Advisory Note on Regulatory Framework And Institutional Issues: Municipal Borrowing in Bosnia and Herzegovina

FINAL REPORT

January 2000

Matthew D. Glasser
Charles Jokay

RTI INTERNATIONAL

Advisory Note on Regulatory Framework and Institutional Issues: Municipal Borrowing in Bosnia and Herzegovina

Advisory Note on Regulatory Framework and Institutional Issues: Municipal Borrowing in Bosnia and Herzegovina

EXECUTIVE SUMMARY

This note was developed for the World Bank-financed Local Development Pilot Project in Bosnia and Herzegovina. This project aims to strengthen the institutional and financial capacity of local governments and introduce sound, market-based lending for municipal infrastructure on a pilot basis. The purpose of this note is to identify and discuss the issues involved in developing a policy framework for municipal borrowing.

The development of a market-based municipal credit system in Bosnia and Herzegovina is not likely in the near term given the weak institutional and financial state of both local governments and banks. Nevertheless, because external donor financing is not a long-term solution to the country's infrastructure needs, private sector lending will be needed. Because the state and entity governments cannot effectively make infrastructure decisions for every local community, locally driven borrowing will be necessary. In order to ensure that such borrowing is carried out in a financially sound and sustainable manner, it is important that appropriate policies are developed that can help guide and protect municipalities as they experiment with borrowing, and can assure that the consequences of mistakes at the local level are not visited on other levels of government.

As a matter of law and policy, municipalities and communal service enterprises are responsible for most local infrastructure in Bosnia and Herzegovina. Local borrowing can be a powerful tool to help them meet their obligations, but it can also magnify the consequences of poor decisions, particularly if the sector is unregulated or poorly regulated. By making it clear how municipalities can borrow and what rights lenders have, a legal and regulatory framework can help assure that municipalities will borrow, and lenders will lend, only when there are adequate resources to repay. By making it crystal clear that local borrowing is an obligation only of the local borrower, the entity and sovereign governments can avoid becoming responsible for others' debts.

The report identifies several areas where it is recommended that policy be explicitly developed. Fundamental policy questions that remain to be decided include the following:

- Issuing debt: Which subsovereign entities should borrow? What security should they be authorized to give? What remedies should be available to creditors?
- Restrictions on debt: For what purposes should short term borrowing be permitted? For what should long term borrowing be authorized? What limits, if any, should be placed on each type of borrowing?
- Authorization of local borrowing: What process should be used within a municipality to issue debt? What, if any, external approvals should be required?

- Disclosure and market regulation: What forms of borrowing should be permitted, with what kinds of public disclosure? How might market regulation evolve?
- Assistance in the municipal debt sector: What kinds of direct and indirect assistance can national government provide to help local borrowing succeed?
- Monitoring, intervention, and remedies: What monitoring of local debt is appropriate? What intervention in troubled municipalities? What should happen to insolvent municipalities?

Current laws and practices are explored in the report, and the pros and cons of various approaches to these policy issues are identified. The report proceeds on the assumption that while market principles must set the broad outlines of possible policies, there is no objectively correct answer to every question -- the appropriate rules for the borrowing game must be determined and implemented by those that want to play the game. The report proposes a process to resolve these important policy questions by involving key stakeholders (potential borrowers and lenders, together with local, entity, and state governments) in the policy decisions and subsequent implementation of the policy framework.

With specific regard to the Local Development Project, the report recommends that municipal authority to borrow be clarified through legislation. The need for clarification exists in both the Republika Srpska and in the Federation, though the specifics are somewhat different, as more specifically identified in the report, under the section "The Way Forward."

Beyond this particular project, the report recommends the development of a more comprehensive and permanent framework to help Bosnia and Herzegovina move toward a market-based system for municipal debt. Developing a clear vision of the role of municipalities is a critical condition precedent to developing policies, especially in the Federation where the relationship between cantons and municipalities must be sorted out.

INTRODUCTION

This note was commissioned as an analytical piece for the World Bank-financed Local Development Project. That Project is intended to make a limited amount of investment capital available to municipalities through existing financial institutions. Moreover, the project is intended to (1) do so in a way that is consistent with the evolution of a healthy municipal credit market, and (2) help create the conditions for that credit market to develop. A sound policy framework is one prerequisite for the successful development of a healthy municipal credit market. A clear policy framework will help assure that the Project is implemented in a way that is consistent with the evolution of municipal credit market. The purpose of this note is to identify and discuss the issues involved in developing such a policy framework.

The focus in this note is on regulatory and institutional issues directly related to municipal borrowing. There are a number of other policy issues in flux in Bosnia and Herzegovina, some of them quite important, which will affect municipal borrowing indirectly, but which are nevertheless largely beyond the boundaries of this note. These extrinsic issues include policies regarding patrimony (municipal and national property), policies on pricing of communal services, policies regarding local and intergovernmental revenues, and policies regarding potential lenders (e.g. banking and insurance regulation).

In the context of municipal borrowing, it is important to keep in mind some of the ways Bosnia and Herzegovina is different from other economies in transition. First, the recent civil war and its legacy of separate near-sovereign entities have created a situation in which national policy discussions, and national policies, are essentially non-existent. What policies there are now and in the near to medium term will be entity[1] policies, not state policies. Second, continuing economic and social instability means that Bosnia and Herzegovina is extraordinarily reliant on donor funding for investment, including local infrastructure investment. The problem is not, as in other CEE countries, moving from central funding to local funding, but rather moving from external donations to funding based on internal taxes, fees, and charges. Third, ethnic and historical divisions prevent many municipalities, like the state itself, from being effective civic institutions. The legitimacy and functioning of local government in divided municipalities is open to serious question. Fourth, while a currency board currently provides medium term stability, within which a reasonable and differentiated interest rate structure could develop, the tremendous uncertainty after the board ends in 2003 means that market-based long-term lending is very risky, especially from the lender's point of view.

