DEBT MANAGEMENT IN TRANSITION COUNTRIES: EXPERIENCE AND PERSPECTIVES

Edited by
Željko Šević

NISPAcee
THE NETWORK OF INSTITUTES AND SCHOOLS OF PUBLIC ADMINISTRATION IN CENTRAL AND EASTERN EUROPE

NISPAcee
The Network of Institutes and Schools of Public Administration
in Central and Eastern Europe

Debt Management in Transition Countries: Experience and Perspectives

Edited by
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**Debt Management in Transition Countries:
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NISPAcee is an international association focused on public administration. Its mission is to foster the development of public administration disciplines and training programmes in post-communist countries, increase the quality of instruction and research and assist the development of its member institutions at both international and national levels.

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Prologue: Managing (Successfully) the 'Public Shortfalls'...

Traditionally, governments have to borrow money to finance different major public undertakings. Almost always, in the middle ages, borrowing was used to prepare military expeditions or wage wars on either the neighbouring countries or on the residents of new possessions (often regarded by the Western countries as *terra nullius*). Latterly, this has changed, especially with the emergence of the socially conscious state/government (not forgetting the Welfare state, as its paramount form), as the major public undertaking focused on building an infrastructure and/or providing good services to citizens. The current revenues generally could (or at least should) have provided for the basic services and cover basic operating costs, whilst additional investment was usually required to major infrastructure developments and attempts to provide a major increase in the service levels provided. In the case of major expansion, the modern government is forced to look for additional sources of finance... Traditionally, as a sovereign power, it can resort to printing money (monetary expansion) and finance the needs in the short-term, before inflation creates an adverse situation, or to resort to borrowing in the financial markets, based on its future, planned cash inflows.

Monetary expansion that leads to inflation and in the long run to hyper-inflation is not a new invention. As history remembers, the sovereign powers have resorted to the 'same trick' now and then – trying to finance budget deficits by providing a credit directly to the government and splashing money into financing the public needs thereby soliciting, in the long run, public support. During the time of the gold standard, the masters who had the rights to mint currency often reduced the weight and the quality of gold coins, thus creating inflation. Today, we still have the ever present Gresham Law that states that bad money will push out good money. In the modern world of fiduciary money, the government does not have to mint lighter coins, but simply print notes. This is certainly easier and in the short-term, more difficult to detect, mainly due to a well-documented monetary policy reaction gap. And, when the public ('economic agents') become aware of the monetisation of debt, their trust in the government and credibility of its policies will be adversely affected; and expectations will be more in line to estimate future inflation and safeguard his or her business; rather than remain loyal to the organisation.

If the government has acted in the best interest of its citizens/voters, it would opt for healthy borrowed finance, whose payback may be financed either through the general budget, or directly by one of the line ministries (but not implicitly given a budget line in the budget preparation process). The 'healthy' borrowing may be more expensive at first sight than monetisation; but in the long run, this choice delivers more benefits than the costs. In contrast, in the case of monetisation, the costs are usually implicit, but in the end, they can be estimated through the concept

of opportunity cost and social costs. In high-inflationary or hyper-inflationary situations, foreign investors would not consider investing in the country, whilst those who had been around would seek the first opportunity to flee the country in order to ensure its investment had not been devalued or even destroyed. Inflation, in fact, can be considered as a particular stealth tax imposed by the government that benefits those who have particularly easy access to hard currency and cheap credit.

When the government is to consider whether or not to raise funds through public debt, it should employ a cost benefit analysis and be fully aware of the costs of not only servicing debt, but also the political cost of having any debt burden at all. Often high debt means that the government policy options are fairly narrow and that there is very little the government can do to alternate the current position. The government has to ensure that the debt is well-structured in terms of maturity, currency and interest rates, to maximise the position of the government and also to ensure that the government rating has been positive and debt has not adversely affected the position of the government and its credibility. Governments have to take into account developments in the financial markets, and to ensure that even when they look for short-term savings, they know how much they are exposed with short-term debts (especially in foreign currencies) which can prove to be more volatile than initially estimated.

The modern government has to have a strategic vision of its role and position and this has to be reflected in the way the public debt is planned and managed. The public debt has to ensure that the government needs are met, but at the same time the servicing of the debt is feasible and that it does not create any imbalances in the longer term. Therefore, whenever the public debt issue is to be tackled, it is necessary to take into consideration not only the needs and public financial management musts, but also the risk exposures associated with the particular debt contract/instrument. The IMF requires a high level of accountability and transparency when it comes to public debt/indebtedness: 1) Clarity of roles, responsibilities and objectives of financial agencies responsible for debt management; 2) Open process for formulating and reporting of debt management policies; 3) Public availability of information on debt management policies, and 4) Accountability and assurances of integrity by agencies responsible for debt management. One must know who can commit the country to (foreign) debt and what the procedures are. Multiple democratic check-ups are both useful and necessary to ensure that multiple stakeholders are aware of the development and current trends. Open process allows different societal stakeholders (primarily bodies of the civil society) to become engaged and exercise societal pressure when important, and that crucial decisions have been made.

Public debt requires a good institutional build-up. The institutions not only have to meet the minimum threshold criteria for delegation, but also ensure that they are really 'fit-for-purpose'. The latter criteria are of a more recent date, but it

requires all the institutions to be able to deliver in accordance with their strategic documents. The focus on strategy and risk awareness certainly has influenced the mid-term planning process in, for instance, higher education institutions. When it comes to the institutional framework, the IMF has generally promulgated the situation in which governance is assessed revolving around: 1) Appropriate Governance arrangements and 2) Management of internal operations. The country also has to have a sound debt management strategy that takes into full consideration the risk assessment and development of a comprehensive debt management strategy. This requires effective and efficient financial markets that are robustly regulated and supervised, so that investors in the government (sovereign) securities are internationally protected. In the former socialist countries, there have been many cases where the government has simply failed to honour its agreements and commitments.

Modern debt management assumes the complexity of different functions - at the macro-level one has to be fully aware of the implications of issuing public debt at a particular moment in time. From a public financial management point of view, the government has to secure funding on time and be able to service debt. As we will point out later on, the modern government has to balance the budget, but the balancing of the budget depends heavily on borrowing and it is difficult to find a single country in the world that does not raise funds through this method. The art is in being able to judge when to borrow and where to invest… The very process of management can be considered to be more exact and consequently following certain rules… The rules that have been constantly changing, especially in an environment where each successive government tries to cut public spending and is somewhat surprised when public services fail… But, the still dominant practice is a resource driven model, so more commitment of resources should lead to better public services… However, practice shows that it may not be the case (at least within the UK context…).

* * *

The papers gathered in this book were initially presented at the NISPAcee Annual Conference held in Ljubljana in May, 2006. The authors had been requested to review their contribution in line with comments provided by peer-reviewers, colleagues who attended the conference and finally by an anonymous referee reviewing the entire book.

This book is a collaborative venture of colleagues who attended the conference and worked mainly following the research protocol developed by the Editor, to ensure consistency which should have enabled comparisons between different jurisdictions. The Editor has also tried to ensure a systemic approach to the issues and 'iron' out the style. To what extent he has succeeded, the reader will be the ultimate judge. Working over the years with these colleagues has been areal pleasure.

The chapters in this book are the work of the individual authors and by no mean reflect the opinion of the editor and the publisher. The book, put before the reader, tells the story of debt management, primarily at the local level in (again, primarily) European transition economies… Certainly, a good read for students of public finance and transition in transitional Europe…

Željko Šević

London, April 2007

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As usual in the edited volume, the Editor retains the overall responsibility for any omissions. All the good points should be attributed to the individual authors and all the bad should be addressed to him.

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1. Managing Public Debt: A Central and/or Local Government Issue

Željko Šević

1.1 Introduction

In present times, it is almost impossible to find a central (national) or a sub-national government unit that does not have outstanding debt, either to a bank or to the holders of the securities that the respective government has issued. To a large extent, the idea of budget surpluses that existed in pre-modern public finance has been largely replaced by the expectation of manageable public debt. Modern government is an indebted government that manages its debt well. In recent years, most governments have honoured their obligations, even during serious financial crisis. A notable exception is the Russian government that put temporary moratorium on the servicing of foreign debt at the peak of the 1998 Russian financial crisis.

Theory states that when the Government records a deficit, it has primarily two major options (see: Šević, 1997) – one – to monetise debt and therefore through additional money, create finance for the obligations, but this would trigger inflation and in the long run would undermine the authority of the government to take care of the national economy. In most recent history, there have been examples of high inflation through which the holes in the government budget were (temporarily) filled. However, it is not even necessary to state to what extent it has undermined the government's position in society. Record inflation and fairly disarrayed public finance have been in Serbia until the late 1990s, as hyperinflation struck and devalued the assets of companies and as a result, the accumulated national wealth has toppled.

To a large extent, the government of countries with an underdeveloped capital market may opt for monetisation, as they would claim that this is the only effective way to cover the budget deficit, either planned or *ad hoc*. Public debt and the capacity to raise debt finance for public sector entities are not necessarily linked with the depth and breadth of the national capital market. In fact, governments in those countries may even opt to have debt finance secured though a bank loan. Due to the size of the loan and probably its term structure, most likely the banks will provide the loan in the form of a syndicated loan, as they may not want to be over-exposed to one customer, regardless of how local. Increasingly, central banks are forbidden to grant credits to national governments, as this may adversely affect financial stability. This generally does not affect the position of local (sub-national) governments as they have to have (in the vast majority of countries) a licence to borrow, either nationally or internationally. Often, the central government has to agree with the plan to issue securities at sub-national level, ensuring stability in a

consolidated national budget. However, even the consolidation of the budget may be an issue in itself, as whilst in advanced transitional economies, it has more or less been fully achieved, in developing countries and late transitional starters, the situation is quite different, as there is still a large number of para-fiscal funds that have a life of their own, but within the government. As a rule, the countries that are in the early/medium stages of transition still experience huge problems with para-fiscal deficit and generally often have to cover the deficit in related public funds from the budget. However, due to the lack of consolidation, the final bill may not be easy to envisage, before the final accounts have been settled.

So, it is very difficult to find a modern government today without debt, either in the form of bank credit or liabilities for issued securities. In both cases, an outsider has a claim against the public entity (government) and the obligation has been established to affect not only the current, but future generations. Overlapping generation models depict this situation to be the best. Often, an additional problem is that politicians are somewhat myopic and they commit the government for much longer than they are in power. Therefore, it may be necessary to institute processes and procedures that would ensure that there is no excessive indebtedness and that future generations will not be overburdened.

Decentralisation, devolution, delegation, deconcentration and similar actions aimed at bringing government closer to the people, assume that sufficient public funds are made available to local government bodies and their independent agencies. In order to deliver this, local governments are to be given enough resources to be successful in delivering newly acquired services and exercising attracted powers. The usual point of departure is that local government will be given approximately the amount that the central government has spent rendering delegated services. However, with the constant squeeze of the public purse, usually the powers and services are transferred, but this move is not followed by the transfer of corresponding resources. Therefore, local (sub-national) governments are forced to look for other sources of revenue. Usually, they may seek to establish independent local revenue streams, but the problem is that often they need prior approval of the central government before the levies are imposed. Similarly, the local governments often have to seek prior approval before applying for loans or other forms of debt.

The papers in this book primarily look at the issue of management of debt at sub-national government level, although there is strong emphasis on the central government and its overall public debt policies and strategies. The paper focuses on particular countries and examines their respective experience with public debt and its management in order to achieve the government objectives set in programmatic documents.

1.2 Understanding the Public Debt

Public debt is a revenue source in situations where other regular revenue sources (taxes, customs and other fees, levies, duties, etc.) are not sufficient to finance the discharge of the functions that are entrusted to the particular government and or public body. It is the liability for the government that has to be serviced according to the condition of the loan, and it should be done from future revenue streams (future cash flow). To a large extent, the regularity and the soundness of the future cash flow will not only determine whether the local government will be given (raise) funds, but also what interest rate will be charged, as well as legitimate bank charges for assistance.

The public debt limits are usually regulated by law and enforced by the central bank, which monitors the national level of indebtedness, acting as a government agent, especially when the debt is with a foreign element. However, the government may also opt to manage public debt itself, usually through a separate government agency, usually called the Public Debt Management Agency. Central governments can, in the final instance, monetise their debt, but this is not an option for local and other sub-national level governments. They are treated similarly to private borrowers and they can default on their debt. Sub-national governments are evaluated by private rating agencies and investors are interested in their standing, as the interest that they will pay will depend not only on inflation and maturing but also on the risk of default associated with a particular class of securities. Although traditionally the focus in western public finance (public financial management) literature has been on attracting funds through the issuance of securities, one should not neglect the classical loans and credits that commercial banks can extend to local governments. In fact, in most developing and transition economies, this is the most preferred form of municipal debit.

It is generally accepted that the government should finance operational expenses from the real revenues and capital investments can be financed from the borrowed source. This has been the rule for a long time, as investments even in the public sector should secure some kind of cash flow and therefore enabling the government to service debt. However, this generally may work in the areas where we have the situation of charging user charges and fees (duties), whilst this may not necessarily be the case if the utilisation of the investment will be financed from the budget. The government can also estimate future cash flows from tax revenues and based on that, can estimate its ability to service debt obligations. Technically, it is feasible, but in practice there are some reservations about these practices, mainly because of the general belief that without proper incentives, misallocation of resources would certainly happen. In our view, the government should be treated in the same manner as any other business that is that the future revenue (cash) flows should be estimated, regardless of the position of the government. In the case of sub-national government, it should also be assumed that the central government would certainly

act as a guarantor of the obligations of its sub-national governments. This is one of the reasons why largely, all over the world, sub-national governments may need a permit from the central government to raise debt finance or at least to conform to general guidelines provided by the central government.

Public debt must be the result of a conscious decision that should be derived following the presentation of a sound business case. In fact, the case for borrowing must be made. Often, governments would be able to finance the project later, but the needs of the public require immediate reaction, and therefore additional funds have to be raised. As public debts are usually of a long-term nature, the decision to issue debt securities or take a loan from the bank has far-reaching consequences for future generations (overlapping generation models), and committing future taxpayers to cover the debts of today, is not really considered ethically sound. However, the needs of the public are to be met and there is a general assumption that there is cross-generational solidarity, so that no member of future generations may object to the fact that money has been raised today, and he or she will have to pick up the bill later. To a large extent, the solidarity model has worked far better in Continental European countries with their understanding of the Welfare State.

The important thing is that when the issue is considered, the economic and financial soundness of the government's case is assessed. Often, governments are ready to overestimate future cash inflows and the receipt of tax revenues. It is of the utmost importance to model future revenues well and to be aware of the strategic developments in a particular area of public policy. For most central governments, it is possible to obtain information on other ratings, and increasingly this is the case with local governments. This should give a potential lender enough information to assess the economic viability of the government as a client. Nevertheless, it should also be said that quite often ratings may be questioned, especially if there is no data or experience dealing with a particular type of central government. For instance, although ratings may be given for all national and many sub-national governments in CEE, the credibility of information may be in question, due to a still chronic lack of good quality data on both private and public entities in these countries.

However, when the decision has been made to borrow and to use the funds for a specific purpose, then the issue of management of debt emerges. Governments at all levels should be fully capable of managing debt and being able to maintain the credibility and financial viability to ensure that the debt-holders are treated fairly. The studies look primarily at the organisation of the debt management function, rather than really look at the models of debt management and instruments used (see Swianiewitz, 2004). So, consider the rules for debt management, and distortions from them.

1.3 Principles of Debt Management

The public debt has to be managed in order to achieve policy objectives. The decision has to be made on the type of instruments, issuing techniques and overall institutional arrangements. The aim of the government is twofold, that is to attract funds and at the same time minimise debt-servicing costs, as associated with the risk profile. One of the major issues to be faced by government is to ensure the best trade-off between cost of debt and refinancing risk. In other words, it is possible that the government will not be able to meet its dues and therefore will have to refinance. In order to assess the best choice, the government has to take into consideration the type of interest rate offered and also to consider the term structure of debt (short- or long-term) In the case of stable government finance, usually the long-term fixed interest rate securities have proven to be the best, especially if the government is highly rated.

A good public debt management process requires the development of a strategy that would manage public debt in such a manner that it would be able to raise the resources required by government, achieve its cost and risk objectives and to meet other sovereign debt management targets as set by the government of the day. In the modern world, the central governments, as a rule, raise the vast majority of debt finance in financial markets. Bank loans can be used for a particular project and if approved, are usually highly centralised and controlled. Responsible governments should ensure that public debt is sustainable in the long run (fiscal capacity to raise funds to repay back). Poorly structured and consequently, poorly managed public debt may play a role in the case of doubt regarding the stability of the financial system. One should not forget that the government portfolio is, as a rule, the largest in the country and therefore, it has complex and risky structures and it can have risks higher than initially assigned. Imbalances in the government portfolio can seriously undermine the stability of the country. Ensuring that good risk management practices are employed by the government public debt manager is of the utmost importance and clearly requires full focus of the line ministry and the central bank.

Governments, especially those that are OECD members, are increasingly considering the Danish model of Cost-at-Risk (CaR), which is in fact similar in its underpinnings to the Value-at-Risk (VaR) model. The authorities are interested in learning of the cost of servicing the debt which is associated with an increase in the interest rate (within a certain probability range). Maturity also has important macroeconomic considerations, especially when information on the economy and its business cycle are available. In the case of supply shocks and hits on public finance, it may be wise to issue more long-term debt, with indexed or predefined interest rates. This certainly would assist the government when an intervention in the economy is pending. Often, in literature, it is said that the maturity structure of debt may serve as an important macroeconomic insurance variable (see: Missale, 1997).

Governments are looking for new models of placing securities, and it is mainly through auctions, as they are market driven and can give the best possible results If they are run as 'multiple-price' then maximisation can be expected. The issuer can earn rents from price discrimination. Auctions can be also realised with the assistance of primary dealers, who are also an important factor in creating market equilibrium. Often, in practice, Governments would like to combine primary dealers and multiple price auction systems. It is also possible for the government to consider and decide to have a special organisation running the public debt. It is often referred to as a Debt management Agency and in many countries the title has been translated literally; one would have expected fast moving changes.

Increasingly, debt management requires a more formalised institutional setting. The traditional model (if we can use this term) commands the Ministry of Finance as the formal institution in charge of public debt, with the central bank acting as an agent for a government and deploying the resources in the best possible manner. Increasingly, the trend is to set up an independent or semi-dependent government agency in charge of public debt management. The agency operates outside the classical framework (Ministry of Finance – Central Bank) and focuses solely on debt management. However, even in the latter model it is necessary to ensure that there is a required level of coordination between the fiscal and monetary authorities on the one side and the debt agency on the other. Otherwise, there may be an adverse influence of public debt management policies on the efficiency and effectiveness of both monetary and fiscal policies – see: Kroszner, 1998). As new institutions, public debt management agencies are usually assessed on the cost (or rather cost saving) basis. They are, as a rule, benchmarked against similar institutions and based on the assessment of a cost-risk relationship (see: Ferre Carracedo and Dattels, 1997).

Risk management practices exercised by the public debt manager can support stability in the country, but by no means can replace ineffective and ill-devised fiscal and monetary policies applied by the governments. As the government has responsibility for the stability of the system, it would be fairly irrational to assume that the government will practise slack public management policies, as this would not only destabilise the markets, but also would destroy the reputation of the government as a deliverer in the eyes of the population. It is usual practice to use stress tests of the debt portfolio, taking into consideration economic and financial shocks to which the government and the country may be (reasonably) exposed. Modelling the response to these shocks can be done by using complex mathematical models, or simply going for mere scenario-based models. The debt manager by default has an advanced knowledge of the domestic market and domestic situation. Therefore, the investment abroad would require additional research and development of different techniques for handling risk. However, not all governments have the same attitude to risk. Some can be risk averse, whilst others may be more entrepreneurial

and would seek far more risky options. Nevertheless, the government, regardless of the level, should refrain from risk management practices that one can describe as casino-like.

The government has to decide on maturities, currencies and interest rate terms that can lower the risk. The government is also responsible for competent fiscal policy, which should also have, as one of the objectives, control over debt issuance. The government should seriously stand and enforce the spending limits, regardless of the reactions from many interested parties and community groups. The government can decide to benchmark its portfolio and policies against some other similar country and to ensure that good/best practices are effectively disseminated. Whilst often governments were managing debt passively, most recently they have been fairly active in management and take into consideration potential 'profits' from movements in interest rates and foreign exchange rates. However, one should be aware that this type of active debt management requires additional and very careful assessment of the (complex) risks involved.

In managing public debt, the managers should be aware of the impact of contingent liabilities on the government's financial position. The appearance of these liabilities may shake the overall position of the government and can even have adverse implications on the government's ability to meet its dues and service the debt. The latter is primarily due to the fact that the overall liquidity of the government is severely affected by the appearance of these liabilities. Often, in practice, it happens that the government does not have a legal obligation to intervene or underwrite certain obligations, but due to the political situation, it may decide to provide support after the incident has occurred. In either case the debt manager can do very little, if anything, in offsetting the risk of the contingent liabilities and/or the government's, politically driven, decision to support (bail out) those in trouble. Even the erratic behaviour of the government may, to some extent, be understandable, as they may think that with the central government showing interest this would undermine local efforts and impose an agreed solution upon the borough residents.

In the developed countries, the major focus in debt management has been put on risk and risk adjustments. It is often a major pitfall for the government when the risk has not been assessed properly and when the stability of the government portfolio has been endangered. In contrast, in developing/transition countries, the focus has primarily been on the development of the institutional infrastructure and really looking at the proof for the existence of fit-for-purpose institutions that can deliver the targets required. It is of the utmost importance to establish a solid legal infrastructure for debt management and security issuance. Whenever government, or any other economic agent, is going to the market, it is not assumed that there will be problems, therefore it is necessary to ensure that a regulation exists that is appropriate and which can be enforced in local conditions. Financial accounting and reporting plays an important role, together with the audit profession, as in-

formation is required and a potential investor should have trust in the reports and information publicly made available. In practice, it is often easier to get information from abroad, and it may even be of better quality than locally collated information. This is often the case with countries in transition. For whatever reason the information data are collected, but either muddled up to demonstrate better trends, or simply not available.[1] Therefore, it is necessary to ensure that information necessary for debt management is available to the public, as a part of a classical accountability relationship, let alone for the sake of debt management.

Debt management operations are taken in both primary and secondary markets. In fact, government securities are usually the first offered when the country is to develop financial markets. When it comes to operations in the primary market, it is necessary to ensure that the operations themselves are transparent and predictable. All the information has to be made publicly available and accessible to all interested parties. Also, the government rules that regulate a new issue should not be discriminatory in any aspect, or in other words, should treat all investors equitably. The new issue should always be done via the market, even if the models of auction and syndication are applied. When it comes to the secondary market, both the government and the central bank (through its open market operations) should promote efficiency in the market and operate effectively within the legal framework provided. One of very rarely practised instruments for promoting trading in government securities is the removal or reduction in tax on gains, or simply making them exempt them from. Also, overall market deregulation usually benefits those who are active in the financial market. The problem that often appears in transition countries is that final government accounts are often late, and many macroeconomic indicators publicly available should be closely scrutinised.

Indebtedness of local government is usually limited by the Law at the central level. This is mainly due to the fact that the state (government) has consolidated accounts, so all the liabilities of all the public bodies are reported there and excessive indebtedness of local communities (local government or self-government bodies) can seriously hamper the macroeconomic stability in the country. Therefore, the local bodies usually have to acquire a permit/approval from the central government (usually the Ministry of Finance – MoF will deal with this request). Local government will increasingly try to issue securities, and mainly will back that with the projection of future income in the form of local taxes or government transfers. Usually, if the local government has its own original revenue sources it is better rated than the income that comes from the central government in the form of general grants. In order to issue securities, a local government body has to be rated, and often this is a problem, as there is no past experience to relate to. Often the rating agencies will

1 It is well documented in the case of Uzbekistan in a book not really of an academic nature, but rather in memoirs published by the former UK Ambassador to Uzbekistan. See: Murray, 2006.

be reluctant even to do so, as they may not be familiar with the particularities/specifics of the intergovernmental relationships in that particular country.

Looking at the debt structure of local governments, it still seems that cross-government borrowing takes place, together with loans taken from commercial banks. In general, the former should not be very problematic from a macroeconomic point of view, as long as there is clear hard-budget constraint enforced. In the latter case, the important issue is that commercial banks are not in a position where their judgements are shadowed by the problems of adverse selection and moral hazard. Namely, in most cases, commercial banks in a largely or entirely privatised banking sector will act rationally and will credit mainly those local government entities that can demonstrate their economic viability and they will clearly be able to service the debt. Also, they will look very seriously at the issues of collaterals, and will require collateral when granting a loan. Methodologically, they will probably apply a similar, if not the same principles as they do to clients from the private sector. However, if the major part of the banking sector is still characterised by state ownership, it is most likely that the credit decision will be influenced by the daily politics of the government and many funding decisions, in fact, will be based on political compromise, rather than the economic viability of the applicant, i.e. local government body. In a predominantly privatised banking sector, it is clear that local banks are more cautious. There were cases where a local community was able to borrow money abroad more favourably than in their own country. Even more interesting the issue was that the lending bank was a mother-company, whose daughter-company in the country in this case had considered metropolitan government too risky. Obviously, the mother-bank had somewhat contrary views.

Management of public debt at the local level is somewhat undeveloped, and local governments are primarily interested in servicing debt without much focus on pro-active methods and models of local public debt management. They do not have to look at the macroeconomic issues of their borrowing and at the larger public debt picture that Treasury has to provide on a daily basis. In order to prevent excessive borrowing abroad that can influence macroeconomic balances, it is usually a legal requirement that the local government body gets permission from the central government. However, a full liberalisation process will probably lead to a point where local governments will be fully free to decide on their borrowing and how this will be organised/managed. However, even if that happens, the central government will probably keep for itself some loose coordinating role and of course the inspection of budgetary users (either regular or extraordinary).

Clearly, in transition and developed economies local public debt management, like the public debt management at the central government level, is a relatively novel task for local governments. In a few countries, the central Treasury will service in accounting terms local governments and ensure that their books are in order. In this

way, the central government has a corrective role even before they have formally learned about public borrowing.

1.4 Summary and Conclusions

Government functions are usually financed from taxes collected on the territory of the government jurisdiction. In most cases, the expenditure match revenues and the government may run a balanced budget. In fact, in some central and eastern European Countries (CEECs) the law requires all public entities to have balanced budgets. This is one of the actions undertaken as these countries (other CEECs not yet members of the EU), which are awaiting membership of the EU had to concede to the request for a balanced budget, that will lead to savings in the public coffers and the target public deficit will be achieved. However, quite often in the long and the short-term governments at all levels experience cash flow problems, or simply the need for a particular good and service emerges and it is necessary to react instantly and raise funds. Historically, the government raised funds in the event of war and often the Kings had to borrow money from lenders to wage wars.

However, nowadays public debt management is very important to ensure the stability of the macroeconomic situation in a country. In fact, if public debt is not controlled, it can affect adversely both monetary and fiscal policy. Therefore, it is of the utmost importance to ensure that public debt is managed properly. The government has to ensure that the structure of debt is good and that the price paid is the market one. It is necessary to have, i.e. prepare, the national public debt strategy and then develop objectives of debt management and ensure coordination amongst all the interested/involved parties. Transparency and accountability are also important criteria, as it is necessary to ensure that there is communication between the government and the voters, especially a debt, a public debt, that will burden future generations. Therefore, support should be kept to a minimum, ensuring that an individual can excel, on an individual basis. Modern public policy process suggests that it is necessary to involve formal and informal organisation within the community in order to ensure that all voices are heard. The necessary infrastructure has to be provided in order to be sure that the instruments will work and that there is societal understanding of public debt and collective responsibility for it. As operations develop and innovations emerge, it is of the utmost importance to regularly review regulations, especially those that have been enforced some time ago. Observance of world trends in this area is very important.

Development of strategy is also very important, as it should reflect government's monetary policy and fiscal priorities and objectives, and link inputs with expected outputs. Similarly, there is a need to develop a Risk Management Framework. This is a modern approach, as the risk is perceived within the concept of management/managing, and should ensure that management delivers its tasks. Assessing the risks in transition and developing countries may seem to be tedious

work. Namely, the risks outside classical insurance have not been common in the dominant line of thought. Now, “risk” is the ‘buzz’ word and certainly risk will be with us for some time to come and will dictate the way we perceive our assets and liabilities… Finally, in theory it is generally assumed that the government securities markets are very important for the development of financial markets in general. Initially, when financial markets were to be developed in CEECs, following the fall of communism, IFC generally supported the trading in government securities, as a way of developing markets quickly and also of promoting flexibility in the use of monetary policy instruments (presuming a growth in importance of open market operations by the central bank).

One of the major problems is overexposure to open foreign exchange positions. Often governments do not hedge these positions and often in the cases of volatile markets their positions may be put in danger, especially in the case of poorly designed portfolios and overexposure to one foreign currency. With the laws allowing local governments to borrow within prescribed limits one may wonder to what extent this liberalisation of borrowings will influence the position of the government in the longer run, as it will be picked up in a consolidated budget. However, with the promotion of fiscal federalism, one should accept that local governments must be asked to be responsible and to perform their duties (including fiscal) with full responsibility. When deciding on deficit financing through public debt, the government entity (and ultimately the State, i.e. Government) has to take into consideration the purpose of the borrowing, how this will be repaid, and then focus on the technicalities of the issue, in order to ensure that the money required is quickly connected, reducing the overall transaction costs.

In general, we like to have governments with balanced budgets and a relatively low level of indebtedness. However, if the resources are not sufficient to serve the national/local needs, the government and/or local government body will be required to borrow. Borrowing *per se* is not bad if this is based on the future real revenues and will be used for capital investments, or one-off operational expenses. In most developed economies recurrent borrowing for covering operational expenses is not allowed by law, and would call for review of the government entity whether it is ‘fit-for-purpose’. Ideas such as ‘value-for-money’ and ‘fit-for-purpose’ will be used increasingly in the future, as public resources are put under even more strain and governments are forced to look for ways to reduce their costs and to deliver good quality services to the population when the revenues are at best stagnant and the population may record the rise. Under those circumstances, debt and debt financing may be perceived as one of the perils, but if managed well, should enable the organisation to deliver its mission.

* * *

This book comprises 15 papers dealing with different aspects of public debt management, and depicts an accurate picture of the situation in CEECs without any

prejudice. It is clear that the countries that joined the EU in 2004 have largely endorsed Western standards of debt management, although there are still some problems reported. In the case of other European transition economies, especially those of FSU, there are still problems in reporting, understanding and applying concepts with still many rollovers from Soviet times. The papers critically examine some aspects of public debt management, discussing the past and giving a glimpse of what the future may bring. The book has value for both academics and practitioners, interested in how public debt is managed in transition countries.

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PART ONE – COUNTRY STUDIES

2. Local Debt in the Context of Decentralisation and Reform: The Slovak Republic

Phillip J. Bryson

2.1 Introduction

Subnational debt in the Republic of Slovakia must be understood in the context of fiscal decentralisation and intergovernmental fiscal relations generally. Municipal debt represents an important source of funds for local infrastructure development and would be expected to be part of the financial portfolios and capital budgets of autonomous, local governments in the process of development. But it is only one piece of a fiscal mosaic that contains elements related in important ways to the whole financial picture. This introduction will attempt to place debt in its larger fiscal context in the transition era of the Slovak Republic.

The Republic began its transition to democratic and market orientation following the "Velvet Revolution" in late 1989 as a part of Czechoslovakia. Together with the Czechs, Slovaks helped establish common institutions that preceded the "Velvet Divorce" of 1993. That fiscal system was more similar to those of Western Europe and less similar to those of central planning.

In the first decade after the decline of the central planning regime, the pattern of public expenditures for both countries was a familiar one. As in the other "OECD post-transition economies," the preponderance of social transfers and of a huge public sector wage bill were notable (Gönenç and Walkenhorst, 2004). In spite of modest wages, the aggregate wage bill ballooned due to the exceptionally high level of government employment. Social transfers, especially in the form of health care costs, were likewise to become a source of serious fiscal concern. (The health care system of the communist era had also been expansive, but was far less expensive.) Total spending in both countries reached levels higher than those typical of lower income OECD countries. The large public expenditures are the more dramatic in the case of Slovakia with its lower per capita income.

The two independent republics had other transition tasks that required a lot of attention, so the first years of the transition saw little noticeable change in their fiscal systems. It was ultimately Slovakia's reforms which began to move away from the joint institutions of Czechoslovakia. This occurred as a part of reform efforts associated with the pursuit of membership in the European Union. The pre-accession efforts included a reform of public administration in both nations, but Slovakia was more serious about the process of fiscal decentralisation which it saw as a *sine qua non* for the public sector transition away from the excessive centralisation of central planning. Slovakia simply carried the reforms further than the Czech Republic, es-

tablishing a "flat tax" system (with a single rate of 19% for individual and corporate income taxes, as well as for the VAT).

These later forms of divergence from the common original system were dramatic and well publicized. But earlier divergence had also been important for the twin republics. Slovakia unavoidably developed a system of greater municipal autonomy for two reasons. First, the Mečiar regime made it clear that the cities and towns of Slovakia would have to fend for themselves financially. There would be no liberal flow of transfers, grants and shared taxes to the municipalities. Second, the Slovak municipalities would have independent management of their property tax.

In the Czech Republic, legislation was established that has kept the property tax strictly symbolic and fiscally insignificant. As opposed to the decentralized practice in Slovakia, the Czech central government even manages the collection of the property tax, which produces a moral hazard problem (Bryson and Cornia, 2003). The state has no incentive to produce copious revenues from this tax; it does not receive any share of its revenues, which are returned to the municipalities. In the Slovak Republic the property tax remains only a significant *potential* revenue source; it currently provides only modest revenues, although they are significantly larger than the nominal revenues produced in the Czech Republic.

Nor have the municipalities of either country had autonomous management of user fees for public services. National law specifies the local "charges" (sometimes user fees, sometimes local taxes) which can be assessed, leaving little flexibility in rate variation for local administrative preferences. With no property tax and no independent user fees, the municipalities have no access to independently generated revenues. Given the centralist traditions that are a legacy of the earlier central planning regimes, there has been only modest fiscal autonomy at the local level. Basically all funding comes from the centre and the outside perception is that, generally, too many strings have been attached (Oliveira and Martinez-Vazquez, 2001). Slovakia has worked with the same governance mentality and fiscal institutions, but there has been greater independence with the real estate tax and revenues have been more seriously and effectively collected by the cities and towns themselves. More recently, the centre has begun to be substantially more generous to the municipalities than in the early transition. As part of the recent reforms, the process of devolution has continued, and this has included an apparent opening of the door to independent municipal action with regard to both property tax and local user fees.

To an important extent, the heavier, historic centralisation prevailing in both countries is a result not only of communism's legacies, but of the practical fact that both republics have been sympathetic to the strong local desire for municipal independence. Under the centralism of the previous era, municipalities were unhappily forced into local government amalgamations to simplify governance activities. After the Velvet Revolution, local governments were freely permitted to declare their individual autonomy and the result was the creation of many small municipalities

in both the Slovak and Czech Republics. No other country in Central and Eastern Europe has anything approximating this number of municipalities, the downside being that the smaller ones lack the manpower, managerial and other resources to cope with the possibilities of autonomous action. The central governments, which are capable of managing the local governments of these small countries much better than could ever be done in, say, Russia, are willing simply to continue that management. But the EU agrees with the standard observation of the literature on fiscal decentralisation that democracy requires more than just competent central management of local governments, even when they are not that many kilometres from the capital.

This paper addresses local debt as a reflection of the fiscal institutions and situations currently pertaining in the Slovak Republic. Considering the insufficiency of autonomous revenue sources, one would expect the possibility to access credit markets to be an appealing one for the towns and cities of Slovakia. If autonomous preferences cannot be satisfied by the revenue flows produced in the centralized fiscal systems, leveraging local projects might provide an opportunity to express municipal developmental preferences while avoiding the strings attached to centrally funded projects.

There is also another source of pressure on municipal authorities to embrace credit sources for local development. As newly acceded members of the European Union, they are encouraged to access EU funds provided for regional integration policies. But subnational governments receiving funds for capital investments must match those funds. Credits empower local governments to take advantage of EU transfers.

This paper will investigate municipal indebtedness as a part of the institutional development of the Slovak Republic in the process of fiscal decentralisation. Section II will consider local debt as a part of the historical development of the fiscal decentralisation reforms of recent years, considering also how it relates to the pre-accession reform of public administration. Section III will review the actual financial situation of Slovakia in the transition process to the present. An evaluation of the debt burden, including the various criteria the Slovak government employs to evaluate the potential hazards associated with various levels of municipal indebtedness will be provided in Section IV. The Slovak Republic's municipal debt regulation will be the focus of Section V, which will be followed by conclusions in Section VI.

2.2 Local Debt in the Transition of the Slovak Republic

After the decline of the communist regime in December, 1989, Czechoslovakia restored local self-government through Municipal Law 369/1990, which established a dual system of local public administration including "state administration" and self-government. This system divides municipal governance into tasks for municipal and for central administration. No one in the twin republics seems to object to the

national government's retention of responsibility for all municipal functions it does not "delegate" to the municipalities themselves. To carry out the federal responsibilities for municipal activities, 38 districts (*okresy*) and 121 sub-districts (*obvody*) were established. The regional administrative units (*kraje*) were abolished, so that only the municipalities represented "territorial self-government." These municipalities grew quickly in number in the early 1990s, as mentioned above.

Slovak cities and towns have remained financially dependent on the central government in the transition era. Each year, the state budget has contributed about a third of municipal revenues through shared taxes and transfers. After a period of lobbying for increased transfers from the central coffers, allocations from the state budget are announced when that budget is made public. Specific municipal shares have been determined by parliamentary action each year; only the municipal share of the road tax is stable and predictable prior to the unveiling of the state budget. Because the state budget is frequently approved late, around the end of the year, municipalities have been notified about what they would receive only at the last minute. That situation has rendered orderly financial planning nearly impossible (Kling and Nižňanský, 2004, p. 183).

After the Velvet Divorce, Slovak municipalities encountered very hard financial times as the Mečiar regime granted them rather significant autonomy in some respects, but with only very sparse revenue transfers (Bryson and Cornia, 2004). Later on, the Slovak Republic began introducing reforms of public administration. These reforms were followed by the adoption of a "flat tax"[1] (as in Russia and a few other countries), the main provisions of which were publicized by the Finance Ministry (2004). The achievement of fairness and simplicity in the tax code and the elimination of double taxation were the stated principle objectives of the reform.

By 2000, Slovak municipal debt was an established part of the fiscal scene. At that point in time, the municipalities did not bear heavy responsibility for the delivery of many services. The new system was designed to strengthen revenue collection for municipal finance and to establish sources of revenue for the revived regional governments. Stage I of the decentralisation of public administration consisted of transferring competence from central administration to these sub-national units, which was basically completed from January, 2002 to January, 2004 (Majerský, 2005).

As the process of decentralisation accelerated in 2002 and numerous additional functions were transferred to the municipalities, new problems were encountered. Most significantly, the transfer of financial resources lagged behind the transfer of powers. Funds transferred from centrally collected taxes did not empower local governments to meet their new fiscal responsibilities. (Kling and Niznansky, 2004, p. 219). The "decentralisation subsidy" was insufficient to operate schools,

1 Kňako Miroslav, 2002. Daňová reforma. Bratislava. Available online at http://www.mesa10.sk/vs/index.asp.

hospitals and other programs adequately. Moreover, the law prevented local governments from achieving more efficient service provision, because funds saved in one area cannot be transferred to another.

It was also burdensome that properties being transferred to local governments were encumbered not only with operational but also capital costs. Being in a poor state of physical repair, apartment and other transferred buildings badly need costly, long-overdue renovations. The most critical repairs were usually undertaken unsystematically and the underlying structural and technical problems were not addressed. The local governments which now own these properties will not receive transferred resources to cover the costs. Although the central government has undertaken financial reforms to speed up economic development, advocates of fiscal decentralisation fear that priorities have shifted away from that process. This problem, combined with the management deficits of the municipalities, threatens the fiscal operation of many of the local governments.

Of greater significance, the Finance Ministry announced that the personal income tax would henceforth be an "own" source of sub-national government revenues, with the municipalities receiving 70.3 per cent and the regions 23.5 per cent of the revenue from that tax. Only 6.2 per cent of its revenue would remain a part of the national budget. Generally, the intent was that about one third of municipal revenues would be derived from personal income tax transfers, one third would come from central government and EU grants and one third would come from municipal "own" revenues – from property tax, local user fees, and the privatisation of publicly-owned assets. [2]

Of the numerous considerations motivating the reforms of local finance, an important one was that the municipalities derive only sparse revenues from the real estate tax as compared to numerous of the OECD and EU countries. Property tax was scarcely the centre of the reform, but the Ministry of Finance nevertheless favoured a strengthening of that tax as a part of the whole package of fiscal decentralisation changes. It was hoped that the new system would stabilize revenue flows to local governments and make it easier to engage in multiple-year financial planning.

From January 1, 2005, Slovak municipal governments were empowered to set "tax rates" (a term applied, interestingly, not only to the real estate tax, but apparently also to the limited number of current user fees) and to introduce new local "taxes." The municipalities were authorized to adjust the old system rates and apply exemptions reflecting their own preferences. Also, it was potentially very important that the municipalities were granted management of property tax policy. They could use the funds raised through the property tax, like those transferred to them

2 Officials of ZMOS, the Slovak Union of Cities and Towns pointed this out to me in Bratislava in March, 2005.

from the personal income tax, autonomously. The state abdicated any right to specify the uses of these revenues. All the old laws specifying coefficients for property classifications under property tax administration are now extinct. The municipalities can use the property tax independently. Along with the donation tax and the inheritance tax, the real estate transfer tax was eliminated as a part of the tax reform (Zachar, 2004: 38). A new Act on Real Estate Tax was to create the legal basis for real estate taxation based on market valuation.

With the adoption of the regions as "higher territorial units," the Parliament transferred additional spending responsibilities to the sub-national governments amounting to approximately 4.5 per cent of GDP. Municipalities, previously in charge of waste disposal, drinking water, public lighting, and maintenance of local roads (where they spent 2.9 per cent of GDP in 2000) received additional responsibility for social assistance, roads and communication systems, environmental protection, territorial planning and building permits, primary schools, sports and some health care. The regional governments assumed responsibility for territorial planning, regional development, secondary education, social assistance, health care, cultural events, regional roads, communications, civil protection, and some additional functions to be coordinated with institutions of the European Union. Total sub-national spending, including both traditional and new responsibilities was expected to reach 20 per cent of total general government spending by 2005.

The approval and management of these decentralized budgets will be by the elected representation of the regions and municipalities. Municipalities will not be required to submit budget proposals to central authority. The regions will submit their proposed budgets each year both to Parliament and to the Ministry of Finance. It will be difficult to control capital expenditures when regions and municipalities remain under their borrowing caps. As a result, planning and implementing general government finances will remain difficult even with safeguards against excessive overspending. Centralizers wonder whether central government funds should be turned over to sub-national discretion for general use within a given program. Doing so could lead to improper maintenance of capital assets where there is a political bias favouring civil service employment and wages (Gönenç and Walkenhorst, 2004, p. 26).

There are those who are concerned about the process of decentralisation, *viz.*, that it brings a measure of autonomy to local spending that may precede adequate prudential spending restraint. If this is the case, the availability of loaned funds could be the worst enemy of neophyte municipal governments. Those with this concern urge restraint in the decentralisation strategy and the imposition of spending and debt restraints, together with "strong functional and procedural audits" (Gönenç and Walkenhorst, 2004, p. 30). Given the country's bias toward centralisation, it would seem more appropriate to engage in appropriate fiscal training and indoctrination *vis-à-vis* the sub-national governments. It might be reasonable to permit

them to learn from their own and from other municipalities' experiences with the hazards of debt, rather than prohibiting (through invasive and restrictive policies) the learning and adjusting experiences that could help make their independent fiscal efforts successful.

2.3 The Debt Situation and Data on Debt

The debt situation in the Slovak Republic will reflect and also have an impact on other financial variables, including many discussed above. A most helpful orientation of the local finance situation in the Slovak Republic is provided by Table 1 below. Here, one can compare important financial categories for the Slovak Republic with those of the Czech Republic, other European countries and the United States, Korea and Japan. It is remarkable that Ireland is the only European country of those reported here with a lower *percentage* of GDP transferred to local governments. The Czech Republic's income transfers are substantially higher, about halfway between Slovakia and the rest of Europe.

Table 1

Local Finance of Select Countries, 2002

Per cent of GDP

	Income transfers	Subsidies	Interest payments	Government Consumption		Gross fixed investment	Other net transfers	Total outlays
				Total	*Wages*			
Austria	18.8	2.8	3.6	19.0	9.8	1.3	6.5	51.9
Czech Republic	13.2	3.0	1.4	20.7	8.2	4.6	6.9	49.9
Denmark	17.5	2.2	3.7	26.3	17.6	1.8	4.2	55.5
France	18.1	1.3	3.1	23.8	13.7	3.0	4.1	53.4
Germany	19.4	1.5	3.1	19.2	7.9	1.6	3.8	48.5
Greece	16.4	0.2	5.5	15.5	12.1	3.8	4.9	46.3
Hungary	16.0	3.4	4.1	18.6	11.9	5.6	3.9	51.6
Ireland	8.3	0.8	1.4	15.1	8.3	4.4	3.5	33.5
Italy	17.1	1.0	5.8	18.8	10.7	1.8	3.1	47.7
Japan	10.6	0.7	3.2	17.9	6.9	4.7	1.4	38.7
Korea	4.2	0.4	0.6	10.4	7.6	6.0	3.9	26.0
Poland	17.6	0.9	4.2	14.9	10.7	3.3	0.6	41.6
Portugal	12.9	1.5	3.0	21.1	15.4	3.4	4.1	46.1
Spain	12.3	1.2	2.8	17.8	10.3	3.4	2.3	39.7
Slovakia[4]	**8.9**	**1.9**	**3.1**	**19.0**	**8.3**	**3.2**	**10.9**	**46.9**
Sweden	17.9	1.6	3.2	28.0	16.3	3.2	4.4	58.4
United Kingdom	13.6	0.4	2.0	20.0	7.4	1.3	3.5	40.8
United States	12.1	0.3	3.0	15.5	9.6	3.4	1.2	35.5
Euro area[5]	16.7	1.3	3.7	20.2	10.7	2.4	3.9	47.9
OECD[5]	12.5	0.8	3.0	17.3	9.3	3.2	3.1	39.0

1. Data is based on Government Financial Statistics (GFS) but it is not fully consolidated, possibly creating a particularly large distortion in 2002.
2. Estimate by the Ministry of Finance.
3. National accounts based except for Slovakia.
4. GFS-based 2003 estimates by the Ministry of Finance have been used for international comparisons, to diminish the impact of the distortion in data for 2002.
5. Weighted average.

Source: Ministry of Finance, OECD, IMF and World Bank.

It stands out that Slovakia's 19 per cent public consumption is among the highest of the nations of the OECD area. The country's wage bill, close to 9 per cent of GDP, is still fairly moderate in spite of prolific public employment. This is largely due to the low wages prevailing in the public sector. It is expected that they will gradually converge with those in the private sector, but planned cuts in public employment would offset that. The cost of health care remained large due to the generous terms of social insurance. Rather large subsidies were provided to Slovak enterprises to compensate for losses arising from the retention of low, regulated prices that fail to reflect costs

In accounting terms, there are two categories of municipalities in Slovakia. "Small" municipalities, those with less than 3,000 inhabitants, which are required neither to use a "double accounting system" nor to submit balance sheets to the Finance Ministry. They must submit only an annual review of assets and liabilities. In 2000 only 224 of the country's 2,883 municipalities had over 3,000 inhabitants. Data on municipal debt is taken from the normal, more complete balance sheets provided by those 224 larger municipalities.

The data reveal that the aggregate indebtedness of Slovak municipalities grows annually and that by 2001 it had reached SKK 12.724 billion. This figure is not very alarming, since it accounted for no more than 3.05 per cent of the total public sector debt by the end of that year. As we would expect, the larger share of municipal indebtedness was recorded by the largest cities. Slovakia's largest cities are the regional seat cities, which accounted for 68 per cent of total municipal debt in 2001. Per capita debt was highest in Bratislava at SKK 11,381 in 2000. Košice and Banská Bystrica followed with per capita debt in excess of SKK 8,000. The remainder of the regional seat cities lagged far behind and thus enjoyed more favourable debt situations, with their *per capita* debt being between SKK 1,000 and SKK 3,000 (Kling and Nižňanský (2004, p. 192).

An overview of the debt-related expenditures of Slovak municipalities is provided by Table 2. It displays the share of total expenditures derived from credits as well as the share of operational expenditures funded through debt. Naturally, if the larger municipalities were not included here, the debt situation of the municipalities would appear quite modest.

The smaller municipalities, those with up to 500 inhabitants along with those in the range of 4,001 – 5,000 inhabitants, have been the least active loan takers. In municipalities with more than 5001 inhabitants, credit revenues represented over one fourth of total revenues in 2001. For municipalities with more than 100,001 inhabitants, credit revenues represented no less than 48.6 per cent of total local revenues (Kling and Nižňanský, 2004, p. 193). For these municipalities, credits represent a natural response to the dismal situation of the early transition in which a backlog of needs was building in local communities.

Table 2
Debt-related Expenditures of Local Budgets

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Debt service [Million SKK]	664.4	928.4	1,136.4	1,795.1	2,015.7	2,515.9	3,195.8	6,258.4	2,717.6
% of total expenditures	3.4	4.9	6.0	7.8	7.6	9.2	12.3	19.8	8.9
% of operational expenditures	5.2	7.2	8.8	12.2	12.1	14.2	16.8	25.8	12.4

Source: Berčík 1999, State financial statement 1997 – 2001.

Table 3
Debt-related Expenditures per Capita in 2000 [SKK]

	Debt Service	% of Total Expenditures
to 500	102.6	2.3
501–1,000	211.6	5.2
1,001–2,000	128.4	3.2
2,001–3,000	284.1	7.4
3,001–4,000	262.1	6.4
4,001–5,000	208.2	4.6
5,001–10,000	421.7	9.8
10,001–20,000	781.8	16.4
20,001–50,000	544.9	12.0
50,001–100,000	1,232.9	21.0
over 100,000	6,071.3	39.0

Source: Kling and Nižňanský (2004, p. 197).

An overview of indebtedness according to the sizes of the municipalities of the Slovak Republic is provided by Table 3. It is striking that cities with more than 10,000 inhabitants have significantly larger amounts of deficit spending and cities with populations exceeding 100,000 also have much greater indebtedness.

Until 1995, the debt-related expenditures of Slovak municipalities did not exceed 10 per cent of their total expenditures. Such expenditures increased to 16.8 per cent of the total in 1999, and increased again to 25.8 per cent in 2000. But they immediately dropped back to 12.4 per cent in 2001. Since 2000, local debt has con-

tinued to decline and Slovak municipalities have begun to manage their indebtedness better.

In 2000, the ratio of overall debt to real current revenues in Bratislava reached a maximum for a seven-year period. In terms of the legal limits imposed by the centre on municipal debt, the situation in Slovakia's cities and towns is not yet critical. In the current decade, the debt behaviour of municipalities has apparently become more prudent and Kling and Nižňanský (2004, p. 200) now see indebtedness as a less significant threat to their fiscal balance.

Only municipalities with more than 5,000 inhabitants have issued bonds, which are an attractive means of finance for the mid-size cities. As is evident in Table 4, half of the cities that have actively engaged in issuing bonds fall into this category, having 10,000 to 40,000 inhabitants. The largest share of the total volume of municipal bonds issued, however, has been issued by municipalities with over 80,000 inhabitants. The funds from such issues are generally used for purposes such as housing and road construction, water and sewage infrastructure, street lighting, sport facilities, health care facilities and renovation of city administrative facilities. Long-term bonds with a maturity of up to ten years typically fund apartment buildings, but municipal bonds also finance construction of technical infrastructure, *e.g.*, gas distribution, water supply, and sewage systems.

In the Slovak Republic, as in the Czech Republic and many other European countries, bank loans are a very important source of municipal funds. For the smallest municipalities, where collateral for such loans is lacking, banks do not represent a strong prospective source of funds. For the somewhat larger municipalities, however, which are not likely candidates for revenues from municipal bonds, bank loans are a very popular method of funding projects. As observed in Table 5, bank loans represented nearly 18% of Slovakia's municipal revenues in 2000.

Table 4

Municiipal Bonds by Population of Municipality [SKK]

Size Category	Number of Issues	Number of Cities	Total Volume
to 9,999	5	5	80,000,000
10,000–19,999	8	7	190,000,000
20,000–39,999	8	7	252,500,000
40,000–79,999	4	4	205,000,000
80,000–99,999	9	4	1,042,500,000
over 100,000	3	1	595,880,000
Total	37	28	2,365,880,000

Source: Kling and Nižňanský (2004, p. 204).

In Slovakia's 20 bank system, six have special credit products for municipalities. In the past few years, the First Communal Bank (*Prvá komunálna banka,*PKB) has been particularly active in helping some of the large, indebted Slovak municipalities (*e.g.*, Banská Bystrica and Košice) restructure their debt portfolios. About 65 per cent of Slovak municipalities use PKB as their first or only bank. It has also helped finance the environmental and investment projects supported by special state funds or by the European Union's pre-accession funds (PHARE).

Table 5

The Role of Bank Loans in Municipal Revenues [Milion SKK]

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Revenues total	20,966	20,072	22,236	25,424	28,786	28,873	27,344	33,657	32,718
Received credits*	1,004	927	3,231	2,566	2,733	2,943	3,163	6,303	2,731
Of which bank loans	n. a.	886	1,173	n. a.	2,259	2,865	2,910	5,968	2,710
Bank loans as % of total revenues	n. a.	4.4	5.3	n. a.	7.8	9.9	10.6	17.7	8.3

Source: Kling and Nižňanský (2004, p. 201).

Although municipal bonds and municipal bank loans are the most common sources of Slovakia's local indebtedness, additional types of direct and indirect borrowing are not insignificant. These include financing from "special state funds," lagged payments to suppliers of goods and services, as well as the arrears of the municipalities in their taxes, insurance and other mandatory payments.

Until 2001, special state funds provided helpful financing assistance for investment projects in the Slovak municipalities. Twelve special state funds were a part of a separate section in the state budget. Of these, four provided significant funding specifically for municipalities: the State Environmental Fund (for sewage systems and waste water treatment facilities), the state fund *Pro Slovakia* for cultural activities, the State Water Management Fund for constructing water supply systems, and the State Fund for Housing Development, for both housing construction and maintenance.

