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Access to Debt Financing - Opportunities for Improvement of the Investment Capacity of Bulgarian Municipalities (for the period 2003-2015)

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Summary

The activities regarding further improvement of the degree of fiscal decentralization in Bulgaria started in 2003. As a result of initiated reforms, Bulgarian municipalities gradually improved their abilities to generate revenue, obtained new responsibilities regarding expenditures, including these for construction, maintenance and expansion of local public infrastructure, and gradually improve their access to debt markets.

This paper presents an examination of the development of debt financing of municipalities in Bulgaria. The aim is to reveal how decentralization opened up opportunities to finance municipal investments through debt, as well as to determine the character of debt financing as regards the increased municipal investment capacity. The period of research is 2003-2015 because this period ensures more accurate results. The object of analysis is debt financing while the research topic is the changes in the municipal domestic debt in Bulgaria. The main information base includes data about the performance of municipal budgets, statistical data of the Bulgarian National Bank and of the National Statistical Institute, data concerning state debt, published on the official site of the Ministry of Finance, and data from a survey conducted among Bulgarian municipalities. The research methods used are: historical analysis; analysis and synthesis; induction and deduction; descriptive analysis, survey.

Key words: debt financing; decentralization; investment capacity.

JEL classification: H74; H76, G32, H63

1. Introduction

Investment capacity of local authorities means the potential and the ability of local governments to participate in the construction and maintenance of public infrastructure. Main determinants of municipal investment capacity are: the level of fiscal autonomy of local governments, structure and composition of budget revenues, the mechanism of government transfers, revenue autonomy, municipal expenditures and their structure, access to capital markets (Hulbert, Vammalle, 2014, p.19).

Debt financing of local public investments is a well-known practice. Countries with high level of decentralization actively apply this practice. Local authorities have limited

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resources and borrowing from private capital markets allows them to make investments in infrastructure that are far bigger than the ones they would have made if rely only on current funding.

Debt financing is an attractive option for raising funds for local public investments. The major reasons for the rising demand for the use of borrowed funds are: an increasing need for implementing and maintenance of local public investments; the lack of sufficient own budget revenues covering future capital costs, the need for maintenance and rehabilitation of existing infrastructure.

The main advantages of debt financing of the construction and maintenance of local infrastructure are: fair distribution of the benefits and of the burden of financing costs - these conditions imply fairness between generations; reduction of operating budget expenditures, promotion of economic development in the municipalities; use of basic methods for analysis and assessment of investments and provision of improved access to European and other international funds and programs (Yilmaz, Ebel, 2002, p.39). The improvement of allocation effectiveness is an additional advantage of debt financing of local infrastructure. This is due to the fact that debt financing creates incentives for local authorities to select the most appropriate and cost-effective priority projects.

Of course, in the scientific literature we can find arguments against debt financing of local public investments. For example, unduly high use of debt financing can lead to the imposition of an additional tax burden for citizens and the emergence of perennial local budget deficits. The high level of indebtedness places the region in a situation of a debt trap or a debt overhang. The formation of budget deficits and debt servicing instead of providing public services are the additional risks of debt financing of local investments. In a situation with imposed high costs for debt service, the local government is obliged to reduce its operating costs in order to avoid problems with the recovery of used borrowed funds. In this a case, because of reduced quality of local services and goods, it can lead to dissatisfaction in the local community (Swianievicz, 2004, p.8).

Local debt bears risk at the macroeconomic level as well, since it is a part of general government debt. Due to economic costs, stemming from the government's refusal to provide financial support to local authorities, often central authorities guarantee repayment of local debt. This deteriorates local authorities' discipline and the latter tend to transfer their expenditures to the central authorities.

According to the Golden Rule, it is appropriate to use debt financing for investment purposes and as an exception – for short-term debt to finance operational costs. Capital markets determine the best way for municipalities to obtain loans and thus encourage local authorities for responsible management of both- their own funds and their borrowings (Kellermann, 2007, p. 1089).

Considering the reforms in local finances in Bulgaria that started in 2003, municipal debt financing has gained popularity as an instrument for financing of local public investments. It is assumed that municipalities' increasing revenue autonomy is essential to the improved access to capital markets (Petersen at all, 2000). The European Charter of Local Self-Government[1], which was ratified by a law passed by the National Assembly in 1995, also recommends the use of borrowed funds to finance municipal investment costs.[2]

[1] Adopted in Strasbourg on 15 October 1985

[2] Art. 9, p. 8 EHMS: In order to finance investment costs, local authorities should have access to the national capital market in accordance with the law.

