CHAPTER 14

MUNICIPAL BONDS IN SERBIAN LOCAL GOVERNMENT FINANCE SYSTEM*

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Abstract

In the last decade, from 2001 to the present, Serbian local government has gone trough a reform process and got specific competencies concerning local infrastructure development, construction of public buildings and delivering various public services. This process was followed with the local finance system reform in which Local Serbian Governments' financial power has been considerably increased: during the above mentioned period the total funds available to LGs have increased by almost 50%. Newly developed legal framework introduced possibility of borrowing funds, first of all, for financing capital infrastructure projects. According to this framework Serbian LGs are allowed to use municipal bonds to finance their functions. It also defined some general rules for issuing bonds (the types of bonds, its purposes, general procedure of issuing and alike). Anyhow, even if it has been for some degree of readiness both at the local and central government level to use municipal bonds, they have not yet become part of financial practice in Serbia.

Key words: *local economic development, local capital budget, LGs financing, municipal bonds, financial instruments, Serbian LGs borrowing limits, accounting and auditing practice*

INTRODUCTION

Municipal bonds are one of the most important financial instruments for financing local governments' functions and activities. Those functions traditionally include organizing and administering local communities and citizen activities and providing number of utility services and social activities. In the last decades some of the new functions were added to those, especially local economic development (LED) which is becoming one of the crucial prerogatives of LGs in developed societies. LED itself is a process in which local governments, business and non-governmental sector cooperate and work together on creating and improving conditions for economic growth of the local level. The focus of this process is on providing sustainable economic growth of the areas within the local government's jurisdiction and in this way on improving economic and overall standard of living of individuals and communities within this area.

All these functions could not be fulfilled successfully without adequate financial means provided to local governments. In most developed countries (especially USA and most of Western Europe countries) municipal bonds are one of the most important and effective instruments for LGs financing, especially for supporting LED. In the last decade Serbian LGs have gone through a reforming process through which they have got significant responsibilities related to different local functions including

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local economic development. The municipal bonds could play a very important role in providing financial means for meeting some of these obligations of Serbian LGs.

THE MAIN CHARACTERISTICS OF MUNICIPAL BONDS

Municipal bonds are debt securities issued by governments at any level beyond the central level. Their issuers could be regions, counties, and cities, groups of local governments or any agencies or bodies established by them. By issuing the bonds an issuer (one of the entities mentioned above) is providing a large amount of financial sources, in a short period of time, which are usually used to finance different types of local capital projects (most often utility or other type of infrastructural projects). Like in any other case of borrowing, financing through municipal bonds is enabling borrowers to finance projects which they cannot, or do not want, to finance with funds (cash) in hand. By using municipal bonds local governments could finance their current functions and needs through their local budgets and at the same time embark on long term capital projects.

By issuing bonds, local governments are borrowing funds from bond buyers and promising them repayment of the principal as well as certain interest throughout the defined payout period. The interest is usually paid semiannually, while the principal debt could be repaid in total at the end of the period or in certain number of installments during the repayment period.

Advantages of municipal bonds as a financing instrument

There are number of advantages and reasons for local governments to use municipal bonds to finance their activities and functions, and especially their capital projects. Finally, they are very attractive options for investors:

- In most countries the return on municipal bonds is usually tax-free or it involves certain tax relaxation for investors. This usually makes them more attractive comparing to central level bonds and regular bank deposits.
- Because they are usually issued on a long term basis, municipal bonds are equally attractive for small and large institutional investors (funds, insurance corporations, banks).
- Municipal bonds are usually backed up by LGs local budgets or they are insured by an insurance company. In some cases they are supported by state, so they can be considered as one of the safest securities. Usually they are rated just behind the central governments securities.
- In the developed countries with strong capital markets, municipal bonds are traded at the secondary markets which provide them liquidity requested by investors
- Municipal bonds are allowing citizens to invest their free financial resources in development of their own city and environment and at the same time to earn attractive return on invested funds.
- On the side of issuers, municipal bonds are enabling them to collect relatively large funds in a short period of time at the price (interest promised to investors) which is lower comparing to other instruments and sources of financing, like bank loans.
- The process of issuing municipal bonds is transparent by its nature, so, directly or indirectly, this process is increasing responsibility of local government officials
- Municipal bond issuing enables LGs to develop local infrastructure faster and in general to improve standard of living in their communities and in this way to attract foreign investors.
- Finally, entering and successfully conducting the process of municipal bonds issuing is promoting an LG as prosperous one, more advanced and more attractive for businesses and prospects.