2.4 The Debt Burden and Potential Debt Hazards

2.4.1 The Perspective of Local Officials.

In considering the debt as a financial burden or potential fiscal hazard, it would seem appropriate to consider first the views of local Slovak officials. In a survey developed jointly and implemented with the assistance of the Slovak Associations of Towns and Cities (*Združenie Miest A Obci Slovenska*, ZMOS) headquartered in

Bratislava, mayors, city managers and economists provides their perspective on the local debt situation. Since the survey sought their perspective on numerous public finance issues, only one question was devoted to the debt issue, which was framed as follows:

The debt burden of our local self-government is appropriate and payments of principal and interest during the repayment period do not cause significant problems with fulfilment of financial obligations which accrue to us by extant legal norms.

The responses provided were: strongly agree, agree, undecided or unable to say, disagree, strongly disagree. Of the local Slovak officials responding to the questionnaire, 62 per cent agreed that debt was not a significant problem for municipalities, with an additional 15 per cent expressing strong agreement with the statement. Only 17% disagreed (12 per cent so indicated and another 5 per cent disagreed strongly), seeing municipal debt as a significant problem for local governments.

2.4.2 Why is Public Debt Worrisome?

The recent growth of public debt has been considerable and a source of concern to public officials. This has been a particularly important issue in the Slovak Republic because the large banks have restructured and the costs of doing so contributed strongly to higher interest payments, which have increased in excess of a full percentage point of GDP in the past six years. Nevertheless, Slovakia's official debt still remains below European averages and is below the levels stipulated by the Maastricht treaty. In 2002, significant privatisation revenues were used to reduce the public debt by SKK 59 billion (which was roughly six per cent of GDP). It is the view of Gönenç and Walkenhorst, (2004, p. 18) that if the 2002 level of the deficit were not sustainably reduced, and privatisation receipts were not used systematically to reduce public debt, the Slovak Republic could reach the EMU debt ceiling (60 per cent of GDP) before 2010.

A process of learning has been occurring among the worst offenders in the area of inadvisable debt in Slovakia. The most serious cases of municipal financial problems were experienced after local elections in Banská Bystrica in 1998 and shortly thereafter in Košice. The excesses were the result of the financial misbehaviour of the previous administrations, including acceptance of unfavourable interest rates on credits, unfavourable maturity arrangements and the failure of calculations (probably a euphemism) of financial feasibility and returns for projects. With reference to this experience, Kling and Nižňanský (2004, p. 215) refer to "misbehaviour attributed to the populist way of managing city finances for the sake of re-election." As we saw earlier, both municipalities have since enjoyed the assistance of the *Prvá komunálna banka* in restructuring their debt and moving toward the elimination of their fiscal problems.

Čapkova (1999) and other experts have called attention to the importance of debt capacity assessment in the management of municipal debt. One can monitor ratios of debt service to annual recurrent revenues, one can consider a municipality's recurrent revenues after meeting current expenditures, or one can apply various credit evaluation indicators. The most widely used of such indicators is the debt burden indicator, which compares total outstanding debt to recurrent revenues. In the next section we will want to consider debt evaluation criteria and regulation efforts in the country.

2.5 Debt Regulation in Slovakia

For several reasons, different countries have opted to limit local government borrowing. Macroeconomic policy considerations are one reason for doing so. If local authorities borrow more to sustain greater spending than would otherwise be possible, the additional spending will reinforce aggregate demand. Usually, however, the motivation for debt regulation is more simple and direct; borrowing controls will usually be imposed on local governments to ensure that they do not pursue more credits than they can manage.

Until 2001, there were no regulations on the conditions, limitations and use of such funds in Slovakia. The growing indebtedness of municipalities in general and the more critical financial situation facing some of the largest cities in particular motivated legislation designed to prevent further financial crises in municipal government. But excessive debt actually seems to be a greater concern for the central governments of the transition countries than for their municipalities. In the Slovak Republic, a small number of municipalities (including Košice, the second largest city), carry excessive debt, but in 2003 the total debt of municipalities was only SKK 14.7 billion out of a total gross public sector debt exceeding SKK 500 billion. Independent auditors now review municipal accounts for compliance with budget rules and debt limits, and they are responsible for warning the finance ministry of any breaches.

Borrowing is now permitted only for capital spending. Loans above SKK 75 million (about USD 2.4 million) must be approved by the Ministry of Finance. Since January, 2005, total debt has been limited to 60 per cent of the previous year's revenues. At the same time, debt service (required repayment of both principal and interest) may not exceed 25 *per cent* of current revenues.

Since 1998, budget procedures have been greatly improved through the addition of consolidated state budgets, a central treasury account and consolidated general government accounts. Gaping loopholes in the spending process, the existence of extra-budgetary funds and irresponsible use of public guarantees, have been eliminated. In the past few years major breakthroughs were achieved in the application of standardized fiscal controls (Gönenç and Walkenhorst, 2004, p. 17).

2.5.1 Recovery Regime

A municipality must introduce a "recovery regime" if it has failed to pay an official liability 60 days after the due date and if the total due is greater than 15 per cent of the previous budgetary year's receipts. When these conditions hold, the mayor of the affected municipality must prepare to introduce a recovery regime within seven days and preparatory measures must include a proposed recovery budget to be presented within the second week.

2.5.2 Forced Administration

If the recovery regime is not introduced as prescribed, or if the recovery regime fails to produce improvement within 120 days of its inception, the ministry is authorized to introduce a "forced administration" on the municipality. Should the forced administration still be in effect at the end of that budget year, the municipality must then begin to administer a crisis budget for the following budgetary year (Kling and Nižňanský, 2004, p. 189).

A municipality's capital budget can show a deficit only if that deficit is covered by funds from previous years or by credits covered in succeeding, multiple-year planning budgets. In an exceptional situation in which a municipality's autonomy is endangered, the municipal council can approve the use of up to 25 per cent of the year's budgeted capital revenues to cover current expenditures (excluding wages and salaries). In summary, the Republic of Slovakia has put into place a series of measures that assure fairly rigorous budget discipline.

2.6 Conclusions

Debt regulations have been enacted by the central government of the Republic of Slovakia in a timely manner to assure that debt management problems can be avoided for its subnational governments. These measures may have come too late for a small number of municipalities mentioned earlier, which are currently in the process of overcoming the effects of bad judgments or insufficient budget discipline.

Most municipalities have seemed to follow a cultural remnant of the previous era which demanded the avoidance of public debt altogether. This general unwillingness to leverage current activities or even future development may not have contributed to the development of Slovakia's cities and towns, which subsisted in the most modest circumstances through the end of the central planning era. But that unwillingness certainly did leave the municipalities without debt burdens to complicate the development paths now opening up to them after fifteen years of transition history and the 2004 accession to the European Union.

When fiscal decentralisation began to be discussed as public policy (even if not pursued ardently) in the early years of the transition, the municipalities of the Slovak Republic could expect very modest revenues through shared taxes, grants

or other transfers. Nor were they endowed with any significant sources of "own" revenues – property tax could yield for Slovakia's subnational governments more *per capita* revenue than was ever collected in the Czech Republic, but bottom line totals were small. Local taxes and fees likewise yielded an insignificant share of total revenues, since they were limited to those prescribed by the central government with parameters and constraints likewise imposed from above. Given the backlog of needs found in the local communities, it would not have been surprising to see many more municipalities taking advantage of the possibilities of leveraged development and many more of them also encountering rough waters as a result of inept fiscal management.

The debt situation was explicated with reference to data in previous sections of the paper. It seems appropriate to conclude here, however, with a summary of the data for the years 1999 through 2004, presented in Table 6. One observes there that per capita debt in 2004 amounted to SKK 3,628.34 (c. USD 116.16 in spring of 2006), which compares to the per capita debt in the Czech Republic for that same year of CZK 7,617.71 (c. USD 320.98 in the spring of 2006). That is not a lot of debt at the municipal level. In that year, local debt was only 3 per cent of the total public sector debt in Slovakia, while it was 13 per cent in the Czech Republic.

During these years, the public debt of Slovakia as a percentage of GDP averaged 45.8 per cent, but local debt was only 1.34 per cent of GDP. It can clearly be stated that if there is a serious debt problem in Slovakia, it is a national rather than local one. By 2004 the public sector, largely the central government, was spending SKK 58,076 (c. USD 1,859 in the spring of 2006) per citizen annually. But local expenditures were increasing quite rapidly over this period on a per capita basis. Whereas they had amounted to only SKK 4,837 (USD 154) in 1999, by 2004 they had grown to SKK 18,934 (USD 606) for each citizen for each year.

Public services are improving over time, but it is clear that Slovak citizens are also paying for those improvements. To a certain extent, that burden will in the next few years, thanks to EU regional development programs, be shared to some extent by other Europeans. But the programs in question will require matching funds from the regions to be benefited. Those matching funds will require additional debt as well.

Public debt in the Slovak Republic is largely central government debt, but local debt has begun to increase significantly. The local debt is owned in good measure by the largest cities of Slovakia, but smaller cities and towns have development needs that make the desirability of prudent debt more obvious to local officials who have long been under subtle, long-standing cultural norms that discourage hasty incursions into deficit spending. Now that inept local debt management experience has surfaced and been publicized, and now that the central government has put debt regulation into place, there is no reason for serious concern about any future fiscal

Table 6

Public Debt and Public Expenditures in the Republic of Slovakia, 1999 – 2004

	1999	2000	2001	2002	2003	2004
GDP current prices (mil SKK)	844108	934079	1009839	1098658	1201196	1325486
Total Public Debt (mil SKK)	404898	472427	498707	481300	492141	563367
Total Public Debt as % of GDP	47.97	50.58	49.38	43.81	40.97	42.50
Total Expenditures (mil SKK)	23490	241125.3	249723.9	272003.8	289044.2	312732.6
Population	5398657	5402547	5378951	5379161	5380053	5384822
Local Debt (mil SKK)	11223	12577	13004	14880	14697	19538
Local Receipts		33657.3	32718.1	57489.6	70323.4	76220.9
Local Expenditures (mil SKK)	26114	28627	59328	80122	86372	101957
Total Expenditures (% of GDP)	2.78	25.81	24.73	24.76	24.06	23.59
Total Expenditures per capita	4351.082	44631.78	46426.13	50566.21	53725.16	58076.68
Total Debt per capita	74999.76	87445.24	92714.55	89474.92	91475.12	104621.3
Local Debt as % of GDP	1.33	1.35	1.29	1.35	1.22	1.47
Local Debt as % of Total Debt	2.77	2.66	2.61	3.09	2.99	3.47
Local Debt per capita	2078.85	2327.976	2417.572	2766.231	2731.757	3628.346
Local Expenditures (% of GDP)	3.09	3.06	5.87	7.29	7.19	7.69
Local Expenditures per capita	4837.129	5298.797	11029.66	14894.89	16054.12	18934.14

Source: Ministry of Finance, Republic of Slovakia

problems related to local deficit spending. Any debt problems henceforth are likely to be national problems.

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3. Municipal Debt in the Czech Republic[1]

Lucie Sedmihradská and Ivana Šimíková

3.1 Introduction

The municipal debt amounted to 80 bill. CZK (2.8 per cent GDP) in 2005 and it was about 10.5 per cent of the total Czech public debt. It included bank credits (51.2 per cent), municipal bonds (33.1 per cent) and returnable financial aid from other public budgets (state and regional budgets and extra-budgetary funds) (15.8 per cent) (see MF ČR, 2005a).

There are 6,244 municipalities in the Czech Republic and therefore there are many differences in the indebtedness of individual ones. There were 3,217 indebted municipalities at the end of 2004 and the debt per capita varied from 0 CZK to 29,112 CZK with an average of 7,337 CZK. Almost all municipalities with more than 5,000 inhabitants are indebted, contrary to the smallest size groups, where only 15 to 20 per cent of the municipalities are indebted (see MF ČR, 2005b).

The goal of this paper is to explore the development of the volume and the structure of the municipal debt and to analyse the factors which influence the decision of a municipality to borrow.

In the first part of the paper we briefly describe municipalities in the Czech Republic, their functions, responsibilities and revenues. In the second part we summarise information on municipal debt in the Czech Republic, i.e., its volume, structure and development. In the third part we analyse the legal environment of municipal borrowing: the different debt instruments and the debt service ratio monitoring. In the fourth part we identify the main factors taken into account when a municipality is deciding whether to borrow or not and we present some cases which illustrate the situation. Finally, we point out the similarities and differences of the municipal and state (national) debt from the point of view of the debtor.

3.2 Municipalities in the Czech Republic

The Czech Republic is a unitary state. The Constitution from 1993 establishes two levels of local governments: regions and municipalities.

Municipalities are basic territorial self-governing communities, i.e., public corporations acting sui juris in legal relations, responsible for the results of these relations. There are currently about 6,244 municipalities.

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The 14 regions were established in 1997, the first regional representatives were elected in November 2000 and the regional governments have been in place since January 1, 2001. The region is a public corporation, which acts in legal relations on its own behalf and carries responsibility resulting from these relations. It takes care of the general development of its territory and needs of its citizens, especially in the field of social care, environmental protection, transportation, education, culture, and security.

Until December 31, 2002 there also existed 76 districts, i.e., deconcentrated branches of the national government in the Czech Republic. Their existence came to an end as a part of the public administration reform.

The basic municipalities' rights are:

1. To own a property: Property has been returned to municipalities in two waves. The first wave was in 1991 and the municipalities received back most of their property. The second wave took place in the framework of the process of regions' creation in 2000 and the decay of districts in 2002 and the subsequent transfer of their responsibilities on the municipalities. Property represents possible rent incomes. Above all, it is an asset-reserve that can be used in financial and budgetary distress (property sale). The property can also be used as a credit deposit (especially real estate).
2. To act on its own behalf, i.e., to decide as a self-government unit in matters dealing with the so-called self-administration area: Self-administration represents for the municipality both rights and duties. There are defined services, which a municipality must provide in the self-administration provision, e.g., elementary schools, kindergartens, children's homes, rest homes and social housing, theatres, libraries and museums, free-time activities facilities, water quality and delivery, gas and electricity delivery, public space cleaning, cemeteries, public roads provision, public lighting, public transport, municipal policy, firemen etc. Municipalities must finance services of the self-administration from their own revenues, especially from tax revenues.
3. To manage responsibilities on behalf of the national government, i.e. to administer tasks delegated by law: The state administration is delegated only on some municipalities. The law on assignment of municipalities with delegated authority and municipalities with extended activity (Act # 314/2002 Coll) lists these municipalities. The scope of the state administration is determined together with the grants for its provision. These grants are drawn from the state budget. The provision of the state administration theoretically should not financially burden the municipality. However, in reality, the grants finance only a part of the total expenses.

Municipal revenues are specified in two laws: the Budgetary rules for territorial entities (Act # 250/2000 Coll.) lists all municipal revenues and Law on tax

assignment (Act # 243/2000 Coll.) specifies the revenue sharing formula. Table 1 shows the structure of the municipal revenues.

Table 1

Structure of the municipal revenues, CR, 1993 – 2004 (%) [2]

	1993	1996	1999	2002	2004
Tax revenues	39.5	45.0	44.4	47.8	46.7
Non tax revenues	21.0	13.2	14.3	11.4	9.4
Capital revenues	6.5	4.5	18.5	5.6	4.5
Grants	32.1	37.3	22.9	35.2	39.4
Other	0.9	0.1	0.0	0.0	0.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

The tax revenues are the largest and the most important source of municipal revenues. Their substantial part comes from taxes, which are shared among state, regions, municipalities and the state funds. In 2002, municipalities received 15.5 per cent of their total revenues from value added tax, 14.2 per cent from personal income tax and 12.6 per cent from corporate income tax. The remainder of the tax revenues came from real estate tax and local, administrative and environmental fees. The decisive factor in the tax sharing formula is the number of inhabitants and the size of the municipality: the bigger municipality the higher the per capita coefficient. This prioritising of bigger municipalities is the subject of an intensive debate.

The non-tax revenues are mostly rental income or user charges. Capital revenues come from property sales. We can observe an increase in the capital revenues in the period 1998 – 2000, with a peek in 1999, when the municipalities sold their shares of the utility companies. All the grants have a special purpose character.

3.3 Municipal debt – an overview

In 2005, the municipal debt amounted to 80 bill. CZK (2.8 per cent GDP) and it was about 10.5 per cent of the total Czech public debt. Table 2 shows the development of the public debt in the Czech Republic and its composition.

The municipal debt in real terms grows continuously, although more slowly than the total public debt and than GDP.

2 MF ČR (1999) State Final Account of the Czech Republic. Ministry of Finance, Prague 1993 – 1999 and MF ČR (2005b) Územní rozpočty v roce 2004. In *Obec a finance*, No. 3, Vol. 2005.

Table 2

Public debt and its composition [3]

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Public debt (bill. CZK)	217.5	240	275.2	332.4	404.5	444.5	553	659.4	760.8	849.4
Public debt (% GDP)	12.2%	12.2%	13.5%	15.5%	17.5%	18.4%	21.6%	23.8%	26.1%	27.2%
Of which (share on the total public debt)										
- state budget	76.1%	77.6%	79.6%	83.6%	82.6%	86.7%	86.8%	88.1%	89.1%	89.7%
- health insurance	1.1%	0.7%	0.4%	0.2%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%
- state funds	7.6%	6.0%	5.8%	4.2%	5.4%	0.7%	0.4%	0.2%	0.3%	0.5%
- territory entities*	15.2%	15.7%	14.1%	12.0%	11.8%	12.5%	12.7%	11.7%	10.5%	9.8%

* municipalities and regions from 2001 and municipalities and districts until 2000

Table 3

Aggregate municipal debt (bill. CZK) [4]

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total	3.4	14.3	20.3	28.3	34.4	39.0	40.0	41.0	48.3	55.8	70.4	74.8
Statute cities		8.8	10.4	12.6	13.6	15.6	16.4	16.9	24.2	29.6	42.4	45.9
Other municipalities		5.5	9.9	15.7	20.8	23.4	23.6	24.1	24.1	26.2	28.0	28.9
- share of the statute cities		61.5%	51.2%	44.5%	39.5%	40.0%	41.0%	41.2%	50.1%	53.0%	60.2%	61.4%

3 MF ČR (2006) Macroeconomic forecast of the Czech Republic. Ministry of Finance, Prague, January 2006.

4 Komárek, E. (2005) Zadluženost samosprávných celků; Skutečný problém nebo jen téma k občanské diskusi? *Veřejná správa* č. 32, 2005, s. VI.

Table 4

Municipal debt and municipal size structure in 1999 and 2004 (CZK)[5]

Municipal size category	Number of inhabitants in the whole size category	Share inhabitants in the whole size category (%)	1999		2004	
			Municipal debt (mil. CZK)	Average debt per inhab. (CZK)	Municipal debt (mil. CZK)	Average debt per inhab. (CZK)
0 – 100	40 392	0.40%	40	990	40	981
101 – 200	166 490	1.63%	257	1 544	260	1 562
201 – 300	222 181	2.18%	385	1 733	346	1 559
301 – 1 500	1 854 138	18.17%	4 454	2 402	6 371	3 436
1 501 – 5 000	1 506 011	14.76%	5 404	3 588	6 225	4 133
5 001 – 10 000	896 863	8.79%	3 240	3 613	4 048	4 514
10 001 – 20 000	961 888	9.43%	3 472	3 610	3 339	3 471
20 001 – 30 000	675 620	6.62%	1 451	2 148	2 675	3 959
30 001 – 40 000	354 678	3.48%	980	2 763	812	2 290
40 001 – 50 000	184 887	1.81%	392	2 120	659	3 563
50 001 – 100 000	1 225 713	12.01%	2 879	2 349	3 408	2 781
100 001 – 150 000	102 246	1.00%	593	5 800	752	7 355
150 000 and more	853 050	8.36%	4 720	5 533	12 161	14 256
Prague	1 160 118	11.37%	11 706	10 090	33 773	29 112
Total	10 204 275	100.00%	39 973	3 917	74 868	7 337

5 *Obec a finance* (2001) Ještě k zadluženosti obcí. In *Obec a finance*, No. 2, Vol. 2001 and MF ČR (2005b) Územní rozpočty v roce 2004. In *Obec a finance*, No. 3, Vol. 2005.

Between the years 1994 and 2004 the municipal debt increased more than five times from 14.3 bill. CZK to 74.8 bill. CZK. Only during the years 1998 – 2000 can we see stagnation. Table 3 shows the development of the municipal debt. The municipalities are divided into two groups: statute cities [6] and other municipalities.

The statute cities owe about 60 per cent of the total municipal debt. This share gradually grows, similarly to the volume of their debt. The debt of the other three thousand municipalities is at a standstill and only a few municipalities have debt problems. See Table 4 for the comparison of the indebtedness of municipalities in the different size groups.

Municipal debt is composed of credits, municipal bonds and returnable financial aid. Table 5 shows the development of these components between 1994 and 2004. Figure 1 shows the comparison of the debt structure in the statute cities and in the other municipalities. First we can see that the growth of the debt in the statute cities is much higher than in the remaining municipalities. Second, the structure of the debt differs significantly in the two groups. Third, the debt composition changes over time in both groups.

Generally we can say that municipal debt is steadily increasing in the analysed period. The statute cities have become the main debtor since 2002. Their share is more than 60 per cent of the total municipal debt. The municipal debt growth is an alarming fact. While the municipal debt growth rate, excluding statute cities is declining, the debt growth rate of the statute cities is increasing. This fast debt growth rate can create long-term problems with municipal budget financing.

3.4 Legal environment of municipal borrowing

Debt regulation for municipalities is addressed in the relevant laws: the Law on municipal establishment (Act # 128/2000 Coll.), Budgetary rules for territorial entities (Act # 250/2000 Coll.) and the Law on bonds (Act # 190/2004 Coll.). Municipalities are generally viewed as any other debtors; however, there are limits on the right of municipalities to issue guarantees of natural and legal entities except for some cases specified by law. The law on bankruptcy and settlements (Act # 328/1991 Coll.) does not refer to municipalities and municipalities therefore cannot go bankrupt.

According to the budgetary rules for the local governments, the annual budget must be drawn up as a balanced budget. It can be approved with a surplus if the revenues of the year in question are especially intended for use in the following years or intended for repayment of a credit principle from previous years. A deficit budget can be approved only if the deficit can be paid using financial means from the past years or a contractually secured loan, credit, returnable financial aid, or by the yield from sales of the municipality's own bonds.

6 Statute cities are listed in the Law on municipal establishment (Act # 128/2000 Coll.) and they are regional capitals and other large cities (19 cities).

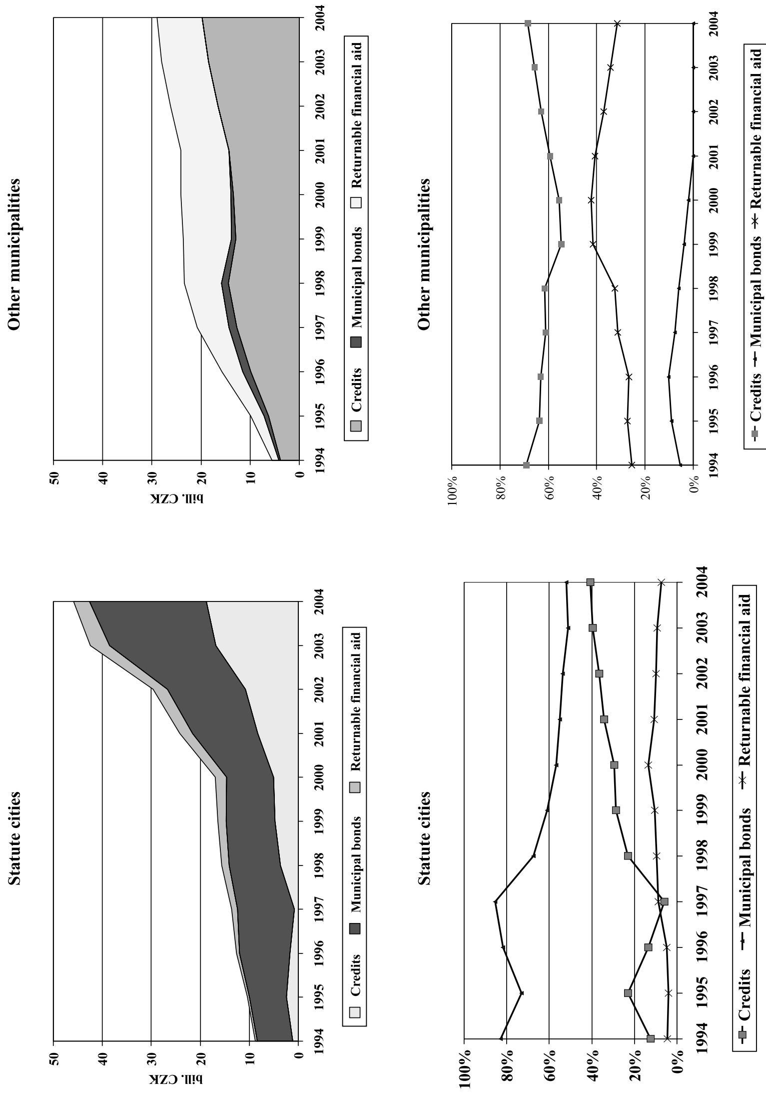
Table 5
Structure of the municipal debt (bill. CZK)[7]

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Credits	2.5	4.9	8.7	11.6	13.5	18	17.6	18.4	22.6	27.3	35.2	38.5
Municipal bonds		7.6	8.5	11.9	13.2	11.9	10.9	10.1	13.3	15.9	21.7	23.9
Returnable financial aid	0.9	1.8	3.1	4.8	7.7	9.1	11.5	12.5	12.4	12.6	13.5	12.4
Total	3.4	14.3	20.3	28.3	34.4	39.0	40.0	41.0	48.3	55.8	70.4	74.8

7 MF ČR (2005a) Pololetní zpráva o plnění státního rozpočtu v roce 2005 Ministry of Finance, Praha, p. 154.

Figure 1

Debt composition in the statute cities and in the other municipalities[8]



8 MF ČR (2005a) Pololetní zpráva o plnění státního rozpočtu v roce 2005 Ministry of Finance, Praha, p. 154 and 155, own adaptation.

The level of the budget deficit is determined and approved solely by the municipal council; neither the Ministry of Finance nor the region has the right to step in, in this decision-making process. The acceptance of credits is subject to approval by the municipal council. There is no central government limitation of the volume of credits (or borrowing in general) a municipality can accept[9]. There are two indirect legislative measures which influence the indebtedness of the municipalities: legal regulation of the issue of municipal bonds, when the Ministry of Finance must approve the bond issue and the law on audit of the territorial entities, which deals also with municipal liabilities (see Komárek, 2005). Since 2004, there is effectively a non-legislative measure, i.e. the debt service ratio regulation (see section 4.2 for details).

3.4.1 Debt instruments and their legal regulation

There are three types of returnable municipal revenues (see Peková, 2004):

- Bank credits,
- Municipal bonds and
- Returnable financial aid.

A bank credit is granted on the basis of a contract pursuant to the Commercial Code. Municipalities can also accept credits from abroad and in foreign currencies.

Bank credits are the most common type of municipal borrowing. The reasons for this situation are both on the side of the municipalities, i.e., general knowledge of the product, larger offer of the bank loans specialised on a municipal sphere and possibility of a real estate guaranty, and on the side of the banks because municipal credits are considered credits with minimum risk. Banks use for the coverage of the credits as a pledge, municipal property, third-party guarantees, and pledges issued against securities and various combinations of these possibilities. Municipalities can also use their future budget revenues as a guarantee.

There is still space in the market. The statute cities did not use bank credits to such an extent as the other municipalities and only during the last two years has their percentage of the loan financing grown.

Municipalities can issue bonds both in the Czech Republic and abroad. The Law on bonds defines the conditions for domestic issue. In the case of the issue abroad, the issuer of bonds is required to inform the Czech securities commission. Municipal bonds in the Czech Republic can be issued only upon approval of the Ministry of Finance, and then the procedure is the same as for any other issuer (see Table 1).

9 In the first half of 2002 there were established two limits for granting credits to municipalities: approval by the government was necessary for acceptance of credits from abroad and a municipality could not accept a credit if its debt service exceeded 15 per cent of the previous year's actual budget. This regulation was after much confusion during its validation, abolished.

Table 6

Basic steps of municipal bond issue [10]

1.	The municipal council approves the bond issue,
2.	Ministry of Finance agrees with the application of the bond issue, which contains the reasons for the intent to issue the municipal bonds, the basic information about the issue conditions and economic analysis of the municipality,
3.	The Czech securities commission approves the issue conditions and the leaflet and assigns the ISIN number, the proprieties of both the issue conditions and leaflet are given by the law,
4.	Publication of the leaflet,
5.	Subscription and public offer of bonds,
6.	Acceptance of the bond at a public market,
7.	Periodic and running information duty.

Bonds are now used for debt financing entirely by the statute cities. The main factor is the capital intensity of the bond issuing from the issuer side. On the other hand, there is more confidence and will to invest in the larger municipality bonds from the investor side. Some of the statute cities issued their bonds abroad – see Example 1.

Example 1

Bond issue of the City of Brno [11]

Brno (367,729 inhabitants) established in June 2001 European Medium Term Note (EMTN) program in the total volume of 300 mil. EUR on the Luxembourg Stock Exchange. Brno can consequently during a period of 10 years issue bonds up to the total volume with lowlier administration burden than single issues. So far Brno has realised two issues: 60 mil. EUR in 2001 for a period of 10 years and 85 mil. EUR in 2002 for a period of 7 years.

For the establishment of the bond program it was necessary to have a rating from Standard & Poor's a agentury Moody's Investors Service.

Brno used the first issue partly for repayment of bonds issued in 1996 on the Prague Stock exchange, as the newer debt was cheaper than the old one.

Returnable financial aid contains specific returnable interest-free loans provided by some ministries or the state funds. Loans are very often made for a specific purpose (e.g. environment protection, municipal housing renovation etc.) and conditioned by the co-financing by the municipality. These loans represent an important fund for investment financing, especially for small municipalities.

10 Law on bonds (Act # 190/2004 Coll.) and Ježek, T. et. Al: Jak emitovat dluhopisy a akcie na veřejném trhu. Komise pro cenné papíry, Praha 2004.

11 www.brno.cz

3.4.2 Municipal debt regulation

In April 2004 the government approved municipal debt regulation through the debt service ratio. The formula for the calculation is:

$$\text{debt service ratio} = \frac{\text{debt service}}{\text{debt base}}.100 = \frac{\text{interests} + \text{principal and bond instalments} + \text{leasing instalments}}{\text{tax revenues} + \text{nontax revenues} + \text{received transfers}}.100$$

The Ministry of Finance calculates the debt service ratio for each municipality and in case the ratio overruns 30 per cent, then the Minister of Finance sends a letter to the municipality. The debt service ratio was first calculated in April 2004 from the 2003 data. The municipality is required to explain within three months, the reasons for this overrun and suggest measures to improve the situation. At the same time, the municipality submits the audit report and the multi-annual budget outlook. Then the ministry evaluates these documents together with the total debt, debt per capita, tax revenues per capita, debt in the past years, size of the municipality and its overall financial situation. In case of an overrun of the debt service ratio in the next year, the Ministry of Finance will put the municipality on a list, which will be passed on to the grant providers (ministries or state funds). The grant providers should consider this list when providing new grants. There is no absolute prohibition of grant provision to these municipalities, but it may be a factor of grant rejection.

The described procedure is effective only for a short time. However, several problems arose. The debt service ratio does not say much about the total indebtedness and about the ability to pay off the debt. The ministry did not inform the municipalities sufficiently about the whole procedure and its goals. In our understanding, the procedure should have alerted both the Ministry of Finance and the particular municipality, that the debt was too high and that some measures should by applied. However many municipalities, which regularly pay off their debt, felt unfairly accused. At the same time, the "debt service ratio" is not very concrete and is therefore often confused with "indebtedness".

The list of municipalities which overrun the 30 per cent limit was not published and also the information about the highly indebted municipalities is very fragmented. Table 7 shows results of the procedure for the first half of 2004.

3.5 Deciding to borrow

Borrowing overcomes the lack of sufficient capital and enables satisfying the capital improvement needs. This also has political implications, i.e., it can influence re-election probability or increase one's self-interest. Another incentive to borrow is changing market conditions and the will to exploit them, for example to finance an older debt with a new borrowing with lower costs (see Example 1). On the other hand there are legal, political and economic factors, which do not work in favour of borrowing (see Hildreth (1996).

Table 7

Indebted municipalities and their debt service ratio [12]

	Number of municipalities		Debt service over 30%			Debt service		
Region	**total**	**with debt service**	**No debt**	**To be addressed**	**same as the last time**	**Less than 50 %**	**50 – 100 %**	**over 100 %**
Praha	1	1						
Středočeský	1145	386	4	33	8	24	5	8
Jihočeský	622	226	2	15	6	10	4	3
Plzeňský	501	204	1	11	4	8	3	1
Karlovarský	131	60	1	4	2	3	2	-
Ústecký	354	155	1	5	2	3	2	1
Liberecký	216	104	1	5	-	2	3	1
Královéhradecký	448	211	1	12	5	7	5	1
Pardubický	452	229	2	21	9	11	7	5
Vysočina	729	237	-	23	9	11	7	5
Jihomoravský	646	304	1	17	8	13	3	2
Olomoucký	393	243	-	7	2	5	1	1
Zlínský	304	185	-	9	3	5	2	2
Moravskoslezský	302	216	-	9	2	5	2	2
Total	6244	2761	14	171	60	111	44	30

12 Eliáš, A. (2004) Hodnocení dluhové služby: Jaký bude vývoj zadlužení a jeho regulace v budoucnosti. *Obec a finance*, No. 5.

There are major differences among the indebtedness of municipalities in the Czech Republic. Municipalities are not equal in their ability or desire to borrow. Due to the high number of municipalities in the Czech Republic and big differences among them, we decided to study only a few cases and to summarise the common features. We combined two methods: first we studied cases presented in local and national press, together with official financial data provided by the Ministry of Finance and by the municipalities themselves on the Internet. Second, we carried out an interview with the mayor of a municipality, which had accepted a loan in 2005.

Municipalities borrow for short, medium or long periods. The short term borrowing, which is necessary in case of short-term lack of available financial means, is mostly realised through a bank overdraft or a bridging loan provided by the bank, which administers the bank account of the municipality. All of the main commercial banks offer special products for the municipalities including short-term loans.

In the case of the medium and long-term borrowing, there are many facts which are to be considered before the municipality actually borrows.

First, the ability to pay back the borrowed funds with interest must be evaluated. How will the revenues be in the coming years? The volume of the municipal revenues grows with the size of the municipality, however, over-proportionally. This is caused first by the construction of the revenue sharing formula, when the bigger municipalities receive more revenues from the shared taxes (personal and corporate income tax and value added tax) and second by the ability of the bigger municipalities to generate more, other than tax, revenues.

Therefore the bigger municipalities borrow more – see the aggregated data in Table 4. Smaller municipalities have to decide more carefully about the acceptance of another credit (see Example 2)

Example 2

Limited capacity to accept a new credit [13]

Náměšť na Hané (1,889 inhabitants) had to refuse in 2005 a grant (24 mil. CZK) form the Joint regional operating program (i.e., the EU Structural funds) for the reconstruction of the castle, because there was a requirement of co-financing (8 mil. CZK). The municipality starts building sanitation and participates in a sewage construction in a nearby town. Therefore the municipality accepted a bank credit of 20 millions CZK. Another credit for co-financing of the grant would be too risky for a small municipality. At the same time the bank did not recommend acceptance of another credit.

13 Švedrlík,M. Seznam dlužníků obce odmítají. MF Dnes, 30. 5. 2005 and Vránová, M. Na úpravy si zámecký pakr v Náměšti počká. Olomoucký den, 21. 4. 2005.

The evaluation of the capacity to borrow is closely linked to the calculation and assessment of the future debt service ratio in order to overcome possible difficulties in case of its overrun.

Acceptance of a long-term credit also limits the space of the municipal management for a long period (see Example 3). This example, however, also shows another common issue – small municipalities often lack basic services, such as water supply and sanitation or gas distribution. Another reason to borrow is to have sufficient funds for co-financing of grants (see Example 2).

Example 3

Financial management with a long-tem credit [14]

Malečov (675 inhabitants) borrowed in 1996, 6 million CZK from the Česká spořtelna for gas distribution; since that time it has paid regularly the instalments and the interests. The credit will be repaid in 2006. The debt service ratio was, in 2004, 20.4%. This debt burdens the municipal budget and limits further investment, however, the gas provision was necessary.

Next is the decision where to borrow. The returnable financial aid from the other public budgets is very limited, both to the total volume and the special purpose. The issue of municipal bonds is costly and therefore this source is accessible only for large municipalities. The bank credit is therefore the most common option.

Selection of the bank, where the municipality will apply for the credit, can be done also in the form of a public order (see Example 4). More common, however, is negotiation only with the bank, which manages the municipal accounts. The bank always analyses the financial statements of the municipality, i.e., the budget outlook and the final accounts usually for the last two budget years, and evaluates the economic situation of the municipality. This is an important fact, which guards against excessive indebtedness, next to the above mentioned legislative and non-debt limitation measures.

14 Zcela bez dluhů bude Malečov za dva roky. Ústecký deník, 11.8.2004 and Ministry of Finance (ARIS).

Example 4

Selection of the creditor through the public order [15]

Třebíč (38 715 inhabitants) participates in an environmental project called Dyje I. The total costs of the construction will be 68 mil. CZK, of which 60 mil. CZK will be financed by a credit. Třebíč announced in March 2005 a public order for this credit on it official Internet site of public orders. Then a commission appointed by the city commission ranked the offers and selected the winner. Then a contract with Česká spořitelna (credit of 60 mil. CZK, with interest rate PRIBOR+0.03 per cent p.a., with no security, maturity 31 December 2016, with utilisation from July 2005 to March 2007) was signed.

3.6 Municipal versus state debt

The situation of local and central government differs in several aspects when deciding to borrow.

The main limitation of borrowing in case of a municipality is its capacity to borrow, i.e., its ability to pay back the instalments and the interest, which may be, in the case of small municipalities, quite low. This condition naturally holds for the central government as well, but in absolute terms it can borrow significantly larger amounts.

The second difference is the usual debt instrument bank: credit in case of the municipality and bonds in case of the state government. Only large municipalities (i.e. the statute cities) can or need to borrow such high amounts that it is reasonable to use bonds. For other municipalities the issuance costs are too high.

The third difference is the special purpose of credit/borrowing in case of the municipality. The requirement of a balanced municipal budget means that the municipality first negotiates and approves the borrowing and then includes into the budget both the borrowing and the expenditures financed through the borrowing. Thus the budget is balanced. On the contrary, the central government submits to the parliament a budget with a deficit and proposes how to finance this deficit. There is no direct link borrowing – concrete expenditure as in a municipality. Therefore the central government can also use borrowing for financing of current expenditures, which is practically impossible in the case of a municipality.

3.7 Conclusions

The total municipal debt in the Czech Republic is not too high (2.7 per cent GDP); however it is growing steadily and there are a few municipalities which have difficulties with repayment of their debts. Therefore the government approved a procedure for the debt service regulation in 2004. Next to this, the municipal borrowing

15 reports from the commission meetings (http://www.trebic.cz) and http://www.centralniadresa.cz

is limited indirectly (1) by the law on budgetary rules of territorial entities, which permits approval of a deficit budget only in case of contractually secured credit or other means of borrowing, (2) by the law on bonds, which requires approval of the bond issue by the Ministry of Finance and (3) by the economic analysis of the municipality performed by the creditor (mainly a commercial bank).

Municipalities are not equal in their ability or desire to borrow. Especially small municipalities (80 per cent of the Czech municipalities have less than 1,000 inhabitants) have very limited capacity to borrow. Their revenues are quite low and repayment of an existing debt hinders the possibility to accept another borrowing. These municipalities thus may even have difficulties in receiving grants requiring co-financing. The possibility to issue municipal bonds is, in reality, closed for small and medium-sized municipalities. There is no system of financial intermediaries.

The position of a municipality and the state as a debtor is different in several aspects: capacity to borrow, debt instrument and special-purpose of debt financing in case of the municipalities.

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Interview with the mayor of Rudn, Dr Jana Kozáková, carried out on 7 March 2006

4. Debt Management of Czech Local Governments: Problems and Solutions Resulting from Case Studies[1]

Robert Jahoda

4.1 Local Government Finance: An Overview

The Czech Republic is a unitarian state. The Constitution specifies three levels of government of the Czech Republic with separate budgets. The top level is represented by Central Government; fourteen higher self-administrating units are called Regional Governments and the lowest level is represented by approximately six and a half thousand Municipal Governments. Regions and municipalities are responsible for expenses within "own" and "delegated" responsibility.

The following Table 1 describes the share of local finance (municipalities and regions) in GDP. The share of expenses in GDP has been stabilised around 12 per cent recently. Comparability of statistical data of local finances is partly biased by the interpretation of district office budgets as part of the state line of public administration of the Czech Republic. Prior to 2000, these budgets were not part of the state budget and were included in local finance, together with municipal budgets. In 2001, until closing of the district councils their budgets were part of the state budget.

For revenues and expenditures of municipalities see Table 2 below. The table shows that the share of expenditures in GDP has been relatively stable, with the volume of revenues corresponding to the volume of expenditures. Economies of municipalities are in deficit, but the balances are relatively low. For more details of the deficit and the indebtedness see the following sections.

The volume of tax revenues has been relatively stable since 1993, with certain increases since 2002. While tax revenues show a slightly growing trend, the non-tax revenues continue to moderately decrease. This does not encourage the trend of responsibility transfer onto municipalities. These two incomes together, however, represent a relatively stable source. Capital income is expected to drop in future years. More than one-fifth of all municipal sources in the Czech Republic come from state budget subsidies, from state funds, and from other programmes, such as EU financing programmes (via the National Fund).

1 My thanks to Dr Zdenka Jiraskova and Alena Holmesova of the Ministry of Finance, Czech Republic, for the helpful discussion of this topic in May, 2003 and to the Lincoln Institute of Land Studies and the Marriott School, BYU for financial support of this project.

Table 1

Distribution of Expenditures between the Levels of Government

	1997	1998	1999	2000	2001	2002	2003	2004	2005
As a percentage of GDP									
Public Sector	39.3	38.4	39.0	39.6	40.7	42.8	43.1	41.6	42.3
State Budget	28.2	27.9	28.4	28.6	28.3	28.4	30.6	29.3	29.1
District offices	1.2	1.0	1.0	0.9					
Regional offices					0.6	1.5	3.7	3.6	3.8
Municipalities	7.2	6.9	7.2	7.5	8.3	8.7	9.6	9.3	7.4
As a percentage of total PSE									
Public Sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State Budget	71.9	72.6	72.9	72.2	69.5	66.3	71.1	70.4	68.6
District offices	3.0	2.6	2.5	2.3					
Regional offices					1.5	3.4	8.5	8.6	8.9
Municipalities	18.4	18.1	18.5	18.9	20.4	20.3	22.4	22.3	17.6

Source: State Final Account for 1997 – 2005, MFCR (2006)

Table 2

Consolidated balance LG's budgets [in % GDP]

	1999	2000	2001	2002	2003	2004	2005
I. Tax revenues	3.7	3.9	3.8	4.1	4.2	4.2	4.3
II. Non-tax revenues	1.2	1.1	1.0	1.0	0.9	0.8	0.8
III. Capital revenues	1.8	0.8	0.5	0.5	0.5	0.4	0.5
Own revenues	**6.7**	**5.8**	**5.3**	**5.6**	**5.6**	**5.4**	**5.6**
IV. Transfers	1.6	1.8	2.7	3.0	4.0	3.5	2.1
2.1 Revenues	**8.3**	**7.6**	**8.0**	**8.6**	**9.5**	**9.0**	**7.7**
V. Current expenditures	4.8	5.0	5.6	6.0	6.9	6.5	5.0
VI. Capital expenditures	2.5	2.6	2.8	2.9	2.8	2.8	2.4
2.2 Expenditures	**7.3**	**7.6**	**8.4**	**8.9**	**9.7**	**9.3**	**7.4**
Balance	**1.0**	**-0.1**	**-0.5**	**-0.3**	**-0.2**	**-0.4**	**0.2**

Source: State Final Account for 1999 – 2005

4.2 Regulation of Local Government Borrowing

4.2.1 Scope of the Local Government Borrowing

Self-administrative units of the Czech Republic for funding communal public investments usually use refundable resources. Small municipalities with small budgets may get into difficult financial situations at the beginning of the year, having no reserves from previous periods and forced to borrow, often for provisional financing of operational costs.

Local governments may make use of:

- **Refundable financial assistance and loans,** for example from the state budget or from state funds, or from the budget of another municipality, or from the regional budget, either interest-free or in the form of low interest bearing loans,
- **Short-term credit loans,** refundable in one year, or by the end of the respective budget year,
- **Medium-term credit loans,** refundable in four years, or sometimes over a five-year timeframe, and
- **Long-term credit loans,** refundable in ten years, or sometimes fifteen years,
- Or, under certain terms, the municipality may **issue securities** for financial source acquisitions (this variant involves additional costs of the bond issuing – issue procurement etc., reducing the net revenue from the issue).

Credit loans, and therefore indebtedness, must be approved by the municipal authority. Loans are provided on the basis of loan agreements concluded with a bank and approved payment schedules – refunding of the body of the loan and the interest from the municipal budget. The banks provide loans to municipalities against collateral (capital, future income, securities).

The municipal self-administrative authority should loan refundable financial means up to the amount corresponding to annual debt service equal to the lowest positive current budget excess assumption (i.e. the difference between regular income and regular expenses) for the period of the loan refunding. The need for realistic planning of the amount is more than obvious. This could represent a problem, especially for smaller municipalities.

Basic information about the encumbrance development in the self-governmental regions is shown in Table 3. This table also compares the encumbrance of municipalities with the total encumbrance of the whole public sector and also with GDP growth.

From this table it can be seen that the major part of public debts is formed by the state debt (central government) and also the dynamics of debt are highest at the central government level. Regions' encumbrance at present is quite marginal and

does not pose any problem for the public budgets. Municipal debt has risen slightly in the last few years, but if we compare it to GDP we can say that its high is quite negligible and has stayed at the same level over the last three years.

Table 3
Development of regional and municipalities' encumbrance in comparison with encumbrance of the whole public sector

	1997	1998	1999	2000	2001	2002	2003	2004	2005
State debt in CZK (bln.)	172.2	193.6	226.8	287.4	342.5	392.9	488.8	585.8	684.2
Debts of regions in CZK (bln.)	-	-	-	-	n.a.	n.a.	1.3	1.5	2.9
Debts of municip. in CZK (bln.)	34.4	39.0	40.0	41.0	48.3	55.8	70.4	74.8	79.0
Debts of municipalities as a percentage of GDP	1.9 %	2.0 %	2.0 %	1.9 %	2.1 %	2.3 %	2.7 %	2.7 %	2.7 %
Proportion of municipal debt on the total public debt	15.8%	16.3%	14.5%	12.3%	11.9%	12.6%	12.7%	11.3%	10.4%
Total public debt in CZK (bln.)	217.5	240.0	275.2	332.4	404.5	444.5	553.0	659.4	762.1
Public debt as a percentage of GDP	12.2%	12.2%	13.5%	15.2%	17.2%	18.0%	21.5%	23.7%	25.6%

Source: State Final Account for 1997 – 2005

The positive aspects of local borrowing include the fact that, as a rule, municipalities used borrowing with a refunding deadline exceeding one year for financing capital costs of investment, mostly into the local public sector. This was mainly due to the poor technical infrastructure in towns and villages.

Significant increase of municipal debt during 2003 was due to major floods in the summer of 2002 and huge reparation works on municipal property in the following years. The image of municipal indebtedness is somewhat distorted by the debts of big cities – Prague, Brno, Ostrava and Plzeň. In 2005, the encumbrance proportion of these four corporate towns reached a total level of 61, 3 per cent of total municipal debt and this debt is slightly increasing (more in Table 4). When we exclude the encumbrance of these four towns we can say that debt of all other municipal subjects in the Czech Republic is, in the long term, around the level of 1 per cent GDP.

Table 4
Balance sheet as at 31st of December in billions CZK

	Praha (1.170.571 inh.)		**Brno (367.729 inh.)**		**Ostrava (311.402 inh.)**		**Plzeň (162.627 inh.)**	
	2001	2004	2001	2004	2001	2004	2001	2004
Total liabilities (202)	268.8	305.1	52.9	62.7	43.8	47.5	24.8	26.9
Foreign sources (159)	28.3	47.0	5.9	10.1	2.2	5.2	1.5	1.0
Long term commitments (166)	11.7	17.3	2.7	5.5	0.1	3.3	0.0	0.0
Short term commitments (189)	8.5	11.6	3.0	3.8	0.6	0.6	0.9	0.2
Bank loans and credits (196)	6.1	16.0	0.1	0.8	1.5	1.1	0.6	0.8
Foreign sources compared to one inhabitant [thousands CZK]	24.1	40.2	16.0	27.6	7.1	16.6	9.4	6.2

Source: ARIS

From a macro economical point of view, the municipal encumbrance at a total high of 2.7 per cent GDP does not pose any problem. But if we zoom in a little, we find that some municipalities have high debts and could face some problems while servicing the debts. Special attention is also paid to the capital city Prague, because of the significant growth of foreign sources in the last couple of years.

4.2.2 Origins of Local Government Borrowing regulation

Not all municipalities were always able to realistically assess the purpose of the investment covered with a refundable financial source (loan), especially in the cases of financing of the so-called profit investments from credit loans, where very often the planned profit to be used for the loan refunding did not reach the levels assumed in the beginning – this was especially the case of certain small municipalities such as Rokytnice nad Jizerou (see case study). Municipalities often underestimated the business risks of their enterprises.

Another negative impact on municipal debts was represented by local business credit loans with the business risks taken over by the municipalities without appropriately weighing the risks. When a businessman failed to refund a loan, the municipality as the guarantor, had to take over the responsibility for refunding the loan.

Following the applicable legislation, the Czech state takes no responsibility for liabilities of local governments. In the past ten years, the state either did not regulate the use of refundable resources and indebtedness of municipalities at all or paid insufficient attention to the regulation. Indirect regulation of municipal indebted-

Case study: How the state solved the problem of the insolvency of Rokytnice nad Jizerou (3.254 inhabitants)

The town of Rokytnice nad Jizerou is a model warning example of failure to manage debt management. In addition to a loan for the municipal wastewater treatment plant (CZK 70 M), issue of communal bonds (CZK 120 M) the town provided collateral for the construction of a funicular (CZK 145 M). The investment into the funicular was not as profitable as expected; the debt of the town increased and Rokytnice nad Jizerou became unable to refund the debt. The Czech Consolidation Agency, taking over the debt in the meantime, ordered the first "forced" auction of municipal property (2002). The auction was to serve as a warning for other municipalities that the state would not perform the role of the "last minute guarantor".

In May 2004, the Czech Republic's government adopted principles for solving the municipal debts that were composed by the Ministry of Finance. In daily practice it means the interruption of pursuits between the municipality on one side and the State Environmental Fund and Czech Consolidation Agency on the other. Within the framework of fiscal relations rectification, Rokytnice nad Jizerou agreed with sale of "redundant" property amounting to a total of 43 M CZK and also with subsequent payoff (till 2008) of the loan's part in the amount of 25 M CZK. Other loans' debt (total amount of 230 M CZK) was forgotten. All the above mentioned operations are documented in the city's balance sheet in Table 5.

Table 5

Balance sheet of Rokytnice nad Jizerou city valid to 31st of December in millions CZK

	2001	2002	2003	2004	2005
Total assets (125)	696.7	487.6	462.3	433.3	378.2
Long term corporeal property (26)	596.1	425.6	409.8	383.5	337.8
Claims (75)	87.9	48.6	40.6	37.1	30.2
Total liabilities (202)	696.7	487.6	462.3	433.3	378.2
Property funds (131)	599.4	429.1	413.3	386.6	341.2
Economic result (158)	-326.2	-263.6	-286.5	23.0	40.2
Long-term commitments (166)	183.4	212.7	200.7	0.0	3.0
Short-term commitments (189)	18.9	17.7	27.0	-9.1	-30.0
Bank loans (196)	206.8	80.7	99.5	32.9	23.8

Source: ARIS

There are more municipalities, however, reported in the press to be approaching this state of affairs. Representatives of all municipalities should take a lesson from this example.

ness by the state was represented by the 15 per cent indicator of maximum debt service share in regular municipal income in the case of applications for non-eligible subsidies from the state budget. We can speak about state regulation in the case of communal bond issues. The regulation was first exercised through granting (or refusing) the obligatory approval of the Ministry of Finance with the issues. In the late 1990s, the regulation took the form of approval by the Securities Commission.

In 2002, Parliament passed an act regulating municipal indebtedness – however, counter-proposals raised in Parliament caused ambiguity of the selected indicator and resulted in the subsequent cancellation of the regulation by amendment to the act.

The Czech Republic's government adopted, in the Spring of 2004, a decree about the Regulation of municipal and regional debts through indexes of a debt service (more on Ministry of Finance). This task – to monitor the debt of municipalities – was assigned to the Ministry of Finance which sends the report about municipalities debts' to the government.

The "Debt service index" compares the amount of the "debt service" to the volume of "debt base" for the last fiscal year. The content of the debt service is defined as: paid interests of settled payments of emitted or bearer bonds, repayment of principals and leasing refinancing. The debt base is formed from: real achieved tax and non-tax incomes plus precisely defined types of grants from the state budget.

This "debt service index" has been calculated for every municipality and for every region by the Ministry of Finance. Those municipalities and regions which cross the given level of the debt service indicator in the high of 30 per cent are informed by mail from the Ministry of Finance with the recommendation to adopt sufficient regulations not to cross this level of debt service in the next period. At the same time, the Ministry of Finance will ask these municipalities and regions to report within a three months' period which arrangements will be adopted. Also, the Minister of Finance will request submission of the Report on the economic results for the relevant fiscal year and opinions on this Report and on the budget perspective. The Ministry of Finance then evaluates all required materials and considers all the facts that led to crossing the stated level. In doing so, the following facts are considered:

- Total encumbrance of municipality or region;
- Total encumbrance of municipality or region conversed per one inhabitant;
- Total taxes yield conversed per one inhabitant of municipality or region;
- Encumbrance trend in last years;
- Size of municipality or region;
- Total financial situation of municipality or region.

In case that municipality or region crosses the given level of debt service in the next year, then the Ministry of Finance can distribute a list of these municipalities and regions to the relevant subjects responsible for resources from state budget and state funds so they can look at this list when they are dealing with requests from these municipalities and regions concerning grants or loans.

