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# LOCAL GOVERNMENT DEBT FINANCING IN THE REPUBLIC OF MACEDONIA

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# INTRODUCTION

The purpose of the thesis is to show that in order to facilitate capital market development for local governments, the ongoing fiscal decentralization programs must strengthen the financial capacities of local governments. For that purpose, the creation and implementation of appropriate legislation, and building and supporting capacity for financial management at the local level are of utmost importance for the success of the decentralization process.

The main goal of this thesis is to provide answers to the following five hypothesis:

1. implementation of investment projects of local governments depends on their ability to raise the necessary funds by combining their resources (own sources of revenues and others) and external financing (borrowing);
2. the financial framework for local governments plays a key role in sustainable development of capital markets for local governments;
3. bonds are the preferred form of funding for major capital projects that need long-term financing;
4. local government's creditworthiness assessment as diagnostic tool to maintain the financial health of the municipalities and
5. local government associations can help improve the local debt legislation, strengthen local government finances and improve local capital market.

The thesis consists of seven parts. The first part of the thesis gives an overview of the fiscal decentralization process in the Republic of Macedonia and establishment of the legal framework.

The second part provides information on basic principles of local government borrowing and a summarized overview of different financing policies, preconditions for local government borrowing and necessity for establishing a sound debt management.

The third part deals with implementation of the investment projects of local governments and their ability to raise the necessary funds by combining their resources and external financing (borrowing). Concerning this, local governments need to compare the need for funds (the estimate for the investment project) with the amount of loan they expect to receive in accordance with the legal limit for borrowing as well as to plan how much annual debt service they can make in order to repay the due amount.

The fourth part provides financial institutions with understanding that the design of intergovernmental fiscal structure along with the accounting system and reporting procedures are important factors that have to be taken into consideration when assessing the opportunity to finance local governments. This part also emphasizes the local government borrowing procedures, authority to borrow and issues related to local government borrowing.

The fifth part deals with information related to available debt instruments. There are two major types of debt instruments available to finance local government capital expenditures: loans and bonds. This part provides local governments with information they need to consider when assessing which debt instrument is appropriate for financing.

The sixth part emphasizes that the local government's creditworthiness assessment is important very much for local governments to maintain their financial health. The issue on how local governments can improve their creditworthiness along with the fiscal indicators and assigning of the credit rating is also presented.

The last part provides an overview of the role of the local government associations and how they can help the local debt legislation and capital market be improved. The relations with different stakeholders in this process is described i.e. lenders, local governments, central governments, national parliaments, donors and international financial institutions.

# 1 THE PROCESS OF FISCAL DECENTRALIZATION IN THE REPUBLIC OF MACEDONIA

Local government in the Republic of Macedonia is territorially and administratively organized in 84 local governments (local government units) and the City of Skopje, as a separate self-government unit (with 10 local governments in its territory). Before 1996 there were 34 local governments. The 1996 Law on Territorial Organization resulted in a more fragmented structure, including 123 local governments and the City of Skopje as a special self-government unit. Out of these 123 local jurisdictions, 46 counted populations of less than 5,000. With a new Law on Territorial Organization adopted in 2004, the Republic of Macedonia was restructured into 84 local governments (15 of which still count less than 5,000 inhabitants) and the City of Skopje as a special self-government unit.

The decentralization process in the Republic of Macedonia has started with the establishment of legal frameworks for the transfer of responsibilities to local governments and the necessary resources for their execution, providing a stable legal framework for financing of the local governments, effectively communicating the ongoing decentralization process and supporting inter-municipal cooperation to achieve efficient and equitable provision of services to citizens.

Local authorities, as autonomous local government units in the Republic of Macedonia, perform tasks of public interest at the local level. The Law on Local Self-Government regulates wide range of local government responsibilities including: urban and rural planning (issuing technical documentation for construction and construction permits, regulation and maintenance of construction land); environmental and nature protection; local economic development (determining of development priorities, running of local economic policy, support of development of small and medium-size enterprises); communal activities; cultural development in accordance with the national programme for culture; sports and recreation; social welfare and child protection (kindergartens and homes for the elderly, social care of disabled persons, orphans, children with educational and social problems); foundations of educational institutions (establishing, financing and administering primary and secondary schools in cooperation with the central government, organizing transport and accommodation); health care (managing the system of public health organizations and primary health care); fire protection provided by local fire units and supervision over the performance of activities under local government competence.

Respecting the law, also, local government unit can found public service companies for performing its competencies, or it can delegate certain public tasks that are of local interest to other legal entities, companies or private entities. When delegating the performance of certain competence, the local government unit is responsible for realization of the outsourced functions.

All local governments are independent in performing their responsibilities and duties, which are determined by the Constitution and laws, while the supervision over legality of their work is within jurisdiction of the central government. As is the case in countries – European Union (hereinafter: EU) member states, local governments enjoy a general power of competence. In accordance with the Charter of Local Self-Government of the Council of Europe, the local governments have financial independence and guaranteed own sources of revenues in form of shares in taxes collected by the central government, local taxes and fees and different (earmarked, block and capital) grants that they receive from the central government (Ministry of Local Self-Government of the Republic of Macedonia, 2009b, p.6).

Fiscal decentralization, in general, is assigning fiscal decision-making powers and management responsibilities to lower levels of government in a devolved government system. Devolution is a process of shifting responsibilities for government functions and expenditures from the central to the local governments in which the local governments are granted substantive decision-making authority.

The main pillars of fiscal decentralization are (Nikolov, 2004, p. 3):

1. Expenditure responsibilities (clear definition of what will be the responsibilities of the LG).
2. Revenue assignment (each revenue stream must follow a function responsibility).
3. Intergovernmental fiscal transfers (ensure vertical and horizontal fiscal balance).

4. Local government borrowing (require well coordinated regulation, strong financial institutions and good management of macroeconomic environment).

Fiscal decentralization process was to be implemented gradually in two phases. In the first phase of fiscal decentralization local governments obtained the right to administer revenues coming from own sources and grants from the central government budget. At the same time, the implementation of the first phase was conditioned on qualification of the local government's administration staff.

The Law on Financing of the Local Self-Government Units introduced certain mandatory requirements for the staff of the local government administration:

1. At least two financial officers responsible for financial management, budget preparation and execution and accounting.
2. At least three employees responsible for tax assessment and collection.

In order to start the second phase of fiscal decentralization process, the local governments were obliged to meet the following criteria:

1. fulfil all conditions from the first phase of the fiscal decentralization;
2. possess adequate financial management staff;
3. show positive financial results for at least 24 months;
4. inform the Ministry of Finance on a timely basis about the financial results and obtain an approval from the Ministry of Finance;
5. have no arrears to suppliers or any other creditors exceeding ordinary terms of payment.

The responsibilities (for block transfers) assigned in this phase of fiscal decentralization are in the area of: culture, social welfare and child protection (kindergartens and homes for elderly), education (primary and secondary schools) and healthcare (public health organizations and primary care). Local government units have full responsibility for these competences, as regards current (wages, maintenance etc.) expenditures, capital (investment) expenditures, management issues, hiring and firing teachers, school management organization as regulated in separate laws for the respective areas.

The process of fiscal decentralization is directly connected with the inter-governmental transfers. The most important rationale of this phased approach of fiscal decentralization is to permit a gradual delegation of competencies in line with demonstration of greater capacity by local governments to undertake those competencies (assignments), and to provide an equitable and adequate transfer of funds for an efficient and ongoing execution of transferred responsibilities (assignments). Thus, local governments are mainly oriented towards building capacity for successful implementation of their transferred authorities and efficient management of their funds.

The process of fiscal decentralization is gradually getting into the final period of actual adjustment of local governments in managing transferred competencies and financial resources. Thus, local governments assumed wider responsibilities in many different areas of operation, aiming through this process of transformation citizens to get faster, better and cheaper services. As of January 2012, 83 municipalities and the City of Skopje are in the second phase of the fiscal decentralization financing their transferred competencies in education, child care, social protection and culture with block grants. During 2012 it is expected the last local government unit, municipality of Plasnica, to enter into the second phase of fiscal decentralization.

In addition, the sources of financing in accordance with the Law on Financing of Local Self-Government Units include own revenue sources, grants from the Central Budget, grants from the budgets of the Funds (Fund for the National and Regional Roads of Macedonia, Pension and Disability Insurance Fund of Macedonia, Health Insurance Fund of Macedonia and Employment Service Agency of Macedonia) and borrowing.

Local government own revenue sources are the following:

1. Local taxes (property tax, transfer of property tax, inheritance tax and gift tax);
2. Local fees (communal fees, administrative fees);
3. Local charges (construction land charges, communal activity charges, spatial planning charges);
4. Revenues from property (rents, interests, capital revenues from property sale);
5. Donations;
6. Revenues from penalties determined by law; and
7. Self contributions.

In addition to above mentioned revenues, local governments also have revenues from personal income taxes collected in the current year, in particular 3% of the personal income tax from personal revenues with salaries of physical persons, collected in the local government in the territory of which the address of permanent residence or stay of such persons is located; as well as 100% of the income tax with physical persons performing a crafts activity. The transfer goes through the treasury system automatically, leaving no room for discretionary decisions by the central government. Local governments also get 4% of the Value Added Tax (hereinafter: VAT) collected in the previous fiscal year, allocated on the basis of criteria determined in the Decree on the Methodology on Allocation of Revenues from VAT, adopted by the Government.

The Law on Financing of Local Self-Government Units envisions the following transfers from the central Government:

1. VAT revenues (total fund equal to 4% of the VAT collections in the previous fiscal year). This unconditional grant is distributed by a formula with at least 50 % according to population (per capita) and other criteria stipulated in a Decree on the Methodology on Allocation of Revenues from VAT. The methodology makes separate provisions for the City of Skopje.
2. Earmarked transfers (grants) for financing a special activity. The appropriate ministries and agencies/Funds monitor the use of the earmarked funds.
3. Capital transfers. This grant is in accordance with programs determined by the Government.
4. Block transfers. These grants are used for financing the local government competencies determined by law. Local government decides for spending of these funds regarding the activity that has to be financed, but the Ministries and Funds monitor the execution of these grants. The appropriate ministries and agencies are responsible for defining the methodology and criteria to be used in the transfer formula.
5. Funds received for delegated competencies. This grant is used for financing the delegated competence from the state administration to the mayor. In this case the amount of funds is determined by way of a contract signed by the mayor of the local government and the appropriate ministry responsible for the competency.

# 2 BASIC PRINCIPLES OF LOCAL GOVERNMENT BORROWING

In general fiscal decentralization processes have opened up the opportunity for local governments to use various instruments of borrowing to finance their local investment financing needs. Thus, the development of local government capital market is substantially important for local governments to increase the volume of local capital investment to support essential local government services.

The Law on Financing of Local Self-Government Units regulates the issue relating to the local self-government indebtedness, on which basis local government may incur debts (as of 1 July 2007) on short- and long-term basis in the country and abroad. In principle, local governments may borrow short-term for covering temporary cash deficit and long-term for funding of capital projects and investments.

As to the short-term borrowing, the loan should be repaid within 12 months from the date of signing the loan agreement, and total debt of the local government made on the basis of short-term borrowing and short-term loan from the Central State Budget of the Republic of Macedonia during the fiscal year, must not exceed 30% of the total realized revenues of the current-operating budget of the local government in the previous fiscal year. Total revenues of the current-operating budget are all budget revenues, except for earmarked grants from the Budget of the Republic of Macedonia and the budgets of funds intended for financing capital investments, assets from the self-imposed tax and assets obtained from loans.

In the long-term borrowing, the total annual repayment of the debt (the principal, the interest and the other costs) made on the basis of long-term borrowing and long-term loan from the Central Budget of the Republic of Macedonia must not exceed 30% of the total revenues in the current-operating budget of the local government in the previous fiscal year. The total amount of undue long-term local government debt, including all guarantees must not exceed the total revenues of the current-operating budget of the local government in the previous year.

There are two major types of debt instruments available to finance local government capital expenditures:

1. loans and
2. bonds.

Loans are granted by a financial institution (e.g. commercial bank) directly to the local government. Applying for a loan is less complex than the procedures required for bond issuance. From this point of view, loans are more advantageous to small and medium size local governments seeking external financing. Many international financial institutions have dedicated programs aimed at supporting and financing local governments' infrastructure projects, especially in the emerging markets. The financing occurs either directly or indirectly, via intermediated loans to local banks in target countries. The terms and conditions of such loans are more favourable to the local governments than in case of typical commercial banking loans (NALAS-Network of Associations of Local Authorities of South-East Europe-countries, 2011, p. 36).

However, many commercial banks are not interested in long-term finance. This is not uncommon because banking regulations normally limit banks' ability to make long-term loans since their liabilities (deposits) are short-term and volatile and their assets (loans) should match this configuration. Furthermore, commercial banks may lack the expertise to understand the local government financial environment and so tend to refuse to consider lending, or propose a very high interest rate, or require significant amounts of collateral in view of their perception of the risk involved (Jackson, 2007, p. 14).

At its simplest, a bond is a debt obligation issued by a borrower in which the borrower promises:

1. to repay the bond debt (principal) either in full at a fixed date in the future or a number of partial payments at fixed dates, and

2. to make regular interest payments to lenders on the debt principal not yet repaid.

Bonds are securities with fixed income, a financial promise and obligation of a person that will pay a certain sum of money on a particular date. A person who commits such a promise is called an “issuer”. Issuers are debtors, while those who invest in the bonds are lenders/creditors because they borrow their funds in a certain period and for a fee. Issuers of bonds may be states, state agencies, local governments, local government enterprises, firms and organizations.

Accordingly, local government experience with bonds is even more limited than experience related to local government borrowing. The municipal bonds issuing means an extra step to the local financial independence. Municipal bond financing can be cost-effective for larger and resource rich local governments but is rather complex as it requires a certain scale of experience and operations and success also depending on conditions of general markets for bonds.

Local governments borrowing also deepen local capital markets and strengthen the commercial banking system to learn how to assess creditworthiness of borrowers. Access to capital markets requires a sound condition of local government finance in order to be able to repay the loan. While accessing credit markets imposes burdens and risks, exposure of local governments to the market’s appraisal of transactions, demands for information, and requirements for budgetary discipline is beneficial and is an important component of responsible self-governance. The exposure of local governments to capital markets can significantly speed up infrastructure development and also requires local governments to be more transparent and to impose a certain control function on their finances.

From a national government and macro-economic perspective there is also the value in mobilising local (also known as domestic or national) savings and thereby developing the domestic financial market. In most countries people save through contractual savings for life insurance and pensions. Pension fund administrators need long term secure investments for the funds entrusted to them, but those in developing countries often have very limited options open to them. They are often limited to investing in national government bonds and bank savings deposits or having to invest offshore in order to diversify their investments. Investing in local government infrastructure enlarges their options and can stimulate the domestic capital market through the demand for good quality long term debt (Jackson, 2007, p. 10).

There are number of reasons why local borrowing can be positive or negative. The following Table 1 lists some of the different benefits and dangers of local government borrowing.

Table 1. Positive and Negative Side of Borrowing

| Pros | Cons |
|---|---|
| 1. Inter-temporal equity, meaning that with the borrowing we overcome the problem of inequitable burden costs among taxpayers i.e. the borrowing promotes intergenerational equity by having the generation of citizens that benefits from capital facility's services pay for its construction; | 1. The microeconomic con is in the potential indebtedness that may lead in default of repayment of the loan and decreasing the level of quality of provision of public services; |
| 2. Optimal allocation of resources, meaning that payments from current users are partially used to repay the loan because by financing a project through loan or through issuing bonds most users will pay for the benefits either through local taxes or directly through user charges; | 2. The macroeconomic con is that the local government unit debt is added to the overall national public debt that might become unsustainable; |
| 3. Benefits from accelerated local development are higher than the cost of borrowing. For example if a piece of land of interest to investors have no good access to a road the local government unit can decide to borrow, to build the road and sale the land benefiting from higher price of the land or higher rent for it. Here are also other positive effects like higher employment, more tax revenues, attracting other potential investors etc.; | 3. The special danger might come from borrowing for covering current operating expenses and possible cash flow problems. This type of borrowing can lead to rolling over loans; |
| 4. Reduction of operational costs. This pro has the same logic as the third one. Namely, if the local government unit wants to improve the condition with the public transportation by replacing old busses it can do this either by replacing the buses one by one using the current surplus from the budget or it can borrow and replace more buses at once; | 4. Borrowing can create a fiscal illusion that the voters/taxpayers are over-demanding the public services sponsored by borrowing and not by their tax effort; |
| 5. There is a tendency that longer projects cost more. If the projects are financed from the current revenues it will delay the completion of the project which might lead to higher fixed costs due to longer period of time for completing the project; | 5. Possible crowding out effect to potential private investors since the local government unit is more attractive to lend to; |
| 6. Access to grant from EU and other development funds but the local government unit will be required to participate in a matching funds scheme and/or to cover all the costs of the project and then to claim reimbursement after completion of the project; | 6. The borrowing by the local government unit can cause an upward pressure of the interest rates; |
| 7. Debt finance typically has a positive effect on local government planning and budgeting, financial management, capital investment planning, project management etc.; | 7. The budget deficits at local government unit can cause rising of inflation and thus, increase of cost of capital i.e. interest rates; |
| 8. Borrowing allows a local government unit to carry out a more ambitious capital program than otherwise would be possible. | 8. Political cycle driven borrowing in order to please the electorate. |

Source: M. Nikolov, *Report on the Process of Decentralization in Macedonia* CEA/USAID, 2007, p. 15. Table 3.

There are always risks in encouraging local government entities to borrow. There may be the temptation to borrow excessively. There may be over-ambitious or unrealistic revenue projections that do not happen as predicted. Local governments may unconsciously pledge the same collateral as security for a loan to more than one lender. National governments need to be aware of such risks and regulate appropriately. This should not result in heavy regulation with government pre-approval of every local government loan. It could be as light as a requirement for regular disclosure of the extent of indebtedness, some prudential ratios to limit total debt, and reasonable limits on pledging intergovernmental transfers. Thereafter it should allow the discipline of the market (including credit ratings) to play its part (Jackson, 2007).

# 3 FINANCING OF THE CAPITAL ITEMS – CURRENT REVENUES OR DEBT FINANCING

When considering what resources are available to fund capital investments, the most important is to consider all possible financial alternatives. A wide range of sources are possible, for example, current revenues, grants from central governments or the EU (or other donors), private sector investments (hereinafter: PPP). Long-term debt is only one option out of many (NALAS, 2011, p. 16).

On one side, borrowing results in additional costs related to bank charges, interest, etc. For sure it would be better to wait until the investment project could be financed from current revenues, thus avoiding additional and unnecessary costs of borrowing. However, in general, financial capabilities of the local governments are smaller than the figures needed for investments. This is normal because the local government budgets are still very modest to take on important projects. One way to satisfy the needs for finances in order to complete the projects is by borrowing long term funds domestically or from abroad as well as combination of their own resources of revenues with borrowing.

## 3.1 Current revenues V.S. Debt financing

Infrastructure services like electricity, roads, water, and sanitation are main drivers of economic activity. Social infrastructure, such as health and education, but also access to clean water and sanitation, lead to direct positive impacts on the quality of life and reduce mortality and morbidity (Boschmann, 2009, p. 85). The rationale of a positive impact of all kinds of loans (including commercial ones) is that the exposure of local governments to capital markets can significantly speed up infrastructure development and in addition requires local governments to be transparent and leads to lenders exerting a certain control function on local government finances (Boschmann, 2009, p. 87).

Table 2 illustrates the pros and cons of different sources of financing local government investment projects.

Table 2. Sources of Financing of Infrastructure Projects

| Source | Pros | Cons |
|---|---|---|
| Own resources | Cheap | Less predictable, rarely sufficient |
| Grants from EU and central governments | Cheap | Restriction on the use of funds, slow pace of approval, strict control |
| MFO loans | Long-term, grace periods, amortizing repayment | Foreign currency risk, restrictions on the use of funds |
| Domestic bank loans | Local currency | Short-term, restricted capacity |
| Bonds | Diversity of investors, liquidity, depth of markets | Expensive depending on size, bullet repayments |
| Own sources or borrowings of enterprises | No direct costs | Contingent liabilities and more expensive |
| PFI/PPP deals | No direct costs, more effective private sector provision of services | Long-term agreement with concessionaires, off-balance sheet risks |
| Investment banks and funds for local government unit | Deposit risk attenuation, lower interest rate, possibility of contributing to capitalization of the bank, local government unit could provide guarantee with their current revenues as well, the Bank can provide consulting services to the local government unit as an auxiliary service | Possible mix between having a role in the capitalization process and possibility of being granted a loan i.e. political interference, Local development fund could prove counter-productive to the objectives of sound, private credit market development. |

Source: M. Nikolov, *Report on the Process of Decentralization in Macedonia* CEA/USAID, 2007, p. 13, Table 2.

