



SOUTH-WEST
UNIVERSITY
·NEOFIT RILSKY·
BLAGOEVGRAD, BULGARIA

VOLUME 2
2004

SCIENTIFIC
Research

ELECTRONIC
ISSUE

MUNICIPAL BONDS MARKET DEVELOPMENT IN BULGRIA: CHALLENGES AND PERSPECTIVES

Desislava Stoilova
Senior Assistant Professor
Faculty of Economics, Southwest University
Bulgaria
dstoilova@abv.bg

Summary

The paper is intended to study the current framework for the development of municipal bond market in Bulgaria and to suggest solutions for some of the impediments, constraints or lack of regulation that presently exist. Introducing municipal bonds as a means for financing municipal budgets and supporting municipal investment projects implies setting up a new institution in Bulgaria, namely the municipal bond market. Despite all challenges and concerns, issuers and investors are preparing to meet at the market. Solving the problems that they face in their entirety and interaction, and facing the challenges will help promote the successful development of the municipal bonds market in Bulgaria.

Bulgaria: Broad Perspective

Bulgaria started transition from a centrally planned towards a market economy in 1990. After seven and a half years of high inflation rate and sharp foreign exchange depreciation the government was forced to establish a Currency Board on July 1, 1997. The very idea of the Currency Board is to tie the local money to an internationally recognized foreign currency. Thus the local money “borrows” creditability from the foreign currency. Bulgarian money (BGL) was tied to DM at fixed exchange rate BGL 1000 per DM. Denomination in 1999 changed this rate to BGL per DM, and since the EURO establishment Bulgarian currency exchange rate has been fixed at BGL 1.95583 per EURO.

The macroeconomic development after the Currency Board establishment is rather encouraging. Inflation rate dropped to 3 - 6 percents per year and the foreign currency reserves increased substantially. Bulgarian economy is in position to service foreign debt smoothly.

The economic growth issue replaced survival strategy until 1998. The domestic demand was the driving force of real growth in the following years. The stabilization calmed down expected inflation and induced a higher real money demand. However, the supply side factors were planned to be the more important source of growth in 1999 and on. Tight fiscal and income policies restrain the aggregate demand and the supply factors gain importance. The most important supply side factors are structure of ownership and financial markets.

In the context, one of the major problems of the Bulgarian economy is the shortage of financial instruments to channel both domestic and foreign savings toward profitable investment opportunities. The importance of financial market development is pointed out by Joseph Stiglitz in its presentation on The Role of the Financial System in Development: “Researches showed a strong link between economic growth and the depth of the banking system and liquidity of financial markets. The magnitudes of the results are striking: one study found that between 1976 and 1993, countries in the highest quartile of stock market liquidity in the beginning of the period saw GDP grow 3.2 percent annually, compared to 1.8 annual growth for countries in the lowest quartile of stock market liquidity. The difference in GDP growth between countries with high and low financial depth was even larger, 3.2 percent versus 1.4 percent.” In a nutshell, the free capital in Bulgaria is far from being automatically allocated to all of the most efficient projects. In effect, bank deposits and governmental securities are the only available financial instruments for households, public and private entities to invest in.

Despite the fact that domestic savings have been estimated to nearly BGL 4 million the National Statistical Institute’s estimations have suggested that more than fifty percent of savings were kept in cash and cash equivalents (mostly foreign exchange) instead of investing them in financial assets. The shortage of financial instruments to invest in is a serious problem of the economy. Currently bank deposits and governmental securities are the only available instruments for investment. Even local banks hold a good part of deposits abroad because of the shortage of local instruments to invest in. Bulgaria is in an uneasy position to simultaneously look for a balance of payments support from abroad and to finance the rest of the world.

Bulgarian capital market is very small and poorly regulated. The daily volume of trade ranges between BGL 20 000 and 50 000. The low level of trade suggests that the capital market does not provide investment opportunities to the net lender of the economy, households. From a broader perspective, municipal debt not only provides an instrument for mobilizing local savings, but also may help boost the capital market development.

Municipalities Need to Finance Growing Investment Requirements

Municipalities are on the front line to serve the growing needs of the people, from urban infrastructure and transport, to energy, the provision of social services, the upgrading of the environment, and culture. Decentralization raises formidable challenges for both central government and municipalities. First, decentralization must be underpinned by a well-conceived system of fiscal federalism, balancing efficiency and equity considerations through a system of transfers, shared taxes, and local taxes. But fiscal resources alone cannot meet the growing demands placed on municipal governments. Secondly, municipalities face limitations to raising their burden of local taxes on the private sector and households. They must therefore invent new solutions to meet the needs of their population. Privatizing municipal services and enterprises, entering into concessions agreements, forging partnerships with private corporations to encourage the participation of all population groups into

productive economic and social life, tapping domestic and international capital markets to finance growing investment requirements are on the critical path to future development.