4.2.3 Regulation of Local Government Borrowing in 2004

According to the approved schedule, the Ministry of Finance calculated the debt service index for the periods of 12/2003 and 12/2004. The calculations utilised data from the territorial database of the Automated Budget Information System of the Ministry of Finance (ARIS).

In 2003, as many as 3,004 municipalities out of the total 6,244 municipalities had a debt service, while the debt service of only 211 of the indebted municipalities exceeded the set-up limit. These municipalities that exceeded the limit set up to 30 per cent were addressed in June 2004 a personal letter from the Minister of Finance asking for the reasons for their indebtedness and to submit proposals for measures improving their debt situation. The replies showed that, based on a minister's appeal, the municipal authorities in many cases re-assessed their budget priorities for the following period with the aim of reducing their debts.

The last published debt service indicator calculation was carried out at the end of 2004. This calculation revealed that 3,107 out of the total 6,244 municipalities had a debt service in the period in question, and 192 of these municipalities exceeded the limit of 30 per cent. Further corrections eliminated 21 municipalities that — although they exceeded the limit of 30 per cent — had zero indebtedness, i.e. paid off all their liabilities. This means that at the end of 2004, the debt service of 171 municipalities exceeded the set-up limit, including 104 new municipalities. The Minister of Finance sent a letter to these municipalities that exceeded the limit for the first time, asking them to give the reasons for their debt service indicator excess and to inform him about the measures they aimed to take, during a three-month period. Representatives of these municipalities were strictly against listing of their municipalities on the list of municipalities with high debt. The case evolution of one of the stricken municipalities can be seen in the following case study (Jindřichovice pod Smrkem).

Case study: Jindřichovice pod Smrkem (624 inh.)

Jindřichovice pod Smrkem is probably the municipality that argued most against monitoring of debt through the debt service index. In the media during the year 2005, there was open mail war between the municipality mayor and the Minister of Finance (respectively representatives of Ministry of Finance). How was this war launched?

This municipality, during the nineties, decided to follow the principle of sustainable development. Part of this decision was the building of an ecological boiler plant and construction of two wind power plants that threw the municipality into debt. In 2003, the municipality began the operation of two wind power plants for a total amount of 62 M CZK. The main portion of this investment was financed by the State environmental fund (85 per cent) from which 45 per cent was an irreclaimable grant and 40 per cent was a loan with a 12-year due date. The rest of this investment was covered by the municipality itself. The above mentioned grant became a subject of discord between the municipality and the Ministry of Finance (the course of balance sheet is in Table 6). After calculation of the debt service index for the year 2004, the municipality reached a result of 31.1 per cent (influenced especially by repayment of a principle). The Ministry asked for an explanation and for a list of further steps to prevent this happening in the future.

Table 6

Balance sheet of the Jindřichovice pod Smrkem to the 31st of December in M CZK

	2001	2002	2003	2004	2005
Total assets (125)	40.1	152.9	177.0	179.7	181.8
Long term corporeal property (26)	37.5	149.9	175.0	173.8	175.0
Claims (75)	0.7	1.0	0.6	1.3	1.1
Total liabilities (202)	40.1	152.9	177.0	179.7	181.8
Property funds (131)	34.3	131.7	170.7	174.6	177.4
Economic result (158)	0.5	0.5	-26.9	-23.5	-23.8
Loan from a central budget level (150)	0.6	0.6	26.8	24.1	21.3
Other foreign sources (159)	4.1	19.4	5.8	3.9	6.2

Source: ARIS

The municipality mayor protested against the listing of his municipality on the list of municipalities with high debt and made several arguments that his municipality had balanced economic results and surplus and thus the monitored index was pointless and could not be used for any final conclusions without having a look at other relevant facts. Among the most important arguments was the fact that the monitored index does not sufficiently consider own incomes of a non-tax character that the municipality had gained in the course of debt (in this case selling of electric energy). The Mayor argued the fact that the sale of electrical energy generated a yearly income of 3.7 M CZK while the debt service (interests and principle repayment) connected with power plants construction is 2,4 M CZK. Therefore the municipality was making a significant profit on those power plants.

The Ministry of Finance made several arguments that the debt service index was correct and that Jindřichovice pod Smrkem was a municipality in debt. To emphasise this fact, the Ministry used a supplemental index – debt conversed per one inhabitant. According to this, in 2004, the municipality exceeded the normal rate 10 times for a municipality of a similar type.

The Mayor was not satisfied with this answer and wrote a second open letter to the Minister of Finance. In that letter he complained that publishing Jindřichovic pod Smrkem as a potentially problematic municipality was incorrect and this therefore damaged the interests of the municipality. A further reaction of this municipality was to complain to the court for spreading rumours.

This case is probably behind the resolution of the Ministry of Finance not to publish any non anonymous information about municipalities' debt in the Czech Republic. Employers of the relevant offices then react disapprovingly to any questions asked on this topic, and typical reactions are: "Why do you ask?" or "I have some advice for you – just leave it."

On the inadequacies connected with making conclusions from the debt service index several other complaints came from the side of the municipalities. The ministry itself is making statements that on one hand this procedure is very transparent and is derived from data that every municipality has to have in its financial sheets. On the other hand, this index in some cases could not cover situations that mean an increase in this index because "account classification, account procedures and account standards do not distinguish between exceptional and regular fiscal operation". According to the Ministry of Finance, we are referring to these "relevant indexes":

1) Book accounts,
2) Revolving (repeating) credit,
3) Single payment loan or credit,
4) Participation in programs such as Phare, Sapard or structural funds (acceptance of credit created for the purpose of participation and pre-financing),
5) Debt that came from activities performed for removing damage caused by floods,
6) Acceptance of mortgage credit on municipal housing construction (repayments of this credit are paid from rent collected from citizens).

If the given limit of debt service index is crossed solely for these reasons, then particular municipalities or regions are not considered as problematic (For more on this topic see Dvořáková, 2006).

Except for particular problems that are recognised by the Ministry of Finance, we could also identify other inadequacies of selected indicators. Presumably the most important fact is that of a municipality interrupts repayment of credit costs or principals then the debt service index does not recognise this as a problem situation.

4.2.4 Regulation of the Local Government Borrowing in 2005

At the end of 2004 there were 171 municipalities with debt service above the given limit. Information for 2005 has not yet been assessed. After collection of the relevant data an analysis was made of the debt in the Southern Moravian municipalities. Here we are talking about just one region from a total of 14 that has about ten percent of the total population in the Czech Republic. As shown in Table 7, the monitored index of debt service was crossed by 17 municipalities last year within the above mentioned region. These municipalities have, in total, about 1.6 per cent of the total population of the region and their bank credit and other commitments are around 1.1 per cent of the similar value for all other municipalities in the region (corporate town Brno with its 367,000 citizens has a share of around 72 per cent of bank credits and other commitments for all municipalities within the region). If we use data from the Southern Moravian region on the whole of the Czech Republic's territory, we could say that the range of municipalities that cross the monitored debts service index does not change. Their debts are in nominal numbers quite low, in total for 17 municipalities they reach around half of the amount that the state "forgot" for the city Rokytnice nad Jizerou. As Table 7 further shows, if we extend the debts service index by values between 20 per cent and 30 per cent, the total number of municipalities that would cross would not change significantly.

Table 7

Index of debt service for municipalities of the Southern Moravian region in 2005

	Number of municipalities	Number of inhabitants	Bank credits and other commitments in M CZK
All municipalities in the Southern Moravia	671	1 130 353	12 515,7
Municipalities with debt service index in range between 20 % and 30 %	37	32 803	264,9
Quotient	5.5 %	2.9 %	2.1 %
Municipalities with debt service index higher than 30 %	17	17 880	134.3
Quotient	2.5 %	1.6 %	1.1 %

Source: own calculations

Because the present debt service index is not adequate for a full-scale analysis of municipalities' debt, I chose for analysis in the Southern Moravian region some other supplementary indicators:

The debt service index was divided into interest costs and principles payments. In the case of index oriented on interests' costs I monitored how many municipalities have interests' costs for servicing their debt lower than 10 per cent and how many municipalities are higher. An example of debt on the level of state shows that interests' costs must be paid all the time, but the payment of principles can be moved on through repayment of one bank credit by another.

In the case of the principles' repayment index, I monitored how many municipalities have an index higher than 20 per cent. This index thus shows how many municipalities are crossing the original debt service index caused by credit repayment, e.g. extra repayment.

Because in reality there might exist a situation where a municipality is insolvent and because of moved credit repayments and principles, the debt service index could not reflect this fact and thus the municipality has problems with repayment of credits. The average debt per one inhabitant of the Czech Republic was, in 2005, around 8,000 CZK (around € 280) and within the Southern Moravian Municipalities it was around 11,000 CZK (around € 380). As a reference value we chose 10,000 CZK.

Specific data about the Southern Moravian's municipalities' debt in 2005 are shown in Table 8.

Table 8

Analyses of debt relevant to the Southern Moravian municipalities in 2005

	Debt service index				**Debt rate conversed per one inhabitant**		**TOTAL**
	Interests' costs lower than 10 %	**Interests' costs higher than 10 %**	**Principles payments lower than 20 %**	**Principles payments above 20 %**	**Debt rate lower than 10.000 CZK**	**Debt rate higher than 10.000 CZK**	
Debt service less than 20 %	616	1	617	0	582	35	617
Debt service between 20 % and 30 %	35	2	14	23	25	12	37
Debt service above 30 %	17	0	0	**17**	13	**4**	17
CELKEM	668	3	631	40	620	51	671

Source: own calculations

If we previously showed that in the Southern Moravian region there were 17 municipalities with a debt service index higher than 30 per cent, then Table 8 showed that in these cases this was caused by high payments of principle debt. This fact could be taken into account as a positive one showing that municipalities are trying to repay their debts (even through extremely high payments) and in the short-term they cross a given debt service index. As another positive fact we can say that those interests' costs higher than 10 per cent are not seen among the monitored municipalities. On the other hand, the debt service index does not record three municipalities where interests' costs were higher than the 10 per cent on a debt base.

An imperfection of the governmental index of debt service could also be presented on the debt rate conversed per one inhabitant of a particular municipality. From the 17 municipalities monitored, only 4 had a higher debt rate per one inhabitant than 10,000 CZK; on the other hand, the debt service index does not include 47 municipalities with a higher debt rate per one inhabitant than 10,000 CZK.

In conclusion, we could say that the governmental index of debt service in 2005 indicated 17 municipalities with a higher risk of insolvency and detailed analysis shows that this was caused by high repayments of principles. Only four municipalities from these 17 have a higher debt rate per one inhabitant than 10,000 CZK. On the other hand this index did not include the 3 municipalities that have higher interests' costs and did not include 47 municipalities with debt per one inhabitant higher than the given limit.

4.3 Why are cities unable to handle debt management?

In this section I would like to make a detailed analysis of the development and causes of municipal debt from the side of particular municipalities that got into problems while repaying accepted loans. As a consequence of the fact that the Ministry of Finance refuses to inform anyone about those municipalities on the list, it is not possible to perform a more detailed analysis of this problem. Certain reasons were outlined in previous case studies. The Ministry of Finance is simply looking for reasons that led a particular municipality to cross the monitored debt service index and it does not seek the primary causes of an over-debt, because of the rare occurrence of this situation. On the basis of several interviews with responsible officers at the Ministry of Finance, we found the following reasons:

- Unfitness of voted representatives (underestimation of ability to repay debt or underestimation of economic return of investment financed through credit). This reason for municipalities' over-debt was relevant, especially at the beginning of the nineties when newly elected representatives began to have an insight into this new situation.
- Intentional infringement of basic means connected with the treatment of municipal debt (irresponsibility – "state will help" or even direct criminal activities of representatives). On this subject, we can only speculate, because it has not

been proven. However, we could suppose that especially at the beginning of the nineties, some vestries relied upon the help of the state in the case of a municipality's over-debt. There were some cases where the vestry approved liability for a company owned by one of the representatives and later it had to pay for that liability.

- Change in rules connected with fiscal flows between different levels of public administration (financing of transferred competency, change of budgetary allocation of taxes, change of requisitions concerning investment grants). Financing of transferred competency is among the unsolved problems in the Czech Republic and it is argued between the state and the municipalities which correctly complain that the state does not pay enough for the municipalities' mandatory expenses. Also, if the state significantly changes the (unpredictably) budgetary allocation of taxes, as happened for example in 2001, then the state prevents any effective long-term planning of investment actions and municipality debt.
- Inconveniently set rules of some grant programs that generate long-term pressure on municipalities in a fast-changing economical situation. Certain problems for some municipalities are linked to drawing investments grants. If, for example, certain municipalities in 2001 drew grants for the construction of gas lines with a requirement to link up 70 per cent of houses and after that gas prices have risen, then this municipality is unable to fulfil this requirement and has to return the given grant. This might generate significant problems with financing of this investment and force the municipality to use more debt financing than was previously considered.
- Sudden change of the income or expenditure side of budget (financing of floods, drop in tax incomes after the bankruptcy of a major employer).

4.4 Conclusions

Does municipalities' debt pose significant problems for the Czech Republic? After complete assessment of all the conditions I believe that it does not. The Ministry of Finance states that after taking into account the explanations of municipalities that crossed the monitored debt service index, it was shown that:

- The majority of municipalities crossing the debt service index happened under the influence of considered indexes. We are especially talking here about single and high repayments of loans and bank credits. This endeavour of theirs to settle their commitments as soon as possible is thus necessary to evaluate as a positive action, even though the index shows that it might be a problematic municipality.
- Some municipalities have only one bank credit established in the past which is being repaid by them in the long-term and without any problems.
- Some municipalities have optimised their credit liabilities and linked them together into one. This step then led to high repayments on the one hand and to

the creation of new credit on the other. An exceptionally high debt service index is thus given by the municipality account operations.

- Many municipalities have several bank credits; the quality of debt management is at a very high level (they have reasonable repayment calendars). For this reason, these municipalities are not able to stay below the given limit of debt service index. In their explanations to the Ministry of Finance they commit themselves to reduce new investments and to decline new loans and bank credits until the monitored index is not below the 30 per cent limit.
- Almost all municipalities in debt accepted the challenge of the Minister of Finance to revalue their budget priorities in the next period with the main aim of lowering its debt.

As a certain negative we can see that the debt service index is not ideal and that during its interpretation we have to take into account that it does not totally cover the problem examined: for municipalities that do not repay their debts, this index could throw a negative light on municipalities that are actively solving their debt service (e.g. through single repayments). Explaining the ability of the debt service index is thus very low.

Up until now the functioning of the debts' regulation system, according to the newly set debt service index, shows that it has achieved its purpose. It has especially taken on a preventive role in the municipality's decision-making process concerning new bank credit agreements. We can also positively evaluate the fact that municipalities reconsidered their budget priorities with the aim of lowering their debt.

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State final account of the Czech republic for 1997 – 2005

Proposal of the State Budget for the year 2006

5. State Regulation of the Municipal Debt in the Czech Republic

Petra Dvořáková

5.1 Introduction

Municipal budgets form part of the system of public budgets and, consequently, the municipal economic results affect also the economic results of the entire system of public budgets in the Czech Republic. At present, the growth of public debt is frequently discussed, especially in relation to the fulfilment of the convergence criteria (Maastricht criteria), and the planned accession of the Czech Republic to the European Monetary Union. Accordingly, emphasis is placed on the monitoring of economic results, i.e. the indebtedness of individual parts of public budgets, including municipalities. In this context, the question arises whether and by means of what instruments the state should regulate municipal debts.

This paper will therefore present a brief analysis of the indebtedness of municipal budgets in recent years. The aim is to determine the factors influencing the indebtedness of municipalities in the Czech Republic, and to specify how municipal budgets participate in the total public debt. Further, the development of instruments for municipal debt regulation in the Czech Republic is briefly discussed. The main emphasis is on the identification of tools that are nowadays used for municipal debt regulation in the Czech Republic.

5.2 Materials and Methods

A literature search was used for the theoretical part of the paper. The analysis of the municipal debt development and reasons of its origin are based on data from the Czech Ministry of Finance, Czech Statistical Office and other institutions. Further, the development of the debt regulation instruments and their practical use in the Czech Republic was analysed. The paper concludes with a synthesis of the above analyses.

5.3 Brief Analysis of Municipal Debt Development in the Czech Republic

Municipalities are obliged by law to provide a number of publicly provided goods for their residents. These include preferred public goods (e.g., compulsory school attendance, or ordered compulsory treatment), national public goods (construction and maintenance of roads, or regulation of water courses), local public goods (mu-

nicipal police, fire brigade, or public lighting) and charged services (fees for water, garbage and sewers, or cultural services).[1]

Local bodies provide these goods by activities both within their "own" and their "delegated" responsibilities (*cf.* Act no. 128/2000 Coll.[2]). In the second case, these activities are connected with the execution of state administration delegated to municipalities by the state. For activities connected with state administration execution, municipalities obtain a direct financial contribution from the state. Further, the municipalities receive subsidies (usually purpose subsidies) from the state budget in order to be able to carry out their other activities. Therefore, one of the goals of the state administration reform that was implemented in the Czech Republic at the turn of the millennium was to increase the source self-sufficiency of local budgets and to strengthen the bond between local budget possibilities and local economic capacities.

By law, municipal revenues can include—apart from resources coming from the state budget—also funds that the municipalities acquire by means of their own activities. Municipal financial management is based on the yearly budget and, possibly, a budgetary outlook that the municipality is obliged to draw up according to the law. Municipalities can also carry out business (i.e. collateral) activities, provided they have appropriate licences. Moreover, municipalities can establish subjects that administer their property and carry on various business activities.

The above mentioned state administration reform affected the finances of both municipalities and regions. After the district offices were closed down, most of their powers (about 80 per cent) were delegated to municipalities and a smaller portion (the remaining 20 per cent) to regional authorities. Subsequently, municipalities had to cope with financing of activities that they did not execute previously, and of subjects now newly under their responsibility (e.g. schools, libraries, museums, galleries, etc.). Moreover, with effect from the beginning of 2001, the new Act no. 218/2000 Coll., on Budgetary Rules, came into operation. This law contains a number of measures that support transparency and budgetary discipline (e.g. the introduction of budgetary outlook, more restrictive conditions for granting state guarantees, or restriction of budget changes during the year).

In recent years, nevertheless, municipal economies have been in deficit, thus causing municipal debt to grow. The development of municipal debt during the years 1995 – 2005 is shown in the graph below. It can be seen that the debt grew both absolutely and relatively from 1995 to 1998; then a temporary improvement of the situation occurred: the absolute numbers stagnated and the share of municipal debt in the total debt of the Czech Republic showed a decreasing tendency. It is interesting that the municipal debt in 1998 and 1999 did not decrease, although municipal economic results ended up in surplus for these years. These surpluses can

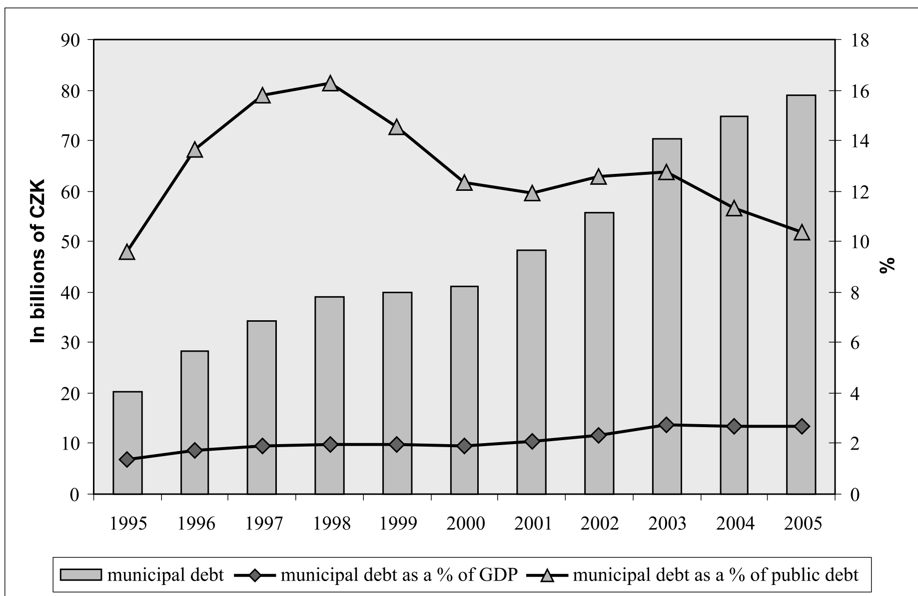
1 Vybíhal, V., *Veřejné finance*. 1995, p. 119.

2 Act no. 128/2000 Coll., on Municipalities, § 7.

be attributed especially to extra revenues of local budgets coming from the sale of distribution companies' voting rights.

Since 2000, the municipal budgets have revealed deficits again despite strengthening their revenue bases that occurred at the expense of the state budget in connection with amendments to Act no. 243/2000 Coll., on Budgetary Determination of Revenues of some Taxes. Since 2001, as can be seen from the graph, the municipal debt has grown again in absolute numbers; however, its share in the total public debt stagnated, and the same can be said about its share of GDP. A considerable increase of the debt occurred in 2002 and 2003, especially due to floods in the Czech Republic and the subsequent necessity to finance the settlement of damages. The municipal indebtedness continued to grow in absolute numbers also in 2004 and 2005. According to preliminary data provided by the Czech Ministry of Finance, the municipal debt amounted to CZK 79.0 billion at the end of 2005, which represented 10.4 per cent of the total public debt and about 3 per cent of GDP. In 2006, according to the predictions of the Ministry of Finance, the debt should not substantially increase in absolute numbers and its share in the total public debt should continue to decrease (see the graph below).

Graph 1
Development of Municipal Debt in the Czech Republic



Source: Author's, based on statistics of the Ministry of Finance of the Czech Republic and the Czech Statistical Office.

According to the Ministry of Finance of the Czech Republic, there is a risk concerning the development of public budgets brought about by the above mentioned changes connected with the new polity. Legislature changes adopted during the year 2002 that concern local budgets open a real space for municipalities to increase their debts. It is particularly the amendment of the Act no. 128/200 Coll. that leaves out the regulations concerning indebtedness, both by bond issue and taking out a loan; the amendment also changes some regulations limiting the self-administration units in the management of property obtained from the state without payment (for more, see section 5.2).

As far as the reasons for municipal debt are concerned, undoubtedly the most crucial cause is presented by financially demanding investments in the public sector. Most towns and villages still have to deal with a poor state of public infrastructure as a result of the past. Municipalities finance more than half of the capital investment of the whole budget system. Only about one quarter of capital expenditure is financed from non-refundable purpose subsidies. Municipalities are then short of their own financial means to finance the remaining part of capital expenditures, and if it is mandatory to implement an investment immediately, the only possibility is to contract debts.

Another reason for running into debt can be the inexperience of municipalities with debts and also the underestimation of problems connected with the debt service. Taking a loan represents an easy way of acquiring financial means for implementation of popular projects. Since most loans, from a time point of view, exceed the length of the term of office, the responsibility for paying back the debt thus accrued is passed over to municipal bodies elected in the future.

A comparison of indebtedness of corporate towns and other municipalities has shown that although only about 30 per cent of inhabitants of the Czech Republic live in corporate towns, the debt share of these towns amounted to 61.4 per cent in 2004 (unfortunately, more recent data are not available at the moment). This is a result of the above mentioned necessity to finance the development programs of corporate towns and of their greater willingness to contract debts than is the case of smaller municipalities. Corporate and large towns also enjoy greater credibility for banks and other subjects, and therefore it is easier for them to obtain loan funds than for the smaller towns.

The capital city of Prague has the greatest share of the municipal debt, followed by the municipal towns of Brno and Ostrava. Prague takes out loans, especially for the completion of its subway construction; Ostrava pays off old loans with new ones, similarly to Brno, that invests also in its infrastructure. As demonstrated by the table above, the corporate towns have a crucial share in the total municipal debt in the Czech Republic. However, the indebtedness of villages of 300 to 1,500 inhabitants is also growing, and since these municipalities form the major part of municipalities in the Czech Republic, this fact may cause a problem in the future.

Table 1
Development of Corporate Towns Debt

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total municipal debt (in billions of CZK)	34.4	39.0	40.0	41.0	48.3	55.8	70.4	82.2	79.0
Debt of corporate towns (in billions of CZK)	13.6	15.6	16.4	16.9	24.2	29.6	42.4	45.9	48.4
Debt of corporate towns (% of total municipal debt)	39.5	40.0	41.0	41.2	50.1	53.0	60.2	55.8	61.3

Source: Author's, according to data from the article Eliáš, A. "Hodnocení dluhové služby." *Obec a finance*. 2004, vol. 5, p. 22 and to data by the Czech Ministry of Finance.

The number of indebted municipalities in the Czech Republic continues to grow. In 2004, as many as 2,761 out of the total number of 6,244 municipalities in the Czech Republic have been indebted. According to data from the Czech Ministry of Finance, in 2004 in the Czech Republic, 1.2 per cent of municipalities had high-risk debts, 43 per cent non-risk debts, and 55.8 per cent had no debts at all. Municipalities with high-risk debts represent municipalities with debts exceeding 50 per cent of their tax revenues. From this point of view, the highest number of such municipalities is constituted by smaller towns and villages.

The names of municipalities that struggle with excessive indebtedness are not well-known. A threat of an auction of municipal property was reputedly held over Podhořany (Chrudim), Smržovka (Jablonec), Psáry (Central Bohemia), Vejprty (Chomutov), Prosečná (Trutnov), or Bublava (Karlovy Vary). According to the data published by the Czech Ministry of Finance, apart from the known case of Rokytnice, two other municipalities have a debt exceeding CZK 100,000 per capita and about seven other municipalities have a debt exceeding CZK 50,000 per capita. The case of Rokytnice and Jizerou, where municipal property had to be sold at auction, is the most extensive case with municipal property as the subject of an auction. The debt of this town has grown for eight years and amounted to CZK 400 million, i.e. nearly CZK 120,000 per capita. The debt was solved in the year 2004.

One of the reasons for the indebtedness of smaller municipalities is the obligation to meet especially the ecological limits after the accession of the Czech Republic to the European Union. This need brings about forced investments into the construction of sewage water treatment plants, sewerage systems, or introduction of gas within the cadastral district of a municipality. Another reason for the debt growth is the necessity of financial means for co-financing of projects from the structural funds of the European Union. The problem can be caused by the fact that the European Union provides financial resources for the project retroactively, i.e.

only after the project is completed. Therefore until its completion, all expenses must be covered by the Czech party, or the municipality, or participating entrepreneurs, which may lead to the increase of municipal debt.

On the other hand, however, the Ministry for Regional Development of the Czech Republic claims that the municipal debts that have emerged due to structural funds of the European Union are short-term and the return on investment will be fast, therefore the municipalities should not suffer in the long run. During the years 2004 to 2006, the state earmarked CZK 7.4 billion for the co-financing of these projects. In the same period, the Czech Republic can obtain from the European Union as much as EUR 2.3 billion (about CZK 72 billion), provided a sufficient number of quality projects is submitted. After their accession to the EU, the Czech Republic can, apart from the structural funds and the Cohesion Fund, also draw on the set allocations for pre-accession aid from PHARE, ISPA and SAPARD funds. At the same time, during 2004 – 2006, the new member countries of the European Union have at their disposal the so-called "Transition Facility". Funds of this aid cover in selected sectors the needs for building and development of institutions ("institution building") that cannot be financed from structural funds.

5.4 Legal Regulation of Municipal Debt

As already mentioned in the introduction, there are debates in the Czech Republic about the possibilities of the regulation of municipal debts in the context of the public debt growth. The previous attempts of the Czech government to regulate the extent of municipal indebtedness have been met with variable success.

5.4.1 Development of legal regulation of municipal debt

During the recent decade, several substantial regulative efforts of the extent of municipal indebtedness in the Czech Republic by legislative ways can be identified. The first attempt was represented by the government resolution no. 229 of April 16th, 1997. This resolution imposed the obligation on the Minister of Finance to enforce such legal amendments in the legislative process of regulations set up for municipal economies that would prevent excessive municipal indebtedness. Government members were obliged by this resolution to take into consideration, when granting purpose subsidies from the state budget and state funds in 1998 – 2000, also the fact whether the particular municipality had reached at least a balanced budget in the year 1997.

Another legislative amendment concerning the municipal debt was issued on November 12th, 1997. It was the government resolution no. 707 that approved the Procedure rules for granting state purpose subsidies to municipalities and district authorities. This resolution imposed the obligation on cabinet members and heads of other state administration bodies to take into consideration, when granting state purpose subsidies to municipalities and district authorities in the years 1999 and

2000, whether these subjects did not have a share of debt service in ordinary revenues in the sense of valid budget structure after consolidation, amounting to more than 15 per cent in the appropriate calendar year.

Another measure that should have contributed to the limitation of municipal and regional debt came into force on December 31st, 2001. It was Act no. 450/2001 Coll., which amended the acts on municipalities, regions, the capital city of Prague and other acts. This act introduced substantial limitations for municipal budget economies. It prohibited municipalities from making loan contracts or receiving foreign loans without government consent, and the government also had to approve the issuing of communal bonds. Further, this act forbade municipalities to make loans in case their debt service exceeded 15 per cent of the previous year's budget. Municipalities and regions also could not use their property to guarantee the liabilities of natural persons and/or legal entities that they had not established themselves. Another important regulation was that the state was not responsible for the financial management and liabilities of a municipality or a region if this obligation had not been assumed by contract.

This act, however, became rather difficult to apply in practice even though an interpretation of some of the regulations of this act was issued by the Czech Ministry of Finance. Therefore, the said measures were annulled by the amendment to Act no. 231/2002 Coll., on Regions (with effect from June 4th, 2002), and the amendment to Act no. 313/2002 Coll., on Municipalities (with effect from July 12th, 2002). These amendments newly modified guaranteeing by municipal and regional property. The regulation according to which the state is not responsible for the municipal financial management and liabilities if this obligation is not assumed by contract has continued to be in force.

As for further measures that can have an impact on municipal indebtedness, let us look at, in particular, the new Act no. 190/2004 Coll., on Bonds, which replaced the no longer satisfactory Act no. 530/1990 Coll. The new act does not allow a bank to become the issuer of communal bonds and use the yield from these bonds in order to provide a loan to the municipality that requested the bond issue while pledging its property. Therefore, municipalities will have to issue communal bonds themselves. However, before they ask the Securities Commission to approve conditions of the issue, they require prior approval from the Ministry of Finance with the communal bond issue. The ministry specified the application requisites for the approval with communal bond issue by Act no. 408/2004 Coll. It should be pointed out that thanks to the final form of Act no. 190/2004 Coll., on Bonds, a certain legislative gap has appeared which allows for requesting the issue of communal bonds abroad without the need to obtain ministry approval.

Further, the government passed the Act no. 420/2004 Coll., on Examining the Economic Management of Territorial Self-Governing Units that includes all measures that will indirectly influence municipal indebtedness. The examination of

economic management of regions that is carried out—according to the law—solely by the Ministry of Finance of the Czech Republic, and examination of municipal financial management carried out by the region or an auditor, focus not only on maintenance and management of goods in the property of a self-governing unit, on observation of regulations concerning financial management of municipalities and regions, and on contracting and implementation of public orders, but also on the claims and bonds of the territorial self-governing unit, on liabilities guaranteed by the self-governing unit and on pledging of the self-governing unit's property for the benefit of third parties. The examination will also include an assessment of purposefulness and economy of the examined operations. Another important modification is also the fact that the final report on examination results must include—as a compulsory requisite—a notice stating possible risks that may have a negative impact on the financial management of the particular self-governing unit in the future. Disproportionate indebtedness is certainly one such risk. A decisive factor for the utilisation of the given procedures is, of course, the fundamental conclusions of local authorities in negotiations over the final account statements of the self-governing units.

5.4.2 Regulation of municipal debt at present

At present, the municipal debt in the Czech Republic is regulated by a non-legislative measure. It is a consequence of negotiations that were carried out in April 2004 in a working committee comprising representatives of the Ministry of Finance of the Czech Republic, the Union of Towns and Municipalities of the Czech Republic and the Association of Regions of the Czech Republic. After the assessment of the overall indebtedness of municipalities and regions, the state of currently effective and prepared legislative measures and other alternatives of debt regulation, it was decided that at that time no legal amendments were necessary to adopt regulation measures. Providers of subsidies from the state budget and state funds can be bound by the government resolution, obliging them to take into consideration the indebtedness of municipalities and towns when considering their applications.

On April 14th, 2004, the Czech government discussed the resulting material of the Czech Ministry of Finance and — in its resolution no. 346 — approved the Regulation of Municipal and Regional Debts by Means of the Debt Service Indicator. At the same time, the government obliged the Minister of Finance to notify—after the assessment of all documents—the municipal and regional representatives in case of exceeding the debt service indicator, set up to 30 per cent, in the sense of valid budget structure after consolidation, and to ask the affected municipalities for justification of the excess. Annually by April 30th, the Minister is also obliged to inform the government about the state of municipal and regional indebtedness. The government further requested the cabinet members and heads of central administration bodies to modify (until December 31, 2004) the rules for granting purpose subsidies, loans, and refundable financial aids from the state budget of the Czech

Republic and from the state funds to municipalities and regions so as to secure that the assessment of subsidies applications also takes into account whether the municipalities and regions do not exceed the debt service indicator, set up to 30 per cent.

The calculation of the debt service indicator is clearly given in Table 2 below. First, it is necessary to calculate the debt basis of a municipality that is given by the sum of tax revenues, non-tax revenues and received subsidies. The table further states the total debt service of the municipality that is given by the sum of paid interests, paid instalments of issued bonds, payments of principles and leasing payments. The debt service indicator is defined as a percentage quotient of the debt service and the debt basis.[3]

Table 2

Calculation of the Debt Servise Indicator

Line number	Item name	Reference to budget structure
1	tax revenues (after consolidation)	class 1
2	non-tax revenues (after consolidation)	class 2
3	received subsidies—financial relation	item 4112 + 4212
4	**debt basis**	line 1 + line 2 + line 3
5	Interests	item 5141
6	payments of principles and bonds	items 8xx2 and 8xx4
7	leasing payments	item 5178
8	**debt service**	line 5 + line 6 + line 7
9	**DEBT SERVICE INDICATOR**	line 8 divided by line 4

Source: Ministry of Finance of the Czech Republic. Municipal and regional debt regulation – debt service indicator. [online]. c2006.

The examination of municipal financial management, or the calculation of the debt service indicator, is carried out by the Ministry of Finance of the Czech Republic based on the ARIS system (Automatizovaný rozpočtový informační systém, i.e. Automated Budget Information System) that collects not only data necessary for drawing up the state budget proposal and the final state account, but also the financial accounting statements of municipalities and regions. The municipalities that exceed the set-up limit of 30 per cent of the debt service indicator are notified about this fact by the Ministry of Finance through a personal letter, and they are asked to adopt measures to remedy this situation. The affected municipality should justify the indicator excess within three months and provide information about remedy measures. Further, the Minister of Finance asks for an elaboration of the Report on

3 Regional Authority of the South Moravian Region. "Regulace zadluženosti obcí a krajů pomocí ukazatele dluhové služby" [Regulation of municipal and regional debt by means of the debt service indicator]. [online]. 2004.

the Results of Financial Management Examination in the given calendar year and for a statement by local authorities regarding this report, and including a budgetary outlook of the municipality too.

Based on the data collected from the addressed municipalities, the Ministry of Finance reviews the reasons for their indebtedness, particularly taking into account recurring debt limit excesses. The ministry further considers all facts that have led to the excess of the given limit. Other assessment criteria include especially the total municipal debt per capita, tax revenues per capita, debt trends in recent years, municipality size and the overall financial situation of the municipality.

The above described calculation of the debt service indicator represents a transparent method of municipal debt regulation based on data published monthly by each municipality in its financial statements and stored centrally in the ARIS system. Nevertheless, in some cases, the debt service indicator is not capable of covering eventualities that give rise to indicator increase, since the chart of accounts, accounting methods and accounting standards do not differentiate between exceptional and regular financial transactions. If the set-up debt service indicator limit is exceeded solely due to such factors, the respective municipalities are not considered problematic according to the above mentioned government resolution. These "consideration factors" are described below.

The revolving account, or the method of its accounting, affects the debt service limit in line 6 (payments of principals and bonds, *cf.* Table 2 above). According to the accounting principle of a faithful and true representation of reality, an accounting entry is made to this line each time the municipality draws on a revolving account with allowed debit transactions, and also in case of a pay-off of this "loan". This may occur repeatedly during the period in question, since the municipality recurrently makes use of and pays off the same credit. In the item of principles and bonds, however, these transactions will appear accumulated as a result.

Another factor that can influence the debt service indicator limit is a revolving credit, i.e. a recurrent loan. During the period in question, such a loan repeatedly provides refundable resources and is paid off. Each use of a revolving credit is again entered into line 6 (payments of principals and bonds), thus consequently affecting the debt service indicator similarly to the revolving account.

Probably the most frequent reason for correction of the debt service indicator is a one-time payment. Payment of credits and loans affect – similar to the two factors described above – the item in line 6, i.e. payments of principals and bonds. As already stated above, the chart of accounts, accounting methods and accounting standards do not differentiate between exceptional and regular financial transactions. Therefore, in this case it is not possible to differentiate between a regular and exceptional (one-time) loan payment. An accelerated or one-time pay-off of a loan is rated highly by the Czech Ministry of Finance, and for that reason – in case of a

repeated evaluation of the debt service indicator – such a municipality is evaluated positively.

It is clear from the above that information on revolving accounts, revolving credits and one-time payments cannot be obtained from the financial statements available in the ARIS system. Municipalities can provide such information only in their reply to the letter of the Minister of Finance within the given three-month period.

When assessing individual municipalities, the Ministry of Finance will evaluate positively also those cases in which the service debt indicator excess is caused by taking a credit or a loan to cover the pre-financing or co-financing of projects supported by the European Union. This includes, for example, the participation of a municipality in the PHARE, SAPARD, structural funds or Cohesion Fund programs. Municipalities can be short of their own resources to finance the required participation, and also the system of recognition of already implemented expenditures can be financially demanding. That is why the municipalities decide to make use of refundable resources. In such cases, the Ministry of Finance will not require observance of the set-up debt service indicator limit, since – in agreement with the government – it supports the maximum utilisation of EU funds by the municipalities of the Czech Republic.

Another factor taken into account is indebtedness that emerged as a result of flood damage settlements. Disastrous floods in 2002 also caused substantial damage to municipal property. In order to settle these damages, municipalities were forced to ask for refundable resources which they are now paying off. This mere fact cannot be, according to the Ministry of Finance, the reason for imposing restrictions because of high indebtedness. In connection with the floods of March and April 2006, it is presumed that municipalities will take further loans and refundable financial aids in order to settle damages brought about by the floods, which fact will of course impact their 2006 economic results and the debt service indicator in the period in question.

At last, corrections in the debt service indicator calculation can be made because of a mortgage taken out by the municipality to finance municipal housing developments. Municipalities cover loan payments from the residential rent and therefore the loan does not threaten the standard municipal economy. If the municipality solves the housing problem on its territory in this way, there is no reason for its restriction because of debt regulation.

After considering and evaluating all of the above mentioned "consideration factors", the Ministry of Finance calculates the modified debt service indicator. Subsequently, the Ministry informs the affected municipalities about the calculation result. Only then, after a complex evaluation of all data from municipalities, the Ministry proceeds to publish a list of municipalities at risk. This list, however, will

not include those municipalities whose modified debt service indicator will not exceed the limit of 30 per cent after including the tolerated factors. As for the other municipalities contained in the list, when deciding upon granting state subsidies, individual budget's chapters administrators should take into account that the respective municipality has problems with its indebtedness.

A crucial problem that the Ministry of Finance aims to prevent through this procedure is the possibility of potential financial bankruptcy of a municipality in case of an inappropriate debt policy (*cf.* the previously mentioned example of Rokytnice). Even if a municipality cannot go bankrupt (based on the Act on Bankruptcy and Settlement), it can get – due to over-indebtedness – into such a financial situation that it ceases to fulfil some of its basic duties and functions arising from the Act on Municipalities. Municipalities are responsible for their debts and their liabilities cannot be assumed by anyone (this also applies to the state, as already stated above). In case the municipality does not own valuable possessions it can sell and amortise the debt by the return of the sale, it ends up in a very difficult situation since there is, in fact, no legal way of solving such a problem.

This danger especially concerns the smaller municipalities that are short of qualified specialists able to analyse precisely the municipal financial situation and its future trends. Therefore, the consequences of a well-intentioned effort to obtain additional financial means can be fatal for the municipality. The threat of financial bankruptcy in case of larger municipalities, or towns, is – at least in the medium-term horizon – far lower than in the case of smaller municipalities due to more extensive possibilities for debt rollover.

5.4.3 Current experience with municipal debt regulation by means of the debt service indicator

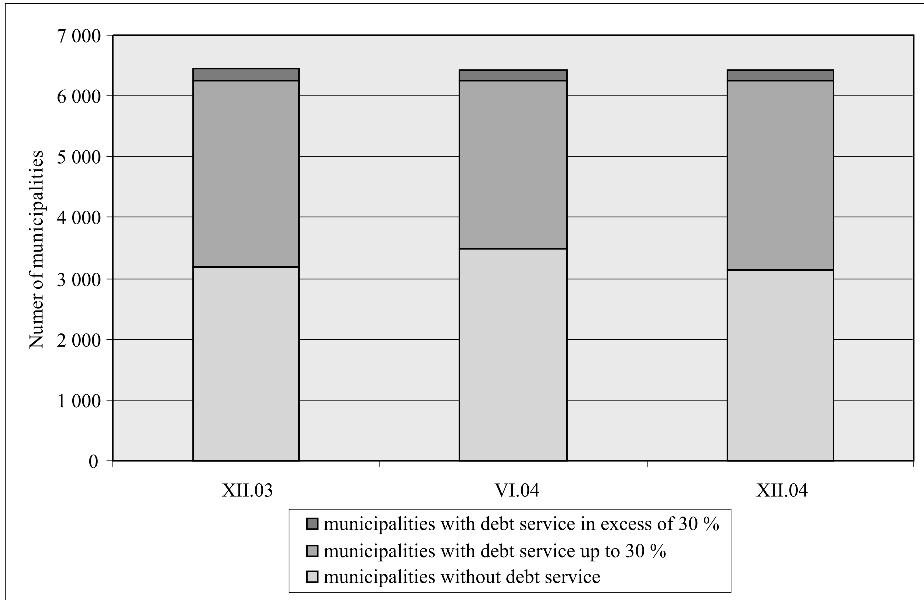
The current measures regulating municipal indebtedness were approved by a resolution of the Czech government in April 2004. This resolution also obliged the Deputy Prime Minister and the Minister of Finance to monitor municipal debt and annually submit a report about the municipal debt development to the government.

According to the approved schedule, the Ministry of Finance calculated the debt service indicator for the periods 12/2003, 06/2004 and 12/2004. The calculations utilised data from the territorial database of the Automated Budget Information System of the Ministry of Finance, the source of which are the accounting and financial statements of individual municipalities. Unfortunately, more recent data or calculations of the debt service indicator are not yet available. They should be published at the end of April 2006.

The calculations provide interesting information about the indebtedness of municipalities in the Czech Republic. Contrary to the macro level data (*cf.* section 1), they disclose the reasons for increasing municipal debt at the micro level. The

overall development of the debt service indicator based on available data is shown in graph 2 below.

Graph 2
Debt Service of Municipalities in the Czech Republic



Source: Author's, based on statistics of the Ministry of Finance of the Czech Republic.

In 2003, as many as 3,004 municipalities out of the total 6,244 municipalities had a debt service, while the debt service of only 211 of the indebted municipalities exceeded the set-up limit. These municipalities that exceeded the limit set up to 30 per cent were addressed in June 2004 by a personal letter from the Minister of Finance and asked to state the reasons for their indebtedness and to submit proposals for measures improving their debt situation. The replies showed that, based on minister's appeal, the municipal authorities in many cases re-assessed their budget priorities for the following period with the aim to reduce their debts.

In June 2004, another calculation of municipal debt service indicators was carried out. The results showed that 2,761 municipalities (i.e. 44.2 per cent) out of the total 6,244 municipalities had a debt service. Compared to the end of 2003, these numbers presented a slight improvement, since the debt service of only 185 of the indebted municipalities exceeded 30 per cent, in comparison with 211 municipalities in the previous period. The Ministry of Finance of the Czech Republic excluded 14 municipalities with zero indebtedness from the municipal debt list. These municipalities implemented their last payments (principles, interests) in the first

quarter of 2004 which affected the debt service indicator calculation. "Problematic" municipalities now included 171 villages and towns, while 111 of them were "newcomers". The remaining 60 municipalities exceeded the debt service limit both in the period of 12/2003 and 06/2004. Since the approved system of debt regulation assessed primarily a repeated excess of the debt limit, these 60 "problematic" municipalities were subjected to a further evaluation.

The evaluation of the data obtained from the municipalities considered all factors that led to the limit excess. In particular, the total indebtedness of a municipality and indebtedness per capita, the debt trend and tax revenues per capita, the overall financial situation of the municipality and its size were taken into account. Since June 2004, the above mentioned factors that can also affect the debt service indicator have also been taken into consideration (current account, revolving account, co-financing of EU funds projects, etc.).

After the overall evaluation of the data from the "problematic" municipalities, it was evident that some municipalities have only one loan from the past that they pay off on a regular basis. Many municipalities, however, have taken several loans with such a schedule of payments that in the near future, these municipalities will exceed the set-up debt service limit. In their debt justification, these municipalities pledged to limit their new investments to the highest possible extent and not to take new credits or loans. Nearly all of the addressed municipalities, based on the appeal of the Minister of Finance, re-assessed their budget priorities for the following period with the aim of reducing their debts. In view of the fact that the approved debt regulation system just passed its first period, indebtedness of these municipalities originated in most cases in the past. The municipalities had to meet their contractual obligations now, and therefore they had practically no possibility of an accelerated introduction of a debt service remedy. For that reason, the Ministry of Finance of the Czech Republic did not apply sanctions against them in the sense of the government resolution on Regulation of Municipal and Regional Debts by Means of the Debt Service Indicator.

The last published debt service indicator calculation was carried out at the end of 2004. This calculation revealed that 3,107 out of the total 6,244 municipalities had a debt service in the period in question, and 192 of these municipalities exceeded the limit of 30 per cent. These numbers represented a slight increase compared to the previous period (*cf.* graph 2 above). Further corrections eliminated 21 municipalities that – although they exceeded the limit of 30 per cent – had zero indebtedness, i.e. had paid off all their liabilities. This means that at the end of 2004, the debt service of 171 municipalities exceeded the set-up limit, including 104 new municipalities. The Minister of Finance sent a letter to these municipalities that exceeded the limit for the first time, asking them to give the reasons for their debt service indicator excess and to inform about measures they aimed to take in a three months' timeframe.

The remaining 67 municipalities exceeded the debt service limit both in the period of 12/2003 and 06/2004. From the data obtained from the municipalities, it was obvious that the reason why the municipalities exceeded the debt service indicator limit were high pay-offs during the year 2004. These municipalities reduced their debt by CZK 74.2 million compared to 2003. The debt service increase by CZK 113 million in 2004 meant an increase of their debt payments by CZK 113 million. These efforts of the municipalities to accelerate the settlement of their liabilities were highly rated by the Ministry of Finance and the Ministry did not apply any sanctions against these municipalities.

The Minister of Finance again addressed a letter to those municipalities that, according to the methodology of the debt service indicator calculation, did not exceed the set-up limit, but whose total indebtedness exceeded the national average of municipal indebtedness per capita. Moreover, these municipalities have failed to pay off their liabilities in recent years.

5.5 Conclusions

The municipal indebtedness in the Czech Republic has continually grown in absolute numbers since its initial emergence. Though the share of municipal debt in the total public debt is not alarming (about 11 per cent at present), it is necessary to address these issues in relation to the overall state debt, or the convergence criteria. The crucial cause of growing municipal indebtedness in the Czech Republic is financially demanding investments in the public sector, brought about by the previously neglected technical and social infrastructure.

The regulation of municipal indebtedness especially concerns the use of credit instruments with a maturity of more than one year, and the use of municipal property as security for the benefit of physical or legal entities whose founder is not the municipality. The reason for regulation is usually the argument of controlling the total public debt and also the protection of local self-governments from excessive indebtedness and future problems with paying off the debt. This also applies to the Czech Republic where the so called "debt service indicator" has been used for municipal debt regulation since 2004. The Ministry of Finance of the Czech Republic attempts to reach a change – by controlling the municipal economies by means of this indicator – in the trend of municipal indebtedness and also to protect the municipalities from the possibility of "bankruptcy". On the other hand, these measures also protect the state budget, which would most probably have to be used (in view of some of the past cases mentioned above) in order to save these municipalities by taking over their liabilities. Since the introduction of the indicator, minor modifications have been made, e.g. the indicator is calculated every half year, contrary to the original government resolution no. 346, and the so-called "consideration factors" of municipal indebtedness are now being taken into account.

Nevertheless, the extent of the debt service represents an important indicator, though it does not have to be the decisive factor in municipal economy evaluation. The purposefulness of municipal debt should also be taken into account, or assessment of its property. Short-term high values of the debt service does not necessarily reflect bad municipal financial management, if the municipal investments have a multiplication effect or improve municipal facilities or extend municipal property.[4] In the case of the Czech Republic, this is partially expressed by including some specific factors into the calculation, or re-calculation, of the debt service indicator.

The concept of public budgets reform counts on other legislative measures that should reduce the possibility of the emergence of uncontrolled debt of local self-governments. In view of the past development, as well as the current situation, it would suffice to introduce stricter rules regarding indebtedness only for larger towns (i.e. towns with more than 5,000 inhabitants) and for corporate towns. In case of smaller municipalities, it would be sufficient to empower the regional authorities to evaluate municipal credits within the examination of municipal financial management, or to introduce the institute of forced administration.

In conclusion, it is necessary to say that in theory it is not necessarily the state that sets the rules or respective limits. What is important for municipalities is their mere existence. The rules and measures can be set up by the municipalities themselves or by institutions entrusted by municipal representatives. The basis for proper debt handling and regulation should be represented by a system of proper reporting and monitoring of the municipal debt, or possibly a regular release and exchange of information.

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6. Managing Local Public Debt in Estonia 2000 – 2005

Viktor Trasberg

6.1 Estonian local government and debt management

The use of borrowed funds is considered as one of the natural sources of financing local governments' activities, particularly for funding extensive long-term capital investment projects. Different external resources allow overcoming limitations due to municipalities' inadequate own revenues or insufficient grant support from the central government. Extensive use of loan instruments became widespread also in former transition countries, despite their still limited fiscal discretionary power (Nam and Radulescu 2004; Fiscal Decentralization 2002).

However, in correlation with sub-governments expanding borrowing activities, various countries are increasingly concerned about securing their fiscal discipline and general macroeconomic stability. Local governments do not take account of all the effects at the national level in their decision-making. Municipalities financing through extensive borrowing may affect lending conditions for other public and private agents (Fiscal Relations across Government Levels 2003). Therefore, setting up different regulations, monitoring and limitations for municipal borrowing are often principal concerns of many central governments.

The main goal of this research is to examine the policy and practice of local public debt related issues in Estonia. The paper gives an overview and evaluates the legal framework, which regulates local governments' fiscal conduct and borrowing activities in particular. The paper examines the role of debt in local governments' budgets, analyses structure of borrowed funds and loan redemption activities.

6.1.1 Government institutional structure

Estonia is a parliamentary republic with a one-tier local government system. On 1 January 2006, there were 227 sub-governmental jurisdictions in Estonia – comprising 33 towns (*linn*) and 194 rural municipalities (*vald*). Estonian territory is also divided into 15 counties, which do not, however, have the status of local governments. The county governor is a representative of the central government and implements central government policies at the regional level. County administration serves as the administrative apparatus of the county governor (Local Government in Estonia, 2005).

All local government units are identical in their legal status. During the last decade, the number of jurisdictions has slowly declined (30 units less) through municipalities' amalgamation. Most of the municipalities are relatively small by popu-

lation, as 83 per cent of municipalities have less than 5,000 habitants. The population is concentrated across the two biggest urban areas (Tallinn and Tartu), where around 38 per cent of the total population lives (Trasberg 2004).

In Table 1, the principal revenue and expenditure structure in different Estonian government sectors is given. As can be seen, local government fiscal activities cover about one-quarter of the size of general government fiscal operations.

Table 1

Estonian general government revenues and expenditure, 2004, million EEK

	Central government (consolidated)	Local budgets	LG revenue and expenditure structure	LG in consolidated budget
Total revenue and grants	**46,526**	**12,852**	**100%**	**23%**
Tax revenue	39,017	6,115	48%	14%
Non-tax revenue	4,327	2,169	17%	33%
Grants	3,183	4,569	36%	
Grants from abroad	2,698	35	0%	1%
grants from other levels of national government	37	4,492	35%	
Total expenditure	**43,895**	**13,077**	**100%**	**25%**
Expenditure on goods and services	10,815	9,665	74%	47%
Subsidies and other transfers	30,487	1,207	9%	4%
Acquisition of non-financial assets	2,110	1,997	15%	49%
Surplus (+)/deficit(-)	2,632	-225	-2%	-9%
..Total financing	-2,632	225	2%	-9%
....domestic financing	-2,982	225	2%	-8%
....financing abroad	350	0	0%	0%

Source: Ministry of Finance and author's calculations

About half of local governments' revenues come from the various taxes. The biggest tax item is the centrally administered personal income tax (PIT). Local governments receive 11.6 per cent from the reported gross income tax amount.

Despite the local governments' relatively high share of nominal fiscal autonomy, municipalities' real fiscal autonomy is rather narrow due to their limited discretionary power (Fiscal decentralisation 2003).

Local governments receive about 36 per cent of their revenues from earmarked and general grants from the central government. The biggest grant transfers are used for educational purposes – to cover school and pre-school teachers' salaries.

Non-tax revenues come mainly from user charges. Municipalities provide various public services – public transport, water supply and sewage, day care and charge consumers for using these utilities.

76 per cent of Estonian municipalities' spending is related to current expenditures for public goods and services and about 2 per cent of Estonian local government activities are financed by debt instruments.

Table 2 presents the Estonian municipalities' expenditure structure. The largest spending is related to education (teachers' salaries and school maintenance) and various economic and cultural activities.

Table 2

Estonian local governments' expenditure structure in 2005 in millions

	EEK	%
Education	6,528	43%
Economic activities	2,147	14%
Culture	2,139	14%
Administration	1,318	9%
Social protection	1,267	8%
Housing	808	5%
Environment protection	683	5%
Healthcare	75	1%
Public order	49	0.3%
Defence	0.3	0.0%
Total expenditure	**15,018**	**100%**

Source: Ministry of Finance and authors' calculations

As opposed to the EU15 practice, Estonian local governments spend relatively less on social protection and healthcare activities. Administrative and general public service costs take about 9 per cent and public order and defence-related expenditures belong mainly to the central government competency.

