LGU Aerodrom related to the tax issues. Should a taxpayer want to register property for the purpose of property tax, the employees in the office just tell the potential taxpayer that he has to go to the PRO

office located in the centre of Skopje to submit the documents for registering a new property. The information on the registration has to be typed and returned by the PRO office to the LGU Aerodrom from where the tax return is finally issued. It can be seen from this example that nothing has really changed for a citizen by way of improved services through the devolution of the tax administration. Devolution has complicated the procedure, has created confusion and imposed additional transaction costs. The new system is likely to hamper the compliance of potential taxpayers.

One set of improvements might be:

1. The LGU Aerodrom prints information about property taxpayers and provides proper guidelines for citizens on the tax procedure. The guidelines should include the new rules the benefits for the citizen will get. The guidelines should be placed where it is easily available for everyone who is interested.
2. Window halls in the PRO should be marked so that a citizen can see which services are provided at each window.
3. Information should be also distributed with the local newspaper of the LGU Aerodrom.
4. The LGU should not require the taxpayer to go to the Skopje PRO office but should accept the taxpayers' documents.
5. The LGU should collect such documents daily or weekly and forward them to the Skopje PRO (this might be done via e-mail as well).
6. The LGU should introduce a phone "hot line" for the taxpayers.
7. The LGU should change the working hours to suit the taxpayers and not close the office at 14:00 hours.

The above are the preliminary steps that the LGU can take in order to:

1. Explain the benefits of decentralization
2. Explain why taxes should be paid
3. Bring decentralization closer to its citizens
4. Ensure future participation by citizens
5. Increase compliance and decrease tax evasion
6. Increase revenue collection
7. Increase the tax effort

What now remain are problems that can be solved easily, for example:

1. The transfer of the record of property taxpayers from the devolved public revenue offices to the PRO
2. Given the low initial base for the devolved taxes, it will help to increase the property tax collections in medium term after devolution
3. This initial momentum should not create space for comfort and allow local governments to forget the need for further development of the revenue system in the areas of assessment, audit, collection and monitoring
4. For local citizens to see progress that is meaningful to them, mayors and council members need to be able to see beyond the appointment of a primary accountant or the transfer of staff from the PRO (see the box above)
5. Self assessment of the tax base requires a strong system of monitoring
6. Building database of taxpayers
7. Building efficient tax administration
8. Increase in the tax effort

5. INTER-GOVERNMENTAL TRANSFERS

The nature and implications of inter-governmental transfer mechanisms can differ substantially. This section, as the ones before, presents a framework for evaluating different mechanisms.

5.1. Structure - types of transfers

The phased approach to fiscal decentralization is closely connected with the inter-governmental transfers. The process of fiscal decentralization is envisaged by the LFLGU to evolve in two phases (for details see Annex 3). The first phase started 1 July 2005 with the introduction of the earmarked grants. The second phase will start upon fulfillment of certain conditions. It is in this phase that block transfers will start to be distributed. The major principle of this phased approach is to allow a gradual devolution of responsibilities in line with the demonstration of greater capacity by local governments to undertake those responsibilities, and to provide an equitable and adequate transfer of funds for an efficient and ongoing execution of transferred competencies.

The LFLGU envisions the following channels of transfers from the central Government:

1. VAT revenues (total fund equal to 3 % of the VAT collections in the previous fiscal year). This unconditional grant will be distributed by a formula with at least 50 % according to population and not more than 50 % according to other criteria. These other criteria will be stipulated in a methodology to be defined by the government in agreement with the Commission for Monitoring of the Development of the Financing System. The proposal for the following fiscal year has to be prepared by 30th June of the current year. The methodology makes separate provisions for the City of Skopje.

2. Earmarked transfers of specific grants for operational costs in the areas of education, culture and social policy. The appropriate ministries and agencies monitor the use of the earmarked funds.

3. Capital transfers. (In accordance with programs specified by the Government.)

4. Block transfers. (In accordance with article 22 paragraphs 5, 7, 8 and 9 of the Law on LGU); the appropriate ministries and agencies are responsible for defining the methodology and criteria to be used in the transfer formula.

5. Funds received for delegated competencies. In this case the amount of funds is determined by way of a contract signed by the mayor of the local government and the appropriate ministry responsible for the competency.

The Bureau for Underdeveloped Regions and the off-budget Road Fund components to provide transfers are still in place. There is an urgent need for evaluation of their cost effectiveness and whether they should be consolidated in the line with the new draft Law on Balanced Regional Development.

5.2. Vertical equalisation

Both central and local governments are required to provide public services. It is common to find that the own-source revenue raising powers of local governments are insufficient to meet the costs of providing the services they have been assigned. The resulting gap can be filled only by increasing local revenue raising powers or by increased transfers. For reasons that include concern for macroeconomic stabilization, the lack of appropriate local revenue bases, and the low capacity to administer taxes locally, transfer mechanisms may be the more suitable way to achieve vertical equalization.

Related to the salaries for transferred staff, the Government has yet to formulate plans for 2007 about when the LGU will be required to pay the staff directly.

The procedures for calculating the earmarked grants are related to the budget process and the budget circular. However, the view of the Ministry of Finance is that even though the procedure for distributing the amount to the LGU is transparent for the education sector (by students), it is based on historical costs and there are indications of substantial under-funding. The situation is similar in the

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culture sector. The earmarked grants for the social sector and the kindergartens are found to be sufficient.

5.3. Horizontal equalisation and equity

There are often wide differences in the ability of local governments to mobilize resources across localities. If only local taxes were available to finance local services, there would be substantial inter-jurisdictional differences in the quantity and quality of public services. Inter-governmental transfers can be used to help equalize those differences. The conflicting views concerning the VAT transfer were discussed earlier. ZELS and the Government should first agree if this is an equalization fund, and, if it is, then this should be stated clearly in the LFLGU. It then needs to be decided how to proceed with the two steps in its implementation:

- 1) The estimation of the total pool;
- 2) The formula.

In this regard, it is strongly recommended to include a formula in the law for calculation of fiscal capacity of local governments.

The equity criterion relates directly to the issue of horizontal equalization. The criterion is complex since it commonly involves a combination of factors that are not easily measured. Transfer systems should distribute resources between local governments in a manner that accounts for differences both in the expenditure needs (providing more to those with greater need where the need factor includes variations in the unit cost of producing public services) and in the fiscal capacity (providing less to those with greater capacity). Specifically, it should attempt to decrease or equalize these differences.

5.4. Revenue adequacy and growth

The objective of revenue adequacy and growth is obviously related to the ability of a transfer system to meet local spending needs, both at present and as those needs increase in the future.

5.5. Predictability, simplicity and transparency

The desires for predictability, transparency, and simplicity are closely intertwined. Fiscal planning requires there is a reasonable degree of certainty associated with the flow of resources from the centre, including its timing. This means that it is desirable for local governments to have a general idea of how much money they are likely to receive from their various sources of revenue when they begin the planning and budgeting process for the following year. Similarly, it is important that the transfers allocated to localities actually are distributed on a timely basis for use at the local level.

Local officials should be able to ascertain how their share of a particular transfer was determined. This understanding is facilitated by use of relatively simple but explicit formulas. This requires that the requisite data is available to be used in a formula.

5.6. Allocative efficiency

Allocative efficiency means that the resources are allocated to those services that are most needed at the local level. Grant systems should not distort local fiscal choices. This means that grants

should not influence how local governments allocate their resources across sectors or in terms of its choice of how to combine factors of production. For example, a transfer limited to investment in rebuilding roads can discourage local governments from maintenance of existing roads. In the presence of jurisdictional spill-over these guidelines will need to be modified in order to achieve an efficient allocation of resources from the national level.

5.7. Overall assessment

Local governments are likely to view the transfers as substitutes for their own resources and to decrease their efforts at raising local revenues. Also, since the existing public infrastructure is a part of the resources that must be "managed" by local governments, grant systems can have an adverse effect on the willingness of local governments to maintain such infrastructure. In Macedonia, the system of capping own revenues provided no incentives for greater fiscal efforts and public infrastructure was maintained by transfers from the line ministries and in the case of the communal services, from user charges. The cap system had adverse effect on the fiscal effort, the transfers from the line ministries were not transparent and the communal services continue to face revenue collection problems. This is a difficult situation and the new system which abolishes the old cap system for own revenues and introduces earmarked grants, is expected to improve the situation.

As for the grants, if they are to be systematically distributed to local governments, several policy decisions need to be made. These include:

- determination of the grant pool, i.e. how much will be available to be distributed to local councils;
- the method used to allocate that pool across all eligible local governments
- the degree of restrictions associated with how the grant funds can be spent by local governments.

In the next table, the typology of grants is utilized to discuss the Macedonian context for PIT and VAT transfers.

Table 2. Typology of grant programs

Methods of allocating the divisible pool among local governments	Method of determining the total divisible pool		
	Sharing	Law decision (Ad hoc decision)	Reimbursement
Origin of collection	A	N/A	N/A
Formula	B	F	N/A
Total or partial reimbursement	C	G	K
Ad hoc	D	H	N/A

Source: Bahl & Linn 1992.

The advantage of A-type is because it is a pure shared tax, it is certain and it simplifies the fiscal planning of the local governments. Further, it is not conditional and it can increase the fiscal autonomy. Sharing gives the local governments an income and inflation elastic tax base. The disadvantage is that it is an inflexible solution because it is difficult to change the percentages once they have been established, and thus the vertical balance. This might be important in the Macedonian context with its

high economic uncertainty (prices of energy, weak economy, high unemployment etc). Another disadvantage is that the A-type does not provide equalization and in principle increases inequality. All in all, PIT-sharing is beneficial given the current level of tax administrative capacity at local level. The percentages can and should be revised after a comprehensive analysis of the fiscal gap and vertical imbalance is done. Higher percentages can provide greater incentives for compliance by the taxpayers and to decrease tax evasion if the taxpayers can consider it as "own".

The PIT tax, even though considered as an own tax for the local governments, is actually a sharing type-A because:

- 1) The local governments have no control over determination of the rate and base;
- 2) The allocation is based on the origin of collection.

As for the VAT grants, the total divisible pool is shared and the allocation is by formula and thus it is a B-type grant. The VAT formula-based grant is transparent but the lack of timely and adequate data to be included in the allocation formula is a serious deficiency.

The way the formula is stated in the law at present makes it difficult to see what the Central Government is trying to achieve. Is it to equalize the fiscal capacity, to reduce the disparities in providing public services or to encourage a local government to mobilize its own resources? This confusion should be resolved as soon as possible. Also, the number of population requirements within the law for the VAT distribution formula (at least 50 % of the weight) probably shows the weakness of the state statistical system and lack of data (the population data being most credible).

Box 2. Examples of intergovernmental transfers based on non transparency, often according to the government majority at the central level, the political party to which a mayor belongs and to different regionally based lobby groups.

The aim of this box is to present some negative practices that might impact on the credit rating of a LGU.

The bases for intergovernmental transfers are determined in the laws: the Law on the Government of the Republic of Macedonia (Official Gazette of the RM No 12/03, 55/03); the Law on Execution of Budget of the Republic of Macedonia (adopted each year and for 2006 published in the Official Gazette of the RM as No 120/05), the Law on Public Roads (Official Gazette of the RM No 26/96, 40/99, 96/00, 29/02 and 68/04); the Law on Environment (Official Gazette of the RM No 53/05, 81/05); Law on Organization and Operation of the State Administration Bodies (Official Gazette of the RM No.58/00); Law on Stimulation of the Development of the Economically Underdeveloped Regions (Official Gazette of the RM No. 2/94 and 39/99); the Law on Limiting the Original Revenues for Financing the Public Needs (adopted every year); the Law on Financing the LGU and other bylaw acts.

Examples:

1. According to the Decision for distribution of assets for the building of water supply and drainage systems in Republic of Macedonia in 2006, the Government (Ministry of Transport and Communications) distributed around 2 million euros allocated as capital subsidies to the LGU, under program 35 - water supply system at LGU. The assets were distributed unfairly and opaquely, without any agreed criteria and favouring municipalities whose mayors are a member of one of the governing parties at central level. The mayors and ZELS have reacted to this kind of distribution.

2. According to the Law on Public Roads, based on the Annual program for building, reconstruction, maintenance and protection of the national and regional roads in the Republic of Macedonia, the municipalities and the City of Skopje, were provided with around 8 million euros as capital transfers for local roads and streets for 2006.

In the latest regulations on the criteria for the distribution of assets, the criteria were changed. Whereas in previous years the main criteria were the number of registered motor vehicles, fuel consumption and the length of the local roads and streets, the latest criteria introduced were the number of citizens and the municipality area. This resulted in significant redistribution of the assets with drastic reductions in the case of some municipalities. This resulted in serious problems brought about by the sudden change in the system. Such problems include damaged road networks, the rapid deterioration of the road network, and municipalities being unable to get other resources for maintenance. Another problem is the inadequate total sum of assets for distribution. The total sum instead of being increased in line with increased revenue from excise duties on oil derivatives, vehicle registration tax and motorway tax, has remained the same or has actually decreased.

3. In 2006 only around 1 million euros were allocated for financing projects based on the Program for investment in the environment for 2006. Although the environment should be the top priority, the Republic of Macedonia sets only symbolic sums for this purpose. A large amount of finance is needed to provide for the acceptance and treatment of solid waste and the building of drainage and collector networks and waste water treatment plants.

4. Typical was the improper distribution of part of the assets from the privatization of the Macedonian Telecommunications that was made by the Government of Republic of Macedonia in April 2001. In this case some of the municipalities were granted over 5,000,000 euros, and in other municipalities, where the mayor was from the opposition parties, no grant was made.

5. A similar case was the distribution of the assets from the "Program for granting finances for investment projects in the economic and non-economic infrastructure and for equity investment in financing individual investment projects in the economy". These assets were distributed through the Bureau for Economically Underdeveloped Regions which is a part of the Ministry of LSG. The decisions made were opaque and greatly influenced by the political elites and lobby groups.