Thus the key to meet the challenge imposed by the rapid decentralization is to develop budget planning and management capacity, develop the capacity to raise local resources and to access domestic financial markets, creating the framework for private participation in infrastructure, and promoting local, regional and global partnerships for development. Developing the municipal bond market can be an important step in providing municipalities with an access to the domestic capital markets in order to meet the growing investment requirements that they face.

In theory, so called “golden rule” of the balanced budget prescribes that local authorities should never create a deficit in the budget for the purpose of covering current costs. But the same rule allows and in some formulations even promotes prudent borrowing for capital purposes. So, why local governments can and should borrow to finance their investments?

The most important arguments in favor of local governments borrowing may be summarized as follows:

- Inter-temporal, inter-generational and geographical equity. The costs of a project undertaken by a local government are incurred as soon as the project is implemented, but the benefits derived from the investment are spread out over a longer period. If capital projects are financed out of current revenues, then some local taxpayers who helped to finance the project through their local taxes may not benefit from them in the future (due to migration out of city, for example). At the same time, those who benefit from the project may not have participated in financing it if they moved to the city after it was completed, or if it was completed either when they were small children or before they were born. By financing such projects through bond issues or bank credit, local governments can ensure that most users pay for the benefits either through local taxation or directly in the form of user charges. In this way, payments from current users are partially used to repay the loan.
- A close relationship between those who benefit from the project and those who pay for its completion supports optimal allocation of resources.
- Benefits from the acceleration of local development due to the borrowed funds quite often overshadow the cost of debt servicing. It may happen that benefits from an appropriate project implementation, as higher price or rents, wider scope of interested investors, quicker economic development resulting in multiple-effects that attract new projects, providing additional jobs and tax revenues are much greater than the cost resulting from interest payments to the investors or banks.
- Reduction of operational costs. If local infrastructure is too old it will be more profitable to borrow funds and build new and more reliable one instead of repairing it. Benefits of this solution are higher reliability, savings in the costs of repair and the employment of service staff and other secondary advantages. In fact, costs related to borrowing may even be less than costs involved in maintaining the old infrastructure for a longer time.

➤ Access to grants from European and other development funds. This is one more rationale for borrowing, specific to Central and Eastern European countries. There are several investment grants available for local authorities, but a necessary condition is to provide matching funds that usually must equal at least 25% of the total project costs (as in the case of SAPARD or ISPA projects). Borrowing may be a means of increasing local capacity to apply for these development grants.

However, there are also potential hazards related to local government borrowing, of both a microeconomic and a macroeconomic nature. The microeconomic danger is related to the potential for excessive indebtedness of some local governments, leading to serious difficulties in repayment of loans and possibly jeopardizing the provision of vital public services. The macroeconomic limitation is related to the fact that local governments contribute to the overall level of public debt, which in turn may have a negative effect on inflation and other important parameters of the national economy.

Why local governments should not borrow to cover their operating spending? There is a common agreement that borrowing in order to cover current expenditures is acceptable only in very rare, specific cases - usually for very short periods, to cover deficits arising from uneven cash flows within a budgetary year. The most typical arguments for the importance of maintaining a balanced operating budget can be summarized as follows:

- Borrowing on operating spending would lead to an unmanageable debt burden. It would quickly lead to the rolling of loans (using new loans to finance the payment of an earlier debt's service) and to a very serious problem of excessive indebtedness.
- Using current revenues to cover current costs prevents the local public sector from growing beyond its optimal size, which may be defined here as the fiscal burden that taxpayers agree to bear in order to finance the desired provision of public goods. Borrowing creates a short term fiscal illusion, in which the demand for public services is artificially high because it is distorted by the supply, financed not by local tax effort but in part by credits, bonds, etc.
- An unbalanced current budget may result in negative macroeconomic and microeconomic consequences, since private investments may be crowded out. It is clear, that public sector borrowings draw on the pool of limited financial resources available. Local government issues are more attractive to investors than private issues, because giving credits to public entities implies lower risk. This competition for borrowing from the public sector exerts an upward pressure on the interest rate, making private investments more costly. Increasing budget deficits negatively affect expectations on inflation, which add more to the upward trend in interest rates. Of course it is worth noting that when local governments offer loans in order to finance investments, this negative "crowding-out" consequence does not occur, unless someone postulates that public investments are less productive than private ones.

This brief overview brings up to the conclusion that in general both investors and issuers (municipalities) are interested in entering the municipal bond play. Whether and when that play can take place shall be determined by the scene (macroeconomic

and regulatory framework) and by the interaction among players, both analyzed below.