6.1.2 Legal frames and regulations for debt activities

In some countries, the central government exercises tight control on local governments by imposing strict administrative controls to decrease the risk related to municipalities borrowing. Even the countries with liberal fiscal rules and a high level of fiscal decentralisation, "have relied on fiscal co-ordination, either through fiscal

rules imposed by the central government… or by setting up co-operative institutions" (Fiscal Relations Across Government Levels 2003, p.41).

In Estonia, the fiscal rules for municipal debt activities are imposed and controlled by the central government. In general, local governments' borrowing practicalities are approaching the E*uropean Charter of Local Self-Government*, which declares – "for the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law" (European Charter of Local Self-Government, art. 9).

During the last 15 years, in correlation with a local government wide-range development, their borrowing activities are also more specified and regulated. However, borrowing regulations are rather liberal and provide the municipalities with various options for using fiscal instruments and borrowing schemes.

Local Government Organisation Act (1993) allows local governments to decide over "debts and other (fiscal) responsibilities", but those liabilities must be correlated with jurisdictions' "development plans". Also it is prohibited for local governments to operate as a creditor or loan guarantor.

Rural Municipality and City Budgets Act (1993) specifies the variety of financial instruments that local governments can use. The list of debt instruments includes "loans, capital leasing, issuing debt securities and other debt liabilities". Therefore, Estonian local governments' are allowed to use various debt instruments to finance their current activities as well as long-term capital investments. The named act also sets clear ratios and limits for maximum amounts of debt instruments municipalities can borrow. The law requires that:

- Total amount of outstanding debt liabilities... shall not exceed 60 per cent of current year estimated budget net revenues (calculated without central government earmarked grants). Such a debt-*to-revenue* ratio is established to prevent debt accumulation over the manageable level;
- Total amount of repayable loans, loan interests and expenditure for redemption of debt instruments shall not exceed … 20 per cent of estimated budget net revenue. Such a *debt-to-expenditure* ratio avoids municipalities overburdening their expenditures with debt service cost, which limits fulfilling other vitally important statutory functions;
- Local governments have access both to domestic and international capital markets;
- Borrowed funds can be used in accordance with investments, specified in municipalities' "development plans";
- Debt collateral can only be municipalities' budget revenues, not real estate or other valuables;
- Named restrictions are not applicable, if the loans are used for co-financing of projects which are funded by European Union structural funds;

- The Ministry of Finance and County Governors' must be informed about the loan issuance;

Another principal regulation – *State Budget Law* (1999) – establishes certain additional restrictions for local governments' borrowing activities and sets sanctions in case of over-debt. In case of breaching the norms, set for borrowing activities, the central government can decrease the general grant transfers to the municipality under consideration. In case of long term insolvency, the municipalities, together with central authorities, must work out a "debt restructuring plan" and provide a realistic timeline to solve the problems. Estonian law does not predict the automatic "bailing out" of municipalities by the central government in case of collapse of local debt management. Nevertheless, the central government does provide serious support to municipalities to find a proper solution (see section 3).

In general, Estonian debt regulation policy gives municipalities enough flexibility to attract additional funds through borrowing from capital markets. At the same time, regulations are established to lower the risk of insolvency and avoid debt accumulation. The debt policy is not focused on reducing actual debt size, which fits in with the established norms, but prevents the collapse and instability of local economies.

To summarise – Estonian legislation allows municipalities the use of various debt instruments to finance their activities through outside funds. However, the set of laws has been constantly amended and improved due to an increase in the complexity of local governments' activities and new debt instruments provided by the financial institutions. At the same time, the legislation gives several strict norms for debt management – to cover the risks; ensure the fiscal sustainability of municipalities and stability of the national economy and monetary system.

6.2 Estonian municipalities' debt activities

6.2.1 Debt structure by government sectors

Estonian public debt is the lowest within European Union countries. In average EU (25) countries, the average general government consolidated gross debt as a percentage of GDP in 2004 was 63.4 per cent. At the same time, the Estonian general government debt ratio was only 4.1 per cent due to limited public sector and conservative fiscal policies. In Table 3, the debt ratio across the government levels is given.

Table 3

Structure and level of debt across the levels of government, 1999 – 2004

	Central government		Local government		LG debt in general government debt	General government debt compared with GDP	Foreign debt with GDP
	Total Debt	of which Foreign debt	Total Debt	Of which Foreign debt			
1999	3,514	3,175	1,944	0	39.1%	6.5%	4.2%
2000	2,716	2,506	1,836	199	42.5%	4.7%	2.9%
2001	2,591	2,411	1,815	198	40.7%	4.3%	2.5%
2002	3,287	3,136	2,415	197	43.1%	4.9%	2.9%
2003	3,356	3,236	2,801	425	46.8%	4.8%	2.9%
2004	3,265	3,265	2,728	349	47.4%	4.1%	2.6%
2004 compared 1999	-7%	3%	40%				

Source: Statistical Office of Estonia and author's calculations

As Table 3 shows, the central government's total outstanding debt size has been rather stable during the period 1999 – 2004 and even slightly decreased. During the period, the general government sector decreased both its domestic and foreign debt liabilities compared with the GDP level. At the same time, local governments have increased borrowing and increased their debt size by 40 per cent. Also significantly increased is the sub-governments share in total consolidated government debt.

Basically, the central government has not borrowed from domestic creditors and the majority of its loans came from international financial institutions. On the contrary, the majority of Estonian local government borrowed funds came from domestic banks and the foreign loan burden is minor.

6.2.2 Issuance of debt instruments

In Table 4, local municipalities' revenue trends and debt financing activities during the period 2000 – 2005 are presented.

Up until 2002, the loans were included in the local governments' revenue part. Principal structural changes were made to local budgets in 2003, which modified the classification of both revenue and expenditure items. As opposed to the earlier periods, with the new budgeting principles, borrowed resources were excluded from the revenue side. The debt items were indicated separately as *Financing Transaction* to cover the deficit in municipalities' revenues. As the classification of revenue articles

has been changed, the total amount of Estonian municipalities' revenues formally decreased in 2003 compared with earlier years.

Table 4

Structure of issued debt instruments, 2000 – 2005, million EEK

	2000	2001	2002	2003	2004	2005	2005 to 2000
Total revenue	7,888	10,903	12,469	11,695	12,854	14,663	86%
Total debt instruments	624	738	949	1,131	1,244	1,564	151%
Loans from domestic creditors (% of total debt)	392 (63%)	604 (82%)	919 (97%)	813 (72%)	790 (64%)	905 (58%)	130%
Foreign loans (% of total debt)	210 (34%)	2.0 (0.3%)	26 (3%)	313 (28%)	0.5 (0.0%)	612 (39%	192%
Loans from other governmental institutions (% of total debt)	6.3 (1%)	24 (3%)	4.1 (0.4%)	4.7 (0.4%)	3.6 (0.3%)	43 (3%	587%
Issued debt securities (% of total debt)	15 (2%)	106 (14%)	0 0	0.5 (0.0%)	449 (36%)	2.2 (0.1%	-85%
Debt compared with total revenues*	7.9%	6.8%	7.6%	9.7%	9.7%	10.7%	
Increase of debt from previous year		18.2%	28.7%	19.2%	9.9%	25.7%	

Source: Ministry of Finance and author's calculations

Table 4 shows that the total amount of newly issued debt instruments have increased year by year and have almost tripled during the period. Also, the debt instruments amount has increased faster than the amount on total budget revenues [1]. The figures characterise only newly issued debt instruments and do not include repayment of obligations, interests, leasing repayments and other debt related cost.

The total size of debt instruments was 10.7 per cent compared with total revenues and borrowed funds have steadily increased during the last 4 years. Interestingly, the structure of debt instruments varies very significantly by year. The choice among the debt instruments depends on access to loans, interest rates and cost of debt securities emission.

In all the years, the biggest loan instrument has been the item *Loans from domestic creditors* (banks). Such a situation is rather predictable as the domestic bank-

1 Nevertheless, we have to take into consideration the fact that from 2003 loans are not considered a part of revenues.

ing sector is quite developed in Estonia. Also, borrowing from the domestic banks is usually the easiest, cheapest and fastest way of attracting additional funds.

The size of loans from foreign creditors is very volatile, varying from almost zero level to 612 million EEK. Access to international capital markets became easier due to Estonian membership of the European Union in 2004.

Similarly, the issuance of debt securities has been rather volatile. Emission of debt securities is a more costly and bureaucratic process than taking out bank loans. Small amounts of debt securities are not attractive to investors and therefore it is a more costly way of attracting funds. Therefore, it is much more reasonable to use short term bank loan instruments than debt securities. Nevertheless, any significant size of available bank loans may be limited for a particular municipality. Therefore, in this case, debt securities may be issued. In 2004, the Tallinn city government issued debt securities worth 500 million EEK.

There are several factors which have supported the increase in loan instruments use by Estonian municipalities:

- Municipalities' functions and operational capacity have increased, which logically increases the need for additional resources. Local governments' own revenues and grants are not covering the required amount of funds for municipalities' development plans;
- Improvement of legal frameworks for budgeting and municipalities increased experience in debt management and allows an easier use of borrowed funds;
- Local governments' access to bank loans has increased, both domestically and internationally. Municipalities credibility has increased and banking institutions issue new loans more easily. A supportive factor to municipalities' loan amounts is also the significant decrease in interest rates during the period;
- Credit institutions have developed various new debt instruments, which make use of borrowed funds more case specific and tailored for particular municipalities;
- The political cycle has clearly influenced the municipalities' borrowing activities. In 2002 and 2005 local government elections were held. Also during these years there was a visible fast increase of debt instruments compared to previous years.

As previously mentioned, municipalities have to submit their loan contracts to the Ministry of Finance and County governor. The Ministry of Finance analyses depict that at the beginning of 2005, the total outstanding debt consists of 38 per cent short-term debt instruments and 62 per cent long-term instruments (Ministry of Finance). Most loans go towards investments or restructuring of existing loans. Nevertheless, very often, local governments consider the reporting on the loan purpose as a formality and actual use may be different from that declared.

6.2.3 Debt redemption

In Table 5, the debt repayment structure and dynamics are presented. Logically, the debt repayment structure should correlate with the outstanding debt structure.

Table 5
Debt repayments, million EEK

	2000	2001	2002	2003	2004	2005	2005 to 2000
Loan repayment to domestic creditors (% of total debt)	145 (20%)	274 (47%)	213 (40%)	420 (58%)	723 (72%)	856 (71%)	487%
Loan repayment to foreign creditors (% of total debt)	29 (4%)	63 (11%)	65 (12%)	42 (6%)	127 (13%)	167 (14%)	475%
Loan repayment to other governmental institutions (% of total debt)	241 (33%)	16 (3%)	9 (2%)	42 (6%)	29 (3%)	90 (8%)	-62%
Debt securities repayment (% of total debt)	314 (43%)	228 (39%)	239 (45%)	177 (25%)	48 (5%)	8 (1%)	-97%
Capital lease repayments (% of total debt)	0 (0%)	0 (0%)	0 (0%)	38 (5%)	76 (8%)	81 (7%)	
Total repayment	731	582	527	720	1,005	1,204	65%
Interest payment expenditure	133	139	153	146	143	118	-11%
Total debt service expenditure	864	722	680	866	1,148	1,323	53%
Total debt service expenditure compared with total cost	10.9%	6.7%	5.4%	7.1%	8.8%	8.8%	-19%
Newly issued debt compared with debt repayments	-107.0	155.0	422.0	411.3	239.1	360.4	
Total debt outstanding				3,004	3,540	3,915	

Source: Ministry of Finance and author's calculations

To generalise, the following aspects of loan repayment structure and dynamics should be pointed out:

- As the amount of outstanding borrowed funds is increasing, the repayments are also increasing significantly. Nevertheless, increase of debt repayments have increased at a much slower pace (65 per cent) than the increase in newly issued debts (151 per cent; Table 3);

- In recent years, most debt reimbursements have been repayments to Estonian domestic banks. The total amount of repayments to local banking institutions has increased about 6 times within the period;
- Borrowed funds repayments to foreign creditors have also significantly increased during the period;
- Debt securities redemption has decreased and consist of only 1 per cent of all repayments;
- Over the past 3 years, interest rates have decreased significantly. Therefore, municipalities' total interest cost has decreased 11 per cent, despite the growth of outstanding debt;
- Total debt service cost has varied during the period and recent years cover about 9 per cent of municipalities' total expenditure;
- Despite the increased amount of repayments, the total number of debts is increasing;

6.2.4 Municipalities distribution by debt liabilities

How is the loan burden distributed across the municipalities? In Table 6, all Estonian municipalities are ranked by outstanding debt (*debt-to-revenue* ratio) in 2004 and then distributed to the 5 equal groups (quintiles). One group consists of 48 municipalities and groups are organised from "highest" to "lowest". The figures, characterising a particular indicator, are the average figures of the groups. Separately positioned are Tallinn (as the capital) and the country's total figures.

By the *Rural Municipality and City Budgets Act*, the total amount of outstanding debt liabilities" shall not exceed 60 per cent of estimated budget net revenue" for that budgetary year and repayable debt and related interests cost "shall not exceed 20 per cent of estimated budget expenditure revenue for the budgetary year". Table 6 presents groups' specific characteristics and the clear differences between them. The following are short comments on the different municipalities' groups:

- On average, Estonian municipalities have 38 per cent of debt outstanding compared with their net revenues (*debt-to-revenue* ratio);
- Column (1) shows that in the first group, the average debt-to revenue ratio is close to the limit set by the law (60 per cent). Also, 8 municipalities here are breaching the established debt limit. Municipalities in the first group are bigger by population (column 9) and more urbanised (column 10);
- Column (2) presents the average size of debt liabilities. The average amount of the debt size varies from 1 million to 30 million;
- Column (3) shows that the total debt instruments are distributed rather narrowly among municipalities. The first group, together with Tallinn city, has issued 77 per cent of all debt outstanding. Tallinn alone has issued 44 per cent of all debt liabilities. On the other hand, municipalities in the lowest groups, which include

Table 6

Municipalities' groups by debt liabilities, 2004

Munici-palities' groups	Debt compared to total revenues (debt-to-revenue ratio)[1]	Total outstanding debt liabilities, thousand EEK	Group share of total debt	Total net revenue[2] thousand EEK	Debt repayment compared with expenditure (debt-to-expenditure ratio)[3]	PIT revenue in total revenues	PIT per capita, EEK	Deficit (-) Surplus (+)	Average population in groups 01.01.05	Number of towns in the group
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Estonia	37.8%	4,402,800	100%	11,645,300	9.9%	47.6%	4,046	-2.6%	1,370,300	39
I	53.8%	30,100	32.7%	61,000	9.3%	42.7%	3,638	-6.9%	7,500	18
II	31.3%	12,200	13.2%	37,800	6.4%	37.2%	2,952	-2.9%	5,300	10
III	20.0%	5,400	5.9%	26,200	4.8%	38.7%	2,979	0.6%	3,400	7
IV	13.3%	2,700	2.9%	19,800	4.7%	35.6%	2,903	1.0%	2,300	2
V	5.7%	1,000	1.0%	15,700	2.3%	36.4%	2,844	1.9%	2,000	1
Tallinn	49.3%	1,948,500	44.3%	3,950,000	14.5%	53.2%	5,272	-6.3%	399,000	1

Source: Ministry of Finance and authors' calculations

1. *Debt-to revenue…*" shall not exceed 60 per cent of current year estimated budget net revenues"
2. Revenue here is defined as "cleaned or net revenue" or total revenue minus earmarked grants
3. *Debt-to expenditure…*"shall not exceed …20 per cent of estimated budget net revenue"

60 per cent of all local governments, have borrowed less than 10 per cent of the total debt amount;

- Column (4) presents a clear correlation between debt ratio and budget size of municipalities. In Estonia, collateral of the borrowed funds can only be the municipalities' current budget revenues. Such a requirement puts municipalities into an unequal situation. As smaller municipalities' borrowing capacity (e.g. for capital investment purposes) is extremely limited, they are not able to use debt instruments for capital investments at all. Bigger municipalities usually have better credibility and debt management capability, which allow them a more wide use of the various debt instruments. Large differences in debt finance capabilities is a strong argument, which favours administrative-territorial reform in Estonia;
- Column (5) presents the average ratio of debt redemption cost (*debt-to expenditure* ratio) compared with total annual budget expenditures. Centrally established norms prohibit municipalities spending more than 20 per cent of their total expenditure for servicing debt repayments, which includes both principal and related (interest) cost. As Table 6 presents, in Estonian municipalities, the average debt service cost is about 10 per cent. There were 7 municipalities in 2004, which spent more than 20 per cent of their total cost of debt service. Most of them belong to the highest group of municipalities;
- Column (6) characterises municipalities' groups' revenue structure. As personal income tax (PIT) is the biggest own income source for Estonian municipalities, its higher level allows municipalities to also exploit more borrowed funds. Therefore, intuitively, one can say that the bigger share of PIT in revenues, the more the municipalities are able to use debt instruments. Nevertheless, despite the fact that the highest group also has the highest level of PIT per capita, the relationship between debt-to revenue ratio and municipalities' personal income revenue share in total revenues is not clearly coming out;
- Column (7) clearly presents that municipalities with a higher income level are also taking more loans;
- Column (8) shows the size of the deficit or surplus by the municipalities' groups. In the highest group, the budget deficit extends to 7 per cent, with a similar situation in Tallinn (-6.3 per cent). On the contrary, in lower group municipalities, the budget balance is positive.

6.3 Debt management and control: case of over-debt

Why are municipalities over-borrowing or why are they not managing debt instruments adequately? On the basis of reports provided by the Ministry of Finance[2], several reasons for debt mismanagement may be generalised:

2 Ministry of Finance prepares annual reports about municipalities debt liabilities, available on http://www.finmin.ee

- Failure of local government;
- Miscommunication between different parts of the government sector;
- Fast growing municipalities conduct aggressive borrowing;
- Populism and election cycle leads to over-borrowing.

In the first situation, the small north-east Estonian town of Püssi is an example. This mono-functional town, with a population of 1850 habitants, has exceeded the allowed debt-to-revenue ratio more than 3 times during the period 2000 – 2004. During the 90s, the town's central heating system was upheld by a big private furniture factory. After a significant decline in its production and financial difficulties, the factory refused to provide heating services to the town. The town was forced to take an extensive loan to construct a new central heating station. However, in the situation of fast declining economic activities in the region, high employment level and increasing poverty, the local government was unable to service the debt. Even worse, the town was not able to nominate an efficient local town government to manage the municipal finances. Therefore, Estonian central government took over temporarily the local governance and worked out a strict plan for loan restructuring and restoring the capacity for local governance.

Another example of over-borrowing is related to miscommunication and information asymmetry within the different levels of the government sector. Some of the local municipalities received funds from the central government to modernise their heating systems, energy or water supply systems during the 90s. But earlier, central government received similar funds from different European Union and Nordic countries as donations, which did not require short-term repurchase. Therefore, the local governments which received those funds also considered them as donations, not as loans. Surprisingly, under pressure from the central government, municipalities were forced to redeem the funds. Some of the municipalities issued new debt instruments for repayments and breached the set norms [3].

Some of the fast growing regions' municipalities have breached the debt-to-revenue ratios intentionally. The highest income municipalities, particularly around the capital city area, are enthusiastic to provide more attractive public services (sports centres, kindergartens, etc.) and are using borrowed funds for this. Despite the fact that there are limited risks for the whole economy, such municipalities violate the established rules. Particularly, extensive borrowing by the big municipalities may put the national economy and monetary system at risk.

The election cycle has also had a direct impact on municipalities' borrowing activities. Table 4 clearly presents the increase in borrowing during the election campaign periods of 2002 and 2005. Local government boards have increased

3 Nevertheless, some municipalities (e.g. Tartu city) are still arguing with the central government over debt liabilities through the courts.

spending to the public services and have used more debt finance to gain a better position in the election process.

6.4 Summary

Estonian municipalities have significantly increased the use of debt instruments during the last decade. Three aspects summarising local borrowing should be mentioned here.

First, during the period, legal regulations and institutional frames for municipalities' debt activities have improved. Borrowing regulations, rules for debt management and monitoring became more specific and general. On the other hand, regulations give adequate sovereignty for municipal debt activities.

Second, Estonian municipalities became more experienced in debt management and in exploring various financial instruments. Their credibility has increased; they have become reliable and responsible partners for financial institutions.

Third, significant developments in the banking sector and favourable interest rates have increased the attractiveness of borrowed funds by the municipalities. New debt instruments (e.g. capital leasing) provide more flexible instruments for municipal finance.

Nevertheless, the monitoring of local municipalities' debt activities should continue to be the in the care of the central government. In case of debt mismanagement or potential risks for national stability and economy, the central government should react fast and adequately.

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7. Managing Public Debt in Romania: Realities and Perspectives

Ana-Maria Bercu and Mihaela Onofrei

7.1 Introduction

For Romania, the years of transition towards a market economy meant not only experiencing a change of leaders in the governmental process, but also of certain financial strategies that did not work out the way they were intended to. According to the types of financial strategies applied in the economy, more than fifteen years of transition can be grouped as follows (Onofrei, 2000, p. 258.):

- The 1990 – 1992 period was characterised by "the shock therapy" strategy. A freedom of prices was applied in 1990, though signs of competition delayed their appearance. The convertibility of the national currency began on November, 11th, 1991 but the liberalisation of the currency exchange, doubled due to the decrease in production, made the national currency extremely vulnerable as regards the other national currencies.
- The 1992 – 1996 period brought a change in the point of view of the strategy applied by the same political forces that won the 1992 elections; thus, the social-democratic government promoted a "gradual therapy", in order to diminish the effect of the reform on the population, making the social cost of change more bearable. Despite the change in the way of implementation of the financial-political actions, the results did not live up to expectations; as a result, 1995 was characterised as being the year of failure of the Romanian step by step reform, the year of the biggest external commercial deficit ever known by our country.
- The 1996 – 2000 period brought not only a change in the political ruling forces (the establishment of a liberal government), but also a renunciation of the "gradual therapy". With the return of "the shock therapy", the new financial strategy did not succeed in generating the needed economic growth. Besides, 1997 brought the lowest level of existence of the population during the entire period of transition.
- The 2000 – 2004 period was also characterised by a gradual therapy because there was a change in governmental; the social-democratic party won the elections and made the social cost of transition more bearable, using social policies such as modalities.
- The 2004 – today period is characterised by the shock therapy; the election in 2004 was won by the liberal and democratic parties who promoted this therapy, influencing the national financial policies, using a unique tax rate of 16 per cent and VAT of 19 per cent. These measures increased the level of the people's revenues and also increased economic growth.

Our paper proposes to examine the most important modalities to administrate efficiently the financial resources at both the national and local levels to realise the investments

The necessity to increase the public and private investments of local municipalities is a challenge to local governments in Romania due to the rules for joining the European Union. The lower level of their funds and the impossibility to increase the local tax with the aim of increasing budgetary revenues at the local level requires finding some alternative financial sources to sustain the local investment projects.

Local governments can borrow in the form of loans or bond issues, in the currency and from the establishment of their choice. Borrowing can be used to find capital expenditure and operating deficits. Local governments are free to invest their available cash flow with the establishment of their choice.

In Romania, as with all countries in transition, local governments can pool resources with other national or foreign local governments. When the transition began, local governments mainly availed of the opportunity to form local government representative associations to represent them and defend their interests in their dealings with central government.

The investments made by local administrations in Romania were and are still much under the demands of the European Union. Most of the infrastructure became dated and requires a great effort to replace and modernise.

Development projects should find the financial resources in proper revenues of local budgets and in transfers and subventions from the state budget, but those are falling short.

Therefore, which are the sources that local authorities have access to for financing investment projects? A first source is by internal or external financial underpayments, as well as those from structural funds such as PHARE and SAPARD received from the European Union on the basis of negotiations between the Romanian Government and the European Commission. Public-private partnerships represent another modality for financing local investments. This means co-operation between local authorities and the private sector to realise economic projects for communities' development. This partnership has demonstrated a certain efficiency to sustain far-reaching projects.

To continue the investments and accomplish another one supposes to look for other source of revenue. Under the circumstances of decentralisation, local authorities have access to local debt instruments:

- municipal certificates;
- borrowing from banks or multilateral organisations.

The legal framework is insufficient for local authorities to sustain financial projects of local development, borrowing from different public and private "actors".

The Urgency Order of Government no. 45 /2003 eliminated those problems. The restriction of local authorities to open a banking account with the commercial banks to accomplish payments and receiving operations was eliminated, which facilitated access of the banks to the financial situation of local governments and estimate their financial creditworthiness.

Using indebtedness appears to have positive effects: increase the welfare of local communities; the implications of private actors in the economic development of local communities and creating new work places. To the local authorities those are resources which, at some time must be repaid. Loans generate extra expenditures for local governments with interest and commissions. Thus, an insufficient experience of local authorities in this field generates negative effects such as the impossibility to repay loans and, inevitably, payment incapacity with serious repercussions on the national economy.

For local governments from Romania, indebtedness represents a concrete way to realise projects for local development. Good local management at the local level, linked with financial politics which sustain local authorities' efforts and sustaining a legal framework are all important stages in increasing the welfare of local communities.

7.2 Broad Institutional Framework: The Governmental System

7.2.1 The Central Administration in Romania

The state administration in Romania consists of a unitary system with one central organ, the Government, led by the Prime Minister, who provides both a material and intellectual coordination. In accordance with the Constitutional Law from 1991, which was changed in 2003 by Law no. 429/2003, the Governmental role is one of coordinating the internal and external politic of the country and also the entire coordination of public administration. The structure of the government in our country is formed by the Ministries, which today count fourteen, with the public administration having a managerial authority in the Ministry of Interior and Administration.

As is known, the organisation of the administration can be made according to the state territory. In all the states, the space framework is judicially defined in territorial-administrative circumscriptions. In Romania, although the state territory is non-divisible and unitary (one of the principles of a state of law), the territorial-administrative circumscriptions are organised for the purpose of better satisfying the interests of local communities. These circumscriptions are called "judete" (counties) and currently number 41 and the city of Bucharest, the capital of Romania. The counties consist of "orase" (towns) and "comune" (groups of villages). Currently there are 262 towns and 2,686 groups of villages. Some towns can be declared "mu-

nicipii" (cities) – with Romania having 67 cities. In their turn, the "commune" consists of villages – Romania having approximately 13,000 villages.

The Constitutional Law of 1991 made important changes regarding the settlement of local authorities. These are horizontally subordinated to the Prefect and vertically subordinated to the Minister. The principles applied in administration, in accordance with the Constitutional Law of 1991, were: local autonomy and the decentralisation of public services. The Law no. 429/2003 which modified the Constitutional Law of 1991 added another principle which organised and made functional the local administration: the de-concentration of public services principle. The Law of Public Administration no. 215/2001 adds to the previous principles – the principles of eligibility of local public administration authorities, of legality and of consulting the citizens regarding solving problems of special interest. Yet, applying these principles cannot reach the characteristics of Romania's national, unitary and non-divisible state. These principles are in accordance with a European principle – the subsidiary principle promoted by the Maastricht Treaty.

According to the Law of Local Public Administration, local autonomy is understood as the effective right and capacity of the local public administration authorities to solve and administrate legally the public affaires on behalf of and in the interests of the local communities that they represent. This right is exercised by the Local Councils and the Mayors, and also by the County Councils, which are authorities of the local public administration elected through universal, equal, direct, secret and freely expressed voting. The local autonomy is merely administrative and financial, being based on and within the boundaries of the law. The local financial autonomy means the local authorities have the fiscal and financial instruments to administrate local financial resources. These instruments are the local budget and the local taxes which form the income of the budget.

The relationship between the local public administration authorities of towns and villages and the county level public administration authorities is based on the principles of autonomy, legality, responsibility, co-operation and solidarity towards solving the problems of the whole county.

In its turn, the principle of decentralisation of public services stipulates the setting up of public services in villages and towns and their elimination at the county or central levels.

The de-concentration of the public services principle supposes the possibility of exercising only an administrative guardianship from the central to the local level by reducing the responsibilities of central government which delegates to the local level. This means creating the "actors" who must take the responsibilities and responding to the local community interests.

Therefore, the local public administration is carried out in villages and towns by the Local Councils and Mayors and at the county level by the County Councils.

There is no subordination between local public administration authorities and the County Council, on the one side, and between the Local County and the Mayor, on the other.

7.2.2 The Local Public Administration in Romania

At the local level, in towns and villages the administration is carried out by the Local Council as a deliberative authority, with the Mayor as the executive authority. These authorities exert the local autonomy in towns and villages. The Local Councils are also present in those towns which are declared cities. The number of each Local Council's members is decided through an order issued by the Prefect and according to the population of the respective village or town. Therefore, the number of councillors can vary between 9 (for villages and towns with up to 1,500 inhabitants) and 31 (for villages, towns or cities with over 40,000 inhabitants), while the General Council of the City of Bucharest has 55 councillors. The Local Council organises specialises committees for its main fields of activity, and its mandate is for a year.

Among the attributions of the Local Council regarding the exertion of local administration there are:

- the administration of the public and private territory of the village/town;
- the setting up of institutions and economic agents of local interests;
- the setting up of specific regulations for its subordinate institution and economic agents;
- to ensure the protection of public order and of a proper environment for the good functioning of the educational, health and cultural institutions (within the limits of their competence).

The Mayor is the executive authority of a village/town. In practice, she/he is the essential element for the administration of the village/town she/he was elected by. According to the Law on Public Administration no. 215/2001, the villages, the towns and the cities each have one Mayor and one Vice-Mayor. The chief cities of each county and the Bucharest sectors each have one Mayor and two Vice-Mayors, elected according to the law. The city of Bucharest has one General Mayor and four Vice-Mayors, all elected according to the law. The Mayor is the chief of local administration and reports directly to the Council regarding the proper functioning of the local administration. She/he represents the village/town regarding justice and also in the relationship with physical and judicial persons from all over the country or from abroad.

The county has a double judicial nature, being both territorial-administrative circumscription and also a decentralised human community. Its main tasks are to guide, coordinate and control the activities of the administration. Through co-ordination, it achieves the rationalisation and simplification of the activities of local authorities, avoiding parallelism and repetition of attributions by the local

public administration authorities. Also, the general interests of the local communities of the county are fulfilled through the control of the administration paperwork's legality.

The specific authority of the county's public administration is the County Council. Its most important attributions are to co-ordinate the activity of town councils and village councils and to ensure the functioning of the public services of county interest. The County Council is led by a President who is the chief of the county public administration and is responsible for its proper functioning. The President ensures the putting into practice of the decisions taken by the County Council, exerts the attributions that the county has as a judicial person and names and releases the personnel of the county public administration with the exception of its secretary.

In Romania, as in other democratic countries, a representative of the state of the executive power was named at the level of territorial-administrative units: the Prefect. Until 2004, the Prefect was named by the Government with the criteria of having political membership at the one level party. Now that the institution of Prefect has been declared an apolitical function, this means that the persons who take up these functions must be high level public servants. In accordance with the Law no. 340/2004 on the institution of Prefect, the attributions of the Prefect is to lead the state services at the local level and control the activities of the Local Councils, the County Councils and the Mayors, within the boundaries of law. As an agent of the executive power in the county, the Prefect may be considered an element of de-concentration within the public administration system that co-ordinates a state sub-system. Between the Prefect and the Government there are relationships of hierarchical authority, determined by the hierarchy structure of the state authority system. In the light of these relationships, the Prefect leads the subordination of the territorial Ministry services, ensuring the state's unity of action all over the county. In this way, the link between the local interests (of villages, towns, cities and counties) and the national interests are expressed by the law.

7.2.3 The Local Financial Autonomy

The local autonomy and the existence of local public authorities create premises for distinct organisation of local finances. In this way, the central finances are relieved of a series of expenses, the number and dimension of monetary flux between the local and central levels is reduced and an environment is created for a proper follow-up of the way the constituted funds are being spent. It is important to study and to continue to analyse how far financial autonomy can reach and what is its impact on the local finances.

The local communities represent human communities that are distinct from the state and that have, as shown previously, public authorities that are different from those of the state. This is a necessary condition for the financial autonomy, as

"administrative autonomy is not possible without a financial autonomy that provides the material support for functioning"(Mosteanu, 1997, p. 140). There is also a strong argument according to which the local communities know their own possibilities regarding public financial resources and especially the needs regarding the expenses that need to be covered. After all, the separation of the local finances from the central ones and their setting up into a distinct sub-system are determined by economic reasons. In each country, the relationship between central public finances and local public finances is different.

The degree of financial centralisation differs according to the degree to which the local authorities are subordinated to the central authorities. In any case, the national interest problems that affect all citizens belong to the central funding, any other type of means being impossible; they are funded by central funds: defence, state public order, state administration, external affaires, protection of the environment and of the citizens, art, education and also the macro-social politics of regularity, stability and welfare.

The financial decentralisation begins to function beyond the limit from which the sphere of the use of public goods and services of national interest begins to tighten, and the comparative cost of decision taking at central level becomes too high. This concerns certain utilities such as road building, police, public lighting, village management, local transports, schools etc. At the same time, there are differences from one territorial-administrative unit to another regarding the request for public utilities and the possibilities of providing them. In addition, the local community is open; they have various relationships between themselves. All these imply local self-funding. In Romania, the functioning of local finance based on financial decentralisation benefits from common techniques of public finance.

The effect obtained in the functioning of local finances refers first of all to taking over some state financial attributions, then to the increase of local resources and expenses. This way, in Romania, the local communities have achieved the right to make loans from the capital market; also, the local finances have achieved large competencies in the field of budgetary and juridical control, and the local authorities have an accounting system of their own.

The main part of local finances is played by the local budgets, which control the financial resources necessary for the achievement of the action part of the competence of the local public administration organs. The local budget is the instrument within the local authorities which exerts their own local financial autonomy. This includes the county budgets, the municipality budgets, the city budgets and the commune's budgets.

To exert the local financial autonomy, the Romanian state respects the principles stipulated by the European Charter of Local Administration (1985):

- as part of the national economy politics, the local collectivities are entitled to their own resources that they can use freely in practising their attributions;
- the financial resources of the authorities of the local public administration must be proportional to the competencies stipulated by the constitution or by the law;
- part of the financial resources of the local collectivities must come from local taxes, whose percentage can be decided within the limits of the law;
- the financial systems that support the resources of the local collectivities must have a sufficiently diversified and evolutionary nature so that they are able to follow in practice as much as possible the evolution of the expenses in their sub-order;
- the support of the local collectivities, weaker from the financial point of view, requires bringing into operation certain procedures of correct financial distribution or of some equivalent measures, meant to adjust the effects of the unequal distribution of the potential financial resources. Such measures must not reduce the freedom of options of the local collectivities in their field of responsibility.

7.3 Public Debt: The Government Deficit Financing

The public governmental debt represents the totality of internal and external financial obligations of the state, resulting from the loans contracted directly or guaranteed by the Government from the financial markets. The Government is authorised to contract internal and external state loans, only through the agency of the Ministry of Public Finance in view of temporarily financing the state budget deficit, financing the deficits from previous years of the state social insurances budget, refinancing the public governmental debt and financing some projects approved through Government decision. In conclusion, the Government is the state authority that can contract internal and external loans for purposes which take precedence over the country's economy.

The general framework regarding the financing of public debt and its management is ensured by Law no. 313 of 28 June 2004. In accordance with the legal provisions, we must analyse a series of theoretical concepts regarding the economic and judicial content of the public debt. Thus, the public governmental debt comprises:

a. the internal public governmental debt;
b. the external public governmental debt;
c. the internal local public governmental debt;
d. the external local public governmental debt.

The internal public governmental debt represents that part of the public governmental debt that comprises the totality of financial obligations, resulting from directly contracted loans (without governmental guarantee) or with governmental

guarantee; from physical or judicial persons, residing in Romania, in lei or currency, and also the sums used temporarily from the general current account's reserves of the State Treasury for the temporary financing of budget deficits. The internal governmental public debt constitutes, for the state authority, an irrevocable and unconditional obligation of reimbursing the contracted loans, of paying its inherent costs: interests and commissions. The internal public debt is determined by (according to the prevision of art. 5 from Law no. 313/2004):

- short term loans, contracted by the state with a view to balancing the state budget and which is reimbursed during the year;
- the issue of treasury money with the purpose of balancing the state budget, reimbursable from the budget resources until the end of the year;
- placing documents, through public subscription, on long and medium term, with the purpose of obtaining the financial resources necessary for covering the annual budget deficit;
- the guarantees given by the state for the internal bank credits contracted by the economical and administrative-territorial units with the purpose of satisfying some economical development needs;
- the short term use of resources from the public treasury accounts.

The competent authority that administers the internal and external loans is the Ministry of Public Finance. Among the Ministry of Public Finance's attributions regarding the state external public debt of the state there are the following:

a. the examination of terms and conditions of external loans permissions from the international financial markets;
b. the issue, the contracting, the administration and reimbursement of external loans and the payment of inherent costs;
c. the analysis of conditions for the refinancing of external public debt and the insurance that the new loans are integrated in the annual external debt ceiling, correlated with the public debt service;
d. the administration, together with National Bank of Romania, of the currency reserve of the state in view of ensuring the necessary resources for its increase, the use together with the National Bank of Romania of the currency reserves for the payment of the public debt service.

The internal and external local public debt is the totality of the financial obligations of the local public administration authorities, coming from loans contracted directly or guaranteed by those from individuals and entities. The public debt is engaged by local public administration decision-making authorities and is an obligation that must be reimbursed from financial resources of which territorial administrative units avail. The instruments for contracting local public debt used by local public administration authorities are:

a) municipal certificates;

b) loans from commercial banks or other credit institutions.

According to the legal previsions, the local public administration authorities cannot lend funds if the overall annual local public debt comprising due instalments, interests and commissions is more than 20 per cent of the amount of the current revenues of the local budget. In Romania, to cover the budgetary deficits, medium and long-term loans are contracted. The direct consequence of credit reimbursement is the increase of the budgetary expenses. Budgetary expenses are supported either by the increase of taxes or by contracting new credits. If the ordinary budgetary revenues do not fully cover the budgetary expenses approved for the next year, the Government must either increase the existing taxes or introduce new taxes, or contract loans. Usually, the second alternative is preferred by authorities. The modality of increasing taxes or introducing new ones is not a solution for authorities, as the standard of living of the population is affected. At the same time, the governing parties are sanctioned by the electing people.

Loans are a simpler modality to procure funds from the perspective of the conditions and of the legal terms for granting them. Irrespective of the modality chosen by the governing authorities, the impact on the population is negative, because taxes are increased. Loans are an expensive way to procure funds and place a burden on the shoulders of future generations. Some theorists consider that "state loans do not cause a transfer of burdens from one generation to another, because the value judgments should be made at the level of the entire society, not by its members individually". The positive impact of loans is shown in production: the modernisation of agriculture, the development of industry, of technology and environmental protection. In Romania, after December 1989, the increase of the public debt increased gradually from 0.6 per cent in 1990 to about 25.6 per cent in 1997. Because of the low development of the internal capital market in Romania after December 1989, the fund requirement was covered through external loans (at a high rate of about 75 per cent) and internal loans (at a rate of 25 per cent). After 1992 there occurred budgetary deficits that had to be funded and after that, refunded. A large part of the Romanian public debt was made up by contracting loans with a special destination, such as covering of the losses made by state companies during the years 1989 – 1990 covering non-performing loans taken over from the state banks, covering the damages produced by calamities, which are reflected in banking unpaid loans.

The quantity of money owed by the country that reflects the balance between the public debt balance and Gross Internal Product (GIP) has a special importance for the problem under discussion. We must take into account the financial effort that the public debt supposes, materialised in the public debt service. These are the expenses with reimbursing the debt, the capital rate, interests and commissions.

The financial effort is expressed with the help of several financial indicators: the absolute measure and the average measure per inhabitant of public service debt, the relations between the public debt service and GIP and the weight of public service in the total public expenses.

The increase in internal public debt was realised with strict limits imposed by a ceiling of the internal public indebtedness, approved by the Romanian Parliament. Thus, for 2002, the internal public debt was 118,067,67 bil. lei, being financed by contracting state loans in lei and currency directly from the internal capital market and also the loans of a temporary nature from the resources of government accounts gathered in the general account of the State Treasury.

Financing the internal public debt generated by the consolidated budget deficit was realized by state loans from the internal capital market and represents 86 per cent of the total internal public debt. Most of these loans were contracted short-term (approximately 92 per cent of the total internal public debt).

During the year 2003, the internal public debt was 114,901 bil. lei, from which 92.1 per cent was generated by the financial deficit. In 2004, the internal public debt was 1,456,27.9 bil. lei. During the year 2005, the limit for the internal public indebtedness was 11,000.0 million lei (RON). The covering degree of this ceiling was, as at 31 December 2005, 87.6 per cent. The internal public debt was 16,350.6 million lei.

Concerning the management of internal debt; efforts were made to extend the maturity curve of instruments for financing and refinancing the public internal debt. Beginning in April 2005, the volume of state stocks with a payment of 2, 3 or 5 years was increased, using the emission of state stocks with terms of 7, 10, 12 and 15 years. Diminishing the service of internal public debt was realised through refinancing the public internal debt on the short-term through state bonds emitted long-term and reducing the rate of interests of state stocks. Taking this direction emphasises the principles of transparency and predictability of the modalities to spread the emission of state stocks. The first step to make these principles work was to create an institutional framework for consulting with the participants from the internal market (primary dealers, the societies of life assurance etc.).

The legal framework of external public debt was defined by Law no. 81/1999 on public debt, as part of the public debt of the state which represents the total obligations of the state from the external capital market, directly contracted or with state guarantee.

Table 1
The evolution of Internal Public Debt since 2002 (bil. lei)

Year	Internal Public Debt (in total amount)	Directly Internal Public Debt		Internal Public Debt (with governmental guarantee)	
		Values	%	Values	%
2002	118067,7	108433,8	92%	9633,9	8%
2003	114901,0	106943,3	92,1%	7957,7	7,9%
2004	145627,4	123030,8	84,5%	22597,1	15,5%
2005	163506,0	139167,0	85,1%	24339	14,9%

Source: Dates remaking after the economics index of Ministry of Public Finance

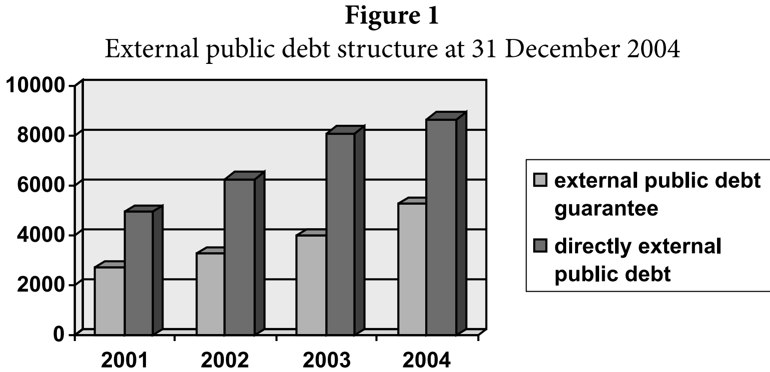
The external governmental debt is constituted from the totality of financial state obligations, resulting from the loans contracted directly or guaranteed by the state from physical or judicial persons who do not reside in Romania. Following negotiations with the European Union, through the Position Document Chapter 11 - Monetary and Economic Union, Romania has made a pledge that, by 31 December 2004, it will modify Law no. 81/1999 about public debt, because it is necessary to correlate the previsions with European Union legislation about the interdiction to finance directly the public sector. To make this agreement available, on 29 June 2004, a new law was ratified on public debt.

When the new law on public debt entered into force it eliminated the possibility for line ministries to contract loans with state guarantees and the state guarantee was limited to projects of major importance and only with the notice of the Competition Council for respecting Romania's commitment in the field of state grants.

In the field of management of external public debt, the Ministry of Public Finance has taken some measures to reorganise the portfolio of external public debt to reduce the annual service of external public debt. To reform the institutional framework, the Ministry of Public Finance benefits from technical and financial assistance from the EU PHARE project concerning "The Improvement of Management System of State Treasury", from the US Treasury and other financial institutions such as the World Bank and International Monetary Fond.

Increasing, year after year, the external public debt has been made on the strict basis for contracting external credits and, also in limits that cannot exceed the state capacity to assure the public debt service and to repay the capital rate, interests and commissions respectively. For this, the ceiling for external public indebtedness is established annually and delivery must be approved by the Romanian Parliament. The amount was established at 3.5 bil. Euro and the equivalent in US dollars was agreed by the International Monetary Fond as a profitability criteria.

Figure 1
External public debt structure at 31 December 2004



Source: Dates remaking on the www.mfinante.ro

From this analysis we can see that the external public debt increased from 7684.3 million USD during the year 2001 and increased to 13,964.8 million US dollars at the end of 2004, due to the new credits contracted and also the appreciation of the Euro over the US dollar.

In July 2004, the Managerial Council of the International Monetary Fond approved, spread over two years, a new stand-by agreement with Romania. The principal aims were:

- maintain the deficit of the current account at sustainable limits;
- maintain the currencies reserves at a comfortable level.

Also, for our country, which wants to become a member of the European Union in 2007, this agreement implies the measures for improvement the government, business climate and finalising the privatisation order.

During 2004, the state external credits were contracted/guaranteed. Their destination was to eliminate the effects of flood, to build sports halls, for educational infrastructures, for the project “economy based on knowledge”, for decreasing the risk of natural calamities and for the reform of the flood sector. The loans with state guarantee were directed to transportation and communications, the power sector, environmental protection, health, public order and national security, boundaries security, radio communication, public utilities and the environment.

The external public debt service for the year 2004 was 2280.0 million US dollars, (44.8 per cent) and for external credits with a state guarantee of 1257.5 million US dollars (55.21 per cent). From total services, 1638.3 million US dollars represents repayments of the capital rate and 641.7 million US dollars represents interests and commissions. The prevision for 2005 – 2008 is that external public debt service will be 2.5 – 2.7 million USD.

Table 2
The financial indicators of external public debt

Financial indicators of external public indebtedness	Effectively (%)	Standard (%)
- the relation between external public debt and GIP	17,3%	50%
- the relation between external public debt service and GIP	3,2%	-
- the relation between effectively external public debt and goods and services exports	46,7%	200%
- the relation between external public debt service and goods and services exports	7,6%	20%
- the relation between external governmental debt and GIP	14%	-
- GIP during 2004	2341400 million USD	
- exports of goods and services	29907,8 million USD	
- medium currency exchange lei/USD	32637 lei/USD	
- currency exchange at 31 December 2004 lei/USD	29067 lei/USD	

Source: Dates remaking on the www.mfinante.ro

For the period 2007 – 2009 it has been estimated there will be a reduction in expenditures with commissions at internal public debt, because the rates of interests and state stocks will be on a downward trend. Also, the service of external public debt will register short levels, with a level of 2.1 bil. Euro in 2007 and 1.4 bil. Euro in 2009 [1]. Because of reduced budgetary deficits, even the degree of public indebtedness will not increase, and because of increasing GIP and reducing the budgetary deficit, it is expected that the weight of governmental public debt in GIP will decrease (Table 3).

It is known that for financing huge external debt, the Government has instruments which have negative effects on the economy, for example increasing taxes or reducing government expenditures. To avoid such phenomena, the politics of budgetary deficit and public debt must remember that Romania cannot permit a great deal of public debt or increase it because of the European legal previsions.

In accordance with these financial indicators, Romania is one of the countries with a sustainable public debt. Sustainability of external public debt is demonstrated by the evolution of the relationship between the external public debt and GIP; this means that the indebtedness degree was and is still under the level recommended of 50 per cent.

1 Rapport concerning the macro economical situation on 2006 and previsions for 2007 – 2009, http://www.mfinante.ro/buget/buget2006/pdf/Raportbuget2006definitiv_Parlament.pdf

Table 3
The previsions concerning the public debt during 2007 – 2009

Financial Indicators	million RON		
	2007	2008	2009
Stock of internal public debt	**21972.1**	**25543.7**	**26544.3**
Interests of internal public debt	1204.2	1357.8	1421.6
% from GIP	0.34	0.33	0.32
Service of external public debt	**2144.3**	**2123.5**	**1368.6**
- Capital rates	1678.3	1698.6	1041.4
- payments of rates of interests and commissions	466.0	424.9	327.2

Source: Dates remaking on
http://www.mfinante.ro/buget/buget2006/pdf/Raportbuget2006definitiv_Parlament.pdf

7.4 Forms of Local Public Debt

As Romania accedes to the EU, it is necessary that the local public administration authorities develop public policies that should lead to a considerable economic increase. Private and public investments should be made in this direction to modernise the infrastructure. The local development projects should be sustained by local budgetary resources as their own revenues, mainly from taxes, fees, income and transfers from the State Budgets. Local administrations have low own revenues and the possibilities to increase the local taxes and fees for increasing their revenues are limited by law. Therefore, local authorities must find alternative financing sources.

These would be:

- unredeemable internal and external funds, financing from European structural funds (e.g. PHARE, ISPA, SAPARD)
- public and private partnerships.

These alternatives are hard to implement, which is why local authorities can only contract loans from various creditors which are paid back within a certain deadline and involve a certain interest. The legal framework is the Law no. 189/1998 regarding the public local financing, Law no. 215/2001 regarding the local public administration and Urgency Order of Government no. 45 /2003 regarding public local financing. These normative acts ensure the financial autonomy of local collectivities. In conformity with article 57 of the Urgency Order of Govern no. 45 /2003, “in order to achieve public investments of local interest, Local Councils, Municipalities Councils, General Council of Bucharest according to the case, may approve contracting internal and external loans in the short, medium and long-term and may guarantee them for economic agencies and public services in suborder”. The

decision-making authorities at the administrative-territorial units level may contract internal loans without a governmental guarantee but with the prior notice of the Ministry of Public Finances, yet external debts may be contracted directly or guaranteed by the local public administration authorities only with the approval of the board that authorises such loans, made up of the representatives of the public administration authorities, of the Government and of the Romanian National Bank and approved by the Government. The local public administration authorities may also benefit from sub-contracts of the local authorities.

Table 4
The relations between local revenues and loans borrowed by the local public administrations

Years	Total; revenues (bil. lei)	Loans (bil. lei)
1991	58.6	-
1992	199.7	-
1993	712.5	-
1994	1,767.2	-
1995	3,336.5	-
1996	4,998.5	46.9
1997	10,468.5	49.4
1998	13,454.2	72.9
1999	22,243.7	362.6
2000	33,445.0	27.8
2001	71,195.7	217.6
2002	93,227.7	551.3
2003	130,781.0	2,392.0
2004	159,558.0	-

Source: The statistical book of Romania from 2005

From the analysis of the presented data, one may notice an increase in loans, especially beginning in 1998. This was mainly because of the administrative reform, from a financial perspective starting from the adoption of the Law 189/1998 regarding the local public authorities.

The authorities of local administrations which ask for the authorisation for contracted loans must present to the Commission the following:

- technical and economical documentation for the investment objective which finance it or assure totally or partially from external loans;
- the decision of the local authority;
- a provisional budget for the actual financial year and for the next three years which must estimate the level of proper revenues of the local budget, the amounts

detracted from income tax, the entries on the local budget of internal and external loans, as well as local expenditures with the service with local debt.

Contracting external loans from the local authorities with governmental guarantee and its realisation on the documentation base, which we have already mentioned, together with the guarantee letter supposes:

- the project of a commercial contract which will be signed with the winner of the auction; the auction will be organised by the local authority of the local community;
- the project of the loan accord which must present the entire value of loans, the terms of repayments, the level of interest and other costs.

The local debt is not an obligation for the Government, being repaid exclusively by the local authority through the revenues which having been guaranteed by the respective local authorities. The documents which demonstrate the local debt having a stipulation that the local authority pledges itself to repay the debt and the interest are commissioned only by using the incomes from the local budget. The local authorities cannot use the credibility and capacity of imposed government taxes to make the loans for financing the local investments.

The loans of authorities of local public administration on the internal capital market dating from 2001 when the city halls of Predeal and Mangalia made bond issues amounting to 15 bil. lei, have an interest rate of approximately 37 per cent. Those loans having been made by the local authorities with the aim of modernising the cities' infrastructure: rebuilding the roads, modernising and extending the networks of waters, gas and drains, ski and artificial snow installations.

This source of financing has become common, having been utilised today by the majority of local administrations.

The positive effects of indebtedness can be as follows:

- the increase of the welfare of citizens making investments;
- public and private partnerships with an active implication of commercial societies to administrative-territorial units' development;
- profitable investments which generate new places of work;
- tourism development financing cultural objectives;
- lower pressure exerted by local authorities on Government on the transfers from the state budget to the local budgets.

Indebtedness also presents the following negative effects:

- generates extra-local public expenses with interests and commissions;
- increases the indebtedness of local authorities, meaning in fact, an increase in the debt of new generations. Even if the opportunities of public investments

in public goods must be carried out under certain conditions, the effective exploitations are not profitable in the material field; earning is an intellectual field (education case) and increases the health care of the population.

We consider that the balancing of the local budget through indebtedness implies a greater responsibility for local administration authorities utilising, with efficiency and rationality, local resources.

The actual legal framework is insufficiently developed; it does not have any provisions regarding the insolvability of local administrations. It is necessary to have provisions for the administration of a local administration which is insolvable, as well has its rights compared to the creditors for obligation payments.

7.5 Conclusions

For Romania, accession to the European Union in 2007 is very important so, it is a political moral duty for our political class to do everything necessary to reach this aim. From a financial point of view, the public governmental debt is sustainable, as we demonstrate in our paper, but, in the long-term, if the authorities are not capable of sustaining at an acceptable level the public governmental debt, the negative effects will be reflected on future generations. For local administrations it is a concrete modality to sustain the development of the territorial-administrative units. Also, it is necessary to enrich the legal framework at this level because, in fact, the authorities are restrained from making loans for local investments.

Indebtedness represents for local authorities a viable modality to sustain investments projects and a contra-weight for transfers and subventions received from the state budget.

Development of a legal framework and the implementation of some strategies in the long-term on the possibilities of financing investment projects constitute a modality to make authorities responsible for the financial development of the local communities.