6. Here are some more examples of the unfair treatment of LGU by the Government of Republic of Macedonia.

a) The Government of Republic of Macedonia made reforms to ARM for it to adjust to the standards of NATO. Many of the assets that were used by the army, eg barracks, and living quarters of ARM, were given to a few municipalities without any compensation and part of that property was sold without any explanation. In addition, the privileged municipalities gained very valuable property without compensation, sometimes to the extent of millions of euros even though these were built by the citizens of the Republic of Macedonia.

b) The Government of Republic of Macedonia without any public procedure made decisions on contracts giving motor vehicles to some municipalities before the end of the government mandate in August 2006. The municipalities involved included Gostivar, Cair, Oslomej and Kumanovo. This brought these municipalities into a privileged position compared with the rest of the municipalities.

c) Typical is the disrespect of articles in the Law on financing LGU for capital subsidies. The Law defines capital subsidies as a subsidies aimed at financing the municipality projects that require capital investments. Such subsidies are used according to the program determined by the Government based on proposals made by the authorized ministries and funds. In addition, priority should be those projects that have fully planned financial assets.

d) The inconsistency of the Government and disrespect for the articles is evident because the Government has not met the deadlines and has not decentralized capital investments in the education sector. There is no logical explanation for this, other than the mistrust of the LGU and the need for the Ministry of Education to maintain control. Instead the Government has managed the expenditure by inviting tenders and issuing contracts at a state level.

Source: Interview with a Mayor from Macedonia and active member of ZELS bodies.

6. FINANCIAL MANAGEMENT

The financial management at LGU level is regulated primarily by the LFLGU, the Law on Budgets, the Law on Budget Accounting and Budgetary Beneficiaries, and Law on Public Procurement.

6.1. Budgeting

The LFLGU outlines a modern type of LGU budget by separating capital and operational budget ("general budget" and "special budget"). However, the building of performance budgeting is far away even though piloting of performance measurement in transferred competencies was introduced in some LGUs although this activity was mainly donor driven.

The LGU budget for each year is passed by the Council of the municipality, pursuant to a proposal from the Mayor, not later than 31st December of the preceding year. If the Municipal Council fails to pass the Budget for any reason whatsoever during this predetermined period of time, the Council is obliged to pass a decision on temporary financing - including a financial plan for implementing temporary financing for the first quarter of the coming year. The Municipal Budget is prepared in accordance with the Law on Budgets and guidelines drafted by the Minister of Finance. The Budget ought to be balanced, meaning that it cannot have a budgetary deficit. Within fifteen days of the Budget being approved, the municipality is obliged to submit it to the Ministry of Finance so that it may be examined in light of the country's overall public expenditures. In approving the Budget, a municipality must pass a decision to implement that Budget. It is important to emphasize that finances must be spent for specific purposes and in accordance with the amounts determined in the Budget. The budgeting process should start no later than 30th September each year. By this date, the Minister of Finance should have prepared and submitted a budgetary circular to inform the municipalities of all economic indicators, detailing the main directions for preparing the Budget, describing the resources that are to be transferred from the national budget to the municipality, and to inform the municipality about various other possible sources of income. Budgeting proceeds in phases and in terms set in a budgetary calendar, as approved by the Municipal Council. The Mayor provides the budget beneficiaries with directions for the preparation of the Municipal Budget. After preparing their plans, beneficiaries should submit their financial plans to the Mayor, who then submits the budget proposal to the Municipal Council.

It is encouraging that in Macedonia there are elements of citizen participation related to the budget process in some LGU. The assessment by the Ministry of Finance is that this is on the right track but what should be further developed is a strong civil sector so that such initiatives are not only encouraged by the government (at both levels) but also by the citizens.

The benefits of citizen participation during the budget process can best be achieved if preliminary information on the budget is available to all interested parties, alongside a public appeal procedure wherein all interested individuals can submit their opinions. Additionally, these benefits can be achieved through organizing public forums to discuss the draft budget - in urban communities, amongst associations of citizens, within educational and social welfare institutions, and through cultural and sports institutions, etc. Once public discussions have been conducted, and useful proposals incorporated into the text of the budget proposal, it is submitted to the Council. If it happens during the fiscal year that revenues and expenditures are not in accordance with the budget plan, the Mayor may propose a re-balancing of the budget to the Municipal Council, whereby amendments and changes to it can be made.

As part of the budget execution it is advanced management to compare the actual with the budgeted expenditures and to calculate the variances through the use of other analytical techniques for the purpose of budget control. The best method is to have a transparent procedure for revenue projection.

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The revenues should be tracked by budget source and compared with the projected income. This is important as politicians may overestimate when faced with hard decisions regarding spending.

6.2. Accounting

The LGU and the public services keep accounting records in accordance with the Law on Budget Accounting and Budgetary Beneficiaries, consistent with generally accepted accounting principles, practices and standards, and in keeping with international accounting standards for the public sector. The Mayor places an accountant in charge (he or she must be a graduate of economics with at least five years of working experience in the field of financing) who, alongside the Mayor is responsible for the legality of municipal accounting.

Still the LGU are using cash accounting with all its limitations (apart for its simplicity) such as not adequately recording the liabilities, future services, recognition of services and goods received which are not yet paid.

6.3. Treasury management

There is a single treasury system, so that, in principle, the government knows at all times the aggregate amount of resources available in the Treasury. The Ministry of Finance also has developed a manual on treasury management for the LGU. This means that, although individual local governments maintain records of their own finances, their accounts are actually under the control of the central government. This, in turn, can constrain local fiscal flexibility.

6.4. Reporting

The LGU in accordance with the LFLGU prepare internal financial reports on a monthly basis and prepare quarterly reports to the Ministry of Finance. The Ministry has prepared guidelines for the LGU on how to report, including arrears, borrowing, financial planning, etc. However, the quarterly reports are to be revised due to the daily input that the Treasury in the Ministry is now receiving on municipal budgets. Our recommendation is that the debt and guarantees report and the quarterly plan for the budget execution should remain and that all other reports are eliminated. This will reduce the workload of the municipality and will help Ministry to introduce discipline on regular and accurate reporting.

This external reporting seems to be well regulated (around 50 out of 84 LGU are reporting regularly which is considered a success by the Ministry of Finance and as a good start) but the internal reporting is not yet strong. The most important thing for the reporting is to be accurate and timely, so to provide the required information and to function as a management tool. However, one must also have in mind that reporting should assist in fulfilling the LGU duty to be publicly accountable. This reporting should enable users to access that accountability, to evaluate the operating results and to assess the level of services that can be provided by the LGU..

6.5. Internal audit

Internal Audit is an assurance function that primarily provides an independent and objective opinion to the organization of the degree to which the internal control environment supports the achievement of its objectives. Internal audit also seeks to help line management improve the internal control environment in an organization.

The LGU are obliged to establish an internal auditing system and procedures consistent with international standards for the performance of a professional audit acceptable to the Ministry of Finance. The internal auditor is appointed by the Municipal Council upon a proposal from the Mayor. The internal auditor has an independent function and answers both to the Mayor and the Council. The external audit of financial accounts is carried out by the State Auditing Service. The Mayor has the responsibility to provide the State Auditing Service with a report on the implementation of the Budget, in addition to a final accounting report, within 30 days of their completion.

6.7. Overall assessment

The development of a modern financial management system at LGU level is something new in Macedonia. Given the good progress made in terms of preparing consolidated budgets by the LGU and in some elements of the budget planning and reporting, overall progress to date can be considered as a success. This initial success is mostly because of the effort from the central level (Ministry of Finance) in preparing guidelines and providing training for the LGU. The Ministry of Finance also considers that donors have been helpful in this regard. Examples of instruments developed by the Ministry are modules for budgeting, supplementary budgeting, treasury plans and financial planning.

However, there are objective reasons (given the scale of the reforms) for possible concern as the staff at LGU level needs further capacity building. Of particular importance is the building of planning capacity especially related to decreasing the systematic error between the planned and realized budget. There are also "ethnic" issues as some LGU are requesting tax returns in two languages but this will require additional money, more staff and time for development.

In Macedonia, there is neither a law nor a separate regulation on LGU insolvency but LGU financial instability is defined within the LFLGU. Financial instability in a municipality occurs if the state auditor determines that there have been major irregularities in financial undertakings. Financial instability also occurs if the municipality account has been blocked for 30 consecutive days or if there have been 45 days with interruptions occurring in a period of 60 days. Finally financial instability occurs in cases where the municipality fails to pay its debt within 90 days of its due date or if its approved loans limits are exceeded. In these circumstances, a special committee must be established to prepare a plan of action to set measures for overcoming the financial instability.

The legal framework for the rights and obligations of participants involved in a process of public procurement is set in the Law on Public Procurement. An LGU is obliged to provide all bidders with an equal and non-discriminatory position in public procurement processes, with fair competition, transparency and exposure to public scrutiny.

7. BORROWING AT LGU LEVEL

7.1. Sources of financing of infrastructure projects

In Macedonia the 2002 Law on LGU designated some responsibilities of LGUs. These functions remain in the central government domain, until the respective line ministries develop sectoral laws spelling out the process of devolution of a particular function. Nowadays, since the line ministries have completed the devolution of designated functions to the local level, local government responsibilities are beyond the "municipal housekeeping," that is, they have responsibilities which require very substantial capital investments.

The underlying purpose of the development of a municipal credit market is to increase the volume of local capital investment to support essential municipal services. Well-designed investment and borrowing plans often can provide immediate finance the construction of infrastructure facilities that are needed and then to repay the debt from the future earnings of the facilities themselves, through user charges or through cost savings in service operations.

The next table illustrates the pros and cons of different sources of financing LGU projects.

Table 3. Sources of financing of infrastructure projects

Source	Pros	Cons
Own resources	Cheap	Less predictable, rarely sufficient
Grants from EU and central governments	Cheap	Restriction on the use of funds, slow pace of approval, strict control
MFO loans	Long-term, grace periods, amortizing repayment	Foreign currency risk, restrictions on the use of funds
Domestic bank loans	Local currency	Short-term, restricted capacity
Bonds	Diversity of investors, liquidity, depth of markets	Expensive depending on size, bullet repayments
Own sources or borrowings of enterprises	No direct costs	Contingent liabilities and more expensive
PFI/PPP deals	No direct costs, more effective private sector provision of services	Long-term agreement with concessionaires, off-balance sheet risks
Investment banks and funds for LGU	Deposit risk attenuation, lower interest rate, possibility of contributing to capitalization of the bank, LGU could provide guarantee with their current revenues as well, the Bank can provide consulting services to the LGU as an auxiliary service	

Source: Felix Ejgel from S&P. Slight adaption by the author.

The next table illustrates the pros and cons for allowing LGU borrowing

Table 4. Pros and Cons for LGU borrowing

Pros	Cons
<p>1. Inter-temporal equity, meaning that with the borrowing we overcome the problem of inequitable burden costs among taxpayers i.e. the borrowing promotes intergenerational equity by having the generation of citizens that benefits from capital facility's services pay for its construction;</p> <p>2. Optimal allocation of resources, meaning that payments from current users are partially used to repay the loan because by financing a project through loan or through issuing bonds most users will pay for the benefits either through local taxes or directly through user charges;</p>	<p>1. The microeconomic con is in the potential indebtedness that may lead in default of repayment of the loan and decreasing the level of quality of provision of public services;</p> <p>2. The macroeconomic con is that the LGU debt is added to the overall national public debt that might become unsustainable;</p> <p>3. The special danger might come from borrowing for covering current operating expenses and possible cash flow problems. This type of borrowing can lead to rolling over loans;</p> <p>4. Borrowing can create a fiscal illusion that the voters/tax-</p>

3. Benefits from accelerated local development are higher than the cost of borrowing. For example if a piece of land of interest to investors have no good access to a road the LGU can decide to borrow, to build the road and sale the land benefiting from higher price of the land or higher rent for it. Here are also other positive effects like higher employment, more tax revenues, attracting other potential investors etc.;

4. Reduction of operational costs. This pro has the same logic as the third one. Namely, if the LGU wants to improve the condition with the public transportation by replacing old busses it can do this either by replacing the buses one by one using the current surplus from the budget or it can borrow and replace more buses at once. The multiple positive effect is higher with the second public choice because there are positive externalities for the environment, health of citizens from lower level of pollution, higher reliability of the vehicles, financial savings in the cost of maintenance of the buses etc.;

5. There is a tendency that longer projects cost more. If the projects are financed from the current revenues it will delay the completion of the project which might lead to higher fixed costs due to longer period of time for completing the project;

6. Access to grant from EU and other development funds but the LGU will be required to participate in a matching funds scheme and/or to cover all the costs of the project and than to claim reimbursement after completion of the project;

7. Debt finance typically has a positive effect on municipal planning and budgeting, financial management, capital investment planning, project management etc.;

8. Borrowing allows a LGU to carry out a more ambitious capital program than otherwise would be possible.

h) Public illumination;

i) Sanitation;

j) Primary social assistance services for child protection and for the elderly;

payers are over-demanding the public services sponsored by borrowing and not by their tax effort;

5. Possible crowding out effect to potential private investors since the LGU is more attractive to lend to;

6. The borrowing by the LGU can cause an upward pressure of the interest rates;

7. The budget deficits at LGU can cause rising of inflation and thus, increase of cost of capital i.e. interest rates;

8. Political cycle driven borrowing in order to please the electorate.

Source: Swianiewicz 2004.

7.2. Regulations on LGU borrowing in Europe

Within perfect capital market conditions, the market itself automatically regulates the financial discipline. If the LGU debt becomes relatively high, high interest rates will sanction such behavior by requiring a higher risk premium. However, the LGU market for borrowing is imperfect because of:

1. Asymmetric information i.e. the lenders do not have all the creditworthiness related information about the LGU;

2. Moral hazard problems i.e. the market expects that the LGU cannot go bankrupt and the central government will bailout the LGU.

Thus, it is more efficient to have well designed system for regulation of LGU borrowing. The practice in different countries is illustrated in the Tables below.