2. Debt financing and Bulgarian municipalities

2.1. Review of the research on the topic

The process of fiscal decentralization is of interest to both business and the research communities. Basic prerequisites for municipal access to the debt market are the gradual rise in the level of fiscal decentralization and improved capacity of the municipalities to generate revenue. Authors that do research in the field of fiscal decentralization and municipal debt financing in Bulgaria are Presiana Nenkova, Desislava Stoilova, Ludmil Naidenov, Todorka Vladimirova, Stefan Ivanov, Ginka Chavdarova (National Association of Municipalities in the Republic of Bulgaria), Emil Savov (National Association of Municipalities in the Republic of Bulgaria), Daniela Ushatova (National Association of Municipalities in the Republic of Bulgaria) and others.

The research of Presiana Nenkova considers municipal debt financing in terms of the sources of municipal investments. Funds for capital investments, in addition to government subsidies and sales revenue, are being provided by using loans from financial institutions and the accumulation of resources through municipal bond issues (Nenkova, 2007, p.134). The issuance of municipal debt in Bulgaria is an alternative option for raising of funds needed to improve the quality of delivered municipal services and related infrastructure. Debt financing of local activities and local infrastructures is considered as appropriate in case of a stable and adequate local revenue as well as a sufficient managerial and financial capacity for the responsible use of credit. Since the majority of Bulgarian municipalities are in a poor financial condition the use of debt financing may lead to further problems and inability to perform their duties (Nenkova at all, 2005, p.39-40).

Desislava Stoilova's research is of interest with regard to deficit financing of municipalities. She studies the general benefits and risks of local debt financing, general opinions concerning the balanced budget, mechanisms for limiting and control of the municipal debt, the practice of debt financing in CEE, an overview of the municipal debt market in Bulgaria in 2005 (Stoilova, 2005).

The studies of Vladimirova and Naydenov are associated with the general issues concerning municipal debt and the regulatory framework of debt financing in Bulgaria (Vladimirova, Naydenov, 2011).

Experts of the Ministry of Finance estimate and disclose periodically the indicators for the assessment of the level of fiscal decentralization and of municipal access to debt markets. Experts in the National Association of Municipalities in the Republic of Bulgaria and in the Institute for Market Economy prepare a periodic analysis of the general indicators for fiscal decentralization and information about the overall municipal debt market context. Municipal debt market in Bulgaria is the subject of analysis in the annual reports prepared by the Network of Associations of Local Authorities of South-East Europe (NALAS).

The aforementioned studies explore basic features of the municipal debt market in Bulgaria, but they do not expose the opportunities available to a single municipality in order to have access to the debt market.

Municipal debt as a part of the consolidated debt of Sector "General Government" is of interest at the macroeconomic level. The impact of government debt on the macroeconomic activities in Bulgaria can be considered with regard to its short-term and long-term effect.

The empirical results show that the increase in short-term government debt stimulates real GDP growth. When long-term impact is considered, however, the stimulating effect of government debt growth on GDP dynamics is observed only up to a certain level, beyond which debt increase produces adverse effects on macroeconomic activity (Velichkov, 2016).

2.2. Practice of debt financing of Bulgarian Municipalities

Since the start of reforms in the 1990s, Bulgarian municipalities have no right to use borrowed funds and to use their own property (different from state property) as a pledge. There was a legal limit for a municipal budget deficit until 2001 – up to 10% of the total value of revenue. This restricts the right for use of debt financing. Limited debt financing is determined by additional factors such as: low value of own local revenue, high dependence on state transfers and lack of opportunity to generate operational surplus.

As a result of reforms of fiscal decentralization, local authorities in Bulgaria gradually increased their revenue and strengthened their administrative and financial capacity. The process began to gather momentum in 2002 when the government adopted a Concept paper on fiscal decentralization and an action plan on its implementation. A number of key reforms were pushed forward with the aim to broaden the municipal own-sources revenue base and increase local government's revenue autonomy. Dedicated action to set a decentralized public finance system in place resulted in a visible improvement of financial self-sufficiency of local authorities. (Nenkova, 2014).

The reform is a prerequisite for the increase of the creditworthiness of local governments, and opens up new opportunities to ensure additional funds for the municipal budgets[3].

Basic legislation concerning municipal debt financing: State Budget Act, Municipal Debt Act, Public Finance Act (which partially replaced the Municipal Budget Act), Public Offering of Securities Act, guidelines, and regulations of the Ministry of Finance, internal regulations of municipalities and municipal ordinances regulating debt financing, and others.