In the Serbian case the government entities which are the natural and logical issuers at this point are the local governments of municipalities and cities. Serbian local governments are organized around municipalities which size in terms of population varied from around 20 to over 100 thousands of inhabitants.[4]

The main types of municipal bonds

Based on various types of financial sources from which the issued bonds are planned to be repaid, the following type of municipal bonds could be differentiated:

- *General obligation bonds* – those types of bonds are backed up with by full faith and credit of the issuer; LGs are obliged to repay debt from any of their revenue sources. Because of this, it is common for LGs, before issuing this kind of bonds, to organize public hearing or even voting (referendum) on this issue, so they are considered to be ”voter-approved” bonds. These bonds are typically considered the most secure type of municipal bonds, and therefore carry the lowest interest rate.
- *Revenue bonds* - those types of bonds are backed up with by a specific stream of future LG income. Usually those incomes are directly related to the project for which the bonds were issued. Projects which could be financed in this way could be, for example, water supply projects, public garages, pay-toll roads and other similar projects in which customers are paying for specific services. Since the income inflow in this case depends on the success of the specific project, general risk is higher and because of that it is common to insure the bonds by some insurance company which, in case of certain financial problems of LG, is taking over the obligation for repaying the investors.
- In addition, there are several other types of municipal bonds with different promises related to bonds - for example *assessment bonds* whose repayment is backed up with property tax assessments of properties located within the issuer's boundaries.

The municipal bonds could be as well classified in accordance with the period of time for which they are issued, i.e. for which the issuer is promised to repay them. The bonds which are due within a year are considered as short-term bonds, and the ones which are due beyond a year (this could go to five, ten or more years) are considered to be long-term municipal bonds.

The purposes for issuing municipal bonds could be numerous, but most commonly they are used in cases when local governments want to implement local infrastructural projects like building roads, sport arenas, schools, utility infrastructure structures and the like. In developed Western countries those funds are sometimes used for implementing projects related to protection of the environment and creating a renewable energy sources.

MUNICIPAL BONDS IN SERBIA

Position and role of LGs (municipalities) within Serbian government system

According to the Serbian *Law on Local Self-government* (2003) the local government represents the basic administrative unit through which citizens are administering the affairs of public interests within certain territory, directly or indirectly, through their representatives. The basic territorial units through which local self-governments are performing their competencies and responsibilities are municipalities and cities. When it comes to scope of LG responsibilities the Law differentiates original from ones which are delegated by the Republic level of government. The *Law* has listed more than 30 activities within the original scope of LGs responsibilities and they could be summarized within the following groups of activities:

[4] We are referring here to an average Serbian municipality among close to 170 of them. The exceptions are Belgrade (officially with around 1, 5 million inhabitants) as the capital and Nis (around 250 thousands inhabitants) and Novi Sad (around 300 thousands inhabitants).

- regulating and ensuring the functioning and development of organizations for providing utility services as well as organizational, financial and other conditions for their functioning; this includes number of services related to water supply, road traffic, cleaning, maintenance of landfills, spatial planning and utilization of farmers' markets, parks, green, leisure and other public areas, public parking spaces, public lighting system, maintenance of cemeteries and burials, etc.
- establishing institutions and organizations and monitoring and providing conditions for their functioning in the field of primary education, culture, primary health care, physical culture, sports, child and social welfare, tourism;
- Regulate and provide conditions for various local communities and citizen activities.

In order to perform their functions (original as well as delegated) as it is prescribed by the Law; the LGs are forming the network of institutions and organizations (enterprises, institutions and other organizations engaged in providing different public services.).

Local Government Finance System - General Framework

The above mentioned activities (i.e. the organizations and institutions which are performing them) are financed through a specific local government finance system. As local government reform process was moving ahead in Serbia, starting from 2002 to the present, the competencies of local governments has been gradually increased and in accordance with that, their financial power has also been increased with the funds needed for assuming all of these competencies. Total local government revenues in 2008, in nominal terms, have been increased 2.5 times comparing to situation in 2003. In real terms, after adjustments for inflation rate during the same period, this increase was 48%.