Table 5. LGU borrowing regulations in Western Europe countries

BORROWING FOR CURRENT EXPENDITURES	
Norway	If the LGU presents an unbalanced current budget it will not receive approval from the state regional commissioner. If a deficit occurs, Norwegian LGU are required to repaid it within two years.
Denmark, UK, France, Spain	There is no approval for the budget but there is compulsory external audit. If a current deficit occurs it has to be paid within the current fiscal year. Spain does not separate current from capital budget.
Switzerland	If deficit occurs and the LGU has done nothing to avoid it, the canton may impose compulsory increase in the LGU tax rate. Also, the tax rate increase can be automatic if the deficit is more than 3 % of the budget.
BORROWING FOR CAPITAL EXPENDITURES	
Denmark	Based on borrowing control. Borrowing is prohibited but LGU can receive permission to borrow for investments in public utilities and/or in priority areas identified by the central government. Another waiver to the prohibition is the discretionary permission for which the government announces an upper limit each year. In this way the central government controls the behavior of the LGU.
UK	Based on borrowing control. Each LGU receives an individual borrowing limit.
Germany	Based on four year financial plan prepared by the interested for borrowing LGU.
Switzerland	Different across cantons. At one canton if a project cannot be covered by annual budget it must go to local referendum.
France	Based on control of the level of indebtedness. The prefect checks the level of LGU each year and if it is not in accordance with the law the case is passed to the Regional Audit Chamber-RAC. The current budget has to be higher than the annual debt repayment. If the deficit exceeds 5 or 10 % of the annual budget (depending on the size of the LGU) the RAC proposes appropriate fiscal measures.
Italy	Based on borrowing control. Interest and capital payments cannot exceed 25 % of the current revenues.
Spain	Based on borrowing control. Central government and regions decide together about the annual limits of deficit and debt level. No individual limits to LGU.

Source: Swianiewicz 2004.

Table 6. LGU borrowing regulations in newly EU countries

	Czech Rep.	Estonia	Hungary	Poland	Lithuania	Slovakia
For capital or operating purposes?	Both	Long-term - for investments only, but no separation of capital budget.	Both	Both	Both	For investments only.
Limit of overall debt	No limit	60% of net revenues (without state earmarked grants)	No limit	60% of total revenues	Borrowing cannot exceed 10% of total revenue in approved budget, sublimitate or 5% for short-term loans	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	10% of total revenue excluding earmarked grants	No limits, but from 2005 - 25% of revenues; state support loans not included
Sanctions for not following	Not applicable	Since 2003 - possibility to hold state fund transfers	Effectively no	Effectively no, but ex-ante control of Regional Audit Offices	Effectively no	Not applicable
Any other conditions	Forecast balance sheet for 2-5 years; internal audit; with some exceptions - guarantees by local govt. prohibited	Presentation of development plan; guarantees by local govt. prohibited	"Core properties" cannot be used as collateral	Limits applying when public debt exceeds 50% GDP	Minister of Finance can impose lower borrowing ceiling for individual municipalities based on budget performance.	Ministry of Finance ex-ante approval of credits over (approx.) 2 mln USD is required
Comments	Limits were introduced for short periods only no larger than 15% of budget revenues	Debt of municipal companies is not included in the limits	Debt of municipal companies not included in the limits (unless formal guarantees exist)	Debt of municipal companies is not included in the limits (unless formal guarantees exist)	Long- term credits must be approved by loan commission of the MOE	Guarantees by local governments prohibited

Source: Caluseru and Johnson (2005, p.68)

Table 7. LGU borrowing regulations in Macedonia, Bulgaria and Romania

	Macedonia	Romania	Bulgaria
For capital or operating purposes?	Both	Both	For investments only
Limit of overall debt	The total amount of short-term loans during the current fiscal year shall not exceed 20% of realized total revenues of the current-operative budget of the Municipality in the preceding fiscal year. The total amount of annual repayment of long-term loans shall not exceed 15% of realized total revenues of the current-operative budget of the LGU in the preceding fiscal year. The total amount of the undue long term debt of the LGU, including the issued guarantees, shall not exceed the amount of the total revenues of the current-operative budget of the LGU in the preceding year.	The annual debt representing the due installments deriving from contracted loans shall not exceed 30 % of the total current revenues of the local budget. About the short term borrowing, the cash flow deficit shall not exceed 5 % of the LGU budgeted revenues including taxes, fees, contributions, other payments, other income and allocated shares from the income tax.	No limits on the size of the outstanding debt of local governments

Any other conditions	<p>The Municipality may borrow from abroad only after an approval by the Government of the Republic of Macedonia, under an opinion of the Ministry of finance.</p> <p>The domestic borrowings shall be in domestic currency.</p> <p>The municipality shall not be allowed to mortgage municipal property that serves for realizing activities of public interest prescribed by law. LGU Regularly submits positively assessed financial reports during a period of at least 24 months since implementation of the Law on financing the Local self governments and has no arrears to creditors in the last 2 years since implementation of the Law on financing the Local self governments (before these deadlines the Municipality can borrow only after an approval by the Government and an consent by the Ministry for a borrowing from international financing institutions.</p>	<p>LGU must have approval of a Commission if maximum amount (periodically updated) will be exceeded. By the 15th of every month, borrowers of funding in outstanding local public debt, including guarantor administrative units, shall report information on the status of borrowing in the previous month, structured as required by MPF-developed norms.</p>	25% of own revenues and equalizing grants
Sanctions for not following if	<p>From the penalty provisions: the municipality has incurred debts abroad, without previous consent of the Government, puts an asset of the municipality, which is used for the activities of the municipality of public interest, under mortgage, uses the means from the short-term loan for payment of penalties and penalty interests, surpasses the limitation of 20% from the realized total revenues of the current and operative budget of the municipality in the previous fiscal year, according to a total short-term incurring debt during the fiscal year, payment of the long-term loan is not conducted in equal or decreasing annuities, the municipality surpasses the limitation of 15% of the total revenues of the current and operative budget of the municipality in the previous fiscal year for the total annual payment of the long-term loan, does not comply with the conditions for the amount of the total not received long-term loan, fails to submit the Loan Contract and compensation plan, within ten working days, to the Ministry of Finance, fails to inform the Ministry of Finance for each paid installment, within a period of ten working days;</p>	<p>Crimes: expenditure commitment, authorization and payment beyond the ceilings approved in the budgets, expenditure commitments in the budgets beyond the approved budget credit, use of local public borrowing proceeds for other than the approved purposes, use of erroneous data in preparing the background documentation for authorization to borrow/guarantee borrowing, perform any finance involving attributions during management of the state of insolvency.</p> <p>Offences are introduced for noncompliance.</p>	If not followed than the municipality has no right to incur new debt or guarantees
Any other conditions	<p>The municipality shall submit the Loan Agreement and the Terms of Redemption to the Ministry of Finance within 10 days of the day the Agreement has been signed. The Municipality shall inform the Ministry of Finance about every installment payment regarding the debt within 10 working days. The municipality shall not be allowed to mortgage municipal property that serves for realizing activities of public interest prescribed by law. LGU Regularly submits positively assessed financial reports during a period of at least 24 months and has no arrears to creditors in the last 2 years.</p>	<p>LGU must have approval of a Commission if maximum amount (periodically updated) will be exceeded. By the 15th of every month, borrowers of funding in outstanding local public debt, including guarantor administrative units, shall report information on the status of borrowing in the previous month, structured as required by MPF-developed norms.</p>	The nominal value of the municipal guarantees limited to 5% of own revenues and equalizing grants. Limit on general government debt of 60% of GDP.

Source: Adopted from the regulations of the proper countries.

As of May 2004, the total outstanding LGU debt in Macedonia is estimated at around 47 millions of euro or 1.4 % of the Macedonian GDP. This compares with the average of 5.6 % in the original 15 EU member states (more in Schlumberger Sema 2004). The structure of local debt in Macedonia is as illustrated in the next table. It should be noted that these figures are arrears and not traditional debt in their nature. However, the LFLGU states in article 18 that all arrears which have been due for more than 90 days will be counted as debt. The experience shows that if the LGUs put aside 15% from the current-operating revenues for payment of their debts, 24 LGU (out of 84) will need more than 7 years to pay their debt and 10 municipalities will need more than 10 years.

Table 8. LSG debt structure in Macedonia in 2004

Debt structure	
Arrears toward construction enterprises	79 %
Restitution liabilities	9 %
Arrears toward Electric Power Company-ESM	7 %
Arrears upon salaries	2 %
Other current liabilities	3 %

Source: Schlumberger Sema (2004).

A similar pattern of arrears as an issue for budget execution is also observed in Romania i.e. around 70-80 % of the arrears are actually payment due to suppliers.

Most of the aggregate amount of debt (arrears) in Macedonia is concentrated in just ten LGU (72 % of the total debt). As can be seen from the table, local debt is dominated by arrears to suppliers. Arrears represent a major problem and article 45 of the LFLGU requires that by the end of 2004, each LGU should provide a plan for solving the outstanding debt that was accumulated prior to 31st of December 2001. However, it appears that no effective resolution is available, although the problem is being considered by the government under the coordination of the Ministry of Finance.

The arrears will have a powerful impact on the creditworthiness of the Macedonian LGU and their capacity to use credit instruments in their capital programs because this is a form of hidden operating deficit.

According to the Ministry of Finance, since the start of decentralization, the LGU are gradually decreasing the amount of arrears (Euro 24 millions at the end of 2005). 29 out of 84 LGU in this period have reduced their stock of debt (arrears), one LGU has increased its debt and the remaining 55 have not progressed in resolving this problem.

Recently a new Department for Debt Management (DDM) was established within the Ministry of finance. The DDM is too remote to perceive the existing debt of the LGU as part of their competency, even though people from the budget department have asked for that. The main problem remains the gathering of the quarterly reports from all Municipalities by the Budget Department. The processing and reporting of the municipal real debt (meaning loans and securities) is a responsibility of the DDM and does not include the arrears. The DDM, according to the Law on public debt, has to agree to all initiatives for borrowing by public institutions (including the municipalities) bearing in mind the debt management strategy, annual borrowing limits and debt sustainability. Regarding agreement for borrowing by the Municipalities, coordination with the Budget Department is carried out. Sensitive to IMF cautiousness on level debt, the central Government might tend to become too demanding in seeking information from the LGUs.

Table 9. Stock of public debt of the Republic of Macedonia (GFS methodology)

(in millions of EUR)	2005	30/06/2006	31/07/2006	31/08/2006
EXTERNAL PUBLIC DEBT*	1,441.16	1,219.60	1,216.36	1,214.08
General Government Debt	1,245.35	1,037.70	1,030.65	1,030.98
Central Government (consolidated)	1,245.35	1,037.70	1,030.65	1,030.98
Central Government	1207.95	999.50	992.60	990.64
Public Funds	37.40	38.20	38.05	40.34
Municipalities	0.00	0.00	0.00	0.00
Central Bank	52.66	47.82	47.45	47.03
Public enterprises	143.15	134.08	138.26	136.07
DOMESTIC PUBLIC DEBT	750.39	753.30	773.16	792.52
General Government Debt	603.66	641.18	656.21	669.48
Central Government Debt	603.46	640.98	656.01	669.28
Structural bonds	533.50	512.00	511.07	510.85
Stopanska Bank Rehabilitation Bond	26.61	21.29	21.29	21.29
Small Bond	0.00	0.00	0.00	0.00
Bond for selective credits	16.98	16.98	16.99	16.99
Stopanska Bank Privatization Bond	77.24	72.95	72.95	72.95
Bond for old foreign exchange savings	306.50	280.90	280.42	280.42
Denationalisation Bond (I, II, III, IV and V issue)	106.16	119.87	119.42	119.21
Continuous Government Securities	69.96	128.98	144.94	158.43
o.w. Treasury bills for monetary purposes	0.00	43.64	64.50	80.84
Municipalities	0.20	0.20	0.20	0.20
Central Bank	146.74	110.59	115.37	121.41
Public enterprises**	N/A	1.53	1.59	1.63
TOTAL PUBLIC DEBT-GFS	2,191.55	1,972.90	1,989.52	2,006.60
GDP***	4,522.00	4,840.10	4,840.10	4,840.10
Average export***	1,624.00	1,858.14	1,858.14	1,858.14
External public debt as % of the public debt	65.76	61.82	61.14	60.50
Domestic public debt as % of the public debt	34.24	38.18	38.86	39.50
Public debt as % of average GDP	48.46	40.76	41.10	41.46
Public debt as % of average export	134.95	106.18	107.07	107.99
General Government Debt-GFS	1,849.01	1,678.88	1,686.86	1,700.46
External debt of the General Government as % of the General Government Debt	67.35	61.81	61.10	60.63
Domestic debt of the General Government as % of the General Government Debt	32.65	38.19	38.90	39.37
General Government debt as % of the average GDP	40.89	34.69	34.85	35.13
General Government debt as % of the average export	113.86	90.35	90.78	91.51
Public debt calculated on the basis of the Public Debt law****	1,992.16	1,770.85	1,762.21	1,757.32
External public debt as % of the public debt	69.70	66.17	66.33	66.41
Domestic public debt as % of the public debt	30.30	33.83	33.67	33.59
Public debt as % of average GDP	44.05	36.59	36.41	36.31
Public debt as % of average export	122.67	95.30	94.84	94.57

* Source: National Bank of the Republic of Macedonia/Ministry of Finance. Author's adoption.

** Beginning April 2006 public enterprises started submitting to the Ministry of Finance reports on the stock of debt (according to the Public Debt Law).

*** Source: IMF tables (data for 2005 and 2006 are revised)

**** Total public debt excluding the debt of the monetary authority (IMF loans; CB bills and Treasury bills for monetary purpose)

The data on local debt consists only of debt incurred through loans and issuance of securities and excludes the arrears (obligations towards suppliers that are due but not paid). Local debt represents 0,01% of the total public debt (or 0.004% of the GDP), which is insignificant and shows that for the purpose of debt sustainability analysis local debt can be neglected and cannot damage the whole system. If we include the arrears in the local debt figures, this represents 1.03% of the total public debt (or 0.47% of the GDP) which is still a very low share.

In most EU countries the local debt to GDP is on average 5 % of GDP which is quite low and in 11 out of 15 EU countries the local debt to GDP ratio decreased between 1995 and 2000 (more in Swianiewicz 2004).

Table 10.
Local expenditure/total public expenditures and local investments/total public investments

(in mill denar)	2005	2006
Local expenditures	5003	8388
Public expenditure	100206	107874
Local expenditure/total expenditure (%)	4.99271501	7.77573836
Local investments	2446	4482
Public investments	10192	12976
Local investments/public investments (%)	23.9992151	34.5406905

Source: Fiscal strategies of Ministry of Finance and budget of LGU for 2005 and 2006.

On an annual basis we can conclude that the Municipalities are becoming more active in the total general government expenditures, both for current and capital expenditure. But the fact that decentralization started in the middle of 2005, advises caution towards interpreting data for that year and to see how 2006 will finish, as the execution of the general budget is turning out to be different from the planned budget for both central and local government.