According to Art. 3 of the Municipal Debt Act, Bulgarian municipalities can take debt by a decision of the municipal council. The decision to take municipal debt should include: maximum amount of debt expressed in nominal value; currency of the debt; type of debt; manner of provision of collateral; terms of repayment; maximum interest rate, fees, commissions and others. The decision has to be taken by a majority of more than half of the municipal councilors or following a local referendum conducted by virtue of a decision of the Municipal Council.

[3] Local Authorities are allowed to independently determine the types and amounts of municipal fees, the right to introduce new prices for services by a decision of the Municipal Council, and the right to exempt indigenous groups from payment of the relevant fee, following amendments made to the LTFA in 2003. In 2006, municipalities began to administer local taxes independently. In 2007, by an amendment to Art. 141 of the Constitution of the Republic of Bulgaria, Municipal Councils of local jurisdictions acquire the power to determine the amount of local taxes under terms, conditions and limits established by law. For the first time Bulgarian municipalities acquire real tax powers as a consequence of the amendment. Based on the change, local authorities set rates in accordance with the legal restrictions, but do not have the competences in determining the types and the tax base of local taxes. During the period 2003-2015, the road tax was dropped from the scope of local taxes, but include: patent tax, tourist tax, and from 2016 the car tax for taxis. The essential prerequisites for achieving a higher level of investment capacity of local authorities are: increase of their authority to collect revenue, improved collection of local taxes and fees by a local administration, as well as enhancement of the expenditure responsibilities of municipalities and accordingly for increase of local investment capacity. The Municipal Budget Act was repealed by a Decision SG issue № 15 dated February 16, 2013

Upon assumption of debt and adopting of a debt strategy, the municipality should take into account the provisions of the Public Finance Act. According to Art. 32. (1): The annual amount of payments on municipal debt for each municipality per year may not exceed 15 percent of the average amount of own revenues and the general equalization subsidy for the last three years, calculated on the basis of data from the annual reports on the implementation of the municipal budget. The nominal value of the municipal guarantees issued during the current budget year may not exceed 5 percent of the total revenue and the general equalization subsidy according to the last annual report on the implementation of the municipal budget. The annual debt payments due include principal, interest, fees, commissions and other payments on debt assumed by the municipality.

Municipal debt consists of municipal obligation bonds, debt taken thorough contract for municipal loans, required municipal guarantees, interest-free loans under the Public Finance Act and financial leasing and commercial loans (Municipal Debt Act).

The Municipality can take a long-term debt for financing of investment projects in benefit of the local community, for refinancing of current debt, debt for prevention and elimination of consequences of force majeure and others.

The Municipality can take a short-term debt for financing of: public services in temporary shortage of funds in case of temporary cash disruptions in the municipal budget; capital expenditures; urgent expenditures for prevention and liquidation of consequences of force majeure etc.

Debt financing of Bulgarian municipalities has evolved substantially in the period 2003-2015 (Ministry of Finance). Bank` loans have the largest share of municipal debt financing. According to the Methodology of the Ministry of Finance, debt to specialized nonbank financial institutions like Fund for Local Authorities and Governments in Bulgaria (FLAG), Energy Efficiency and Renewable Sources Fund (EERSF) and Enterprise for Management of Environmental Protection Actions (EMEPA) is included in the total value of municipal` loans.[4]

We have to note that at the end of the budgetary year a major portion of the bank loans are investment loans. The overdraft loans which the municipalities use are extended for a period of one year and have to be repaid at the end of the year. Usually at the end of the year local authorities repay also the revolving loans Therefore, the exposure of municipal debt at the end of the year is used for financing of municipal investments, which is a prerequisite for the increase of the investment capacity of local authorities.

Bulgarian municipalities increased the value of borrowed funds annually during the period 2003 – 2015. While at the beginning of the period the value of attracted resources in local budgets amounts to BGN 43 million, in 2015 the value of domestic debt financing reaches nearly BGN 697 million (Statistics of the Bulgarian National Bank and the Ministry of Finance).

Bank financing has a dominant share in the total municipal` debt financing and represents between 50% and 75% of the total amount of municipal debt financing.

Financing through financial leasing and commercial leasing is also on the rise during the survey period. The municipalities finance through leasing the construction of street lighting, purchase of vehicles, purchase of waste collection equipment,

[4] To encourage local investment, the state creates funds and non-banking institutions that support the financially weaker municipalities. Examples are the EERSF, EMEPA and FLAG.

etc. There is no requirement for additional pledge[5] when municipalities lease, and it is possible to negotiate longer term for servicing of the obligation which means less burden on the municipal budget. Financial leasing is being used by big municipalities with a good fiscal position, as well as by small municipalities with limited fiscal assets. As at the end of the survey period obligations under financial leasing amounted to approximately 3% of the domestic municipal debt (Ministry of Finance, Information on general debt in Sector "General Government")

In order to cover the temporary deficit in municipal budgets, commercial banks provide financing thorough short term loans or loan overdraft to municipalities for the implementation of infrastructure projects.