Potential Issues: Addressing the Problems of Municipal Budgets

Bulgaria has undergone a process of gradual decentralization during the last thirteen years. The process started in 1991 when the Local Self-Government and Local Administration Act was adopted. According to the law, our country has two tiers of sub-national administrative government - regions and municipalities. The region is administrative unit of the Central Government. It comprises several neighboring municipalities. The region can be created and liquidated only by law. A regional governor, who is appointed by the Council of Ministers (the Government), governs the region. Presently 28 regions exist, which were established by splitting the 9 regions, which existed before 1999. The Regional Administration is a decentralized state authority on regional level. It has three main functions: to manage the state properties on the territory of the region, to monitor compliance of the municipal council decisions with law, and to implement the state policy on local level. In addition to their controlling function, which was intended mainly to combat and curtail corruption, the Regional Administrations were formed to foster development and to unite municipalities to work together on large-scale projects and common cause. Although the fact that the regions coordinate national and local interests they do not perform executive functions. So the Regional Administrations are mediators between the central and local authorities. They do not have independent budgets and financial independence, and do not provide public services to the population. The budget of the regions is determined by the Central Government and the funds are used for the operation of these units. The Regional Administrations do not have their own revenues. Their budget is entirely formed of subsidies from the central budget. The budget of the Regional Administrations is 0.1% from the consolidated public expenditures and 0.04% from the general domestic product (GDP).ⁱ

According to the Constitution the municipality is the main (and by now the only one) tier of local government in the country. The municipality is legal entity. It has its own budget and property, which can be used for serving its interests. The bodies of local government - the Municipal Council and Mayor- are elected directly by the population of the whole municipality. Despite the fact that Bulgaria is a small country (approximately 111 000 sq. km), presently there are 263 municipalities. Although legal possibilities for splitting and merging of municipalities exist, their number is not very dynamic. The characteristic features of the municipalities are as follows: average territory is approximately 422 sq. km, average population is approximately 30 000 people and average number of settlements is approximately 20.ⁱⁱ

In fact, gradual decentralization process results in increased local self-governance and ever increasing responsibilities for the municipalities to provide solutions as to how to meet the population demands (ranging from transportation to cultural events and leisure). At the same time, data supplied by the National Association of Municipalities in the Republic of Bulgaria (NAMBR) shows, that local budgets relative share to the GNP has decreased to 6% in 2003 as compared to 12.3% in 1991 and 8.9% in 1999.

Table 1 Bulgaria: Macroeconomic and Budgetary Indicators

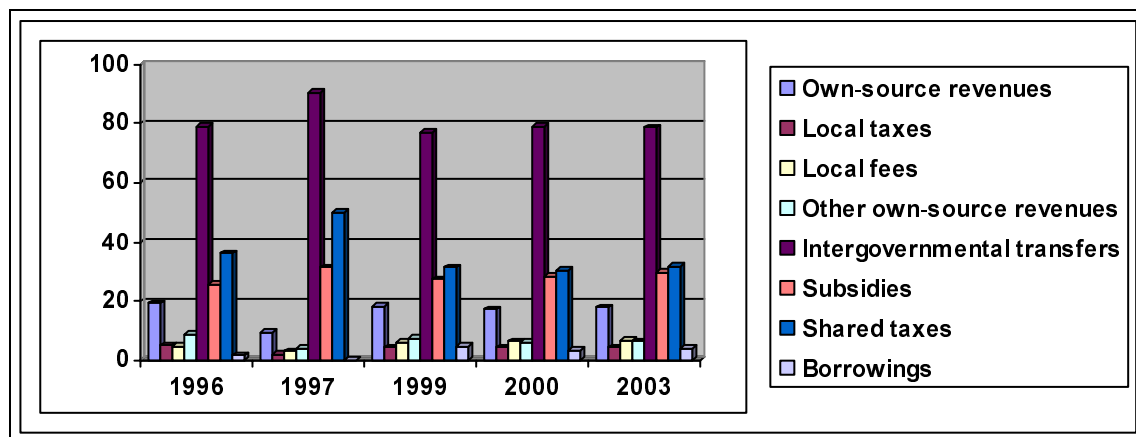
Indices	1999	2000	2001	2002	2003
GDP (BGL million)	22776.0	26752.8	29617.7	32323.7	35285.5
Consolidated State Budget (BGL million)	9912.2	11334.3	12096.5	12732.5	13636.6
Municipal Budgets (BGL million)	2022.3	2178.1	2113.9	2388.5	2110.8
Consolidated State Budget / GDP (%)	43.52%	42.37%	40.84%	39.39%	38.65%
Municipal Budgets / GDP (%)	8.88%	8.14%	7.14%	7.39%	5.98%
Municipal Budgets / Consolidated State Budget (%)	20.40%	19.22%	17.47%	18.76%	15.48%