This note results from a visit to Bosnia and Herzegovina by Matt Glasser and Charles Jokay in September 1999. The individuals interviewed in connection with the preparation of this report are identified in Appendix 1. Our sincere thanks go to all of them, as well as to Sarah Forster, Michael Schaeffer, Goran Tinjic, Ljiljiana Simunovic, and Srecko Bogunovic.

[1] The two entities comprising Bosnia and Herzegovina are the Federation of Bosnia and Herzegovina (hereafter "Federation") and the Republika Srpska.

1. The need for private investment

In Bosnia and Herzegovina, as elsewhere, attracting private capital to help finance municipal infrastructure is necessary and desirable because the public sector has limited resources. Borrowing private money can allow municipalities (and each entity, or the state as a whole) to leverage the revenues they do have, building more infrastructure, and faster, than can be done on a pay-as-you-go basis. From a political theory point of view, municipal borrowing from the private sector is consistent with decentralized local decision-making. With access to their own funding sources, local communities and their citizens can set their own priorities. From an economic point of view, capital markets will allocate funding to those municipalities and projects that are most creditworthy, promoting healthy management and financial practices at the local level and minimizing the need for supervision by other levels of government.

While Bosnia and Herzegovina is recovering from its civil war, foreign donations are providing the bulk of financing for rebuilding local infrastructure. Neither potential borrowers nor potential lenders have given much thought to future private sector lending for municipal infrastructure. However, as grants and subsidized credits dry up, it would be useful to have in place a facilitative policy framework for municipal borrowing. Given such a framework, together with a stable and adequate revenue structure for municipalities, a viable private financial sector, and good municipal management skills, we can expect municipal capital markets to develop, and to take on an increasing share of the infrastructure financing burden.

2. The reasons for a policy framework

Municipalities and communal service enterprises in Bosnia and Herzegovina are responsible for providing most local infrastructure. Although there is discussion of utility concessions to attract equity capital, and widespread interest in the idea of municipal borrowing to attract debt capital, there are no clear state or entity policies as to whether or how private investment should be attracted to help fund local infrastructure. There is no clear, common understanding of how or where municipalities will get funds for infrastructure investment. Movement towards a market economy is a basic tenet of the Dayton Framework, and financial institutions are intended to be privatized (or have a clear strategy for privatization) by 2001, but there is not yet a private financial sector to which municipalities can turn for capital.

For reasons discussed below, long term municipal borrowing for infrastructure is not likely to be widely possible for some time. Nevertheless, there is substantial interest in long-term borrowing by municipalities in Bosnia and Herzegovina. Whether or not a sound policy framework is established, this interest will lead municipalities to find opportunities for long-term borrowing. Some are already in discussions with potential lenders.[2] Existing legislation gives, or at least is

[2] At least two cantons in the Federation are considering "lending" offers from a German firm. It appears that the firm would not only be providing the financing, but also the underlying construction and/or equipment. The interest rates being quoted are unbelievably good for the Bosnian context (LIBOR plus 0.5%). Among the possible explanations for this low rate – extraordinarily low given the Bosnian context – two seem likely: (1) the interest rate may be low because the price of the goods and/or services is high enough to compensate for the financing risk, and/or (2) there may be a German government or other solid guarantee of the payment stream. Vendor financing is neither unusual nor undesirable, but experience elsewhere has shown that by disentangling the financing function and the procurement function, municipalities can usually get cheaper goods

perceived to give, sufficient authority for long term municipal borrowing. If *ad hoc* borrowings default – the Odessa, Ukraine municipal bond issue is one recent example – such failures can damage the prospects for responsible local borrowing for a long time to come. It is hoped that a thoughtfully considered and integrated policy framework can channel the urge to borrow into constructive experiences.

Local government borrowing can be a powerful tool for providing badly needed infrastructure, but it can also magnify the consequences of poor local management and irresponsible local choices. Sound policy requires an integrated framework which encourages the private sector to lend to municipal borrowers only after considering creditworthiness, and which encourages municipalities to borrow only when they are convinced (1) they will have the resources to repay the debt, and (2) the improvements to be financed are worth the loss of flexibility implied in the long term debt service commitment. To attract private debt for infrastructure finance on a sustainable basis, a policy framework is needed to identify the legal authority and institutional supports for municipal borrowing. A policy framework for equity investment (concessions, franchises, BOTs, etc.) is a separate topic, which is not addressed in this note.

Although Bosnia and Herzegovina is one country, it is made up of two entities. Each entity is developing its own policy toward municipal borrowing, and indeed toward municipalities and their financing generally. Each entity has its own banks and financial institutions, its own municipal structures and laws, and its own ministries charged with these issues. Of these differences, the most significant is that the Federation's cantons retain great authority over the powers, actions, and revenues of municipalities. One manifestation of this authority is that some municipal revenue shares in the Federation have been changed from year to year, rendering them too variable to support long-term borrowing. If revenue and decision-making authority is retained at the canton level, it is likely that the cantons will have to assume the burden of borrowing for local infrastructure. This is different from the Republika Srpska, where there is no intermediate level of government and municipal revenue shares appear to have been stable. This divergence in underlying policy toward municipalities will require either a flexible framework accommodating both structures or two separate policy frameworks. Because the country is small, the more commonality that can be found, the better – a common policy framework makes a common credit market more likely, with greater efficiency to be expected from a larger number of potential lenders and potential borrowers.

POSITIVE ASPECTS

Despite the challenges posed by the special circumstances of Bosnia and Herzegovina, and the very real barriers to effective municipal borrowing (discussed below), there are at least three positive aspects to the current situation in Bosnia and Herzegovina:

---

and services and cheaper financing. Municipal procurement policies should perhaps require that financing, like goods and services, be competed.