In the period 2003-2015, municipalities' debt exposure (bank financing) increased significantly. In 2003 the domestic debt exposure of bank financing stood at around BGN 22 million and at the end of 2015 it was around BGN 602 million. Substantial growth was reported during the period 2010-2012 and as at the end of 2015.

The financial support of "Fund for Local Authorities and Governments in Bulgaria – FLAG", JSC contributed to the increased exposure of the municipal loans. The Company-activities are targeted at supporting the municipalities in the implementation of projects financed by the Structural and Cohesion Funds of the EU. It provides bridge financing and financing of municipality`s own contribution in the European projects.

Small and medium-sized municipalities with limited own revenues are the financing targets of the fund. In order to enable local authorities with low creditworthiness to borrow resources from FLAG, the State has the right, at its discretion, to recover some of the interest payments incurred by municipalities. At the end of 2015 FLAG funding constitutes about 41% of the domestic municipal debt, incurred through municipal loan contracts (Fund for Local Authorities and Governments, 2015).

The increase in 2015 is due to the end of the payment period on projects under the programming period 2007-2013. For the successful implementation of projects under various European programs, municipalities actively use loans provided by FLAG for bridge financing and for funding of their own contribution.

As already noted, besides FLAG, the State supports municipal debt financing through the EERSF and the EMEPA.

As at the end of the budget year, bank investment loans have a significant share in the total debt exposure. Banks approve loans to municipalities with high creditworthiness. The municipality has to be in a satisfactory fiscal condition (including absence of or low value of reported outstanding liabilities and receivables, positive net operating balance, etc.), should have good indicators for liquidity, moderate indebtedness and have a good credit history. [6]

Municipal obligation bonds as a debt instrument are important and popular among municipalities. Obligation bonds are an alternative form of financing of investment projects. They allow for raising of funds from capital markets at attractive prices as well as for diversification of investors/creditors. External resources accumulated through bond issues are used only for financing of vital municipal projects.

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[5] except property that is acquired as a result of lease Ministry of Finance, information on the consolidated debt, Sector "General Government", www.minfin.bg.

[6] According data of the Ministry of Finance, at the end of 2015 overdue liabilities of Bulgarian municipalities are equal to BGN 189.9 million. The number of municipalities without overdue liabilities is 116, and the number of municipalities with overdue liabilities is 149. Vidin, Kardzhali, Velingrad and Pernik are municipalities with the highest level of overdue liabilities.

Total value of debt incurred by municipalities under bond issues increased in the period 2003-2011. During 2011 the bond issues reached their highest exposure – BGN 113 494 thousand. During the next 2 years bond exposure decreased due to repayment of part of municipal obligations as well as because of deterioration of fiscal markets, which is the reason for lack of investor` interest in municipal bonds.

Although, during the study period the municipal bond issues reach up to 25% of the total domestic debt financing, they remain a relatively rarely used by Bulgarian local authorities instrument. At the end of 2015 municipalities with residual debt on bond issues are only nine – Nessebar, Varna, Kavarna, Dupnitsa, Kyustendil, Pazardzhik, Plovdiv, Svilengrad and Shumen. The total value of municipal bond issues at the end of 2015 is around 14% of the domestic municipal debt.

The municipalities that use domestic debt financing for investment purposes are the–municipalities with good fiscal position, high share of own revenue, low dependence on state transfers. At the end of 2015, local governments using debt financing intensely are: Burgas (debt exposure is around 4.70% of the value of total domestic municipal debt), Varna (debt exposure is around 11.4% of the value of total domestic municipal debt), Plovdiv (debt exposure is around 5.06% of the value of total domestic municipal debt) and Stara Zagora (debt exposure is around 3.50% of the value of total domestic municipal debt). Municipalities with debt exposure around 2% of the value of total domestic municipal debt are: Kustendil, Pazardzhik and Shumen. Municipal bond issues constitute a major portion of the debt.[7]

The Sofia Municipal Council uses debt financing only from foreign creditors. The debt exposure of the Municipality of Sofia at the end of 2015 stood at BGN 570 million which is close to the amount of total exposure of domestic municipal debt. Japan Bank for International Cooperation, European Investment Bank and European Bank for Reconstruction and Development are the main creditors of the Municipality of Sofia. The share of the Municipality of Sofia debt compared to the total municipal debt is around 48% for 2013, around 52% for 2014 and around 47% for 2015.