Local governments rarely maintain cash surpluses large enough to pay for the entire cost of big capital projects. They can either finance a capital project from own resources, by accumulating savings in their current account budget (pay-as-you-go financing) or by tapping credit markets (pay-as-you-use financing). Pay-as-you-go financing is paying for capital projects and acquisitions from sources other than debt such as current taxes and revenue, funds from capital reserves, special assessments or impact fees and grant revenue from federal, state, or foundation sources. Pay-as-you-use financing – every long-term improvement or expenditure is financed by serial debt issues with maturities arranged so that retirement of debt coincides with depreciation of the project. When a projects' useful life finally ends, the last dollar of debt is paid off (NALAS, 2011, p. 17).

Table 3 and Figure 1 below, present the share of local government revenues in the Republic of Macedonia as a percentage of GDP and of total public expenditures between 2004 – the year before the local government finance law went into effect – and 2010, when 73 of Macedonia’s 84 jurisdictions (90 % of the population) had entered into the second phase of decentralization (Levitas, 2011, p. 6).

Table 3. Evolution of Local Government Revenue 2004–2010 (in 2010 MKD)

| Year | GDP (bln MKD) | Public Expenditure (bln MKD) | LG Revenue (bln MKD) | Pct.of GDP (%) | Pct. of Public Expenditure | Per capita (bln MKD) |
|---|---|---|---|---|---|---|
| **2004** | 306.0 | 101.7 | 5.1 | 1.7% | 5.0% | 2,532 |
| **2006** | 358.3 | 119.9 | 7.2 | 2.0% | 6.0% | 3,553 |
| **2007** | 395.1 | 133.6 | 10.6 | 2.7% | 7.9% | 5,234 |
| **2008** | 435.1 | 153.1 | 20.1 | 4.6% | 13.1% | 9,933 |
| **2009** | 409.9 | 140.5 | 19.9 | 4.9% | 14.2% | 9,857 |
| **2010** | 430.6 | 151.6 | 23.3 | 5.4% | 15.3% | 11,510 |

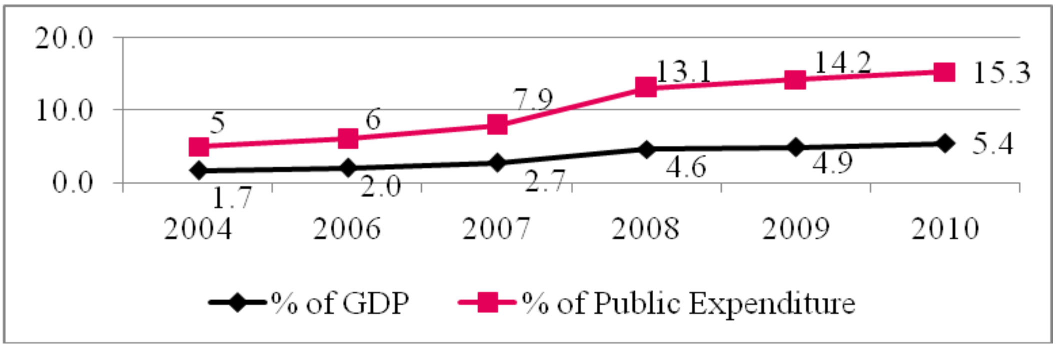
Table 4. Evolution of Local Government Revenue 2004–2010 (in 2010 EUR)

| Year | GDP (bln EUR) | Public Expenditure (bln EUR) | LG Revenue (bln EUR) | Pct.of GDP | Pct.of Public Expenditure | Per capita (bln EUR) |
|---|---|---|---|---|---|---|
| **2004** | 4.98 | 1.66 | 0.0830 | 1.7% | 5.0% | 0,041 |
| **2006** | 5.83 | 1.95 | 0.1172 | 2.0% | 6.0% | 0,058 |
| **2007** | 6.43 | 2.18 | 0.1726 | 2.7% | 7.9% | 0,085 |
| **2008** | 7.08 | 2.49 | 0.3273 | 4.6% | 13.1% | 0,162 |
| **2009** | 6.67 | 2.29 | 0.3240 | 4.9% | 14.2% | 0,161 |
| **2010** | 7.01 | 2.47 | 0.3794 | 5.4% | 15.3% | 0,188 |

*Note:* Transfers to local governments from the central government have not been netted out of the calculation of total public expenditures; for 2004 total public revenues were used instead of total public expenditures.

Source: T. Levitas, *Local Government Finances and the Status of Fiscal Decentralization in Macedonia: Statistical Review 2008–2011*, 2011, p. 6, Table 1.

Figure 1. Local Government Revenue as Share of GDP and Total Public Expenditures, 2004–2010 (in %)




Source: T. Levitas, *Local Government Finances and the Status of Fiscal Decentralization in Macedonia: Statistical Review 2008–2011*, 2011, p. 6, Chart 1.

As can be seen from the table and chart, there has been a remarkable growth in local government revenues as both a share of GDP and total public expenditures. Both have more than tripled since the beginning of Macedonia's decentralization process, while the per capita revenues of local governments have more than quadrupled. The progress with decentralization in Macedonia has proceeded quite rapidly and successfully (Levitas, 2011, p. 7).

Borrowing allows a local government to carry out more ambitious investments than otherwise would be possible. It also promotes intergenerational equity by having the future generations of citizens which will benefit from a facility's services pay for its construction. However, borrowing is not always an appropriate financing strategy. Borrowing to cover current expenditures or account deficits has just the opposite effects. It shifts the costs to future generations, while today's taxpayers enjoy the benefits (NALAS , 2011, p. 17).

Most of the local governments practice a combination of Pay-as-you-use and Pay-as-you-go policies. There are advantages and disadvantages to both approaches, local governments need to consider the merits of both methods to guide their future financing in accordance with a long term plan. "Pay-as-you-go" financing is normally useful for low cost repair and maintenance projects or the purchase of equipment with short useful life. "Pay-as-you-use" is appropriate for capital improvements with a high cost and a long useful life (NALAS, 2011, p. 17).

"Pay-as-you-go" financing (Probst, 2004):

1. Saves interest charges,
2. Capital projects must be evenly spaced over time,
3. Needed projects have to be delayed until necessary funds can be accumulated,
4. Not equitable if the population is relatively mobile.

"Pay-as-you-use" financing:

1. Avoids many of the problems of "pay as you go" financing,
2. Everyone pays for the capital improvements they use,
3. Ideally, all long-lived projects should be financed by debt that is retired over the course of the project's life.

When projects are built sooner, people benefit earlier. When projects are deferred, the benefits are postponed, as well. Many national and local governments in the developing world are looking closely at the benefits of using borrowed money to build the infrastructure needed for more and better local government services. Capital expenditure requirements are enormous and the flow of current revenues, government grants or donor funds will not be sufficient to meet those needs in the foreseeable future (Jackson, 2007, p. 10).

There is also the value of exposing local governments' development plans to public and expert analysis and the "discipline of the market". Local government taxpayers and national government officials can take some comfort from the knowledge that a local government's proposed infrastructure capital expenditure programmes will be subject to review by financial and technical experts before they are financed. These experts check that the proposed capital expenditures are appropriate and affordable for the local government. They assess whether they are willing to invest in that local government and determine what level of return they would require for their investment (Jackson, 2007, p. 10).

Local governments need to compare the need for funds (the estimate for the investment project) with the amount of loan they expect to receive in accordance with the legal limit for borrowing as well as to plan how much annual debt service they can make in order to repay the due amount.

The most important arguments for borrowing by local governments are as follows (Swianiewicz, 2004, pp. 5–7):

1. **Equitable burden of cost and access to benefits ("inter-temporal equity").** Borrowing over time is an effective way to overcome the problem of inequitable burden of costs among tax payers. Normally, the costs of an investment are incurred when the project is implemented (e.g., when a sewage treatment plant is constructed or a city bus is purchased), but the benefits from it are spread out over a longer period. When the capital project is financed from current revenues, those who financed it through their local taxes may not always benefit from it in the future if, for example, they move to another city. At the same time, those who benefit from the project may not have participated in financing it if they moved in to the city after it has been

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.

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 the reasons made clear in the previous point.
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 accessible 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 trying to attract an investor a few years from now on; 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.
4. **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 those 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.
5. **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.
6. **Stabilization of required budget resources.** As noted above, the volume of capital spending in local government units fluctuates from one year to another. If capital

projects are financed from current revenues, the demand for resources changes over time, as well. In countries where a large proportion of local revenues is raised through local taxes, an irrational fluctuation of local tax rates may result.

7. **Access to grants from European and other development funds.** This rationale for borrowing is more specific to Central and Eastern European countries, where there are several investment grants available for local authorities. A necessary condition, however, is to provide own matching funds. Usually this is at least 25% of the total project costs (such as SAPARD or ISPA projects). Moreover, in many cases the local government is required to cover all costs related to the investment, and reimbursement occurs only after completion of the project. Borrowing may be a means of increasing local capacity to apply for these development grants.

For most local governments in developing countries a rapid increase in spending on infrastructure projects is needed as soon as possible, not only to build new infrastructure but to refurbish existing infrastructure. Borrowing for capital expenditure can make this possible. Borrowing can provide large capital sums for immediate use, and the resulting longer term debt can be serviced from a regular stream of local government income, whether directly from revenues resulting from the investment or indirectly through increased tax revenues. Additionally, there is a growing trend toward the decentralisation of service delivery, where locally elected councils decide on capital expenditure priorities and are expected to raise some or all of the funds to meet them (Jackson, 2007, p. 10).

However, 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 (Swianiewicz, 2004, p. 7).

Some local governments have high share of special revenues and are thus less dependent on transfers from the central government. This provides them a more stable budget to finance capital investments. Such local governments meet the preconditions to obtain a credit rating that will enable them to choose in future whether their borrowing is cheaper in the form of credit or securities (municipal bonds). The rest of the local governments have limited capacity to perform their main functions stipulated by law. Due to high insecurity and risk, these local governments do not meet the requirements for borrowing, considering their fiscal stability and the question of debt sustainability. However, each local government should understand its capabilities and on this basis to define its medium-term development policy.

## 3.2 Debt Management

Debt financing enables local governments to carry out more infrastructure projects in a shorter period of time compared to the financing from own funds. But, the risks associated with borrowing have to be understood well in terms of their potential impact on local budget in the future. Thus, before local governments to start the borrowing procedure, it is recommended that each local government has in place a debt management strategy and a written debt policy. The debt management strategy should ensure that the local government maintains at all times an adequate level of indebtedness which would not impair its financial stability and would enable it to implement the investment objectives (NALAS, 2011, p. 14).

Any decision to fund local government investment needs through borrowing has to be accompanied by debt management capability and capacity at the local level. It is crucial that debt management capacity and capability should be enhanced as local borrowing also bears substantial financial risks for local governments (e.g. when debt repayment exceeds the financial capacities of local budgets) (NALAS, 2011, p. 18).

Debt management is a set of measures and activities the local government undertakes within the responsibilities specified in the Public Debt Law or other law. In the Republic of Macedonia borrowing by local government units, public enterprises and companies fully or predominantly owned by local governments units and the City of Skopje is carried out in accordance with Public Debt Law, the Law on Financing of the Local Self-Government Units and the Law on the City of Skopje. The manner and the procedure for borrowing by local government units, public enterprises and companies being owned by the state and the local governments is regulated in more detail by the Government of the Republic of Macedonia.

According to the national methodology, public debt of the Republic of Macedonia comprises general government debt, debt of both public enterprises and companies being fully or predominantly owned by the state, local governments and the City of Skopje as well as debt of the National Bank of the Republic of Macedonia (NBRM). However, debt of the NBRM, pursuant to the Public Debt Law, is only used for statistical purposes, not being subject of the Public Debt Management Strategy.

General government debt includes all financial obligations created through borrowing by the Republic of Macedonia, including the debt of the local governments and the City of Skopje, not including the debt of public enterprises and companies being fully or predominantly owned by the state, local governments and the City of Skopje and of the NBRM.

Debt of local government, of public enterprises and companies owned by the state or local governments and the debt of the National Bank of the Republic of Macedonia is included in the calculation of public debt, but it is not a liability of the Budget of the Republic of Macedonia, except in cases of issuance of sovereign guarantee.

Servicing of liabilities in respect with local borrowing is made by local government units. In case when the Republic of Macedonia borrows and on-lends the funds to the local governments, servicing of liabilities is made by the local government units which are the final beneficiaries of the resources obtained by borrowing from the Republic of Macedonia. In case the Ministry of Finance, on behalf of the local government, services the liabilities, the Ministry of Finance is entitled to collect the claims including principal, interest, default interest and other costs incurred due to the inability of local government as final beneficiary of the borrowing to service the liability on the due date.
In case the local government fails to pay the claim to the Ministry of Finance, the Ministry of Finance is permitted to:

1. shift resources from the local government's budget account to the account of the Budget of the Republic of Macedonia up to the amount necessary to collect the claim,
2. keep a part of the grants to be distributed to local government up to the amount necessary to collect the claim.

The next table represents consolidated general government budget.

Table 5. Consolidated General Government Budget

| **Consolidated General Government Budget** | **2010** | **2011** | **2012** |
|---|---|---|---|
| (millions MKD/EUR) | | | |
| Consolidated Government Budget-revenues | 151.474/2.46 | 159.188/2.59 | 169.610/2.76 |
| % of GDP | 35,8 | 35,6 | 35,3 |
| Consolidated Government Budget-expenditures | 161.927/2.64 | 170.259/2.78 | 179.214/2.92 |
| % of GDP | 38,3 | 38,1 | 37,3 |
| Consolidated Government Budget-Deficit | -10.453/0.17 | -11.071/0.18 | -9.604/0.16 |
| % of GDP | -2,5 | -2,5 | -2,0 |
| Central Budget-revenues | 85.350/1.39 | 92.294/1.51 | 102.149/1.67 |
| % of GDP | 20,2 | 20,7 | 21,2 |
| Central Budget-expenditures | 94.547/1.54 | 101.628/1.66 | 109.378/1.78 |
| % of GDP | 22,3 | 22,8 | 22,8 |
| Central Budget-deficit | -9.197/0.15 | -9.334/0.15 | -7.229/0.12 |
| % of GDP | -2,3 | -2,1 | -1,5 |
| Extrabudgetary funds-revenues | 44.459/0.73 | 44.417/0.72 | 44.397/0.72 |
| % of GDP | 10,5 | 9,9 | 9,2 |

*"(table continues)"*

"(continued)"

| Consolidated General Government Budget | 2010 | 2011 | 2012 |
|---|---|---|---|
| Extrabudgetary funds-expenditures | 45.715/0.75 | 46.154/0.75 | 46.772/0.76 |
| % of GDP | 10,8 | 10,3 | 9,7 |
| Extrabudgetary funds-deficit | -1.265/0.02 | -1.737/0.03 | -2.375/0.04 |
| % of GDP | -0,3 | -0,4 | -0,5 |
| Local government budget-revenues | 21.665/0.35 | 22.477/0.37 | 23.064/0.38 |
| % of GDP | 5,1 | 5,0 | 4,8 |
| Local government budget-expenditures | 21.665/0.35 | 22.477/0.37 | 23.064/0.38 |
| % of GDP | 5,1 | 5,0 | 4,8 |
| Local government budget-deficit | 0 | 0 | 0 |
| % of GDP | 0,0 | 0,0 | 0,0 |
| GDP | 423.080/6.90 | 446.654/7.29 | 480.702/7.84 |

Source: Ministry of Finance of the Republic of Macedonia, *Public Debt Management Strategy of the Republic of Macedonia for the period 2010 to 2012*, 2010, Table 1.

Total expenditures in the period 2010–2012 in conditions of rational management of public finances at all government levels, according to the planned policies and low level of budget deficit, decline as a share of GDP from 38.3% in 2010 to 37.3% in 2012. Such determined main postulates of the fiscal policy provide for optimal level of budget deficit of around 2% of projected GDP on the medium term. This level of budget deficit ensures sustainable level of both general government and public debt on the medium run, without jeopardizing the ability of the country to timely and regularly service its liabilities (Ministry of Finance of the Republic of Macedonia, 2010, p. 6).

### 3.2.1 Debt Policy

Any local government planning to issue a debt should adopt a written debt policy. A formal debt policy is essential to effective financial management. Debt policies are written guidelines and restrictions establishing maximum debt thresholds, the type of debt to be issued and at the same time documenting the issuance process. Such policy helps establish limits and provide general direction to local government executive officials in the planning and issuance of debt. A carefully crafted and consistently applied debt policy signals lenders and rating agencies that the local government is committed to a sound and sustainable financial management (NALAS, 2011, p. 19).

The policy must be developed within the framework of existing laws and based on projections of the local government's future condition. It anticipates future financing needs and limitations that the policy imposes. Specifically, it should address the following questions (NALAS, 2011, p. 20):

1. What are acceptable levels of short and long term debt? Debt issuance involves a trade-off. In exchange of funds for current capital improvements, future spending is limited. The degree to which a local government is willing to make these trade-offs depends on the urgency of its capital needs, its expected rate of growth, economic trends and the stability of its overall finances.
2. What are acceptable purposes for which debt can be issued? Does the investment have a life-span which equals at least the duration of the debt-repayment schedule?
3. To what extent and for what purposes will the local government use general obligation debt vs. revenue debt?
4. What covenants, pledges, or securities is the local government willing to give, in order to make borrowing possible and/or lower the cost of borrowing?
5. How will the local government ensure that the borrowing is made under competitive conditions (i.e. obtain the lowest possible cost).

Public debt management policy should include:

1. determining the amount (limit) of debt on the medium term;
2. determining the amount (limit) of guarantees on the medium term;
3. maximum amount of new borrowing in the current year;
4. maximum amount of newly issued guarantees in the current year;
5. identification, monitoring and managing risks which the debt portfolio is exposed to;
6. financing the needs of the local government with the lowest possible costs on the medium and the long-term and sustainable level of risk, and
7. development and maintenance of an efficient domestic financial market.

Furthermore, a debt policy: establishes maximum debt thresholds and ensures that proper procedures are in place to keep debt within limits, communicates with citizens the importance placed on financial management and to investors that the local government is being prudent with its resources, communicates with the financial community that the local government is prudent and has a policy basis for debt (NALAS, 2011, p. 20).

Debt management may be defined as a process of providing payment of interest and principal payments on existing debt, and the planning for incurrence of new debt at a level which will optimize borrowing costs and not weaken the financial position of the local government. Estimating the impact of the current and future debt burden on the local budget in future years is also a part of the debt management process. The financial position of a debtor determines its maximum borrowing capacity as well as the cost of borrowing. Thus, the maximum indebtedness capacity of a local government varies in time, depending on economic and market conditions. However, in future each local government unit should understand its capabilities and on this basis it should define its medium-term development policy (NALAS, 2011, p. 18).

# 4 GENERAL FINANCIAL FRAMEWORK OF THE LOCAL GOVERNMENTS

The design of intergovernmental fiscal structure along with the accounting system and reporting procedures are important factors that are taken into consideration by financial institutions when assessing the opportunity to finance local governments. By establishing the general structure of local revenues and expenditures, the intergovernmental fiscal framework determines in broad terms the borrowing capacity of local governments from within a country (NALAS, 2011, p. 20).

In formulating a local government debt policy, policy-makers must decide a number of important issues which must comply with the corresponding legal framework concerning local government debt as well as borrowing procedures. The frameworks vary across countries, although the underlying issues are largely the same. Developing an efficient and prudent debt policy requires first of all thorough knowledge and understanding of the laws and regulations that govern all the fields related to local borrowing. The legal framework for local borrowing provides a set of clear and comprehensive rules that would guide local governments seeking external financing. The legal framework defines the overall objectives for debt management, sets out borrowing restrictions, clarifies the transparency and accountability and outlines the budgetary and financial reporting and auditing requirements. Procedures for local government default, insolvency or what happens in case of financial market failures are other areas which should be regulated in the legal framework for borrowing (NALAS, 2011, pp. 20–21).