1. Tradition of Decentralization

The former Yugoslavia was more decentralized than many of its neighbors in Central and Eastern Europe. Central control of local decision-making was consciously relaxed in several stages, beginning in the late 1970's.

2. Tradition of self-financing

The old Yugoslav tradition of communities voting to approve self-financed projects, which were then funded by a surtax on salaries within the municipality, evidences both local decision-making and local responsibility for the cost of improvements. This is a potentially valuable tradition, and generally consistent with much modern thinking on local capital finance.

3. A fresh start

Although Bosnia and Herzegovina has inherited some traditions and structures from the former Yugoslavia, there has been very little municipal borrowing and little legislation or regulation concerning municipal borrowing. There is an opportunity to carefully consider the likely stages in the evolution of municipal capital markets, and to create a staged policy and regulatory framework largely from a *tabula rasa*.

DEFICIENCIES AND BARRIERS

It appears that there are several systemic deficiencies and barriers in Bosnia and Herzegovina that will prevent the rapid evolution of a healthy and robust system of local borrowing from the private sector. Many of these are capable of being addressed through the strategic formulation and implementation of a policy framework for municipal borrowing. Part of the purpose of this note is to identify those issues that are capable of resolution through such a policy process. The most critical issues appear to be the following:

1. Instability

Despite massive external support, confidence in the long-term stability of the state and the economy are lacking. Although the horizon of confidence is lengthening, an environment that is not perceived to be stable creates a poor context for long-term lending.

2. Lender financial and human resource capacity

Potential lenders in Bosnia and Herzegovina lack both financial capacity and analytic capacity. The biggest problem is lack of investment capital. Banks and other financial institutions simply do not have significant capital aggregations, e.g. in the form of household savings or deposits from private enterprises. To the extent such deposits exist, they are short-term demand deposits which are not a desirable basis for long-term lending. Foreign financial institutions consider country risk to be high, largely due to political and economic uncertainty, and as a result long-term foreign capital is not available in the international markets. Such long-term capital as is available to

lenders, or is likely to be available in the near term, is generally provided by international donor programs.

In many countries, insurers and pension funds are important investors in long-term municipal debt. In Bosnia and Herzegovina, at least some insurance companies are interested in municipal debt, but they do not have significant amounts of capital. And although legal requirements in at least the Federation call for insurance companies to invest in government bonds,[3] these are not available, so some insurance companies invest what capital they do have in invest in real estate mortgages, office buildings and loans to clients. At least one insurance company[4] anticipates that municipal and cantonal bonds will be available before state and entity bonds, and looks forward to being able to invest in the sector. Pension funds in Bosnia and Herzegovina are reported to be under-funded, with many not able to meet current pension obligations, let alone invest assets for the long-term. Further discussions with insurers and pension funds would be needed before firm conclusions could be drawn about the likelihood of investment from these sources.

In sum, the investment capital that is needed to provide loans of the length and amount needed for reconstruction is not yet present. Flows from donor and multilateral lending institutions can help strengthen lenders' financial capacity, of course. Properly handled, such projects can also strengthen local lenders' analytic and management capacity against the day they can access market capital -- that is one premise of the World Bank's Local Development Project for Bosnia and Herzegovina.

Lenders generally lack the skills and experience to analyze municipal creditworthiness and to structure municipal borrowing. Banks and other potential lenders do not have experience with long term lending to municipalities. Banks do some short term lending to depositor municipalities, mostly for cash management purposes, and these loans are well secured by municipal income streams. In both entities, banks and other potential lenders think of municipal borrowers as no different from commercial borrowers. This may not be inappropriate in the current situation, when many municipal assets are commercial assets, but it will not serve once municipalities have privatized their commercial operations. Banks in Bosnia and Herzegovina think first about tangible collateral, rather than revenue streams, when discussing the potential municipal lending. Most potential lenders do not know how to analyze or structure secured financing for revenue-generating projects.

3. Predictable, adequate revenues for municipalities.

Without stable, predictable, and adequate municipal revenues, no regulatory framework can deliver a healthy municipal credit market. Unless municipalities have dependable revenues to repay debt, private sector lenders will not lend to them, and well-managed municipalities will not

[3] Article 50 of the Federation's Property and Persons Insurance Law provides that at least "30 percent of the total amount of the mathematical reserve" must be invested in securities of the Federation, and that another 25% can be invested in loans guaranteed "by the Federation – Canton." No investigation has been made into the insurance laws of the RS.

[4] Bosnia Reassurance, whose management indicated they consider investor education regarding potential municipal investments critical.

borrow. In other words, apart from any direct regulatory issues, governmental policy regarding municipal revenues will be a key determinant of municipalities' ability to borrow. Where government policies result in stable and predictable shared revenues, or make possible stable and predictable own-source revenues, municipal borrowing is possible. Where municipal revenues are unstable and inadequate, municipalities will not be able to borrow, nor should they borrow.

Local government revenue practices vary significantly between the Republika Srpska and the Federation, and may change in future. In both entities, the local share of sales and service tax revenues is vitally important to municipalities. In the RS, this share is fixed at 30% for municipalities, and has reportedly been stable at that level. In the Federation, cantons have significant discretion over municipal revenues, and municipal revenues are not predictable.[5] This unpredictability will be a major barrier to the development of private sector lending.

4. Borrower capacity.

In order to borrow responsibly, municipalities must have the skills and information to budget for the current year and future years (including both operating and capital budgets); the ability to understand the impact of borrowing for infrastructure on both annual debt service and annual operational and maintenance expenses; and the ability to identify, prioritize, and plan strategically for capital investment. Municipalities must be able to identify and analyze technical and financial options, and must be able to show investors that they have adequate and reliable revenues to meet their debt service obligations.

Where these budget and planning skills are lacking, municipalities are ill equipped to engage the investor community. Technical assistance and training for elected representatives and appointed officials alike is needed. Borrowing has both technical and political implications, and requires both managerial and political decision-making. Some training and technical assistance designed to build municipal capacities has been done, e.g. by USAID and its contractors, but there remains a tremendous need for assistance in these areas.