Municipality of Plovdiv, Municipality of Varna and Municipality of Burgas also have access to the internal capital market. These municipalities use financing from the European Bank for Reconstruction and Developments. The financing is targeted at important municipal investments for education infrastructure, street infrastructure, rehabilitation of boulevards and others.

We reach the conclusion that during the surveyed period according to the statistics, debt financing of municipal investments marks a significant growth in absolute value. However, the data presented does not allow us to reach conclusions concerning the opportunities for small and medium- size municipalities to access the debt market. So a survey concerning the ability to access the debt market was conducted among Bulgarian municipalities.

3. Study on attitudes of local authorities regarding access to debt financing

A questionnaire regarding access to debt financing was prepared and sent to Bulgarian municipalities in order to evaluate the attitudes of Bulgarian municipalities concerning the use of investment debt financing. The research was done by the Department of Finance, University of National and World Economy, Sofia.

[7] This information is based of public information accessible on the websites of the municipalities.

The questionnaire addressed 60% of the Bulgarian municipalities. Responses were received from 37% of respondents. The big municipalities with high level of own revenue like Sofia, Varna. Plovdiv, Varna, Burgas, Stara Zagora and others are not included in excerpt. It is clear that these municipalities have no difficulty to access debt financing. Small and medium – size municipalities are the main target of the research.

The survey is instantaneous and concerns data for the years 2003 and 2013. The survey involves two groups of questions, namely:

1. What kind of debt instruments the municipality used in the years 2003 and 2013?
2. Did the municipality have difficulties in accessing debt financing? If the answer is yes, please point out the reasons.

As a result of the survey we received answers from 57 municipalities or 37% of the respondents. The respondents are as follows: Pomorie, Yakoruda, Gorna Oryahovitsa, Kula, Lyaskovets, Karnobat, Gabrovo, Chepelare, Mezdra, Sevlievo, Godech, Belogradchik, Nessebar, Chavdar, Asenovgrad, Suvorovo, Nevestino, Banite, Polski Trambesh, Pavlikeni, Dolna Mitropoliya, Krumovgrad, Simeonovgrad, Aksakovo, Lovech, Dimitrovgrad, Madan, Beloslav, Vratsa, Aitos, Pirdop, Zlatograd, Dulovo, Maritsa, Boychinovtsi, Belene, Ruzhintsi, Popovo, Kazanlak, Rakitovo, Rila, Loznitsa, Zavet, Rodopi, Harmanli, Dzhebel, Tvarditsa, Satovcha, Ruse, Chelopech, Gurkovo, Elin Pelin, Bolyarovo, Koprivshtitsa, Gotse Delchev, Karlovo, Strumyani.

The results after data processing are as follows:

3.1. Comparison of debt instruments that have been used by municipalities in the years 2003 and 2013.

In the survey municipalities report on the number of debt instruments which they have used in the years 2003 and 2013. The submitted survey information is in areas such as: bank investment loans; overdraft loans; municipal bond issues; financing from EMEPA; financing from EERSF; financing from FLAG; financing from foreign creditors.

The selection of debt instruments is in line with the practice of municipal debt financing during the last years. Even though they are state enterprises which support debt financing of Local Authorities, the loans provided by FLAG, EERSF and EMEPA are considered as debt instruments.

FLAG provides loans to municipalities and municipal companies with temporary shortage of resources in the implementation of projects financed by the Structural and Cohesion Funds, EERSF finances the construction of energy efficient municipal buildings, including schools, and EMEPA finances the construction of municipal infrastructure related to environmental protection.

Any debt area is reported as 1 if the municipality is funded by it and 0 if the municipality is not funded by it. The number of financings through one and the same (item of) debt instrument within a municipality is not being recorded. The results after processing the questionnaires regarding the use of debt instruments are shown in Table 1.

Table 1. Results from analysis of debt instruments used during the period 2003-2013 by municipalities which participated in the survey.

Year	Bank investment loan	Overdraft loan	Municipal bond issues	EMEPA	EERSF	FLAG	Foreign creditors
2003	71,4%	0,0%	0,0%	14,3%	14,3%	0,0%	0,0%
2013	22,5%	8,8%	1,3%	22,5%	3,8%	39,8%	1,3%

Source: Questionnaires

The results for the year 2003 show that the municipalities have benefited most from bank investment loans - financing through this debt instrument represents 71.4% of all types of financing, then the percentages are divided between funding by EMEPA and by EERSF – around 14.3% for each debt instrument. Total number of debt financings through all debt instruments is very limited. Only five of the respondent municipalities have used debt financing, of which only Zlatograd has benefited from funding under two items simultaneously.