According to the current laws the revenues of local governments consist of the following groups of revenues[5]:

1. Own revenues;
2. Revenues transferred from higher government levels (Republic and/or Province); within these, two separate types could be differentiated (shared or so called allocated) revenues and transfers or grants from the central level; and
3. Borrowed funds.

Own (or "original" or "source") revenues - The own revenues are those that local governing bodies can themselves introduce and determine, and dispose of relatively freely by making decision on their spending within the existing legal limits (minimum or maximum which could be set by law, i.e. the central government). Local authorities determine the basis and rates for certain forms of public revenues and perform activities regarding their collection. At the same time this gives them right and makes them responsible: first of all, for increasing tax burden, and than for spending these tax revenues in efficient manner and in accordance with laws. The above mentioned laws have defined exactly 16 different types of own revenues, out of which most significant ones are fees related to construction land (construction land use fee, construction land development fee) and different local utility and administrative fees. The Law on Local Government Finance introduced an important change in this field by changing the status of the property tax from shared to own revenue.

Shared (or allocated) revenues - Shared revenues are revenues whose base and rate and calculation method and measures are defined by law (i.e. the central level government), whereas the yield generated on the territory of a local government unit is shared, fully or partially, with that local government unit. The most important shared revenues are personal income taxes (within this group the most important is the wage tax which is shared in the way that 40% goes to LGs and 60% remains to

[5] Besides the above mentioned Law on Local Self-Government, this issue is regulated by the following laws: Budget System Law, Law on Public Debt, Law on Public Procurement, Law on Securities and others.

the central level), the tax on inheritance and gift (100% of this revenue goes to LG) and the property transfer tax (also 100% for LGs.).

Transfers (grants) from the central level - There are two main groups of transfers according to the Law on local government finance: *I) non-categorical transfers* and *ii) categorical transfers*. The first one (non-categorical transfers) are set at the level of 1.7% of the national GDP which makes them relatively predictable; their important feature is that LGs are free to use them in accordance with their independent decisions.

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The increase of autonomy, i.e. competencies and corresponding funds needed for their performance, which happened in the last decade, was followed by an increase of importance of own revenues: from 2004 to 2008 their share increased from 20% to 39%. At the same time the share of transfers or grants was reduced to around 23%.

It is important to note that within the Serbian accounting system it is possible to differentiate this entire group of revenues, but anyhow there is no unified, standardized report format in which they could be presented. Because of this, comparing revenue structure of different LGs, presented usually in different formats which are similar, but always with certain specific items typical only for individual LGs - could sometimes create difficulties and be misleading just because of a different way of grouping and presenting revenues.

Borrowed funds – After introducing reform laws, Serbian LGs were enabled to borrow from banks but also at capital markets by issuing bonds, but with the previous approval by the MoF. The Republic of Serbia MoF Treasury's Debt Management Department reviews applications for borrowing, submitted by local government units. The review process does not have formalized application forms, or a written rulebook. Instead, applications are evaluated based upon two criteria: compliance with a debt stock limit of 50% of annual revenues, and concurrent compliance with a debt service limit of 15% of revenues using the previous completed year's data. The Treasury review process does not consider projections of either indicator into the future during the term of the loan, nor does it concerns itself with the purpose of the borrowing, the interest rate and other features such as grace periods, escrow structures, etc. However, the Ministry of Finance only gives its "opinion" on the municipal loans, so no formal Ministry approval is needed. In many cases it is interpreted as an implicit guarantee by the local government.

Experience and conditions for introducing municipal bonds in Serbia

The legal framework for issuing municipal bonds in Serbia is, in general, in place and in that sense there are no obstacles for Serbian LGs to initiate this process. Anyhow, up till now there have been no attempts of any of Serbian municipalities to issue municipal bonds. The main reason for this is, first of all, lack of professional experience, knowledge, but also the fact that there are, still no developed and clearly elaborated procedures at the local level.

The procedure for issuing municipal bonds begins with a decision of a local government on this matter. After this the LG needs to apply to the Ministry of Finance for their approval, which is a formal step and it includes checking by the MoF whether the LG debt is within the legal limit or not (total debt up to 15% and/or debt service up to 15% of revenues from the previous year). If the debt indicators are within these limits the LG will get a positive answer without further checking. The next step is opening the account within Central Security Register and than submitting the Prospect for bond issuing to the Central Security Commission. Once the Prospect is approved, the LG can publicly announce bond selling - this step is not needed if bonds are going to be sold by private placement. The last step of the procedure would be listing the municipal bonds at the secondary security market.