In Bosnia and Herzegovina, doubts about stability and management at the local level seem dwarfed by country risk concerns, but as the macro-economic and political situation stabilizes, stability and capacity at the local level are likely to become more important.

5. The need to improve information systems.

Disclosure of municipal debts, defaults, and security interests—along with improved accounting systems—will enable market participants to distinguish between good and bad municipal credits. Although "brand-name" accounting and auditing services are available, the quality of accounting and auditing is not yet up to international standards. New public accounting laws are in place in both entities, but have not been widely implemented.

---

[5] Significant changes were common from 1997 to 1998, and mostly in the direction of lower shares for municipalities. From 1998 to 1999, the changes were fewer, less dramatic, and as many cantons raised average local shares as lowered them. There is reason to hope that as cantons adopt laws on distribution of public revenues, these shares will stabilize somewhat. See discussion at footnote 13 below.

6. Lack of a clear and common vision

By contrast with countries like Poland, Hungary, and South Africa, where decentralization and municipal empowerment was embraced as a political antidote to the prior system, neither Bosnia and Herzegovina nor the two constituent entities seem to have a strong political commitment to decentralization to the local level. Although municipal budgets are said to be autonomous, there is not a widespread vision of municipalities as independent actors deciding on investment priorities and their financing (this is especially true in the Federation), nor of private financial institutions competing for capital and for investment opportunities. There is a desire to attract private capital to fund local infrastructure, but little sense of what policy choices are necessary to do so.

STAKEHOLDERS IN MUNICIPAL BORROWING POLICY

Who has a stake in establishing a functional policy framework for municipal borrowing? The biggest and most obvious interest is that of **municipalities and their citizens**.[6] Unless government policies effectively induce investors to lend, municipalities will not be able to borrow for infrastructure. And yet municipalities must borrow -- given Bosnia and Herzegovina's tremendous needs for local infrastructure, neither state nor entity governments will be able to finance all of these investment needs through grants and transfers. Municipalities, as well as municipal associations should be involved in formulating a workable policy framework.[7]

In the Federation, **cantons** are *de facto* important stakeholders. They control municipal powers and revenues, and can change or revise municipal decisions. Borrowing at the municipal level in the Federation requires the active collaboration of cantons, either in general by delegating effective control to municipalities and providing them with stable revenues, or in specific instances by participating structurally in specific deals.

The state and entity **governments**' interest in providing local infrastructure should be the same as municipalities. These governments have the additional interest (perhaps in opposition to that of municipalities) of ensuring that municipal borrowing doesn't become a burden on the state or entity budgets or adversely affect credit markets. A functioning municipal credit market allows these state and entity governments to provide for financing without having to provide the funds itself – this leverages whatever public funds can be made available.

Potential lenders also have a stake, though their interest is less pressing. Especially as Bosnia and Herzegovina opens to the global economy, large and small investors will have a variety of investment options that compete for their available capital. While for municipalities, private sector investment is absolutely essential, for private investors, investing in municipalities' obligations will be one option among many. To the extent they do invest, lenders will want to be

[6] The term "municipality" is intended here to encompass both elected representatives and appointed officials, and even more broadly the entire local community.

[7] Finance professionals, such as those represented by the Federation's government finance officers' association, JAFIS, also have an interest, though the interest of these professionals may depend on where they sit. JAFIS includes municipal, cantonal, and Federation level finance professionals.

sure that laws regarding municipal debt give them clear remedies, establish clear priorities between conflicting claims, and protect them against fraud and deception.

MUNICIPAL DEBT POLICY OPTIONS

In formulating a municipal debt policy in any country, policy-makers must decide a number or questions. Laws and regulations affecting municipal borrowing sometimes reflect conscious policy choices, but too often this is not the case. The choices that each country deems appropriate will vary, but the underlying questions are largely the same. An objective of this note is to identify, for policy makers in Bosnia and Herzegovina, the questions that they may want to ask in formulating policies related to municipal borrowing. This note will discuss some pros and cons, but will generally avoid specific recommendations, since policy decisions should be taken only after the issues have been discussed in more detail with and between the above-mentioned stakeholders in Bosnia and Herzegovina.

For convenience of discussion, we have grouped the policy issues into groups. Because many of the issues are linked, any grouping is somewhat arbitrary, but we have tried to build from the most fundamental issues to more specific and detailed considerations.

1. Issuing debt

Generally, the issues to be considered in this group are what municipal or quasi-municipal entities should be issuing debt, and what kind of debt should be issued.

The first set of questions in this group deals with which sub-sovereign institutions should be permitted to borrow. Should municipalities of all population and budget sizes be permitted to borrow? Should cantons (in the Federation) be permitted to borrow? Should communal service enterprises, e.g. those providing water and sewer services, solid waste collection and disposal, and district heating, be authorized to borrow?

Current legislation in Bosnia and Herzegovina

In the former Yugoslavia, no municipalities of any size could borrow[8] and cantons did not exist. Municipal borrowing is now authorized by budget legislation (not local government legislation) in both the RS (in draft form) and the Federation (existing).[9] Articles 38 and 39 of each of these laws are very similar in wording, and clearly have the same genesis. They authorize borrowing by cantons (in the Federation), and by municipalities and cities in both entities. These provisions and the policies underlying them are unclear. Moreover, some stakeholders are giving them interpretations that are difficult to reconcile with the plain language of the legislation.

Article 38 of each law seems to be intended to authorize short-term borrowing. It authorizes municipal borrowing:

[8] One former municipal official said this was because the municipal borrowing would have represented a debt of the state.

[9] It is not clear why this authority appears in the budget law as opposed to a law on local government.

- only for the part of the budget which relates to investment expenditures, and
- only from the RS/Federation budget for short term deficits.