7.3. The LFLGU in Macedonia

The LFLGU establishes a budget of the current revenues and expenditures and a budget of the capital revenues and expenditures.

The budget of the current revenues and expenditures consists of all revenues and expenditures, including the payment of interest on long-term borrowings but excludes capital donations, self-contribution revenues, revenues from property sales, block grants and borrowing inflows.

The Macedonian LFLGU prescribes the 20 % debt limitation for long term borrowing that might prove inflexible in future. A good example is the case of EBRD investment in Romania where one LGU was required to create a "reserve fund" equal to the amount of the annual debt service of the loan. In the case where the debt has been fully reimbursed during the year, it is questionable to have such a conservative debt limitation of 20 % for the Romanian LGU which they are required to keep the reserve fund in the Treasury without bearing interest thus increasing the cost of financing. Following this practice and the recent change in the Romanian legislation prescribing a 30 % limit of debt, perhaps the debt limitations in Macedonia should be more flexible for the LGUs that have good creditworthiness indicators.

7.4. Net operating surplus at LGUs in Macedonia

The net operating result is simply the difference between an LGUs operating revenues and its operating expenditures over a given time. If the result is positive and large enough to cover a local government's anticipated debt service payments, the LGU can be considered creditworthy. Conversely, if the result is negative, or less than what is needed by a local government to cover its debt service payments, then the LGU should not borrow and a bank should not lend even if the anticipated debt service payments are less than the statutory limit.

The operating revenues in Macedonia for an LGU are considered to be all revenues except for:

- Projected savings from the operative revenues for financing of capital expenditures
- Block grants from the budget of RM for financing of the capital investments
- Revenues from property sale
- Self-contribution revenues
- Inflows from borrowing

Thus the revenues which are considered are from: property tax, communal fees, PIT and VAT transfers.

The operating expenditures are all expenditures except the ones on capital investments (purchasing of equipment, IT, furniture, physical space, preparation of projects, infrastructure).

Table 11. Macedonian LGU operating surplus

	2000	2004	2005
Taxes	712,628,158.00	3,195,760,482.00	3,293,469,433.00
Transfers Received	204,644,405.00	1,258,231,939.00	2,001,540,168.00
Other	7,070,711.00	310,441,253.00	189,320,841.00
Current Revenue	924,343,274.00	4,764,433,674.00	5,484,330,442.00
Operating expenditure	783,991,179.00	2,081,679,723.00	2,303,634,812.00
Operating Balance	140,352,095.00	2,682,753,951.00	3,180,695,630.00
Interest Paid	261,502.00	3,483,246.00	2,896,549.00
Current Balance	140,090,593.00	2,679,270,705.00	3,177,799,081.00
Capital Revenue	1,672,592.00	107,029,025.00	75,149,262.00
Capital Expenditure	100,870,960.00	2,660,268,957.00	2,665,409,943.00
Capital Balance	- 99,198,368.00	- 2,553,239,932.00	- 2,590,260,681.00
Balance Before Debt Variation	239,288,961.00	5,232,510,637.00	5,768,059,762.00
Debt Repayment	-	15,411,230.00	32,000,000.00
New Borrowing	424,000.00	3,953,168.00	13,640,000.00
Net Debt Increase (Decrease)	424,000.00	- 11,458,062.00	- 18,360,000.00
Net Surplus/(Deficit)	239,712,961.00	5,221,052,575.00	5,749,699,762.00
DEBT STOCK			
Short-term	N.A.	N.A.	N.A.
Long-term	N.A.	2,900,000,000.00	1,400,000,000.00
Total debt	N.A.	2,900,000,000.00	1,400,000,000.00

Source: Ministry of finance. Author's calculation.

Analyzing the 2006 budget of the Municipalities, all of the municipalities run an operating surplus (84 out of 84), which may look like they are capable of incurring debt in the future. However, these figures do not reflect the whole reality, as they do not take into account the arrears which are monitored off the balance and must be paid before a municipality starts any new borrowing.

The biggest obstacle in Macedonia to monitor and to define the capacity of the municipalities to borrow is the cash/accrual accounting issue. The central government does not have the correct data and the municipalities does not provide adequate budget accounting and reporting of the operational-current balance. If this situation does not change by the end of 2006 to enable the municipalities and the Ministry of Finance to have an accurate operational-current balances for 2006, it will not be possible to start the new phase (planned to start at 1st August, 2007) which would allow the municipalities to borrow within the limits defined in the law.

Thus, the data in the table do not reflect the reality in the local government sector in Macedonia and must be treated with reserve.

It should be noted that some revenues that are classified as operating revenues by Macedonia's charter of accounts, most importantly the revenues from the Land Development Fee, should be considered capital revenues because they come from the one-time use or sale of assets and are not recurrent revenues.

7.5. The EU perspective

The general principles of LGU functioning are set in the EU Charter of LSG. Accession to the EU will require considerable financial resources for investments in the environment sector and the Macedonian public sector will have to meet the requirement for 25 % matching funds to obtain pre-accession grants.

The Stability Pact and Maastricht Criteria limit the overall public debt (which includes the debt on the central, regional, and local governments including social security funds, but excluding public enterprises) to less than 60 % of the GDP and the total annual budget deficit to 3 % of GDP. In Germany it was discussed whether to give 1.93 percentage points out of the 3 % to the federal government and the rest to the other tiers of the government but this proposal was not adopted. (Farber, 2002). The definition of public debt can be an important policy issue in deciding the boundaries of local government borrowing prerogatives. Concern about how to meet the limitations imposed by the Maastricht Criteria has led to discussion about how to coordinate debt incurred at the sovereign level with that at the sub-sovereign level. A special problem can be that the debt of public utility companies is usually not counted in the debt to GDP ratio thus creating a hidden debt. These companies are owned at local level (in Romania and Macedonia) and LGU give them guarantees and subsidies.

Box 3. Approximation/Convergence

*Approximation, in an accession context, is described as a unique obligation of membership of the EU. It is an obligation to fully align national laws, regulations, rules and procedures in order to give effect to the entire body of EU law contained in the *acquis communautaire*.*

There are three key steps to approximation:

- 1. Transposition. Transposition is the first step toward approximation in an EU accession context. It means that the requirements of EU legislation must be fully incorporated into national legislation. This will require adoption or amendment to national laws, regulations, rules and procedures;*
- 2. Implementation. Also known as Practical Application. Implementation is the incorporation of EU law by the competent authority/ies into individual decisions. It includes providing the infrastructure, budgets and provisions*

needed to enable the competent authorities to perform their obligations under EU law and to take appropriate decisions; and

3. *Enforcement.* The necessary controls and penalties must be provided to ensure full and proper compliance with the law. Thus the objective of the approximation process is to fully integrate all the EU legislation requirements into the national legal system so that the accession country is then ready and able to fulfill all the EU Member States' obligations. This will usually include a complete institutional re-structuring so that the accession country can comply with all EU requirements such as reporting to the Commission.

Convergence is a somewhat different process. It means bringing two legal systems closer together rather than the full alignment required by approximation. Convergence implies that the main principles/features of one legal system should be reflected/integrated into the other legal system, taking into account the specificity of the other system and without necessarily adopting exactly the same requirements in detail. Convergence implies the following process:

- *Analysis of the relevant EU legislation in order to define the main principles and features;*
- *Review of the national legislation in the particular area and analysis of institutional arrangements to determine to what extent it integrates these EU principles and features;*
- *Adaptation of the national legislation and / or development of implementing regulations which integrate the main principles and features of the EU legislation; and*
- *Adaptation of the institutional arrangements to implement the adapted national legislation in practice.*

The Nomenclature of Territorial Units for Statistics-NUTS classification is hierarchical in that it subdivides each member state into three levels: NUTS levels 1, 2 and 3. The second and third levels are subdivisions of the first and second levels respectively. Member states may decide to go further still in terms of hierarchical levels by subdividing NUTS level 3.

The territorial units are defined in terms of existing administrative units in the member states, which are associated with a geographical area of authority. The classification of these areas is based on the population according to the following criteria:

Table 12. Classification criteria of NUTS area

Level	Minimum population	Maximum population
NUTS 1	3 million	7 million
NUTS 2	800,000	3 million
NUTS 3	150,000	800,000

Source: EC

At NUTS Level II Romania created 8 development regions to comply with European Union accession requirements and to be eligible for the EU structural funds. These regions are not territorial administrative structures; that is they do not have executive or legislative powers or separate budgets but rather serve the purpose of providing units of observation for collecting statistical data according to EU rules and providing the framework for implementing Romania's regional development policy and to be the recipients of EU structural funds. In Macedonia the preparation of the Law on balanced regional development is yet to be adopted.

Here is information on population by the NUTS Level III in Macedonia. (Vardarski region does not comply with the minimum population requirements in accordance with the NUTS criteria)

Table 13. Population by NUTS 3 level in Macedonia

NUTS 3 level	Population (census 2002)
Pelagoniski	238.136
Vardarski	133.180
Severoistocen	172.787
Jugozapaden	219.741
Skopski	578.144
Jugoistocen	171.416
Poloski	305.930
Istocen	203.213

Source: Census 2002. Author's calculation.

(For more about indicators by NUTS 3, 4 and 5 in Macedonia visit www.lsg-data.org.mk).

With the introduction of the development regions it is expected that self generated revenues will have to increase and that they will benefit from the following EU funds:

- SAPARD - for agricultural and rural development, and the protection of the environment and
- IPA - for financing important projects which aim to protect the environment and to support trans-European transportation networks.

Since the EU system is founded on a promotion of compliance and enabling approach to regulation and the Macedonian approach is still largely based on command and control (weak institutional capacity), convergence will require a focus on the identification of instruments or legislative provisions that move the society and institutional structures towards more modern approaches to compliance, backed by economic incentives.

There may be certain risks in Macedonia that can impede or delay legal convergence for example:

1. Political climate must be mature for changes in legislation;
2. A "difficulty" in convergence is to select what not to transpose/ implement. However, generally, if convergence is embarked on, it would seem advantageous to transpose as much of the EU legislation as possible. The limits are likely to be those of cost and lack of compliance in implementation. Provisions with no prospect of implementation and enforcement should be reconsidered;
3. The consequences of convergence may not be fully known, which could lead to wasted opportunities in terms of "getting it right";
4. Institutions and human capacity for management planning and implementation may not be available. The institutional set-up may also carry inherited conflicts of interests.

The changes in legislation should be accompanied by standards and guidelines to assist the implementation. The imposition of minimum standards can eliminate local decision-making powers. By setting minimum service standards, there is the implication that the local government is primarily accountable to the central government (which sets the standards) rather than to the residents who elected the council and mayor. On the other hand, if standards are set well beyond the abilities of local governments to meet those standards with existing resources, the situation is no different than another type of unfunded mandate. Another way is to establish a system of benchmarks across LGU but this will require a strong statistical system.

7.6. Financial market structure in Macedonia

The economy in Macedonia used to operate on a cash basis with a small and highly centralized banking sector and no functioning capital markets. Major capital spending at LGU level was financed by grants or soft loans and was directed by the central government or, in the case of smaller routine projects, financed on a pay-as-you go basis by the LGU. Donor help was not systematic but rather at their discretion. As a result of the format and purpose, financial reports often gave little insight into the financial condition of the local governments.

Table 14. Risk categories and levels by instruments

	Sovereign Risk	Exogenous Idiosyncratic Risk	Credit or Solvency Risk	Maturity Risk	Exchange-Rate Risk
Current Government Bonds	Moderate	Low		Moderate	
Future LGU bonds	Moderate	Low	Moderate	Moderate	
Government T-Bills and T-Bonds	Moderate	Low		High to moderate	
Current NBRM Bills	Low	Low		Very high	
Bank Deposits		Moderate	Moderate, heterogeneous	High	
Corporate Shares		High	High	Low	
Mortgage Securities		Low	Low	Low	
Corporate Bonds		Moderate	Moderate	Moderate	
Foreign Investments (Foreign Government Bonds)	Very low	Very low	Very low	Low	High: ST-MT (LT) deprec (apprec) risk

Source: Mr. Klaus Schmidt-Hebbel presentation on pension funds and capital markets in Macedonia. Adoption by the author.

The financial institutions in the Republic of Macedonia are banks (20), insurance companies (10), leasing companies (8) and the brokerage houses (11). All these entities function in separately regulated and supervised segments. However, the Macedonian financial system has the same characteristics as the continental one (Europe) as most dominant sector is the banking sector (table), where around 90% of the total assets of the financial institutions are located together with a 50% share of GDP.

Table 15. Financial institutions in the Republic of Macedonia (as of end of 2005)

	Banks	Insurance companies	Brokerage houses	Leasing companies
Assets (in mill denar)	140345.0	13618.0	447.0	2275.0
Share in the total assets of the financial institutions	89.6	8.7	0.3	1.5
Share in GDP (%)	50.6	4.9	0.2	0.8
Concentration in % (largest two/three) from the total assets of the industry	66.0	81.4	58.8	61.0
Capital (in mill denar)	21670.0	2894.0	348.0	121.0
Foreign capital in %	52.5	63.0	100.0	100.0

Source Ministry of finance. Author's adoption.

■
The remaining segments in the financial markets of the Republic of Macedonia are in a process of development. In the last couple of years the capital market and the insurance segment have seen rapid development, though much remains to be done.

Until now the only issuer of bonds has been the Government (except in 2004 when one private company issued bonds to a known buyer). The Ministry of Finance started issuing government securities in 2000, when big structural problems (frozen currency deposits from the former Yugoslavia, denationalization, rehabilitation and privatization of the banking sector) in Macedonia were resolved through issuance of long term securities to the legal and physical entities concerned. However, the typical government securities (3 and 6 month) were first issued in 2004. Since then the Ministry of Finance conducts regular auctions for both short and long term government securities (primary market) allowing these securities to be traded afterwards on the Macedonian Stock Exchange and in the Over-the-Counter Market (secondary market).

One can gain a general idea of the relative size of the financial markets by comparing figures that are collected at the international level. For example, the volume of listed securities in exchanges or transactions in the exchanges to the overall GDP of the country is a rough indicator of the relative role of the financial markets in the economy (in Macedonia this ratio is 11% at the end of 2005).