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8. Practices of Local Borrowing Development and Local Debt Management in Ukraine: Problems and Prospects

Iryna Shcherbyna

8.1 Introduction

Local budgets in Ukraine play a significant role in funding basic services to the population. Particularly, local budgets cover expenses for general and secondary education, health care, social welfare, public utilities, improvement of ecology and many other spheres. There are more than 12.5 thousand local budgets in Ukraine in total. Expenditures of the local budgets for 2006 amounted to 36.5 per cent of the consolidated budget, which amount to USD 10.2 million. At the same time, analysis of the local budget structure exposes the following:

- Local budgets depend on transfers from the state budget (the share of transfers in the local budget revenues was 43.5 per cent in 2005)
- Financial resourses of the local budgets are only sufficient to cover current expenditures (consumption expenditures), which make up the lion's share of all expenditures (their share in 2005 was 94.9 per cent).
- Sources of revenues for the so-called capital budgets are unstable (in compliance with the Budget Code of Ukraine these are the receipts from privatisation and sale of commmunal property and land). These resources will be exhausted in time.

Therefore, the current situation with local budgets in Ukraine requires seeking other alternative sources of financing for local and regional development projects. Local borrowing is one such source; however this tool is scarcely employed. The author analyses the development and modern state of a system of local borrowing in Ukraine in order to detect the reasons restraining its development and to give recommendations for improving the situation in the future.

8.2 Problems and Prospects

After acquiring independence in 1991, Ukraine inherited a highly centralised system of public administration, where sectoral management was the key. The Soviet system (system of local councils ("*Soviet*" means "council" in Russian), their executive committees, and party authorities) was based on negating the concept of division of powers and supremacy of representatives bodies. The system provided that all councils, beginning at the lowest level, are bodies of State power in their respective territories. The sytem of councils was characterised by the hierarchical subordination of all of its elements and lack of real independence of local authori-

ties. The budgeting system, which was regulated by Law of Ukraine "On the Budget System of Ukraine" [1] was fully in line with the power structure and was centralised to a significant degree. Even though the Soviet system included some components of fiscal decentralisation, there were no financial instruments, which would promote effective management of budget funds. For instance, the rates of taxes and fees were set in a centralised manner, and the shares of taxes, which could be kept by local authorities or which were transferred from higher-level budgets, were constantly changing. Generating higher than expected local budget revenues led to the reduction of the allocated share in tax revenues for the following year.

At the same time, despite a rather rigid centralisation of financial resources, the Law "On the Budget System of Ukraine" (Article 18) stated such types of expenditures as development expenditures and established the concept of local budget deficit (Article 21). Notably, the deficit could be established for all types of local budgets, while there were no standards with regard to the structure of development expenditures and the mechanisms of their implementation, etc.

Setting of the budget deficit was limited in the said law by two restrictions. First, where there was a deficit, the local authority was mandated to finance current expenditures on a priority basis. Second, when approving the budget, its deficit ceiling could not exceed the amount of budget expenditures for development. Therefore, it can be stated, that under centralised management of budget resources, the issues of local budget deficit and local debt management were hardly regulated by the State at all.

At the same time, according to Article 23 of the same law, all businesses based in Ukraine, irrespective of their form of ownership and subordination, could obtain grants or subsidies from budget resources, in accordance with programs for economic and social development. The lack of legislatively established rules, criteria, and procedures for the above financing from the budget of non-budgetary institutions and organisations did not promote the effectiveness of expenditures and worsened the equilibrium of local budgets, especially given the worsening financial crisis in the public sector.

Moreover, local governments were hardly accountable for the inefficient use of budget funds and worsening balance of their own budgets. Conversely, Article 37 of the Law of Ukraine "On the Budget System of Ukraine" in fact places such responsibility on higher level authorities. The provisions of this article established the granting of interest-free loans from higher-level budgets into a lower-level budget to cover temporary cash gaps, which emerged in the course of budget execution. Even though the law provided for repayment of such loans before the end of the budget year, in reality, the majority of such loans was never repaid, and was either written off based on various bylaws, or were reflected in the books as accounts payable. According to the State Treasury of Ukraine, the said debt of local budgets

1 The Law of Ukraine "On the Budget System of Ukraine" No. 513-XII of 5 December 1990, *Vidomosti Verkhovnoi Rady Ukrainy*, 1991, No1., Article 2, with revisions and addenda.

before the State budget amounted to over UAH1.2 billion as at January 1, 2002. The official reports data on the debts between local budgets have not been made public. According to expert estimates, this amount approached almost UAH1 billion.

The Edict of the President of Ukraine "On Regulating Internal and External Borrowing of Local Governments" No. 655/98 of June 18, 1998, presented an attempt to regulate in some manner the process of economically unjustified accumulation of local debt; however, at the same time, this document had virtually no effect on accelerating the development of the local borrowing market. The Edict provisions were mainly of a regulatory and restrictive nature. The said Edict has mandated coordination with the Ministry of Finance of Ukraine of the amount of the local bond issue, and loans and credits obtained by local governments from banking institutions. As of the Edict promulgation date, any issue of local bonds had to be registered with the State Securities and Stock Market Commission.

Given the above circumstances, the local borrowing market remained undeveloped. Obtaining loans or credits by local budgets and their granting of guarantees for borrowing by communal enterprises was random and selective. In the majority of cases, decisions on local borrowing were economically unjustified and borrowing was undertaken to cover current expenditures.

Borrowing intended to cover current expenditures has led to an uncontrollable growth of local debt. Moreover, obtaining such loans created a fiscal illusion of budgets being balanced, which prevented a real evaluation of their tax capacity and the effectiveness of the existing fiscal system in general. These factors also had a negative impact on the macroeconomic situation by squeezing out private investments. Competition from the State sector for credit resources had pushed the interest rates up. To complete the cycle, all the described phenomena had a negative effect at the micro-level, again, on the situation of local budgets, through reduced efficiency of budget spending.

Enactment of the Budget Code of Ukraine in 2002, initiated the first step on the road to budget reform. The most important achievements of the Budget Code, included laying down the foundations for creating an institution of strong local finance. This is supported by a clear division and long-term allocation of revenues and expenditures by type of budget and the introduction of rules and procedures for transparent intergovernmental finance practices, etc.

Following the adoption of the Budget Code, there emerged rather significant changes in the matters of local budget debt regulation. The most important of these changes are as follows:

1. The Budget Code has imposed a ban on obtaining loans from other budgets. This issue needed to be settled, as intergovernmental loans have become a means of providing opaque additional grants and have come to substantially decrease

the level of responsibility of local governments in terms of balancing their own budgets and effective spending of budget resources, as previously mentioned.

2. The Budget Code of Ukraine[2] has restricted the right to borrow (except short-term borrowing) by reserving this for the Supreme Council of the Autonomous Republic of Crimea and for city councils. In this case, external borrowing could only be implemented by councils of the cities with a population of over 800,000[3].
3. The Budget Code of Ukraine has also established certain restrictions with regard to borrowing. For instance, medium- and long-term borrowing can only be used in the development budget and debt servicing expenditures may not exceed 10 percent of the budget general fund. At the same time, it is stipulated that if, in the process of principal repayment and debt servicing, as agreed between the lender and borrower, there occurs disruption of the repayment schedule through the borrower's fault, the respective council shall have no right to apply for new loans for the next five years.
4. The right has been granted to local budgets to obtain short-term loans from commercial banks for a period of up to three months to cover cash gaps in the execution of local budgets. This step has both positive and problematic consequences. Among its positive effects is that the source has been removed of emergence of a debt, and most importantly, of an unproductive debt. When borrowing from banks with interest, local governments began to take the cost of money into account and try to use them efficiently. The process of local borrowing has become more transparent thanks to market borrowing, rather than bureaucratic mechanisms, as was previously the case.

Certain negative considerations were that the borrowed resources were used for current expenditures; however, borrowing from commercial banks requires paying rather high interest rates, where borrowing from higher-level budgets was interest-free. Thus, according to the Ministry of Finance data, local budgets paid UAH36.8 million in interest payments to commercial banks in 2002, at an average interest rate of 22.5per cent per year.

Another problem, of an informal nature, which however was repeatedly covered by the press, was that credits, as a rule, were obtained from local commercial banks and there was a possibility of artificial hiking of interest rates on such credits, with subsequent sharing of extra profits between the borrower and the lender. This is evidenced by comparative data regarding interest rates on credits by regions of Ukraine (see Table 1) and materials of inspections[4] to investigate the matter.

2 *Budget Code of Ukraine*, No.2542-111 of June 21, 2001, Article 14.

3 *Budget Code of Ukraine*, No.2542-111 of June 21, 2001, Article 16.

4 *Control and Audit Authority of Ukraine Report for 2002*, Kyiv, May 2003.

Table 1
Amount of loans obtained by local budgets from financial and credit institutions as of January 1, 2003

Administrative-territorial units	Amount of loans obtained from financial institutions	Interest rate	Debt servicing amount (UAH thousand)
1	2	3	4
Autonomous Republic of Crimea	22698.5	17-31%	1226
Vinnytsya oblast	15122.3	20-25%	694.8
Volynska oblast	8088.2	25%-35%	76.2
Dnipropetrovsk oblast	414778.7	0.0	0.0
Donetsk oblast	15617.8	17-30%	473.2
Zhytomyr oblast	20166.0	20-22%	454.2
Zakarpatska oblast	2800.0	20-32%	108.4
Zaporizhya oblast	71400.5	20-28%	1636.6
Ivano-Frankivsk oblast	23671.1	20-32%	890.8
Kyiv oblast	4108.5	15,3-25%	235.1
Kirovohrad oblast	17801	20-31%	308.2
Luhansk oblast	10850.1	19-31%	292.1
Lviv oblast	1220.0	25-34%	37.3
Mykolaiv oblast	200	28%	13.8
Odessa oblast	57030.4	18-27%	1548.7
Poltava oblast	6871.5	12-30%	453
Rivne oblast	12035.0	19-27%	501.3
Sumy oblast	16355.0	17-32%	313.6
Ternopil oblast	8911	17-28%	508.7
Kharkiv oblast	16910.7	20-30%	467.1
Kherson oblast	962.8	30%	18.4
Khmelnytsky oblast	2991.4	10-25%	135.9
Cherkasy oblast	13175.0	18-22%	254.1
Chernivtsi oblast	0.0	0.0	0.0
Chernihiv oblast	1813.0	15-25%	138.1
City of Kyiv	581101.5	15-25%	25959.1
City of Sevastopol	2425.0	25-30%	96.7
Total	1349105.0	10-35%	36841.4

Source: Analysis of Execution of Local Budgets in 2003. *Materials of the Collegium of the Ministry of Finance of Ukraine*, Kyiv, 2004.

In order to partially correct these negative consequences in the laws on the State budget of Ukraine, a norm with regard to the right of local governments to obtain short-term loans from the State Treasury of Ukraine, drawing on the general resources available in Treasury accounts, was set annually beginning in 2002. This method of borrowing allows significantly reducing the cost of short-term borrowing for bridging cash gaps (current expenditures deficit); still, in essence, this represents a violation of the Budget Code. The violation is that Treasury loans are, in fact, loans from the State budget. Hence, this method of crediting is also insufficiently transparent and should have been more clearly regulated and justified, not just by the need to cover cash gaps, but also by possible consequences for the stability of local budgets.

Thus, the provisions of the adopted Budget Code of Ukraine have only set the right and stipulated certain restrictions with regard to borrowing. Therefore, the rules, mechanisms, and procedures for regulation of local borrowing and local debt management required clarification in bylaws. However, it was only in 2003, i.e. with a delay of one year, that the Cabinet of Ministers approved the Procedure for Borrowing for Local Budgets [5]. Again, this Procedure was of a purely regulatory and restrictive nature. At the same time, the need to apply certain legislative limitations regarding the amount of local debt was quite natural, as at the end of the day, it is the State that is responsible for the socio-economic situation in any administrative-territorial unit. It is essential that these limitations should be applied simultaneously with the provisions aimed at development of the local borrowing market and improved conditions for local debt management.

Overall, local borrowing no longer plays a significant role in Ukraine today, both as a source of development for local government and a tool of budget policy (in recent years, one can mention an attempt by the City of Kyiv to enter the market of external borrowing in 2003, when Kyiv received about USD 200 million from a Eurobond issue). This represents a rather serious problem, as allocation of sufficient budget resources for development of territories seems unlikely in the medium term. Moreover, given the level of depreciation of the absolute majority of communal infrastructure facilities (water and heat networks, sewerage, roads, housing, and other structures), such investments are vital. Achieving them without a developed borrowing market would be impossible.

Among the existing problems, it should be noted that oblast councils have been removed from the opportunity to borrow for regional development. The problem lies in their constitutional status, according to which they may not own any property; therefore, they are unable to provide any property security. Probably, this issue needs to be revised, as oblast councils are, in fact, responsible for

5 *CMU Resolution "On Approving the Procedure for Borrowing for Local Budgets"*, No.207 of February 24, 2003.

development of their regions and they should have the right of borrowing or providing guarantees.

Having embarked on the road of market transformations, Ukraine has made several attempts at implementing reforms in its budget system, including local finance, during the years of independence. However, the reform results are yet to fully satisfy either the central or local authorities, or, for that matter, users of public services. The main reason is lack of a clear strategy for regional policy and, accordingly, the vision for the necessary level of fiscal decentralisation, which results in legislative uncertainly with regard to local borrowing and local guarantees.

The existing legislative base is fragmented and incomplete. It does not have a comprehensive system of regulation of local government borrowing and performance of their obligations before creditors. The legislative base for regulation of local government debt operations in Ukraine is represented by individual provisions of the Budget Code of Ukraine, Presidential Edict "On Regulating Internal and External Borrowing by Local Government" of June 18, 1998, CMU Regulation "On Approving the Procedure of Borrowing for Local Budgets" of February 24, 2003, Resolution of the State Securities and Stock Market Commission "On Approving the Regulations on the Procedure of Issuing of Domestic Local Bonds" of July 19, 2003.

From among other pieces of legislation, closely linked to the problem of local borrowing are certain provisions of the Land Code (providing for land mortgaging), Laws "On Secured Agreements", "On Securities and Stock Market", "On Local Self-govenrment", and others. It should be noted, however, that the existing legislation does not completely regulate certain aspects of local borrowing yet. There are particularly numerous problematic issues related to the provision of property security for borrowing and to claiming of such security. The possibility of providing security in the form of future revenues of local budget also remains unresolved. Therefore, one of the most important problems, which are currently hampering development of institutionalized local borrowing in Ukraine, is lack of an opportunity to use future revenues of local government budget to secure the performance of borrower's obligations before the creditor. The Ukrainian law does not prohibit to do so today; however, to assume the risks of lending to cities, commercial banks require existance of an effective mechanisms of using property and resources of local budgets as security and claiming this security in case of borrower's default. Otherwise, credits for local government are considered blank credits, which sharply increases the interest rate charged.

As regards debt collection, the lack of a clearly prescribed legislative mechanism for such collection, including pronouncement of local budget default (given inconsistency of legislation on the issues of ownership and alienation of property, division of land, etc.) is another factor, which prevents the banking sector from actively pursuing the local lending business.

All these issues lead to uncertainties and risks for players on the local credit market. Therefore, in addition to the Budget Code of Ukraine, there exist a series of normative-legal documents and problem issues, which could have a significant impact on local borrowing, such as, for example, the provisions related to the regime and property rights in public properties; lack of medium-term budget planning, in particular with regard to planning of intergovernmental transfers from the State budget into local budgets; the issues of development and regulation of the banking system; issues of court enforcement of rulings on budget funds and communal property, etc.

8.3 Conclusions

Stabilisation of legal and financial principles in a manner which would clearly stipulate the legal rights and support the idea of securing borrowings with the predicable sources of revenues of local budgets, communal property, while granting local governments clear control at the political level over a significant portion of local finance, should become the priority for further economic reforms. Potential players in the local credit market, including borrowers, banks, and other stakeholders, are natural and essential subjects of these reforms. Therefore, it is vital that reforms of the key approaches to the area of local borrowing should be implemented with their participation, in an evolutionary, progressive manner.

Today, local finance in Ukraine has achieved a certain level of development. The lessons learned during implementation of the budget reform show that further steps need to be taken for ensuring availability of the optimal amount of resources needed by Ukrainian local government to impelement capital investments in a manner which would create the conditions for developing the market of commerical credits.

The market of local borrowing should develop bi-directionally: from top down — in terms of legal and political foundations, which would promote an effective operation of the credit market; and bottom-up — in terms of practical skills for banks and other lenders in the area of provision of credits, as well as for local governments to be able to borrow for financing their priority investment projects and making timely debt service payments.

Simultaneous development in both directions is extremely important: creating a favorable legal and regulatory environment and accumulating practical expertise in the area of local borrowing.

It should be noted that the impact of certain of the above described risks could be neutralised by means of credit agreements between the lenders and local governments, even before the fully-fledged legal base is in place. At the same time, given the potential for development of long-term financial relations between players in the local borrowing market, it should be noted that it is only for banks and

other lenders to decide whether or not risks are acceptable for them, and some of them, contract provisions notwithsanding, remain in the local borrowing market in any case.

Thus, the author believes the key reasons preventing development of local borrowing in Ukraine include lack of a legislatively stipulated proper guarantee for credits with regard to recovery of borrowed funds, lack of medium-term budget planning both at the central and local levels, low level of financial decentralisation in Ukraine and lack of debt management expertise at the local level.

The next steps of the budget reform in Ukraine with regard to development of the market of local borrowing and increasing their role as the main source of investments for regional developent should be based on the legislative:

- setting of characteristics for local borrowing (terms and ensuring performance of oblications);
- stipulation of the mandatory nature of financial commitments;
- application of economically justified restrictions on local borrowing;
- stipulation of a possibility of using future revenues of local budgets as collateral;
- establishment of real remedies available to the creditor in case of infringement on his rights and the procedures for declaring a local budget as being in default.

Therefore, the need for developing the system of local borrowing as one of the key methods for strengthening the financial foundations of local government is obvious today. The first steps have been made. However, the success of these efforts will ultimately depend on how balanced and impartial the decisions are, to be made at the legislative level. The author believes Ukraine will need to develop its own model of local borrowing market, which would not only learn from best international practices, but also be based on national historical and economic circumstances.

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PART TWO – RELATED ISSUES

9. Local Governments and the Financial Markets: Problems and Prospects of Interaction in Belarus

Yuri Krivorotko

9.1 Introduction

Municipal loans act as an important component of a local financial management mechanism. In global practice they are a normal source of local budgets' revenues. It is sufficient to note that the share of municipal loans in local budget revenues in central and eastern European countries is of a rather significant size. In 2001 the parameter in Slovakia was 38.9 per cent, in the Czech Republic – 29.0 per cent, in Estonia – 18.3 per cent, in Poland – 15.4 per cent, in Hungary – 6.3 per cent, in Russia – 4.0 per cent and in Romania – 1.98 per cent (Swianiewicz, 2004, p.399).

In CIS countries, municipal loans can be performed in three basic forms: inter-budgetary loans, credits in banks and bonded loans. It is known that bank credits are more convenient for covering short-term cash breaks; inter-budgetary loans – for covering a deficiency in the local budget and bonded loans – for financing long-term capital investments. However, under transition conditions the attraction of bank credits inconveniently, and until recently, generated various bill circuits. Financing of deficiencies due to inter-budgetary loans is at a loss deficiency of higher budgets. Allocation of long-term bonded loans is also connected with difficulties due to the short-term character of capital markets and the absence of "long money". It should be noted that bonded loans are favourable only by their great volumes which is also the limiting factor in their use. Since 1992, however, bonded loans began to draw increasing attention from local authorities in the transition countries, including Belarus.

Serious reserves of Belarus local government finance to be developed are focused on the ways and methods for accessing the financial markets. According to the Belarus Law on Local Government and Self-Government, the local governments can accumulate their financial resources through loans. In practice, however, the Belarus local governments have no full access to the financial markets for borrowing. On the one hand, Belarus banks are not ready to grant credits to the local government for investment purposes, because banks have not yet had long- term financial resources, due to rather high rates of inflation. Moreover, huge credit risks to lend to local government needs are passing through the banks. On the other hand, sub-national governments are also not ready to make loans due to the absence of a municipal borrowing legislation procedure. Currently, many of our local councils do not have their own current banking accounts in the banks and they per-

form their activities through the banking accounts of local executive committees [1]. This generates serious difficulties for accessing the financial markets. Therefore, local governments fail to obtain serious loans for current and capital purposes.

9.2 The first steps of municipal borrowing in Belarus

The beginning of the first municipal loan in Belarus was in March, 1993. During that period, bonds with a view of borrowing for financing the construction of habitations were issued and had to be repaid after a year. The loan consisted of 2,250 bonds of different face value (return of 30 per cent per bond) in a total sum of one billion Belarusian roubles (equivalent to 1,250,000 US dollars). Later, municipal borrowings evolved in the next bond issues indicated in Table1.

Meanwhile, the opportunities to win the rights to purchase apartments in Minsk have been very important.

However, only 41 bonds have been sold at the Minsk stock exchange. Other bonds have been transferred to the National Bank of the Republic of Belarus to be a pledge for the credit of 1 billion roubles. After the end of the bond repayment the loan was paid to the National bank by means of the apartment sales at the auction intended for a lottery.

At the same time, the first experience of the local loans in 1993 cannot be named successful, due to the confluence of various circumstances: economic crisis, high rates of inflation, complete absence of a legislative base and regulations for the loan process. However, the positive sides of municipal loans have become an experience for the targeted loans mechanism, its legal base regulating issues and the circulation of municipal securities, development of an organisational structure of loan making and control and advisory councils on local bonded loans, etc.

Later, development of municipal loans has been found in the subsequent issues (see Table 1).

As the table figures show, the municipal borrowings are limited by the housing construction only. This is explained by the cautious and weighted position of local authorities in points of guarantees of loans repayment and by providing its return.

The financial mechanism of municipal bonds in Belarus was reduced to the following stages: first – financial resources received from the municipal securities issues should go to the funding of housing construction. Second – repayment of bonds should be performed due to the financial resources received from the sales of constructed apartments. So, all the necessary infrastructures for allocation and service of municipal loans have been created in Belarus. It should be noted that the mechanism of municipal bond allocation to local loans through the institute of

1 In Belarus the Chairpersons of local executive committees are appointed by the President and, as a matter of fact, executive committees belong to the Central power. Therefore local governments do not have their own executive bodies.

the authorised banks has been organised. The general agents of the Minsk municipal loans were the Joint-Stock Company "Invest-system", "Belarus *Birzhevoj* Bank", Joint-stock commercial bank "*Belinvestbank*".

Table 1

Borrowing in housing sector (housing bonds in Belarus)

Borrowings	Duration	Number of issues	Amount of issues
The first Minsk targeted housing loan (one tranche)	1.11.96 – 30.06.99	1	500 (mil. Belarusian roubles)
The second Minsk targeted housing loan (one tranche)	22.11.96 – 22.11.02	1	3900 (mil. Belarusian roubles)
The first Brest targeted housing loan (two tranches)	22.11.96 – 22.11.02; 6.07.99 – 10.07.01	2	1500 (mil. Belarusian roubles)
The first Grodno targeted housing loan (one tranche)	15.10.99 – 15.09.02	1	400 (mil. Belarusian roubles)
The first Gomel targeted housing loan (one tranche)	14.06.00 – 14.10.03	1	2000 (mil. Belarusian roubles)

Source: Author's own calculations based on the State Committee of securities of the Republic of Belarus reports

Mechanisms of primary bonds allocation for local borrowing have been created by "The Belarus currency stock exchange" and they became more convenient for the authorised banks.

Since 2000, stock exchange auctions on allocation of targeted bond housing loans began to take place. The authorised banks, which carry out the function of bonds allocation for local loans, have been accepted in the security market workshop and they have passed a procedure of admission to municipal securities' tenders. In coordination with "the Central Republican depository of securities" the function of a clearing depository at the municipal securities market is performed by the exchange depositary. Only the sphere of the secondary municipal securities circulation through the stock exchange was carried out.

By the beginning of 2002, municipal securities occupied a place in the security portfolios of the Belarus banks. Their share, however, was insignificant and made 1.1 per cent in the trading portfolios of the Belarus banks. It is illustrated by the following table.

Table 2
The structure of security portfolios of Belarus banks by the beginning of 2002 (per cent)

	Content of security portfolios of Belarus banks	Share in per cent
1.	Bills of exchange issued by the Central government organisations of the Republic of Belarus	66.9
2.	Bills of exchange of other residents	8.0
3	Own banking bills of exchange redeemed	2.5
4.	Bills of exchange issued by the National Bank of the Republic of Belarus	2.5
5.	Shares	1.3
6.	Other securities	1.3
7.	Bills of exchange of banks	1.2
8.	Municipal security	1.1
9.	Bills of exchange of foreign banks	0.1
	Total:	100.0

Source: Author's own calculations based on the National Bank of the Republic of Belarus securities reports.

In spite of an insufficient share of municipal security in the bank's portfolios (see Table 2), the Belarus municipal bonds had a certain investment appeal. First, they have the profitability closer to the refinancing rate of the National Bank of the Republic of Belarus as the Central bank. Second, municipal securities have passed a listing on the "Belarus currency stock exchange", and depend on the financial and economic parameters of the local bodies issuing these securities. They are included into the quoted sheet of the stock exchange. As a result, transparency and publicity of the housing bonds segment into the securities market have increased. Third, housing bonds possessed a sufficient degree of liquidity. For example, a municipal securities' coefficient circulation on an exchange trading system made 3.4 in 2003 (*Ustoichivost finansirovania – garantia privlekatelnosti*, 2004, p.9).

The experience of municipal loans in Belarus has shown that the problem of the systemisation of the local loan process has great importance. Direct copying and placing foreign experience into local borrowing practices can bring about a negative result because each loan has features determined by the political, economic, national and cultural aspects of region. Therefore, the application of foreign experience demands adaptation to domestic conditions. The loans as a financial tool of local development are only the means to resolve certain problems connected with the normal functioning of the municipal economy. It should be mentioned that under the realisation of municipal programs and projects, the first issue to appear is the question of local infrastructure development. The issues of profitability are frequently overshadowed. Therefore, today, local authorities badly need an insur-

ance mechanism to be able to "amortise" the shocks connected with the "failure" of local bonded loans.

The first steps in municipal borrowing practice have revealed that the main guarantee for the investor during the performance of a bonded loan is its security. Municipal loans are provided with all material, financial and physical assets which are taking place in the municipal property of a municipality.

Any municipal property can act as a pledge except objects which have historical, cultural or other value. In this case, however, a pledge is not requested. On the other hand, the insuring of a loan by objects of a city's facilities (water pipes system, sewerage and other communal objects) is practically of no value and are unattractive assets from the position of loan repayment in case of failure to repay a loan. Therefore, it is expedient to carry out real insurance of investment loans due to the mechanism of guarantees of authorised commercial banks or the creation of special insurance or reserve funds.

It should be pointed out that in contradiction with local financial administration practices accepted in the world, the concepts of local budget, investment process, loans and municipal securities are considered separately in Belarus. It limits the opportunity to estimate borders of practical utilisation of securities by the local authorities. Actually, the issues of the budget and debt securities are deeply interconnected. The using of loans by means of securities opens up for the local government bodies a real opportunity to finance local budget expenditures – to accept various investment programs and projects to finance them due to borrowing. It allows not only providing a common equation of the budget, but also to balance the structure of budget expenditures that enables local authorities to manage the regional reproduction process. On the other hand, the budget of development predetermines a borrowing policy of municipalities and establishes their needs in depending on municipal facilities. A weakness of municipal loans in Belarus is their unilateral orientation – housing construction only. Municipal loans which also have an important social and economic value, for example, telephone bonds, electricity bonds, rural bonds, etc., are not performed.

During the municipal borrowing process an important point is the profitability of municipal bonds. There is a contradiction between the constantly growing depreciation of Belarus currency and the unwillingness of investors to put capital into projects of city facilities and other public projects with a low circulation of investments. Taking into account the low recouping of communal service objects, it is expedient to define the profitability of bonds not lower than the level of similar governmental securities. Thus it is necessary to make bonds appealing due to the use of various kinds of income. For example, commodity income, monetary income, investment income and benefits from the property rights to the object of the loan. One of the attractive sides of municipal securities should become the privileges and preferences in taxation of municipal bonds holders. This approach is not

new. In overseas countries, tax privileges and preferences are the main attraction of municipal loans. In Belarus, meanwhile, a full clarity in municipal bond taxation and transactions on them is absent. In Russia, for example, the securities issued by the subjects of the Federation are equal to governmental security and transactions operations which are exempt from tax.

The analysis of Belarus municipal bonded loans has determined the following sequence: accumulation of financial sources or allocation of bonds, using the accumulated financial sources for the purpose of an investment project, interest rate payments (on issue of coupon bonds), and return of financial assets to holders or bond repayments. Thus, in this sequence, the mechanisms of the accumulated funds may be different. The methods of the accumulated funds mechanisms which are used in targeted loans are so various, that they allow resolving practically any effective financial problems. The most widespread is the mechanism of the investment project implementation using the municipal loan. The essence is that the effective investment process of the accumulated funds should be implemented in municipality interests. Thus, the realisation of a given project is the basic purpose of the loan implementation. Therefore, bonds of the targeted municipal loan may have an exchange character and should be converted, whenever possible, into shares of the project for the purposes of which the issue has been made. It considerably raises the appeal of municipal bonds on a securities market.

Despite limited success during the organisation of local loans implementation in Belarus, further work will demand the coordinated actions of all governmental and non-governmental institutions. Special attention should be given to the decision-making mechanisms for local loans, selection of structures to participate in the loan process and control over the loan procedures, and the systems of taxation and guarantees should also be taken into account.

9.3 The problems of municipal loans evolution in Belarus

Further development of the municipal loans process as an important tool for local financial management badly needs some radical measures to be introduced for the access of Belarus local authorities to the financial markets.

1 An important direction should be the creation of a local borrowing regulation mechanism in Belarus. A central part of that mechanism should be a legislative base of municipal credit. The nucleus of such a base should be “The Law on municipal credit”, providing the procedures for the sanction of loans, access of local governments to financial markets, authority to borrow, guarantees, debt services, loan repayment, security for debt, loan limitations and others.
2. Another important component should be the development of municipal loans’ economic regulation. Usually economic regulation of municipal loans includes two basic elements: approval of the municipal loan by the Central government and system of debt limitations. Any municipal loan should meet with the ap-

proval of the Central government. Such approval is connected with the coordination of municipal loans and their purposes with a uniform public policy in Belarus and also loan insurance in the case of "failure" of the loan and providing possible financial assistance to the municipality for debt repayments. On the other hand, loan approval should create an encouraging atmosphere and confidence of creditors and of the public in the viability of loan implementation. As to loan limitations, that component requires to work out three kinds of limits: a limit on an aggregate amount of indebtedness, a limit on the amount of debt services and other restrictions (prohibition of municipal loans except for financing municipal investment projects only; restriction of short-term loan repayment by the terms of the fiscal year; loan limitation due to the unused remainder of previous loans; restrictions of the loan depending on performance of the budget, passing of an independent external audit in cases of default of principal and interest, etc.).

3. A serious precondition of municipal loans' evolution should be the improvement of the local budgeting process. Further evolution of municipal loans in Belarus urgently demands the division of local budgets into an operational budget and capital budget. At present, the local budgets are not developed without their corresponding division into operational and capital budgets as happens in overseas and transition countries. Such rules of local budgets division will help to increase the transparency of the local finance management. It also facilitates estimating whether the current revenues are sufficient to cover operational expenditures or revenues on capital investments for financing investment programs. This information supports the construction of viable programs of capital development and helps to estimate the creditworthiness of a municipality.
4. An important condition for municipal loan evolution in Belarus should be the expansion of budgeting horizons up to 7 – 10 years. Actually, the procedure of setting up and the performance of the long-term municipal budget provide communication between the strategic purposes and concrete procedure of investment realisation and allow the performance of control over the implementation of investment decisions. Long-term budgeting represents an analysis process for a possible investment choice for a municipality and aids the decision-making process in choosing a set of available alternatives. It also promotes revealing potential risks linked to the investment projects connected with their realisation. The long-term sliding of the local budget establishes the sums and terms of capital expenses expected, the revenues received on separate existing and new projects and defines the municipal need for loans and provides the necessary information for the maintenance of the liquidity of local budgets.
5. There is one more precondition for municipal borrowing improvement in Belarus. It is connected with the setting up of a book-keeping report or balance at local government. The presence of municipality book-keeping reports will allow a definition of credit rating, creditworthiness, solvency, reliability or the unreli-

ability of the potential borrower. It also gives economic information to potential investors who are ready to invest at the local level.

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10. Ukrainian Local Governments and Financial Markets

Sergii Slukhai

10.1 Introduction

The Ukraine's democratic path of development involves giving a real meaning to local self-governance. Up until now the autonomy of local government units has been quite limited; their activities concentrating mainly on fulfilling the centrally mandated tasks. The state revenues devoted to these tasks range from about 90 per cent to total. It means that they are very limited in exerting responsiveness to local public service demands.

This kind of problem could be solved through the expansion of independent local sources of revenue which could be created, not only by the introduction of new local taxes, (such as the local property tax which has been debated for a decade, but still not introduced), but also through the creation of objects of communal property that could generate a sustainable flow of revenues for the local governments.

Current legislation allows local governments to have a so-called "development budget" that can be formed through allotments from the current budget and central transfers. As a source, borrowing could be an option.

Generally speaking, borrowing, this common source of local revenue in developed and many transition economies, has not yet occupied any significant role in Ukraine: its percentage in local government revenues is very close to zero. But potentially, its role in local finance could grow rapidly.

The study below presents an overview on recent developments of local finance in Ukraine with a special emphasis on the prospective steps towards enhancing local fiscal autonomy and increasing local government ability to influence local economic development, which are connected to transactions on the fiscal markets.

The paper aims to cover the following questions: (i) how complete is the legal basis for local borrowing and whether it delivers a sufficient basis for pursuing a sound borrowing policy; (ii) what are the lessons of experience of the mid 1990s; and (iii) what are the characteristics of current fiscal market borrowing of Ukrainian municipalities from its prospective of being a sustainable source of funding local development needs. By answering these questions, we expect to show the prospects of this source of local revenues and possible governmental policies in this field.

Local borrowing is one of the vivid topics discussed by experts in transition economies. One of the first inputs to the topic was a chapter in a book edited by Ter-Minassian (1997). The current developments were summarised in Wetzel (2001) and Swianiewicz (2004).

The topic of local borrowing has not been discussed extensively in domestic literature because of its minor role in local finance. But there exists some insights dedicated to local government fiscal market participation represented by papers by Baranovski (Барановський, 2000), Kravchenko (Кравченко, 1999), Varfolomejev (Варфоломєєв, 2003) which deal with the lessons of local municipal bond development in the 1990s. It is still too early to estimate the last trends in this field initiated by the newest municipal bond issues since 2005. Some international experts such as Thirsk (2005) and others offer new approaches that could be useful to improve current borrowing practices by Ukrainian cities.

In order to address the issues stated as objectives, this paper is structured in the following way. Section 1 gives an introduction to the paper stressing the scope of the problem and its importance for local finance. Section 2 concentrates on the institutional background of the borrowing problem, presenting the latest developments in the legislation which are relevant to the topic. Section 3 attempts to summarise the development of legislation in the field, stressing its deficiencies and possible cures. Section 4 deals with the importance of local borrowing in Ukraine and lessons delivered by generally not very successful developments in the mid-1990s, trying also to show some of the peculiarities of the last activities of the municipal authorities in the bond market. Section 5 delivers the conclusions and some policy recommendations for the central government.

10.2 Institutional Framework of the Local Government System

In 1991 Ukraine began its existence as an independent state. The nation began to look for a way to build up a self-relying economy and effective state. There was a lot done in the domain of the national economy: privatisation of productive assets, liberalisation of entrepreneurial activity, and the introduction of market institutions etc. But the nation state itself, despite progress in market reform, was still very slow in self-rebuilding in a new, modern way. This relates not only to the central government, but especially to local governments.

The approval of the Constitution of the independent Ukraine in 1996 and of the basic legislation on local government created a legal framework for public administration at the regional and local levels. According to the Constitution, the central government bears most of responsibilities in the delivery of public services. A portion of these is vested onto locally elected bodies through the delegation mechanism. After the Budget Code was adopted (2001), new possibilities for fostering local autonomy arose. This potential path of development became clearer after the enacting of political reform since January 1, 2006 and declaring the beginning of the second stage in public sector reform, aimed at empowerment of local self-government.

The functioning of local government in Ukraine is regulated by a set of national acts, comprising the Budget Code (2001), the Law on Local Self-Government (1997) and the Law on Local State Administrations (1999). This legislation creates a basic legal framework for local government activity. As in many other transition countries, some secondary legal acts provide a significant input into the legal environment the local governments are dealing with, especially annual budget laws and regulations of the Ukrainian Cabinet of Ministers.

The Law on Local Self-Government provides a broad definition of responsibilities of the local governments at different state tiers defines their budgetary rights and structure of the budget sheet and accorded independence to the local budgets. Item 62 of this law fixed that the state is responsible for granting per capita minimal local budgets to any local government, according to nationwide standards, with special allowance for specific conditions in which the respective government operates. Item 66 of this law claims for non-deficit local budgets which could be achieved with state support. The local governments received the right to impose local taxes and fees, issue securities and take out loans in commercial banks.

The Law on Local State Administrations sets the framework of local state administration activities and their interaction with local self-government. These bodies represent the executive power at the respective territorial (*oblast* and *rayon*) level and, being directly subordinated to the President's Office, have a wide range of responsibilities, ranging from managing the delivery of basic social services up to composing and executing the *oblast* and *rayon* budgets. The functional departments of local state administrations are territorial departments of the respective ministries.

Despite these pieces of important progressive legislation, it should be mentioned that the soviet legacy in intergovernmental finance has not been fully eliminated. The local government sector was, in general, treated like a supplement to the central government; so the common place was the central administration of fiscal flows. A new era has begun with the enactment of the Budget Code which substituted the old Law on Budget System (1995) and other linked acts. The Budget Code introduced new approaches to the budgetary process; it settled the budgetary issues on a more solid ground, diminishing to a certain degree subjectivity and arbitrariness in fiscal issues; at last, the local governments received clearly defined sources of revenue, together with a definition of the expenditures they are responsible for.

Currently, Ukraine has two types of local authorities. First are the local state administrations at the region (*oblast*) and county (*rayon*) level. The heads of local state administration bodies are currently not elected, but appointed directly by the President of Ukraine. Second are the bodies of self-government at the *oblast*, *rayon*, and municipal level. The elected councils at these levels have no executive bodies which had been incorporated into the local state administration structure in the mid-1990s.

The elected councils in cities, settlements, and villages form their own executive bodies. The local authorities extend to jurisdictions which are based on the current administrative-territorial composition of Ukraine:

1) The regional level is represented by one autonomous republic (Crimea) [1], 24 *oblasts* and two cities of national significance, Kyiv and Sevastopol,
2) The local level is represented by 490 rural *rayons*, 453 cities and towns (including 176 of oblast significance), 118 urban districts, 886 settlements and 28,597 villages (Держкомстат України, 2004).

The number of local communities in general and especially in rural areas is quite large. But at the same time, up until now, most of them are not in a position to execute the whole range of their own rights: only about one-third of them have even formed councils. The obsolete territorial structure has many inconsistencies. For example, some territorial units such as the large cities of national or *oblast* significance administer not only urban districts, but also other units of the same territorial level – small cities, villages and settlements, which comprise, according to the Law on Self-Government, the self-governing communities.

A large number of small jurisdictions create the situation of a fragmented local government sector that formally have some scope of legally prescribed tasks, but cannot perform them because of a lack of funding and administrative capacity. Here the situation is quite similar to some Central-European countries (see Kimball, 1999).

There have been motivated suggestions to lessen the number of *oblasts* and *rayons* and to make them more self-reliant. The most challenging issue is the amalgamation of rural communities (villages and settlements) with urban communities and thus approaching an integrated type of local government.

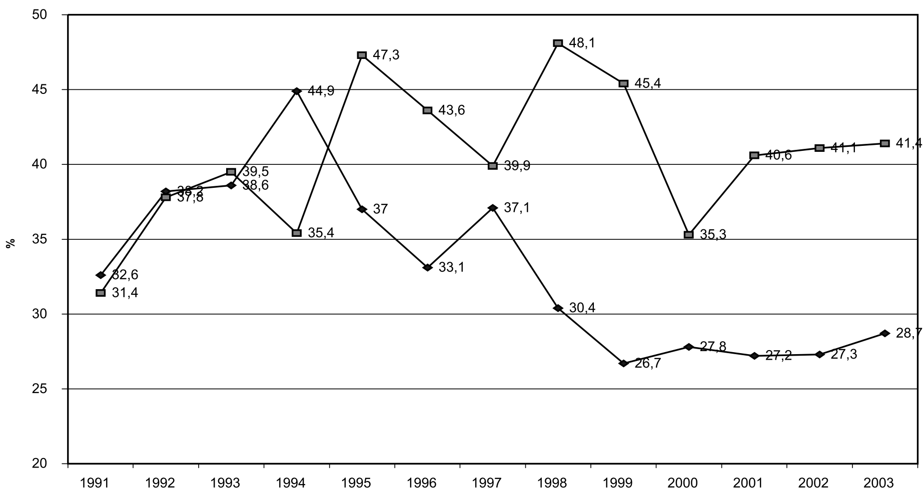
What are very important are the trends in local expenditure share: Graph 1 below shows that up until 2001 there were no clear trends to decentralise public expenditures in Ukraine. Only since 2001, when the first steps to budgetary reform were undertaken, did these shaky ups-and-downs turn to decentralisation. Throughout the 2000s, there has been no stable growth in the sub-national government share observed, as opposed to many other post-socialist countries.

The line with rectangular bullets measures the total general government share of GDP and the line with rhombic bullets measures the local government share in total general government expenditures.

1 Unlike the other territorial units at the regional level, the Autonomous Republic of Crimea has some attributes of independent governance: its own Parliament, Cabinet of Ministers, constitution and legislation (that should not contradict the national one). But in terms of public finance, its status has not much difference from that of the other units at the regional level.

Graph 1

Trends in development of the total general government expenditure share in GDP and local government share in the total general government expenditures.



Since most public revenues of local units are the national ones (ceded taxes and transfers, as presented in Table 1), local governments are obliged to be accountable for their spending to the central government, not to local voters. From the data below, we can also conclude that property tax in Ukraine is limited exclusively to motor vehicle tax; local taxes and duties deliver a very small fraction of total revenues with a clear trend to decline with time. A tax on private housing and commercial property has still not been introduced, despite several attempts to approve the respective legislation.

Local budgets mainly rely on cash transfers from the central government; a portion of this type of revenue has grown significantly over the last years.

In addition to the very weak revenue autonomy, local government spending is strictly controlled by the State Treasury, which holds the accounts of the sub-national units.

Summing up, current institutional settings, sub-national revenue and spending patterns do not hold out much hope for having a strong and extensive market of local borrowing.

Table 1
Composition of sub-national government revenues in Ukraine

Revenue type	1999	2004
	Per cent	Per cent
Tax revenues	55.3	46.2
Taxes on revenue, profit, market value increase	40.0	32.1
Personal income tax	15.7	31.8
Enterprise income tax	24.3	0.3
Property taxes	1.5	1.7
Motor vehicle tax	1.5	1.7
Fees for special usage of natural resources	5.9	5.9
Land tax	5.5	5.8
Internal taxation of goods and services total	5.1	2.2
Licences for entrepreneurial and professional activity total	.7	.8
Other taxes	2.7	4.3
Local taxes and duties	2.2	1.4
Unified tax for small businesses	.3	2.6
Non-tax revenues	2.8	5.5
Incomes from property and entrepreneurial activity	1.1	.4
Administrative duties and payments, incomes from non-commercial sales	.7	1.1
Fiscal penalties	.5	.0
Other non-tax revenues	.5	-1.8
Capital revenues	.0	4.3
Earmarked funds	8.2	1.5
Regional and local earmarked funds	.2	1.0
Revenues without transfers	66.3	57.5
Official transfers	33.7	42.5
General donations from the state budget	10.2	23.5
Mutual settlements	4.0	.0
Earmarked subventions from the state budget	20.0	18.5
Total revenues	100.0	100.0

Source: Міністерство фінансів України (2000, 2005).

10.3 Local Debt Regulations

The right to have transactions on the fiscal markets the local governments was formally received in 1990 according to the Law on Local Councils and Local Self-Gov-

ernment. According to this law, they can attract bank loans and invest their money in the statutory capital of the banks.

The Law on Securities and Stock Exchange (1991) granted the local councils the right to issue local bonds for the domestic financial market. The revenues from these bond issues could be used for any stated purpose. The registration of local bond issues was subject to registration by the Cabinet of Ministers or by the Ministry of Finance. (In 1996, however, the State Commission on Securities and Stock Markets was established and this took over the regulation function of all securities, including municipal bonds.)

After independence, in 1992 the Law on Local Councils and Self-Government was amended. In the course of the amendments the right to issue bonds was confirmed; according to the amended act, the proceeds from issuance of debt should be accounted to the off-budget funds.

These basic rights were also confirmed later in the Law on Budget System (1995). That law gave a more detailed description of the debt issuance regulation. It was stipulated that the amount of the internal debt issued should be defined by the decision of the respective local council – *oblast* or urban. The total amount of the local internal borrowing was subject to the total public debt approved by the *Verkhovna Rada* in the Annual Budget Law.

Despite some legal provisions, no bond issue was registered until 1995, but this fact did not mean that local borrowing was prohibited, as some authors suggested (Ter-Minassian, 1997).

Summing up the legal development in the field during the first year of Ukrainian independence, one can conclude that in that time, a clear-cut procedure of debt issuance and respective control mechanisms which could prevent possible negative developments in the debt markets did not exist. As a result, in 1998, Odessa city council which issued a significant share of local bonds at that time was declared default.

In 1997, the State Commission on Securities and Stock Market issued a Regulation on Issuance and Circulation of Local Bonds through which the state tried to limit the chaotic issue of bad debts of the local authorities. According to this, the amount of debt issued could not exceed 30 per cent of the local budget revenue; in case the local government relied mainly on central government donations, the Ministry of Finance had to approve the issue. It also stipulated that a further bond issue cannot be a source of debt repayment; the total face value of issue in the amount of more than UAH 5 million would require public subscription through official security market structures, registered by the State Commission on Securities and Stock Exchange.

The next decisions of the central authorities practically stopped local government activity on the fiscal markets for more than five years.

After 1998, the development of new legislation on local borrowing began. The new borrowing framework was approved by the Budget Code in 2001.

The above mentioned national act put clear defined limitations on the local government's ability to issue debt. So, Article 16 of the Budget Code limited the right to issue internal debt only to the Autonomous Republic of Crimea and urban councils; the external debt could be issued only by cities with at least a population of 800,000 [2].

Article 17 grants local authorities the right to issue warranties towards debt made by non-public economic subjects that involve payment for issuance; these warranties should be backed by local property.

The maximum total amount of debt issued and warranties must be approved for each budgetary year by the decision of the respective local council.

The Budget Code also allowed short-term (up to three months due) borrowing from financial institutes to bridge temporary cash deficits which should be repaid during the same budgetary year. The inter-budgetary loans, this important means of borrowing during the 1990s, were in fact prohibited.

The Budget Code sets institutional limits on local borrowing power. First, borrowing could be made only with the goal of development, i.e. not for short-period projects. Second, the state is not responsible for local government fiscal obligations. Third, the debt servicing could extend for no more than 10 per cent of the annual general budget expenditures (paying-off of the principal is not counted here and relates to expenditures of the development budget). Fourth, any kind of problems with the payment schedule would result in borrowing being prohibited for a period of five years.

The Budget Code stipulated that the regulation of local borrowing should be elaborated by the Ministry of Finance in accordance with the above mentioned requirements.

This Cabinet of Ministers' Regulation # 207 on Regulation of Borrowings to the Local Budgets was issued on February 24, 2003. In fact, this document currently serves as a basic sub-legal act in the field of municipal borrowing.

Regulation # 207 states two types of local borrowing: (i) municipal bond issues and (ii) contracts on loans, credits and credit lines with financial institutions.

In order to receive permission for internal borrowing, the local council must deliver a lot of documentation stating the purpose of borrowing, statement on the execution of the city budget for the previous year to year of borrowing, statement on borrowing for the last 5 years, and information on the sources of loan repayment,

2 There are only six cities in Ukraine which respond to this criterion: the national capital Kyiv City, Kharkiv, Dnipropetrovsk, Odessa, Donetsk, Zaporizhzhja.

together with an assessment carried out by a distinguished rating agency[3] etc.; each borrowing is to be empowered by a Cabinet of Minister separate decision.

More precise technical prescriptions concerning the issuance procedure contain the Regulation # 982/8303 of the State Commission on Securities and Stock Markets dated October 10, 2003.

The latest Ukrainian Law on Securities and Stock Market (2006) allowed local councils and *Verkhovna Rada* of the Autonomous Republic of Crimea to issue internal and external bonds in line with the above mentioned regulations.

The most important demands for local bonds come from institutional investors. That is why the regulations concerning limits imposed on financial institutions are quite important for the demand on municipal bonds in the fiscal market. So, the legislation has put on the institutes of mutual investments a limit of 10 per cent of their portfolio to be invested in municipal bonds; the non-public pension funds are allowed to invest no more than 20 per cent of their fund into municipal bonds and the State Pension Fund is not allowed to invest more than 10 per cent of its pension assets in these securities.

There are no direct limitations on investments of the commercial banks into municipal bonds, but the state regulations on banking activity do contain some implicit norms which stimulate the banking institutions to buy municipal securities instead of giving loans to local authorities. For example, the calculation of the normative of regulatory capital adequacy set by the National Bank of Ukraine, which aims to minimise shifting the credit and insolvency risk onto bank debtors and creditors, involves different weighting coefficients for different asset types; for municipal bonds it is set at a level of 20 per cent, but for credits given to municipalities – at a level of 50 per cent. Of course, this kind of weighting approach makes the banks prefer buying municipal bonds instead of granting credits (Варфоломєєв, 2003).

10.4 Local Public Debt Issuance: Experience of the 1990s and Recent Trends

The first issue of municipal bonds in Ukrainian history took place in 1876, when Kyiv municipality issued bonds in a total amount of 500,000 Roubles. Until 1917, many municipal bond issues were undertaken. Municipalities issued mostly external debts with long maturity. For example, bonds of Kyiv City issued in 1909 had a maturity of 77 years which had no precedent in the history of municipal borrowing in the Russian Empire; this city experienced 22 municipal bond issues during the period 1876 – 1914 which were mainly subscribed by foreign investors. After the October Revolution in 1917, the cities lost their autonomy and borrowing in finan-

3 At the moment there is only one such rating agency in Ukraine (Credit-Rating Ltd) which is accredited by the World Bank.

cial markets became non-existent; this period of no municipal borrowing lasted from the end of the 1920s to the early 1990s, when Ukrainian independence was declared.

The very high interest rates in the credit markets in the 1990s pushed local governments to try to attract off-budget means through debt issuance. The first municipal bond issues in modern times were issued after some legislative basis was created in 1995. It was characteristic for this period of time that not only municipalities (regardless of their size) issued bonds, but also regional authorities issued them – the respective examples are two bond issues of the Autonomous Republic of Crimea and of Odessa *oblast*.

During the period of 1995 – 1998, the State Commission on Securities and Stock Market registered 23 bond issues with a total face value of UAH 400 million; the subscription value was UAH 222 million. Most of them were not successful because the rate of subscription was far below the appropriate level; some of them were cancelled (see Table 2 for some examples).

Table 2 also gives some insights into the subscription rate and status of some municipal debts. Table 3 delivers a generalisation of the municipal bond borrowings during 1995 – 1998.

Table 2

Selected bond issues of Ukrainian cities in 1995 – 1998

City, year	Amount in face value, UAH million	Subscribed, UAH million	Status
Dnipropetrovsk, 1995	21.0	0	Cancelled
Dnipropetrovsk, 1996	35.0	6.3	Redeemed
Donetsk, 1995	1.952	.554	Cancelled
Kyiv, 1995	51.3	1.8	Redeemed
Lviv, 1996	2.0	1.5	Redeemed
Odessa, 1997	61.0	61.0	Restructured
Kharkiv, 1997	10.2	2.1	Redeemed
Brovary, 1998	1.0	.5	Redeemed
Cherkassy, 1995	4.0	.5	Not redeemed
Komsomolsk, 1995	1.5	.05	Redeemed

Source: Базилевич, Баластрик (2002).

There were three basic models of municipal bond issuance employed (Барановський, 2000):

- independent emission with the creation of a department for debt servicing (Lviv, Kyiv);

- shared emission with a general subscription agent (Kharkiv, Zaporizhzhja);
- delegated emission when a specific investment company took over all the functions associated with the borrowing (Donetsk, Maruipol).

Table 3
Aggregated data on subscribed bond issues of Ukrainian local governments, 1995 – 1998

	1995	1996	1997	1998
UAH million	4.5	128.7	80.2	.5
Subscription rate	6.0	57.0	...	...

Source: The World Bank (1999).

The experience for local borrowing in 1995 – 1998 has shown the following negative facts:

- the total subscription value in comparison to budget revenues of respective sub-national unit was extremely low – only a fraction of one per cent;
- the borrowing was made for a very short period of time – so they had no sufficient temporal structure in order to fund important investment projects that could improve local economic performance;
- there existed no unique approach to the security of the bond issues – some bonds were backed by communal property and even used in the process of privatisation, others by potential revenues from to-be-implemented projects; many issues were so-called "barter bonds" emitted, for example, to finance housing construction in exchange for apartments, to support crop buying or the acquisition of transportation means for communal needs.
- state regulation and audit on local borrowing activities seemed to be very weak because many issues ended up with no success and even with default.

The last point can be illustrated by a very negative case with the largest, in new municipal history, the Odessa municipal loan (face value of about UAH 61 million, or USD 33 million) issued in 1997. The total debt obligation, including interest, amounted to UAH 91.5 million. The rate of return was fixed at a level of 50 per cent and this fact attracted many foreign investors: 70 per cent of the bond issue was bought by foreign institutional investors. However, because of mistakes in the use of money attracted, and partly because of the city mayor's dismissal, only UAH 250,000 were paid off to investors; a further default of the issuer contributed to a long-term ban on sub-national governments' operations in the financial markets. The Odessa municipal debt has now been restructured and is slowly being paid off.

Another problematic bond issue was a second Crimean one emitted in 1996 in the amount of UAH 120 million. Investors of the issue, which were several off-shore

companies, received about UAH 500 million in interest; in fact, this bond issue was used to legalise the transfer of money abroad (Варфоломєєв, 2003).

These two examples above show that one of the main reasons for having such a negative result was a very subjective, non-systematic regulation of the matter.

As some experts argued (Wetzel, 2001), the Ukrainian experience in local borrowing delivers a good illustration to what could happen under conditions of absence of fiscal discipline and weak state regulation. Fortunately, the negative development was stopped in a timely manner; it prevented a possibly heavy fiscal disaster.