Source: National Association of Municipalities in the Republic of Bulgaria: Statistics (2003). In <http://www.namrb.bg/library/statistic.html>

To a large extent, this is due to the fact that local authorities have been assigned various responsibilities, while municipal revenues coming from state transfers have not been particularly increased, rather, these tend to decrease in real terms. By virtue of the current law municipalities are fairly restricted to exercise an influence on their revenues coming from local taxes and fees. It is, therefore, imperative that municipalities continuously look for new sources, to increase their revenues and to raise funds in order to adequately meet their increased responsibilities. So far privatizations of municipal properties and/or streamlining of its management and maintenance as well as extending concessions have been utilized as major methods to increase revenues. For various reasons municipalities do not have extensive experience in raising funds yet. It could be maintained that the amount of bank loans extended to municipalities has been nominal so far. Therefore, it could be expected that other, less traditional approaches, such as equity participation and issuing municipal bonds would grow in importance in the future.

The municipality provides basic public services to the population, but it has very limited powers for setting local revenues. In order to facilitate the further analysis municipal revenue assignment according to the Municipal Budgets Act is presented by Chart 1 below.

Chart 1 Municipal revenue assignment
(% of total local revenues)



Source: Club Economics 2000. (2002) Needs Assessment of Sub-national Governments Draft Report, Sofia, p.11 and National Statistical Institute (2003). In www.nsi.bg/economics/municipal_budgets.htm

Bulgarian municipalities are fiscally weak. Because of overly restrictive interpretations of the Constitution, local governments are not allowed to impose own taxes or levy surcharges on central government's taxes. For this reason, Bulgarian municipalities do not have a lot of opportunities to show flexibility with regard to revenues. Revenue analysis of municipal budgets clearly indicates that since 1991, state transfers have been of crucial importance. Virtually, Bulgarian municipalities rely heavily on the intergovernmental transfer system. The revenues from state transfers comprise about 80% (namely, 94% in 1991, 78% in 1994, 90% in 1997, 80% in 2000, and 78% in 2003) of the total budget revenues of Bulgarian municipalities. As a comparison, the average ratio between the two main local revenue sources across all Western European countries is 37% (transfers) to 50% (local own-source revenues).ⁱⁱⁱ According to the economic and financial point of view, such a proportion allows local governments to be compensated for the vertical imbalance, horizontal imbalance and spillover effects. But according to the political and institutional point of view, the dominant role of the transfers gives to the central government significant political and financial control over local governments.

The intergovernmental transfers in Bulgaria are not competitive. They are allocated as entitlement. As financial flows, they descend from two sources: shared taxes and state subsidies. The revenues from the shared taxes, amount to as much as 51% to 30% of the total municipal budget revenues, while the percentage of the state subsidies to the total municipal budget revenues has slightly increased from 22% in 1991 to 30-31% in 2003. State subsidies are allocated based on a formula, which is stated in the Annual State Budget Acts and since its introduction in 1993 it has been changed each year. Basically, the formula takes into account the expenditure needs and revenue capacity of local governments. Traditionally, Bulgarian municipalities are granted general supplemental subsidy, general equalization subsidy, and target capital investment subsidy.

The most important shared tax revenue is the personal income tax. It was shared among the state and municipalities in 50:50 ratios during the previous years. Since the beginning of 2003 the personal income tax has been defined as municipal revenue entirely, except for 35 municipalities with great fiscal capacity. They receive a certain percentage of the personal income tax revenues, which varies widely from 17.6% to 99.1% in any particular case.^{iv} In spite of this attempt at equalization, significant interregional disparities are inescapable, because the individual income tax is a progressive tax, collected by withholding at source and the tax bases are unevenly distributed, favoring the richer local governments. From the point of view of the grant taxonomy the shared personal income tax in Bulgaria is an unconditional, open-ended grant.