More precisely in terms of credit markets, one would look at listed securities in the debt market (such list including any exchange listings, as well as bonds in the OTC market) in relation to the GDP. In Macedonia the only listed bonds are government bonds, the stock of these securities to GDP is insignificant (only 13.7% in August, 2006)

One source of useful information regarding potential demand (as well as an overall measure of perceived sub-sovereign risk) is the weighting that banks must use to calculate their capital adequacy. Although these have varied internationally, they are increasingly coming into conformance with the BIS-Bank of International Settlement capital adequacy ratios. The ratio refers to the ratio of bank capital to performing loans (non-performing loans carry special provisions). The BIS minimum is currently at 8%.

Under the BIS regime, loans to the sovereign government of the same country as the bank are assigned a 0 sectoral risk weight (i.e. they are assumed to be domestically risk free) and those of private-sector firms are assigned a 1. The BIS recognizes that the relationship between the central government and sub-national governments vary from country to country and therefore allows the central bank in the respective countries to assign the appropriate risk weight. Thus, the weightings provide the central bank's opinion as to the relative risk of loans to the sub-national governmental sector in comparison to the sovereign and the private sector.

In the US, the BIS credit factors range from 0.1 for general obligations to 1 for private activity (corporate) bonds. In foreign countries, sub-national government obligations that have explicit central government guarantees have BIS ratios of 0 (which makes them tantamount to direct sovereign obligations) and those that do not, have ratios that can range up to 1 or even higher. Ratios can be changed to recognize overall changes in sectoral credit strength. This recently happened in South Africa, where the ratio was increased from 0.1 to 1 for sub-national governmental securities when the national government announced that it would no longer guarantee municipal and provincial debt.

7.7. The demand side of LGU borrowing in Macedonia

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.

Table 16. Stakeholders in municipal credit market development

Demand Side (Borrowers)	General purpose LGU, municipally owned companies, public-private joint ventures
Supply Side (Creditors)	Commercial banks, specialized banks, insurance companies, pension funds, wealthy individuals
Market Makers	Stock Exchange; Licensed Financial Intermediaries; Financial Advisory Firms; Credit Rating Agencies
IFIs	World Bank; European Bank for Reconstruction and Development; European Investment Bank
Overseers & Regulators	Ministry of Finance, Court of Accounts, Securities Commission, National Bank, IMF
TA Providers	USAID, US Treasury and SEC advisers, World Bank, EBRD, private consulting organizations

Source: USAID and LGAP 2002. Adapted by the author.

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.

The EAR project on strengthening the capacity of the Ministry of environment and physical planning prepared estimates for meeting the capital and operational costs of the investments required to comply with European Union directives and policies in the "heavy investment" areas of environmental management. Within this project, the indicative estimates for the cost of accession in the heavy investment areas have been estimated as:

Table 17. Assessment of total investments in millions of euro/per capita in euros for approximation of Macedonia, Romania and Bulgaria to EU environmental legislation

	Macedonia	Romania	Bulgaria
Urban waste water treatment, sewerage	229/113	1,385/63	2,056/267
Large combustion plants	274/136	402/18	1,627/211
Municipal waste management, landfills	80/40	NA	NA
Municipal waste management, other installations	120/59	NA	NA
IPPC-air emissions	381/187	806/36	3,261/424
TOTAL	1,084/537	10,593/475	6,944/902

Source: EAR 2002-2003 and WB 2005. Adapted by the author.

7.8. The supply side of LGU Borrowing in Macedonia

The financial sector in Macedonia is still dominated by the banks as the core of financial activity and commercially based funding. Due to the weak performance of the commercial sector, most banks have shifted away from customer lending towards investment in central government securities and NBR deposits.

Absorptive capacity of domestic capital market:

- Outstanding stocks of financial assets:
- Government debt outstanding: EUR 669 m. (August 2006)
- Total bank deposits: EUR 1.79 b. (June 2006)

The Macedonian financial system and the real economy are gradually developing. The banking sector is gradually reducing the non-performing loans (10% at the end of 2005) and broadening the range of entities for financing (crediting). Average credit growth in Macedonia in the recent years is 25%. Municipalities may be interesting entities for banks but with high captiousness, as the financial statements quality within each municipality needs carefully to be checked (which initially will make municipalities less attractive for the banks).

Apart from the banking sector, the capital market shows rapid deepening as well as an increment of awareness in the broader population about the advantages of investing in securities. However, the corporate governance issues have to be reflected in the practice as well in order to increase confidence in the capital market issuers and institutions. At the moment, the securities law does not make any specific or additional requirements for the municipalities as potential issuers of debt (in a form of municipal bonds). The main obstacle for the supply/investors would be:

- untrustworthy financial statements of the municipalities
- lack of transparency and accountability in the local governance
- lack of skillful staff within the municipalities for long term financial planning
- lack of good ideas/projects to be financed with limited possibility to forces the revenues from the investment

7.9. The investment at economic scale

Economic scale can be analyzed by considering the regional balance, relative size of LGU, instruments to attract investors (inter-municipal cooperation for example) and institutional solutions (Municipal credit bank for example).

The next table reveals a wide disparity in expenditure level and composition among LGU in Macedonia. Disparities in expenditure per capita are quite dramatic. The poorest LGU spends in per capita terms only one-fourth of the average LGU and just a small fraction of that of the wealthiest LGU. Expenditure composition is also varies a lot. It appears that some LGUs spend 100 percent of their current expenditures on the wage bill while other LGUs have relatively high shares of investment expenditures. It seems that the situation improved in 2006 as the variability and discrepancy is lower.

Table 18. Disparity in LGU expenditure level and composition in 2002

	Min	Average	Max
Expenditures			
Current (as % of total)	22	84	100
Wage bill (as % of current)	7	45	100
Investment (as % of total)	0	16	78
In per capita terms			
Current (in \$ US)	3	12	102
Wage bill (in \$ US)	1	5	27
Investment (in \$ US)	0	3	38

Data Source: Ministry of finance. Author's calculations.

Table 19. Disparity in LGU expenditure level and composition in 2006

	Min	Average	Max
Expenditures			
Current (as % of total)	24	61	91
Wage bill (as % of current)	13	30	53
Investment (as % of total)	9	39	75

Data Source: Ministry of finance. Author's calculations.

Having in mind that in Macedonia a certain percentage of LGU are too small to access the private capital market, it could prove beneficial to reorganise the Bureau for Underdeveloped LGU as a Municipal Bond Bank. Small municipalities frequently have financing needs that are of such a small scale that they cannot attract sufficient attention and gain access to various sources of capital. Additionally, the costs of debt issuance are a substantially higher percentage of project costs and are often prohibitive. Capital supply sources are often not interested in expending the effort to lend to such small-scale projects and to smaller municipalities. Thus, a Municipal Bond Bank could be created by legislation in order to:

- Borrow from the private capital markets on behalf of smaller municipalities,
- To lend capital to the smaller municipalities and
- To benefit economies of scale and share the costs of debt issuance among several projects.

The policy issue is whether a special intermediary should be created for jurisdictions that cannot access credit markets through existing market mechanisms. Special intermediaries should not replace existing commercial lending and underwriting institutions, but instead should complement them. Many kinds of intermediary models are possible, beside a Municipal Bond Bank, such as bond pools, revolving loan funds, and municipal lending institutions.

A fundamental consideration has to do with fiscal capacity. This relates to the ability and willingness to pay, and largely governs which units are candidates for debt issuance. Such considerations are not always correlated with size, but larger jurisdictions typically are of greater interest to private providers of credit for a number of reasons, including greater sophistication, the ability to draw upon more resources and the ability to spread the fixed costs of debt transactions over larger volumes of borrowing. Three groups of jurisdictions can be identified as regards to the likelihood for the issuance of sub-sovereign debt in private markets:

- Those units that because of size and financial and managerial resources already have access to capital markets;
- Those that either have none or only limited access to capital markets, but can generate revenues sufficient to their responsibilities and are otherwise capable of borrowing private capital. This group consists of those units that (a) are large and that have sufficient capabilities to attract private interest without direct central government help, and those (b) that are too small or that lack the managerial capability to attract private lending at present, but with assistance could gain access;
- Those that cannot generate sufficient revenue either to provide the services they require or to build the needed infrastructure. Jurisdictions in this group, which for all practical purposes are "financial wards" of higher levels of government, do not have access to capital markets and most likely should not. That is why consideration should be given to the creation of a Municipal Bond Bank.

The above classification of the LGU in accordance with the creditworthiness is useful for analytic purposes, such as describing potential demand for credit access and the likely size and viability of a local government securities market. But, should such distinctions be codified into a law or regulation for purposes of predetermining which units can access the markets and obtain credit? In developed economies, freely operating credit markets effectively classify borrowers on their merits, and reflect their credit assessments in the prices charged for borrowing. Nonetheless, even in these mature markets, regulatory classification is sometimes practiced by central or state governments in order to provide certain privileges to some borrowers or to impose restrictions on others. For example, in the United States most state governments differentiate among local governments through various legal classification mechanisms, and these differentiations can include differential borrowing powers. However, the credit market itself further differentiates among governments, based on varying assessments of creditworthiness. These assessments are based on perceived differences in the jurisdictions' economic vitality, managerial efficiency, financial condition, and the necessity for and viability of individual projects. Such a detailed prescription of creditworthiness by the regulator can crowd out the self regulation of the efficiency of the capital market.

However small an LGU is, it will need capital investment and if it is not ready to finance its needs in order to provide a certain level of quality in its services, it becomes a central government obligation to step forward to fill the gap. If central government chooses to do so by subsidy for a loan or by guarantee, the potential exists for large amounts of failure which can lead to national bailouts, an increase in the supply of credits and to inflationary pressure.

Encouragement to investors from relatively small LGUs can come from upgrading LGU financial management practices, reporting and disclosure in order to attract attention.

Table 20. Percentage of LGU having less than 2000 (1000 for Bulgaria) and less than 5000 inhabitants

	Percent of total	Number of inhabitants
Romania (census 2002)	451 LGU (16 %)	< 2000
Romania (census 2002)	2095 LGU (72 %)	< 5000
Bulgaria	0 LGU (0 %)	< 1000
Bulgaria	30 LGU (11.4 %)	< 5000
Macedonia	1 LGU (1.2 %)	< 2000
Macedonia	15 LGU (17.9 %)	< 5000

Source: NISES- National Institute of Statistics and Economic Studies for Romania, NSI Bulgaria.

In general those LGU with less than 5000 citizens are too small to build technical, fiscal and financial capacities. Also, such municipalities are too small to undertake investments at an economic scale. They are likely to have higher average costs than larger jurisdictions (one instance where economies of scale cannot be realized). They may find difficulty in retaining capable staff and are more likely to lack the capacity to provide public services effectively.

With the Law 339 in Romania, the local government units are classified into two categories, depending on their administrative capacity (Article 10):

a) 1st category, to which belong the local government units that have the necessary administrative capacity to perform the transferred competences. These local governments can efficiently, fully and immediately perform the transferred competences;

b) 2nd category, to which belong the local government units that do not have the necessary administrative capacity to perform the transferred competences. These local governments cannot efficiently perform the transferred competences.

The local governments belonging to the 2nd category are temporarily excluded from the transfer of competences until they can build the administrative capacity necessary to perform the transferred competencies, according to the law.

Thus it is critical to establish a regulatory framework to enable these municipalities to form various types of joint ventures to undertake and finance investments. These can take the form of municipalities associations, special purpose districts, intermunicipal companies, mandating the combining of communes (counter to the spirit of decentralization and in the disputed case of Ceshinovo and Obleshevo for example) and providing financial incentives for LGU to join forces in the provision of certain services. Pilot efforts by the donor community to demonstrate the economies that can be gained from cooperative efforts among communes may be appropriate. Asymmetric functions that is, some service responsibilities could be assigned to LGU but the responsibility of providing similar services in rural LGU could remain a central function etc. The urban/rural discrimination in relation to the asymmetric functions should be defined in the Law on LGU. In Romania the amendment of Law 215 Article 11 among other says:

"Associations for community development shall be set up based on local council's decision, respectively county council's decision, in order to carry on together development programs of regional or zone interest or common delivery of a number of public services. The deliberative and executive authorities at the level of each constituent local authority maintain their local autonomy, according to the law".

This "according to the Law" phrase might create problem of "no action" as is the case in Macedonia when 37 % of the LGU that were interviewed expect the Ministry of LGU and 34 % expect the line ministries to initiate any inter-municipal cooperation. Most of them believe that the obstacle for such cooperation across competencies is of legal nature⁴. This once again proves that simply adopting laws means nothing in reality if there is no capacity to implement them in practice.

Having a large number of small municipalities is not an impediment to the undertaking and financing of investments at an economic scale as long as such joint ventures can be formed, revenues can be assigned to them, and they have a right to borrow against these revenues streams to finance investments. Some forms of those joint ventures can be:

4) From an EAR project on decentralization in Macedonia.

- Entities created by agreement by more than one municipality to accomplish a special purpose (e.g., to provide fire protection efficiently across a broad area). Their revenues and expenditures can be separated from those of the organizing municipalities. Their powers can derive solely from the municipalities ("joint powers"), or through legislation which can limit or extend such combining powers
- Quasi-municipal entities created by state or national legislation. These entities might provide municipal services (e.g., water development, disease control, or transport services) where needs do not necessarily relate to municipal boundaries.

Typically, in a transition economy such as Macedonia, LGU are highly dependent on transfers from the central government. While transfers can be very volatile and untested for sustained periods of time, they form a major portion of revenues and are attractive for interception to cover debt service payments. Intercepts can have a powerful impact on local borrowers, especially small and remote units.

7.10. LGU services and borrowing

The LGU provides services many of which don't generate profits but are in heavy need of capital investments. Also, municipal loans typically cannot be secured by real property that is used for the provision essential public services.