In terms of legal framework, the Republic of Macedonia has a solid base for financial management regulating the level of the local government borrowing. The legal framework for local borrowing is regulated by the Public Debt Law and the Law on Financing of the Local Self-Government Units. The Law on Financing of LGUs regulates the limits for short-term and long-term debt of the local governments related to the total short-term debt of the local government and the total annual repayment of the long-term debt. Bylaws for borrowing are in the form of Rulebook of the format and the contents of the request for borrowing of the public institutions established by the Republic of Macedonia and the local governments, local governments and the City of Skopje and Rulebook of the format and the contents of the request for borrowing of the public enterprises and companies fully or predominantly owned by the local governments, the local governments and the City of Skopje. These Rulebooks are designed to standardize the format and contents of the request for borrowing, which local governments (holders of public debt) submit to the Ministry of Finance in order to establish a simpler procedure for approval of the borrowing.

## 4.1 Intergovernmental fiscal relations

In some countries intergovernmental transfers constitute important source for sustainability of local public finances, whereas in others they even constitute dominant part. Central governments regularly increase the level of their financial involvement in local governments.

The Republic of Macedonia has chosen a system of decentralization with gradual transfer of responsibilities and resources to perform the transfer competencies. Intergovernmental transfers signify grants meaning transfer of financial assets from the Budget of the Republic of Macedonia and from budgets of the Funds to the local governments' budgets. The grant scope, type, structure and quality are supplementary to the goals of the fiscal system established by each country, and as a result, this area differs against different countries (Bexheti & Ismaili, 2007, p. 46).

The phased approach to fiscal decentralization is closely connected with the inter-governmental transfers. The major principle of this phased approach is to allow a gradual devolution of responsibilities in line with the demonstration of greater capacity by local governments to undertake those responsibilities, and to provide an equitable and adequate transfer of funds for an efficient and ongoing execution of transferred competencies. The first phase started with the introduction of the earmarked grants and local governments obtained the right to administer revenues coming from own sources and (earmarked) grants from the central government budget. The second phase started with fulfilment of certain conditions and local governments started to finance transferred competencies in education, child care, social protection and culture with block grants. With the entrance of the local governments in the second phase of the fiscal decentralization funds for salaries and allowances in local public institutions were transferred from the central government budget. This ensures proper proportionality of funding for the transfer competencies. In 2011 also the competencies for management of construction land and treatment of illegally constructed buildings were transferred to local governments.

Grants from the Budget of the Republic of Macedonia and budgets of the Funds provide additional revenues to the Budget of the local government for financing its competencies determined by law. The Law on Financing of LSGU's envisions the following types of grants to be allocated from the Budget of the Republic of Macedonia and budgets of the Funds:

1. VAT revenues (total fund equal to 4 % of the VAT collections in the previous fiscal year). This unconditional grant is distributed by a formula with at least 50 % according to population (per capita) and other criteria stipulated in a Decree on the Methodology on Allocation of Revenues from VAT. The methodology makes separate provisions for

the City of Skopje. Grant from VAT is a general grant which is not conditioned and local government decides independently on the use of the revenues from VAT.

2. Pursuant to the Decree total funds of revenues from VAT which is collected in the previous fiscal year are distributed in the following manner: constant amount of 3 million denars for all local governments including the local governments of the City of Skopje and the City of Skopje. Other part of this revenue-grant from VAT is distributed as variable portion to local governments in Macedonia in the amount of 88%, and local governments in Skopje and City of Skopje in the amount of 12%. Variable part of funds for local governments in Macedonia is distributed according to the following criteria: 65% by number of inhabitants in the local government, 27% by area of the local government and 8% by number of settlements in the local government. Part of the grants for local governments in Skopje and City of Skopje is distributed in the ratio 60%:40%. The proportion of local governments in the City of Skopje is allocated according to criteria that apply to local governments in Macedonia (65% by number of inhabitants in the local government, 27% by area of the local government and 8% by number of settlements in the local government).
3. Earmarked transfers (grants) for financing a special activity. The appropriate ministries and agencies/Funds monitor the use of the earmarked funds.
4. Capital transfers (grants) according to the program prepared by the Government of the Republic of Macedonia are used to finance investment projects. The respective Ministries and Funds, in distributing the capital grants, give priorities to projects with fully defined financial structure. The competent Ministries and Funds monitor the earmarked usage of the grant of this article.
5. Block transfers (grants). These grants are used for financing the local government competencies determined by law. Local government decides for spending of these funds regarding the activity that has to be financed, but the line Ministries and Funds monitor the execution of these grants. The appropriate ministries and agencies are responsible for defining the methodology and criteria to be used in the transfer formula. The amount of block grants should not be lower than the amount of funds from the Budget of the Republic of Macedonia that have been used for the same purpose in that field in the previous year from the year in which the appropriate competence is being transferred.
6. Funds received for delegated competencies. This grant is used for financing the delegated competency from the state administration to the mayor. In this case the amount of funds is determined with a contract signed by the mayor of the local government and the appropriate ministry responsible for the competence.

The structure of local government revenues has changed radically since the beginning of the second phase of the decentralization process. Figure 2 below illustrates how the block grants for social sector functions have radically increased the total local government revenues (Levitas, 2011, p. 9).

Figure 2. Composition of Local Government Revenues (2010 billion MKD)

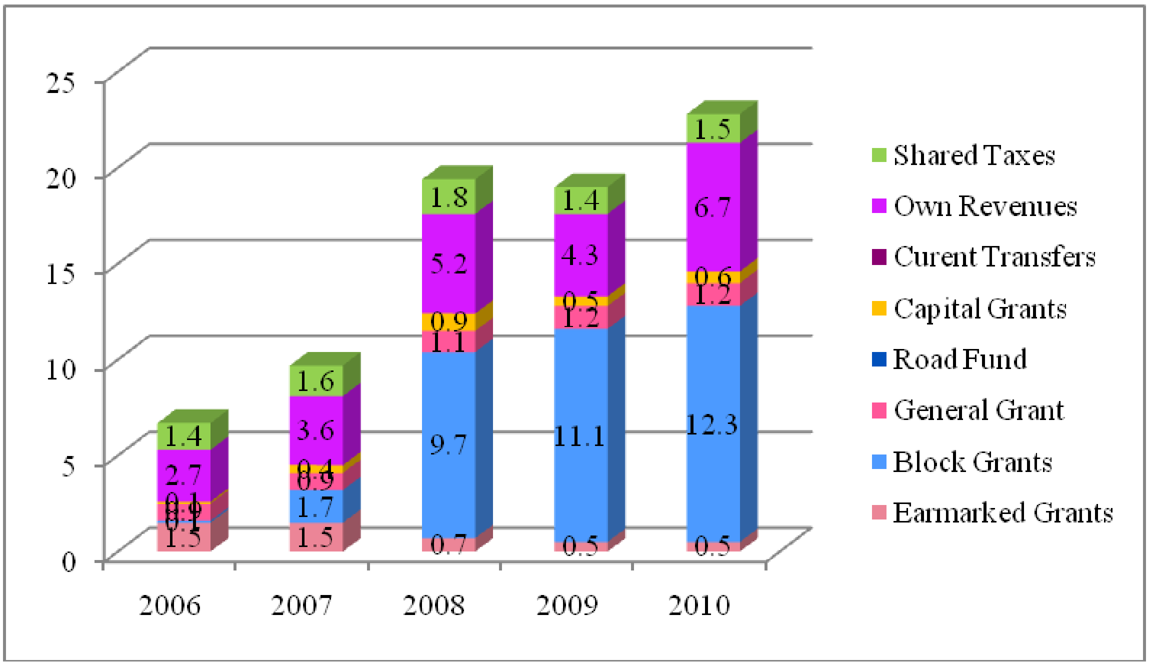
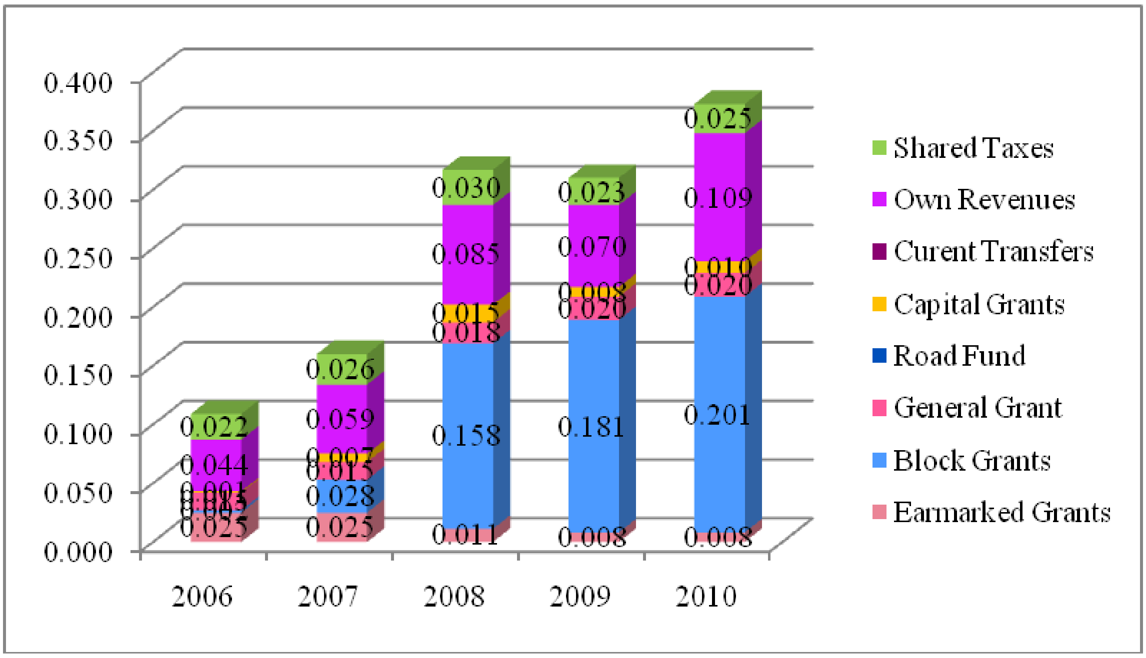



Figure 3. Composition of Local Government Revenues (2010 billion EUR)




Source: T. Levitas, *Local Government Finances and the Status of Fiscal Decentralization in Macedonia: Statistical Review 2008–2011*, 2011, p. 9, Chart 2.

### 4.1.1 Vertical equalization

Experience across regions indicates that the potential benefits of decentralization will be materialized if only intergovernmental fiscal relations are supported by substantial vertical and eventually horizontal transfers to local governments in order to compensate for the lack of locally generated revenue and to provide stability, equity and efficiency. These transfers can take many forms, with a varying degree of control, conditionality and equalization, which reflect political priorities (Boschmann, 2009, p. 8).

The differences in fiscal disparities among units of governments are called fiscal imbalances, and represent the unequal conditions under which the government units are discharging their competences. There are two types of fiscal imbalances. Vertical fiscal imbalances refer to the difference in fiscal disparities between the central government and all local governments together. Horizontal fiscal imbalances refer to the differences in fiscal disparities among governments at the local level (Musharraf, Martinez & Timofeev, 2009, p. 5).

Both central and local governments are required to provide public services. It is common to find that the own-source revenue raising powers of local governments are insufficient to meet the costs of providing the services they have been assigned to. The resulting gap can be filled only by increasing local revenue raising powers or by increased transfers. For the reasons that include concern for macroeconomic stabilization, the lack of appropriate local revenue bases, and the low capacity to administer taxes locally, transfer mechanisms may be the more suitable way to achieve vertical equalization (Nikolov, 2006, p. 81).

### 4.1.2 Horizontal equalization

There are often wide differences in the ability of local governments to mobilize resources across localities. If only local taxes were available to finance local services, there would be substantial inter-jurisdictional differences in the quantity and quality of public services. Inter-governmental transfers can be used to help equalize those differences. Transfer systems should distribute resources between local governments in a manner that accounts for differences both in the expenditure needs (providing more to those with greater need where the need factor includes variations in the unit cost of producing public services) and in the fiscal capacity (providing less to those with greater capacity). Specifically, it should attempt to decrease or equalize these differences (Nikolov, 2006, p. 82).

There is wide consensus in literature that the potential benefits of both, decentralization in general, and fiscal decentralization in particular, will materialise if only such allocation system relies on a stable, equitable and efficient horizontal allocation mechanism in order to provide stability, equity and efficiency. As such, formula-based grants can be an important component of intergovernmental fiscal relations. Furthermore, there is a consensus among fiscal experts that rules of transfer systems should be clear and transparent and should encourage behaviour consistent with good management practices/give incentives for good fiscal performance and not encourage local governments to “remain poor” to receive more funds. Formulae are mostly based on the idea that districts with a higher population deserve a higher allocation; districts that are poorer deserve a higher allocation. In some countries, further aspects are added: districts that improve their local revenue collection (as compared to the previous year) deserve a bonus; and finally districts which have a larger gap between what they locally collect and what they need for staff expenditure deserve a large allocation (Boshman, 2009, p. 44).

The following guidelines are often given for defining appropriate allocation formula (Boshman, 2009, p. 44):

1. Keep it as simple as possible;
2. Keep it transparent and objective (i.e. the outcome cannot be manipulated by any of the involved parties by manipulating the data for the variables);
3. Variables need to have an unequivocal relation with the purpose of the grant and should not be related;
4. Variables should be avoided that create disincentive to enhance performance either revenue or expenditure sides.

The Republic of Macedonia is moving towards the implementation of a comprehensive transfer system with some conditional grants for current and capital expenditure programs and with an equalization grant based on fiscal disparities (defined as difference between expenditure needs and fiscal capacity), whereby for all local own services expenditure needs (thus excluding delegated responsibilities to be financed with conditional sector grants) be defined on the basis of per client expenditure norms defined for separate expenditure categories (Musharraf, Martinez & Timofeev, 2009, p. 46).

The intergovernmental transfer system plays a key role in establishing the local governments’ revenues base. It constitutes an important share of local government’ total revenues and may act as security on local government debt. Very often intergovernmental transfers, if not tied to particular investments, are a key feature of local government budgets and play a crucial role in financing of capital expenditures (NALAS, 2011, p. 22).

## 4.2 Accounting systems and reporting procedures

Financial institutions need readable, credible, transparent and comparable financial documents and reports as an input in the credit risk analysis of local governments. This can be achieved if only local governments adhere to national accounting standards which accurately reflect the true financial position of local governments. Authorisation process of local borrowing should ensure that all legal aspects related to local indebtedness are met;

there is a real necessity to pursue external financing which benefits the local economy and the financial stability of the local government is not threatened by the future debt repayment. Limits to local indebtedness should be clearly stipulated in legislation on local public debt and should include at least the purpose of borrowing and maximum debt thresholds (NALAS, 2011, p. 9).

However, regulatory framework alone cannot support the development of a healthy local government credit market. Unless local governments can demonstrate that they have a track record of reliable revenues from which repay the debt, financial institutions will not enter into financing agreements with local governments. Basically, it is the financial health of a local government that determines its creditworthiness. In general, own revenues and shared taxes account for the largest share in local governments' budgets and these revenues should be the main source for local governments to pay back the debt (NALAS, 2011, p. 21).

Accounting is one of the most important functions of an organization, whether it is a non-profit, public institution, local government, or multi-national business-oriented firm. Accounting is also a vital element of everyday local government life, recording the entity's development and, after analyzing figures, suggesting paths for the future. Accounting summarizes and submits all financial information in reports and statements. The reports are intended for the local government itself, for the central government, and for outside parties. Concise, accurate and reliable accounting helps local government management to formulate appropriate decisions for development, expansion and sustainability of a financially healthy local government. In almost all countries with well-conceived decentralization strategies and effective, well-managed local governments, external independent audits have a very important role in high quality financial management. Not the least of the benefits of an annual external independent audit is the development and preservation at a high level of local government creditworthiness. There are many other benefits of independent external audits, including overall high quality financial management and improved transparency and accountability to citizens (United States Agency for International Development, 2008).

Accounting policies, accounting evidence, inventory of material assets, revenue classification and interpretation of capital transfers by the central authority in the Republic of Macedonia are regulated by the laws and by-laws below: Law on Accounting of the Budget and Budget Beneficiaries, Law on Financing of Local Self-Government Units, Law on Public Internal Financial Control, Rulebook for the Form and Content of the Reports and the Statement for the Quality and the Condition of the Internal Controls from the Annual Financial Report, Rulebook for the Way of Implementation of the General Financial Processes, Rulebook for the Way of Implementation of the Competences of the Finance Affairs Unit, Rulebook for the Manner for Granting Authorizations, Rulebook for the Basic Elements of Financial Management and Control and Internal Control Standards in the Public Sector, Rulebook for the Form, Content and the Way for Submission of the Statement for Quality and Condition of the Internal Controls, International Standards for the Professional Practice of Internal Auditing, Rulebook for Code of Ethics of the Internal Auditors, Rulebook for the Charter for Internal Audit, Rulebook for the Manner of Performance of the Internal Audit and the Manner on Reporting for the Audit, Regulations Book for Accounting for Budget and Budget Users and Guidelines for Internal Control Standards for the Public Sector.

Local governments and the public services keep accounting records in accordance with the Law on Budget Accounting and Budgetary Beneficiaries, consistent with generally accepted accounting principles, practices and standards, and in keeping with international accounting standards for the public sector. The Mayor places an accountant in charge (he or she must be a graduate in economics with at least five years of employment in the field of financing) who, alongside the Mayor is responsible for the legality of local government accounting (Nikolov, 2006, p. 87).

Accounting in local government units, or acknowledgement of revenues and expenditures and assessment of balance positions are carried out according to the accounting principle on "cash statement" i.e. cash-based, which principle is consistently applied by all local governments. The next table presents the accounting systems and standards as well as reporting procedures that local governments in South-East Europe countries apply.

Table 6. Accounting Systems and Standards, Reporting Procedures

| **Cashed based accounting system** | **Modified accrual accounting system** | **Accrual accounting system** | **International public sector accounting standard (IPSAS)** |
|---|---|---|---|
| Cash based accounting system recognizes revenues and expenditures only when cash is received or spent. | Modified accrual accounting system recognizes the revenues in the period they become available and measurable, and the expenditures are recognized in the period the associated liability is incurred. | Accrual accounting system recognizes the financial effect of transactions when they occur, regardless of the timing of related cash flows. | IPSAS are accounting standards for use by public sector entities around the world in the preparation of financial statements. |
| Albania, Kosovo, Macedonia, Moldova, Serbia, Slovenia | Bulgaria, Croatia, Montenegro, Republika Srpska, BIH, Turkey | Romania | Croatia, Macedonia, Moldova, Montenegro, Romania, Serbia |

Source: *NALAS*, 2011, p. 23, Table 1.

Regardless of the system in use, the most important and necessary condition for local borrowing in this respect is that local governments adhere to the national accounting standards in place. This determines whether financial documents and reports are readable, transparent and comparable for potential investors, as they need this information in order to assess the creditworthiness and credit risk (NALAS, 2011, p. 24).

### 4.2.1 Treasury management

There is a single treasury system, so that, in principle, the government knows at all times the aggregate amount of resources available in the Treasury. The Ministry of Finance has also developed a manual on treasury management for the local government units. This means that although individual local governments maintain records of their own finances, their accounts are actually under the control of the central government (Nikolov, 2006, p. 87).

### 4.2.2 Reporting

Quality financial statements and the quality of information provided by the financial reports are grounded on many requirements, including existence of accounting policies, explanations and interpretations accompanying financial reports. Local governments in accordance with the Law on Financing of LSGUs prepare internal financial reports on a monthly basis and prepare quarterly reports to the Ministry of Finance. The Ministry has prepared guidelines and rulebooks for local governments on how to report, including arrears, borrowing, financial planning, etc. Periodical financial statements, adoption of annual account and statement are defined in the Law on Financing of LSGUs and the Rulebook for the form and content of the periodical financial statements of local governments.

Periodical financial reports are as follows:

1. Monthly report on local government budget beneficiary on the reporting period (cumulative) to the month the report refers to;
2. Monthly report on local government budget beneficiary on the due outstanding obligations;
3. Quarterly report on realization of the local government budget (cumulative) to the quarter the report refers to;
4. Quarterly report on due outstanding obligations of the local government (cumulative) to the quarter the report refers to, and
5. Quarterly report on local government indebtedness.