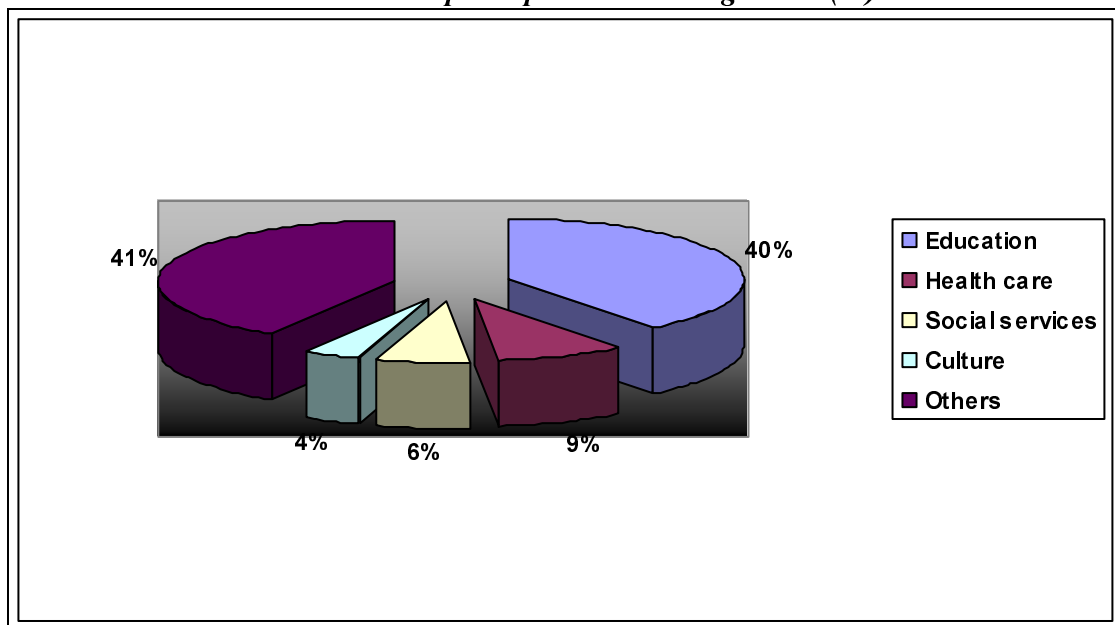
Revenues from the company profit tax were also shared during the previous years, but since the beginning of 2003 the corporate income taxes have been defined as state revenues entirely. Municipalities do not receive any share of excises, customs duties or VAT, which are the main central budget's revenue sources.

Where own revenues are concerned, municipalities are only allowed to determine the amount of local fees^v within certain margins and to streamline the process of municipal property management (including privatization, concessions, rents, sales of real estate and the like). From the figures above it can be concluded that the share of own-source municipal revenues to the total municipal budget revenues in Bulgaria is about 17-18% only. In the context, it must be pointed out that Bulgarian local governments do not have power to determine the type, the rates or the basis of the local taxes. In fact, the only reason they are called "local" is that they are stated by the Local Taxes and Fees Act. In terms of modern public finance, if local governments do not have any say in the "design" of the local tax, it could not be considered as a local tax, but as a special transfer. Thus, according to cited taxonomy, up to 90% of the Bulgarian municipal budgets are formed by transfers and are determined directly by the central government.

Neither do municipalities have a lot of opportunities to show flexibility with regard to expenditures. Over 59% of their funds are directed to financing health care, education and social care activities. These three are a matter of shared competence between municipalities and state. In practice municipalities provide the necessary financing, while the state (through the respective authorities) determines the amount of the average salary, the number of persons employed and appoints the management of municipal bodies (although, mayor or municipal council is entitled to suggest the persons appropriate for the respective position). While analyzing municipal expenditures, it has been established that 2/3 of total municipal funds are used to finance development activities in the above mentioned spheres, namely, health, social care and education. It is interesting to note, that the municipalities have financed up to 70% the total amount of funds used to sustain education in Bulgaria in the 90s. In the recent years this share dropped to 55-57%. The change is due to the fact that the expenditures of the secondary professional schools and the schools for disabled children started to be financed from the central budget. Similar trend is monitored in

the field of health care, but the reason here is the gradual introduction of the health insurance system, which started in 1999.

Chart 2 Municipal expenditures assignment (%)



Source: National Association of Municipalities in the Republic of Bulgaria: Statistics (2003). In http://www.namrb.bg/library/statistics/municipal_expenditures.asp

The share of raised funds (including loans from financial institutions, issue of municipal bonds, interest-free loans from the state budget, loans from municipalities, and off-budget funds) is fairly insignificant. For instance, their share for the last 5 years varies between 5 to 0.3% of the total municipal revenues. Loans taken from financial institutions have been nominal, but the case of Sofia Municipality. In practice 81% from the borrowed funds are used by Sofia (the capital city), and 17% by the largest municipalities.^{vi}

Bulgarian municipalities to a great extent rely on obtaining financing from international organizations to support infrastructure projects. The latter, as in the case of Poland, might delay the municipal bond market development since easy access to low cost external financing may reduce municipalities' motivation to be more initiative. Furthermore, the Ministry of Finance (MoF) following the Annual State Budget Act usually approves and/or elaborates municipal investment programs and its financing. As a rule, target subsidies from the state budget are used to finance investment projects. A good example in this respect is the Kyustendil Municipality. A PHARE program covered all schools on the territory of the municipality, the water supply system renovation was financed through the resources of a loan extended by the World Bank, referred to as the water loan. Presently, these sources of revenues are about to be exhausted. The existing four or five municipal companies are no source of revenues, all of them functioning below the break-even point.