In addition, Article 38 provides that:

- borrowing cannot exceed 20% of total budgetary revenues, and
- the debt must be repaid within the same fiscal year.

Article 38 seems to be aimed at short-term borrowing to cover cash flow irregularities. However, if the goal is to provide a way to cover short-term cash flow problems, it is not clear why municipal authority to borrow in the short term should be limited to investment expenses. Requiring that short-term deficits be financed only by borrowing from the RS or Federation puts an unnecessary burden on entity finances.[10] If its purpose is to control the level of borrowing, it does not appear to be effective -- notwithstanding the requirement, short-term borrowing from local banks is not uncommon.

Article 39 of each law seems to be directed at long-term borrowing, and authorizes:

- incurring debt domestically and abroad,
- for financing "capital investment" expenditures in accordance with criteria to be specified.

In addition, Article 39 of each law provides that:

- the decision on the debt is to be taken by the municipal assembly (in the RS) or the Canton Parliament (in the Federation),[11] and
- borrowing cannot exceed 20% of total budgetary revenues.

It is not clear if there is intended to be a difference between "investment expenditures" as used in Article 38 and "capital investment expenditures" as used in Article 39. The criteria mentioned in Article 39 have not been adopted in either entity, resulting in a lack of clarity about what long-term borrowing is authorized.

The 20% limits in these two articles are the cause of confusion and are being variously interpreted. Notwithstanding the plain language of the legislation, many people in both entities believe that these provisions were intended to limit debt service to 20% of revenues, rather than to limit the principal amount of borrowing. Unfortunately, as written, it will be an effective barrier to any significant long-term borrowing, because 20% is too small a number when applied to limit the total amount of borrowing. More common in international experience is to limit debt service (rather than borrowing) to e.g. 15 or 20 per cent of revenues. Despite the clear language in Article 39, several mayors in the Republika Srpska indicated that they believed the 20% limit applied only to emergency funds from the RS budget, and was not a limit on long-term borrowing by municipalities. Confusion among key stakeholders about the fundamental rules of the game is highly undesirable, and will not help stable credit markets develop.

---

[10] The literal wording, limiting borrowing to the entity's "budget," seems to reflect a common view in the region that a national budget is a source of money, rather than a plan for spending money.

[11] It is not clear if the Federation's requirement for cantonal approval was intended to foreclose autonomous municipal borrowing. Many people interviewed in the preparation of this note felt that it was a drafting error, and it is being interpreted by some stakeholders to require canton parliament approval for canton borrowing and municipal assembly approval for municipal borrowing. See footnote 14 *infra*.

Policy Options

The role of municipalities

In the Federation, a fundamental threshold issue deals with the nature of a municipality, and its roles and responsibilities, especially in comparison with those of cantons. If municipalities are conceived to be separate, autonomous political and fiscal actors within their sphere of competence, then it follows that they will need reliable revenues (and perhaps the authority to set their own revenue policies), that they should develop their own investment plans, and that they should probably be authorized to borrow at their own discretion. On the other hand, if municipalities are intended to merely implement canton policies, and will have neither reliable nor adequate revenues, then any municipal borrowing would probably require a canton guarantee, and municipalities would have no real use for independent borrowing authority.

In the Federation today, this question of the role of municipalities is unclear because municipal revenues, and authority over infrastructure and planning depends largely on canton-level legislation. In three of ten cantons, legislation is lacking. Even where legislation exists, it does not address all aspects of task and revenue allocation.[12] In at least two cases, the cantonal legislation reserves broad discretion over policies and practices to the canton government. Some cantons give substantial capital and operating responsibilities for infrastructure to municipalities without providing for adequate revenues. And in some cantons, local shares of canton-controlled revenues have been falling.[13] Uncertainty in municipal revenues, uncertainty about municipal responsibilities, and large unfunded mandates do not bode well for municipal viability, let alone for municipal borrowing.

In the Federation, municipal authority to borrow independently for the long term is also unclear, due to the provision in Article 39 which provides that the decision to borrow is made by the "cantonal parliament." No criteria or parameters are provided for the cantonal decision. Although some observers believe this to have been a drafting error in the legislation,[14] as it stands the language would prevent any reasonable lender from lending to a municipality without approval of

---

[12] Pursuant to article 19 of the 1995 Federation Law on Local Self Government, cantons were required to pass municipal framework legislation within 30 days of being "constituted in the interim period." It was intended that the "cantonal law on local self government shall regulate in greater detail issues…of self government….property and financing of local self government…" We have evaluated two cantonal municipal framework laws (Bosansko-Prodrinjski and Herzegbosanski), and understand that three cantons (Tuzla, Zenicko, and Herzegovacko) that do not yet have municipal framework legislation in place as of September 1999.

[13] Of ten cantons for which 1997 data was available, nine showed a decrease in municipal revenue shares from 1997 to 1998, from an average of 26.7% of canton revenues to an average of 18.8%. Of twelve cantons for which 1998 data was available, four showed an increase, four showed a decrease, and three were steady, with the average share changing only slightly from 20% to 19.58% of canton revenues. Of course, for a potential borrower the average revenue share doesn't matter – the predictability of its own revenues does. No data was available on variability in individual municipal revenue shares.

[14] If it is a drafting error rather than a policy decision, this could be corrected by changing the language to read: "The decision for borrowing…is to be made by the cantonal parliament *for cantonal borrowing, and by the municipal assembly for municipal borrowing*." (new language in italics). However, due to the other issues concerning the existing legislation, a more comprehensive approach is recommended. At a minimum, Articles 38 and 39 should be reworked. Ideally, authorization for municipal borrowing should be either in a separate municipal borrowing bill, or in a comprehensive local government law.

the cantonal parliament. And cantonal approval could create or reinforce the impression that the cantonal parliament stands behind municipal borrowing.

Who should borrow?