But this was not the only reason for the bond market failure[4]. Among other important factors were the bad macroeconomic conditions of that time (economic growth was registered only in 2000), low institutional and administrative capacity of local authorities together with a non-transparent budgeting process at the local level and no clear assignment of responsibilities in fiscal matters between national government, regional and local authorities. It is also worth mentioning the high reliance of local authorities on the central government which made them unaccountable to the local voters for the results of bad fiscal administration.

The lessons learned from the previous development were taken into consideration when in 2003 a new period of municipal borrowing began. That year, the first new municipal bond issue was successfully subscribed; most of the subscribers were, in fact, international investors.

So, in 2003, Kyiv City Council issued two Eurobonds with a total face value of Euro 350 million and one issue of internal bonds with a total face value of UAH 100 million. In the same year, Illichivsk, a seaport city in the Odessa region, issued bonds in the amount of UAH 10 million in face value.

In 2005, the city councils of Zaporizhzhja issued two bonds in the amount of UAH million 25 and 75 in face value, Donetsk – in the amount of UAH 20 million, Kharkiv in the amount of UAH 100 million (for metro construction, street reconstruction and street lightening). The city council of Zaporizhzhja issued bonds in the amount of UAH 75 million to realise several investment projects such as bridge and road construction and school renovation. Odessa Council issued in the same year UAH 150 million (UAH 125 million subscribed) in order to repay the restructured bond issue of 1997[5]. Ivano-Frankivsk city council issued bonds in the amount of UAH 5.5 million to modernise street lighting.

In 2006, Cherkassy city council (*oblast* capital) emitted bonds in the amount of UAH 5 million to reconstruct the water management system.

4 See also detailed comments on the matter by I.Burakovski (Бураковський, 2001).

5 This of course is not in line with current legislation, which stipulated that bonds should be issued only with long-term investment goals, backed by the creation of physical objects that could generate sufficient income flow to repay a loan.

In the nearest plans, the bond issues of Vinnytsja council in the amount of UAH 20 million and Odessa council in the amount of UAH 150 million and others are projected.

It looks like Ukraine is experiencing some kind of renaissance of municipal borrowing. The rapidly growing amount of municipal bonds could be seen and could really serve as an alternative to the central government domestic bonds. As a matter of fact, the total bond face value issued during the last three years has exceeded the total amount issued by municipalities during 1995 – 1998 by more than 10 times (more than UAH 2.6 billion against 222 million).

Such development looks very promising. But, many domestic experts still remain quite sceptical concerning the prospects of the Ukrainian municipal bond market. Their argumentation extends to low incentives for domestic subscribers to buy municipal bonds because of the high taxation of interest incomes (Поддубный, 2004; Хохлова, 2004); it means that the most attractive market for Ukrainian municipalities will remain external; however the access to it is limited only to the six largest cities. But what is more important, there are dangers in the growing municipal bond market.

The problem is hidden in the fact that there are some factors still at play that could trigger the repetition of the negative events of the late 1990s.

First, many city councils are still not aware that the money lent should be repaid and they need to have enough money to do so; the borrowing act must generate a sufficient income flow in order for the local public service provision not to suffer. Just as before, a lot of bonds borrowing have been intended to maintain or construct objects of social infrastructure which will not create a flow of payments; it means that loans will be redeemed from the current budget proceeds diminishing the possibility to finance the current level of public service delivery. Because of the obsolete annual budgeting approach, borrowers do not develop long-term programs for future borrowing.

From this point of view, the caution of some experts (Thirsk, 2005) concerning possible changes in legislation that could loosen the state control over local borrowings could be evaluated, as well as motivated. Before creating strong fiscal discipline and prudent budget policy at the local level, any loosening of the budgetary leash would be quite dangerous both for the local public finance and the whole public finance system as well.

Second, as before, there exists no tight connection between the market of municipal borrowing and of corporate securities. The former is still far below the qualitative level of private borrowing. So the choice of debt instruments on the municipal fiscal market is very narrow (no derivatives, no convertibles are practised yet), the securities are issued without serious analysis of potential risks and future conse-

quences for favourable and unfavourable scenarios of development in local fiscal situation.

Third, a low level of integrity of the market for local borrowing is still present. Most of them are subscribed at the local level, within local financial institutions; the creditors from other regions have a very limited access to the local market and frankly speaking, have no major desire to get a tight grip on it.

Fourth, the municipal bonds are still not designed to serve as an instrument of private domestic investments. The city authorities do not see much interest in attracting private savings, relying on the institutional investors.

To make a possible negative development path impossible, some institutional reforms should be undertaken. The most important is raising the institutional capacity of local authorities through granting them more autonomy in dealing with local budgetary policy. It involves first of all creating more independent revenue sources (we have mentioned before that in Ukraine there is no property tax introduced yet) and, at the same time, making municipalities more sensitive to the needs of local voters. The on-going political reform and intended empowerment of local self-government deliver some promising insight to this development. However, there is a long way to go before these innovations will expose their potential and bring about social results.

10.6 Conclusions

Municipal bond market in transition economies such as the Ukrainian one is hindered by a weak reform of municipal finance. Ukrainian local governments have a too narrow own revenue base to create an extensive system of local borrowing. The high rates of interest on bank credits made it profitable for them to issue bonds instead of receiving bank loans.

Some steps in creating solid ground for local government transactions in the fiscal markets are being taken, thanks to the approval of the Budget Code and some other supplementary legal acts.

The prospects for the municipal bond market in Ukraine at the moment are not so clear. There are several reasons. First, the negative experience with first the Ukrainian and both central government and municipal bonds have disappointed possible buyers in the domestic market for a long time.

Second, the savings of the population are not very high and it prefers to deposit money in the commercial banks instead of lending it to public institutions; so, only commercial banks or foreign investors have any free money to buy local securities (but to do so they need to know that repayment of these loans will be guaranteed).

Third, the taxation system does not encourage domestic investors to buy bonds. That is why the recent bond issues were designated only for foreign (European) investors.

Fourth, the macroeconomic prospects of Ukraine are still not clear because of the political turmoil of the last years.

The main problem still remaining is a level of municipality control over their revenues and their institutional capacity. The share of truly local revenues – such as local taxes and fees – hardly exceed one per cent on average, with a trend to further diminishing. If some new affluent local taxes were introduced – we have had long-lasting discussions, with no success, on the introduction of the property tax and on making land tax a local one – then local governments would receive a more or less sustainable revenue source that could secure the bond issues.

Another problem that does not give enough room for the municipal bond market is slow development of the internal state security market that could deliver well-defined benchmarks for investors in the local bond market.

The market for local borrowing is now expanding rapidly. But there exist some dangers that require further limitations on the local borrowing policy. The existing limitations still seem to be quite weak and would not prevent a repetition of the events such as those with Odessa and the Autonomous Republic of Crimea borrowing. So, imposing these limitations on the supply side of the market tends to be a lasting central government policy.

One of the factors which hinder the demand for municipal bonds is the uncertainty about the fulfilment of obligations of the issuer in case of a change in local authority administration. A precedent with the Odessa bond issue, when the redeeming of bonds was stopped immediately after the dismissal of the city mayor by his successor, will remain a bitter memory for a long time and hamper the development of the municipal bond market.

The current trends in the local borrowing market show a clear bias of big cities to try to access the external fiscal markets which are much bigger than the Ukrainian one and propose cheaper and longer-term money than the internal market.

In order to overcome the problems listed above, the public sector reforms (including re-shifting of revenue sources and expenditure responsibilities between state levels in favour of self-government units) should be accelerated. Only fiscally strong local governments can develop a sound long-term borrowing policy that will contribute to local economic development.

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11. Communal Bond Market in Poland

Agnieszka Kopanska

11.1 Introduction

The history of bonds is strictly connected with issuances made by municipalities or on behalf of them. In the past, the financial needs of cities exceeded the abilities of one creditor and it was therefore necessary to group the financial funds of many creditors. This historical argument has been outdated for quite some time. Nowadays banks or financial institutions have capital large enough that they can help, without a problem, even the largest towns and cities. Nevertheless, bonds can still be an attractive way of borrowing for municipalities. The cost of bond indebtedness may be lower than that of a credit obtained from a bank and this happens thanks to the liquidity which is given by the capital market and risk diversification, where each bondholder grants only a small part of the debt. Simultaneously, investors should be interested in municipal securities because they constitute (usually) a safe and long-term means of allocating capital.

The above statements may be acknowledged as a fundamental motive for municipal issues. However, the practice of particular countries shows that the real attractiveness and functioning of bonds will decide the combination of legal and institutional conditions. There are important regulations connected to bonds as well as to the capital market, banking system and shape of municipal finance.

Some elements forming municipal bonds in Poland will be submitted to an analysis in this article. The analysis will be performed in comparison to a "model" market, which is the market of municipal bonds in the US. It will allow us to answer the question on which factors are most responsible for the current functioning of Polish municipal bonds and also to evaluate the perspectives of a further development of this market.

11.2 Municipal bonds in Poland – basic legal regulations and size of the market

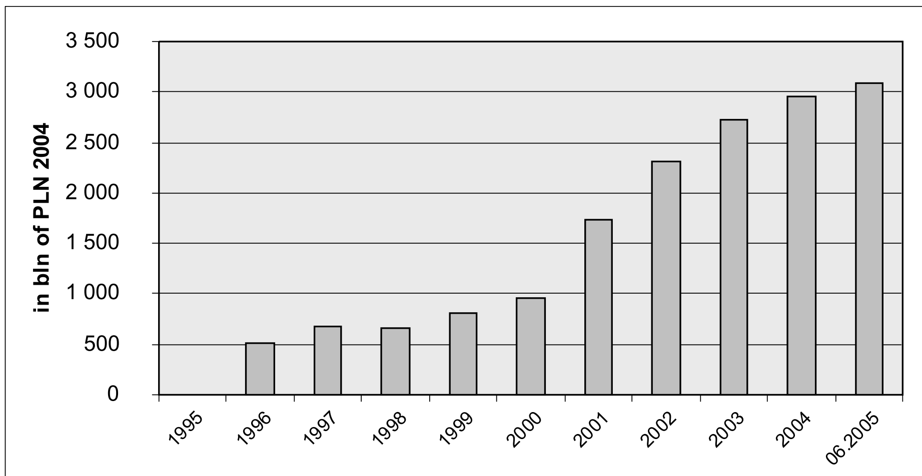
Polish municipalities may issue two kinds of bonds:

- general bonds – secured with the whole property of an issuer – issued especially by municipalities but this is also possible (although it is not indicated directly in the regulations) to issue such securities by other entities (e.g. municipal corporations) for municipal purposes;
- revenue bonds, where the security is a designated property or a flow of incomes – those securities are, according to the Polish Act on bonds, created especially for municipal issuers.

So far, over 200 municipal entities in Poland have made use of the legal opportunity to issue general bonds and the local bond debt has been growing successively from year to year (compare fig. 1). The first issue of revenue bonds and simultaneously the first municipal bonds of a company occurred in the market at the end of 2005 (these were securities of the water and sewage company in Bydgoszcz).

Figure 1

Market value of bonds issued by municipalities during 1996 – 06/2005



Source: Own calculation based on Raporty o stanie rynku pozarządowych papierów dłużnych; Fitch Polska

11.3 Municipal bond market – American patterns

At the end of 2004, bonds constituted approximately 20 per cent of the indebtedness of *voivodships* and towns on the rights of an administrative district and districts, but in municipalities it was only 9.7 per cent of their total indebtedness [1]. Nonetheless, against the background of other European countries, it may be said that bonds in the structure of the Polish municipality debt are of great importance.

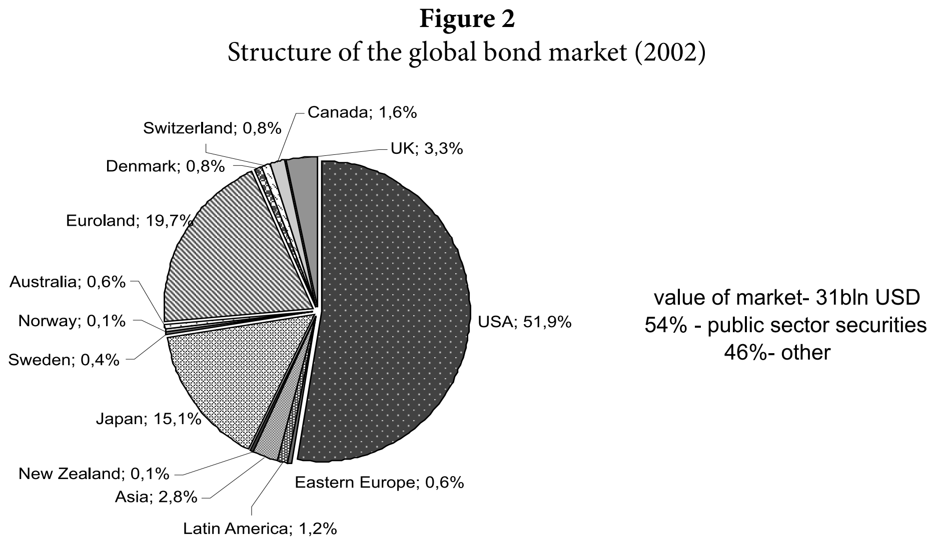
In Western Europe, municipal bonds are mostly issued by the larger cities (capitals) and also by municipal units of a higher level. Communes obtain the majority of their debt funds directly from financial institutions (banks). For example, in Germany, bonds represent a mere 1.2 per cent of the debt of municipalities. In Italy as well, bond issues do not exceed 2 per cent of the new debt, whereas, for example, in 1998 for issues of ITL 1,150 bln of municipal bonds, almost one-third

1 Own calculation based on Ministra of Finance information.

came from Torino and a further 15 per cent constituted bonds from two provinces – Verona and Milan. In Spanish communes (*minicipio*) the bond debt amounts to a mere 6.5 per cent of the debt and the majority falls to the biggest cities (there the debt resulting from bonds amounts to 20.4 per cent of their indebtedness). Most bonds are issued in Spain by municipalities of provinces – there, bonds constitute approximately 33 per cent of indebtedness (Dafflon 2002). Bonds in Eastern European countries Europe are slightly more popular. Bonds amounted to 27.5 per cent of indebtedness of municipalities in the Czech Republic, 21.7 per cent in Estonia, 18.2 per cent in Hungary and 12 per cent in Slovakia in 2001 (Swianiewicz 2004).

Undoubtedly, the most developed municipal bond market (and of other kinds of bonds) is the American market (compare fig. 2).

Figure 2
Structure of the global bond market (2002)



Source: http://www.allianzinvestors.com

This market can be acknowledged as exemplary and it is worth considering the functioning of Polish municipal bonds against its background. The treatment of American bonds as a pattern for the Polish municipal bond market (or the market of bonds in general) is based on at least two reasons – first, on the world bond market, securities from the US prevail and second, Polish regulations connected with municipal bonds were created with strong American support (USAID and World Bank).

It is worth mentioning among the factors influencing the functioning of the municipal bond market in the US the following:

1. the developed capital market and especially the market of non-treasury debt securities,
2. the decisive predominance of public issues,
3. the application of ratings,
4. the attractiveness of municipal securities for investors.

Ad 1) A benchmark for the development of the capital market may be in relation to the size of the capitalisation of the stock exchange market (share market) to GDP. This amounted to 130 per cent of GDP in the US, whilst only 17 per cent of GDP in Poland in 2003 (for a comparison of countries in the euro zone it was 60 per cent of GDP). This predominance is visible also on the bond market and in 2003 the domestic bond debt amounted to 160 per cent of GDP in the US and only 24 per cent in Poland. An analysis of the reasons for the development of this market is beyond the scope of this article. However, it should be assumed as a necessary factor, although not as an ultimate factor, of the development of the bond and municipal bond market. An example is the United Kingdom where the capital market is also very well developed (the capitalisation of the share market amounts to 134 per cent of GDP), but the bond market is considerably less developed – the debt resulting from domestic bonds amounted to only 41 per cent of GDP in 2003 (WDI 2005).

Differences resulting from the tradition of the functioning of particular markets should be emphasised here. Generally, the European municipal debt market and the wider European non-treasury market are dominated by banks, whilst issues of debt securities predominate in the US. Where municipal units are concerned, the above difference is additionally intensified through the functioning in the majority of Western European countries of special, public financial institutions brought into existence for the crediting of municipalities (Kopańska 2001). Admittedly today they are privatised; however their position is still predominant in the market. In the US, which we will show, bonds have this special position.

Ad 2) Municipal securities issues in the US are performed by the public market. Private issues amounted to less than 1 per cent of the total amount of issued municipal securities in recent years (www.bondmarket.com). Only public issue allows for obtaining all the positive features of bonds, giving the issuer the cheapest financial means. In order for an issue for the public market to make sense, the appropriate size of the issue is necessary. This applies to the issuer as well as investors. A significant amount of the issue lowers its unit costs. This relates to expenses connected with entering the market – namely commissions for the organiser of the issue, underwriter, advisors, promotion costs etc. In turn, bond purchasers usually expect risk diversification – namely a share only in part of the debt. This will be connected to the individual policy of an entity as well as with different regulations, forbidding an excessive capital concentration in the securities of one issuer. It is also obvious that the size of the issue depends on which type of investor to which the

securities are directed. In the US, issues of municipal bonds intended for individual investors have a value of at least USD 25,000 while for institutional investors this sum is USD 100,000 (Fabozzi 2000).

Not all municipalities would be able to afford such issues and this is where Municipal Bond Banks are helpful. Municipal Bond Banks are financial institutions, usually public, grouping the bond debt of smaller issuers, which is thereafter secularised and issued as a large municipal issue of several entities.

Ad 3) Another important feature, significant from the perspective of the functioning of American bonds, is the popularity of rating performed by an external entity – a rating agency. It allows investors to have a better evaluation of the risk connected to a security of a given entity. It should be noted that contrary to commercial issuers, municipal entities have relatively few information duties connected with the issue; rating evaluations are treated as sufficient information on the issuer. The correlation between the granted rating and the issue price is obvious and visible. Securities of less sure issuers, with which a higher risk is connected, have a higher interest than bonds of municipalities with a higher rating.

The Municipal Bond Banks also play an important role in this aspect. Due to the grouping of the debt of many municipalities, a diversification of risk happens, namely issued securities may have a higher evaluation than the debt of particular entities. Additionally, those banks enjoy a good reputation on the market. Thus, thanks to the help of the Municipal Bond Banks, smaller municipalities gain not only a liquid debt but also at a lower price.

Ad 4) A further feature of municipal bonds in the US is their attractiveness for investors. This is due to many factors among which are tax exemptions or an institution of a trustee. In the US, incomes from municipal bonds are exempt from federal income tax but also often from state and local taxes (BMA 2004). For this reason, on the one hand, municipalities obtain financial means at a cheaper rate and simultaneously, investors evading taxes prefer to allocate their money in municipal securities. It should be pointed out that tax exemptions are *de facto* a sort of extra charge on the interest of municipal bonds which are made by federal and state governments – therefore it can be said that bonds are a special credit for American municipalities.

A further factor adding to the attractiveness and confidence of investors in bonds is the institution of a trustee who plays an intermediary role between an issuer and bondholders. An agreement with the trustee allows, for example, for the introduction of many issuers' obligations which are not included in the bond alone and which decide *de facto* about the safety of the issue. A trustee may be a complicated instrument, which is not obvious to the average bondholder, but which is safer because of it (Angelides 2003; FSV 1999).

11.4 Municipal bond market – conditions in Poland

The direct transfer of American patterns to the Polish municipal bond market is obviously not possible. However, it is worth looking at Polish municipal bonds from the perspective of the features of the American market described earlier. This will allow us to understand the specificity of those instruments in Poland and the analysis of factors which form it. The considerations will include:

1. size and structure of the debt securities market;
2. presence of public issues and size of issues;
3. use of rating and wider use of an external audit of municipal finance;
4. attractiveness of municipal securities for investors.

Ad 1) The debt securities market in Poland represents only 24 per cent of GDP. Simultaneously, this is a market very strongly dominated by treasury securities.

Bonds of entities other than the State Treasury represented only 8 per cent of the total domestic bond market in the middle of 2005. In the meantime, in the US, debt securities issued by enterprises and banks in the municipalities have a significant share in the entire debt securities market and treasury bonds represent only 17 per cent of the total market (See Figure 3).

The dominance of treasury securities which (as everywhere) are treated as the most secure way of capital allocation, means that bonds from other entities, including municipalities, have problems with finding investors. Furthermore, other aspects of municipal issues in Poland do not encourage investment in municipal securities.

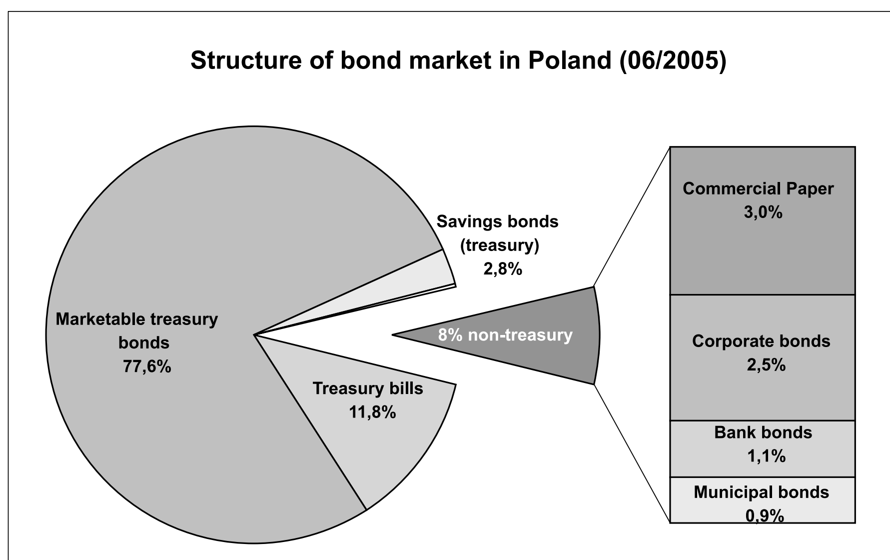
Ad 2) The majority of Polish municipalities bonds were issued in small (even very small) amounts (see table below). Such small issues do not allow for public issues. That is why only in three cases the municipal issue was noted on the public market, and on the regulated over-the-counter market MTS-CETOSA. However, even here those securities have not gained liquidity, and there were years when no transactions were made with those securities.[2]

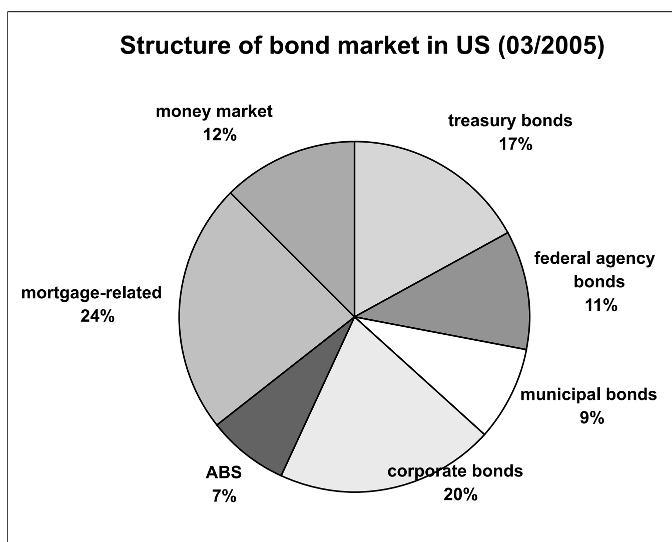
Potential investors on the municipal securities market are pension funds and insurance companies. They are especially important in Poland since each year they have larger and larger financial means (at the beginning of 2005, Open Pension Funds (OFE) had PLN 66 bln which was almost 40 per cent more than in the previous year[3]), resulting in the fact that they are interested in investing in municipal bonds. Furthermore, Polish regulations place municipal securities in the catalogue of investments of those entities. Representatives of pension funds indicate, however, that the fundamental disadvantage of bonds functioning on the municipal market

2 Majcherczak (2003).

3 "Aktywa funduszy emerytalnych – OFE – II 2005"; www.bankier.pl

Figure 3
Structure of the domestic debt securities market in Poland and in the US





Sources: Own calculation based on Ministry of Finance and Fitch Reports; and BMA 2005

is their small amounts. One should remember that funds have fixed norms as regards a share in the debt of one entity. They would accept even non-liquid assets but it is not worth their while to begin transactions which concern such a small amount. It is estimated that, in order that OFE will be interested in an issue, it should exceed PLN 200 mln. It should be added that the small interest in municipal securities also results from the dominance of treasury bonds on the market, which is visible in the structure of OFE's assets which represent approximately 57 per cent.

Table 1

Number of municipal bond issues according to the size of a launched issue program [4] during 1996 – 2004

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004
Value of Issue	Number of Issues								
(0 – 5 mln>	2	13	12	10	25	38	36	27	27
(5 – 10 mln>	2	2	2	3	13	15	9	6	7
(10 – 20 mln>	2	3	0	2	4	9	5	3	11
under 20 mln	4	1	5	0	5	8	10	2	4
All Issues	10	19	19	15	46	70	60	38	49
	Value of Issues								
Minimum	0.9	1.3	0.95	1	0,7	0,8	0,7	0,9	0,7
Maximum	99.3	25	206.3	20	144	105	124	500	40

Source: Own calculation based on Rating&Rynek; Fitch Polska SA 2004; SRGG Reports

Ad 3) Rating evaluations granted by external agencies have already rated several Polish municipalities. However, this is not popular in Poland. Several factors influence this:

- issues are non-public (which is a reason as well as a result of the lack of ratings);
- investors generally deem municipalities as safe and information on the budget of an municipal unit disclosed by the same entity, or regional chambers offices are usually deemed as sufficient;
- limitations for an issue (and wider for an indebtedness) in foreign currencies have limited the demand for ratings made for the needs of foreign investors;
- empirical data suggest that there is no transformation between the obtained rating evaluation and the bond price (compare the listing below).

4 Issue program is value of planned issue which is usually split into several parts. In reality the value of issues was lower than in the above table.

Table 2
Examples of evaluation ratings for municipal bonds (issues in 2002)

Issuer	Rating Agency/ mark	Value of issue and issue date	maturity- rate above 52 week treasury bills
Bydgoszcz	Standard & Poor's BBB – stable - international	72 mln PLN started in VII 2002	4 – 0,3 5 – 0,35 6 – 0,4 7 – 0,45 8 – 0,5 9 – 0,55
Wrocław	Standard & Poor's BBB stable international	80 mln PLN started in XII 2002	4 – 0,45 6 – 0,5 8 – 0,57 10 – 0,7
Ostrów Wielkopolski	Fitch Polska A – communal bonds A general, for local currency	10 mln PLN started in IX 2002	4 – 0,7
Tychy	Fitch Polska AA – general for local currency	13 mln PLN strated in VII 2002	1 – 0,5 2 – 0,5 3 – 0,5 4 – 0,6 5 – 0,7 6 – 0,8

Source: Majcherczyk 2003 and Rating&Rynek; Fitch Polska

It may be said that in the Polish municipal market from the perspective of local authorities, rating is just unnecessary. It makes no sense to pay for such an evaluation if it has no influence on the activity of the credit institutions, which will be analysed later in this article. It is worthy of note that a similar problem occurs in the case of issues for the public stock exchange market. In such cases, municipalities have to have an audit of their finances performed by an entitled entity. There have been, in principle, no such audits so far, mainly because municipalities are afraid of the high costs of them being carried out and also of a potential detection of any irregularities about which even the authorities are not aware. Such opinions constitute an effective barrier for public municipal issues.[5]

Ad 4) The aforementioned features of Polish municipal bonds mean that they are not an attractive instrument for investors – they are non-public, illiquid, issued in small amounts and the evaluation of an issuer is difficult. The only advantage would seem to be the profitability of bonds which, and this should be emphasised, is not supported in Poland with any special tax allowance. However, it is difficult to make an unequivocal evaluation of this profitability because there is a huge variety

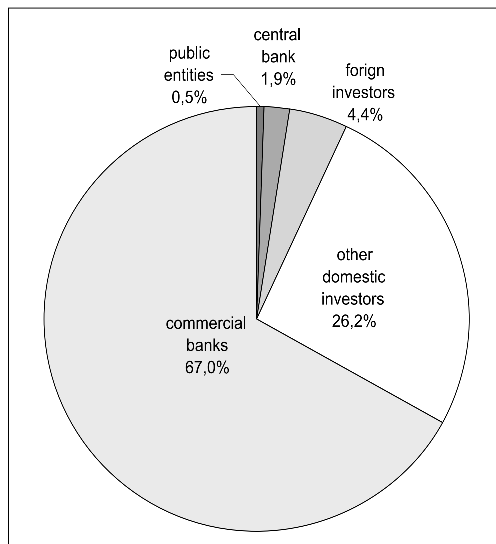
5 According to opinion of cities treasurers, (Jonas 2005).

of interest, which in relation to the basic rate (which is most often interest of 52 week treasury bonds) fluctuates in the case of similar issues even by several percentage points. Such differences which are not connected to the length of the issue, its size or rating evaluation (compare Table no. 2) indicated that issuers do not determine the interest for purposes connected with the attractiveness for investors.

However, data presented at the beginning of this article indicate that the bond debt of Polish municipalities is growing successively. Thus, in spite of the disadvantages mentioned earlier, there are investors on the market who are willing to purchase those securities. As the following diagram shows, those investors are banks and according to information from the market, they are especially those banks which were organisers and sub-issuers of issues.

Illustration 4

Structure of investors on the Polish municipal bond market (31/12/2004)



Sources: Own calculation based on Ministry of Finance information about sub-sovereign budgets

Note: the only issue purchased by a foreign investor was in Krakow.

11.5 Banks as the most active participants of the municipal bond market in Poland

The relation between the banking sector and the municipal sector in Poland may be acknowledged as almost a natural one. Each municipal unit should, according to legal regulations, have a bank account and a bank is chosen on the basis of the Act on Public Procurement. Similarly, there is a freedom of choice of a bank crediting

a municipality or a bank-agent of the issue of securities – although, and this will be shown, there are differences in the mode of this choice.

It is worth remembering that from the perspective of a bank, a municipal client is extremely attractive. Financial means which flow through the municipal budget and therefore through the municipal banking account are significant amounts and, even more important, safe and to a significant extent, predictable as regards their size and the timing of their in-payments and out-payments. Simultaneously, credit co-operation with a municipality is attractive for banks. Firstly, Polish banks have had a problem with their over-liquidity for years, so they actively search for ways of allocation of financial means. Additionally, the municipal debt is preferred in relation to the indebtedness of other entities. It results especially from the conviction in a small risk of municipal credits prevailing among representatives of banks, which is supported by banking provisions.

The fact that a municipal unit, according to Polish regulations, cannot go bankrupt is very often acknowledged by banks as a synonym of reliable solvency (Kopańska and Lewita 2004). Of course, this is not true. Municipalities do not always realise in time their financial liabilities and the due liabilities of municipalities amounted to 2 per cent of their total liabilities in 2004. It is worth emphasising that the basic majority of those arrears are connected to trade loans and only 0.39 per cent of due liabilities constituted liabilities against commercial banks.

Simultaneously, in recent years, several Polish communes have had problems with the repayment of their liabilities and even with the realisation of current tasks. Those communes obtained a loan from the state budget for the realisation of the reparation program (Wojtuch 2004). Of course, municipalities may count on help in case of financial problems. However, this help in Poland does not mean that the State Treasury takes over the liabilities of municipalities and only helps through lending them money for the realisation of the reparation program (article 65 of Act on public finance).

Nevertheless indeed, in comparison to other entities, municipalities are safe clients. First, a large portion of municipalities still very rarely use reimbursable financial means. In 2004, over half of the *voivodships* and 20 per cent of administrative districts have not raised any new credits or issued bonds. Communes, whose financial situations predispose them to incur debts, are also wary of this. In 2004, 25 per cent of rural communes, 15 per cent of rural and municipal ones and 20 per cent of municipal communes have not used any reimbursable means (Swianiewicz and Kopańska 2005). This factor is worthy of note because Polish municipalities treat borrowing with extreme restraint. It results from the incomprehension of the principles of local finance but it is also an indication of "the rationality of the policy". It is clearly visible from the experiences of recent years that borrowing may be treated during electoral battles as an argument against former governing groups (Kopańska and Levitas 2004).

The analysis of the portfolio of banking receivables also indicates the good quality of the municipal debt. There were 10.5 per cent of receivables at risk among receivables of commercial banks in 2004, whereas receivables from the municipal and government sector amounted to only 1.6 per cent. (GINB 2005-1).

The good quality of municipal receivables is confirmed by banking regulations determining risk rations for particular entities necessary in the calculation of the solvency ratio of the bank. Securities and other liabilities of municipalities have a risk weight of zero, similar to, for example, enterprises or private persons when they are secured with money amounts transferred to a bank account or guarantees or securities of relevant entities. However, if there is no such security, the risk weight for municipalities amounts to 20 per cent, while for enterprises and private persons - 50 per cent and even 100 per cent[6].

The above factors mean that banks are extremely willing to lend to municipalities. They may do it primarily in two ways – granting credits and purchasing municipal bonds. It turns out that the latter has become more and more attractive for banks as well as for municipalities. From the banks' side one may mention at least two reasons:

- First, the choice of an agent of the bond issue is not subject to the provisions of the public procurement whilst, if a municipality plans to raise a credit, it has to prepare a tender. It raises the attractiveness of bonds from the perspective of the municipality as well as from the perspective of a bank which, without additional formal measures, may offer bonds to its municipal clients.
- Second, the control of the financial and economic situation of a debtor is mandatory for a bank in the case of a credit[7], while the investment in securities, which are bonds, is not subject to such detailed regulations, although, of course, is suggested by the banking supervision (GINB 2002).

One may say, with certain simplification, that municipal bonds for a bank will be a much easier way for the allocation of financial means, not burdening the bank with any additional work until redemption of the issue. Simultaneously, advantages resulting from the good financial situation of a municipality (regardless of whether it is the real one or resulting from legal regulations) are the same in the case of a credit as well as in the case of the issue of bonds.

The above factors mean that banks offer their services as agents and underwriters of municipal issues wanting to maintain municipal bonds until their redemption by the issuer. Such bonds are more a kind of bank credit than a real security because they do not fulfil the basic feature assigned to securities – the feature of circulation.

6 Rozporządzenie Komisji Nadzoru Bankowego nr 4/2004 z dnia 8 września 2004 r.

7 Rozporządzenie Ministra Finansów z dnia 10 grudnia 2003 r. w sprawie zasad tworzenia rezerw na ryzyko związane z działalnością banków; Dz.U. 2003 nr 218 poz. 214.

It is significant that such a situation seems to be advantageous for municipalities which also more and more frequently prefer to raise a bank credit in the form of bonds. Those which have made an issue are more ready to repeat this process than to raise the "usual" credit (Jonas 2005). Apart from the fact that the issue does not require the choice of an organized issue on the basis of the Act on Public Procurements, from the perspective of municipalities among the advantages of bonds we find most often the following:

- possibility to divide an issue into a few tranches which may be more consistent with the schedule of realised investments;
- adjustment of the issue to the needs of an issuer and not, as is often the case with credits, to the banking regulations;
- according to banking regulations, a credit may not usually constitute the entire amount of an investment but there is no such a limitation in the case of the issue of bonds (compare for example, Śliwiński at al. 2005).

It is interesting that the above advantages of bonds may become disadvantages. One should remember that the flexibility of adjustment of a credit to the investment needs of a municipality is admittedly lower than during the conclusion of an agreement, but simultaneously together with changing circumstances throughout the duration of this agreement, it is possible to renegotiate it. Bonds give no such a possibility which means that they are less flexible. Furthermore, means from the issue may be destined only for the purpose indicated in the bond and if any delays in the realisation of an investment occur, those financial means have to wait "unproductively" and interests have to be paid. Such a problem may be avoided in case of credits, thanks to the flexibility of the agreement.

In other words, the basic advantage of bonds is the lower cost of the issue. As was mentioned in case of significant issue amounts, a bond may be indeed cheaper, provided that there is a market for such securities. On the other hand, in case of small "credit" issues, this cost will depend, to a large extent, on the attitude of a bank and its interest in credit or bonds respectively.

11.6 Development perspectives of the municipal bond market in Poland

The current history of municipal bonds in Poland has begun together with the entrance into force of the Act on Bonds in June 1995 which is still valid. Since then, this security was used by almost 200 entities. However, as has been shown above, the previous issues in the basic majority fulfilled only the credit function and were bought back by banks – organisers of issues. In principle, it was only for banks that the investment in municipal securities in the previous form of small and non-public issues was interesting. Furthermore, municipal bonds are, from the perspective of those institutions, very attractive. It especially concerns the risk ratios assigned to

those securities necessary to count the solvency ratio of the bank. Despite a possibility of changes which the regulations of the New Capital Accord give, published by the Basel Committee on Banking Supervision in June 2004, risk weights preferential for municipalities will be maintained in Poland (GINB 2005-2).

It means that municipalities, whilst using the opportunity to avoid the public procurement law and a reach offer of banks, will issue securities in the following years, which may be called a bond credit. Of course a basic condition here will be the price, and thus *de facto* the attitude of banks towards credit and bonds.

The development of public municipal bonds will probably mean it would be necessary to fulfil at least three conditions.

First, the reduction of treasury issues should happen, which supersede other debt securities from the market. If further governments will endeavour to decrease the size of the public debt and deficit, this predominance of treasury bonds should indeed decrease. Simultaneously, unfortunately it may be connected to a limitation of municipal issues (especially of large centres which most often issue for the public market) which also constitute a part of the public debt.

The second condition of the occurrence of public municipal issues is building on their attractiveness to investors other than banks, therefore, for example, the introduction of an institution which functions in the US – a trustee of bondholders. This condition is especially significant for the issue of income bonds. Admittedly, in the case of the issue of the water and sewage company in Bydgoszcz, no such provisions have been necessary, but nevertheless, the introduction of proper regulations would significantly facilitate the next issues. Simultaneously, in the near future, the municipal services market may become a significant factor of the development of municipal bonds. Necessary adjustments to the norms of the European Union mean that there will be significant investments made, for example, connected to water and sewage conditioning.

The third condition is connected with the building of the opportunities of public issues for smaller entities. As has been shown, the Municipal Bond Bank is a necessity. The initiative of the building of such an institution has occurred several times in previous years. The last one was the Rural Communes Association which intended appointing the Inter-Commune Association for the creation of the Polish Commune Financing Agency (*Polska Agencja Finansowania Gmin*, PAFG). The initial plans for the formation of the Agency indicated the beginning of its activity in 2006. However, due to the stipulations of the *voivodeship* supervision it is not know if and when finally the Polish Commune Financing Agency will be created (www.gminyrp.pl/pafg/).

11.7 Summary

The municipal bond market currently functioning in Poland has almost no similarity with the American market on which the legal relations were based. Polish municipalities issue non-public, non-liquid securities in small amounts and the evaluation of an issuer is difficult. In principle, the only investors in this market are banks which, while wanting to gain a municipal client, create a product which has nothing to do with classical bonds. As has been shown in this article, among the factors responsible for such a situation are the following:

- the strong dominance of treasury bonds limiting the market for other entities;
- the lack of an external financial audit in the form of the introduction as a mandatory audit in regulations or constrained by creditors;
- the reluctance of municipalities to borrow;
- the excessive competition among creditors – banks;
- the lack of legal regulations concerning the institution of the trustee of bondholders and others, building the attractiveness of bonds for investors outside the banking sector.

The aforementioned factors will still surely be present in the coming years. However, one may hope that they will abate at least partially. Simultaneously, the Polish municipal bond market, despite its formation according to the American pattern, is leaning towards a more European model. In this model, issues are reserved for the largest municipalities and the basic majority of local indebtedness comes from banking credits.

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12. The Budgetary Liquidity Management in the Republic of Moldova

Angela Casian and Eugenia Busmachiu

12.1 Introduction

Since it became independent, the Government of the Republic of Moldova has focused on the political issues which negatively influenced the promotion of economic reforms. Strong interdependence between economic and political reforms shows that important strategic options surpass the political limits, proving that technocratic solutions are insufficient for the reforms' implementation. Moreover, each shift from one social-economic system to another requires good preparation, strategy development and the preparation of a program of radical changes, considering national economic and geopolitical interests. Even at the first stage of reforms, the political and economic decedents of the Republic of Moldova would focus on three items: first – which measure out of the following is the most important: economic stabilisation and/or structural and institutional reforms, or economic liberalization; second – what is the sequence of the reform processes; third – what is the rhythm adjusted to transition.

Since the beginning of the 1990s, Moldova has been amongst the first reformers in the CIS countries. In 1993, with the introduction of the "leu" as national currency, the country entered into a financial stability period. This stimulated new measures: economic liberalisation with control differentiation of prices and production, macroeconomic stabilisation with control of money volume, privatisation, etc. It looked as if things were not going too badly, but there was no progress in establishing clear objectives on the one hand and creating legal conditions in order to facilitate private investments on the other. As a result, the Government was inconsequent in both economic and political reform implementation.

The economy of the Republic of Moldova will not show outstanding results unless long-term objectives are accomplished: meaning institutional and structural reforms. Moldova had two opportunities for the reforms: radical or "shock therapy" and step-by-step reforms. The "shock therapy" presupposes the shift from centralised planning to a market economy within one-step of reforms. The "step-by-step" approach aims towards the same goal, but within a longer timeframe. They would lead to income increases with positive results. The policymakers of the Republic of Moldova rejected the shock therapy method, avoiding the high social and political costs of such an approach. Therefore, trying to avoid political shocks, Moldova followed the second method of economy liberalisation. However, based on the experience of other states, it has been demonstrated that secondary consequences are easier to control in case of shock therapy, rather than in the case of steady reform.

Different types of problems that have occurred during the transformation processes are not only the consequences of transaction, but also specific aspects related to the economic conditions of the country itself. Some of the consequences were the decline of the population's living standards, absorption by society of the costs of stabilisation on the macro level, reduction of production volumes, costs of the external debts payments and inflation.

An improvement in the budgetary process is possible under conditions of maximal reduction of ad-hoc approaches and suggestions of a perspective developed-based economic, financial and program analysis. Ideally, an economic analysis must include fiscal and budgetary perspective plans, an estimate of the resources required, development of an alternative fiscal strategy and an evaluation of the impact of the budgetary resources allocation decisions and those of taxation.

The importance of the public finance management system has, in reaching its goals set out in the Strategy of Economic Growth and Poverty Reduction (SEGPR) defined its Plan of Activities. The Plan is intended to meet the objectives included in SEGPR of the "Public Finance Management" project implementation under the aegis of the Ministry of Finance. This project provides the redefinition of the functionality and architecture of the existing system of public finance management using the best international experience.

In budgetary liquidity management, planning and qualitative forecasting of the basic indicators and budget cash execution are very important. They are used both for decision-making on debt or investment and in case of current management of the territorial administrative units' balances.

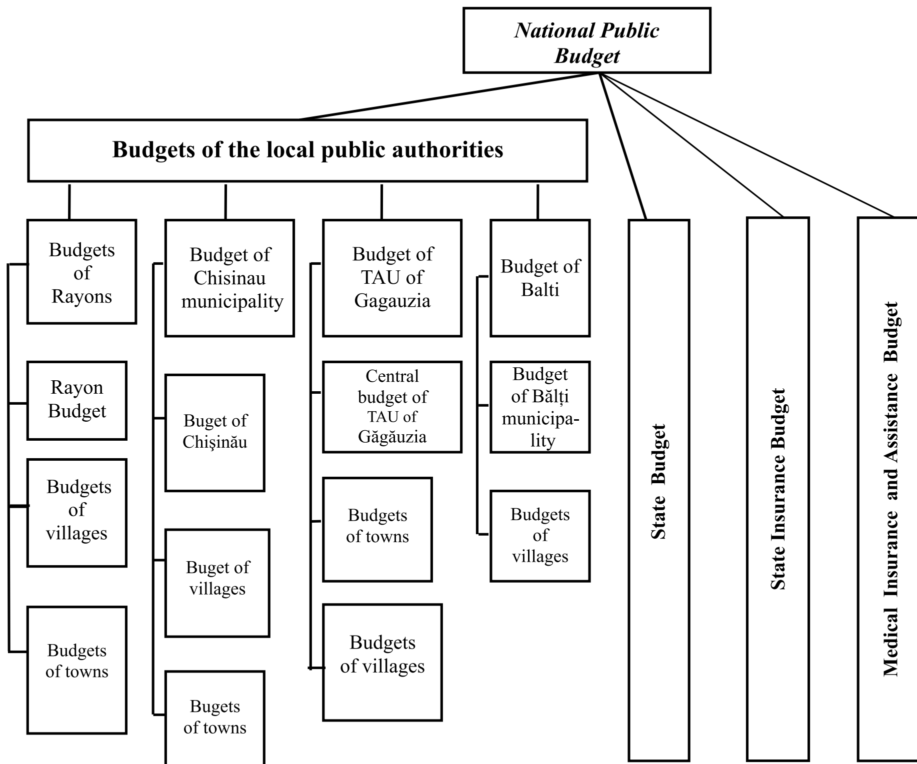
12.2 The Budgetary System of the Republic of Moldova

The public budgeting processes in Moldova reflect the openness of democracy, balancing various interests and priorities in the community. The budget role is manifested in economic, social and financial activities; from the financial standpoint it assures the distribution of financial resources of the state in order to perform its functions and objectives and from an economic standpoint, the state budget includes different instruments and intervention techniques into economic and social activity through which the state carries out an economic stimulation policy and social protection policy.

The National Public Budget includes: the state budget, social insurance budget, medical insurance budget and local public authorities budgets. (Figure 1). Budgets are constituted and executed on the basis of unique Budget classification. Budget classification is developed by the Ministry of Finance and approved with a Parliament decision. Budget classification includes classification of the budget revenues functional, organisational and economic classification of budget expenditure. Classification of the budget revenues represents grouping of the budget revenues by the

resources that form them. Functional classification of the budget expenses represents grouping of the budget expenses, which leads to the utilisation of financial means for fulfilment of state main functions.

Figure 1
National Public Budget Structure



As stipulated in the legal provisions [4], the public budget represents the synthesised expression of economic relations, which are manifested in the processes of creation and use of the basic centralised state fund of monetary means and the funds of administrative-territorial units, for financing activities intended to improve the population's living standards (education, health, culture and art, physical training and sport, ecological and social protection), activities leading to economic development of the country, scientific research, amplification and improvement of infrastructure, the creation of state reserves, national defence, public order and law.

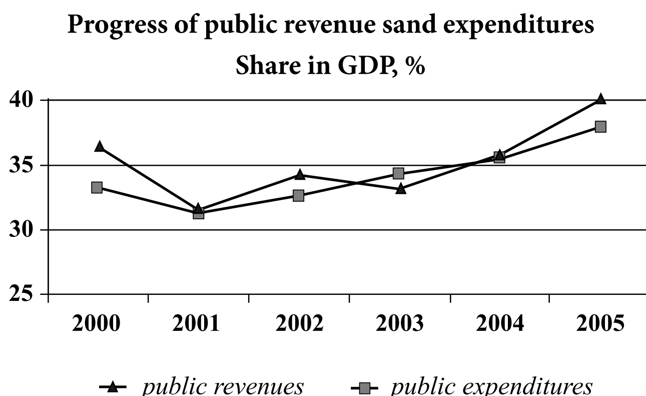
As the main financial balance sheet, the public budget is the basic document, with the power of law, which stipulates, on the one hand, the nature and volume of incomes mobilised at the state's disposal, and, on the other, the type and volume of

budgetary allocations that will be managed by the state for financing various activities during the year.

In 2005, as a result of these actions, the national public budget accumulated revenues amounting to MDL 14.7 billion, which is 3.3 billion or 28.8 per cent more than in 2004. The state budget collected revenues of MDL 9.1 billion, which is 37.9 per cent more compared to the same period in the previous year.

Figure 2

Evolution of public expenditures and revenues, Source www.scers.md, [14]



The main revenues came to MDL 7.8 billion, exceeding by 40 per cent the level of collections from 2004. The revenue part of the TAU's budgets in 2005 increased by MDL 843 million or by 28.7 per cent compared to 2004. According to preliminary estimates, total public expenditures grew from MDL 11.3 billion in 2004 to MDL 13.9 billion in 2005, with a concurrent increase of all elements of the global expenditures framework.

The structure of budgetary revenues did not suffer any significant change. The main part of fiscal payments was created by indirect taxes and fees on external trade transactions, followed by contributions for medical and social insurance. Contributions to the social insurance and medical budget are similar to taxes but are not identical from the point of view of tax legislation, since the first ones become onerous if payment of insurance is required: illness, child birth etc. and therefore are different from taxes and fees. Direct taxes made up MDL 5,272.1 million or 35.9 per cent of the total amount of national budget revenues. Indirect taxes accounted for MDL 6,475. 9 million (44.1 per cent) and were collected at a level of 100.4 per cent compared to annual reviewed provisions. Throughout the reporting year, other revenues (including revenues from special means and funds, grants, proceeds from privatisation and sale of public goods) were collected at a level of 102 per cent as compared to budget provisions, as the amount of special means

(paid services) was reduced in the context of the regulatory reform. At the same time, the share of the above mentioned revenues within the national budget made up 20 per cent (2.4 per cent more than in 2004). In 2005, public expenditures did not achieve the forecasted amount of 7.3 per cent. The analysis of the structure of public expenditures in the reporting period shows that almost 63.3 per cent from public expenditures account for socio-cultural expenses for social assistance and insurance – 30.4 per cent, education – 19.3 per cent, health protection 11.3 per cent. Approximately 14.1 per cent of public expenditures account for expenditures related to the economy sectors. Compared to 2004, public expenditures in the socio-cultural area registered an increase of 24.9 per cent, and public expenditures for economic development increased by 45.4 per cent, compared to the general growth of 23.8 per cent of the national public budget. [15]

The State Budget is approved annually by the Parliament of the Republic of Moldova as a law. State insurance budget (SIB) is a constituent part of national public budget and includes "income, expenditure and financial results of the public system" [3, art.10].

State Insurance Budget covers the payment of pensions, social insurance programmes (unemployment allocations, sick and maternity leave) and hardship allowances. SIB revenues are generated by social insurance taxes paid by natural and legal persons and state budget transfers.

The State Insurance Budget priority is to ensure the financial stability of the public system of social insurance and its share in the National Public Budget and Gross Domestic Product is increasing. According to Article 47 of Law number 847-XIII, dated 24 May 1996, on the Budgetary System and Budgeting Process "the development of the State Insurance Budget project document is responsibility of the Government and is carried out by the Ministry of Health and Social Protection and Ministry of Finance".

The State Insurance Budget is approved by the Parliament of the Republic of Moldova simultaneously with the state budget. According to Law number 1585-XIII, dated 27 February 1992, concerning obligatory medical insurance and Law number 264-XV, dated 26 June 2003, concerning implementation of obligatory medical insurance, special Funds of Obligatory Medical Insurance (FOMI) have been introduced.

Obligatory medical insurance represents a guaranteed system of health protection by creating funds. FOMI consist of payments of obligatory medical insurance and other payments. Together with the implementation of obligatory medical insurance and the creation of such funds, the share of health protection expenditure in the National Public Budget has increased during the last years.

Budgets of territorial-administrative units (TAUs) are made up of the sum of incomes and expenditures envisaged by law for the implementation of own strate-

gies and objectives of local public authorities or those delegated by the Government.

In the Republic of Moldova, territorial-administrative organisation is stipulated by Law number 764-XV dated 27 December 2001 and the territory is divided in 32 rayons and 5 municipalities: Balti, Bender, Chisinau, Comrat and Tiraspol, TAU of Gagauzia, 982 villages and towns and TAUs on the left bank of the Nistru River.

In compliance with Article 2 of Law number 397-XV regarding local public funds, dated 16 October 2003, budgets for TAUs comprise (see Figure 1):

- budgets of local public authorities at the second level (rayons' budgets, central budget of TAU of Gagauzia, municipal budget of Chisinau) which are approved by representative and deliberative authorities at the second level and are performed by their executive authorities;
- municipal budget Balti that is approved by the Municipal Council and administrated by the Mayor;
- local budgets (budgets of villages and municipalities with exception of Balti municipality, towns) are approved by the local councils of local public authorities at the first level and are administrated by mayors.

In compliance with Article 9.88 of Law number 123-XV, dated 18 May 2003, regarding local public authorities and Article 3 of Law number 397-XV, dated 16 October 2003, regarding local public funds, budgets of TAU of *Gagauzia "are independent elements developed, approved and performed under conditions of financial autonomy"*..

Beginning in 2005, by the Law number 224, dated 1 July 2004, regarding modification of some legislative acts, Law number 847-XIII, dated 24 May 1996, on the budgetary system and budgeting process and Law number 397-XV dated October 16, 2003 regarding local public funds have been amended. These modifications envisage that the National Public Budget includes the following resources: in the state budget, besides main revenues and expenditure, the following funds are included: special funds and means, investment projects implemented with external grants and debts; in the TAU's budget, besides the main income and expenditure, special funds include special means. Following these modifications, special funds and means will no longer be outside of the budget and instead they will be an integrated part of the national public budget.

The budgetary process represents an ensemble of operations, which concern the drawing up and approval of the draft of the annual budget law, the current budget's implementation and the closing and approval of the accounts of budgetary execution, as well as budgetary control.

Thus, the budgetary process is decisional, and consists of setting priorities and allocating the resources necessary for the financing of the stated objectives which

concern public utility. The decision that should be taken is very complex because the mobilised resources are scarce and are placed below the level of public necessities during the period.

The budgetary process is cyclic, being realised consequently and according to a rigorous calendar, in conformity with the requirements against the principles of budgetary annularity and publicity.

The budgetary process is strictly regulated, in such a way that the observance of the existing legislation and methodological norms elaborated by the Ministry of Finance for this goal are imposed during the budgetary process implementation. The Ministry of Finance is the competent authority responsible for the preparation of the National Public Budget in Moldova. The quality of budget preparation has improved considerably over the past few years, together with the introduction of medium-term expenditure frameworks (MTEFs). In this area, the Ministry of Finance has recently made commendable progress; MTEF improvement and the broadening allowed for a better allocation of resources. Social sectors account for most of the public expenditures – 63.3 per cent of insurance and social assistance accounted for 30.4 per cent, education 19.4 per cent and health protection, 11.3 per cent. Approximately, 14.1 per cent of public expenditures account for expenditures of the economic sectors. Compared to 2004, they registered a growth of 45.4 per cent versus the general 23.8 per cent growth of public budget expenditures [14].