Municipal finance managers clearly prefer to finance budget deficits with the cheapest resources available and these are ranked in the following order:

- Revenues coming from municipal off-budget accounts (interest not due);
- Obtaining loans from other municipalities (no interest is due);
- Borrowing from banks.

In fact, debt is rolled over. At the end of fiscal year, debt is paid back to the off-budget account. Obtaining loans from other municipalities is the second best alternative. Bank loans are much more costly and most of the municipal finance managers believe that the cost of bond issue would be even higher. Currently, this financial instrument is new to them and they feel more inclined to rely on borrowings from other organizations and even bank loans than bond issuance. It must also be noted that all officials who considered issuance of municipal bonds as means of fund-raising have stated that the choice between obtaining a bank loan and issuing bonds would depend on the type of investment project and should be made on a case by case basis. Given the fact that Bulgarian banks extend investment loans for up to two years and the latter are very short of supply, no wonder that the municipal officials of Svishtov and Troyan (two relatively small towns) have chosen to launch public issuance of general bonds to finance renovation of the local water supply systems regardless of the fact that the transaction cost of such issue could be higher as opposed to obtaining a bank loan.

In addition, employment of new financial instruments, namely municipal bonds, requires better quality of management at the local level and changing dramatically the relationships between the municipalities and central government. Undoubtedly, the financial instruments issue is a final point of many other activities, which strengthen the principles of local self-government and regulate the relationship among the municipal bond market participants: municipalities, business, and investors. The transparency of the local government and the public debate are very important for defining the local priorities and the public support of the municipal investment program. For example in 1999 the Municipality of Sofia issued Eurobonds on the Luxembourg stock exchange with nominal value EURO 50 millions. The debt was placed successfully with foreign investors within a couple of days and was paid back without any problems. However, the point is that the population of Sofia knows almost nothing about the investment projects and financial plans of the municipality.

In conclusion, as proven by the recent examples of the municipalities of Sofia, Svishtov, Troyan, Varna, Dupnitsa, Bulgarian municipalities are able to issue bonds and this financial instrument has potential. In order to facilitate the development of the municipal bond market the major problems of the municipal budgets have to be addressed. The basic problems can be summarized in the following groups:

- Insufficient authority to manage municipal own revenues and strong dependability on state transfers;
- Limited potentialities to manage and exercise an influence on expenditures in fields of shared competence, where state authorities are entitled to determine levels of

salaries, number of personnel, management of municipal budget institutions, etc., while the respective municipalities provide the financing;

- Lack of sufficient transparency and constantly changing mechanisms employed in distribution of subsidies among municipalities that restrict municipal potentialities to make independent, stable and long-term budget projections;
- Lack of sufficient knowledge, skills and experience to practice financial management, or efficiently mobilize and utilize financial resources, and apply alternative sources to fund local services.

Reviewing the national policy in the field of municipal finance could potentially solve the first three problems. Amendments in the Municipal Budgets Act are needed to stabilize the interrelationship between local and central budgets. The last problem requires constant improvement of knowledge in the field of public finance that can be achieved through various types of technical assistance or support by the National Association of Municipalities in the Republic of Bulgaria (NAMBR) or other NGO's.

Ability of Bulgarian Municipalities to Receive Loans and to Service Debt Payments

From a broad perspective the capability of municipalities to repay their debts is dependent on their tax revenue base. Municipal tax capacity determines both the amounts of their own revenues and the revenues, coming from shared taxes. It is crucial for municipality that local companies headquartered in the municipal territory are operative and profitable. However, taxes are collected by the tax administration, which is directly subordinated to the Ministry of Finance, and municipalities have limited capacities to prevent tax evasion and to increase tax efforts. In the long run, the status of municipal budgets is dependent on both the macroeconomic situation in the country and the capacities of local population and entrepreneurs to successfully meet ever-occurring challenges. Given the positive outlook for Bulgaria it can be expected that the capability of municipalities to repay their debts shall increase in the future.