Once the role of municipalities is more clear, as in the RS, a policy question is whether all municipalities should be authorized to borrow, or whether borrowing should be restricted to cities of a certain size or classification. The argument for restricting which municipalities may borrow is often paternalistic – that smaller entities won't have the management capacity or revenues to handle debt, and that borrowing can do more harm than good. In countries that allow all municipalities to borrow, the underlying theory is that borrowing is a useful tool, and should be available to all, with smaller-scale borrowing for smaller municipalities, and larger borrowings for larger municipalities with more financial capacity.

Most countries allow regional governments, such as the Federation's cantons, to borrow, though in many countries such regional governments administer national policy mandates and do not make autonomous borrowing decisions.

Most countries allow private communal service enterprises to borrow in their own name, but not necessarily where government has a significant ownership interest in the enterprise. If there is no real separation between the finances of the municipality and those of the enterprise, and especially if the municipality in fact subsidizes the communal service enterprise from general revenues, then there is good reason not to permit the enterprise to borrow in its own name. In that situation, borrowing in the name of the municipality, secured by a pledge of enterprise revenues, is perhaps more appropriate.

Given the stated policy that municipalities (and cantons in the Federation) are to be responsible for financing local infrastructure, it seems that they should be permitted to borrow for such infrastructure. No basis for size-based restrictions has emerged at this point.

A related set of questions is whether intergovernmental authorities and/or special districts for financing and providing specific services should be envisioned. Potential quasi-municipal borrowers include:

- special authorities created by intergovernmental agreement to more efficiently provide services and infrastructure
- special districts created by property owners to provide more services than they would otherwise get from local government
- special assessment or beneficiary districts created by a municipality to provide special services in particular parts of the municipality.

Depending on policy choices and supporting legislation, such entities can have their own revenue structure and can be authorized to issue their own debt against these revenues. Their finances would be completely separate from any municipality or canton. They allow a way for those specifically benefited by improvements (e.g. in a downtown business area) to bear the cost of the improvements, and by issuing debt, to pay for improvements over time. The potential uses of these structures include the provision of such services as water and sanitation, fire protection,

and improvement of business or tourist districts, to mention just a few. None of these mechanisms are well developed in Bosnia and Herzegovina,[15] but they may be useful financing mechanisms for the future. Though of more general use, they could be especially useful in providing infrastructure and services to ethnically divided communities or groups of communities.[16]

The question for policy makers is, should borrowing by such intergovernmental authorities and special districts be envisioned, or is the issue likely to be a distraction from the more immediate issue of enabling existing institutions to borrow responsibly? If such borrowing is to be pursued, the role and powers of the intergovernmental authorities and/or special districts will need further legislative definition.[17] For each separate type of structure, policy questions which would need to be decided as a prelude to enabling legislation include:

- For what services and infrastructure should intergovernmental authorities and/or special districts be created?
- By whom and how should they be created?
- What governing body would have decision making power?
- What should their powers and duties be, e.g. with regard to revenues (taxes and fees), expenditures, and borrowing?

Safeguards to prevent debt of cantons, municipalities and of any intergovernmental authorities or special districts from being perceived or treated as State or Entity debt would also be appropriate as part of any legislation. Other limits on subsovereign borrowing may also be desired, as discussed in the remainder of this note.

The nature of a municipal debt

If a healthy credit culture is to develop, it is important that all stakeholders clearly understand that a subsovereign debt is a debt of the legal entity that issues the debt, and no other.[18] A municipal debt is not automatically the debt of the canton, entity, or state in which the municipality is located, even when the municipality defaults. Where governments are clear about this, creditors are generally cautious and municipalities generally borrow responsibly. Where implicit or explicit guarantees by higher levels of government are offered, the parties can develop the expectation

---

[15] The Federation's Law on Local Self Government, article 16 provides that: "municipalities shall have the right to co-operate mutually with other municipalities in order to perform tasks of mutual concern…they may associate in municipal associations for a certain area in accordance with the Constitution and law." Cantonal legislation from Herzegbosna and Bosansko-Podrinjski also mentions such service associations. Herzegbosna (article 7) allows municipalities to associate within the canton or across cantonal lines in accordance with the Federation's legislation. Article 9 of Bosanko's local government legislation is essentially similar.

[16] The Dayton Agreement called for the creation of public corporations to operate and finance infrastructure. These could prove a useful model for quasi-municipal corporations, especially in ethnically divided areas. A somewhat similar approach has been taken with regard to Brcko, a municipality that the Dayton accords left divided between the two entities, and which was later reassembled as a self-governing "neutral district."

[17] Hungary has adopted legislation relating to municipal service associations, with special financial incentives, and local government laws in Hungary specifically authorize municipalities to hand off some tasks to such service associations or to NGOs that have special tax privileges.

[18] At least in the absence of a specific legal guarantee, which would be the exception rather than the rule.

that if they lend unwisely or borrow excessively, they will be rescued from the consequences of their decisions.

Even where it is clear that the debt is a municipal debt alone, there are policy issues to be decided as to what kind of municipal debt should be authorized, and nature of a municipal debt. Should the law treat a municipal debt as an unconditional promise by the municipality to pay from any and all available sources? Could it, and should it sometimes be something less (e.g. a debt backed only by specified revenues, without recourse to the general funds of the municipality)? Could it, and should it sometimes be something more (e.g. a debt backed by specific revenues, but also guaranteed by all revenues of the municipality)? Should the law treat a municipal guarantee of another legal entity's borrowing as "debt?"