Reporting on budget execution has also improved and disclosure of final annual accounts is made in a timely fashion. In a range of other areas, Moldova does to some extent meet fiscal transparency requirements, but further improvements would be useful. The coordination mechanisms between budget and off-budget activities are formally rather well defined, but social funds, extra budgetary funds, and donor-financed projects should be fully integrated into the central government budget. The relations between central and local governments should be put on a sounder and more stable footing, following more intensive consultations between the state budgets and all budget levels.

12.3 Financial policy and budgetary liquidity management

The term “policy” designates the behaviour of a set of actors, such as an official, a governmental agency, or a legislature, in an area of activity such as public transportation of consumer protection. Political Scientist Carl J. Friedrich regards policy as an offered course of action of a person, group, or government within a given environment providing obstacles and opportunities which the policy was suggested to utilise and overcome in an effort to reach a goal or realise an objective or a purpose [5, page 5]. Policy involves what governments actually do, not just what they intend to do or that they say they are going to do.

Financial policy of the government differs, depending on the interests of the social levels, expressed by the parties in power: potential of each country, social system and system of government.

Simultaneously, financial policy is a sphere which is relatively independent in government's functioning and an important element in implementing state policy in all fields of economic activity. The role of financial policy is to research and develop new policies for government relating to the financial management and resource framework for the public sector and to provide advice and assistance to stakeholders, particularly public sector agencies, promoting a better appreciation and understanding of financial management initiatives and assisting with the implementation of endorsed reforms.

The realisation of financial policy is based on a set of principles of both a general and specific character. The general principles essential for ensuring the efficiency of financial policy are: taking into consideration the impact of economic laws; taking into consideration specific historical conditions; taking into consideration past experience and world experience. Specific principles ensure a rational structure of the financial system, establish a rational financial mechanism, maintain equilibrium of expenditures and revenues in all sectors of the financial system, create financial reserves, accumulate financial resources in order to realise the main economic and social objectives of the government through development of rational fiscal policy, concentrate financial resources within the government's power and set the balance between financial and monetary and credit policies.

To exercise the sound policy of long-term development in the Republic of Moldova, it is vital to continue the improvement and development of financial relations, mechanisms that ensure stability and macroeconomic equilibrium, mechanisms that stimulate investments, economic growth and as a result, increase living standards. The given strategic objectives of economic and social policy of the government might be achieved if all components of fiscal policy are accomplished and the corresponding mechanisms and measures are implemented.

The Treasury system provides central governments with essential financial services, including the processing of payments, accounting, fiscal reporting and financial management on a comprehensive, often centralised, basis. The most advanced economies have networked computer systems that integrate all of these functions for the finance and line ministries and their spending units; these systems may also include modules for budget preparation, debt management, extra budgetary funds, local governments and other functions.

The treasury system has several components: the treasury department within the Ministry of Finance, which, through its regional offices, collects revenues and makes government payments; consolidation of government financial resources in a "treasury single account" in the central bank; the introduction of a better account-

ing regime for government operations through a "treasury general ledger" and the development of financial management and planning for the government sector.

In the Republic of Moldova, the state Treasury comprises the Central Treasury and 38 territorial units of the State Treasury. Budget execution is focused on the activity of territorial units which perform transactions and budget executors financed by the State Budget and by the TAU's budgets at levels 1 and 2. The State Treasury in Moldova is responsible for the management of budget cash inputs and outputs. Cash management provides daily information on liquidity available for budget administrators and the necessary cash for the next period.

If addressed, the cash management process would ensure greater predictability of cash release and reduce penalty payments on overdue liabilities. The establishment of a Cash Management Unit in the Ministry of Finance in 2001 was a positive development but much still needs to be done in order to improve its methodological skills. In addition, greater coordination is needed between related departments e.g. Budget Synthesis Department and the Debt Department of the Ministry of Finance and the Tax and Revenue authorities. More needs to be accomplished in order to communicate cash forecasts and budget execution reports to the line ministries.

The complex process of budgetary liquidity management is related to the limitation of authority between Central Government and the local public authority regarding the mobilisation of financial resources corresponding to different levels of budgets on the one hand, and regulation and harmonisation of financial relations between Central Government and TAUs on the other.

In Moldova, within the process of local public funds consolidation, local public authorities are responsible, according to legislation, for the execution of the main components of financial priorities, and the Government cannot impose additional expenditures on local public authorities without offering additional funds and cannot modify local budgets, unless they contradict the law. Consolidation of local public funds is carried out in parallel with the improvement of intra-budgetary relations between the state budget and the budgets of TAUs. The system of allocations from main state expenditures and transfers consolidates inter-budgetary relations and increases the responsibilities of local authorities.

Implementation of an effective financial autonomy at the local level implies a diminishing local authorities' role in quantum, fiscal and non-fiscal revenues categories determination at the local level, and using local revenues and administrative coordination of fiscal apparatus at the local level.

From this standpoint, the role of the state is played in the framework of general policy, consisting of development of institutions and bodies of local administrative autonomy. An analysis of the financial autonomy level, in the context of decision-making regarding the determination of quantum and revenue categories that form the local budget, should follow the relationship between three large categories of

main resources that generate local budget: own revenues, allocations from main state expenditures and transfers. The Law on Local Public Funds includes the main principle of inter-budgetary relations, according to which allocations from main state expenditures to budgets of territorial administrative units at the second level are carried out, ensuring that they are not lower than the shares stipulated in the legislation.

Inter-budgetary relation stabilisation stimulates local public authorities to underestimate available resources and overestimate expenditure necessities; this means that it is necessary to establish predictable and plain regulations regarding relations between the state budget and territorial administrative units' budgets that will lead to promotion and progress towards decentralisation. The income equalisation of TAU is carried out through an adequate system of equalised transfers and transfer ratio. These tools can ensure the stabilisation of achievements between different levels of administration. But this equalisation system contains some errors: transfers are carried out using a general formula and the correction coefficient of expenditure per inhabitant is not clear; expenditure estimation is realised based on capacity indices (volume, quantity, number) instead of the necessity factor.

The Central Government should provide necessary socio-economic conditions, formulate sustainable development strategies, as well as support strategic plans of social-economic development and establish stimulus for local authorities. The existing system represents a set of aspects, which interrupt the efficient use of public resources such as:

- Lack of well-stated goals concerning both the efficient use of public resources and the resulting indicators, as well as the indicators regarding the appreciation of the results of the public entities' activity;
- Limited circle of the authorities delegated to be budgetary executors and, as a result, reduced responsibility concerning budgetary formulation and execution;
- Domination of the external control regarding the conformity of the "home-calculated" indicators because of the lack of procedures and methodology of the internal and external control implementation. The control deals with the quality of planning and use of public resources. Thus, it is necessary to change the budgetary executors' mentalities from the concept of "maximal valuation of public resources" towards the concept of "achievement of some commeasurable results having general importance for society".

The reference model of the organisation of the activities of budgetary assets and liabilities' management could help the consequence of activities as follows:

- Creation of an information database and definition of the technology and methodology of drawing up annual, quarterly, monthly and daily plans of payments and collections, an important role belonging to specialised computer applications;

- Signing of a general credit agreement with the National Bank of Moldova in order to grant intra-day credits;
- Identification of partners and definition of the mechanisms of performance of deposit operations and contacting "overnight" credits on the financial market;
- Organisation of the collaboration of the State Treasury with the Public Debt Direction within the Ministry of Finance in order to coordinate the amount and terms of attraction of borrowed resources or placement of temporarily free resources.

It is evident that in order to apply the above mentioned, some adjustments of normative acts are carried out.

12.4 Conclusions

In Moldova, the revenue comes from three main sources – taxes, local fees and a share of the taxes collected at the central level and transferred from the state budget to Rayons and then to City Halls. The functioning of local governments is primarily financed through transfers from the central budget and the Rayon and, to a lesser extent, from a share in state taxes, while own revenues play a minimum role.

For the medium perspective, improvement of the fiscal system and maximisation of its stimulating and equitable character are carried out. The main objectives of fiscal policy are to continue the diminishing of fiscal pressure, simplify and stabilise the fiscal system and improve the taxation basis. The improvement of the fiscal system based, in general, on indirect taxation, the performance rate of producers' activities and the possibility of stimulating exports, increase the role of taxes, and relate, to a great extent, with the results of economic activity.

In order to modernise the budget process and liquidity management, the following measures are expected to be enforced: implementing modern econometric models in order to correlate planned budget revenue with forecasts on the dynamics of macroeconomic aggregates and with economic and social policies of the government for a given year and improving the system of transfers allocated to local budgets from the state budget. The problem of enhancing the strategic methods used, while planning public revenues and expenditures, is subject to improvement during 2006 – 2007 and will be carried out by the Ministry of Finance with the support of the World Bank.

Concentration of all possible public finance cash flows to one system with a concentration of data of public cash flows in one electronic database system, to make public finance cash flows more transparent, improving the efficiency in the usage of public finance, improving the quality of reporting, ensuring effective management of liquidity, contributing to effective management of state debt are all necessary.

Liquidity budgetary management implies operational development of reports on cash execution of budgets, as well as information exchange between the budgetary process actors. Cash flow prognosis in close coordination with fiscal, customs, public debt service and the banking system contribute to an efficient budget execution.

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13. The High Level of Centralisation and Local Debt in Slovenia

Maja Klun

13.1 Introduction

The financing of local communities and the issue of centralising or decentralising financing is an important fiscal policy issue for every country. There is considerable diversity in the levels of financial centralisation from country to country and the level of centralisation usually depends on the tradition of a particular country. A number of research works have already been carried out to investigate the advantages and disadvantages of centralisation or decentralisation. The level of fiscal centralisation is generally measured using the ratio of local revenue to total public revenue and/or the ratio of local expenditure to total public expenditure. Data indicates that developed countries have, on average, a higher level of decentralisation than developing countries. Research into the relations between the level of decentralisation and economic development (e.g. Oates 1993; Ebel and Yilmaz 2002) have indicated a positive correlation, as well as a trend towards increasing centralisation in developing countries, particularly countries in transition. The research also raises the issue of local borrowing in relation to the level of centralisation.

The article will first present some results from research into the advantages and disadvantages of fiscal decentralisation, and the level of centralisation in Slovenia since independence. Although the legislation on local financing changed in 1998, there were no significant changes to the level of decentralisation and municipality borrowing. The article also compares Slovenia's position to the level of centralisation in other EU countries in 2001 and 2004, and the level of borrowing during those years.

13.2 Advantages and Disadvantages of Fiscal Decentralisation

As mentioned above, a positive correlation was found between the level of decentralisation and economic development. The average level of fiscal decentralisation in developed countries is considerably higher than in developing countries. Economic development in countries in transition has been accompanied in most cases by an increase in the level of decentralisation. In studying the relation between the level of fiscal decentralisation and economic development, there remains the unresolved issue of which is the dependent variable, as data on the level of decentralisation and economic development from the middle of the 20th century does not indicate a positive correlation. The thesis of a positive correlation between these phenomena has not therefore been fully attested (Blažić, 2004).

Despite this, decentralisation certainly offers a range of advantages. Fiscal decentralisation should have a positive impact on improvements to public services, improving the coordination and supervision of designated use of funds, improving how local populations' requirements are met, and increasing their participation in managing finances. Greater decentralisation should increase the responsibility of local authorities over development, stimulating competition between, and ensuring greater fiscal stability for, local communities. Decentralisation reduces public spending and hence contributes to reducing budget deficits (Mello and Barenstein 2001).

Nevertheless, alongside the advantages of greater decentralisation, one must also mention some disadvantages. Greater decentralisation can lead to poorer supervision over public finances, can restrict fiscal policy management, overloading local finances with liabilities delegated by the state, etc.

Local community borrowing is one possible source of local revenue, especially for financing investments. The transfer of debt arising from borrowing to future generations in such situations is justifiable, as current investments will have benefits for future generations. If local communities do not make investments, their development may be harmed, so from that point of view, borrowing is appropriate. In certain cases, borrowing is also suitable for covering an imbalance between local community revenue and expenditure. In this case, borrowing can also be justified, as it is preferable to the negative effects of a deficit and cuts in public services. Despite the advantages of borrowing set out above at the local level, it must be regulated to avoid excessive and ungrounded borrowing by local communities. The regulations should set out the procedures, revenue levels, and capacity to pay off debt (Ebel and Yilmaz 2002).

13.3 Fiscal Decentralisation and Local Debt in Slovenia

The Slovenian state has only one level of local community organisation – its municipalities. Although legislation sets out specific criteria for establishing a municipality, the number of municipalities has continually increased due to approvals being granted to various exceptions and above all for political reasons. At the end of 2005, Slovenia had 193 municipalities, with an average population of over 10 000 inhabitants. Excluding urban municipalities, the average population is a little over 7 000. The municipalities are therefore rather small and cannot independently collect sufficient funds, and are operated by small municipal administrations that struggle to provide the necessary public services. Despite the fact that small municipalities are heavily dependent on financing from the state, in Slovenia the number of municipalities continues to increase. In March 2005 a further 12 new municipalities were established, and referendums will be held on the creation of eight new municipalities. Despite the relatively large number of municipalities with respect to Slovenia's size and population, the level of fiscal decentralisation is quite low, and is below the

EU average. Local governments in Slovenia are practically unable to raise their own resources. They can introduce some specific charges, but all taxes are determined by the state.

Table 1
Fiscal Decentralisation in Slovenia from 1992 – 2004

Year	Local revenue/total public revenue (%)	Local expenditure/total public expenditure (%)
1992	11.14	11.36
1993	10.83	10.98
1994	11.21	11.04
1995	10.82	10.44
1996	11.29	11.02
1997	11.60	10.80
1998	11.52	11.01
1999	11.52	11.21
2000	11.99	11.60
2001	11.75	11.49
2002	12.17	11.73
2003	11.69	11.38
2004	11.59	11.23

Source: Ministry of Finance of Republic of Slovenia, Bulletin for Public Finance, 1/06.

In 1998, the first large scale amendments were made to the legislation on the financing of municipalities. Table 1 indicates that this has not changed the level of fiscal decentralisation. Slovenia's first Financing of Municipalities Act, which was in force until 1998, set limits on municipality borrowing, but did not set out detailed restrictions on obtaining funds from the national budget for investments and other inflows from the national budget. As a consequence, after independence, municipalities began various forms of borrowing up to the legally defined limits. The amended Act which came into force in 1999 defined a different form of financial equalisation for municipalities, a new distribution of income tax revenues between the state and municipal budgets, and changed the method of allocating funding for co-financing projects from the national budget. The borrowing limit for municipalities was also changed (Klun 2001).

Until amended, the Act envisaged that the guaranteed expenditure for a specific municipality was set on the basis of measures determined by the competent ministry. This did not clarify which measures were used and how they would change for the next year. The amended Financing of Municipalities Act, however, determines

that "fixed expenditure per inhabitant is determined by the Slovenian parliament when adopting the national budget for each budget year. The fixed expenditure per inhabitant is determined as the average sum of funds per capita for the population of the Republic of Slovenia". The fixed expenditure per person is then determined for each municipality using a formula stated in the Act. The formula envisages that the fixed expenditure per capita for each municipality is corrected with factors such as area, length of roads, population under 15 years and population over 65 years as a ratio between the municipality and the whole country. Greatest emphasis is placed on the total population of each municipality and the number of inhabitants under 15 years. A greater emphasis is also placed on population in city municipalities. Financial equalisation is applied to municipalities whose own revenues cannot provide 90 per cent of the centrally defined fixed expenditure, calculated according to the formula. This funding can reach up to 100 per cent of assessed revenue. The large number of small municipalities means only a few municipalities are able to collect sufficient revenues to cover 90 per cent of the calculated fixed expenditure. The average value of the financial equalisation per inhabitant in 2004 was SIT 36 186 (c. EUR 150), with 48 per cent of municipalities receiving a financial equalisation higher than the average, and with 87.6 per cent of municipalities receiving a financial equalisation.

The distribution ratio for revenue collected from income tax was changed to the benefit of municipalities, from 30 to 35 per cent. This gave municipalities a greater proportion of income tax revenue, but also led to a reduction in the funds available from financial equalisations and an increase in powers delegated to the municipalities. The Financing of Municipalities Act on obtaining funds from the national budget for various investments also introduced a scale for municipalities to obtain such funds. Wealthier municipalities (depending on the income tax collected per inhabitant) can obtain up to a maximum of 10 per cent of an investment, while the least wealthy municipalities can obtain up to 70 per cent.

An important amendment was connected to the limits on municipal borrowing, and stated that municipalities could only borrow up to a level that was 10 per cent of realized revenue (this revenue does not include funds from the national budget to co-finance investments and grants). The procedure for obtaining consent form the Ministry of Finance was also made stricter. The legislation also permitted borrowing on the capital market. However, the implementing regulation that would regulate this form of borrowing has yet to be passed. As a consequence, since 1999, municipalities ended borrowing through the issue of bonds, and from 1999 their only borrowing has been via domestic commercial banks. Borrowing by means of issuing securities reached its highest proportion of total municipal borrowing in 1992, when it reached 71.5 per cent. From that year on, the proportion continually fell, down to 7.2 per cent of total borrowing in 1992 and just 0.9 per cent in 1998. Despite the reduction in borrowing through issuing securities, the ratio of borrow-

ing to total municipal revenue did not fall, and ranged from 0.5 per cent to 3 per cent of average municipal revenue throughout the entire post-independence period (see Table 2).

Table 2
Ratio of Average Local Borrowing and Debt Repayment to Local Revenue (%)
1992 – 2004

Year	Local borrowing/local revenue (%)	Debt repayment/local revenue (%)
1992	3. 77	1.98
1993	2.49	1.60
1994	1.35	1.11
1995	0.46	1.62
1996	0.73	1.34
1997	1.11	1.34
1998	1.35	1.43
1999	1.06	1.18
2000	0.83	0.91
2001	1.25	0.94
2002	2.98	0.85
2003	2.00	0.80
2004	2.64	1.06

Source: Ministry of Finance of Republic of Slovenia, Bulletin of Public Finance, 1/06.

In 2004, 19 municipalities exceeded the legal limit on borrowing, which defines the highest permitted amount of borrowing as 10 per cent of realised revenue, and the number has risen year by year since 2000. Most municipalities in Slovenia do not borrow. From 2000 to 2004 the proportion of municipalities that did borrow was between 25 per cent (in 2001) and 34 per cent (2004). Just under a third of municipalities engage in borrowing, despite the fact that, on average, municipalities only recorded a surplus in 2000 and 2004. Before 2000, on average, municipalities had a surplus of revenue over expenditure. In 2004, 56 per cent of municipalities recorded a budget surplus, and average debt per person was SIT 5,015 (c. EUR 20.90). A detailed analysis of municipal borrowing and debt repayment is given in Table 3.

An additional restriction on borrowing is the amount of debt repayment, which cannot exceed 5 per cent of realized revenue. Some municipalities have also exceeded this restriction, however, they are far fewer in number than those exceeding the limits relating to borrowing. In 2004 just 4 per cent of municipalities exceed-

ed the debt repayment limit. Despite this small number, the average debt repayment amount per inhabitant is increasing consistently. In 2004 the average amount was SIT 1 761 (approximately EUR 7).

Table 3
Selected Local Borrowing and Debt Repayment Figures in Slovenian Municipalities 2000 – 2004
(%)

	2000	2001	2002	2003	2004
Proportion of municipalities that have borrowed	25.9	25.4	33.2	21.2	33.2
Proportion of municipalities with borrowing:					
- below 2% of revenue	80.3	79.7	70.9	81.9	71.5
- below 5% of revenue	89.1	87.0	79.3	88.1	81.3
- below 10% of revenue	96.9	95.8	94.3	93.8	90.2
Proportion of municipalities making debt repayment	61.1	57.5	60.1	60.6	61.7
Proportion of municipalities with debt repayment:					
- below 1% of revenue	73.0	68.9	72.5	73.5	73.5
- below 3% of revenue	91.2	86.5	88.1	93.8	93.8
- below 5% of revenue	95.3	90.7	92.2	95.9	95.3

Source: URL: http://www.fu.uni-lj.si/sib/vhod.asp

The data indicates that municipalities use most of their revenue for the provision of delegated public services. Not a great deal of funds remains for investment, so the investment trends remain the same, with the average proportion of funds for investment and investment transfers being around one third of expenditure, or just under 20 per cent of revenue. The low level of borrowing is due in part to Slovenia's high level of centralisation. Slovenian municipalities persist with a financing method that is largely dependent on funds obtained from the state budget. This means that municipalities place most of the burden for providing their public services on the state. On the other hand, smaller municipalities cannot manage large debt, given their small number of staff. Some smaller municipalities have fewer than five staff. Debt management at the municipal level is also restricted in another area. Municipalities only borrow on the domestic market, and do not have the possibility of borrowing on the capital market, so domestic financial institutions are their only option. As the financial market in Slovenia is an oligopolistic market, it does not offer much diversity and municipalities have very little choice in their borrowing. The largest proportion of municipal borrowing is from credits taken out at domestic commercial banks. This proportion ranged from between 72 per cent to 86 per cent of total municipal borrowing during the period 2000 – 2004. Table 4 gives an analysis of municipal borrowing from 2000 to 2004. Municipal borrowing grew as

a proportion of overall public sector borrowing throughout the studied period. The local debt also grew as a proportion of GDP.

Table 4

Local Public Debt, 2000 – 2004

Year	Budget surplus/ deficit (SIT million)	Primary surplus/ deficit (SIT million)	Current surplus/ deficit (SIT million)	Ratio of borrowing to total public borrowing (%)	Ratio of credit from commercial banks to overall borrowing (%)	Local borrowing as proportion of GDP (%)
2000	620	-930	18 987	1.0	71.9	0.04
2001	-1 897	-3 487	29 650	1.2	72.6	0.06
2002	-8 668	-10 063	34 535	2.7	86.0	0.15
2003	-1 114	-1 862	38 661	2.4	77.2	0.10
2004	138	-204	40 970	3.0	81.1	0.13

Source: Ministry of Finance of Republic of Slovenia, Bulletin of Public Finance, 1/06 and own calculations.

The audits performed by the Court of Auditors of the Republic of Slovenia from 2002 to 2004 also found that only a few municipalities exceed the legally defined upper limit on borrowing and the Court did not find any other irregularities relating to borrowing. Based on its audits, in 2004, the Court informed the state that municipalities are increasingly turning to other methods of borrowing that legislation in force until the amendments in 2005 did not anticipate and did not therefore define limits for. Commercial borrowing is increasingly being used (e.g. commercial credit, leasing, etc.).

In 2005, a set of amendments were made to the Financing of Municipalities Act to enable the state to reduce municipalities' dependence on the state, offer them greater independence in obtaining funds, and redress some deficiencies related to borrowing. The main purpose of the amendments was to enable municipalities to perform their duties within regional development programs and to increase their capacity to draw on additional revenue from EU funds. Municipalities obtained the first transfers from EU funds in 2004, but the proportion was relatively low, with such transfers worth just 0.5 per cent of overall municipal revenue on average.

Municipalities should be entitled to further special incentives for co-financing investments in the field of regional development programs within the structural and cohesion policies. According to the amended Act, municipalities still require the Minister of Finance's consent, but the procedures have been simplified. The threshold up to which municipalities can borrow was raised to 20 per cent of realized revenue, while the restriction for debt repayment remained at 5 per cent of

realised revenue. Borrowing now includes all forms of debt, i.e. including commercial credits, leasing etc. In addition to these basic forms of borrowing, municipalities have the possibility of additional borrowing of up to 3 per cent of anticipated revenue, if they are borrowing for investments co-financed by EU funds, and to finance investment in elementary school education and public infrastructure for waste water treatment.

In addition to the amendments relating to borrowing, the Act also anticipates additional revenue for municipalities that obtain funds to co-finance investment in development programs and structural and cohesion policies. These additional funds may not exceed 3 per cent of a municipality's fixed expenditure. The Act also sets out a special incentive aimed at small municipalities that opt to jointly perform municipal administration tasks. As already mentioned, small municipalities are inefficient when performing various service provision tasks, and asset and debt management. Above all, these administrations lack the professional staff to prepare programs to draw on EU funds. The state will return half the costs used for this purpose to municipalities that opt to provide services jointly.

There is also a special form of liquidity borrowing available to municipalities, which they do not, however, make use of. This is via the Treasury Single Account (TSA, Slovenian abbreviation: EZR) managed by the Public Payments Office. A TSA is a joint account for direct and indirect spending units that enable lower cost repayment of liabilities, while also enabling short-term placement of available funds and liquidity or non-current borrowing under more favourable conditions than those offered by commercial banks. Municipalities do not make use of this form of borrowing. For municipalities that have opened a TSA (there were 143 such municipalities at the end of 2004), the Public Payment Office includes available funds in the account, on a daily basis, in the form of night deposits in various commercial banks and controls deposits returned by banks. Each month, interest is calculated for municipalities depending on the balance on their TSA accounts.

13.4 Fiscal Decentralisation and Local Debt in the European Union

In 2004, there were 90,500 local communities in the 25 EU Member States whose funds represented 12.7 per cent of EU GDP. The level of decentralisation has increased in most member states, as only six countries recorded a reduction in the ratio of local public expenditure to overall public expenditure, one of which was Slovenia. Comparing Slovenia to other EU countries indicates that Slovenia is one of the most centralized countries, as in 2001 it was ranked fourth in the EU-25 by ratio of local spending to total spending, and in third place in 2004. Slovenia is therefore behind the average level of decentralisation of both the old (EU-15) and new EU member states. According to data (Ebel and Yilmaz 2002) on the ratio of local expenditure to total public expenditure around the world, the highest level

Table 5
Local Public Expenditure and Local Debt in the European Union, in 2001 and 2004

Country	Local expenditure as % of total public expenditure		Local public debt as % of GDP	
	2001	2004	2001	2004
Austria	15.8	15.9	2.5	2.4
Belgium	13.2	13.8	5.9	5.4
Cyprus	4.1	4.5	2.5	2.3
Czech Republic	20.8	28.5	2.3	2.8
Denmark	54.6	60.4	4.6	5.1
Estonia	24.4	24.8	2.1	2.5
Finland	37.9	38.5	2.8	3.9
France	18.9	20.3	7.2	6.8
Germany	15.2	15.4	4.8	5.2
Greece	5.5	6.0	0.6	0.8
Hungary	23.7	25.9	0.8	1.7
Ireland	39.9	42.4	1.8	2.3
Italy	30.0	32.5	3.4	5.6
Latvia	25.8	28.1	2.3	2.3
Lithuania	21.7	26.8	1.1	0.7
Luxembourg	14.8	13.0	2.4	2.3
Malta	1.7	1.5	0.0	0.0
Netherlands	36.7	35.1	9.8	8.9
Poland	22.2	30.3	1.7	2.1
Portugal	13.5	12.8	2.8	3.4
Slovakia	7.3	17.5	1.3	1.5
Slovenia	11.6	11.2	0.1	0.1
Spain	37.3	52.1	9.4	9.1
Sweden	44.3	44.3	5.2	9.1
United Kingdom	23.2	29.0	5.4	4.4
Total 25	24.0	26.8	5.3	5.6

Source: Local finance in the twenty five countries of the European Union. Dexia, 2004 and 2005; for Slovenia Bulletin of Public Finance, 1/06.

of decentralisation is found in the most developed OECD member states, where the ratio exceeds 30 per cent. They are followed by European and Central Asian countries with a ratio of over 25 per cent, while the lowest ratio is found in southern African states, where it is around 15 per cent. In Slovenia the ratio is therefore lower than the average for all the various world regions. If we compare ratios of local revenue to total public revenue the situation is somewhat different, as the ratio is higher in Europe and Central Asia, where it reaches 20 per cent, while the lowest is found in the Middle East and Africa, where the ratio is below 10 per cent. In this case, Slovenia's ratio exceeds the average for those countries.

The finding from the preceding section that Slovenian municipalities practically do not engage in borrowing or that their borrowing is very low is clearly demonstrated by the comparison with other EU member states. Alongside Malta where there is no borrowing at the local level, Slovenia has the lowest local public debt as a proportion of GDP. With local debt at 0.1 per cent of GDP, it is considerably below the EU average of 5.6 per cent of GDP. The EU-15 average in 2004 was 5.8 per cent of GDP, while the average for the 10 new states was lower at 2 per cent of GDP.

Comparing the level of decentralisation and municipal borrowing in individual states, one cannot conclude that having greater fiscal decentralisation means higher local level borrowing. In 2004, Denmark, which has the highest level of decentralisation, only ranked eighth in terms of local borrowing as a proportion of GDP. The main influence on the amount of borrowing therefore comes from the regulation of local borrowing by the state. By acceding to the EU's stability and growth pact most EU countries have introduced measures to reduce public debt at all levels, including the local. Despite this, the proportion of local debt in GDP increased over the period from 2001 to 2004 in half of EU member states, however, in most cases by less than one percentage point.

13.5 Conclusions

Slovenia has one of the lowest levels of public debt as a proportion of GDP of the ten new EU member states, and its local debt is also among the lowest as a proportion of GDP. Compared to other EU member states, it has the lowest proportion of local borrowing in GDP, except for Malta which does not have local level borrowing. This situation is the result of the restrictions on local borrowing and the low possibility of other forms of borrowing. Slovenian municipalities can only borrow on the domestic financial market, where there is not a great deal of competition. Most municipalities do not exceed the legally defined limits. In recent years, in their search for additional funds, municipalities have increasingly turned to commercial borrowing not regulated by law. In 2005, the state addressed this area and restricted all forms of borrowing to 20 per cent of realised revenue. The low proportion of municipal borrowing and the actual size of municipalities mean that in Slovenia one cannot practically speak of managing local debt, as it is almost completely in just

one form, i.e. credits from domestic commercial banks. The new legislation does open up more borrowing options to municipalities, but does not anticipate offering incentives for different forms of borrowing that could lead to a debt management policy at the local level. One important incentive included in the amended Act is the co-financing of costs for joint municipal administration, as in that way, smaller municipalities could employ professional staff, which is essential for drawing on European funds.

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14. Diversification of Local Government Revenue

Zaychykova Vitalina and Khomra Ivan

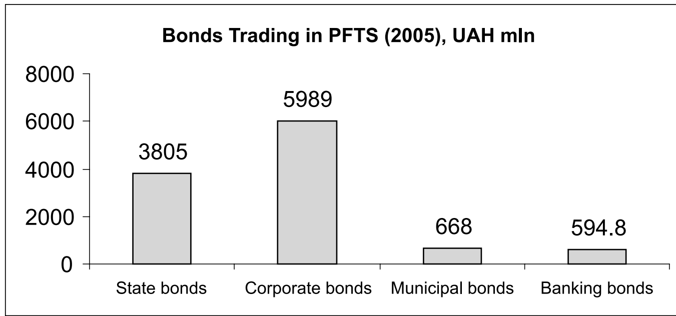
14.1 Trends of the Ukrainian stock market

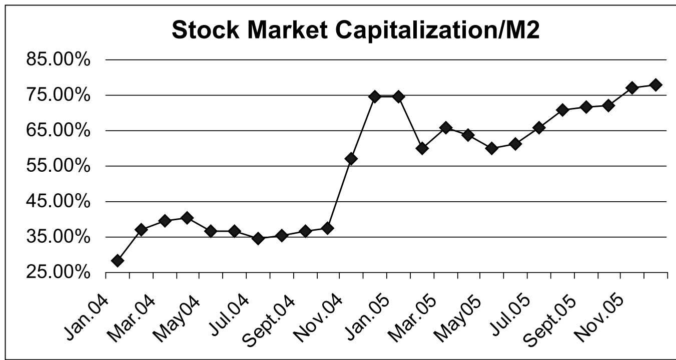
Year 2005 was characterised by huge capital inflows to the Ukraine stock market (fig. 1 – 3), which boosted substantially both trading volumes and the PFTS index. Especially high was the growth in steel stocks, despite price dynamics deceleration and declining production volumes, chemical and machine building, which however has changed negatively since September. Total annual trading volume on PFTS grew by 1.9 compared to 2004 which amounted to UAH 13.5 bln.

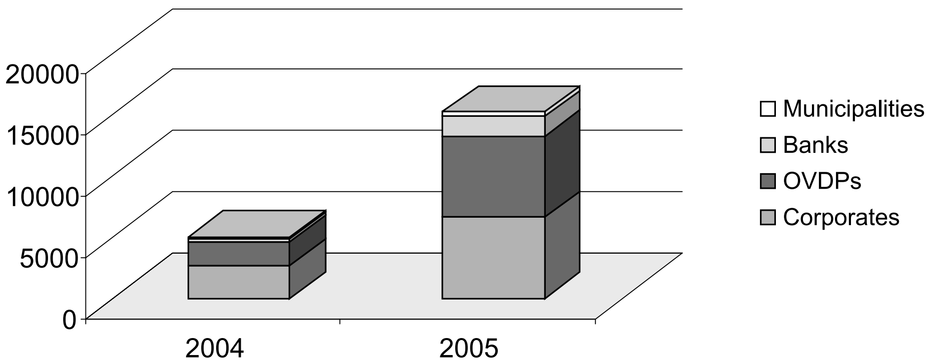
Both corporate and bank bonds' trading amounted to UAH 6.6 bln. remaining the leader in the structure of trading. Annual growth in trading volume of these securities amounted to 40 per cent. They were followed by state securities trading, which amounted to UAH 3.8 bln, growing more than 5 times compared to the previous year. Such an increase in demand was caused by the April 2005 hryvnya revaluation and possibilities of obtaining a yield of more than 10 per cent in US dollars. Market capitalisation has also grown, almost twice exceeding UAH 145 bln at year end (USD 27.7 bln). Stock market capitalisation ratio showing the degree of the market's overheating grew further, especially in the last month of 2005 (when the highest monetary growth was registered) reaching 77 per cent. Yet, on an annual basis, it represents a tiny growth of a few per cent (it stood at 74 per cent in January). It implies that the potential for the market to grow remains high at the cost of undercapitalised enterprises, mostly in machine building, oil and gas and the banking sector.

Fixed income instruments issuance was characterised by declining market interest rates, which made the bonds issuance more popular. In general, issuance of domestic hryvnya denominated bonds tripled in 2005 and amounted to UAH 15.2 bln. The volume of corporate bond issuance has more than doubled in 2005 compared to 2004, reaching UAH 6.64 bln. In the meantime, growth in bank assets has been in part spurred on by bond issuance: it rose by 6.5 compared to 2004, reaching UAH 1.65 bln. The growing fiscal gap of 2005 occurred prior to midyear financed with state domestic bonds issuance (OVDPs) in the amount of UAH 6.6 bln. A threefold increase of state bonds sold at primary auctions in 2005 as compared to 2004 was caused by the growing attractiveness of those instruments among non-residents: it enabled the average yield on those instruments to decrease to 6.97 per cent. In addition, a higher amount of state Ukrainian Eurobonds was issued in 2004. We regard the above mentioned 3 years' record decline in the rate of fixed capital investments growth to be temporary. Higher (and positive) real interest rates in 2006, especially in the first half of 2006 are likely to attract more savings, which will be

Figure 1 – 3
Trends of Ukraine stock market







Source: JSC VABank Macroeconomic and Financial Market Outlook Friday, 20 January 2006, p.17.

transformed into investments through banks. Corporate bonds issuance will thus remain at least as high as in 2005 as the profitability of companies will decline and they will turn to cheaper sources of financing. As far as bank bonds are concerned, the higher level of savings reported in late 2005 and expected in 2006 will restrain them from increasing debt issuance on the domestic market at the 2005 rate, so they are likely to increase Eurobonds issuance.

14.2 Borrowing as the main source of financing local self-governments

A budgetary deficit is an efficient fiscal policy instrument. It is used both at the national and local levels. In many countries, consolidation of regional and municipal budgets with a deficit became a widespread phenomenon. In particular, in European countries they are used for the financing of capital expenditures. At the same time, financing the deficit of current expenditures of the local budgets is considered unfavourable. But it must be emphasised that in some cases, such financing occurs.

Consolidation of the local budgets with a deficit is carried out for certain reasons. On the one hand, there are factors that exert influence on the formation of budgetary incomes and thus on expenses for all elements of the budgetary system. It is, in particular, the declining volumes of GDP, narrowing base of taxation, expansion of the shadow economy etc. At the same time, consolidation of budgets with a deficit at the level of territories depends on many other factors. These are, in particular, the increase in powers that are passed from state to the local levels, not backed by relevant financial resources. The necessity in financing deficits of expenditures arises from incomplete or untimely transfers by the local authorities. The deficit can also result from non-fulfilment of planned tasks with own incomes for local budgets and less than expected profits etc.

Ukrainian economists, researching the foundations of financial strategy for economic growth in Ukraine, came to the following conclusion: state assistance to the economic development on the basis of deficit-free financing was doomed to failure. State financing of economic expenditures in terms of insufficient resources is possible by an increase in taxation, or non-tax receipts.

Such conclusions can be drawn concerning the local budgets. Over the last years their formation with deficit and raising additional funds for financing the expenditures through loans became limited. There were a few reasons for this. Quite often, the loans for financing the deficit of local budgets were inefficient. In some cases their redemption was untimely. Local authorities proved to be not ready for such a difficult scheme as financing the deficit of local budgets.

With the adoption of the budgetary code of Ukraine, consolidation of local budgets with the deficit was hardly regulated. In particular, it is foreseen (item 72) that the budget of Crimea and city budgets can be adopted with a deficit, exception-

ally for the budget of development. As for the regions, districts, districts in towns, settlements and rural budgets, their consolidation with a deficit is not allowed.

The possibilities of raising funds for financing the deficits of local budget are limited. By a decision of the local municipality at the relevant level, executive branches can raise loans only for covering temporary cash breaks. Those can be short-term loans from financial institutions up to three years and within the current budgetary period. Providing loans from the budget to another is forbidden (Budgetary code of Ukraine, Article 73).

Substantial limitations for different types of borrowing were introduced. Raising domestic funds (which exceed temporary cash breaks) is allowed exceptionally to the Parliament of Crimea and city councils. As for foreign borrowing, this is only allowed to municipalities with a population exceeding 800,000 (Budgetary code of Ukraine, Article 16).

There are also requirements on servicing the borrowing to the local budgets. The total sum of expenditures on servicing the debt cannot exceed 10 per cent of expenditures in the general budgetary fund during the budgetary period. In the case of violation of the redemption schedule, the municipality is not allowed to contract any new borrowing during the following 5 years. (Budgetary code of Ukraine, Article 74).

Limited possibilities for financing the deficit of local budgets in Ukraine restrain raising additional funds for financing the expenditures. In the group of cities which belong to the regional centres, in 2006 this instrument was most actively used in Zaporozhia (Figure 4). The amounts of budgetary deficits came to 66087.4 which were 10.91 per cent of the total budgetary incomes. In some cities of this group such indexes were notably lower: in Lvov – 4.07 per cent; Donetsk – 3.49 per cent; Kharkov – 2.80 per cent; Dnepropetrovsk – 2.46 per cent. In some cases the budgets were adopted with profits. Among them were: Poltava, Khmelnitskij, Kirovograd, Ivano-Francovsk, Lutsk and Uzhorod. There were the budgetary debt salary payments, payment of energy bearings and completed works. In particular, in Lutsk this debt reached around 14; Poltava – 3.4; Khmelnitskij – 1.5; Kirovograd – 3.3.

Attention must be given to the insignificant volumes in the budgets of local authorities. For 2002 – 2005 the share of development budgets in the total expenditures of local budgets did not exceed 5.5 per cent. In particular, the budget of Poltava development in 2004 (city budget was adopted with a surplus of 4.9) was 19.6 or 8.41 per cent of the total expenditures. The relevant figures in Kherson reached 5.99 per cent, Kharkov 7.06 per cent, Cherkasy – 6.23 per cent, Ternopol – 4.68 per cent. Similar phenomena are observed in regional towns. In Bila Tserkva the budget for development amounted to 4.57 per cent of the total budgetary expenditures, New Kahovka – 10.96 per cent, Berdjansk – 9.24 per cent, Voznesensk – 2.83 per cent.

Figure 4
Bonds issued by municipalities

City (series)	Volume	Beginning of placement	Maturity date	Yield	Underwriter
Zaporozhia (À)	25 million UAH	01.07.2004	28.12.2006	15.35%	UkrSibbank
Zaporozhia (Â)	25 million UAH	12.07.2005	1.07.2007	10.5%	UkrSibbank
Zaporozhia (Ñ)	20 million UAH	12.07.2005	08.07.2008	11%	UkrSibbank
Zaporozhia (D)	20 million UAH	12.07.2005	07.07.2009	11.5%	UkrSibbank
Zaporozhia (Å)	10 million UAH	12.07.2005	06.07.2010	12%	UkrSibbank
Kiev (À)	150 million UAH	25.11.2003	25.11.2008	14%	Khreshatyk Bank
Kiev (Eurobonds 2008)	150 million USD	29.07.2003	08.08.2008	8,75%	"Wasserstein Kleinwort Dresden", "J.P. Morgan", Warburg "UBS
Kiev (Eurobonds 2011)	200 million USD	15.07.2004	15.07.2011	8.625%	Deutsche Bank, Morgan Stanley
Kiev (LPN 2015)	250 million USD	24.10.2005	06.11.2015	8%	Boston First Suisse Credit, Citigroup
Donetsk (À)	20 million UAH	16.08.2004	15.08.2007	14%	Khreshatyk Bank
Donetsk (Â)	45 million UAH	11.07.2005	11.07.2010	11.75%	Khreshatyk bank
Kharkov (À)	100 million UAH	30.06.2005	26.06.2008	10.75%	UkrSibbank
Odessa (À)	50 million UAH	23.12.2005	31.12.2007	12%	UkrSibbank
Odessa (Â)	70 million UAH	16.12.2005	31.12.2008	13%	UkrSibbank
Odessa (Ñ)	30 million UAH	16.12.2005	31.12.2010	14%	UkrSibbank
Cherkasy (À)	5 million UAH	26.12.2005	27.12.2010	12%	VABank
Ivano-Frankovsk	5.5 million UAH	28.02.2006	28.02.2011	12%	Khreshatyk Bank

Source: Adaptation of EU countries' experiences in Ukraine

Odessa is a good example. Despite the city needs for solving social and economic problems, the city budget in 2002, 2003 and 2005 (for 9m2005) ended with a surplus. In 2004, a deficit of UAH 5.46 millions was registered, which was 0.72 per cent of the total budget expenditures. It is worth noting that the deficit was financed through residual budgetary items as for the beginning of 2004 (4.1) and a medium-term non-interest loan at the expense of the treasury account.

The situation is similar in other towns. Thus, 2002 and 2003 budgets ended with a surplus. In 2004 the budget deficit was 8.73 per cent of the total expenditures. And for the third quarter of 2005 it reached 2.67 per cent. In 2004, the deficit was covered through remaining items as for the beginning of year.

In European countries local authorities are active participants on the stock market. Funds are raised for financing capital expenditures through borrowing. As for current budgetary expenditures, loan facilities are not usually used. At the same time, it is necessary to pay attention to the limits of local borrowing. This is set by market instruments or local authorities by adopting certain limitations.

In Ukraine, market instruments have not yet become the main regulators of territories' financial development. In other regions (Odessa is a good example) violations of investors' rights and non-redemption of the placed local issues under the agreed terms took place. To avoid such practices in 1998 a Decree by the President of Ukraine, imposing restrictions on domestic and external borrowing from local authorities, was issued. Such measures resulted in the prohibition of borrowing, which had been conducted in recent years at the local level. At the same time, they became an obstacle for the development of territories.

In recent years, the volume of borrowing from local authorities began to grow markedly. In 2004 – 2005 both domestic and external municipal issues grew. Ukrainian economists pay attention to the "danger" of conducting local borrowing. In their opinion, comparison of debt terms and financial possibilities of their redemption shows that such practice is the crucial factor of risk for local capital investments. It has not been ruled out that local loans "will actually become an alternative for future investments". At the same time, the authors consider that sometimes local loans can be substantiated. To limit the risks arising from such operations it was proposed to tighten the requirements for their permission on the side of the central bodies of the state administration.

Approaches to conducting the reforms of public administration in Ukraine, suggested by the group under the Centre for Political and Legal Reforms, imply changes to the budgetary system. In particular, it is suggested that instead of a two-tier budgetary system, to implement a three-tier system, which will consist of the state budget, regional budgets and local budgets. The authors recommend the practice of domestic and external borrowings at the level of cities (that meet the criteria), and Crimea. As for regional authorities, they will "have a right to borrow only

if they initiate the laws of Ukraine regional taxes and collections, which enable the regions to participate in own profits".

However such approaches limit the possibilities of local self-government from raising funds through loans. It is expedient to extend the powers of territories with such an instrument of financing the budgetary expenditures and to enable using it not only at the level of communities but also of the regions. Special attention needs to be drawn to the issues of strengthening the market base for the raising, utilisation and redemption of loans. It is expedient to carry out their placement on the primary financial market and provide their circulation on the secondary market. The experience of creating clubs of creditors at the level of regions deserves special attention.

At the same time, caveats concerning high risk of such operations are substantiated. That is why their limitation for insolvent local self-governments is expedient. But in Ukraine they are already sufficient. Separate requirements for the use of such instruments are too strict. Requirements, which are written in the budgetary code, limit the possibilities of such an important instrument as budget deficit for financially prosperous communities.

Based on an analysis of debt financing problems for budgets of the region, one can draw the following conclusions:

1. Instruments of the debt financing for local budgets in Ukraine is not sufficiently used. In order to intensify the local self-government's financial activity, it has to be applied more actively.
2. Raising additional resources through debt instruments for financially developed territories has to be simplified.
3. To limit the risk operations with debt instruments at the level of territories, an additional law regulating the terms of debt redemption (through mortgages, guarantees of future profits, reserves for necessary resources, insurance of assets etc).
4. Development of the local borrowing in Ukraine demands the strengthening of the market instruments of influence on their terms and use. They include, in particular: rating of regions, placement of bonds according to market conditions, organisation of their circulation on the secondary market, exerting the control for placement and redemption of loans by clubs of creditors.

14.3 Problems of the legislative framework

Problems, which are to be solved by law, can be described as follows:

1. The practice of new borrowing and granting the guarantees is insignificant and does not always have a positive orientation. In terms of insufficient personal funds of local authorities for financing the projects of infrastructure renovation and modernisation of cities and insufficiency of state financing for this sphere, borrowing can boost the investment activity of the cities. Borrowing is justified

in the case of creating publicly useful durable goods; its financial burden in relation to return is distributed in time, or for introduction of the projects which are important at the level of the communities.

International organisations, (in particular the World Bank, the European Bank for Reconstruction and Development) that support development of city infrastructure projects in Ukraine, and other financial institutions provide loans directly to the cities and their communal enterprises without participation of the state and without state guarantees on conditions of creating the legislative pre-conditions for municipal credit market development. International organisations regard the insufficiency of legislatively defined mechanisms as a core problem of market development for the protection of creditors' rights in case of default by local authorities on debt obligations.

2. On the other hand, operations with local borrowing carry considerable risks for the local budget and territorial community in general. Current legislation does not contain sufficient instruments for protecting the interests of the territorial community and the local budget from the inefficient use by local authorities of the right for local borrowing and providing local guarantees.

   In particular, the legislation does not contain sufficient requirements in relation to transparency for the territorial community and order of operations with local borrowing and guarantees. Neither does it create sufficient tools for the territorial communities and state to exert control over local debt. The level of local authorities' responsibility both before creditors and territorial communities is low and the division of such responsibilities is unclear. Efficient and long-term corporate strategic planning of local budgets does not exist. Thus, operations with local borrowing and guarantees bring the risk of leaving the local budget with no sources of capital investments in future budgetary periods. Thus the danger of accumulation of the local debts arises. It can threaten the ability of local authorities to finance the implementation of regular functions and socially useful budgetary services.

3. Since pursuing the common public policy, in particular the management of the public debt, is the function of central government, the government has to carry the responsibility for the stability of the whole budgetary system.

   In case of failing to fulfil the responsibilities concerning foreign local borrowing, the threat of a decline in international trust in Ukraine and a worsening of its credit rating may appear.

   In addition, there is a risk of additional expenditures for state budget in the process of solving the problems of the local budgets related to insolvency of local authorities to properly fulfil the debt obligations and to finance the implementation of regular functions and socially useful budgetary services. Involvement of the state budget in fulfilling the obligations of the local debt cannot be carried out directly, for example through providing grants to the local budgets.

14.4 Aims of the reform

The goal of the draft Law of Ukraine on local borrowing and guarantees is an improvement in the legislative base, which regulates the relationships of borrowing for local budgets and to granting the guarantees at the cost of local budgets. The draft is directed on the establishment of clearly defined rules for local borrowing and local guarantees and the creation of efficient and safe mechanisms for financing the priority directions of the cities' socio-economic development by the local authorities.

The goals of the state regulation can be defined as follows:

1) Clearly defined rules for local borrowing and local guarantees and the unification of legislative framework, which determines such rules;
2) Implementation of a common fiscal policy by the state and stability of the budgetary system;
3) The observance of the rights and interests of the territorial community, transparency and publicity, in the process of local borrowing and guarantees;
4) Creating the conditions for a municipal credit market development, in particular for lowering the risks of creditors, specification of rights provided by the law in the field of the local borrowing and guarantees and defining their implementation.

14.5 Alternative methods for reaching the above goals

Achieving the goals of the state regulation indicated above must be carried out by different complex methods, one of which is the state legal regulation of relationships in the field of local borrowing and guarantees. In the meanwhile, achieving the aims of the state regulation only by other, non-legal regulative methods is unlikely.

Improvement in the legislative base, avoiding collisions, unification of the legislative base and defining the mechanisms for implementing the rights for participants of legal relationships can be carried out only through appropriate changes in the legislation.

Introduction of public policy and state control must be carried out on the basis of a legislative framework, in accordance with Article 19 of the Constitution of Ukraine. It states that public authorities are obliged to act only on the basis, within the limits of plenary powers and according to methods provided by the Constitution and laws of Ukraine.

Introduction of principles for observing the rights and interests of the territorial community and transparency and publicity in the process of local borrowing and guarantees are linked to the necessity for imposing additional duties on local authorities and certain requirements. It also needs to be displayed in the legislative base.

Municipal credit market development also requires conformity with the different positions. The absence of a state regulation in this sphere is not instrumental in the positive practice of local borrowing and guarantees as well as in credit market development. The legislation does not contain the appropriate mechanisms for protecting the rights of the participants in these legal relationships. As a result, the cost of borrowing thus increases.

14.6 Mechanisms for solving the above problems

It is proposed to create a unified complex legislative act, which expressly and consistently regulates different aspects of local borrowing and guarantees, diminishes collisions of legislative regulation, specifies the mechanisms for protecting the rights underwritten by the law, sets additional rights and duties for participants of the legal relationships related to the local borrowing and guarantees, with the purpose of protecting the interests of the territorial communities, creditors and the state.

The legislative bill clearly determines the main terms used in the legislation, which regulate the legal relationships in the field of local borrowing and guarantees and in particular, for foreign and domestic local borrowing, maintenance of debt, local guarantee etc.

Plenary powers as to the local borrowing and guarantees are expressly outlined. The decision-making on borrowing or guarantees for proper agreements is carried out exceptionally by the local council or relevant body of the Republic of Crimea, as a representative of territorial community interests. The agreement on the local borrowing or guarantee cannot go into effect without the approval of the relevant council.

To specify the right to local borrowing, the law provides that local borrowing can be carried out in the form of signing agreements on loans, bonds issue or local loans. Thus, in the Law of Ukraine "On securities and stock exchange", the term "local foreign loans" is defined otherwise the right to the issue of such bonds is questionable.

For the provision of mechanisms to exert the rights of local authorities and creditors in conducting foreign local borrowing and the possibility to choose the legislation of the country which regulates the rights and duties of the borrowing agreement, the right for denomination of the foreign borrowing in the foreign currency is defined. Changes were made to the Law of Ukraine "On securities and the stock exchange", which defines the foundations of the bonds issue procedure for foreign local loans.

With the purpose of improving the transparency and publicity of operations with local borrowing and guarantees, and taking into account public opinion, the duty of local authorities to conduct the public discussion on making such a decision before signing the treaty on the local borrowing or guarantee is legislatively guaran-

teed. For this purpose the project draft on the decisions concerning local borrowing were published in order to receive relevant suggestions from the members of the proper territorial community.

The draft law contains amendments in the norms of the Budgetary Code of Ukraine, which requires the principle to grant the guarantee by its property as well as a guarantee of a financial institution. The above regulation makes the guarantee useless. According to the draft law, the principle can provide some collateral for the fulfilment of its commitments – property or uncalled and absolute guarantee of the bank whose financial conditions are in conformity with the National bank of Ukraine requirements.

In order to safeguard the proceeds to the local budget from the operations with a guarantee, the draft law obliges the principle to grant the guarantee in the amount of 1 per cent from the annual amount of guarantee.

The draft law defines the substantial terms of agreements on borrowing in the form of loans and bonds, agreement on the guarantee, and the compensation to the local budget. It guarantees the transparency of the regulation, facilitation of control of creditors, both public and state, and will be instrumental in protecting the rights of creditors (especially in the case of bonds' issue) and compensation of expenditures to the local budget for the guarantees.

The draft law also contains non-regulative norms, aimed at achieving the goals of state regulation, as defined above.

The period of the law is proposed to be unlimited in time.

14.7 Substantiating the possibility of reaching the goals of the state regulation in case of adopting a new law on local borrowing

The Ministry of Finance of Ukraine considers the adoption of this law to be instrumental in achieving the goals of the state regulation. In the meanwhile, absence of such laws will make the goals of state regulation impossible.

Laws, which provide the additional rights for participants of legal relationships related to the local borrowings and guarantees, will assist the development of positive practices for local borrowing and guarantees.

14.8 Expected results of adopting the draft law

Approving the draft law "On local borrowing and guarantees" will improve the legal base in the field of local borrowing and guarantees, create additional possibilities for legal relationships in this sphere, will protect market participants' interests and will create the pre-conditions for gaining positive experience and more efficient local borrowing and guarantees. It will also provide publicity and transparency of

borrowing and guarantees; will decrease the risk of inefficient use of local powers by public servants to conduct the borrowing and provide the guarantees and will improve the possibilities of monitoring public debt by the state.

The negative consequences of adopting the draft law are non-existent.

Indicators of efficiency are:

1) Positive practice of local borrowing and guarantees, rational use by the local authorities of the right to carry out borrowing and provide guarantees;
2) Improve the ability of local authorities to implement mid-term and long-term projects, which require capital investments for communities;
3) Improve financial discipline for local authorities and the efficient use of financial resources management;
4) Improve state control and monitoring of the local debt.

Controlling the efficiency of the above law will be conducted through a register of local borrowing and guarantees, where the information on all local borrowing and guarantees will be contained.

Applying obligatory positions from the law will not result in additional expenditure for either the state or local budgets, will not entail considerable or unnecessary expenses for legal entities and will not cause a substantial increase of burden on the State.