This means that the 71.4% financing through bank investment loans are barely equal to *five municipalities in absolute terms*.

Or in other words, in 2003 out of 57 municipalities which responded, only five municipalities have indicated the use of bank investment loans. These municipalities are Sevlievo, Zlatograd, Popovo, Loznica and Chelopech. One municipality - Zlatograd stated in its response that it uses a loan from EMEPA and another municipality stated that it uses a loan from EERSF – the Municipality of Banite. There are no reported municipalities which use bond issues or overdraft loans. Based on the processed results, a *very low level of activity* regarding the use of debt instruments by local authorities is reported in 2003.

At the beginning of the fiscal decentralization reform of 2003, it is worth noting that there were no clear and exact legal regulations on municipal debt financing. Clear opportunities and rules for use of debt instruments by municipalities were established in the adopted Municipal Debt Act. By a subsequent amendment to the tax structure and to the competences of the Bulgarian municipalities, and by improving legislation that regulates debt financing, the number of municipalities which use debt financing, mainly bank investment loans, increased.

This conclusion is confirmed by the results of the survey for the year 2013. There is a significant rise in the use of debt instruments in 2013. Around 74% of the respondent municipalities use debt financing for certain budget items. The biggest increase, however, was observed in the financing provided by Fund FLAG - nearly 40%.

Bank investment loans and funding from EMEPA share around 22.5% each. Municipal bond issues and financing from foreign creditors are the least used debt instruments. It is not surprising that FLAG financing predominates because many municipalities which implement European projects need additional financing. The reasons for using FLAG financing are: temporary shortage of funds in the course of project implementation (when the so called bridge financing is used, it recovers the funds from the grant), and/or need of funds to provide the own contribution of the municipality in the project.

In addition, payments to FLAG are not included in the percentage of the limit for payments on municipal debt according the Public Finance Act.[8]

The prevalence of FLAG financing cannot be interpreted unambiguously. On one hand, local authorities use borrowed funds under the rules of the Municipal Debt Act and the Public Finance Act, on the other hand, municipal budget funds are not the source for the majority of debt payments, and with the source are grants. The latter inhibit the link between the revenue capacity of local authorities and debt financing.

[8] According to Art. 32. (1) The annual amount of payments on municipal debt for each municipality in each year may not exceed 15 percent of the average amount of own revenues and the general equalization subsidy for the last three years, calculated on the basis of data from the annual reports on the implementation of the budget of the municipality. (5) the limitation under par. 1 does not include the debt of municipalities in temporary interest-free loans and loans granted to them by others from the Sector "General Government". The Sector "General Government" includes FLAG.

3.2. Difficulties in accessing the debt market

When asked whether they encounter difficulty in accessing the debt market, 60% of the respondents indicate that they do not face difficulty, 12% of the respondents indicate that they have difficulty accessing the debt market, and 28% of the respondents did not answer.

The municipalities which responded that they have no difficulty are: Gabrovo, Kostinbrod, Chelopech, Gotse Delchev, Nessebar, Chavdar, Chepelare, Lovech, Dimitrovgrad and Beloslav.

High level of own revenue and good creditworthiness are the characteristics of the aforementioned municipalities. Municipality of Chelopech and Municipality of Chavdar have high revenue from concessions which often is higher than tax revenue. High budget revenue presupposes a lack of necessity for additional attracted funds.

A high percentage of municipalities did not provide an answer. We should mention the municipalities of Rila, Loznitsa, Zavet, Rodopi, Dzhebel - municipalities with low own revenue and limited creditworthiness and at the same time the survey shows they do not use debt instruments. The lack of answers can be regarded as unwillingness of municipalities to use debt instruments due to insufficient own revenue and poor fiscal condition. The fact that municipalities have limited revenue, while paying debt may not exceed 15% of their own income, suggests stronger restrictions on the access of the debt market.

Seven municipalities or 12% of the respondents report that they have a difficulty in accessing the debt market. The response of municipalities which have difficulty is as follows:

- **Municipality of Belogradchik** states that the main obstacle are the high liabilities of the municipality, which creates difficulties in accessing the debt market
- **Municipality of Suvorovo** states that "there are a variety of debt instruments to meet the needs of each borrower. But legal restrictions do not allow free "shopping" of such products by municipalities . This creates difficulties in developing our investment program, which must comply with these limits"
- **Municipality of Nevestino** states that it does not use debt instruments because municipal management considers debt financing too risky as an instrument.
- **Municipality of Dolna Mitropoliya** responded that the main obstacle for active use of the debt instruments is the legal restriction for annual payment (15% of the own revenue and total equalization subsidy)
- **Municipality of Pirdop** states that the municipality is in a poor fiscal condition, with liabilities of over BGN 3 million inherited from the previous mandate. This circumstance impedes access to municipal use of debt financing. Financing institutions have placed the municipality in the risk group.
- **Municipality of Zlatograd** responded that they used FLAG` financing during the past years. Furthermore, another reason for selecting FLAG as a financing institution is the compensatory mechanism for interest paid and fees. A selection procedure under the Public Procurement Act is compulsory for all other credit institutions, which in turn greatly extends the duration of the procedure for assumption of debt.[9]
- **Municipality of Belene** states that access to debt financing is difficult due to lack of appropriate collateral which the municipality can offer.