Local government property devolution

One of the critical problems related to bond issuing, as well as any other type of borrowing, is the fact that cities and municipalities in Serbia do not have formal ownership of assets they are using in their operations. Because of this, Serbian LGs cannot use these properties as a basis for guarantying their debts to potential borrowers. It should be noted that in practice it is not common to put mortgage at LGs properties in order to secure debts, and absence of this option, does jeopardize the credibility of the LGs as debtors.

In 1995, by introducing the Law on Assets of the Republic of Serbia, the properties of all Serbian local governments were formally transferred to the Republic level. The Law specified that the Republic was to manage those properties through its Republic Property Directorate, while the LGs were to continue to use and maintain them. In cases when LGs want to sell some of these properties, they are supposed to apply to the Republic Directorate asking for a permit to do so.[6] The situation in which LGs are deprived from ownership on local assets could represent a real problem in the procedure of bond issuing.

Even though the current law (through Republic Directorate) is enabling the process, the current situation is (and experience is confirming so) making the whole procedure unnecessary complicated, and at the same time, causing reluctance on the side of investors, especially the foreign ones.

The Law of 1995 anticipated that LGs has to continue with keeping records in their books of all changes related to the assets which they are using; even they do not formally own them. Most of the Serbian LGs did not follow this instruction and their Balance Sheets are today rather incomplete. Additional negative effect of poor accounting records of the assets is the valuation of the assets. In mid 90-ties, Serbian economy was exposed to the two digit inflation, and the assets which were not regularly re-evaluated (which very often has been happening in the case of Serbian LGs), considerably lost in terms of their book value.

Public utility companies (PUCs) status

The status of local public utility companies is ambiguous and it is still one of the largest unsolved transition issues in Serbia. As mentioned above local Public Utility Companies (PUCs) do not have a status of budget users, rather, their revenues are dominantly provided from local budgets. They are usually related to services which PUCs are delivering to LGs directly (LGs through their budget act as clients/users of PUC services); but sometimes (this happens when PUCs for some reasons underperform and generate losses) these funds could be transferred in a form of operating subsidy to cover incurred losses.

PUCs are formally out of the budget finance system: their accounts are not in the local treasury system, but within the commercial banking sector, and they are functioning within the regime of business sector (account system, legal system, etc.).

The structural problems in this area are stemming from the fact that PUCs are simultaneously representing quasi market entities (market operating firms) and quasi social entities (institutions through which LGs are trying to provide utility services to citizens under privileged conditions, i.e. at the prices below the real costs of these services). It is most likely that, when bond issuing becomes related to utility infrastructure projects which are supposed to be implemented and afterwards run and managed by some of local government PUCs, their unclear status, can be one of the obstacles for investors to take part in the investment process.

[6] The Directorate usually does not deny such requests from LGs, but it is not uncommon to wait for this kind of permission for more than a year.

Operating vs. capital budget

Serbian budget accounting system does not differentiate between the operating and the capital budget. The budgetary process in Serbian LGs begins with covering all current expenditures (salaries, goods and services, etc.), and the capital needs are than tailored in accordance with the residual amount: the part of the budget which remained after covering all of the current expenditures. Even though there are a few sources of revenues which should be, by definition, used for capital investments (like land development fee), there is no mechanism to separate them from other revenues. This is one of the reasons why the capital share of the total budget varies among LGs – it goes from 15% to over 50% and the average is around to 1/3 of the total budget). This could be one of the factors which create additional uncertainty and risk from the viewpoint of potential investors.

Accounting budget system and practice

The accounting budget system and practice are related to the above mentioned issues with differentiation between operating and capital budgets. There are certain issues related to accounting system which could potentially cause misunderstanding of the actual position of local budgets. Budget accounting system, again, does not explicitly differentiate between current and capital revenues, but since all of these revenues are broken down to the lower analytical level, it is possible to do so. By regrouping certain analytical revenue items, it is possible to "extract" capital from current revenues and to get relatively clear picture regarding relations between these two critical items within local budgets.