### 4.2.3 Internal and external audit

Internal audit is an assurance function that primarily provides an independent and objective opinion to the local governments of the degree to which the internal control environment supports the achievement of its objectives. Internal audit also seeks to help line management improve the internal control environment in an organization. The role of the internal audit is to give a support to the line management of the local government unit in the accomplishment of the objectives of the unit through:

1. Preparation of strategic and annual plans for internal audit on the basis of an objective risk assessment as well as performing separate internal audits in accordance with adopted audit plans.
2. Assessment of adequacy, economy, efficiency, effectiveness of the financial management and control system for determination assessment and risk management by the management of the unit in relation to: conformity with the laws, by-laws and the internal acts and contracts; credibility and completeness of the financial and operational information and safety of the information.
3. Giving recommendations for improving the operations and the work procedure.
4. Monitoring of implementation of measures undertaken by the head of public sector entity on the basis of executed audits.

The local government units are obliged to establish an internal auditing system and procedures consistent with international standards for the performance of a professional audit acceptable to the Ministry of Finance. The internal auditor is appointed by the Municipal Council upon a proposal from the Mayor. The internal auditor has an independent function and answers both to the Mayor and the Council. Table 7 demonstrates the development and results of internal audit on local level.

Table 7. Development and Results of Internal Audit on Local Level

| | **2006** | **2007** | **2008** | **2009** | **2010** | **2011** |
|---|---|---|---|---|---|---|
| **Established internal audit units** | 0 | 17 | 32 | 40 | 49 | 59 |
| **Internal auditors** | 15 | 27 | 33 | 35 | 44 | 52 |
| **Heads of Internal Audit Units** | / | / | 15 | 18 | 19 | 18 |
| **Internal audit reports** | 88 | 107 | 134 | 132 | 172 | |
| **Recommendations** | 455 | 626 | 707 | 815 | 1033 | |
| **Percent of implemented recommendations** | 60 | 68 | 69 | 58 | 72 | |

Source: Ministry of Finance of the Republic of Macedonia, *State of the System for Internal Audit*, 2012.

The external audit of financial accounts is carried out by the State Auditing Service. The Mayor has responsibility to provide the State Auditing Service with a report on the implementation of the Budget in addition to a final accounting report.

## 4.3 Borrowing provisions

According to the Public Debt Law, the Government of the Republic of Macedonia, on behalf of the Republic of Macedonia, concludes a loan agreement which is signed by the Minister of Finance on behalf of the Government of the Republic of Macedonia. Borrowing procedure of the public debt issuers begins upon prior consent of the Ministry of Finance. The Ministry of Finance provides consent for borrowing of the local governments taking the limits for short-term and long-term borrowing into account regulated in the Law on Financing of the Local Self-Government Units. Local governments may give initiative on commencing negotiations for borrowing upon prior approval by the Ministry of Finance. This initiative includes the following:

1. decision on borrowing including the amount and purpose of such borrowing,
2. request for borrowing containing project data and data on financial capacity of the local government.

Representatives of the Ministry of Finance and other authorized representatives of the Government of the Republic of Macedonia are obliged to participate in such negotiations. Local governments (public debt issuers) conclude loan agreement for each new foreign borrowing upon adoption of a separate law and for each new domestic borrowing local government conclude loan agreement upon adoption of a decision by the Government of the Republic of Macedonia.

### 4.3.1 Short-Term Borrowing provisions

As to the short-term borrowing, the loan should be repaid within 12 months from the date of signing the loan agreement, and total debt of the local government made on the basis of short-term borrowing and short-term loan from the Central State Budget of the Republic of Macedonia during the fiscal year, may not exceed 30% of the total realized revenues of the current-operating budget of the local government in the previous fiscal year. Total revenues of the current operational budget are all budget revenues, except for earmarked grants from the Budget of the Republic of Macedonia and the budgets of Funds intended for financing capital investments, assets from the self-imposed tax and assets obtained from loans.

### 4.3.2 Long-Term Borrowing provisions

In the long-term borrowing, the total annual repayment of the debt (the principal, the interest and the other costs) made on the basis of long-term borrowing and long-term loan from the Central Budget of the Republic of Macedonia may not exceed 30% of the total revenues in the current-operating budget of the local government in the previous fiscal year. The total amount of undue long-term local government debt, including all guarantees may not exceed the total revenues of the current-operating budget of the local government in the previous year. According to the Law on Financing of LSGUs the local government may borrow long term for: financing of capital projects and investments, refinancing of debts arising from borrowing for financing of the capital projects and investments, liabilities of activated state guarantees, liabilities based on loans and for protection and elimination of consequences of natural and environmental disasters. The Municipal Council approves the long-term borrowing. The local government may borrow or issue a guarantee upon the Decision issued by the Municipal Council. The Council decision applies only if the borrowing agreement or issuing of the guarantee is concluded in the fiscal year in which it is made. The funds provided by long-term borrowing are used for the purpose for which they are approved.

Local governments can provide various types of loan repayment guarantees. They can pledge physical assets, general revenues from taxes and transfers, or project generated revenues from user fees or charges collected from the project's beneficiaries. They can also provide guarantees for local public enterprises and companies. Public enterprises and companies being fully or predominantly owned by local governments may borrow only after a guarantee is issued by the Municipal Council. The local government reserves the funds in its budget for the possible costs for payment upon the issued guarantee. The Mayor of the local government unit is obliged to notify the Ministry of Finance for any guarantee issued. The types of allowed guarantees and collaterals that local governments in South-East Europe countries can provide are shown in the Table 8.

Table 8. Type of Allowed Guarantees and Collaterals

| | **Allowed** | **Not allowed** |
|---|---|---|
| **Own revenues** | Albania, Bulgaria, Croatia, Kosovo, Macedonia, Moldova, Montenegro, Republika Srpska, Romania, Slovenia, Turkey | |
| **Physical property** | Albania, Bulgaria, Kosovo, Macedonia (partly), Montenegro, Slovenia, Turkey | Croatia, Moldova, Republika Srpska, Romania |
| **Reserve funds** | Albania, Croatia, Kosovo, Macedonia, Montenegro, Turkey | Bulgaria, Moldova, Republika Srpska, Romania, Slovenia |
| **Private insurance** | Slovenia | Bulgaria, Croatia, Kosovo, Moldova, Republika Srpska, Romania |
| **Others** | Macedonia: Credit enhancements (guarantees by USAID through Development Credit Authority) | |

Source: *NALAS*, 2011, p. 35, Table 5.

The Government of the Republic of Macedonia may guarantee and take liabilities deriving from the long-term borrowings of local governments, including also public enterprises established by the local government, only in cases when liabilities are undertaken according to Law on issuance of a sovereign guarantee. On behalf of the Republic of Macedonia, the Minister of Finance signs the agreement on issuance of a sovereign guarantee.Local governments and the public enterprises established by local governments cannot begin a borrowing procedure as from the day of adoption of the Decision for local elections until the election of a Mayor or members of the council.

The financial framework of local governments plays a key role in the sustainable development of local capital markets. The design of intergovernmental fiscal structure together with the accounting system and reporting procedures are important factors that are taken into consideration by financial institutions when assessing the opportunity to finance local governments. By establishing the general structure of local revenues and expenditures, the intergovernmental fiscal framework determines in broad terms the borrowing capacity of local governments from within a country. Limits to local indebtedness should be clearly stipulated in legislation on local public debt and should include at least the purpose of borrowing and maximum debt thresholds (NALAS, 2011, p. 20).

# 5 TYPES OF DEBT INSTRUMENTS

There are two major types of debt instruments available to finance local government capital expenditures: loans and bonds.
Both bank loans and bonds have strengths and weaknesses. Since bond issuance goes along with many disclosure requirements, bonds contribute to more transparency in local government, from which the public would profit as much as lending institutions. Thereby, the monitoring function of the public may contribute to strengthening accountability. However, some local governments might rather avoid the modality for that particular reason. Local government may borrow by signing the loan agreement and issuance of securities (bonds). Even if borrowing appears to make the most sense, the type of borrowing that is most appropriate to finance capital projects needs to be considered. Local governments may borrow through a local or national bank and they can issue debt in either the domestic or international capital markets, as well.

## 5.1 Bank Loans

Most local governments borrow money from the bank to solve the liquidity problems, to overcome the discrepancy between the revenues and expenditures, to level the fluctuations in income and to realize investment project. In this respect, many local governments have approached banks for larger sums for capital investment. Most banks lend to local governments only for short term, or approve loans for few years (2–5 years), which is hardly adequate for large infrastructure projects. Regarding the aforementioned, most commercial banks are not involved in long-term financing of the local governments. Having in mind that banking regulations limit the banks to make long-term loans because their liabilities (deposits) are short-term and volatile and their assets (loans) are long-term, this is not unusual.

The cost of the bank loan is made up from the interest rate and other commissions and fees that banks usually charge. Banks set the interest rates based on current market interest rates, maturity and collateral of the loan and creditworthiness of the borrower. Rates can be fixed or floating. Floating interest rates are made up from a reference interest rate (e.g. EURIBOR) plus a fixed margin, which accounts for banks' profitability and borrower specific risk (NALAS, 2011, p. 38).

Table 9. Stakeholders in Municipal Credit Market Development

| | |
|---|---|
| Demand Side (Borrowers) | Local government units, Public enterprises and companies being fully or predominantly owned by local governments, Public-private joint ventures |
| Supply Side (Creditors) | Commercial banks, Specialized banks, Central Government, Insurance companies, Pension funds, Investment funds, wealthy individuals |
| Market Makers | Stock Exchange, Licensed Financial Intermediaries, Financial Advisory Firms, Credit Rating Agencies |
| IFIs | World Bank, European Bank for Reconstruction and Development, European Investment Bank, KfW |
| Overseers & Regulators | Overseers & Regulators |
| TA Providers | USAID, US Treasury and SEC advisers, World Bank, EBRD, private consulting organizations and think tanks |

Source: M. Nikolov, *Report on the Process of Decentralization in Macedonia,* 2007, pp. 17–18, Table 5.

Furthermore, commercial banks may lack the expertise to understand the local government financial environment and so tend to refuse to consider lending, or propose a very high interest rate, or require significant amounts of collateral in view of their perception of the risk involved. As a result, for many local governments, borrowing from the private sector is still a long way off. Local governments could also use their business to leverage borrowing opportunities as much as possible within their bank's prudential limits. Clearly, a good credit rating makes this process easier for the borrower. Potential borrowers should look at ways to start small, on projects with quick returns such as reducing losses (e.g. on water or electricity supplies) or increasing revenues, and agree with the bank that good performance would entitle them to better terms next time (Jackson, 2007, p. 14).

Having in mind the opportunity for local governments to use various instruments of borrowing to finance their investment needs, development of local government capital market is considerably important in this respect. Accordingly, Table 9 describes the main stakeholders in local government credit market development.
Advantages of bank loans (NALAS, 2011, p. 38):

1. Provide a readily available source of financing based on competing existing local banks,
2. Applying for a bank loan is much simpler process than issuing a municipal bond (which makes them more suitable for smaller local governments),
3. Credit analysis is performed directly by the lender,
4. An additional credit rating from an external rating agency may not be required,
5. Loan terms and conditions are negotiable to some extent, but they are bounded by the borrower's credit quality.

Disadvantages of bank loans (NALAS, 2011, p. 38):

1. Interest rates tend to be higher than other types of debt (depending on economic cycle, maturity, ancillary services etc.),
2. Higher loan to value requirements – i.e. collateral requirements are more conservative,
3. Less suitable for large investment projects requiring long term financing.

In many countries, local governments are allowed to borrow from the central government. The Law on Financing of LSGUs created a legal basis for a new instrument for funding assistance to local governments as short-term and long-term loan from the Central Budget of the Republic of Macedonia in order the local governments to overcome the discrepancy of revenues and other receipts and expenditures and other outflows. The short-term and long term loan to the local government from the Central Budget of the Republic of Macedonia is approved by the Government decision on the proposal of the Minister of Finance after having submitted a written request from the local government. The manner of proceeding the approval and repayment of the loan from the Central Budget are presribed by the Minister of Finance. In case the local government does not repay the amount (annual instalment) or a part of the amount of the loan until the end of the current fiscal year, to the borrowed unpaid funds (due and unpaid annuities) at the beginning of the next fiscal year interest is calculated in total of 2% per annum until the final payment.

At the same time, Rulebook on procedures for approval and repayment of short-term and long-term loan (up to 10 years) to the local government from the Central Budget, which prescribes the manner and procedure for approval and return of short-term and long-term loan to the local government, was adopted. The Rulebook establishes the procedure to request the loan, to determine the type, purpose, amount, term and repayment and projections of revenues and expenditures of the local government. This contributed the local governments, which had blocked accounts, to unblock their accounts and enter into the second phase of fiscal decentralization. Additionally, long-term loans from the Central Budget of the Republic of Macedonia was approved to local governments that have court decision or proceedings for payment of arrears thus creating normal working conditions for local governments.

## 5.2 Municipal Bonds

The primary investment objective of each investor is to protect capital and achieve a relatively higher yield with minimal risk. Municipal bonds are of particular interest to investors because the local government is a guarantor for their return and an additional incentive is the tax-free status of interest payments.

Bond is a long-term debt security with which the issuer commits to pay to the holder of the bond a certain amount of nominal value and interest on a certain date. Bonds, as securities with fixed income, represent financial promise and obligation of a person that will pay a certain amount of money on a certain date. A person who commits to such a promise is called a publisher. Publishers are borrowers, while those who invest in their bonds are creditors because they lend their own funds in return for certain yield. Issuers of bonds may be states, state agencies, local governments, local governments' enterprises, companies and organizations.

Through issuing bonds, local governments borrow money from the buyers of municipal bonds and promise payment of principal and interest for a certain period of time. The bond holder receives periodic interest payments on the principal invested until the bond matures, or receives both interest and payment in one lump sum when the bond reaches maturity. Interest usually is paid semi-annually while the principal may be paid either after maturity or periodically. The interest received by the bond holder may be tax-exempted although this will depend on the type of project funded. The yield on municipal bonds is usually greater than the yield realized by investing in bank deposits. Besides the attractive interest rates realized by investing in bonds, the investor is also exempted from paying personal income tax.

Municipal bonds are listed on the secondary market so that investors have the necessary liquidity. Some of the benefits for local governments from issuing bonds are the following: mobilizing resources, implementation of planned development projects, acceleration of regional and local economic growth, increasing of the quality of life of citizens and acquisition of greater financial independence from central government.

Issuing bonds represents one possible and important way to finance local capital projects. The most important arguments for issuance of bonds by local governments and against another form of financing are as follows (Kovacs, 2005, pp. 1–2):

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. Financing through issuing of bonds, there is an assurance that most of users will pay for the benefits either through local taxes or directly through user charges and hereby an optimal allocation of resources can be achieved.
2. Benefits from accelerated local development can overshadow the cost of borrowing. Carrying out the investment as quickly as possible operational costs (related to the given service) can be reduced.
3. Stabilization of required budget resources: The volume of capital spending in local government units fluctuates from one year to another. If capital projects are financed from current revenues, the demand for resources changes over time, as well. In countries where a large proportion of local revenues is raised through local taxes, an irrational fluctuation of local taxes rates may result.

Issue of municipal bonds should be more and more popular among local government units because (Jastrzębska, p. 6):

1. Cost of getting money is lower compared to credit (lower commission and interest rate);
2. Interests are usually paid once a year and in case of credit – monthly or quarterly;
3. Issue of municipal bonds does not have to be protected;
4. Time of getting money is short;
5. Interests are paid till the end of last issued series and when the period duration of bond is over (from one year and longer) the issuer gets back all money for owner of municipal bond according to its nominal value;
6. Flexibility of issue of bond programme is adapted to investment needs and credit ability of issuer;
7. There is promotion effect, especially in case of issuing municipal bonds;
8. There are also social benefits. Inhabitants of local government units as the issuer are really interested in problems of their unit and they are able to invest money in safe securities.

To have a more diversified debt portfolio is another advantage of bonds. The main motive for bonds, in addition to publicity reasons, is the need to diversify funding sources. Other benefits of bonds are their greater flexibility since the local government can eventually buy back debt at a lower rate on the bond market, and their ability to catalyze further investment. Municipal bond financing can be cost-effective for larger and resource rich local governments but is rather complex as it requires a certain scale of experience and operations and success also depends on conditions of general markets for bonds. (Boschmann, 2009, p. 90)

Further, bonds have higher fixed costs (for road shows and administration as well as for listing fees) and many local governments felt that they are too small for issuing bonds. It does not make sense to issue a bond smaller than a certain amount due to the fixed costs that arise. In addition, it is necessary to get an expensive rating from an international rating agency such as Fitch, Standard & Poor's, or Moody's.

### 5.2.1 Municipal bonds in the Republic of Macedonia

The procedure for borrowing starts with reaching decision for borrowing by the municipal council, which contains the following elements:

1. Purpose of borrowing,
2. Draft conditions under which the local government can borrow.

The decision reached by the municipal council, for each new borrowing, is submitted to the Ministry of Finance upon which the Ministry issues opinion for borrowing. When submitting the decision for borrowing to the Ministry of Finance, the local government also submits the following data:

1. Documentation (prescribed forms) for execution of the local government budget for the current and previous two years, revenues and expenditures projected for the next three fiscal years;
2. Information about the type of borrowing (loans from foreign banks/financial institutions, loans from domestic bank or borrowing by issuing bonds);
3. Statement from a mayor verified by notary public, and with personal criminal liability respectively, for existence of unsettled liabilities towards creditors within expiry of 90 days from the due date.

Based on the decision reached by the municipal council and submitted documents the Ministry of Finance, upon prepared analysis, issues positive/negative opinion and informs the local government unit.

Local government may borrow by signing the loan agreement and issuance of securities (bonds). Pursuant to the provisions of the Public Debt Law, initiative on commencing negotiations for borrowing starts upon prior approval (positive opinion) by the Ministry of Finance. The procedure for borrowing by issuing municipal bonds commences after adoption of a decision by the Government of the Republic of Macedonia for each new domestic borrowing. The procedure for issuing municipal bonds is stipulated in the Law on Securities and the relevant secondary legislation and bylaws implemented by the Security Exchange Commission. Upon receipt of the decision on borrowing from the Government, the local government unit starts proceedings with the Security Exchange Commission. According to the Law on Securities, the issuance of municipal bonds is carried out upon approval granted by the Commission. According to the Law, municipal bonds may be issued through private and public offer. For public and private offer of over 25,000 euro approval by the Security Exchange Commission is required.

**Private offer.** Private offer is a direct offer of securities/bonds to a limited number of investors, which in advance agree to buy the bonds subject to the offer. When bonds are issued by private offering, there is no need of preparing and publishing a prospectus. For this purpose, it is necessary the local government to find interested investors (buyers) to buy the bonds and to make prior negotiations with the potential investors.

The procedure for issuing bonds through a private offer is as follows: Municipal council reaches a decision to issue bonds through private offer. The municipal council determines the period within which the decision has to be implemented. The local government unit prepares a statement to inform the public about issuing bonds through private offer and publishes the statement in daily newspaper published in the Republic of Macedonia in Macedonian language and in one of the languages of the communities in the Republic of Macedonia.

Security Exchange Commission reaches a decision for approving the issuance of municipal bonds through private offer based on the request for approval submitted by the local government. The request for approval consists of the following: basic data about the local government; data about the bodies of the local government (municipal council and mayor) and data about previously issued bonds.

The Commission, based on the entire documentation, issues a formal decision to approve or reject the request for approval of issuing bonds through private offer not later than fifteen (15) calendar days following the day of submission of the request. Local government pays in the bonds fifteen (15) calendar days prior to the decision for approving the request for issuance bonds through private offer, notifies the Commission of the quantity of the subscribed and paid bonds and publishes the information in at least one daily newspaper. Local government registers the bonds with authorized depository within, and not later than, three (3) calendar days following the day of payment of the bonds.

**Public offer.** The public offer is public invitation for subscribing and purchasing bonds, published in public media. It is made to many unknown investors that have equal access to information for the issuer's operations and the offer of the bonds. Therefore, when the issuer makes public offer, it is required to prepare Prospectus with disclosure of all public information about its operations and data about the public offer of bonds.