The following issues for Romania, related to services provided by the LGU and the need for borrowing, also hold true in the case of Macedonia. (USAID LGAP 2002):

- The treatment of the citizen right of access to essential services in the legal framework, and the role of national social welfare policy in assuring access to service among poor Romanian households
- Investment funding capacity of the local governments and municipal services providers relative to assigned investment funding responsibilities
- Scale of investment required to meet recognized standards and policy goals
- Determination of the roles of market and non-market finance in supplying investment finance needs
- Treatment of household ability to pay, especially for user charges for municipal services
- National sectoral modernization policy, especially for district heating

Investment capacity in Romania is limited because of:

- household incomes are low
- payments arrears are high
- rates do not cover renewal of existing assets, nor expansion of the system
- underlying assets are owned by local governments, and under Romanian legal doctrine cannot be sold, mortgaged or pledged to secure borrowing
- national policy denies access to targeted investment subsidy from GOR sources
- previous subsidy experience in district heating, the largest subsidy area, was premised on wasteful producer subsidies and poorly targeted end user subsidies

We would add in the case of Macedonia, related to communal enterprises-CE (see more in EAR Phase 2; 2006):

- a. Low level of revenue collection
- b. Subsidy system based on affordability of the consumers rather than pursuing cost recovery pricing

- c. Problem of requirement for invoiced VAT payments by the Public Revenue Office
- d. The court procedure for collecting revenues due
- e. The LGU do not settle their liabilities toward the CE even though they are their founders
- f. The regular political disputes between the Mayor and the Council leads to a late decision or no decision made about financial accounts, prices, programs etc while the CE should operate daily and because of that regularly operate outside their legal framework
- g. The waste locations are far from modern facility's standards for the disposal of solid waste which is nice example that communal activity is not an environmental issue but rather a cross cutting problem with environmental issues.
- h. Some of the bye laws of the CE are not in accordance with the separate laws that regulate the activity.
- i. There remain activities such as construction and trade set within the bye laws as communal activities
- j. No tariff system developed for the price of communal services
- k. Depreciated assets
- l. Still some CE are not re-registered

How the Macedonian CE can provide the 25 % contribution necessary to access EU funding is questionable and this is one reason more why LGU borrowing in Macedonia will be attractive in near future.

7.11. Sub-sovereign Rating Factors in Macedonia

Credit analysis is a product of the operation of a credit market and only becomes viable when and where there are a variety of competing investments with differing risk and reward characteristics. Credit ratings are the leading form of institutionalized credit analysis and assist in developing an active securities market by pooling skills to develop opinions. Ratings play an important role in that they focus on credit risk (risk of payment delay or default) which is then used to help judge risk and reward.

While the major agencies have different ways of weighting the factors, they agree on the major analytical ingredients they consider in judging the creditworthiness of sub-sovereign credits. These can be summarized as in the next table, with some indications as to how various factors help or hurt a credit rating.

Table 21. Factors considered in judging the creditworthiness of sub-sovereign credits

Factor	Comment
Sovereign Rating Ceiling	The rating of the national government usually sets the top limit on the rating that a sub-sovereign unit can enjoy. National government set monetary and fiscal policy and usually have first claim on foreign exchange and can change the rules of the game for the junior units of government. Exceptions to this rule can be found if the debt is secured by offshore assets or revenue streams.
Economy	Fiscal health is usually closely linked to the health of the local economy and the diversification in activity (which often comes with size) helps balance the economy's performance. Demographics are important. A high dependency population (the very young and very old are negatives) and a too rapid growth in population are negatives. Higher-income and more educated population is a plus, as is an acceptable

	<p>distribution and rate of growth in income. Creditors are also interested in the structure of the local economy. Particularly, how much of it is in private hands, and how dependent it is on a single industry, or a small number of large employers. As a result, local governments should be able to present to creditors accurate information on the distribution of employment across types of firms and industries, as well information on the general economic situation of the largest employers. Of particular value here, is information on the number of enterprises (and in fact individuals) who have substantial tax arrears, because tax arrears are generally a good sign of economic distress and monitoring them is often used by local governments and creditors to anticipate potential economic problems. Indeed, rating agencies typically require local governments to provide them with lists of the largest employers and as well as lists of the firms with the largest tax arrears. For Macedonian LGU individually it is worth estimating whether they depend more on property tax revenues or PIT revenues in the context of economic activity since the PIT revenues are more elastic to economic fluctuations. Here a reasonable long run solution for Macedonian LGU is to improve own tax administration, enforcing, collection.</p>
Structure and Management	<p>An assignment of functional spending responsibilities consistent with revenue resources is a plus. Intergovernmental transfers are looked at for their size and predictability. The willingness and ability of the national government to detect and stem financial emergencies is a positive. The rigor and timeliness of budgetary and financial laws are examined and can be either a plus or negative depending on the flexibility they provide localities. Past performance in achieving budgetary balance are important. Timeliness and comprehensive of financial reporting and following consistent standards are a plus. In Macedonia, LGU were being assigned new expenditure responsibilities without being assigned new sources of adequate revenues especially in the education. Changes in environmental standards, for example, can lead to significant increases in local government costs, while changes in the way businesses are regulated can have an impact on their revenues.</p>
Fiscal performance	<p>Revenue composition and trends are considered with ability to set rates at the local level seen as a plus. Tax burdens should be acceptable in comparison to neighboring regions. Effective use of charges and fees are viewed favorably, large transfers of general funds to local enterprises are not. Possible indicators: % of revenues of GDP and % of LGU that have revenues less than nation average. Another important weakness of the current intergovernmental finance system is that Macedonian LGU have limited powers to increase their revenues through their own policy decisions thus, the vast majority of their revenues come from shared taxes and fees, or transfers. This is problematic for creditors for two reasons. On the one hand, it means that local governments have relatively little ability to adjust their revenue policies to meet their debt service needs. On the other hand, it means that their revenues are fundamentally dependent on the tax policies of the central government. Another problem can be adverse effect of poor collection performance of own revenues from property. If some taxpayers are not paying their legal tax liabilities whereas others are, the system becomes less equitable. Particularly problematic is the case where wealthier and more powerful segments of the locality are also delinquent in paying. This, in turn, can lead those who comply with the tax to conclude that the tax is unfair and decide that they too should stop paying. Another problem is the lack of forecasting abilities and possi-</p>

	<p>ble overestimation of revenues (experience in Macedonia and Romania). The capital budgeting should move from a wish list preparation to setting clear priorities and cost benefit decision making. The unsuccessful transition and insider privatization process led to a negative perception of private business thus, giving little space to PPP as a window for the LGU to consider off budget projects. Other problematic areas are the unpredictability of the system with the following determinants: the central government (PRO) is resistant in transferring the records for the purpose of the property tax collection, no vision and solution to solve the arrears, instead of increasing the transfers for decentralized competencies they are decreased (education and fire fighting for example) breaking the basic rule of assigning competencies/services without revenues to cover the costs of providing them, the possible change within the fiscal system (introduction of flat tax) and the poverty, high dependency of central government in terms of revenues. Within such a framework it is difficult to do any forecasting, analyses etc.</p>
<p>Composition and trends in expenditure</p>	<p>Capital spending and maintenance spending are a plus; a large wage bill is a negative since the expenditures are more rigid and there is less chance for operating surplus. It also will create a hidden risk of unfavorable outcomes in bad economic times. In such a situation the reserve funds of the LGU are becoming more important. The ability to budget and to accurately realize budgets are a plus. Positive balances (surpluses) in current operating budget are a strong positive. Capital budget planning and paying for large amounts with current revenues a plus. Possible indicators: % of expenditures of GDP and % of LGU that have less than the nation average. Forecasting and budget planning and execution are important indicators of financial management of a LGU. If the trend is toward lesser ratio of collection in time this is a clear signal that the budget planning is bad and the technical skills in forecasting are poor it is also a risk to build short term debt.</p>
<p>Financial position</p>	<p>Liquid assets and marketable real assets are favorable factors, as are healthy reserves in relationship to annual expenditures. Outstanding debt is considered. Short term debt is a concern if not periodically retired. Long-term debt and contingent debt (where there are guarantees to others) is generally a negative unless used in support of productive (self-supporting) activities. Short maturity debt with principal due at the term (bullet maturity) is a negative because of continuing pressure to refinance and potential burden on current revenues. Overlapping debt of other governments that relies on same economic base is considered. Possible indicators: % of investment from total expenditures and % of LGU less than national average.</p>
<p>Legal framework</p>	<p>The lack of clear laws, legal precedent or effective judicial system is major impediments, especially where there is restricted revenue or enterprise-based pledges. A history of repudiations or insolvencies is a large negative. Approval of borrowings by senior units and other restrictions on local borrowing may be a positive if efficient and nonpolitical, but can be a negative if complex, difficult and political. In Macedonia LGU are forbidden from using as collateral any piece of property that is used for the provision of essential public services. This classification requires lenders to set aside higher percentages of their own capital as reserves in case borrowers default. The regulatory requirement that banks "set aside" or reserve different levels of their own capital depending on the risk rating of a credit is designed to protect the banking system as whole. But the high reserve ratio requirements required for high risk credits means that</p>

	banks can use less of their capital for other loans, a cost that usually is reflected in higher interest rates. Sinking or debt retirement funds are also used for other types of loans and serve to provide lenders with the guarantee that even if the municipality experiences temporary financial difficulties, there will always be enough cash on hand to meet a specified number of debt service payments. For this assurance to be legally sound however, LGU must be able to deposit money in such funds for periods longer than one year. In Macedonia, however, the Law on Budget states that public budgets are purely annual constructs and that all monies unspent in a given year, should be returned to the general budget. As a result, to make such debt retirement funds possible, the Law on budget should be amended to allow for multiyear budgetary appropriations for the sole purpose of setting such funds.
Accounting and financial reporting	The basis and quality of financial records is examined, and prompt, consistent reports are a plus. Timely and independent audits are a positive. Cash flow information or cash basis accounting that provides reliable information on cash available to pay debt service is a positive. Evaluation of liquid assets and accounts receivable can be issues in that required investments in government bonds can be risky and accounts may be in arrears. Of special importance is the clear financial relationship between the LGU and the enterprises (like communal ones) that might create hidden debt. Clear relationships between them and possible accrual accounting recording all the accruals will increase the rating of the LGU.

Opinions on credit quality are not static and the relative importance of factors can change over time. National policies concerning items other than local debt per se can change the mix and weighting of credit factors. Laws governing purchasing policies, public employee retirement benefits or wages, or the reassignment of functions and revenue sources can all shift the focus of analysts.

8. CONCLUSIONS

In Macedonia it is important for the central level government to understand that decentralization is a process and it is a process that will take many years to complete. It is not a process that can rely only on the drafting of laws but it needs to be managed in a consistent fashion so that the government has a vision of what it wishes the role of LGU to be. The monitoring unit established at the centre following the work of the Decentralization Working Group has so far proved to be only a one way "window hall" for receiving complaints and problems but with no will to make changes and decisions to create analytical abilities and "bureaucratic- political" strength. The monitoring at the moment is not based on hard data and analysis but rather on speculation and conjecture. Also the main driving force for the process remains donor sponsored projects rather than domestic will and intellectual debate.

Transition is required to go from a system in which financial capacity and strength is centrally controlled to one in which financial capacity and strength is distributed and independence of action at local level is institutionalized.

Donors tend to have unique perspectives and interests, which underscores the need for effective coordination across donor programs, and a mechanism to surface and address both potential collaborative synergy and occasional conflicts.

Determining the strengths and weaknesses in fiscal decentralization will require constant monitoring of the process. The DWG will need strong analytical abilities but also sufficient "bureaucratic-political" strength since its conclusions are likely sometimes to run counter to the preferences of ministries

and in some instances, ZELS. The monitoring should be based on "hard" data and analysis which requires compilation of more detailed financial data than is available from the current single treasury system in order to understand and analyze local fiscal conditions.

In general, the legal framework in Macedonia is sufficient to provide rules for successful fiscal decentralization. Given the complexity of the process and the scale of the reform the legal framework can be seen as a good start. Whether the process will continue on track will depend on the monitoring system and how problems are identified, how (fast) solutions are identified and how the correct decision is reached. Another important dimension of success is the participation and satisfaction of each party (central government, local government, citizens and donors).

In moving ahead, the process should be more domestic than donor driven in terms of initiatives, and ownership of the process should be claimed as soon as possible especially by the citizens. So far the citizens have not been sufficiently informed and have had a low level of participation.

The current territorial division should be re-examined considering the capacity of some LGUs, and possible asymmetric solutions should also be considered. A clear distinction between urban and rural LGUs will benefit not only individual LGUs (and thus in the end their citizens) but will also help in the future regional development strategies by narrowing the regional misbalances and to provide help in the development of agriculture strategies as well.

As for the assignment of competencies, the subsidiarity principle has generally been respected in the process so far. The risk is, however, that the local government system remains with a weak system of financing, high arrears, low accountability and increasing economic and social misbalances between different LGUs. To avoid this, the central government must enhance the analytical capacity of the Ministry of Finance and Ministry of LGU in order to become more effective in the monitoring and evaluation process. Examples of the areas that should be urgently addressed by these analytical units are the fiscal gap in the provision of services by LGUs and to find solutions for revising the inter-governmental transfer system.

The structure of own revenues and the devolution of authority to LGUs to set their own tax rates is indeed a step forward in building accountable and efficient LGU system (as well as providing LGUs with more funds). Furthermore, at the same time the LGU need support in the establishment of modern tax administration (zoning, property value assessment, database building, cadastre and other information systems) and need to build a regular tax system and financial management skills.

The possible introduction of flat taxing system should be considered more widely with an assessment of its impact on the poor stratum of the population and the social assistance programs of the LGU. The problem will be to establish the suitable tax rate given the poor wages and defining poverty so that some categories of people can be exempt from taxes.

There exists some confusion in the definition of PIT as an own revenue whereas by all standards it is a "classic" shared revenue and in the VAT transfer which is implicitly an equalization transfer. The Ministry of Finance should, within the fiscal gap analysis, consider revising the PIT and especially the VAT transfers. The wording in the LFLGU should be precise, the envelope for horizontal equalization should be revised, the fiscal capacity formula should be stated in the LFLGU, and the equalization formula should be such as to get the best from the data available in the statistical information system.

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The unclear status of the so-called "fund for equalization" but formally defined as own source revenues from the VAT show that clear wording in laws is essential to prevent future misunderstandings and problems⁵. The transfer of the VAT which defined as an own revenue, is perceived by the LGU in Macedonia as such and not as a fund for equalization. The central government has a long history of resistance to the equalization fund for many reasons including a lack of understanding its role, fear of political abuse before even legalizing the instrument. Thus, the VAT transfer has ended with a perverse definition as an own revenue but also with the hope of providing equalization (a view from the central government). A way forward is to amend the LFLGU, stating clearly that the VAT transfer is an equalization fund or to introduce another equalization instrument.