[9] In 2016, based on the newly adopted Public Procurement Law- the selection of a financing institution for local governments was dropped from the scope of the law. This is a prerequisite for reducing the time for selection of banking services and products and to increase competition between banking and non-banking financial institutions.

We can draw the following conclusions from the responses of the municipalities: first – the limit of 15% for the annual amount of payments on municipal debt from own revenue and the general equalization subsidy[10] is the reason for limited access to debt financing; second - difficulties occur as a result of deteriorating financial conditions of the municipalities; third - unwillingness of the municipal management to use debt instruments because of their high risk level.

Since the study examines data from the year 2013, and we have to note the amendment of the debt financing of municipalities - object of the study in the years 2014 and 2015.

In 2014, 15 municipalities-respondents do not use debt financing – Strumyani, Pavlikeni, Polski Trambesh. Kula, Ruzhintsi, Krumovgrad, Nevestino. Boychinovtsi, Maritsa, Zavet, Dulovo, Tvarditsa, Elin Pelin, Chavdar and Chelopech. The number of municipalities which use FLAG financing is 28, this is around 49% of the respondents. FLAG financing represents around 10% of the debt exposure of 4 municipalities, between 10% and 50% of the debt exposures of 12 municipalities, and 12 municipalities used debt financing only from FLAG.

In 2015, 13 municipalities-respondents do not use debt financing – Suvorovo, Polski Trambesh. Kula, Ruzhintsi, Nevestino. Boychinovtsi, Zavet, Dulovo, Tvarditsa, Madan, Elin Pelin, Chavdar and Chelopech. The number of municipalities which use–FLAG financing is 26, this is around 45% of the respondents. FLAG financing represents around 10% of the debt exposures of 3 municipalities, between 10% and 50% of the debt exposures of 11 municipalities, and 12 municipalities used debt financing only from FLAG.

On the basis of processed questionnaires and the additional information for the years 2014 and 2015, we can confirm the finding in the first part of the study – municipal investment debt financing reports a significant development during the period 2003-2015. However, the main debt instruments such as investment loans from commercial banks and municipal bonds remain accessible only to big municipalities which are in a good fiscal position.

The small and medium size municipalities use debt financing through FLAG. The peculiarity here is that the debt instrument can be used only for financing of European municipal projects and can not be used for financing of municipal investments under the capital program of municipalities. We can conclude that the investment capacity at local level can not be significantly improved if it depends on the access to debt financing. Opportunities for improvement of the access to municipal debt markets and the use of best practices for debt financing of municipal investments need to be explored.

4. Opportunities for improved access to municipal debt market

The results revealed that although debt financing in absolute terms during the survey period increased, the majority of municipalities are not successful in the use of debt financing.

Other conditions being equal, small and medium-sized municipalities with a limited revenue base have no access to capital markets as indicated in the legislation and according to the practice of setting limits on municipal debt. However, there are options that allow local authorities to benefit from investment debt financing.

Municipal Development Funds and Local Government Funding Agencies are the two innovative tools addressing financially weak municipalities.

[10] In 2010, the restrictions regarding the annual debt payments were amended downwards. According to the Municipal Debt Act until 2010 annual service charges on municipal debt should not exceed 25% of the amount of own municipal revenues and the general equalization subsidy in the last audited annual municipal budget.

Economic Alternatives, 2017, Issue 2, pp. 265-282

4.1. Local Government Funding Agencies

Local Government Funding Agencies are financial institutions which can increase investment funding for Local Authorities such as municipalities, regions and states by facilitating the access to capital markets using the 'joint procurement of credit' principle. Local Authorities are the owners of the agencies. In some cases the State may hold a minority interest. The Agency works as a cooperative in which Local Authorities participate together as one legal entity targeting lower interest levels on loans. This type of companies are not established for profit, and in case of a generated profit, it is reinvested in their operations. Agencies work in a self-control mode. Shareholders which participate in the entity should be in a good financial condition and have acceptable creditworthiness in order for the entity to be successful.