Procedure for issuing bonds through public offer is as follows: Municipal council reaches a decision to issue bonds through public offer. Local government unit selects the consultants and agent for the issuance of bonds. The procedure can be run by law firm (if the local government has no legal capacity for running the procedure, providing necessary documents for obtaining permission for issuance of bonds), bank or brokerage company with double function (financial adviser and enforcer of the issue). Stock exchange or Depository may appear as enforcer of the issue.

Local government is obliged to prepare a Prospectus and invitation for subscribing and payment of the bonds. The Prospectus contains all relevant information about the local government that allow the investor to make assessment of the issuer's legal, financial and business operations, of its investment risk and the rights arising from the offered municipal bonds. The invitation for subscribing and payment is an excerpt from the Prospectus and it contains basic information about the bonds issued through public offer as well as information for the issuer/ local government. The Commission issues a formal decision to approve or reject a Request for Approval of issuing bonds through public offer not later than sixty (60) calendar days following the day of submission of the Request.

Local government unit may issue advertisements in conjunction with a public offer of bonds. All advertisements relating to a public offer of bonds include information for the day of the first publishing of the Prospectus and the location where a copy of it may be obtained. Advertisements have promotional nature.

Local government unit commences the procedure for subscribing and payment for publicly offered bonds within, but not later than, thirty (30) calendar days following the date of receipt of the Commission's approval for issuance of bonds. The public offer is considered successful if at least 60% of the bonds offered in the Prospectus are subscribed for.

Not later than fifteen (15) calendar days following the close of a public offer, local government notifies the Commission for the quantity of subscribed and paid bonds i.e., the realization percentage. Local government publishes the information set forth in at least one daily newspaper published on the entire territory of the Republic of Macedonia in the Macedonian language and its Cyrillic alphabet or in a language of the ethnic communities in the Republic of Macedonia no later than fifteen (15) calendar days after the offering is closed. Issued municipal bonds are registered in the Central Depository in the form of electronic records and denominated on behalf of the owner of the bonds. The rights and obligations arising from bonds begin from the time of subscription in the Depository.

No government loans or donations are final solution for local governments' need of financing. Building important infrastructure objects, implementing effective public services at local level, maintaining and developing better communal services as well as education, culture, child protection facilities are the main focus of local authorities. All of these require new attractive sources of finances to improve local government sustainability.

For a longer period of time in the Republic of Macedonia the offer of securities is very small. On the other hand, the intent of the Macedonian local governments to finance their development and investment projects by issuing municipal bonds could not be realized unless there are institutional investors who will have legal grounds and interest to buy these bonds issued by the local authorities. Long-term securities are more suitable for pension funds to invest in because the investments in these instruments and the realized return matches with the length of the time frame in which mandatory pension funds in the future will pay the pensions to its contributors. In the Republic of Macedonia some two-year and three-year government bonds are issued until now, but corporate bonds or bonds issued by joint stock companies as long-term securities have not revived in the capital market yet.

Having this kind of situation in mind, in order to encourage local governments, as soon as possible, to begin the procedure for issuing municipal bonds, the Ministry of Finance of the Republic of Macedonia in 2010 proposed introduction of municipal bonds as a new possible and suitable instrument in which mandatory and voluntary pension funds in the future will be able to invest a part of the collected funds. Pursuant to this amendment, along with banks, insurance companies and management companies of investment funds as well as pension funds as major institutional investors will have the legal opportunity part of the collected funds from contributors to invest in municipal bonds. Based on the above mentioned, local governments should not worry about the success of the emissions of municipal bonds, because there are already set legal regulations in the Republic of Macedonia that enable municipal bonds to be redeemed by institutional investors who hold a higher amount of free financial funds. At the same time, issuance of municipal bonds will enrich the offer of long-term securities in the country which, in turn, will contribute for reviving the market for securities in the Republic of Macedonia.

The Ministry of Finance in relation to the implementation of the governmental plan to improve the financing of local governments, among other measures, strongly supports the idea of introducing municipal bonds and encourages the local governments to begin the procedure for issuing municipal bonds to finance their investment projects. The Ministry has prepared Guidelines for issuance of municipal bonds in order to acquaint the local governments with the procedure for issuing municipal bonds. It can be expected in the near future depending on the readiness of the investment projects some of the local governments that have greater fiscal capacity and have already received credit ratings to express their interest in borrowing through issuance of municipal bonds.

From the above stated it can be concluded that prior to issuing municipal bonds the local government passes through several filters; request for issuing municipal bonds has to be prepared, local government has to justify the issuance of the bonds and be able to repay the debt connected to the bonds. The countries of the region that have closest legislation system to our system, such as Croatia, Bulgaria, Romania and Poland have already introduced municipal bonds as possible instrument in which mandatory pension funds are able to invest a part of collected funds.

Some of the benefits for local governments from issuing bonds are the following: mobilizing resources, implementation of planned development projects, acceleration of regional and local economic growth, increasing of the quality of life of citizens and acquisition of greater financial independence from central government. Benefits for investors from buying bonds are the following: receive yield that depends on the quality of the issuer and maturity of the bond, development of capital market in the country and opportunities for better diversification of portfolios, the return on these bonds is exempted from personal income tax, investing in the development of the environment in which they live (visibility effects).

Recommendation for the local governments:

1. Examination of investors' market,
2. Determining the amount of the bond and the interest rate,
3. The municipal bond to be annuity bond in order to achieve attractiveness for investors, liquidity and confidence for timely servicing of debt or repayment of principal and interest,
4. Determining the maturity of the bonds according to the interest of investors,
5. The way of issuing the bonds (public / private offering) to depend on the cost analysis regarding with the issuance of the bonds and duration of the procedure.

### 5.2.2 Types of municipal bonds

In terms of cash flow we distinguish two types of municipal bonds:

1. **general obligation bonds** and
2. **revenue bonds.**

The **general obligation bonds** are characterized by the issuer obligation to repay the debt (bond) from any source of local government revenue. This means that the full taxing authority of the local government is pledged to pay back the bonds. They are commonly used for infrastructure investment projects that are not self-liquidating (i.e. projects that are non-revenue producing). These bonds are approved by voters and are the most secure of the municipal bonds. They generally have low interest rates.

**Revenue municipal bonds** are issued for specific project whose implementation is expected to generate revenue. Example: construction of water networks, sewage systems, public parks and other projects of importance to local authorities. The issuer may be a sub-sovereign or some sort of public authority, such as a water authority, which is independent of the government. They are secured only by the expected stream of revenue from the project being financed. Failure to raise sufficient revenues to make payments will result in default of the revenue bonds. Typically, revenue bonds are “limited obligations” and do not have recourse to a local government’s general revenues.

There are several groups of municipal bonds that have specific investment opportunities. One is the group of **insured municipal bonds**. The insurance company guarantees that it will pay the principal and interest upon maturity if the local government does not pay.

**Municipal bonds with a variable or floating interest rate** do not carry a fixed interest rate and it changes with the change of selected reference interest rates.

**Zero coupon bonds** are traded at a deep discount and they offer the entire payment at maturity. These bonds tend to fluctuate in price much more than coupon bonds.

There are special bonds that give investors the opportunity to force the issuer to repurchase the bond at specified dates before maturity. These bonds are called ***“put”* bonds.** The repurchase price is set at the time of issuance and it is usually a par value.

On the other hand, the bonds that give the issuer opportunity, at any time, to withdraw the issuance of bonds before the maturity date are called ***“callable”* bonds.** Usually a premium is paid to the bond owner when the bond is called. The main cause of a call is a decline in interest rates. If interest rates have declined since local government unit first issued the bonds, it will likely want to refinance this debt at a lower rate of interest. Hence, the local government will call the current bonds and reissue them at a lower interest rate.

However, the market for municipal bonds is still emerging with several constraints to growth to be overcome: On the demand side, most local governments have no or have only elementary understanding of this financing mechanism and there is no secondary market for bonds. Accordingly, local government experience with bonds is even more limited than experience related to local government borrowing. Even middle income countries are hesitant in this regard: While bank credits are a common local government financing instrument today, most local governments are reluctant to issue bonds (Boschmann, 2009, p. 90).

Regardless of the degree of local fiscal autonomy in a country, central governments will always need to carefully monitor and project local government finances. Legislation with regard to the borrowing powers of local government must also be reviewed. Direct access to capital markets by local governments will take time to develop. Loan and bond financing are viable options for a considerable number but not all local governments (Boschmann, 2009, p. 94).

There is no need to choose a single instrument as the “right” way to handle local government credit. Many countries simultaneously use bank lending to local governments and local bond issuance. The policy rationale, however, justifies emphasizing development of local bond markets. The public monitoring and public disclosure required for efficient bond market operation are consistent with greater transparency for all public financial transactions (Jackson, 2007, p. 16).

Given the limited interest of the private sector to engage in local government borrowing, there is considerable merit to the establishment of a sub-national development fund to promote lending to local governments for long-term capital investment. This may be the only effective way to allow small local governments to fulfil their capital investment responsibilities. The desirable structure for such a sub-national development fund is that of an autonomous institution that takes direct and final responsibility for borrowing and investment projects. The bulk of funds for this institution should come from direct bond issues in the capital market. The central and local governments could contribute initial capital shares. The institution should be managed by independent professionals who answer to a managing board composed of central and local government representatives (Boschmann, 2009, pp. 94–95).

## 5.3 National and international development program loans

Some local governments borrow from development banks either with direct loans or through an on-lending programme by central governments. These loans are typical for longer periods than those available from commercial banks and might include concessionary provisions such as a below-market interest rate and grace period before the repayments start. Frequently, repayments of on-lent funds are based on a mortgage type system with a regular periodic payment for time duration of the loan. Interest payments are mostly in the early years and paying off the capital is in the later years (Jackson, 2007, p. 14).

It is common that development banks take a more optimistic and generous view of the repayment prospects than commercial banks. This may be supported by a more informed appraisal of the financial health of the local government by specialists or because of some form of credit enhancement such as a guarantee from another level of government. However, such loans should always be on the basis of a thoroughly appraisal and some degree of commercial thinking concerning risks. In this way local governments can be encouraged to adjust to the discipline of the market in preparation for the time that they may need to approach the private sector for finance (Jackson, 2007, p. 14).

In most of the countries some sort of local government development fund is established. These development funds act as a credit institution at sub-national level. International development banks (World Bank, KfW, EBRD etc.) are using these funds as a way to channel loans to local governments. The financing of local governments through such programs occurs either directly or indirectly (on-lending) via intermediate loans to local banks in target countries. The terms and conditions of these loans tend to be less rigid than those of “normal” banks. Their objective is to assist local government long-term development needs rather than to make a profit. Another characteristic of these loans is the existence of an initial grace period on principal repayment, which shifts the debt burden further on in the future. In addition to lending funds to local governments, the development programs use incentives in form of grants or technical assistance if borrowers meet some requirements (NALAS, 2011, p. 39).

International financial cooperation (development programs) in the Republic of Macedonia is carried out through cooperation with bilateral creditors and multilateral financial institutions.

Concerning cooperation with bilateral creditors, it is more intensive with the Federal Republic of Germany, Japan, Italy and other countries as well as with their development financial institutions: Credit Bank for Reconstruction – KfW, Japanese International Cooperation Agency – JICA and others.
Cooperation with multilateral financial institutions is carried out with the World Bank Group, the International Monetary Fund (IMF), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the Council of Europe Development Bank (CEB).

Bilateral and multilateral development cooperation of the Federal Republic of Germany is implemented by KfW, while the technical cooperation is implemented by the German Association for Technical Cooperation (GTZ).
KfW is in charge of financial cooperation with the developing countries and it provides long-term capital and encourages investments in the field of infrastructure, financial systems and environment protection. KfW mission in the Republic of Macedonia is promoting sustainable development, supporting transitional process and assisting in the EU accession process. KfW offers support to the following sectors: provision of safe and high-quality utility services, water supply, wastewater and solid waste, nature and environmental protection, energy efficiency and renewable energy, and promotion of job creation through development of the private sector (Ministry of Finance of the Republic of Macedonia, 2010).

Table 10 lists some of the projects financed by German Development Bank – KfW.

Table 10. On–going Projects Financed by German Development Bank – KfW

| Project name | Short description | EUR mil | FY of the agreement | Year of final realization |
|---|---|---|---|---|
| | **Water and environment** | | | |
| Irrigation Programme Southern Vardar Valley I | Rehabilitation and modernization of irrigation infrastructure approximately 2,500 ha arable land in 4 modern and efficient irrigation schemes (Negorci,Paljurci,Udovo and Mirovci) Beneficiary: Ministry of Agriculture, Forestry and Water Economy | 6.65 | 2003 | 2011 |
| Rehabilitation of Water Supply and Sewerage Prilep | Protective measures at the existing wells, reservoir reconstruction, restructuring of distribution network,provision of water meters, replacement of water meters in households, replacement of pipes in selected areas. Beneficiary: Ministry of Finance | 8.18 | 2004 | Ongoing |
| Transboundary Biosphere Reserve Prespa(co-financed by GEF/UNDP) | Promotion of an integrated ecosystem management of the cross border Prespa Park region through participation of all stakeholders and by enhancing cooperation among the three participating countries Macedonia, Greece and Albania. Beneficiary: Galicica National Park | 1.53 | 2007 | Ongoing |
| Supplying, erection and put into operation of LOT 3–Main coal conveyor belt system from Brod Gneotino to Suvodol | The project is aimed at activating new coal mine Brod Gneotiono for TPP Bitola. Beneficiary: AD ELEM | 16.6 | 2007 | 2010 |
| Water and Sewerage Programme Macedonia, Phase I | The project is aimed at ensuring sustainable supply of drinking water for the population in 8 municipalities: Bitola, Gevgelija, Gostivar, Kavadarci, Kocani, Negotino, Radovis and Tetovo. Beneficiaries: municipalities | 8.64 | 2009 | Ongoing |
| Rehabilitation of six hydro power plants | The project encompasses rehabilitation of electrical and hydro-mechanical equipment, as well as certain construction works in 6 hydro power plants: HPP Globocica, HPP Tikves, HPP Vrutok, HPP Raven, HPP Vrben and HPP Spilje. Beneficiary: AD ELEM | 31.89 | 2010 | Ongoing |
| | **Good Governance and Decentralization** | | | |
| Studies and Expert Fund (SEF I + II) | Engagement of experts for preparation of feasibility studies and projects. Beneficiaries: Different Macedonian institutions. | (II)3.07 | 2001 | Ongoing |

Source: Ministry of Finance of the Republic of Macedonia, *Bilateral Cooperation*, 2010.

Japanese International Cooperation Agency (JICA) provides support to the developing countries in their realization of sustainable social and economic development and promotes international cooperation. JICA is in charge of implementing development assistance such as bilateral loans, bilateral assistance with grants and technical cooperation.

EBRD is one of the largest investors in the country. Cooperation between EBRD and the Republic of Macedonia is within the priority sectors and goals set in EBRD Strategy for the Republic of Macedonia 2010–2013. The Bank approved more than 60 projects in the private and the public sectors in the Republic of Macedonia in total amount of EUR 563 million (Ministry of Finance of the Republic of Macedonia, 2011). Table 11 encompases some of the on-going projects financed by EBRD.

Table 11. On-going Projects Financed by EBRD

| **Project Name** | **Project Objective** | **Loan Amount (EUR mil.)** | **Year of Project Commencement** | **Year of Project Completion** |
|---|---|---|---|---|
| Regional and Municipal Roads Programme | This Project is aimed at improving the conditions and the quality of local and regional road network in the Republic of Macedonia, thus reducing the costs for access of municipalities in the country to markets and services. | 50 | 2009 | 2012 |
| Macedonia Bulgaria Transmission Interconne-ction Project | Objective of the Project is to improve interconnection with the Republic of Bulgaria, thus improving the quality of electricity transmission network in the Republic of Macedonia and strengthening institutional capacity of MEPSO AD. | 36.77 | 2003 | 2014 |
| Rail Corridor X Project | Objective of the Project is repair of several sections of the railroad on Corridor X at motorway sections Tabanovce – Kumanovo, Miravci – Smokvica, Zgropolci – Gradsko – Negotino, thus reducing the costs for its maintenance and ensuring safe traffic on these sections. | 17.6 | 2010 | 2013 |

Source: Ministry of Finance of the Republic of Macedonia, *Multilateral Cooperation*, 2011.

World Bank Mission in the Republic of Macedonia is focused on encouraging and supporting job creation as well as improving the living standard of by implementing and financing projects, advisory services and research aimed at capacity building, human resource development and investments in infrastructure. Assistance from this international institution is in the form of support to the country on its path to the EU, strengthening its competitive ability and improving macroeconomic surrounding, increasing economic growth by strengthening employability and supporting investments in renewable energy sources to contribute to development of significant projects in the energy sector. The next table lists the projects financed by the World Bank.

Table 12. On-going Projects Financed with a Loan by the World Bank

| **Project Name** | **Short description** | **EUR mil** | **FY of the Agree-ment** | **Year of final realiza-tion** |
|---|---|---|---|---|
| Legal and Judicial Implementation and Institutional support | Improving efficiency of the judicial system, thus improving the business climate by enhancing the capacity of the Ministry of Justice, Ministry of Economy and the judiciary to systematically implement Judicial Reform Strategy and key laws, pertaining to judiciary, improvement of judiciary infrastructure and judiciary IT systems. | 10 | 2006 | 2011 |
| Energy Community of South East Europe Program APL 3-Republic of Macedonia | Extension of Skopje 5 transformation station, rehabilitation and construction of overhead transmission lines, upgrading the existing electricity and energy system management, planning software, upgrading and rehabilitation of 110 kV transformation stations. | 20.1 | 2006 | 2011 |
| Business Environment Reform and Institutional Strengthening Reform Project | Strengthening the capacities of the Government of the Republic of Macedonia in the process of continuing the business environment reform by applying appropriate quality analysis of the existing regulations and the one to be adopted in future, by improving the process of efficient registration of business entities, improving the quality of entry of Macedonian products on the foreign markets, improved access to information necessary for staring up and conducting business in the Republic of Macedonia. | 6.4 | 2005 | 2010 |
| Education modernization project | Improving the quality of learning and strengthening the schoollevel planning and management, as well as support and efficiency for a decentralized education system. | 3.6 | 2004 | 2011 |
| Health Sector Management Project | Strengthening the capacity of both the Ministry of Health and the Health Insurance Fund to efficiently implement health policies, health insurance, financial management and contracting of health care providers to the end of improving and restructuring hospital services | 7.3 | 2004 | 2010 |

*"(table continues)"*

*"(continued)"*

| **Project Name** | **Short description** | **EUR mil** | **FY of the Agree-ment** | **Year of final realiza-tion** |
|---|---|---|---|---|
| Railways Reform Project | Strengthening the capacity of railway transportation and mechanization and modernization of railway infrastructure. | 15 | 2006 | 2011 |
| TTFSE 2 - Second Trade and Transport Project | Eliminating bottlenecks on Corridor 10 infrastructure and the main border-crossing between Republic of Macedonia and Kosovo, strengthening the capacity to trade and invest in road corridor by modernizing the pay-toll system, supporting harmonization of data on rail transportation of goods exchanged by the customs administration and the railway company. | 15 | 2007 | 2011 |
| Agriculture Strenghtening and Accession project | Improving the capacity of the Ministry of Agriculture, Forestry and Water Economy to disburse and monitor the use of rural development funds and evaluating their impact on the agriculture sector, providing EU IPARD funds to be paid to farmers in compliance with EU requirements. | 15 | 2007 | 2011 |
| Real Estate Cadastre and Registration Project | Improving the safety of ownership rights and real property market performance, improving services for property transaction registration by supporting the completion of the real estate cadastre and building institutional capacity to support land ownership transfer. | 10.3 | 2005 | 2010 |
| Real Estate Cadastre and Registration Project - Additional Financing | Improving delivery of public services in the real estate cadastre sector and registration of rights, having direct impact on the economic development through the real estate market. At the same time, the project will provide support to the Property and Legal Affairs Office within the Ministry of Finance and its regional offices, thus providing for the Property and Legal Affairs Office to obtain modern conditions for performing its competences, and service beneficiaries to use the benefits of significantly improved and more efficient services. | 9 | 2010 | 2013 |
| Social Protection Implementation Program | Improvement of effectiveness and efficiency of social protection system through improved administration and long-term sustainability of the pension system and improved targeting and administration of cash benefits | 7.2 | 2004 | 2011 |

*"(table continues)"*

*"(continued)"*

| Project Name | Short description | EUR mil | FY of the Agree-ment | Year of final realiza-tion |
|---|---|---|---|---|
| Regional and Local roads Program - Support Project | Reconstruction and investment maintenance of regional and local road network in the Republic of Macedonia, as well as strengthening institutional capacities for project implementation. | 70 | 2008 | 2013 |
| Conditional Cash Transfer Project | Strengthening effectiveness and efficiency of Macedonia's social safety net through: (a) introduction of conditional cash transfers; and (b) improvements in the administration, oversight, monitoring, and evaluation of social assistance transfers. | 19.3 | 2009 | 2014 |
| Municipal Services improvement project | Improvement of the performance of urban economies and quality of management at municipal level through providing adequate financial and advisory support to more municipalities and their public enterprises as regards both improvement of utility services and promotion and strengthening municipal functions and competences. | 18.9 | 2009 | 2014 |
| GEF Sustainable Energy Project-financed with grant | Objective of this project is to stimulate investments for the purpose of increasing energy efficiency and better utilization of sustainable energy sources by eliminating institutional and financial barriers, creating and supporting a framework, institutional capacity and financing mechanisms. | 5.5 | 2007 | 2011 |

Source: Ministry of Finance of the Republic of Macedonia, *Multilateral Cooperation*, 2011.