From a narrower perspective basic criterion for a municipality to be eligible to receive loans and to issue bonds in particular is its creditability. The potential of a municipality to generate own funds is, on the one hand, basic factor applied in determining its creditability; on the other hand, due to restrictions, defined in the Municipal Budgets Act, municipal potentials to borrow is limited: the annual interest and principal debt payments cannot exceed 25% of its own revenues plus total equalizing subsidy granted to the municipality. Undoubtedly, this regulation puts larger municipalities in a better position to raise funds.

Is regulation on local government debt really necessary? It may be argued that it is enough to rely on financial market discipline. This line of argument suggests that the adoption of legal rules might be redundant since tighter bonds market conditions - in particular, higher interest rates - already impose effective sanctions. If the total debt of local governments in the country grows too high, this will indeed be the case. Also, investors will refuse to buy municipal bonds or will demand a very high interest

premium for those municipalities that borrow more than they can carry out effectively.

Dafflon (2002) suggests, however, that in practice there are several doubtful assumptions behind the arguments presented in the previous paragraph. One such assumption is related to the adequacy of the information possessed by investors. Another practical observation is that investors usually assume that no real risk exists in case of local government default. They believe that the state will eventually pay the debt. Although a local government bankruptcy is technically possible in several countries, it is rarely observed in practice because it is so politically unacceptable. For these reasons, then, external regulations and control of local borrowing may play a positive role supporting the local credit market.

The recent regulations of the Maastricht stabilization pact related to the introduction of a “Euro zone” have brought a new element into discussions on local indebtedness. The Maastricht agreement limits the overall level of public debt to a maximum of 60% of GDP, and also limits the annual total public budget deficit to 3% of GDP. It should be noted also that the level of central debt is usually much higher at the central than at the local level.

At present, the total debt of all Bulgarian municipalities does not exceed BGL 70 million^{vii} or up to 1% of the consolidated state budget and 0.2% of GDP. It can be concluded that the low share of the own municipal revenues is one of the most significant impediments for a further development of municipal bonds market in Bulgaria. One way to overcome such an impediment is uninterrupted application of measures to improve local self-government, adequate to the municipality’s financial interests and potentialities. New solutions for increasing own municipal revenues should be sought, for example municipalities should have more freedom and discretion in determining the amount of local taxes and fees, especially when those arise from user charges or rendered services.

Larger municipalities are clearly in a better position to receive loans and to issue bonds. They are in a good bargaining position in receiving state transfers. The probability to have larger target capital investment subsidy from state budget corresponds with the size of the municipality rather than with the needs for investments in the local infrastructure and services. It can be assumed that at this stage only a very limited number of financially independent municipalities can afford to invest in infrastructure projects. Therefore, it can be expected that only a very restricted numbers of all 263 municipalities in Bulgaria, will be able to successfully issue bonds under the current circumstances, since they will have to simultaneously meet the following requirements: to be relatively large and to be financially independent.

Potential Investors

Banks, insurance companies, pension funds, private companies and households constitute the list of potential investors in municipal bonds. The legal framework on

municipal bonds does not adequately protect the interests of investors, especially in the event of default. There are two main reasons to explain this: first of all, event of default is not adequately defined, and second, common practice of bank foreclosures in cases of defaulting loans clearly indicates that legal protection provided to lenders is extremely inefficient. Due to the reasons mentioned above, it is crucial to investors that they are enabled to monitor that funds raised by bond issue are efficiently invested and have the measures to restrict risks of defaulting. The best way to achieve this (apart from executing a perfect bond agreement) is to have access to prior experience and information on municipal activities.

At present, banks are the only institutions that are in position to invest abroad. The net foreign assets account for more than 40% of the consolidated balance sheet of the banking system (excluding the Bulgarian National Bank). Supposedly, this is due to the lack of domestic financial instruments and the artificially maintained low primary interest rate. Municipal bonds are new instruments for the Bulgarian financial market and in order for the banks to invest in them more confidently bank personnel would need to better understand how municipal finance works. In Poland, for example, bank personnel were literally induced to undergo training in the field of municipal finance as well as bond issuance risks. It must be noted, that the major driving force to develop municipal bond market was competition among banks, especially competition between local and foreign banks. None of these is in place in Bulgaria now, but countries experience may differ.

The few banks that have been allowed to service municipal budgets have access to much more information with regard to municipal activities as opposed to those that are not allowed. In addition, banks are better suited to monitor execution of investment projects as compared to a multitude of individual investors. That is why it is very probable that banks will be the major investors in municipal bonds in the immediate future.

It can be expected that in long-term perspectives, institutional investors like insurance companies and pension funds will most certainly show growing interest to invest in bonds as these are the only investors of long-term financial resources. Currently, portfolios of insurance companies and pension funds comprise basically of state securities and bank deposits, although they are allowed to invest their resources in low-risk financial instruments.