The draft Law of Ukraine "On local borrowings and local guarantees" has been prepared by the Ministry of Finance and aims at improving the legislative base, which regulates local budgets borrowing relationships and relevant guarantees to the local budgets.

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15. Sustainability of General Government and Local Government Fiscal Balances in Selected Transition Countries

Aleksander Aristovnik and Boštjan Berčič

15.1 Introduction

Fiscal sustainability has recently drawn increased attention in transition countries. Indeed, almost all transition economies have experienced large deficits in both balances since the start of the transition process. On the one hand transition economies collapsed, prompting the government to adopt an expansionary fiscal policy in the form of increased expenditures (to build up social and physical infrastructure) and extended tax incentives to encourage investment. Moreover, fiscal deficits expanded as governments tried to absorb the revenue and expenditure pressure associated with the sharp falls in GDP and fiscal restructuring. Consequently, a substantial increase in the public debt/GDP ratio has emerged in the region. Recently, a shift from Keynesian to more classical oriented economic thinking and its conservative stance has been noticed. Thus, the demands also supported by many international organisations (e.g. the IMF) and international credit agencies for balanced budget balances and even budget surpluses have emerged considerably. Moreover, a stable public finance is an explicit criterion for many transition economies' eligibility for Economic and Monetary Union (EMU).[1]

The most common way of assessing a given economy's fiscal position is to analyse fiscal sustainability, where the 'sustainable' level of the fiscal imbalance was that level consistent with solvency, i.e. satisfies the criterion that the total public debt to GDP ratio should not increase. While the original literature on fiscal sustainability mostly focused on industrial countries (see Blanchard, 1990) there are, by now, a few pieces that, like this one, focus on fiscal sustainability in transition countries (for some early attempts, see Buiter, 1996; Budina and van Wijnbergen, 1997; Green et al., 2000, etc.). Work that is closely related to ours includes Pasinetti (2000) and builds upon some previous similar attempts for transition countries (see Fanizza and Mourmouras, 1994) in the following two important directions:

a) assessment of short-term, medium-term and long-term general government fiscal sustainability for twenty-four transition countries, based primarily on 2004 and/or 2001 – 2004 period average data;

1 Recently, an important step towards the Euro Area was taken by Estonia, Lithuania and Slovenia which joined the ERM II with effect from 28 June 2004 and latter by Latvia with effect from 2 May 2005 (ECB, 2005). Nevertheless, only Slovenia managed to fulfil all Maastricht criteria (including both fiscal criteria) and joined the EMU in 2007.

b) assessment of medium-term local government fiscal sustainability for ten new EU member states based on data from the year 2004 and their comparisons with the selected results for ten old EU member states;

The article is organised as follows. The next section briefly summarises trends and developments of fiscal positions in transition economies. Section 2 introduces the concept of fiscal sustainability and discusses its main definitions and the main sustainability indicators that have been proposed by the theoretical and empirical literature. The empirical framework and results of the estimations of selected indicators under a variety of assumptions are presented in section 3. The final section provides concluding remarks and some policy implications.

15.2 Fiscal Imbalances in Transition Countries

At the beginning of the transformation process, fiscal policy had an important role in replacing the decline in private consumption which had appeared as a consequence of the collapse of output. Government expenditure in most transition economies in 1992 was significantly higher than in market economies with comparable levels of per capita GDP (in purchasing power parity terms), sometimes more than ten percentage points of GDP higher. Consequently, most transition economies implemented major fiscal reforms, some more successfully than others. In the early stage of the transition, the need for major fiscal reforms was generally underestimated. The emphasis was more on the need for rapid privatisation and 'getting the state out of the economy'; the need to reform state structures and the public administration in order to perform their very different, but crucial, roles in a market economy received less attention until a number of fiscal crises emerged (Economic Survey of Europe, 2000). Nevertheless, more recently, practically all transition economies have admitted the need for totally new systems requiring not only new tax laws, but also new fiscal institutions, new skills, technical knowledge and political capital.

Within the transition process, economic reforms have taken place with damaging impacts on existing public finances. First, by the destruction of central plans and the elimination of information on quantities of goods produced and their prices. Consequently, the government had to rely on other sources, including taxpayers' declarations that increased tax evasion. Second, the reforms dramatically increased the number of producers and thus of potential taxpayers. In fact, the large state enterprises which once provided the bulk of tax revenue have been replaced by new, small and difficult-to-tax private producers. Since a tax culture never developed in the centrally planned economies, people reacted with hostility to the introduction of an explicit tax system. Finally, the economic reforms removed the restrictions on payment methods that had existed under central planning when all payments were channelled through the central bank. Accordingly, tax arrears and payments in the form of barter have grown, creating major difficulties for the new system (Tanzi, 1999).

The patterns in public revenues and expenditure reflect local factors as well as the mixed advice transition economies received from Western economies and institutions such as the IMF and the WB. An analysis of the fiscal data of transition economies yields several stylised facts. Most importantly, almost all transition economies went through a dramatic fiscal adjustment. In fact, the turnaround in fiscal imbalances has been especially remarkable for CIS economies which reduced their average deficits from an average of 8.8 per cent of GDP in the 1992 – 1997 period, to a moderate fiscal deficit of 2.1 per cent of GDP in the 1998 – 2003 period. The extent of this fiscal adjustment in CIS is more than twice as much as that of SEE economies whose average deficit was reduced from 5.9 per cent of GDP to 3.9 per cent of GDP in the same period. These fiscal imbalance trends were the outcome of a major revenue shock at the start of transition. For many CIS economies, independence from the Soviet Union also meant the loss of large fiscal transfers from Moscow which further compounded declines in government revenues from the recession and the flawed tax system with its weak administration.[2] Consequently, the CIS' average budget revenues declined from 29.3 per cent of GDP in 1992 to 24.1 per cent of GDP in 2003.

The sudden loss of control over state resources in CIS economies forced governments to sharply cut expenditures. In fact, the average expenditure for CIS economies fell from about 43.8 per cent of GDP in 1992 to 25.0 per cent of GDP in 2003. In some cases, the expenditure cuts were dramatic, as in Tajikistan and Armenia, where general government expenditure declined from the CIS' highest levels of 65.7 per cent and 46.7 per cent of GDP in 1992 to the CIS' lowest levels of 15.6 per cent and 18.9 per cent of GDP, respectively. Accordingly, as the transition process progressed, especially after the Russian (financial) crisis of 1998, the fiscal balances of CIS economies improved largely due to the boom in energy prices which positively effect CIS energy exporting economies as well as due to revenue collection improvements, expenditure restraints and the more prudent management of external debt reflecting the 'lesson of the Russian crisis'.

Contrary to the CIS and SEE fiscal imbalance trends, CEE economies began with much lower average fiscal deficits, averaging out at 1.8 per cent of GDP in 1992 – 1997 and even deteriorating to an average 3 per cent of GDP in 1998 – 2003, generally as a result of maintaining relatively high government expenditure shares (an average of 38.3 per cent of GDP in the 1998 – 2003 period) and a moderate decline of government revenues in the period (e.g. in the Czech Republic and Poland by more than ten structural points in the 1992 – 2003 period). An important measure to deal with the revenue shortfall was the adoption of value-added tax (VAT). The rate initially adopted has generally been reduced, and in most CEE states, VAT now provides about the same proportion of total fiscal revenue as in most Western Euro-

2 For example, in 1992 both Uzbekistan and the Kyrgyz Republic lost transfers from Moscow which were equivalent to about 18 per cent of GDP in 1991 (see Alam and Sundberg, 2002).

Table 1

Public balances in selected transition countries, 1992 – 2003 (in % of GDP)

	1992 – 1997 (averages)	1998 – 2003 (averages)	1992 – 2003 (averages)
Czech R.	0.5	−3.4	−1.5
Estonia	−0.1	−0.4	−0.2
Hungary	−3.5	−5.4	−4.5
Latvia	−1.0	−2.2	−1.6
Lithuania	−4.1	−3.6	−3.8
Poland	−2.9	−3.4	−3.1
Slovakia	−4.1	−4.0	−4.0
Slovenia	0.2	−1.4	−0.6
CEE	−1.8	−3.0	−2.4
Albania	−14.4	−8.9	−11.6
Bulgaria	−1.7	−4.1	−3.3
Bosnia and Herzegovina	−6.9	−0.4	−3.6
Croatia	−1.6	−5.2	−3.4
Macedonia	−4.8	−2.4	−3.6
Romania	−3.4	−3.5	−3.5
Serbia and Montenegro	n. a.	−2.6	−2.6
SEE	−5.9	−3.9	−4.9
Armenia	−18.1	−4.0	−11.0
Azerbaijan	−6.0	−1.9	−3.9
Belarus	−3.2	−1.4	−2.3
Georgia	−13.1	−3.8	−8.4
Kyrgyz R.	−4.9	−1.6	−3.3
Moldavia	−9.3	−8.0	−8.7
Russia	−10.2	−1.1	−5.6
Tajikistan	−7.4	0.6	−3.4
Ukraine	−11.8	−1.1	−6.5
Armenia	−3.1	−0.9	−2.0
Azerbaijan	−11.2	−0.5	−5.8
Belarus	−7.6	−1.4	−4.5
CIS	−8.8	−2.1	−5.5
Total	−5.5	−3.0	−4.3

Sources: EBRD (2006), EIU (2005), IMF (2005), author's calculations.

pean states (i.e. 15 to 25 per cent). Moreover, a number of CEE and SEE economies have introduced, or are in the process of introducing, uniform personal income taxes.

As mentioned above, the recent worsening budgetary performance in CEE economies marks a departure from the pattern of most CIS and SEE economies. However, in some CEE economies (e.g. Estonia – increasing government revenues, and Lithuania – declining government expenditures) a relatively significant improvement in the fiscal balance has been seen in recent years. While most CEE economies are clustered in a narrow band, there are extremes, for example the Czech Republic's overall budget in 2003 posted the highest deficit among all transition economies of 6.6 per cent of GDP while Estonia posted a surplus of 1.7 per cent of GDP. Nevertheless, when one looks at the change in primary balances, CEE economies generally maintained the average balance of their primary budget, while CIS economies drastically reduced their large deficits in the 1992 – 2003 period since interest expenditures were growing in the same period. However, despite the declining share of expenditure in GDP, real public expenditure has been increasing in many transition economies, due to the relatively high GDP growth. Therefore, the fiscal reform process in the region consists more of ensuring that the budget process continues to require the necessary instruments for increasing efficiency, in the course of which further control over expenditure is likely to provide savings. In addition, less government interventions in the market, further reductions of budget deficits and structural reform of public finance aiming at improving the quality and efficiency of government remain important targets of economic policy in most transition economies.

15.3 Theoretical Background and Empirical Methodology

To decide whether a country may need debt reduction or not requires assessing if a country suffers from a solvency problem. The intertemporal solvency criterion does however impose some limits on the behaviour of *non-interest* fiscal balance (i.e. the primary fiscal balance). Such solvency constraint implies that the discounted value of primary fiscal balances should be at least equal to the initial government debt; if a government is initially running primary fiscal deficits and has a stock of foreign debt, it needs to run primary fiscal surpluses over time to remain solvent. More specifically, as long as the discounted value of government debt is non-zero in the infinite limit, the public sector is solvent. This means only that the government cannot increase its debt faster than the real interest rate on this debt.

However, the theoretical criteria for government solvency are quite loose. Indeed, the IMF (2002) and Croce and Juan-Ramón (2003) suggest that solvency is only a necessary condition for sustainability because solvency could be achieved with very large and costly future adjustments. Therefore, a non-increasing government debt to GDP ratio is seen as a practical sufficient condition for sustainability,

i.e. a government is likely to remain solvent as long as the ratio is not growing. So, we can define a policy stance as sustainable if a borrower is expected to be able to continue servicing its debt without an unrealistically large future correction to the balance of income and expenditure (IMF, 2002, pp. 4). Moreover, this criterion is related to the so-called *fiscal primary gap*, which is the difference between the actual fiscal primary balance and the primary balance required to stabilise the debt to GDP ratio. Simple accounting identity helps shed light on the fiscal sustainability issue. According to Hemming and Miranda (1991, pp. 70-72) and Roux (1993, pp. 327) the (short-term) budget constraint is presented:

$$\Delta D_t / Y_t = (r_t - g_t) D_{t-1} / Y_t + B_t / Y_t + R_t / Y_t \qquad (1)$$

where D_t, Y_t, B_t, R_t stand for total public debt, nominal GDP, nominal primary (negative) balance of the public sector (i.e. the gap between *non-interest* expenditure and total revenue) and a residual factor applicable to he public sector, respectively. In addition, r_t represents the real interest rate applicable to the public sector and g_t the real economic growth rate. Note that the first part of right-hand area in equation (1) refers to the interest component of government expenditure $((r_t - g_t)/ D_{t-1}/Y_t))$. Indeed, when $r_t > g_t$ this indicated upward pressure on the debt/GDP ratio, while $r_t < g_t$ indicates downward pressure. On the other hand, the remaining part of the right-hand area indicates *non-interest* flows of government. If it is negative, government runs a primary surplus, implying downward pressure o the debt/GDP ratio. If it is positive, government runs a primary deficit, putting upward pressure on the debt/GDP ratio. Depending on the magnitude and signs of the both right-hand parts there will be a net positive or negative effect on the debt/GDP ratio.

When assessing the fiscal sustainability issue, the main priority is to indicate whether a continuation of the present policy stance (as expressed in the present relation between the levels of expenditure and revenue) causes the debt/GDP ratio to explode, implode or remain stabile. In this relation, Bispham (1987) developed a set of equations that fulfils that need. If interest is paid and the primary deficit (b=B_t/Y_t) is a constant ratio of GDP, the overall public deficit ratio is not constant. Hence, interest payments can cause the overall public deficit to change. What happened to the debt/GDP ratio depends on the relationship between the interest rate, r, and the economic growth rate, g, which can be presented as (if $g > r$):

$$D_t / Y_t = -b\left(\frac{1+g}{g-r}\right) \qquad (2)$$

or as (if $r > g$):

$$D_t / Y_t = -b\left(\frac{1+g}{r-g}\right)\left(\frac{1+r}{1+g}\right)^t + b\left(\frac{1+g}{r-g}\right) + \left(\frac{1+r}{1+g}\right)^t D_0 / Y_0 \qquad (3)$$

When $r > g$ the change in the debt/GDP ratio depends on the size and sign of initial debt/GDP ratio and primary balance. If there is initial public debt and

primary deficit, the debt/GDP ratio explodes as $t \to \infty$ (fiscal policy is unsustainable). On the other hand, if government runs a primary surplus and have no initial debt (or have even initial net claims), government has an explosive net worth position. Although this situation is unlikely to appear in reality, fiscal policy will also bee unsustainable. However, if we want to estimate the (un)sustainability position when first and third right-hand terms operate in opposite directions, we have to determine if:

$$\left| -b\left(\frac{1+g}{r-g}\right) \right| > \left| D_0 / Y_0 \right| \qquad (4)$$

Thus, according to the presented equations, to establish (short-run) sustainability, government should run a primary surplus sufficient enough to cover the excess caused by the real interest rate over real growth rate, i.e. sustainable primary surplus (Mourmouras, 1994), which can be presented as (Gonzalez-Paramo *et al.*, 1992, pp. 275):

$$-B_t / Y_t = (r_t - g_t) D_{t-1} / Y_t \qquad (5)$$

Unsustainability is indicated as a position where the real interest rate, r_t, exceeds real economic growth, g_t, and where the primary balance, B_t, is persistently either in deficit, or in a surplus not large enough to cover the excess of the real interest rate over the real growth rate. Additionally, Buiter (1985) suggests an alternative indicator of sustainability, where it depends on the difference between actual primary surplus and the surplus that stabilises net government wealth (as ratio to GDP). However, this indicator is hard to apply since the government net worth is very difficult to measure.

On the other hand, in order to measure the medium-term and long-term tax gaps (Blanchard, 1993) and the sustainable conventional public balance alternative indicators has been introduced. For example, sustainable budget deficit ($-GOVB_t$) is derived from equation (5) and equals the growth rate multiplied by the debt ratio:

$$-GOVB_t / Y_t = (r_t - g_t) D_{t-1} / Y_t - rD_{t-1} / Y_t = -gD_{t-1} / Y_t \qquad (6)$$

Moreover, because equation (6) ignores the relationship between the real interest rate and the real economic growth rate, the conventional deficit is too crude a measure to use when analyzing the sustainability of fiscal policy. Therefore, as alternative the medium-term tax gap ($t^*_n - t$) can be taken, where the real interest rate, real economic growth rate and the projected path of no-interest expenditure are taken as given. In this respect, the required tax rate necessary to stabilise the debt/GDP ratio is as follows (Blanchard, 1993):

$$t_t^* = \sum (\exp + trf) / n + (r - g) D_0 / Y_0 \qquad (7)$$

where *exp*, *trf* and *n* state for government expenditure, transfers (both as a ratio to GDP), and the numbers of years over which *govexp* and *trf* are incurred,

respectively. However, equation (7) holds if the values of *n* and *(r – g)* are not large. The long-run tax gap is similar to the medium-term tax gap. But, it is specified for a period of 30-40 years and allows for factors that change expenditure (e.g. demographics) (see Wickens, 1992).

Indeed, equations (2) – (7) provide a set of satisfied test indicators to determine potential unsustainability of public finance given that the current (primary) public balance is maintained and that the interest rate and economic growth rate are on a stabile (medium-run) path. Nevertheless, we should bear in mind, that fiscal policy is sustainable only if the assumptions made about the variables hold. Therefore, caution must be undertaken when setting the assumptions of the model.

15.4 The Empirical Framework

15.4.1 Assumptions and Data

First, we estimate public finance sustainability for twenty-four transition economies, i.e. the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia (CEE), Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia and Montenegro (SEE) and Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Moldavia, Russia, Tajikistan, Ukraine and Uzbekistan (CIS).[3] However, in order to calculate a sustainable level of their fiscal balance, some assumptions must be made. Indeed, this exercise is, by nature, quite sensitive to the various assumptions made about what is the steady state of the economies under consideration. Arbitrarily, the steady state for transition countries is considered to reflect the historical values of the key variables as follows:

- the equilibrium level of public debt (D/Y) is assumed to be for year 2004 (short-term) or the average of the 2001 – 2004 period (EBRD and Eurostat data); alternatively, it is assumed for all sampled economies that governments are comfortable tolerating a debt ratio of 60 per cent (D/Y^*);
- the (nominal or real) interest rate (*i or r*) is the average of effective interest rates on public debt in 2004 (short-term) or in 2001 – 2004 period (IMF data);
- nominal (g_n) and real growth projections (g) are the average over the 2000 – 2008 period (EBRD and IMF data) for medium-term and the average over 2000 – 2040 period (UN/ECE GDP growth projections) for long-term period.

Furthermore, local government public sector finance sustainability is also estimated in selected transition economies, i.e. in new EU member states. Similar to the previous calculations, various assumptions were also considered in this case, such as:

- the equilibrium level of local government debt (D_L/Y) is assumed to be the same as in 2004 (Eurostat data);

3 Due to data deficiencies other transition economies were not included in the sample.

- real growth projections (g_L) are the average over the 2004 – 2007 period (Eurostat data).

The empirical results are summarised in the next sub-section. First, the checking of short-, medium- and long-term sustainability of public finance is performed by applying methodology suggested by Fanizza and Mourmouras (1994). The results for the selected transition countries, including the scenario dynamics of public debt to GDP ratio in 5 and 10 years periods, are reported in Tables 2 and 3. Secondly, Wickens (1992) and Blanchard (1993) methodology is applied to calculate long-term public balance sustainability levels for the transition countries. Empirical results are reported in Table 4. Finally, an assessment of medium-term local government fiscal sustainability for the ten new EU member states based on data from the year 2004 and their comparisons with the selected results for ten old EU member states is performed and shown in Table 5.

15.4.2 Empirical results

15.4.2.1 General Government Fiscal Sustainability

In this subsection we apply equations (4) – (6) in order to assess fiscal sustainability in the great majority of transition countries. First, we are concentrating on the short-term sustainability of twenty-four transition countries. In Table 2, the first three columns (1 – 3) show the relevant magnitudes (public debt/GDP ratio, nominal rate of growth, and nominal interest rate) for the calculation of sustainable level of primary public balance. Thus, columns 4 and 5 show the computation of equation (2), as applied to each transition country. Each figure represents the maximum fiscal deficit each country can sustain. More precisely, it indicates the maximum hypothetical ratio between fiscal deficit and GDP that each transition country can afford, while keeping a non-increasing public debt/GDP ratio. Columns 7 and 8 show the gap between the corresponding calculated (columns 4 and 5) and actual primary fiscal balance (column 6). Since each year's deficit goes to increase the outstanding public debt, the higher the (positive) gap is between actual fiscal deficit and hypothetical fiscal deficit, the higher the speed at which the public debt decreases.

Table 2 shows the results of fiscal sustainability based on equation (2). In 2004, actual and calculated (short-term) sustainable fiscal levels seem to be the same, i.e. fiscal deficits of 0.6 of GDP, if we consider actual public debt in CEE countries. On the other hand, if we take into consideration targeted public debt (i.e. 60 per cent of GDP), the calculated (permitted) average fiscal deficit is relatively higher and the gap between actual and calculated deficit amounts to 1.2 percentage points.[4] However, this average covers substantial differences between the countries. Thus,

4 While many of the transition countries under consideration reported public debt stock below tolerating benchmark for the EMU (60 per cent of GDP), their sustainable public primary deficits could be even higher. In particular, this is valid for Baltic States, Slovenia and Romania where public debt to GDP ratio is well below the different transition region's averages.

the short-term fiscal policy stances of the Czech R., Hungary and Poland seem to be unsustainable. On the other hand, by far the most favourable position is that of Estonia. Indeed, Estonia is the only country of the CEE region with a budget surplus, i.e. 1.7 per cent of GDP (in 2004). In the remainder of the transition regions (SEE and CIS countries), only Croatia seems to have an excessive short-term fiscal deficit. Actually, in 2004 the gaps between actual and calculated primary fiscal balances are positive and high on an average level, indicating sustainable fiscal positions in both transition regions.

However, the preceding employment of a (short-term) fiscal sustainability indicator may give a distorted picture of the amount of adjustments that would reasonably be required for different reasons. Indeed, the calculated (primary) fiscal balances (as GDP ratio) can be distorted by, for example, speeding up privatisation receipts (if the privatised assets would have yielded positive future net cash flow to the government) or by cutting back government capital formation (if the present discounted value of the future net cash flow to the government would be positive). Additionally, Buiter (1985) pointed out two further weaknesses of the one-period primary gap indicator. The first emphasises that actual current primary fiscal balance could be affected by cyclical increases or reductions in public sector revenues and/or expenditures. And the second, the current nominal interest rate and growth of nominal GDP may be unrepresentative of their respective long-term expected average values. Hence, the need for the medium- and long-term perspectives emerges, which are adopted in the resumption of the paper.

Hence, we gauged medium-term fiscal sustainability of the same twenty-four transition countries. Under the set assumptions presented in the previous subsection; the primary public balance seems not to be medium-term sustainable for most of the countries in the CEE regions (exceptions are Estonia, Slovenia and Slovakia). Indeed, their calculated sustainable size as a percentage share of GDP is relatively small, fluctuating between 0.2 (Poland) and -3.0 (Slovakia) if we consider actual public debt. The lowest sustainable current account balance, namely in Poland, can chiefly be explained by the fact that this economy has been projected to have one of the lowest average growth rates of real GDP (3.6 per cent p.a.) and one of the highest levels of real effective interest rates among all CEE countries (4.2 per cent). On the contrary, Slovakia is confronted with one of the lowest real effective interest rates (1.7 per cent). However, similar to short-term fiscal sustainability results, Estonia again shows the strongest sustainable fiscal position in the CEE region. Contrary to the CEE region, most of the remaining transition countries show a sustainable medium-term fiscal policy stance. The only exceptions are Albania, Croatia and Macedonia (SEE region) and Armenia (CIS region). While Croatia and Macedonia have excessive fiscal deficits, primarily due to relatively moderate real GDP growth averages (4.0 and 3.7 per cent, respectively), a high real effective interest rate is the

main reason for unsustainable medium-term fiscal position in Armenia (7.5 per cent) and Albania (4.9 per cent).

In addition to the analysis above, a special attention is paid to the evolution in the debt to GDP ratio for periods of 5 and 10 years. If we assume, that relatively high real GDP growth rate and existent real interest rate (average 2001-04) is maintained, then only CEE region as a whole is faced with an increase of an average public debt to GDP ratio. Indeed, the average public debt to GDP ratio is planned to increase from 30.7 per cent of GDP to 33.9 per cent of GDP after 5 years and 37.2 per cent of GDP after 10 years in CEE region. Actually, only Estonia and Slovenia are planning to have lower public debt to GDP ratio after 10 year period in the considered region. On the other hand, the average public debt to GDP ratio is planned to decline from 47.1 per cent of GDP to 44.1 per cent of GDP after 5 years (42.2 per cent of GDP after 10 years) and from 49.3 per cent of GDP to 39.3 per cent of GDP (31.7 per cent of GDP) in SEE and CIS region, respectively. There are only few countries where public debt is planning to rise under set assumptions, such as Albania, Croatia, Macedonia (SEE region) and Armenia and Belarus (CIS region). Nevertheless, in these circumstances the most significant lowering of public debt to GDP ratio is noticed in CIS region, in particular in Moldavia, Ukraine and Russia.

Finally, we consider briefly the long-term fiscal sustainability in all three transition regions under consideration. Table 4, because of its similarity to Table 2 and 3, does not need to be illustrated in detail. It refers to equation (6) which helps us to reveal long-term sustainability of public finance. The results indicate that practically all CEE countries (except Estonia) and majority of SEE countries show unsustainable long-term public finance.[5] The group of countries including Latvia, Lithuania, Slovenia (CEE), and Albanian, Macedonia and Romania (SEE) face moderate sustainability problems with the (negative) gaps between actual and calculated fiscal balance of around 1.0 – 2.0 percentage points. However, the most substantial long-term fiscal problems might affect countries such as the Czech Republic., Hungary, Poland, Slovakia (CEE) and Croatia (SEE).[6] On the other hand, practically all CIS countries under consideration (except Belarus) show a sustainable long-term fiscal policy stance.

5 When taking into account targeted public debt assumption (60 per cent of GDP) the fiscal situation is slightly better in both of the regions since great majority of the countries have public debt below the assumed one.

6 Indeed, Convergence Report (2004) set out that regarding the sustainability of fiscal developments, keeping the overall and primary balance ratios at current levels would not be sufficient to keep the public debt ratio below 60 per cent of GDP in the medium to long term, which points to a need for further substantial consolidation. With the fiscal deficits projected for the coming years, all countries under consideration would not comply with the Stability and Growth Pact's medium-term objective of a fiscal position that is close to balance or in surplus. In addition, the revenue and expenditure ratios of the public sector are rather high. In this context, a more efficient and employment – friendly tax/benefit system could strengthen work incentives and make a significant contribution to fiscal consolidation, while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy.

15.4.2.2 Local Government Fiscal Balance Sustainability

A key challenge for many transition economies has been to reap the economic benefits of decentralisation while maintaining control over public expenditures and borrowing, restoring growth and improving accountability of local governments and officials to limit corruption. It is generally acknowledged that the manner in which decentralisation is maintained or carried out can have a significant impact on macroeconomic management and performance. A common view in the literature is that decentralisation may aggravate fiscal imbalances, thereby endangering overall macroeconomic stability, unless sub-national governments are committed to fiscal discipline and the decentralisation package includes incentives for prudence in debt and expenditure management. Empirical evidence on the relationship between decentralisation and macroeconomic instability is mixed. Shah (1998) and King and Ma (2001) find that decentralised fiscal systems have a better record in controlling inflation and deficits. However, Fornasari *et al.* (2000) and DeMelo (2000) find that increases in sub-national spending and deficits lead to an increase in spending and deficits at the central level.

Differences in institutional, economic and political development can be expected mainly to influence the extent of decentralisation across these countries. These factors not only have influenced the degree of decentralisation across the region, but also whether decentralisation policies are effective and have had their desired impact. At the same time, macroeconomic and fiscal policies adopted at the outset of transition have had an impact on the system of intergovernmental relations that has evolved in many countries. Many of the more advanced reformers (new EU member states), with more stable macroeconomic conditions, including low overall public sector deficits, have made considerable progress in carrying out fiscal decentralisation and, in particular, have promoted institutional settings that are supportive of effective decentralisation. However, even in these countries, weaknesses in existing systems have prevented them from fully exploiting the potential public finance and service delivery benefits from decentralisation (see Dabla-Norris, 2006).

According to the presented facts, a local government fiscal balance sustainability assessment could be a useful element in order to assess overall (medium-term) local fiscal sustainability in transition countries. In our analysis we primarily concentrated on ten new EU member states, i.e. CEE countries plus Cyprus and Malta. Table 5 shows that according to set assumptions, almost all countries under consideration do have sustainable local government fiscal balances. Indeed, the results suggest that within the group of CEE region, only Hungary and Slovenia seem to have unsustainable local finance positions, albeit by a low margin. Nevertheless, we should also take into account that Slovenia had the lowest local government debt in the CEE region that enables it to have higher local finance deficits, at least in the medium-term. On the other hand, some CEE countries can easily afford higher lo-

Table 2

Short-term fiscal sustainability in 24 transition countries

Country	Public Debt (D/Y) (2004) (1)	Growth rate of nominal GDP (gn) (2004) (2)	Nominal interest rate (i) (2004) (3)	Calculated (short-term) primary public balance ((i-gn)/(1+gn))*(D/Y)		Actual primary public balance (-b) (2004) (6)	Diff. (Actual-Calculated (actual public debt assumption) (7)	Diff. (Actual-Calculated (targeted public debt assumption) (8)
				Actual public debt assumption (4)	Targeted public debt assumption (60 % of GDP) (5)			
CEE (average)	31.1	9.5	6.2	-0.6	-1.8	-0.6	0.0	1.2
Czech R.	24.0	7.4	5.5	-0.4	-1.1	-2.2	-1.8	-1.1
Estonia	5.5	10.8	5.5	-0.3	-2.9	2.0	2.3	4.9
Hungary	60.7	8.7	8.3	-0.2	-0.2	-1.2	-1.0	-1.0
Latvia	14.7	14.8	5.4	-1.2	-4.9	-0.2	1.0	4.7
Lithuania	21.4	8.9	5.8	-0.6	-1.7	-0.1	0.5	1.6
Poland	50.1	8.8	7.1	-0.8	-0.9	-2.8	-2.0	-1.9
Slovakia	42.6	9.2	6.4	-1.1	-1.5	-0.8	0.3	0.7
Slovenia	29.5	7.5	5.5	-0.5	-1.1	0.2	0.7	1.3
SEE (average)	42.9	10.6	4.7	-2.2	-3.0	-0.1	2.1	2.9
Albania	55.6	8.8	7.6	-0.6	-0.7	-0.2	0.4	0.5
Bulgaria	48.3	6.4	4.0	-1.1	-1.4	1.7	2.8	3.1
Bosnia and Herzegovina	31.1	5.9	1.3	-1.4	-2.6	-0.7	0.7	1.9

Croatia	41.5	7.5	5.6	-0.7	-1.1	-4.2	-3.5	-3.1
Macedonia	37.6	2.6	2.4	-0.1	-0.1	1.6	1.7	1.7
Romania	26.2	24.1	9.9	-3.0	-6.9	-0.2	2.8	6.7
Serbia and Montenegro	60.2	19.0	2.1	-8.5	-8.5	1.2	9.7	9.7
CIS (average)	39.9	19.4	3.2	-4.7	-8.0	0.2	4.9	8.2
Armenia	35.6	16.0	0.7	-4.7	-7.9	-1.2	3.5	6.7
Azerbaijan	18.6	17.0	0.8	-2.6	-8.3	-1.0	1.6	7.3
Belarus	9.0	32.8	6.4	-1.8	-11.9	0.5	2.3	12.4
Georgia	54.3	13.3	2.8	-5.0	-5.6	-0.3	4.7	5.3
Kyrgyz R.	93.7	11.2	1.5	-8.2	-5.3	-3.7	4.5	1.6
Moldavia	60.6	20.1	2.1	-9.1	-9.0	2.9	12.0	11.9
Russia	21.7	25.2	5.6	-3.4	-9.4	6.2	9.6	15.6
Tajikistan	39.4	17.7	5.4	-4.1	-6.3	-2.1	2.0	4.2
Ukraine	26.0	21.1	3.3	-3.8	-8.8	0.3	4.1	9.1

Sources: EBRD (2006), EIU (2005), IMF (2005), Eurostat (2006), author's calculations.

Table 4
Long- term fiscal sustainability in 24 transition countries

Country	Public debt (D/Y) (2001-04) averages)	Growth rate of real GDP (g) (2000-40 project.)	Calculated (long-term) public balance ((g*(D/Y))		Actual public balance (2001-04 averages)	Diff. (Actual-Calculated)	
			Actual public debt assumption	Targeted public debt assumption (60 % of GDP)		Actual public debt assumption	Targeted public debt assumption (60 % of GDP)
CEE	30.7	3.1	-0.9	-1.7	-3.2	-2.3	-1.6
Czech R.	32.4	2.4	-0.8	0.0	-6.9	-6.1	-6.9
Estonia	5.5	3.0	-0.2	-1.8	1.7	1.8	3.5
Hungary	55.6	2.6	-1.4	-1.6	-6.0	-4.5	-4.4
Latvia	14.6	3.6	-0.5	-2.2	-1.7	-1.1	0.5
Lithuania	21.6	4.0	-0.9	-2.4	-2.0	-1.2	0.4
Poland	41.7	3.7	-1.5	-2.2	-3.9	-2.4	-1.7
Slovakia	44.6	3.2	-1.4	-1.9	-4.7	-3.2	-2.8
Slovenia	29.4	2.1	-0.6	-1.3	-2.3	-1.7	-1.0
SEE	47.1	5.1	-2.5	-3.1	-3.1	-0.7	-0.1
Albania	66.0	6.9	-4.6	-4.1	-6.3	-1.7	-2.1
Bosnia and Herzegovina	46.0	6.2	-2.9	-3.7	-2.6	0.3	1.2
Bulgaria	62.9	4.0	-2.5	-2.4	0.0	2.5	2.4
Croatia	41.8	3.9	-1.6	-2.3	-5.7	-4.1	-3.4

Macedonia	32.5	5.5	-1.8	-3.3	-2.8	-1.0	0.5
Romania	27.6	3.9	-1.1	-2.3	-2.2	-1.1	0.1
Serbia and Montenegro	53.1	5.3	-2.8	-3.2	-2.4	0.4	0.8
CIS	46.7	7.0	-3.2	-4.2	-1.1	2.1	3.1
Armenia	39.5	10.0	-4.0	-6.0	-1.8	2.2	4.2
Azerbaijan	24.8	11.0	-2.7	-6.6	-0.3	2.4	6.3
Belarus	10.9	3.8	-0.4	-2.3	-1.3	-0.9	1.0
Georgia	60.9	6.2	-3.8	-3.7	-2.6	1.2	1.1
Kazakhstan	19.8	8.8	-1.7	-5.3	2.4	4.2	7.7
Kyrgyz R.	106.3	6.0	-6.4	-3.6	-5.2	1.2	-1.6
Moldavia	64.1	7.0	-4.5	-4.2	-0.3	4.2	4.0
Russia	46.1	3.7	-1.7	-2.2	2.4	4.1	4.6
Tajikistan	57.1	8.0	-4.6	-4.8	-2.6	2.0	2.3
Ukraine	37.9	5.3	-2.0	-3.2	-1.5	0.5	1.7

Source: EBRD (2006), EIU (2005), IMF (2005), Eurostat (2006), author's calculations.

Table 5

Medium – term sustainability of local government balances in new EU member states and in some selected old EU member states

	Local government revenues (in % GDP) (2004)	Local government expenditures (in % GDP) (2004)	Local government balance (in % GDP) (2004)	Local government debt (DL/Y) (2004)	Calculated (medium-term) balance (in % GDP)	Growth rate of real GDP (2004-2007 averages) (gL)	Diff. (Actual-Calculated
New EU-10							
Cyprus	1.8	2.0	-0.2	1.4	-0.1	3.8	-0.1
Czech Republic	12.6	12.6	0.0	2.6	-0.1	4.4	0.1
Estonia	8.8	9.0	-0.2	2.6	-0.2	7.8	0.0
Hungary	12.6	12.9	-0.3	1.1	-0.1	4.6	-0.2
Latvia	10.0	10.1	-0.1	2.4	-0.2	8.5	0.1
Lithuania	9.0	8.9	0.1	0.8	-0.1	7.0	0.2
Malta	0.7	0.7	0.0	0.0	0.0	0.1	0.0
Poland	13.5	13.6	-0.1	1.7	-0.1	5.3	0.0
Slovenia	9.2	9.3	-0.1	0.3	0.0	4.2	-0.1
Slovakia	7.3	7.1	0.2	1.3	-0.1	5.5	0.3
Selected EU-15							
Austria	8.1	7.9	0.2	4.5	-0.1	2.4	0.3
Finland	19	19.7	-0.7	4.1	-0.1	3.6	-0.6
France	10.7	10.8	-0.1	7.2	-0.2	2.3	0.1
Greece	3.1	3.0	0.1	0.0	0.0	4.7	0.1
Ireland	14.5	14.3	0.2	2.1	-0.1	4.5	0.3
Italy	14.9	15.8	-0.9	9.6	-0.1	1.2	-0.8
Luxembourg	5.8	5.9	-0.1	2.9	-0.1	4.5	0.0
Netherlands	15.9	16.4	-0.5	7.4	-0.1	1.3	-0.4
Portugal	6.0	5.9	0.1	3.0	0.0	1.2	0.1
Spain	5.9	5.9	0.0	8.0	-0.2	3.1	0.2
Sweden	25.2	25.0	0.2	5.6	-0.2	3.7	0.4
United Kingdom	12.7	12.7	0.0	4.6	-0.1	2.5	0.1

Sources: Eurostat (2006), author's calculations.

cal finance deficits, especially Slovakia and Lithuania. When comparing CEE countries, we can see that local finance balance positions in the region are in relatively good shape even when comparing them with some selected countries in the EU-15. In particular, in Finland, Italy and Netherlands local finance deficits are above the levels which keep a non- increasing local public debt/GDP ratio. To sum up, the results show that medium term local government finance balances in CEE region are probably in line with the sustainable one and do not pose any significant threat for general government fiscal balance sustainability. However, as fiscal decentralisation progresses in the regions, the problem of fiscal (un)sustainability might easily emerge. Indeed, in the absence of further strengthening of institutional and legal supports mechanisms and appropriate intergovernmental fiscal arrangements to support a decentralised system a favourable fiscal situation might easily vanish.

15.5 Conclusions

The sustainability of public finance has been an important issue for transition countries in the last fifteen years. Policy-makers in transition countries have been facing a combination of historical expenditure commitments, uncertainty about new revenue sources coupled with uncertainty about the general macroeconomic situation in the country. Indeed, the state of public finance usually acts as a litmus test of the progress achieved and the degree of internal consistency and soundness of transformation policy. In these circumstances, if fiscal policy is inconsistent there is a substantial and continuing risk that public deficits can leap out of control and eventually become unsustainable. Unsustainable government debt paths can eventually lead to sharp adjustments, if not to a crisis. Hence, fiscal sustainability is a highly desirable quality which should be measured on a regular basis in order to avoid unfavourable macroeconomic conditions. Moreover, fiscal policy sustainability has also become a recurrent theme for many transition countries, especially for new EU member states in the run-up to Economic and Monetary Union (EMU) since the Maastricht Treaty makes fiscal sustainability an explicit criterion for a country's eligibility for EMU.

By using the mainstream (primary fiscal gap) theory (proposed by Buiter (1983) and Blanchard (1990)), the analysis ensures some degree of restrictiveness. Indeed, given the looseness of the theoretical criteria for solvency, a non-increasing public debt to GDP ratio is seen as a practical sufficient condition for the sustainability of fiscal policy; a country is likely to remain solvent as long as this ratio is not growing. In this respect, the primary fiscal gap, defined as the difference between the required primary fiscal balance to GDP ratio and the actual primary fiscal balance to GDP ratio, is calculated for selected transition countries. Based on simple mainstream theory measures of fiscal sustainability, the results indicate that fiscal sustainability seems to be a problem in many transition countries, particularly in CEE (e.g. the Czech Republic, Hungary, and Poland) and the SEE region (e.g. Al-

bania and Croatia). In this respect, it is vital for these economies (especially for the CEE) to consolidate their fiscal (balance and debt) positions in order to be able to join the EMU as soon as possible. Moreover, when analysing local government fiscal positions in the CEE region, the situation is much better, with a (medium-term) potential unsustainable position found only in Slovenia and Hungary.

Because of the simplicity and restrictiveness of the presented indicators, at least three main caveats should be set up at the end. First, all the indicators used in the analysis are sufficient (but not necessary) conditions for long-run sustainability. Indeed, for an economy, it may be sub-optimal to prevent a country from smoothing expenditure because this would lead to overshooting a fiscal ratio that corresponds to a long-run equilibrium. Second, most of the indicators require assumptions about macroeconomic variables (e.g. GDP growth, interest rates etc.) which are implicitly assumed to be exogenous. However, most of the included variables tend to be endogenous and/or correlated with each other. Indeed, it is unrealistic to assume that changes in economic growth do not affect the primary surplus or vice versa. Finally, a great majority of factors that characterise the situation in transition economies are not included in these indicators.

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16. Theoretical Foundations and Practical Applications of Municipal Debt Regulation (Focusing on the Situation in the Czech Republic)

Josef Mech

16.1 Introduction

After a long debate, in 2004, the Czech Republic government adopted a resolution which established methods in the regions and municipalities regarding debt regulation through a so-called debt service index. The relatively long debate about its sense, construction and meaning has shown that there are quite a large number of approaches that can be applied within this field.

This has led to a number of questions. Should municipalities be limited while making loans? Should the regulation and relevant index be limited to one year or for a longer period? Should the purpose of the loan be monitored? What is the best approach to over indebted municipalities to their debtors? [1]

Our work is divided into three main parts that together form a compact methodological approach to the evaluation of the current system of municipal debt regulation in the Czech Republic.

The starting point of our work is represented by a summary of theoretical bases, practical approaches used and well-proven in other countries and their comparison with the model that is being constituted in the Czech Republic.

The first part gives a summary of basic theoretical arguments for and against municipality debt. The second represents the basic mechanisms that are being used in other countries as a prerequisite to presentation and relegation on the Czech model that will be presented in a conception form. The final part will be dedicated to a comparison of the Czech system with earlier presented bases.

16.2 Theory of fiscal federalism and regulation of municipal debt

Theory of fiscal federalism has been developed for decades and currently it is a relatively compact concept that enables complex approaches during the realisation and of fiscal decentralisation and related questions – assessment of the territorial entity's area, allotment of expenses accordingly to the subsidiary principle, set-up of appropriate sources in adequate mix of own and grants, and finally, efforts to eliminate vertical and horizontal imbalances in the system.

1 This list is certainly not complete, but without any doubt, it covers the main topics.

There is no clear answer to the question of under what conditions municipalities could use loans or what method should be used for their debt regulation. The authors basically agree that it is forbidden for municipalities to use debt instruments for financing normal expenses (with very few exceptions). In the area of capital (investment) expenses the theory brings in arguments that support the usage of debt financing for several different reasons.

On the legitimate question regarding regulation in the debt area of the otherwise independent self-government municipalities there is no easily found single answer. On the one hand there are risks from regulation of the self-government principle and a decrease in its efficiency concerning their outcomes through the "global" regulation mechanism and issues regarding its appropriate setting.

On the other hand, it is necessary to take into account specific factors that enter into the decision making process concerning debt from the position of a municipality but also of a loan provider. There is also the risk of moral hazard when making a calculation that, in case of an over debt and potential bankruptcy, the state becomes involved, together with the moral hazard connected with the political process on the side of municipality's representatives.[2]

16.3 Need for external regulation on local borrowing

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

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

- that lenders possess adequate information on the local governments whom they are financing;
- that local governments react appropriately to market signals and act to avoid exclusion from the credit market;

2 In this entry we are not going to deal with the situation where the necessity of falling into dept is caused by an inappropriately set model of co-operation between central and local government and so connected financial flows, in other words – existence of systematic disparity among expenses and allocated resources. This will be covered in a more detailed analytical work by my colleagues.

- that lenders could assume they would receive a bailout by central government in case of local government default (note that although a local government bankruptcy is technically possible in several countries, it is politically unacceptable and thus rarely observed in practice).

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

Increasing a municipality's debt could induce a lot of other implications and negative consequences that could create prerequisites for the assessment of the introduction and consequently, also an appropriate form of regulation mechanism. If we try to catalogue and present all these risks, we have to consider three basic problem levels – the municipal, national and loan providers' side.

Among the risks from the side of the municipality are especially:

- Insolvency and risks emanating from this, especially penalties and sanction payments
- Increase of pressure on the operation budget
- Interrupted or unfinished projects that consequently do not return invested means
- Risk of losing municipality property
- Possibility of interrupting public services provision
- Political risks
- Sanctions from the side of central government (e.g. limitation of grants, interruption of other payments, prosecution….), pressure to merge with another municipality, possibility of state supervision
- Being placed on a black list by financial institutions

Risks from the side of a central government:

- In case of the guarantee's requirement (if they are issued) there is a possibility of threat to the state budget [3]
- Risks from international agreements and membership in international organisations (e.g. Maastricht criteria, limitations from the membership of the International Monetary Fund, OECD etc.)
- Risks emerging while "saving" debtors
- Loss of invested resources in interrupted projects
- In case of over debt there could be a transformation of the municipal liabilities to state level

3 In Latin American countries these pressures led to an over dept of the state and the destabilisation of the whole financial system.

- Fallback of credit ("reputation") and deterioration of the medial picture for all municipalities

Risks from the side of the loan provider or holder of a bond:

- Costs for management of bad assets
- Negative publicity in case of pressure on municipality (e.g. sale of property)
- Risk of losing assets in case of a trial with a debtor
- Risk of losing the entire municipality sector in case of insensitive process
- Basic principles of the municipality debt's regulation

For now, let's put aside the question about the sense of the debt's regulation to which we will return during the course of almost the whole text. We will pay sufficient attention to each of the regulation's styles later, but now we will summarise the basic mechanisms that are used around the world.

Control of a loan includes the individual loan's approval and individual setting of limits could be listed among the less flexible styles that are not frequently seen, especially in the light of quite heavy administrative costs and dissonance with requirements on the municipalities' independence while executing self–government of a given territory.

Another style is the Budget control, with special emphasis on the limit of debt service monitoring, especially the rate of resources reserved for service of a debt and other dispensable resources. This does not significantly limit the competences of municipalities (if the debt service index as well as of the monitoring system are set appropriately), but it is basically of an ex post character. So, control of a budget does not precede the problems but is aimed mostly at the level of theoretical problem solving. When using this style it is possible that there will be quite large administrative burden that is comes from the debt service index setting.

Restrictions in the area of issuing the municipalities' guarantees and collateral represent a limitation of credibility towards financial institutions. The regulation's goals are thus assured through an indirect method in the form of a law or governmental regulation. This style is administratively not so costly, but it significantly influences the possibilities of the municipalities' independent choice.

16.4 Borrowing for operating expenses

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

- Borrowing for operating spending would lead to an unmanageable debt burden. It would quickly lead to the rolling over of loans (financing payment of previous debt with new loans) and to very serious indebtedness problems reflecting a structurally imbalanced financial situation.
- Covering current costs from current revenues prevents the local public sector from growing beyond its optimal size, which may be defined here as the fiscal burden that voters/taxpayers agree to bear in order to finance the desired provision of public goods. Borrowing can create a short term fiscal illusion and cause the demand for public services to be artificially high, since it reflects the supply financed partially by credit or bonds rather than by a local tax effort.
- An unbalanced current budget may result in negative macro- and microeconomic consequences, since private investments could be crowded out. This could happen for the following reasons:

Public sector borrowing draws on the pool of limited financial resources available from local banks, etc. Local government borrowers are more attractive to banks than private borrowers, because giving credit to public entities implies a lower risk;

The competition for borrowing from the public sector exerts an upward pressure on the interest rate, making private investments more costly;

An increase in budget deficits negatively affects concerns about inflation, adding more to the upward trend in interest rates.

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

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

As Musgrave (1959) argued, to follow the "golden rule" that borrowing is allowed for capital projects but prohibited for current purposes requires a clear distinction between the current and capital budgets of local governments. In this situation a capital budget includes capital receipts (such as revenues from municipal property, various grants received for capital purposes and borrowed funds) which are spent on local investments, while the current budget includes current revenues used basically to cover operating expenditures. The surplus in the current budget can also be used to support capital needs—typically to repay loans contracted for investment projects. This system increases the transparency of local financial management. It makes it easier to assess whether current revenues are sufficient to cover operating costs, or what the level of operating surplus is. This information supports the building of viable capital development programs and helps in assessing creditworthiness. The separation of current and capital budgets is generally followed in Western Europe (with some exceptions) but is rarely the case in Central and Eastern Europe, as we will see in the following chapters.

16.5 Borrowing to Finance Investments

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

16.5.1 Equitable burden of cost and access to benefits

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

of capital spending were relatively constant throughout several subsequent years. But this assumption does not hold true, especially in relatively small units such as municipal-level local governments in which the volume of investments fluctuates considerably from year to year.

16.5.2 Optimal allocation of resources.

A close relationship between those who benefit from and those who pay for a project encourages optimal allocation of resources. Financing capital projects through borrowing usually makes this relationship much closer, for reasons made clear in the previous point. Though this argument may appear abstract, virtually any text on management or economics supports it.

16.5.3 Benefits from accelerated local development overshadow the cost of borrowing.

This can be illustrated by a simple example. Imagine that a certain city possesses a piece of land that may be very attractive to a potential investor, but there is no good access road to the plot. The city government could do one of the following:

- finance the road construction from current revenues, allowing a few years to complete the project and then try to attract an investor a few years from now;
- try to find a potential investor now, agreeing that the price received for the plot has to be lower and understanding that some potential investors may withdraw from the tender;
- take a credit, complete the construction of the road as quickly as possible and negotiate the sale of the plot. The benefits of the third alternative (higher price or rent, wider scope of interested investors, quicker economic development resulting in multiple-effects by attracting new projects, providing additional jobs and tax revenues) may well be much greater than the costs resulting from interest payments to the bank.
- Reduction of operational costs. Consider another simple example: a local public transport company has ten old buses that require frequent repairs and consume a lot of fuel. The city can replace them using current revenues, but will only be able to purchase one new bus every two years. Alternatively, the city could contract a loan or issue bonds and replace more buses at once. The benefits of borrowing are considerable, including the comfort of local citizens, lower consumption of fuel, higher reliability of local transport, savings in the cost of repairs and employment of service staff, etc. Such reductions in current expenditures may in fact be much larger than the costs related to borrowing.
- Longer projects cost more. Financing from current revenues usually delays the completion of the project for a longer period of time. This leads to higher constant costs and higher total volume of spent resources.

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

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

16.6 The Czech way of municipality debt regulation

The regulation's style that is being used in the Czech Republic belongs primarily to a category based on limitation of the debt service range. Defined index is monitored by the Ministry of Finance that reports to government. This Ministry, on the basis of collected data, counts debt service index and compares it with a given value of 30 per cent. In the case where the given limit is crossed then the Ministry informs the municipality and asks for detailed information about the situation, its reasoning and to report on steps taken for purposes of improvement. At the same time, the Ministry evaluates the budget prospect and report on the results of the economy's revision. The following is taken into account:

- total debt of municipality or region;
- total debt of municipality or region connected to one inhabitant;
- tax yield referred to one inhabitant of municipality or region;
- debt trend over the last years;
- size of village or region;
- complete financial situation of the municipality or region.

In case that municipality or region crosses the given limit of debt service index again in the next year then the Ministry of Finance will hand out a list of these municipalities and regions to providers of resources from state budget and state funds, so they can at any given time look at this list while discussing requests from these municipalities and regions concerning grants, loans or returnable financial support (RFS). The municipality is also put on the "black list" which is accessible also by institutions on financial markets. These are not bound by this resolution, but they logically monitor it and use it during the municipality's assessment.

Crossing the 30 per cent rate of debt service index does not automatically mean losing the chance to receive a state grant. It is just one criterion that is being used by subjects providing grants during the final process of selection of which the municipality or region will receive a purpose state grant. Providers will use this criterion while making decisions about providing purpose grants and loans to newly launched actions. On the other hand, this criterion will not be used in the following cases:

- for actions that were approved and that have been in progress from previous years,
- in the case of grants that are part of a financial relation between state budget to budgets of the regions and municipalities and that are approved in the context of the law on the state budget during the relevant calendar year,
- in the case of grants that are nominally designed for single municipalities or regions and approved within the context of law on the state budget during the relevant calendar year.

This style has only been used for quite a short time – from the year 2004 - which implies a relatively small chance of the results evaluation. Previous attempts aimed at the constitution of regulation mechanisms have more or less a marginal character and do not appear to make a detailed analysis of them or to compare them with current methods.

Debt service is compared to the real volume of the debt base for the past calendar year. The result of this ration is the "debt service index":

debt service index = debt service / debt base

Content of debt service is defined in this way:

- paid interests,
- paid payments of issued obligations,
- payments of principals,
- leasing payments (entry 5,178 of budget composition).

Debt base consists of:

- real attained tax incomes and non tax incomes for given calendar year
- grants of a complete financial relation

16.7 Conclusions

The aim of this short article was not to provide a complex view on the municipalities' dept issues, but rather to present a type of entrée to research that is being conducted with my colleagues as part of our work in the department.

A summary of the theoretical basis was shown as beneficial, especially from the view of rooting these issues into the broader context. It became clear that the theory does not delimitate single solutions, but rather defines basic starting points that should be taken into account while considering the regulation of municipalities' loans and searching for an appropriate mechanism.

As was stated in the article there is no uniquely postulated solution. Nevertheless, theory as well as practice, tends towards the fact that it is not allowable in the long term for municipalities to take out loans to cover regular expenses. At the same time, we can agree that by fulfilling certain (defined hereinbefore) conditions it is possible to allow loans while financing capital needs.

From this view, the Czech model of municipal dept regulation is obviously quite simple. We could say that it is aimed especially at a one year horizon and it does not systematically distinguish causes of municipality dept origins. According to its construction, it could cause that limit to be crossed, even by municipalities that generate a surplus in a given year which points out certain methodological imperfections.

Putting these municipalities on a publicly accessible list of subjects with problematic financing could cause difficulties on the financial market and the solution could complicate the municipality's situation or threaten investment plans while undergoing the process with the Ministry of Finance.

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