The case of the Republic of Macedonia, where the World Bank and the Ministry of Finance initiated EUR 18.9 million USD Municipal Services Improvement Project, is a very good experience, especially in the early stage of local government credit market development. This on-lending program was launched in 2008. The main objective of the project was to improve transparency, financial sustainability and delivery of targeted local government services in participating local governments by providing sub-loans to local governments for investments in revenue-generating public services and other investment projects of high priority to local governments and with cost savings potential. These investments contributed to the improvement in performance in service provisions and strengthening local governments' functions and competences. Along with the loans the Project provided grants to local governments as an incentive and reward for implementation of reform initiatives aimed at performing improvements in service delivery. The awarded grant to an individual local government amounts to 20% of the investment loan. The grant funds may be used solely for financing of investment projects. The project encompasses the local government units which are in the second phase of the fiscal decentralization process and which, according to the Law on Financing of LSGUs, fulfill entirely the conditions for long term borrowing.

Many international financial institutions have dedicated programs aimed at supporting and financing local governments' infrastructure projects, especially in the emerging markets. The financing occurs either directly or indirectly via intermediate loans to local banks in targeted countries. The terms and conditions of such loans are more favorable to the local governments than in case of typical commercial banking loans (NALAS, 2011, p. 36).

# 6 LOCAL GOVERNMENT'S CREDITWORTHINESS ASSESSMENT

The different statuses of local government units in a certain state, variations in fiscal capacities, different level of service responsibilities in education, culture, social protection and other public activities, variations in revenues and expenditures and many other facts reveal huge differences in the financial stability of certain local government units. These factors can adversely influence on the local government credit rating. Thus, officials that govern local government units focus on improvements of these issues and enhance the credit rating.

Additionally, the increasing of local government borrowing calls for fiscal transparency and greater disclosure of independently audited financial accounts. The local government credit market is deepening over time as the economy develops and matures. Local governments are increasingly engaging international rating agencies to rate their creditworthiness which serves as a direct way of promoting their unit. This leads to positive competitiveness between local government units and increase the efficiency of the complete local government sector.

The market potential for local government loans depends on the general creditworthiness of local government units and on the unused debt capacity. Creditworthiness of local governments is a demand-side requirement for local borrowing. Generally speaking, creditworthiness refers to the ability and willingness of a borrower to repay the debt. Assessment of creditworthiness leads to a good credit rating enabling the local governments to attract lenders and borrow at reasonable prices. Information about creditworthiness is a key factor for a working local government credit market. It is a tool that allows local government units to assess current credit condition and future direction based on historical budget trends and future revenue and expenditure scenarios. It also gives the local government officials a diagnostic tool to better understand their current credit condition and to analyze the factors that may improve the collection of revenues and the efficiency of spending money as well as to perform certain scenario analysis. This is pretty much complex process and covers thoroughly and systematic analysis of the local governments' financial and institutional variables, assessment of the local economy in which the local government operates and evaluation of the national macroeconomic environment.

## 6.1 The creditworthiness self-analysis conceptual framework

Local governments should perform a self-assessment of their creditworthiness prior to approaching financial institutions. This leads to the diagnosis of the credit problems and the steps the local governments can take to mitigate these problems and risks. Important in this context, for local governments, is to analyze the influence of local economic performance to their creditworthiness through diagnosis of several factors such as: demographic factors, growth projections, key industries, poverty, employment levels and the diversification of the local economy. Local institutional-political factors comprise the quality of governance and financial management capacities like accounting, planning, reporting, public disclosure and marketing skills.

All rating agencies analyze a range of qualitative and quantitative variables to derive a final credit rating score. They design conceptual framework to evaluate the general credit condition of local governments and present the indicators associated with the credit risk. Indicators must be interpreted within the overall legal, political and administrative context of the local government. Nevertheless, indicators may assist in the diagnosis of the basic problems that contribute to the poor credit condition. Local governments need to understand the causes that allow mitigating the risk.

The risk categories include:

1. Economic and Social conditions;
2. Financial Operations: budgetary performance, fiscal flexibility and financial information; and
3. Financial Management and Debt Information.

The indicators associated with these risk categories do not represent a credit rating, but a simple tool to diagnose the general credit condition of a local government. Local governments use the indicators to establish a "creditworthiness" baseline and to determine their capacity to repay a debt obligation (Nikolov & Josifov, 2007, p. 12).

### 6.1.1 Economic and demographic base

The economic database and revenue projection tools can serve to local governments to predict the impact of macroeconomic changes on expected local government revenues. Demographic indicators point toward future trends in demand for services provided by local governments and alert financial manager to long term expenditure requirements.

Creditors will feel more comfortable if a local government shows that it is aware of these trends. Also, fiscal stability is closely connected with stability of the local economy. Creditors are also interested in the structure of the local economy. Therefore, local authorities should be capable of providing the creditors with correct information about the structure of employees – per types of companies and activities as well as information about the general economic condition of the largest employers. The rating agencies most often request the local authorities to provide them with a list of the largest employers as well as a list of companies with the largest unsettled tax obligations. It is useful for any local government unit in the Republic of Macedonia to make a separate evaluation as to whether they depend on revenues collected from property taxes or from revenues collected from personal income tax since the revenues from personal income tax are more flexible in relation to economic fluctuations. Long-term solution for local governments is that they improve their own tax administration (implementation and collection), to update their database of tax payers and to make re-evaluation of the property value.

Demographic indicators include: population size, natural growth rate, age structure, distribution in urban and rural areas as a percentage of the total population in the local government unit. These statistical data provide basis for general conclusions about the level of changes of the service demand. It gives the local finance officers a baseline to understand the impact of these changes to the costs for these services based on specific demographic growth. Thus, finance officers are able to explain the source of the additional funding to creditors required for increased local government's social service costs and whether this funding comes from additional inter-governmental transfers or own sources of revenues (Nikolov & Josifov, 2007, p. 14).

The economic indicators should reflect the long term stability of own source revenues and inter-governmental transfers. The inter-governmental transfers are usually fixed by some fiscal arrangements – formula based – and thus may not be too responsive to the performance of the local economy. Own source revenues is likely to be affected by local economic conditions. Since the property tax and utility fees are the primary source of own source revenues, economic indicators should focus on the factors that generate these revenues, such as: property value trends, commercial building occupancy rates, building permits trends/new construction, resident housing, etc. Own sources of revenues also include a share of personal income tax generated by the local economy. Economic indicators for this tax source should reflect the local employment (sector breakdown and multi-year trends) and historical and future personal income tax trends. The rest of the local revenues are inter-governmental transfers and share from VAT. These revenues have a higher degree of stability. The economic indicators should reflect the extent to which the local economy relies on a particular sector or major employer that generate its property tax and share of personal income tax and VAT revenues. The indicators should also show the linkage between the local economy and the regional and national economies (Nikolov & Josifov, 2007, pp. 14–15).

### 6.1.2 Financial Operations Indicators

Financial operations indicators that reflect the budgetary performance, fiscal flexibility and other aspects of financial operations are the most important factors that determine the ability of the local government unit to repay its debt obligations. Lenders and rating agencies evaluate the degree of revenue and expenditure flexibility during times of economic stress: the ability to balance the annual operating budget, ability to manage potential fiscal imbalance, willingness to control expenses, ongoing liquidity and cash flow management, and the weight of capital investments on the fiscal performance are all critical credit considerations (Nikolov & Josifov, 2007, p. 16).

Budget performance includes an analysis of the initial budget projections against final figures. Revenue composition and trends are considered. Composition and trends in expenditure are analyzed. Differences between projected and executed budget are considered by rating agencies and lenders. They also want to know what tools the finance manager has to prepare for unexpected changes in revenues and expenditures and how the local government decision makers respond to these changes. Capital spending and maintenance spending are a plus. Also, positive balances (surpluses) in the current operating budget are a strong positive.

Fiscal flexibility is the extent to which the local government unit can increase revenues and reduce expenditures during a crisis in order to maintain a balanced budget without jeopardizing timely debt service payments to creditors.
In the event of a decline in revenues from whatever reason, creditors are concerned whether the local government will have sufficient revenues for payment of debt service obligations while, at the same time, will perform its public service delivery obligations. The most flexible revenues available to local governments are own sources of revenues, primarily property tax and utility fees as well as the share of local personal income tax. They are the most important source of debt service payments. The creditworthiness diagnosis should focus on historical trends and reasons for annual variations of these revenue sources and the hierarchy of operating expenditure claims on these revenues. However, a local government may have difficulty making a timely debt service payment if most of its own revenues are needed for payroll and other inflexible expenditures or if intergovernmental transfers are insufficient to cover decentralized service expenditures. It is possible, for instance for the local government to increase its revenue by being more efficient in the way it manages the local economy (Nikolov & Josifov, 2007, pp. 17–18).

The local government's flexibility in spending depends on its ability to manage expenses. Indicators for expenditure flexibility will focus on the extent to which the local government can reduce expenditures without jeopardizing its service responsibilities. Expenditures that cannot be reduced for political or legal reasons are the most inflexible and may exert a claim on own revenues used for debt service. Inflexible expenditures often include local government employee salaries and maintenance of essential services. Essential services include utilities, such as water, sewer, electricity, garbage collection, public transportation. The self-diagnosis also examines capital expenditures even though they can be often reduced without interfering with the delivery of essential local government services. Capital expenditures are important to maintain and expand basic local government infrastructure, such as roads, water, sewer, etc., which are critical for a growing local economy and for attracting private investment to improve their own source tax base.

The fiscal flexibility indicators include revenue, expenditure and other recurrent budget ratios that are relevant for creditworthiness diagnostic purposes. Revenue indicators include indicators such as: property tax revenues as a percentage of own source revenues and other recurrent own source tax revenues as a percentage of own source revenues. These indicators measure the extent to which the local government depends on property taxes for debt service payments. Expenditures indicators, among others, analyse personnel expenditures as a percentage of total recurrent expenditures. This analysis includes historical trends in personnel costs and future payroll direction (Nikolov & Josifov, 2007, p. 18).

### 6.1.3 Financial Management Indicators

Financial management indicators include evaluation of local government unit financial policies, budget preparation and execution, revenue collection and management, procurement procedures and daily cash management. Elements that should be included in the diagnosis of risks associated with a local government unit’s financial management system are as follows: assessment of the local government unit’s financial policies; capital budgeting methodology and execution; review of the local government unit’s budget/accounting, cash management, procurement, revenue collection to estimate revenues and control expenditures; financial reporting and monitoring (both legally required reports and other ways the local government unit monitors its financial performance) (Nikolov & Josifov, 2007, p. 22).

It is very important to submit accurate and consistent reports based on quality and good financial calculations. Timely and independent audits are also very important, as is reporting on cash or cash accounting which provides authentic information, i.e. the available cash for debt servicing. Timely and comprehensive financial reporting and following consistent standards are a plus. Clear financial relations among local government units and the utility companies are very important as the utility companies may have hidden debts. The clear mutual relations and introduction of accrual accounting would increase the rating of the local government units. Financial analysis assists officials to better understand the local government’s fiscal situation and identify emerging trends of which they may be unaware. Moreover, financial analysis guides the local government financial planning and fiscal policy.

### 6.1.4 Debt Indicators

Debt indicators are divided into two categories: Local Government Units that have issued debt and First Time Borrowers.

For first time borrowers, the debt indicator is the local government debt capacity (the 30% legal debt limit). For local government units that have already borrowed, the debt indicators include: Maximum Annual Debt Service as a percentage of Own Source Revenues and Outstanding Debt Principal Per Capita (Nikolov & Josifov, 2007, p. 22).

Maximum Annual Debt Service as a percentage of Own Source Revenues – the limit under the current law is that no more than 30% of own source revenues may be used for debt service. However, there are conservative or liberal ways to interpret the numerator and denominator of this indicator. For purposes of preparing disclosure documents for a new debt issue, the local government should use a conservative interpretation of the law. In this case, maximum annual debt service is the highest debt service payment that occurs in any future year during the term of the loan.

Own source revenues are the actual amount of revenues estimated in the year that the loan is executed. Although not technically considered as “debt” local governments in the Republic of Macedonia may delay contractor payments and accumulate large arrears in accounts payable. There is no specific debt indicator for these payment arrears, but they should be carefully reviewed. If a local government accumulates payment arrears over 90 days it is important to understand the reasons for the delays and whether they are related to revenue collection arrears or due to a deeper structural fiscal imbalance.

Outstanding Debt Principal Per Capita – it is useful for the financial manager to understand the local government debt burden, i.e. total outstanding debt principal per capita, compared to the debt burden of other local governments to allow creditors to compare debt burden among borrowers (Nikolov & Josifov, 2007, pp. 22–23).

## 6.2 Credit rating

An independent, objective system of credit ratings of high quality is seen as an essential element to promote capital market development and enhance fiscal transparency. Good results of creditworthiness allow local governments to raise funds in the capital market and to reduce the cost of capital. Obtaining a credit rating increases the marketability of the local government. It opens up more financing options and enhances the local government’s ability to choose the most efficient and cost effective source of funding. By obtaining the credit rating, the local government will understand what the main determinants of its creditworthiness are and can decide what changes are needed to improve its credit risk profile and thereby reduce its borrowing costs. Publicly available local government credit rating could promote the best local government and warning those that under perform, motivating them for improvement. Thus, it would be possible to enhance positive competitiveness between local government units which could increase the efficiency of the complete local government sector.

The credit rating process (NALAS, 2011, p. 54) :

1. Local governments approach credit rating agency.
2. Application with specific financial information related to the local governments' activity is sent out to the credit rating agency.
3. Credit rating agency analyzes the local governments' application along with the local and national economic conditions and assigns a credit rating to the local government. As a rule, the credit rating of a local government cannot exceed the country sovereign rating.
4. After the initial rating, the credit rating agency periodically reviews the rating to take the latest financial and economic information into account related to the local governments' position.

Benefits of a credit rating for a local government (NALAS, 2011, p. 54 & Handbook for municipalities, 2009, p. 10):

1. Access to a broad number of potential investors, thereby reducing the local government borrowing costs as competition will increase.
2. Independent opinion on the future ability and legal obligation of an issuer to make timely payments on its financial commitments.
3. Independent estimation of current local government credit condition and future revenue and expenditure scenarios based on budget trends and budget projections.
4. Diagnosis of the basic risk factors that contribute to the creditworthiness condition and identification of the critical risk areas that may threaten the ability of the local government to make timely principal and interest payments on their debt obligations.
5. Objective assessment of important local government financial operations of critical concern to mayors, municipal councils and citizens.
6. Increased transparency and accountability of local government operations.
7. A good credit rating is an exceptionally good marketing tool as prospective investors will be assured that services are well run and that service infrastructure can be financed.
8. Better creditworthiness will mean that more sources can be tapped for finance. Higher creditworthiness also means easier credit decision-making by the financial institutions.
9. A credit rating and the information available in it can improve the negotiating position of the local government unit.

10. A formal detailed scrutiny and opinion by an independent agency is welcomed every year by potential lenders and investors as means of monitoring financial progress at the local government unit without the lender having to do the analysis itself.

Benefits of a credit rating for national government and regulators (Handbook for municipalities, 2009, pp. 10–11):

1. Credit rating reports provide national government departments and regulators with additional information supplementary to their own information sources, which is often very valuable. Credit rating reports constitute additional monitoring of the local government and in some cases the reports may alert national government departments to emerging problems earlier than conventional monitoring procedures.
2. The existence of the credit rating report will also make it possible to better target any necessary preventive or corrective interventions. The fact that the credit rating is an independent view of the local government is also valuable to a regulator or government department.
3. Policy formulation is also assisted if government is able to draw upon credit rating reports on many of its local government for information and insights. Indicators in credit rating reports can even in appropriate circumstances be used as a base for performance agreements, such as between government and the local government regarding turnarounds or in a performance contract of senior local government officials.

Benefits of a credit rating for potential lenders (Handbook for municipalities, 2009, p. 11):

1. Credit ratings publicly available and regularly updated allow investors to efficiently take a view on whether the extra risks are worth of an additional yield and to update their yield curves. Credit ratings, as far as risk is concerned, are not sector specific, and allow comparison across sectors. This encourages sector diversification in the portfolio, which further mitigates the risk.
2. Lenders need the independent external views to supplement own credit decisions. Formal ratings are done by independent rating agencies whose only real asset is other people belief in their integrity and skills. These independent views are very important for asset management companies to ensure integrity in their portfolios.
3. Ratings help investor to take a view on the probability of loss, the potential severity of loss and the potential for recovery, but do not replace investment decisions.
4. Ratings are helpful in monitoring and triggering interventions, because investors will not necessarily have the time or expertise across all sectors to adequately monitoring of their investments. They may depend on a larger degree on the monitoring services of the rating agencies which could trigger intervention caveats.

### 6.2.1 Credit rating of Macedonian Local Government Units

Rating agencies have different ways of evaluating the credit rating. However, they agree on the major analytical factors they consider in judging the creditworthiness of local government credit standing. These factors can be summarized in the next table, with some indications as to how they can help or hurt a credit rating.

Table 13. Factors Taken into Consideration in Assessment of LGU Credit Standing

| Factor | Comment |
|---|---|
| **Economy** | Fiscal security is often closely related to the security of local economy and diversity in the portfolio of the economic activity (usually is followed by the size). Demography has important role. Very young and very old have negative influence. Higher revenue and much more educated population are positive. Creditors are also interesting in the analysis of the local economy structure. Particularly, what is the size of the part in private ownership and how much local government economy is dependent on one industry or small number of large size employers. Yet, credit standing agencies usually require that local authorities provide lists of largest employers as well as lists of firms having largest overdue obligations. |
| **Structure and Management** | Intergovernmental transfers are taken into account for their size and predictability. National authorities' preparedness and capability to detect and resolve financial instability is a positive step. Strictness and timeliness of budgetary and financial procedures are checked and may present either positive or negative aspect, depending on the flexibility they provide. Timeliness and comprehensiveness of financial reporting and adherence to consistent standards is a positive step. |
| **Structure and trends of expenditures** | Capital consumption and maintenance costs are positive aspect; high salary rate is negative since expenditures are more rigid and provide little possibility to generate operative surplus. This creates hidden risk concerning unfavourable outcome in critical periods for economy. In that situation LGU reserved funds become very important. Budgeting capability and precise budget realization are positive aspects. Capital budget planning and payment of high amounts with current revenues is positive aspect. Budget predicting and planning as well as realization are important indicators of the LG financial management. If the trend leads to lower extent of timely collection, this is a clear signal that the budget planning is poor, and professional capacity to predict is weak, thus being a risk to build up a short-term debt. |

*"(table continues)"*

"(*continued*)"

| Factor | Comment |
|---|---|
| **Financial Position** | Liquid assets and market real assets are favourable factors. Outstanding debt is taken into account. Short-term debt should be taken into account if not serviced periodically. A short-term debt with bullet maturity is negative factor due to the continuous refinancing pressure and potential burden to the current expenditure. |
| **Legal framework** | Lack of clear laws and precedent in law are big obstacles. The history of lack of fulfilment or insolvencies is negative aspect. Granting loans by central authority and restrictions on local indebtedness may be positive aspects if efficient and not politicized, but it may be negative if complex, hard and politicized. LG in Macedonia are forbidden to use property as pledge if used for provision of public services. |
| **Accounting and financial reporting** | The base and quality of financial reports are examined, and accurate and consistent reports are positive aspects. Timely and independent audits are also positively evaluated. Information on cash or cash-based accounting that provides authentic information on the money that may be used for debt servicing is positive aspect. Clear financial relation between LGs and enterprises that may create debt is of particular importance. Clear relations between them and the possible increasing accounting perceiving all growths, raises the LSGU rating. |

Source: M. Nikolov, *Future of Local Public Finances: Case studies in Romania, Bulgaria and Macedonia*, 2006, pp. 107–110, Table 21.