At the moment we could say that the main problems related to budget accounting are coming from actual budget accounting practice, i. e. the way in which the accounting system is applied by LGs. Budget accounting reports vary pretty much from LG to LG, because of the evident differences in ways in which certain changes are recorded. This is especially true for LG investments which are implemented through Directorates (specific LG Agencies which are commonly in charge of local investments in Serbia) as well as through some other direct or indirect budget beneficiaries. In such situation the same financial flow in certain cases can be recorded as a capital expenditure and in other as a current, which can considerably deform the real picture of investment activity and general investment capacity of the specific local government. The main reasons causing this problem would be the following:

- Lack of specific instructions from the Republic level (Ministry of Finance) about a way in which accounting records should be done in some specific circumstances. This is especially important in a situation in which some of the structural reforms still haven't happened (like the above mentioned property devolution and defining the status of PUCs) and the local government system has still not been clearly and completely defined.
- Lack of effective central auditing system which is necessary to impose needed level of discipline in the local government financial system. The Central Auditing Agency which was envisaged by the Budget System Law (2002) and was formally established in 2007 is still not operational at the local level. The Agency has begun with its operations during 2009, but even so, it will take considerable time before it become fully effective instrument in improving local budget practice.
- Finally, especially for smaller, poorer LG, one of the reasons could as well be insufficient internal capacity to effectively perform this function.

The availability, reliability and accuracy of data regarding LGs financial position

When considering municipal bond issues the most important information definitely refers to the LG finance in the most general sense: the revenue side (the structure of LG revenues, the relevance of the specific revenues items for the local budget, the present and future expected stability of specific sources of revenues); the expenditure side (the largest expenditure items and its relevance to total budget, its trends, economic and functional purpose of certain expenditure items, etc.); and finally the relation between budget revenues and expenditures (inflows and outflows), i.e. the budget surplus/deficit which could be defined through different perspectives, i.e. by including and/or excluding specific inflow and outflow items.

The local government fiscal system in Serbia is providing a lot of very usable financial data. If these data would be appropriately processed and put into correct prospective that would reveal issues relevant for bond issuing – the information provided could be sufficient to initiate municipal bonds issuing.

Anyhow, there are several shortcomings in this area which need to be taken into account when considering municipal bond issues. Some of them are stemming from the structural inconstancies which still exist in the Serbian local governmental system, and they could not be resolved without necessary system reform measures. The other shortcomings are more technical by their nature, and they could be resolved through improvement of fiscal information system at the local as well as at the central (Republic) level.

CONCLUSION

Functions and activities which Local governments are performing in their geographical area of jurisdiction are becoming very numerous and complex. LGs are administering the life of communities and citizens and providing some of the very basic and crucial utility and social services. In the last decades LGs especially in the Western developed world are resuming active role in promoting and supporting economic development within their area.
Serbian local governments have a long tradition in performing traditional activities and functions, but do not have much experience in local economic development. The reform of local government system in Serbia, on the other hand, has considerably increased range of responsibilities of Serbian LGs, including activities related to local economic development.

One of the most critical components of LGs position is the availability of the funds which are supporting LGs activities and in general adequate LG finance system. LG finance system in Serbia envisaged three types of revenues: original (or “own”) revenues, transfers and/or grants from the central level and finally, the borrowing. The last mentioned source includes issuing municipal bonds as one of the options.

Municipal bonds are the instrument which is widely accepted among the LGs in the USA and Western European countries where it is one of the most important sources of financing of large capital infrastructural and other projects. Legal framework for introducing municipal bonds has been established in Serbia and there are interests expressed from the most advanced LGs to use these options, but still there are no practical cases of issuing municipal bonds in Serbia.

There are certain limitation and obstacles which need to be overcome in Serbia in order to speed up the process of introducing municipal bonds as one of the most important and effective financial instruments to finance LGs operations, especially the ones related to supporting local economic development. Besides underdeveloped capacity of local staff, which needs to be upgraded, some of the system and technical limitations, also, need to be overcome. Among the biggest are: finalizing the process of devolution of LG property which has been transferred to the central (Republic) government level in the beginning of 90’s. The other big systemic obstacle pertains to resolving the status of public utility companies (PUC) owned by and controlled through Managing Boards by LGs, and clearly defining ownership of their assets. In addition to these systemic issues, there are a few administrative and technical issues, like -developing local budget reporting format and differentiating between operating and capital budget items ,improving accounting practice, etc - which need to be adjusted to some of the specific aspects related to procedures for issuing municipal bonds. Finally, it is necessary to provide information on financial position of LGs which will be available, reliable and accurate enough to provide needed transparency.

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