Another way of asking, "what is the nature of the debt?" is to ask what kinds of security may be given by municipal borrowers. Security (in the sense of collateral) and remedies are aspects of the same question. Debt markets require clarity about both. Before they invest, creditors want to know what their remedies or security will be in the event of default. Efficiency in debt markets requires clarity, and also effective remedies and adequate security. Unless the available remedies and security are deemed adequate, potential creditors may set risk premiums that make credit unaffordable to many municipalities. The question of what remedies should be available by operation of law to municipal creditors is therefore important. So are voluntary security interests created by the contracting parties. As part of a regulatory framework for municipal borrowing, it is wise to spell out what powers municipalities have to pledge assets, to pledge revenue streams, and to pledge the exercise of their powers to set taxes, tariffs, and other levies. It will also be important to spell out how such security can be executed upon in the event of default.

Bankers in Bosnia and Herzegovina today often think about physical assets when they think about security for municipal debt. Several bankers expressed the opinion that municipalities were no different than commercial borrowers, and should be expected to give the same collateral. Some thought that a tangible asset with a marketable value at least twice the amount of the loan should be pledged. This attitude toward municipal borrowing may not be inappropriate in the current situation, given that many municipal assets are in fact buildings and businesses used for non-governmental purposes. But this approach will become inappropriate if and when municipalities focus more on governance and have privatized their commercial operations.

Municipalities are different from commercial enterprises in at least two important ways. First, they generally have a permanent and continuous existence. They will generally not disappear or go bankrupt,[19] unlike commercial enterprises. Second, the tangible assets they will retain in the long term, for governmental purposes (e.g. water treatment plants, streets, and sewer systems), are not good candidates for liquidation. Many of these have no market value, and those that do are often needed to serve citizens.[20] The real security for a lender is in the projected municipal revenue streams: from taxes, fees and charges, or intergovernmental transfers.

[19] Section 6 below briefly addresses municipal insolvency

[20] For now, banks in Bosnia and Herzegovina generally take a pledge of municipalities' commercial buildings and other assets if they lend. One banker noted, "municipalities always have interesting property." Several reported that they seek between 2:1 and 4:1 asset value to loan coverage ratios on short-term municipal borrowing.

Therefore, the question ultimately becomes, which revenue streams can be pledged to secure a municipal debt, and to what extent? If all municipal revenue streams, without limit, can be foreclosed upon, the lender will be well secured, but not the citizens. If too many revenues are protected from creditors, it will be difficult to attract investment. The most important thing from both the borrowers' and the lenders' point of view is clarity. Specific revenue streams could be protected by law, but not others, or revenue streams could be partially protected (e.g. creditors could be authorized to attach only a specified proportion of a municipality's tax revenues in any given period).

Contingent debts, in the form of guarantees, can be viewed as a kind of municipal debt. The policy question is this: if a canton or municipality guarantees the debt of a municipal enterprise, for example, should that guarantee be considered debt, for the purpose of regulation, at the moment the guarantee is issued (when it might never cost a thing) or at the moment the primary obligor defaults (when the canton or municipal debt becomes clear and unavoidable)? Because contingent debts can cause great financial havoc when they become real, the need for some kind of regulation is clear. The question is which pieces of the full regulatory framework should be triggered, and when. The most conservative, and safest approach, would be to treat any guarantee by a canton or municipality as a debt to the full extent of the exposure, and to count such guarantees as debt both for the purpose of authorization and registration requirements, and for the purpose of debt restrictions and limits. Such debt should also be fully disclosed in the financial statements of the canton or municipality.

Competition for municipal debt

In principle, competition among potential investors can keep municipal borrowing costs down. At present, there is too little prospect of a market to speak meaningfully of formal competition or of requirements for competition.[21] But at some point in the future, as the financial sector strengthens and experience is gained, policy makers may want to consider encouraging or requiring municipalities to offer prospective debt issues for competitive bid. In a competitive process, the municipality would solicit bids from various investors and/or underwriters and would award the debt issue based on the lowest interest and issuance cost. This requires that the municipality assure that the debt documents are properly prepared and structured for the marketplace, which is probably not something for which municipalities in Bosnia and Herzegovina are yet prepared. Specialized financial advisors can help structure debt for competitive sale, but financial advisory services of this nature do not appear to have emerged yet, nor is it likely they will do so soon.

In practice, there is every reason for any municipality interested in borrowing to talk to as many potential lenders as possible, and to become skilled at distinguishing quoted interest rates from the true cost of borrowing.

[21] The World Bank's Local Development Program envisions competition by banks for investment capital, but that must be distinguished from competition for the municipality's debt, whether evidenced by a note or bond.

Creditor remedies

The discussion of the nature of a municipal debt leads to the related question of what remedies should be available to creditors, in the event the municipality fails to pay its debts as and when due. A basic set of remedies would probably be provided by law. Additional remedies could be created by contract between the borrower and the lender.

Remedies provided by law:

The essential nature of a municipal debt is largely determined by the basic remedies provided **by law** for municipal creditors, in the event of default. Among the remedies that policy-makers might want to provide by law for creditors are the following:

- The right to attach municipal funds,
- The right to attach municipal assets and cause them to be liquidated,
- The right to attach municipal tax or fee revenues, subject to whatever limits are deemed appropriate.
- The right to intercept funds due to a municipality from another level of government,[22]
- The right to trigger the imposition of an additional tax or fee within the defaulting municipality, and
- The right to trigger the appointment of a receiver or board to control expenditures and/or other operations of the municipality.[23]

The more clear and predictable the remedies provided by law, the more efficient will be the overall borrowing environment. Where clarity is lacking, borrowers must pay risk premiums to compensate lenders for the possibility of delay or failure in the exercise of their rights. Each potential remedy just listed could provide security for the creditor, increasing the likelihood of a loan and decreasing its cost. However, each remedy could also negatively impact a municipality's ability to provide continuing service to its citizens. Thus, in each case, the law must create rules that strike an appropriate balance. For example, allowing a creditor to force the sale of a municipally owned retail space might be perfectly acceptable, but forcing the sale of a municipally owned water treatment plant might not be. Attaching municipal revenue streams might be good security, but should some percentage, or certain kinds of revenues, be protected to allow the municipality to continue to provide the most essential services?