Local government credit rating is very important for the local government future, since now they can access capital markets and borrow money for local development. Macedonian local government units recognize that transfers from the central government and revenues from local taxes and fees are not sufficient to finance the increased needs for new infrastructure and other capital projects. Hence, they understand the need to borrow funds through loans or bonds issuance at the capital markets. In order to ensure the best possible price for their loans, to attract the investors and to control the cost of borrowing, it is essential to obtain a credit rating prior to accessing the private capital market and issuing debt. By developing their creditworthiness and gaining a positive credit rating they are eligible for entering into the world credit market, thus attracting international investor, beside the domestic.

Over the past years USAID Macedonia Local Government Activity (hereinafter: MLGA) has been working on enhancing local government creditworthiness and establishing local government tools for good local government credit rating. Strumica and Veles are the first two local government units in the Republic of Macedonia that got the B1 credit rating by the world known credit rating obtaining agency Moody's Investor Services. So, Strumica and Veles became the first local governments in the history of local self-governance in the Republic of Macedonia that were assessed according to the internationally recognized criteria and got approached by commercial banks as a result. Having already obtained a credit rating, Strumica got EUR 9.8 million grant from EU IPA component on environment that will be used for construction of waste water treatment facility.

Based on the positive experience of Strumica and Veles, USAID MLGA is continuing to work with several additional local governments in assigning credit rating. Five most creditworthy local governments were selected to receive credit rating from the international credit rating agency Moody's Investors Service as their prize. The five winning local government units are: Gevgelija, Gostivar, Ilinden, Kumanovo and Shtip. Local government units Gevgelija, Gostivar, Kumanovo and Stip have acquired international credit rating B1, whereas Ilinden received B2 rating. The favourable credit rating demonstrates that the local government's budget has been properly managed; the local government has no debts, possessing fiscal capacity; financial state is good; local government possesses favourable liquidity and is not exposed to large indebtedness. The credit rating legitimizes the local government before all international financial institutions.

Most investors, especially smaller institutions and individual investors do not have enough resources and analytical skills to make solid credit analysis in order to understand a particular variety of credit, so they prefer to rely on the experts' opinions. The role of the expert opinion is best reflected in the function of the credit rating agencies. An independent, high quality, objective system of credit ratings is crucial component for the development of capital market. Credit ratings are commonly used in the financial and banking sectors as an independent view of the creditworthiness of the institutions being rated. They rate local governments on their ability and willingness to repay the debt at certain time. Higher creditworthiness means easier credit decision-making by the financial institutions. Thus, only potentially creditworthy local governments can consider borrowing to finance their needs. Credit rating is particularly important when the security market investors are numerous and "passive" and they have to rely on information received from the issuers in making investment decisions. Credit rating also can serve as constant monitoring instrument and tool for institutional investors to balance their portfolios of financial assets with different risk levels. Since by becoming creditworthy, local governments can significantly decrease the cost of borrowing, it is generally advisable for them to make strong and continuous efforts to improve their creditworthiness and so that they can obtain a formal credit rating or enhance the current rating.

# 7 LOCAL GOVERNMENT ASSOCIATIONS

Local government associations are voluntary membership organizations comprising local governments from within a country or region, acting as an effective and authoritative advocate on behalf of members in relation to central government, the parliament, potential investors and other stakeholders. With regard to local public debt local government associations should aim to create and/or improve appropriate legislation, provide information and statistics to potential lenders, central government and other stakeholders and assist member local governments to develop and improve debt management plans and operations (NALAS, 2011, p. 92).

Key activities of local government associations include: representation of local government on national bodies and ministerial councils, providing submissions to government and parliamentary inquiries, raising the profile and concerns of local government at the national level and providing forums for local government to guide the development of national local government policies (Australian Local Government Association, 2012).

Primary goal of the local government associations is promotion of their strategic goals and support for their implementation by improving and advancing the process and manner of communication with target groups.

Target groups (NALAS, 2011, p. 92):

1. In relation to lenders – mediating communication and information flows between local governments and potential investors.
2. In relation to member local governments – timely and clear definition of the needs and interests of the local government units, promotion of the said needs and interests in the public, providing assistance to members in structuring and financing investment; maintaining ongoing communication with member local governments to set/develop best practices in accordance with international standards.
3. In relation to central governments and parliaments – emphasize the partnership relations, articulate the common interests of local government units in front of the central government bodies, lobby and campaign for changes in policy, legislation and funding on behalf of its members.
4. In relation to donors and international financial institutions.

**Local governments associations in relation to lenders** – As mentioned in the previous parts, local credit markets in emerging economies lack the functionality of developed economies; financial institutions willingness and capacity to finance local governments is reduced by the low degree of knowledge and transparency of local finances. In this context, associations can play a crucial role in bridging this information gap and thus may contribute to a better understanding by lenders of local economics (NALAS, 2011, p. 93).

Local government associations should disclose publicly information about member local governments which would help financial institutions identify potential lending targets based on their internal credit risk policy. Data should be updated regularly and presented in a standardized format that would enable comparison across member local governments. Also, associations should present important data that could be of interest to potential investors: geographical positioning, natural resources demography, dynamics and structure of local economy, list of projects to be financed, financial figures and political structure of the local government. This would enable potential investors/ lenders to have an accurate overview of the local government's long term revenue generation potential and over its indebtedness capacity. Detailed financial statements of each local government should be published regularly on the associations' website. They should include consolidated budgetary executions, balance-sheet data as well as information on arrears and off-balance sheet items. Legal provisions for the purpose of loans as well as limits on maximum indebtedness level should be clearly identified and outlined on the associations' website in order to be well understood by the lenders and investors (NALAS, 2011, p. 93).

Large investment projects for which local governments seek external financing should be promoted by associations to potential lenders/investors. Thus, they should disclose the capital investment strategies of individual local governments. A solution to increase accessibility and transparency could be the development of an electronic platform where members could upload a detailed description of their future investment projects. Thus, interested investors/credit institutions would find out about the local governments' investment plans in advance and would have time to analyze and decide when and where to allocate their resources. Eventually, the associations could bring together member local governments and financial institutions in discussion forums where the former would present their capital investment strategy and describe the most important projects. Local government associations may get involved in the development of local credit markets by lobbying at the central government level and international financial institutions for creation of different market enhancement mechanisms (NALAS, 2011, pp. 93–94).

**In relation to member local governments** – The perception about financial markets among inexperienced local governments is usually incomplete leading to inefficiencies in terms of structuring, contracting and servicing financial debt aimed at funding investment projects. In this context, local government associations should assume a proactive role, by helping members to better understand the mechanics of credit markets and thus to be able to make the right decisions when they access debt financing (NALAS, 2011, p. 94).

Setting up a database with loans contracted by member local governments – including transaction details such as interest rates, commissions and fees, grace period, maturity, amortization schedule or refinancing options – would enable associations to have an extensive overview of the market activity. Depending on market conditions, associations should advise members when to pursue debt financing. For example, at times of financial market distress, with low liquidity and high risk premiums – as the case during the recent global financial and economic crisis –, debt financing can be difficult and expensive. In such cases, associations could work with local governments to prioritize investment expenditures and postpone them, if possible, until market conditions resume to normal (NALAS, 2011, p. 94).

Local government associations should issue recommendations, based on identified best practices on how members should structure tender documentation when contracting loans or issuing bonds. Depending on the type of investment project and the financial position of the contracting local government, different requirements can be included in the public procurement documentation. Designing the criteria for identifying and selecting the best suited offer is also an important aspect that needs to be addressed by associations (NALAS, 2011, p. 95).

At the same time, local government associations have a critical role to play for the emergence of "developmental" local governments worldwide, both by advocating and sustaining the momentum of decentralization reforms, and building the capacity of their members to adopt good local governance practices and promote good local development. But such potential varies greatly from country to country. There are significant, sometimes dramatic differences in mandate, structures and capacity, reflecting variations in both the advances of decentralization reforms and the nature of the local governments they created, in any given country (Romeo, 2010, p. 2).

As a general rule, the ability of local government associations to act as an independent advocate of their members interests, speak with credibility on their behalf, and provide them with effective services, depend on the extent to which local governments are recognized as an autonomous sphere of government within the national State, and have the executive and administrative capacity to function as such. Therefore, local government associations are less effective and capable precisely in developing countries where independent local government associations are needed most, to move the decentralization reform process beyond its initial political rationale and build developmental local governments (Romeo, 2010, p. 2).

**In relation to central governments and parliaments** – The balance of power between central and local government matters. It matters because improving the lives of local people and local communities matters, and because where the balance of power between central and local government lies, there lies the responsibility and accountability for the delivery of those improvements (House of Commons Communities and Local Government Committee, 2009, p. 3).

Local governments should make every effort to develop and consolidate a cooperative relationship with central governments as the first necessary step in the pursuit of their aims. The relationship between local government associations and central government in the design of legislation regarding local public finance and debt is of crucial importance. The relationship may be institutionalized or ad-hoc. In the former case, a national regulation should provide that draft legislation influencing local governments must be separately discussed and debated with representative associations. The names of the associations should be clearly stated. In addition, a procedure should be laid out dealing with at least the following issues:

1. the type of draft legislation to be consulted with local government associations (laws, government resolutions, emergency ordinances, minister orders etc.);
2. the areas of legislation to be consulted separately with local government associations (anything that influences the operation of local governments – finance, allocation of expenditure responsibilities, human resources etc.);
3. the phase(s) when the consultation takes place (before the final approval decision, before or after the first draft is completed, before endorsement by the initiating central government institution etc.);
4. the forms of consultation (written communication, meetings, conferences etc.);
5. the deadlines for written communications (for instance, the line ministry would expect feedback from the associations in 10 days from communication and 3 days in emergency situations);
6. the report on the consultation procedure and the associations' points of view should be included in the described documentation accompanying the draft legislation to the decision-makers;
7. the sanctions for non-compliance with the consultation procedure (challenges to the administrative/constitutional courts, fines etc.) (NALAS, 2011, p. 95).

The ad-hoc relationship does not require special consultation with local government associations. This can be carried out as a part of the general public consultations. Special local government consultations take place only if the central government deems necessary. In certain situations, central governments may deliberately seek to avoid discussing to local government associations and stick to the minimum legal requirement for transparency. As a result of this approach the message of local government associations may not be heard at all. Consequently, it is wise for local governments to push an institutionalized relationship with central governments as a prerequisite for successful influence on national legislation (NALAS, 2011, p. 96).

Central governments may not always know the demands and grievances of local communities. Hence, the heads of the associations should seek to meet the members of the government and other decision-makers as often as possible. Also, local government associations should develop the habit to regularly inform the government and line ministries about their status and the most pressing problems. Such reports should be sent regularly including the tangible and reasonable solutions; the associations should be aware that no ministry gives attention to radical or unrealistic proposals. Finally, local governments could invite central government experts to visit their premises and experience firsthand how the legislation is implemented and what problems are encountered (NALAS, 2011, p. 97).

Parliament is a significant player in the balance of power debate. The manner in which parliament considers and debates local government activity helps to define the parameters of media and public debate about the role of local government. Parliament also has the ability to influence the balance of power through its formal legislative and scrutiny roles. If there is a case for parliament to withdraw from some of the more tactical local issues, there may equally be a case for parliament to engage more fully at the strategic level, to legislate on and then scrutinise the balance of power between central and local government (House of Commons Communities and Local Government Committee, 2009, p. 3).

Local government lobbying for better regulation on local public debt must not stop once the draft piece of legislation is developed and endorsed. In the case of laws, local government associations should continue with their work within the parliaments. Although parliaments do not practically draft much of the legislation they approve all laws and emergency ordinances put forward by central governments. Members of parliament have the last word on any draft which is set to become law. Hence, local governments associations must devote time and appropriate expertise in lobbying parliaments to ensure that approved legislation meets their objective (NALAS, 2011, p. 97).

Parliaments work in special committees and general assemblies. Most debates take place in committees; stakeholders can be invited to take part. Committee debates do not usually have a detailed technical content; members of parliaments are more concerned with political objectives of the draft laws and particular situations arising from their constituencies. The central government representatives take part in the committee hearings by default. Local governments should also make sure their voice is heard especially if they are seeking specific aims. If invited, the associations should not send only technical staff, but also local elected officials wielding political influence in their parties, such as mayors of big local governments. They are more likely than central governments to convince the members of parliaments because they are credible representatives of local communities (NALAS, 2011, p. 97).

In parallel, local government associations must seek to develop a permanent relationship with the members of parliaments and technical staff from specialist parliamentary committees in a similar way to that with central government experts and decision-makers. Such a relationship greatly enhances the associations' powers of persuasion and also allows them to by-pass the central government, if needed. As regards the legislation on local public debt, local government associations should pursue the same specific goals outlined above making sure the content of draft laws is not altered against their wishes (NALAS, 2011, p. 98).

**In relation to donors and international financial institutions** – The scarcity of resources which the local government associations can draw from their members should prompt them to look for alternative funding. To this end, donors represent the most likely source of funds. The EU, the United States Agency for International Development and the likes may provide much needed technical assistance and funding to the associations projects. Donor aid can be materialized in direct support to member local governments. In the case of local public debt, the associations could draw technical assistance for development of analyses, handbooks, draft legislation, local debt strategies and even carrying out credit ratings. As regards international financial institutions, the associations could play a role in facilitating contact to member local governments and promoting local capital market enhancement mechanisms, such as development funds or guaranteed funds. Such examples are already present in South-Eastern Europe (NALAS, 2011, p. 98).

## 7.1 Association of the units of local self government of the Republic of Macedonia, ZELS

Association of the units of local self government of the Republic of Macedonia, ZELS, is a non-profit organization and the only national association in which all of the 84 local governments and the City of Skopje as a separate unit of local government are voluntary members. It was founded on April 26, 1972. ZELS unites all 84 local governments in Macedonia and the City of Skopje as its members. To realize the objectives that are undeniably unique, ZELS find mechanisms for active involvement of all intellectual and technical capacity of local governments to form special committees covering all aspects of decentralization.

Structure of ZELS:

1. General Assembly;
2. Steering Committee (19 members);
3. Supervisory Board (5 members);
4. Committee of the council (12 members);
5. Council for Development of ZELS (5 members);
6. Professional staff (15 employees).

Promotion of local democratic values, representing the interests of local government to central government, the role of active participants in building regulations for decentralization, lobbying and initiating legislative changes and adoption of new solutions in the interest of local government, the exchange of best practices from developed European democracies and finding ways for their implementation in Macedonian local governments and greater financial stability of the local governments, are priorities that ZELS continuously advocates and contributes to their best solution.

According to the Statute of ZELS, adopted in October 2004, the overall mission of the Community is to advance the principles of local governance through the following activities:

1. promoting and encouraging mutual cooperation and exchange of information among members;
2. serve as a lobby group and act as an advisory body to the central government in local government;
3. promote continuous and constructive cooperation of local and central government authorities;
4. establishing relationships with national and international associations of local authorities;
5. organizing training courses and conferences for its members (Association of the units of local-self government of the Republic of Macedonia, 2011).

Furthermore, ZELS contributes to the development of local democracy and successful implementation of the process of decentralization. ZELS decisively represents the interests of local governments before the central government. ZELS representatives realize meetings with the Prime Minister and line ministers, the President of the Assembly, where they carry out the attitudes of local authorities for all significant issues and challenges offering concrete initiatives and solutions. ZELS managed to open a new dimension in advocating favorable legislation for local governments through establishment of parliamentary Committee on Local Government in the Parliament of the Republic of Macedonia (Association of the units of local-self government of the Republic of Macedonia, 2011).

ZELS Strategic goals:

1. Lobbying and building capacities for lobbying;
2. Current problems solving;
3. Financial stability of the local governments;
4. Establishing a system for training of local governments representatives;
5. Support of its members in their access and use of the EU pre-accession funds;
6. Accuracy of committees;
7. Ensure financial sustainability of ZELS;
8. Strengthening/building the capacity of the services of ZELS.

**Lobbying and building capacities for lobbying** – ZELS has established a modern system of lobbying based on various grounds and levels of improvement in local government position. ZELS successfully represents the interests of local governments before central government, parliament and other domestic and foreign institutions. It follows the modern trends of development of local governments, contributes for strengthening the position of local governments in the country and practices international lobbying experiences. ZELS continuously develops and builds the capacity of their lobbying bodies.

**Current problems solving** – ZELS has established a system for rapid detection, targeting, responding and resolution of the current problems of local governments. When solving the problems local governments are in constant communication and coordination with the professional correspondence office of ZELS, ZELS committees and other institutional bodies.

**Financial stability of the local governments** – ZELS establishes and follows policies for long-term financial stability of local governments. Financial condition of most of the local governments is improved as a result of: increasing sources of revenues, transfers from the central government budget, PPP, donations, loans and other financial sources. Most of the local governments are trained to exploit their own resources; they are financially stable and with a higher degree of local economic development. Each local government works hard and permanently on finding new sources of funds that will provide financial independence.

**Establishing a system for training of local governments representatives** – With ZELS assistance standards for monitoring of the needs, evaluation and certification of the expertise of civil servants, mayors, councilors and other officials of the local government units have been established. There is a transparency and disclosure for the opportunity to train LG representatives from all ZELS members. With ZELS assistance and coordination local government administration is capable to professionally carry out the responsibilities, to prepare projects, to successfully use ICT and other modern methods of work. ZELS regularly organizes training and cooperates with various donors to support the development of local governments. Within ZELS it is established an institutionalized, functional and sustainable ZELS Training Centre (ZTC), which offers professional training.

**Support of its members in their access and use of the EU pre-accession funds** – With ZELS assistance local government administrations have been trained for successful and timely preparation of applications and projects. They are well informed and focused on current programs, projects and donors. Local government administrations receive necessary assistance in the preparation of projects related particularly for the use of IPA funds. Through ZELS office in Brussels, ZELS lobbies for obtaining international grants to support local governments. According to this, ZELS has built good relations with international and domestic financial institutions. ZELS is also a participant in the institutional bodies that establish the criteria for allocation of funds. Also, Fund to support local government development with international institutions and banks funds is established.

**Accuracy of committees** – ZELS has a total of 12 Committees covering all areas of competence and interest related to local governance. Each committee has a work plan. There is synergy between implementation of the policy of committees and professional networks of ZELS. Committees have the practice of regular monitoring of new laws and other by-laws and documents and call meetings whenever necessary. Committees are proactive in finding effective solutions regarding the problems and needs of local governments. Besides regular meetings, committees use electronic communication as a form of policy-making and share semiannual reports on their operations. Regarding the committees, ZELS provides an exchange of positive experiences in the region and beyond that will help for promotion of local government policies and conditions.

**Ensure financial sustainability of ZELS** – ZELS is financially independent. It is established a policy that provides full payment of the membership fee. Also, there is a categorization of basic and paid services.

**Strengthening/building the capacity of the services of ZELS** – ZELS professional services/bodies employ qualified staff that performs its tasks in timely manner, offers high-quality services and quickly and efficiently accomplishes the delegated tasks. Professional services/bodies build the staff capacity through an established carrier system for professional development, training and continuous evaluation of all employees and the CEO. They also monitor the current problems of all local governments and equally participate in finding their solution. ZELS professional services/bodies have developed capacity to deliver the basic and paid services. At the same time, they cooperate with domestic and international nongovernmental organizations and apply best practices and positive examples for their own organization.