The Agency monitors and supervises its members (shareholders) and takes immediate action upon detection of a deteriorating financial position of one of its members. These actions are crucial for the rating of the agency and for the access of its members to capital markets.

The supervision is a safeguarding mechanism against over-indebtedness on the part of the Local Authorities. In Europe, the existing agencies which support local investments by providing easier access to debt financing are located in Denmark, Norway, Sweden, the Netherlands (Andersson, 2016). These agencies were established at a time when Local Authorities are under high pressure to provide resources for infrastructure investments. The agencies use state guarantees or other type of security guaranteeing reimbursement of borrowed funds by Local Authorities.

Due to observed difficulties in accessing financial markets for the majority of Bulgarian municipalities, the establishment of this type of a Company is justified. Local authorities get together and jointly issue common debt bonds on the basis of the so called "club deal". Each participant in the issue is responsible for the payments on his share of the issue, and the Agency further ensures payment of the debt to the creditors. Companies of a similar type successfully operate in Italy, Canada, France and the Scandinavian countries.

Improvement of the access to the municipal debt market justifies the establishment of a similar type of institution in Bulgaria. Pooling several municipalities into a consortium will allow small municipalities to obtain significantly cheaper funding. Since the incidental expenses for the issuance of bonds are not small, along with the economies of scale, in the case of an association of a greater number of municipalities, basic costs will be shared by all parties.

4.3. Municipal Development Funds

Municipal Development Funds (MDFs) are created on the initiative of the central government. They support financially weak local communities by granting low-interest or interest-free loans, often combined with grants for investments in construction and improvement and modernization of infrastructure within local jurisdictions. The funds provide consulting services in order to support activities for improvement of the administrative capacity of Local Authorities, assistance with the preparation of financial plans, project preparation, etc.

The main target of proposed financing is the construction of urban infrastructure, housing in poor neighborhoods, schools, hospitals, parks, water facilities and other important local community infrastructure.

According the authors (Davey 2005, Petersen 2005), MDFs are considered as transitional tools which prepare the Local Authorities for a self-sustaining municipal credit system that can use domestic and international capital markets for funding. Municipal Development Funds are created in partnership with the international banking institutions[11] and can be considered as tools for deficit reduction and substitution of government transfers with commercial debt financing of investment projects.

The literature under study (Dafflon, 2002; Davey 1988; Davey, 2003; Diamond, 1984; Frere, Peterson, Valdez at all, 2010; Magrassi, 2000) indicates that the funds are established to support decentralization processes in the developing countries. Increasing the level of capital investments, improving local creditworthiness and access to the capital debt markets are the targets of the fund. Main advantages of financing of this type of companies are: determining the interest of the financing granted under the market rate; government subsidies on interest payments on the debt; more liberal restrictions on debt ratios and annual debt costs.

Experience shows that in many cases the funds have a limited life. After achieving their goal, they decapitalize and cease their activities. The length of life depends on the motivation and desire of the central government to provide loan resources for implementation of local public investments, to promote market competition in municipal financing and provide preferential conditions, such as interest payments to municipalities at below market rates.

A fund with a structure similar to the structure of a Municipal Development Fund operates in Bulgaria - FLAG. As already noted, the Company provides financing only for municipal projects under European programs which is the main disadvantage of its funding policy.

In order to contribute to the improved access of small and medium-sized municipalities to debt financing, there is a need to establish a Municipal Development Fund aimed at financing capital expenditures of municipalities under their regular capital budget programs. Practices under study show that the typical restrictions regarding annual payments on debt and total exposure of municipal debt, are a little more liberal when using funding from municipal funds.

5. Conclusion

Debt financing of municipal investments is undergoing a significant development in the period 2003-2015. The high degree of fiscal decentralization is a prerequisite for improved municipal creditworthiness. Statistics and the results of the a survey show that during the period under study municipal debt has increased not only in absolute terms, but increase in the number of municipalities using debt financing is reported.

However, the main debt instruments used by Bulgarian municipalities are not the standard loans from commercial banks and/or bond loans. General statistics

[11] Like the World Bank, the European Bank for Reconstruction and Developments or USAID.

and the data obtained from the survey show that a major share of the financing through bank loans is funded by FLAG. The specific issue here is that through this type of debt, the typical municipal capital expenditures under the capital program of the municipality cannot be financed.

This, in turn, means that a major part of investment needs cannot be covered because of lack of funding. In order to increase the investment capacity at local level by improving the access to municipal debt markets, two recommendations are made - the establishment of Local Government Funding Agencies and establishment of Municipal Development Funds. Naturally, the proposed instruments should be used, taking into account all the potential problems which lead to shortage of funding.

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