At present, it cannot be expected that business companies will show exceptional interest to invest in municipal bonds unless serious tax preferences are implemented. Not to mention the fact that companies themselves suffer severe shortage of credit resources and working capital. Current analysis reveals that lately inter-corporate indebtedness has reached extremely high levels.

Households and individuals have been ruled out as investors in municipal bond during the recent years, due to the assumption that people has not as yet overcome their mistrust in the financial system, a mistrust originating from the high inflation levels, the existence of financial pyramids and the severe bank crisis of 1996-1997. However,

the low interest rates of bank deposits and state securities can be a precondition for channeling households' savings toward more profitable investment opportunities.

In conclusion, it can be summarized that a key factor to promote purchasing of municipal bonds, apart from availability and execution of a sound contract, is the availability of sufficient information and transparency of municipal finance, currently unavailable. The problem can be overcome by implementation and strict observation of legally defined requirements that will ensure transparency of public finance as a whole, as well as launching of programs concerned with providing information to potential investors about municipal activities, preparing and presenting municipal financial statement. The MoF experience in launching state securities of 5-year maturity proves that the local market is not ready yet to purchase long-term bond issuance of fixed profitability which implies that in order to sell better municipal bonds should have variable interest rate. The most experienced investor currently are Bulgarian banks, a fact that comes to support the statement that the most favorable (and the cheapest) way to develop municipal bond market would be private placements.

Because the regulatory framework, concerning municipal bonds issue is more inefficient and scarce as compared to corporate bonds regulations, the separate act on municipal bonds should be elaborated. Another unfavorable factor is that municipalities are entitled to issue general bonds only. They should be allowed to issue revenue bonds as well. Because revenue bonds are project oriented, they would be favorable for the smaller municipalities, since larger municipalities are in a better position to raise funds. Furthermore, it is dubious whether the private placements are permitted under the present legislation. This can impede the development of the municipal bond market since private placements involve lower transaction costs.

Conclusion

Building a better legal and institutional framework for fiscal decentralization is critical to advancing a wide array of objectives aimed at achieving more effective and responsive local government in Bulgaria. From the narrower perspective of municipal bond market development, clearly progress on this front is a pre-requisite for municipal bonds to emerge as a predominant means for financing local investment needs. The recommended reforms should be aimed to:

- Strengthen municipal authority and capacity to increase revenues and control operating expenditures, with an eye to generating a meaningful level of annual net savings in the operating budgets on a predictable and recurring basis;
- Motivate and reward those municipalities that take the initiative to borrow and invest, particularly for capital improvements that pay for themselves through savings in operating costs.

Specific reforms which would advance the above objectives include:

- Establishing a budget with separate operating and capital accounts, and multi-year capital investment plans, that would include the ability to carry forward surpluses;
- Granting greater local discretion to set local taxes and fees;

- Instituting a more transparent and predictable system of transfers; and
- Allowing more local responsibility for the forecast of own source revenues.

From the investors' point of view some additional recommendations should be made:

- To simplify due diligence for lenders. Financial institutions will be more inclined to take the trouble to underwrite municipal credits if they have ready access to reliable information on municipal financial condition – particularly in respect to accrued and contingent liabilities and outstanding indebtedness;
- To give investors confidence in the financial procedures, systems, and management capacity of local government that will help ensure timely repayment.

In conclusion, Bulgaria has a unique and timely opportunity to establish a well-conceived policy and legal framework in order to advance the municipal bond market development. Despite all challenges and concerns, issuers and investors are preparing to meet at the market. Solving the problems that they face in their entirety and interaction, and facing the challenges will promote the successful development of the municipal bonds market in Bulgaria.

Notes

¹ Club "Economics 2000" (2002), Needs Assessment of Sub-national Governments Draft Report, Sofia, p.10

² Ibid p.7

³ McCullough, J., T. Spofford, E. Savov, S. Ivanov (2000), Bulgaria: Comprehensive Municipal Finance and Fiscal Reform Proposal: Final Report, Sofia, p.6-7

⁴ They are listed in The Annual State Budget Act of the Republic of Bulgaria for Fiscal Year 2003, published by the State Official Journal, Issue 120, December 29 2002, Appendix 3

⁵ Notwithstanding that local fees in practice are payments for rendered services municipalities are entitled to define the amount of local fees through a decision taken by the Municipal council within minimum range, regulated by normative act.

⁶ Club "Economics 2000" (2002), Needs Assessment of Sub-national Governments Draft Report, Sofia, p.11

⁷ Joint Research/Exchange Program (1999) A Set of Recommendations on the Practical Arrangements for the Issue of Municipal Bonds in Bulgaria Working Paper, JREX, Sofia