As mentioned above, ZELS has fruitful and successful cooperation on international level. ZELS is a member of:

1. CLRAE – Congress of Local and Regional Authorities of the Council of Europe with seat in Strasbourg, is one of the three basic bodies of the Council of Europe, besides the Committee of Ministers as decision-making body of the organization, the Parliamentary Assembly as driving force for European cooperation and the Congress which presents the voice of the European regions and local governments. The Republic of Macedonia has nominated, by means of ZELS, three mayors as its members and another three as deputies;
2. CEMR – Council of European Local governments and Region has existed for more than 50 years and ZELS became its member at the beginning of 2004. The greatest part of CEMR activities is financed by the membership of its members as well as from the European Commission and they are mainly oriented towards the EU member states. Nevertheless, ZELS takes active part in some of its projects. Accent can be placed on the project for gender equality in local governance, which produced a Declaration on Equal Participation of Men and Women in Local Governance as its final product, and has been adopted by the ZELS Managing Board and recommended to all the local government units. ZELS is also actively included in the project for twinning of the European local governments, for which CEMR made a web page and ZELS administration prepared a complete translation into the Macedonian language. The goal

is all Macedonian local governments to use actively this tool in the future processes of fraternization with the European local governments;

3. NALAS – The Network of the Associations of Local Authorities in Southeast Europe has been active for more than seven years. It was established officially in 2004 in Strasbourg, France. The first session of its General Assembly was held in Skopje, in September 2005. Since March 2007, NALAS has also had a Secretariat, which is run by an Executive Manager and employs five people. The Secretariat's base is located in Skopje, in the ZELS building, the House of the Local governments. Several working units are formed within NALAS each led by one association, member of NALAS. ZELS is in charge of NALAS activities in the area of Associations Development. The tasks of this unit include establishing the best operation systems of training local government and elected officials, best practices exchange, establishing cooperation of different structures of employees in the associations, introducing the system of standards in the associations, exchange of experiences in view of using the IPA funds as well as training related to these funds. The first workshop within the frameworks of this group, called Operational Standards was organized in ZELS, where the counterparts from the other associations supervised the work of ZELS and gave recommendations for improvement as well as a number of positive assessments. NALAS also organized the first workshop for the Associations' PR and IT officers, in Ohrid in order to establish a more intensive cooperation and exchange of information between NALAS and its members (Knowledge Centre).
4. ALDA – Association of the Local Democracy Agencies was formed in Strasbourg and the seat is located in Italy. It has active cooperation with its offices open throughout the region and its office in Macedonia is located in the ZELS building. At the moment, ALDA and ZELS are working together on a project financed by the Lower Normandy region. The concept of this Project is based on joint cooperation in the sphere of citizen participation, local governments twinning and other activities.

ZELS has also developed Communication Strategy which primary goal is promotion of strategic goals of ZELS and support for their implementation by improving and advancing the process and manner of communication with target groups (local government units, public, central government and employees). The Communication Strategy of ZELS developed from the vision and mission of ZELS and it supports their implementation (Association of the units of local-self government of the Republic of Macedonia, 2011).

Objectives of the strategy are the following:

1. Increasing the satisfaction of the local governments with the work of ZELS by improving their information awareness and promoting their common interests in the public;

2. Increasing public understanding of the role and work of ZELS by intensifying presence of ZELS representatives, the Governing Board and committee representatives in the media;
3. Continuing and advancing the positive image of ZELS in the public by more efficient use of identification forms;
4. Promoting the interests of ZELS members before the central government by improving the system and communication intensity;
5. Providing increased efficiency and motivation of ZELS employees by improving the system of internal communication and information awareness;

ZELS accomplishes the general goal and the specific objectives of the communication strategy through:

1. Introduction of a system for regular and timely communication;
2. Promotion of the forms and manners of communication;
3. Delegation of the personal responsibility for the implementation of the strategy and its parts;
4. Optimal use of the resources (human, equipment and similar) for implementation of the communication strategy;
5. Regular evaluation and updating of the communication strategy.

In the process of implementing the communication strategy, ZELS adheres to the following principles of communication: the communication process to be clear and known to all ZELS members, communication to be made in a timely manner and be open, fair and sincere, information to be available to everyone and communication to be two-sided between ZELS and local governments.

Target groups:

**Local government units** – ZELS maintains two-sided communication with local governments in order to make timely and clear definition of the needs and interests of local governments, to promote the said needs and interests in the public and, at the same time, to strengthen the position of local authorities in front of the central government on behalf of all local governments. ZELS encourages its members to provide information on all important events and activities in their local government units in order to strengthen the feeling of belonging to the local governments in ZELS and by this to provide two-sided communication.

**Citizens** – ZELS regularly informs the citizens of the Republic of Macedonia about its activities with the purpose to increase the visibility of its work, to emphasize the benefits the citizens have from ZELS activities and to strengthen the public support for its work.

**Central government** – ZELS actively promotes the communication with the central government in order to emphasize the partnership relations, to articulate the common interests of local governments in front of the central government bodies and to influence the decision-making in function of speeding the local governments development, which are in interest of the citizens on local level.

**International organizations and donors** – ZELS permanently informs the international organizations and donors about its activities, projects and needs with the purpose to demonstrate accountability for realization of the current projects and to stimulate the support for the following activities and needs.

**Non-governmental sector** – ZELS communicates and informs the non-governmental organizations about its activities and programs in order to initiate active support, participation and joint projects in the interest of the local governments' development.

**ZELS staff** – ZELS promotes the channels and forms of internal communication among the staff as an additional input in the strengthening of their role in the advocacy and proclamation of ZELS interests.

ZELS uses and promotes communication instruments with all target groups building proactive relation towards media as main resource to transfer its messages to the target groups. Having the role and the importance of media in the society into consideration, ZELS maintains continuous and stable relations with media. ZELS defines instruments and activities for communication with public individually for each activity in order to maximize the possibilities for visibility of the activities. ZELS uses the following communication instruments and activities: weekly information, frequently asked questions, ZELS newsletter, web site, publications (special brochures, manuals, informers, guidebooks etc.), press conferences, informal meetings with media representatives, meetings with central government representatives, formal letters, meetings with donors, special events, holding regular staff meetings, intranet, etc.

ZELS conducts monitoring for implementation of the communication strategy on permanent basis. During the period of monitoring, ZELS implements quantitative and qualitative measurement of results of implementation of the communication strategy. For the needs of quantitative measurement there is a precise evidence of the number of implemented activities foreseen with communication strategy while surveys are conducted to evaluate the satisfaction level of target groups regarding qualitative measurement. Indicators obtained as a result of monitoring serve as base for evaluation of efficiency of use of the communication strategy and for updating and adjusting the strategy according to ZELS needs. ZELS updates the communication strategy minimum once in a year, at the end of each calendar year. Results from monitoring of implementation of the current strategy are taken into consideration during updating process.

ZELS activities have been focused especially on finding the legal bases to ensure greater financial independence of the local governance units. ZELS continues to carry out the goals aimed at affirming local democracy values, based on the principles of de-politicization, members' equality, loyalty, political independence and professionalism, all directed towards building a strong local government in the Republic of Macedonia.

Access to capital is a major issue for local governments in the Republic of Macedonia, especially now once they are allowed to borrow from the private credit market to stimulate growth. The establishment of local government associations can help the development of the local capital market. The associations could play a role in facilitating contact to member local governments and promoting local capital market enhancement mechanisms.

## CONCLUSIONS AND FUTURE PERSPECTIVE

The decentralization process in the Republic of Macedonia has started with the establishment of legal frameworks for transfer of responsibilities to local governments and the necessary resources for their execution, providing a stable legal framework for financing of the local governments, effectively communicating the ongoing decentralization process and supporting inter-municipal cooperation to achieve efficient and equitable provision of services to citizens. The process of fiscal decentralization is gradually getting into the final period of actual adjustment of local governments in managing transferred competencies and financial resources. Thus, local governments have assumed wider responsibilities in many different areas of operation with aim citizens to get faster, better and cheaper services through this process of transformation.

In general, fiscal decentralization processes have opened up the opportunity for local governments to use various instruments of borrowing to finance their local investment financing needs. Thus, the development of local government capital market is significantly important for local governments to increase the volume of local capital investment to support necessary local government services.

In principle, local governments may borrow short-term for covering temporary cash deficit and long-term for funding the capital projects and investments. Local government borrowing deepens local capital markets and strengthens the commercial banking system to learn how to assess creditworthiness of borrowers. Access to capital markets requires a sound condition of local government finance in order to be able to repay the loan. The exposure of local governments to capital markets can significantly speed up infrastructure development and also requires local governments to be more transparent and to impose a certain control function on their finances.

However, there are always risks in encouraging local government entities to borrow. There may be the temptation to borrow excessively. Local governments may unconsciously pledge the same collateral as security for a loan to more than one lender. National governments need to be aware of such risks and to regulate them appropriately. Regulation could be as light as a requirement for regular disclosure of the extent of indebtedness, some prudential ratios to limit total debt and reasonable limits on pledging intergovernmental transfers. It should allow the discipline of the market (including credit ratings) to play its part.

Namely, the purpose and the main goal of this thesis are achieved. The five hypotheses that are subject to this thesis are conformed. The first hypothesis is that: "Implementation of investment projects (capital items) of local governments depends on their ability to raise the necessary funds by combining their resources (own sources of revenues and others) and external financing (borrowing)." When considering what resources are available to fund capital investments, it is the most important for local governments to consider all possible financial alternatives. A wide range of sources are possible, for example current revenues, grants from central government funds from donors, private sector investments (PPP). Some local governments have high share of special revenues and are thus less dependent on transfers from the central government. This provides them with a more stable budget to finance capital investments. For most local governments in developing countries a rapid increase in spending on infrastructure projects is needed as soon as possible, not only to build new infrastructure but to refurbish existing infrastructure. Many national and local governments in the developing world are looking closely at the benefits of using borrowed money to build the infrastructure needed for more and better local government services. Capital expenditure requirements are enormous and the flow of current revenues, government grants or donor funds will not be sufficient to meet those needs in the foreseeable future. Borrowing for capital expenditure can make this possible. Borrowing can provide large capital sums for immediate use, and the resulting longer term debt can be serviced from a regular stream of local government income whether directly from revenues resulting from the investment or indirectly through increased tax revenues.

From one side, borrowing results in additional costs related to bank charges, interest, etc. For sure it would be better to wait until the investment project could be financed from current revenues thus avoiding the additional and unnecessary costs of borrowing. However, in general, financial capabilities of the local governments are smaller than the figures needed for investments. This is normal because the local government budgets are still very modest to take on important projects. One way to satisfy the needs for finances in order to complete the investment projects is by combination of their own sources of revenues with external financing (borrowing). However, in future each local government should understand its capabilities and on this basis to define its medium-term development policy.

The second hypothesis is that: "The financial framework for local governments plays a key role in sustainable development of local capital markets." The design of intergovernmental fiscal structure together with the accounting system and reporting procedures are important factors that are taken into consideration by financial institutions when assessing the opportunity to finance local governments. Very often intergovernmental transfers, if not tied to particular investments, are a key feature of local government budgets and play a crucial role in financing of capital expenditures. Limits to local indebtedness should be clearly stipulated in legislation on local public debt and should include at least the purpose of borrowing and maximum debt thresholds. Regardless of the system in use, the most important and necessary condition for local borrowing in this respect is that local governments adhere to the national accounting standards in place. This determines whether financial documents and reports are readable, transparent and comparable for potential investors as they need this information in order to assess the creditworthiness and credit risk. However, regulatory framework alone cannot support the development of a healthy local government credit market. Unless local governments can demonstrate that they have a track record of reliable revenues from which to repay debt, financial institutions will not enter into financing agreements with local governments. Basically, it is the financial health of a local government that determines its creditworthiness.

In terms of legal framework, Macedonia has a solid base for financial management regulating the level of the local government borrowing. The legal framework for local borrowing is regulated by the Public Debt Law and the Law on Financing of the Local Self-Government Units. The Law on Financing of LGUs regulates the limits for short-term and long-term debt of the local governments related to the total short-term debt of the local government and the total annual repayment of the long-term debt. The phased approach to fiscal decentralization is closely connected with the intergovernmental transfers. Grants from the Budget of the Republic of Macedonia and budgets of the Funds provide additional revenues to the local government budget for financing its competencies determined by law. Macedonia is moving towards the implementation of a comprehensive transfer system, with some conditional grants for current and capital expenditure programs and with an equalization grant based on fiscal disparities (defined as difference between expenditure needs and fiscal capacity), whereby for all local own services expenditure needs (thus excluding delegated responsibilities to be financed with conditional sector grants) be defined on the basis of per client expenditure norms defined for separate expenditure categories.

The third hypothesis is that: “Bonds are the preferred form of funding for major capital projects that need long-term financing.” There are two major types of debt instruments available to finance local government capital expenditures: loans and bonds. Since bond issuance goes along with many disclosure requirements, bonds contribute to more transparency in local government, from which the public would profit as much as lending institutions. Thereby, the monitoring function of the public may contribute to strengthening accountability. However, some local governments might rather avoid the modality for that particular reason. As mentioned above, local government may borrow by signing the loan agreement and issuance of securities (bonds). Even if borrowing appears to make the most sense, the type of borrowing that is most appropriate to finance capital projects needs to be considered. Local governments may borrow through a local or national bank and, also, they can issue debt (bonds) in either the domestic or international capital markets. Most commercial banks are not involved in long-term financing of the local governments. Having in mind that banking regulations limit the banks to make long-term loans because their liabilities (deposits) are short-term and volatile and their assets (loans) are long-term, this is not unusual.

Many countries simultaneously use bank lending to local governments and local bond issuance. The policy rationale, however, justifies emphasizing development of local bond markets. The public monitoring and public disclosure required for efficient bond market operation are consistent with greater transparency for all public financial transactions.

Municipal bonds are of particular interest to investors because the local government is a guarantor for their return, and an additional incentive is the tax-free status of interest payments. Besides the attractive interest rates realized by investing in bonds, the investor is also exempted from paying personal income tax. Some of the benefits for local governments from issuing bonds are the following: mobilizing resources, implementation of planned development projects, acceleration of regional and local economic growth, increasing of the quality of life of citizens and obtaining greater financial independence from central government. Benefits for investors from buying bonds are the following: receive yield that depends on the quality of the issuer and maturity of the bond, development of capital market in the country and opportunities for better diversification of portfolios, the return on these bonds is exempted from personal income tax, investing in the development of the environment in which they live.

In the Republic of Macedonia some two-year and three-year government bonds have been issued until now, but corporate bonds or bonds issued by joint stock companies as long-term securities have not revived in the capital market yet. Having this kind of situation in mind in order to encourage local governments, as soon as possible, to begin the procedure for issuing municipal bonds, the Ministry of Finance of the Republic of Macedonia in 2010 proposed an introduction of municipal bonds as a new possible and suitable instrument in which mandatory and voluntary pension funds in the future will be able to invest a part of collected funds. At the same time, the issuance of municipal bonds will enrich the offer of long-term securities in the country which, in turn, will contribute for reviving the market for securities in the Republic of Macedonia.

The Ministry of Finance in relation to implementation of the government plan to improve the financing of local governments strongly supports the idea of introducing municipal bonds and encourages the local governments to begin the procedure for issuance of municipal bonds to finance their capital projects. The Ministry of Finance has prepared

Guidelines for issuance of municipal bonds in order to acquaint the local governments with the procedure for issuing municipal bonds. Depending on the readiness of the investment projects it can be expected in the near future some of the local governments that have greater fiscal capacity and have already received credit ratings to express interest in borrowing through issuance of municipal bonds.

Recommendations for the Macedonian local governments are: examination of investors market; determining the amount of the bond and the interest rate; the municipal bond to be annuity bond in order to achieve attractiveness for investors; liquidity and confidence for timely servicing of debt or repayment of principal and interest; determining the maturity of the bonds according to the interest of investors; the way of issuance of bonds (public / private offering) to depend on the cost analysis regarding the issuance of the bonds and duration of the procedure.

The fourth hypothesis is that: "Local government creditworthiness assessment as diagnostic tool to maintain/improve the financial health of the local governments." The market potential for local government loans depends on the general creditworthiness of local government units and on the unused debt capacity. Creditworthiness of local governments is a demand-side requirement for local borrowing. Generally speaking, creditworthiness refers to the ability and willingness of a borrower to repay the debt. Assessment of creditworthiness leads to a good credit rating enabling local governments to attract lenders and borrow at reasonable prices. Information about creditworthiness is a key factor for the working of local government capital market. It is a tool that allows local government units to assess current credit conditions and future direction based on historical budget trends and future revenue and expenditure scenarios. It also gives the local government officials a diagnostic tool to better understand their current credit conditions and analyze the factors that may improve the collection of revenues and the efficiency of spending money as well as to perform certain scenario analysis.

Obtaining a credit rating increases the marketability of the local government. It opens up more financing options and enhances the local government ability to choose the most efficient and cost effective source of funding. By developing their creditworthiness and gaining a positive credit rating they are eligible to enter into the world capital market, thus attracting international investor, beside the domestic. Macedonian local government units recognize that it is essential to obtain a credit rating prior to accessing the private capital market and issuing debt. Over the past years USAID Macedonia Local Government Activity (MLGA) has been working on enhancing local government creditworthiness and establishing local government tools for good local government credit rating. Seven local government units (Strumica, Veles, Gevgelija, Gostivar, Ilinden, Kumanovo and Shtip) received favourable credit rating from the international credit rating agency Moody's Investors Service. The favourable credit rating demonstrates that the budget has been properly managed; the local government has no debts; possesses fiscal capacity; has favourable liquidity and is not exposed to large indebtedness. The credit rating legitimizes the local government before all international financial institutions.

Since by becoming creditworthy, local governments can significantly decrease the cost of borrowing, it is generally advisable for local governments to make strong and continuous efforts to improve their creditworthiness and by this to obtain a formal credit rating or to enhance the current credit rating.

The fifth hypothesis is that: “Local Government Associations can help improve the local debt legislation, strengthen local government finances and improve capital market.” Key activities of local government associations include: representation of local government on national bodies and ministerial councils, providing submissions to government and parliamentary inquiries, raising the profile and concerns of local government at the national level and providing forums for local government to guide the development of national local government policies. Primary goal of the local government associations is promotion of their strategic goals and support for their implementation by improving and advancing the process and manner of communication with target groups.

Association of the units of local self government of the Republic of Macedonia, ZELS, is a non-profit organization and the only national association in which all of the 84 local governments and the City of Skopje as a separate unit of local government are voluntary members. Promotion of local democratic values, representing the interests of local governments to central government, lobbying and initiating legislative changes and adoption of new solutions in the interest of local government, the exchange of best practices from developed European democracies and finding ways for their implementation in Macedonian local governments and greater financial stability of the local governments, are priorities that ZELS continuously advocates and contributes to their best solution. ZELS has also developed Communication Strategy which primary goal is promotion of strategic goals of ZELS and support for their implementation by improving and advancing the process and manner of communication with target groups (local government units, public, central government and employees).

The establishment of local government associations can help the development of the local capital market. The associations could play a role in facilitating contact to member local governments and promoting local capital market enhancement mechanisms.

Given the limited interest of the private sector to engage in local government borrowing, there is a considerable merit to the establishment of a sub-national development fund to promote lending to local governments for long-term capital investment. This may be the only effective way to allow small local governments to fulfil their capital investment responsibilities. The desirable structure for such a sub-national development fund is that of an independent and self-governing institution that takes direct and final responsibility for borrowing and capital projects. The bulk of funds for this institution should come from direct bond issues in the capital market. The central and local governments could contribute initial capital shares. This institution should be managed by independent professionals who answer to a managing board composed of central and local government representatives.

At the same time, access to capital is a major issue for most of the local governments in the Republic of Macedonia, especially now once they are allowed to borrow from the private capital market to stimulate development and growth. In order to facilitate capital market development for local governments, the ongoing fiscal decentralization programs must strengthen the financial capacities and capabilities of local governments. For this purpose, the creation and implementation of appropriate legislation, building and supporting capacity for sound financial management at the local level are of utmost importance for the success of the decentralization process. Hence, local governments activities should focus especially on improving their ability to raise the necessary funds, strengthening their finances and finding legal bases to ensure greater financial independence, creating sustainable financial framework and improving the local debt legislation, all directed towards building a strong local self government in the Republic of Macedonia.

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