In relation to financial management it appears that the right framework has been provided in terms of laws and bye-laws. One of the main needs is for more experienced and skilled personnel at the LGU-level, and so the LGUs should employ staff only based on quality and merit. Also, the possibility for borrowing should soon be available to the LGU, and the Central Government should therefore adopt a Law on LGU insolvency and establish a separate unit within the Ministry of Finance related to LGU-borrowing.

The Council must approve a local government's budget and with it, the year's investment priorities. This means that funding for major investments is always in competition with the other investments that may appeal to the municipal council in a given year. Indeed, what typically happens when local governments do not use debt financing is that they end-up maintaining extremely broad, but shallow, investment programmes as municipal councils divert (planned) funding for major, but costly investments in facilities like water and sewage plants to other investments such as road improvements that are cheaper and which have more immediate "political returns". In contrast, the decision to incur debt "locks in" the decision to build and pay for a costly but necessary piece of public infrastructure and thus, serves to discipline the entire investment planning process by forcing local governments to more carefully prioritize their investment spending.

In Macedonia most importantly we have macroeconomic stability, low inflation but relatively high interest rates although these are on a declining trend. The decentralization process on the other hand has just started and is celebrating one year after kicking off. It is still expected that much has to be done in the area of improving the stability and predictability of the fiscal decentralization system, strengthening of fiscal autonomy and predictability in LGU budget planning and execution and in cash flow projections. There is not any substitution for municipal creditworthiness as the essential element of a municipal credit market.

In relation to the macroeconomic stability, the central government would like to lower the level of borrowing by the LGUs whereas the LGUs would like to increase it. On the other hand the central government would to avoid increases in local tax rates and thus to lower the investment level at local level. This happened during the period of centralized management in Macedonia when large fraction of the LGUs arrears was incurred for this reason. In future if the central government wants to avoid the incurring of such LGU arrears, it should either increase the level of grants and/or allow long term borrowing for investment.

5) From an EAR project on decentralization in Macedonia.

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A LGU would prefer a grants rather than a loans. Thus, there is the certain theory of game interplay by introducing a loan limit and allowing grants and the level of local taxes as instruments of central government to influence LGU behavior and to manage the macroeconomic stability. This is a further complication which has a typical lack of full cost recovery for the utility services. The prices being charged for public services such as water supply and sewage treatment are often so low that any attempt to fully cover the costs of a new investment through price increases would be politically unacceptable.

Another fact is that because prices for public services in transitional countries are so low, consumers are often over-consuming them. As a result, consumption can decline substantially if prices are increased to cover the costs of a new investment. Because the scale of the decline in consumption can be difficult to forecast, it is also difficult to forecast how much revenue the utility will have at its disposal to pay back the loan. Creditors interested in lending to municipalities' utilities are aware of these risks. They also know that in Macedonia municipal councils are ultimately responsible for approving utility rates. As a result, creditors are typically reluctant to lend directly to utilities without at least three things, first, a clear municipal contribution to the costs of the investment, second, a so-called rate covenant in which the municipality promises to raise rates in line with a specified schedule so that the utility can meet its debt service payments and third, a municipal guarantee of all or part of the loan. The latter is in part to make sure that the municipality makes good on the first two promises and also because the assets of the utility cannot be used to secure the credit.

The restriction on the LGU in Macedonia to keep their deposits in the treasury prevents the development of a municipality as a customer of a bank and in turn for the banking sector to become more familiar with the financial affairs and needs of municipalities. As a result of this restriction, municipalities are not presently perceived by banks as "potential customers" since they are legally restricted from depositing their funds in a bank. This situation results in the lack of development of bank-client relationships in which bankers become generally familiar with the financial affairs and needs of their LGU clients. In Romania a recurring comment from bank representatives in connection with the development of a municipal capital market is the lack of familiarity with municipalities, their financial affairs and their creditworthiness in general. We recommend that the LGU in Macedonia to be allowed to open accounts in the banks and that prudent investment requirements be established for such accounts (government securities, only "best" banks).

Related to loans a legitimate question can be raised. Is the banking system in Macedonia stable enough to allow deposits by an LGU? This issue should be negotiated between the central and local governments. In the same context, are the LGUs mature enough to distinguish safe from risky banks as politics is involved in the banking sector in Macedonia. In Macedonia it seems that the banks do not understand the structure of municipal finances, or the types of information that should be used to assess creditworthiness LGU. In the face of such uncertainty, the bank's normal reaction is to secure municipal loans through a Government guarantee or to demand substantial liquid collateral or to charge a high premium in terms of high interest rates (as per the NBRM, where the bank's claims are "blocked" in the courts to the amount of 400 millions of EUR which is more than 10 % of GDP).

In Macedonia it would be interesting for an LGU to assess whether the cost of bank loan is higher or lower than issuing bonds i.e. to compare the interest rate of the bank loan with that of the bonds. The banks are not familiar with the LGU finances and given the non profit type of services for which the LGU investment projects are generally needed, it is likely that bank loans will cost more than a

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bond issue. On the other hand in the case of bonds, there are additional costs for the LGU in the need to disclose a lot of information to potential investors as well as transaction costs for the registry, disclosure, regulators and administration. Bonds are perceived more expensive and less flexible than the bank loans but following the Romanian experience we could expect that the interest rate in the capital market in Macedonia being lower than the current oligopoly in the banking sector and this could make loans being more attractive than bonds. Macedonia should apply to both types of debt instruments without discriminating between them. Competition between banks and a bond market can help to keep the costs of capital as low as possible for municipal borrowers.

However, the first bank to enter the field on a significant but financially prudent scale would have an advantage in subsequent competition for market share. The following areas might be of special interest for the banks to look at:

- Clarification of the legal rules surrounding municipal lending, use of collateral, legal recourse in the event of non-repayment, etc and application of these rules to real-world management of municipal credits.
- Analysis of a municipality's ability to repay loans, based on its financial statement, balance sheet and other information, as well as its entitlement to transfers and revenue sharing from the central level.
- Reducing risk through the use of collateral and other forms of security for local loans.
- Realistic assessment of a community's capital needs and the process of prioritizing investments through preparation of a local capital investment planning and local capital budget.

In summary, progress in fiscal decentralizing in Macedonia has been made but much hard work and many difficult decisions remain.

Annex 1. Relevant legislation in Macedonia

1. Constitution (OG 1/1991; 1/1992; 31/1998; 91/2001)
2. Law on LGU (OG 05/2002)
3. Law on territorial organization (OG 49/1996)
4. Law on the city of Skopje(OG 49/1996)
5. Law on financing LGU (OG 61/2004)
6. Law on civil servants (OG 59/2000; 112/2000; 34/2001; 103/2001; 43/2002; 98/2002; 40/2003; 85/2003; 17/2004; 69/2004; 81/2005; 30/2001; 100/2002 and 84/2003)
7. Law on public procurement (OG 19/2004)
8. Law on budget (OG 62/05)
9. Law on budget execution (OG 3/2006)Company Law (OG 28/2004)
10. Law on banking (OG 63/2000; 103/2000; 37/2002; 51/2003; 85/2003)
11. Law on securities (OG 95/2005)
12. Law on public debt (OG 62/2005)
13. Law on education (OG 52/2002)
14. Law on high education (OG 64/2000; 49/2003)
15. Law on environment (OG 4/2003)
16. Law on communal activities (OG 45/1997;23/1999;45/2002;16/2004)
17. Law on public enterprises(OD 38/1996;6/2002; 40/2003)
18. Law on culture (OG 17/2003)
19. Law on balanced regional development (draft)
20. Law on agriculture and rural development (draft)
21. Law on sport (OG 29/2002;66/2004)
22. Law on construction (OG 53/2001; 97/2001)

Annex 2. Basic data for Macedonia, Romania and Bulgaria

Table 22. Basic data about Macedonia, Romania and Bulgaria for 2006

	Macedonia	Romania	Bulgaria
GDP (billion USD)	6,0	204,4	71,2
Surface area (million sq. km)	25,7	238, 3	110,9
Population (millions)	2,02	22,3	7,7
GDP per Capita (USD)	3002	9446	9223
Population Density (inhabitants/sq. km)	79	91	69
State Budget Balance (percent of GDP)	0.8	(0.8)	2.3

Source: For Romania and Bulgaria-from Internet (CIA, IMF).

Annex 3. The two-phased approach of fiscal decentralization in Macedonia

Table 23. Illustration of the two-phased approach of fiscal decentralization in Macedonia

Phase	Starting date	Assignment of responsibility	Conditional on
1. Phase	1 July 2005 (with amendments on 30 Dec. 2004)	<ol style="list-style-type: none"> 1. Transferring own revenues from tax sources (the PIT sharing) to municipalities (GOV) 2. Developing a methodology for transferring the capital and earmarked (GOV) 3. The local governments will start with the plan implementation of solving the arrears up to 31st of January 2001 (local governments) 	<p>If 90 % of the total municipalities comprising 90 % of the total population will provide:</p> <ol style="list-style-type: none"> 1. At least 2 financial officers 2. At least 3 tax experts
2. Phase	Conditional	<p>Assignment of the responsibilities (for the block transfers):</p> <ol style="list-style-type: none"> 1. Culture 2. Social welfare and child protection (kindergartens and homes for elderly) 3. Education (primary and secondary school) 4. Healthcare (public health organizations and primary care) 	<ol style="list-style-type: none"> 1. All the conditions from phase 1 are satisfied 2. A proper capacity of the financial officers (also in the phase I) 3. Viable results of 24 months for on time and regular reporting confirmed by the ministry of finance 4. There are no accounts payable than usual ones (up to 90 days) 5. The phase commission will evaluate if all the conditions are satisfied 6. There is a written request from the municipalities to the proper ministry and the Ministry of finance for granting block transfers after all the conditions is satisfied.

Annex 4. Comparative insolvency matrix in Estonia, Macedonia, Romania and Bulgaria

Table 24. Comparative insolvency matrix in Estonia, Macedonia, Romania and Bulgaria

	Insolvency Criteria	Initiator	Method of Initiation/Cert.	Administration of Proceeding	Tasks of Trustee	Restrictions for Municipality and Creditors	Support for Insolvent Municipalities	State Guarantee Debt Relief or reduction	Exiting	Unmet Claims
Estonia	No clear threshold; "Failure to demonstrate financial discipline."	Court or Creditor	Proclamation Filing by creditor	Appointed Board (Oversight Committee: Representatives of the creditors and the states)	Manage all financial issues Formulate recovery plan in cooperation with Oversight Committee	Lose all financial issues create stabilization plan three year projection replaces municipal budget	Funds from the state budget may be requested to fulfill portions of the recovery plan	No guarantee for the municipal debt	After recovery period is maintained and creditor's claims are paid. LGU could be consolidated into another LGU	NA
Macedonia	Lack of insolvency definition and procedure. Only financial crises definition	NA	NA	NA	NA	NA	NA	No guarantee for the municipal debt	NA	NA
Romania	If it is unable to pay the matured debts exceeding 50% of its budget for a period of 120 consecutive days or salary payments as planned in the budget are more than 120 days in arrear	Any creditor or group of creditors	File with the Court of Law in the territory the unit is located, an application for opening the proceedings of insolvency of that administrative-territorial unit	The manager/administrator will administrate the insolvency recovering procedure of the administrative-territorial unit.	Develop recovery plan	No finance-involving attributions whatsoever may be exercised by the primary spending authority and deliberative authority during the management of the insolvency situation	NA	NA	If the state of insolvency is found to have ended, the official receiver will, at manager's proposal, issue an order to end insolvency proceedings for the administrative unit. The manager shall notify the end of insolvency order to the primary spending authority, creditors and any interested persons. Continue with financial recovery plan.	NA
Bulgaria	Municipal Debt Act does not define the insolvency	NA	NA	NA	NA	NA	NA	NA	NA	NA

Source: Jokey 2005. Adopted by the author.

Annex 5: Strategic assessment of borrowing at LGU level

TABLE 25
ASSESSING THE STATUS OF LGU BORROWING AND
INFRASTRUCTURE DEVELOPMENT BY COUNTRY

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central government institutional and regulatory framework	(D) Local government institutional and regulatory framework	(E) Participation by civil society and private sector
MACEDONIA Fast pace of decentralization process	Uncertainty about the LGU debt/arrears solution; No insolvency definition and procedure; Only financial instability definition.	Law on financing provides provisions for borrowing and instruments for controlling; Borrowing allowed with prior consent from the central government based on the opinion of the Ministry of Finance.	Body for public debt management established; Reporting forms for debt registry developed but not practiced; Confusion on who should maintain debt registry for LGU.	Lack of initiative for solving the existing debt; Need for assistance. ZELS under political risk ethnically driven.	No participation of the private sector
ROMANIA Slow pace of decentralization process	Major changes in legislation and definition and introduction of insolvency.	LFP allows borrowing.	Commission for authorization of LGU debt. Registry defined.	Active participation of LGU association in law changes ensured in accordance with a law.	Weak participation of the private sector.
BULGARIA	Current expenditures crowd out capital expenditures. Low level of LGU borrowing.	Municipal Debt Act defines the borrowing rules.	Central Register on municipal borrowing is being created at the Ministry of Finance	NA	Current expenditures crowd out capital expenditures. Low level of LGU borrowing.

TABLE 26
KEY LGU BORROWING AND INFRASTRUCTURE DEVELOPMENT INITIATIVES PURSUED
BY COUNTRY

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central government institutional and regulatory framework	(D) Local government institutional and regulatory framework	(E) Participation by civil society and private sector
MACEDONIA	Borrowing legally allowed 1st of July 2007	Law on regional balanced development a priority	NA	Solution for arrears.	CEA initiative for studying LGU borrowing.
ROMANIA	Insolvency procedure defined; Changes in a set of laws; Positive political will.	Framework Law on Decentralization adopted.	Introduced insolvency managers	NA	Intensified banks participation in the market.
BULGARIA		Municipal Debt Act adopted.			

TABLE 27
REFORM PRIORITIES FOR LGU BORROWING AND INFRASTRUCTURE DEVELOPMENT
BY COUNTRY

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central government institutional and regulatory framework	(D) Local government institutional and regulatory framework	(E) Participation by civil society and private sector
MACEDONIA	Development of a viable solution for the arrears; Development of insolvency law.	Law on insolvency development; Law on balanced regional development developed	Debt management body of the ministry of finance to build capacity to manage LGU debt in the future; Commission for financing of decentralization should consider more in depth monitoring.	Capacity building for the financial management; Develop credit rating procedures. Developing a capacity for asset management.	Securities commission, banks, credit ratings agencies etc. intensify their activities. Independent/private consulting companies to start contracting with sub-national governments to provide TA.
ROMANIA	Separate insolvency law.	Working groups for the decentralization of competences are set up within ministries and other specialized central government bodies	Further developing in accordance with best practices	Further developing in accordance with best practices	Further developing in accordance with best practices
BULGARIA		To find co-financing for borrowing on infrastructure financed by the EU funds.			

Annex 6. The EU perspectives

Table 28. The EU perspectives in Macedonia, Romania and Bulgaria

	(A) Overall policy stance	(B) Administrative Capacity	(C) Institutions	(D) Financial capacity	(E) NUTS II
MACEDONIA Fast pace of decentralization process. Initial momentum from 1999 boosted with the Ohrid Framework agreement	National development strategy developed.	Low administrative capacity. Problems in recruiting and retaining qualified staff. Relatively lower wages in the public sector and low morale lead to high turnover and quit rates. Without changing these conditions, training of existing employees is not a solution because once the public employees have received skills that will gain them more lucrative employment they transition to a different job in the private sector. Private consulting companies not yet begun contracting with sub-national governments to provide TA.	EAR closure and transfer of functions to the Ministry of finance. Weak statistical information system.	To the extent that local governments are not able to generate the needed additional resources to execute the EU funds programs, the opportunity could be lost. No PPP rules.	Draft Law on balanced regional development in procedure. Possible political dispute related to NUTS 3 level definition.
ROMANIA Slow pace of decentralization process. Lack of political commitment and possibly vision for the process.	National Development Plan prepared for the period 2007-2013. It provides the foundation for prioritizing the use of scarce government funds in helping sub-national governments with the counterpart financing for accessing EU funds. Ministry of European Integration has been in charge of preparing the National Development Plan as well as the regional development	Low administrative capacity. Ministry of European Integration has also drawn up an action plan to address the weak administrative capacity of sub-national governments with these main elements: A project for Euros 3.8 million to prepare the private sector and SMLs to deliver coaching for EU funds and also targeting staff of regional development agencies New training programs for local	The Ministry of Administration and Interior endorses, according to the law, the initiatives and draft normative acts regarding the administrative and financial decentralization developed by ministries or other specialized central government bodies (Law 339). Important as determinant of absorption capacity. Requirement for strong fight against corruption and promoting rule of law	To the extent that local governments are not able to generate the needed additional resources to execute the EU funds programs, the opportunity could be lost. Large fraction of the funding is expected to come from contributions of the sub-national governments, and at this time there is no clear plan on how this will be done. The effectiveness of the regional Operational Program and other elements	8 regional development agencies corresponding to the NUTS II 8 development regions

	plans, and is the management authority for the implementation of the regional development programs.	and judet councils in programming execution and monitoring ERD Fund to train local and judet officials with a strong component on infrastructure, although sub-national governments are expected to contract with the private sector. Proposal for the creation of the Infrastructure Development Company by the Romanian Academic Society and the Group of Applied Economics following the success of the Estonian PPF. Administrative capacity shall be assessed and established by law (in accordance with the Framework law on decentralization 339).		of the National development Plan will depend crucially on their integration in the medium term expenditure framework of the local governments.	
BULGARIA	National Development Plan for 2007-2013 has been prepared. All regulations concerning planning in place.	Limited administrative capacity.	Two institutions responsible for EU issues: Ministry of Finance and Ministry of Regional Development and Public Works.	Local governments are not able to generate funds for co-financing. Therefore there is an idea to create Local Development Fund in December 2006 to provide loans for co-financing.	Six planning regions (NUTS II) were established in 2000 in order to meet the accession requirements.

Source: Adopted from Martinez 2005

EU 8 experiences:

(B) Administrative Capacity:

Member nations and candidate countries alike appear to have problems in recruiting and retaining qualified staff. Relatively lower wages in the public sector and low morale lead to high turnover and quit rates. This means that without changing these conditions, training of existing employees is not a solution because once the public employees have received skills that will gain them more lucrative employment they transition to a different job in the private sector.

■
Estonia supported the creation of a project preparation facility (PPF) in 2001, outside the public sector. Administratively the financial resources available through the PPF have been useful in hiring professional consultants to help draft the documents required by the EU. In 2001, the Estonian PPF produced more applications that were acceptable to the EU than in all the years from 1994-1998.

Poland: numerous private consulting companies have begun contracting with sub-national governments to provide all the necessary documents and with the quality required by the EU for access to the transfer funds.

(D) Financial capacity:

Special legislation considered in a number of EU8 countries to relax existing borrowing limits for sub-national governments.

Latvia: consolidation of smaller LGU.

Romania so far has not made a concerted effort to promote PPP. One explanation, which Romania shares with many EU8 countries, is the general mistrust of private businessmen in Eastern Europe.

Czech Republic: the Ministry of Finance developed budget rules to account for PPP projects with transparency, even if they do not formally constitute debt, and ensure that EUROSTAT accounting regulations are followed. Also, World Bank also assisted in developing "PPP Centrum" (a joint stock company, fully state-owned), which is a small-scale resource center for technical assistance for ministries, regional governments, and municipalities designed to be a focal point for procuring additional technical resources for these agencies when needed for particular projects.

(E) NUTS II:

Hungary is proposing the creation of a special 'equalization fund' to be used to help regions with fewer resources to meeting the EU requirements (Davey, 2003 in Martinez 2005).

Annex 7. Illustrative credit rating analyses for Macedonian LGU

1. Fiscal performance indicators:

- a. % of revenues of GDP;
- b. LGU revenues of LGU average;
- c. % of own revenues over transfers (revenue autonomy);
- d. % of CAPEX over operational expenditures (expenditure rigidity).

2. Composition and trends in expenditure indicators:

- a. % of expenditures of GDP;
- b. LGU expenditures of LGU average;
- c. Operating balance to operating revenues (operating performance);
- d. Balance after CAPEX to total revenues (overall performance).

3. Financial position indicators:

- a. % of investment from total expenditures;
- b. LGU investment of LGU average;
- c. Debt to operating revenues (debt stock);
- d. Debt service to total revenues (debt service).

Table 29. Illustration of credit rating comparison of Macedonian LGU (2006)

LGU Fiscal performance indicators	% of revenues of GDP*	LGU revenues over LGU average=1; under LGU average=0	% of own revenues over transfers	% of CAPEX over operational expenditures
ARACINOVO	0.00%	0	55.08%	26.99%
BEROVO	0.05%	1	9.85%	308.09%
BITOLA	0.15%	1	149.56%	39.48%
BOGDANCI	0.01%	0	44.45%	85.78%
BOGOVINJE	0.03%	0	37.55%	172.43%
BOSILOVO	0.02%	0	27.31%	167.33%
BRVENICA	0.01%	0	53.75%	52.90%
VALANDOVO	0.02%	0	54.42%	29.47%
VASILEVO	0.01%	0	30.90%	82.33%
VEVCANI	0.00%	0	43.14%	87.51%
VELES	0.07%	1	115.94%	39.17%
VINICA	0.04%	0	26.41%	105.80%
VRANETICA	0.00%	0	89.91%	28.23%
VRAPCISTE	0.02%	0	285.40%	59.78%
GEVGELIJA	0.07%	1	57.76%	137.58%
GOSTIVAR	0.09%	1	81.45%	77.87%
GRADSKO	0.01%	0	33.93%	128.23%
DEBAR	0.04%	0	93.99%	117.32%
DEBARCA	0.01%	0	23.18%	63.00%
DELCEVO	0.03%	0	60.85%	51.20%
DEMIR KAPIJA	0.01%	0	28.55%	132.96%
DEMIR HISAR	0.02%	0	21.81%	81.25%
DOJHRAN	0.01%	0	107.04%	65.72%
DOLNENI	0.01%	0	32.16%	26.71%
DRUGOVO	0.01%	0	38.94%	25.23%
ZELINO	0.02%	0	48.54%	88.22%
ZAJAS	0.01%	0	35.50%	40.15%
ZELENIKOVO	0.01%	0	149.47%	40.52%
ZRNOVCI	0.00%	0	29.93%	101.18%
ILINDEN	0.02%	0	140.58%	41.59%
JEGUNOVCE	0.01%	0	51.80%	29.93%
KAVADARCI	0.07%	1	224.48%	96.79%
KARBINCI	0.01%	0	11.40%	85.77%
KICEVO	0.04%	0	137.13%	41.64%
KONCE	0.01%	0	38.10%	81.61%
KOCANI	0.04%	0	77.06%	41.03%
KRATOVO	0.01%	0	35.82%	100.30%
KRIVA PALANKA	0.04%	0	32.03%	18.38%
KRIVOGASTANI	0.00%	0	69.34%	22.20%
KRUSEVO	0.01%	0	43.99%	58.66%
KUMANOVO	0.12%	1	92.11%	25.10%
LIPKOVO	0.01%	0	30.12%	302.05%
LOZOVO	0.01%	0	14.38%	10.10%
MAVROVO I ROSTUSE	0.01%	0	29.44%	25.91%

* GDP projected for the whole 2006

MAKEDONSKI BROD	0.01%	0	33.93%	114.34%
MAKEDONSKA KAMENICA	0.01%	0	46.16%	62.83%
MOGILA	0.01%	0	61.67%	65.16%
NEGOTINO	0.03%	0	111.20%	37.61%
NOVACI	0.01%	0	40.79%	110.30%
NOVO SELO	0.02%	0	22.06%	26.51%
OSLOMEJ	0.01%	0	19.99%	108.11%
OHRID	0.12%	1	374.38%	38.27%
PETROVEC	0.01%	0	60.70%	140.87%
PEHCEVO	0.01%	0	18.63%	186.67%
PLASNICA	0.01%	0	11.81%	42.02%
PRILEP	0.10%	1	167.96%	127.95%
PROBISTIP	0.04%	0	48.30%	168.00%
RADOVIS	0.06%	1	170.29%	90.86%
RANKOVCE	0.01%	0	14.91%	36.49%
RESEN	0.03%	0	62.82%	125.09%
ROSOMAN	0.01%	0	59.44%	91.78%
STARO NAGORICANE	0.01%	0	31.73%	124.35%
SVETI NIKOLE	0.05%	1	64.02%	52.49%
SOPISTE	0.01%	0	179.65%	48.48%
STRUGA	0.14%	1	234.63%	52.83%
STRUMICA	0.08%	1	149.60%	14.42%
STUDENICANI	0.01%	0	117.15%	51.23%
TEARCE	0.02%	0	76.53%	37.24%
TETOVO	0.09%	1	172.90%	19.79%
CENTAR ZUPA	0.01%	0	97.78%	23.29%
CAJKA	0.01%	0	18.47%	80.35%
ZESINOVO I OBLESVO	0.01%	0	141.68%	102.43%
CUCER SANDEVO	0.03%	0	228.39%	27.86%
STIP	0.05%	1	130.32%	116.47%
AERODROM	0.17%	1	349.64%	78.08%
BUTEL	0.05%	1	167.77%	55.19%
GAZI BABA	0.10%	1	109.93%	50.76%
GORCE PETROV	0.05%	1	236.50%	89.11%
KARPOS	0.13%	1	280.09%	56.98%
KISELA VODA	0.10%	1	269.96%	47.08%
SARAJ	0.02%	0	91.32%	104.44%
CENTAR	0.17%	1	477.38%	33.36%
CAIR	0.07%	1	146.15%	28.23%
SUTO ORIZARI	0.01%	0	127.30%	120.37%
CITY OF SKOPJE	0.87%	1	657.50%	26.99%
TOTAL:	3.93%		351.01%	79.79 %

The credit rating agencies and investors sometimes look at other comparative data and indicators to assess the credit worthiness of LGU. Here are examples of some indices at NUTS III level (see more www.lsg-data.org.mk developed by CEA and sponsored by USAID through World Learning) for Macedonia.

Table 30. Composite index of economic development

Region	Composite index of economic development	Ranking
Republic of Macedonia	-0,80	1,00
Pelagoniski	-0,40	2,00
Vardarski	0,00	3,00
Severistocen	0,90	4,00
Jugozapaden	0,30	3,00
Skopski	-1,30	1,00
Jugoistocen	-0,40	2,00
Poloski	1,00	4,00
Istocen	-0,10	3,00

Source: www.lsg-data.org.mk

Note: The more negative the number the better the situation.

Table 31. Statistics available for the variable

Avg	0,00	2,75
Max	1,00	4,00
Min	-1,30	1,00

Source: www.lsg-data.org.mk

The CEA MCI Index is giving overall base for comparison among Macedonian LGU. It facilitates targeting for decision makers not only for the central government but for the donor community as well. CEA believes that the CEA MCI Index will be useful for the local governments and officials in making strategy and development plans as well as making comparisons among themselves and boosting competition among them in Macedonia. The ranking system is aimed at assessing the socio-economic performance of Macedonian LGU.

Table 32. CEA MCI Index based on 28 variables

Composite population index	Composite index of economic development	Composite index of social infrastructure	Composite index of communal infrastructure
1. Aging index 2. Annual population growth 3. Total birth rate 4. Migration net	5. VA of non-financial sector 6. Growth rate of VA in non-financial sector 7. Unemployment rate	8. Education - Illiteracy rate - Number of students in tertiary education 9. Health - Physicians - Infant mortality - Deaths by tuberculosis 10. Culture - Cinema performances - Public cultural objects 11. Youth at risk - Youth unemployed - Convicted juveniles 12. Democracy - Candidates for LSG per elected counselor in LSG - Number of NGO 13. Gender equality - Female activity rate - Elected female in LSG as a share in total elected	14. Roads 15. Telephone subscribers

Source: www.lsg-data.org.mk.

Thus, one can choose to see the scores among the separate indices and/or the composite MCI:

1. Composite population index
2. Composite index of economic development
3. Composite index of social infrastructure
4. Composite index of communal infrastructure
5. CEA Municipality Composite Indicator MCI

Table 33. Number of classes according the Sturges' rule

NUTS	NUTS 3	NUTS 4	NUTS 5
Units	8	34	123
Number of classes (in accordance with Sturges' rule)	4	6	8

Number one rank illustrates best performance thus, the higher the rank the worse the performance.

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