Remedies provided by contract:

In addition to the remedies provided by law, policy-makers should consider what remedies a municipality may create **by contract**. In other words, what leeway should the parties (municipal

[22] Creditors could be given the right by law (or by contract, see *infra*) to intercept specified revenue streams from the entity or cantonal government or other sources. Such revenue intercepts can provide a creditor with access to a stable, predictable, and sufficient revenue stream in the event of a municipal default. However, unless there is a disincentive, it may be tempting for some municipalities to not pay their debts and force creditors to rely on intercepts. This works against conscious priority choices at the municipal level. To discourage this, a significant penalty or administrative fee could be assessed to the borrower in the event a creditor uses an intercept, so that the municipality is better off collecting its own revenues and paying its own bills.

[23] See Section 6 below for a discussion of interventions by other levels of government in the finances of troubled municipalities.

borrower and private sector lender) be permitted to craft security provisions that meet their needs? These provisions would be negotiated as part of the lender-borrower contract or bond covenants. Practices would likely evolve over time as both sides gain experience. Because the law regarding creditor remedies is likely to be relatively stable over time (and appropriately so), a policy which allows the parties broad leeway to create remedies appropriate to specific situations can provide flexibility and adaptability. It allows lenders' and borrowers' practices to evolve over time. One danger in this approach is that financial institutions and underwriters, who typically have access to the best legal talent, may overreach. Another danger is that courts might decline to enforce contractual remedies that are radically different from those envisioned by law, leading to uncertainty.

These contractually created remedies could include all of the remedies listed in the preceding paragraph, to the extent they are not provided by law, as well as a range of other arrangements as listed below:

- Tariff and rate covenants: municipalities can covenant to maintain utility tariffs or tax rates at a level sufficient to cover projected debt service by an agreed ratio (for example, to maintain water tariffs in each year at a level to generate 1.5 times the annual debt service)[24] If the municipality fails to maintain the tariffs at the prescribed level, the lender (or a trustee acting on behalf of bondholders) would be entitled to a court order raising the tariffs to appropriate levels.
- Initial or contingent assignments of revenue from other levels of government (i.e., contractual revenue intercepts).[25]
- Irrepealability of relevant local legislation during the term of a debt.[26]
- Lock boxes: the parties may provide that some revenues that would otherwise go directly to the municipality would be set aside, escrowed, or placed into a "lock box" arrangement. Only after debt service and any reserve fund requirements had been satisfied would remaining revenues be paid over to the municipality.[27]

---

[24] One of the primary reasons for default on project debt around the world is the borrowing entity's failure or inability to increase service tariffs to the levels envisioned at the time of borrowing. An enforceable promise to keep tariffs and/or tax rates at a level sufficient to cover debt service (and reserves) is an important part of the security package that will help lenders feel secure about lending for a revenue-generating project.

[25] This approach is widely used in Bosnia and Herzegovina today, for short-term municipal borrowing. It takes the form of "accept orders." These are instruments whereby a municipality assigns expected revenues to a creditor on a contingent basis. If the municipality does not pay, the creditor notifies the Zavod za Platni Promet (ZPP) which pays over the assigned revenues to the creditor. This system works because all municipal revenues must go through the ZPP. Once that system is abolished in favor of a private banking system, which is expected to happen soon in each entity, that particular form of security will no longer be available to creditors. However, other forms of contractual security could be created that are consistent with a private banking system.

[26] Local government officials in Bosnia and Herzegovina report their perspective that that the city's promise to pay takes legal form when it is included into local laws on budget execution. However, because these laws are adopted each year, the possibility of subsequent city councils not budgeting for debt service, and not including it in their budget execution laws in out-years is a real possibility, and the legal consequences of such a situation are not clear. One possible way to deal with this would be to authorize sub-sovereign borrowers to adopt binding and irrepealable legislation, perhaps in the form of a multi-year budget execution law, that would provide legal assurance to creditors that debt service would be budgeted and spent. The form of the law is not important – providing for its irrepealability and supremacy over any contradictory legislation is.

[27] Reserve funds, sinking funds, and rate covenants are other voluntary structures that could be created to ensure things go smoothly. Where the investors are bondholders, the parties can also provide that a trustee would act on their behalf to enforce

- Dispute resolution: the parties may agree that in the event of a dispute, arbitration or other forms of alternative dispute resolution will be employed in an attempt to settle the issues. They may also create notice and negotiation mechanisms designed to forestall anticipated defaults before they occur.
- The parties may provide for "private" intervention, such as having a bank, accounting firm or other operating entity take control of some portion of municipal operations in the event the municipality defaulted on a payment or on specified loan covenants.

Again, a balancing act will be necessary. Broad provisions authorizing municipal covenants in connection with borrowing will allow borrowers and lenders more flexibility to create appropriate remedies, but policy-makers may feel that it is necessary to avoid over-reaching on the part of aggressive lenders and their legal counsel.

2. Restrictions on Issuance and Use of Municipal Debt

Most countries place limitations on the use of debt by local governments. Existing Federation legislation and draft RS legislation authorizing municipal borrowing, which is summarized in section 1 above, contain important limitations, the purpose and application of which are not completely clear. The most important of these limitations are as follows:

- Short term borrowing is limited to "investment" expenditures
- Short term borrowing can only be from the entity (RS or Federation)
- Short term borrowing must be repaid within the current fiscal year
- Long term borrowing is limited to "capital investment" expenditures
- Long term borrowing is restricted by "special criteria" yet to be devised
- Both long and short-term borrowing is limited to 20% of budgetary revenues.

The policy issues that we will discuss in this section include:

- What restrictions, if any, should there be on the use of short-term debt?
- What restrictions, if any, should there be on the use of long-term debt?
- If there are to be restrictions as to the amount of municipal borrowing, how should the limitations be formulated?

Purists may argue that a *laissez-faire* approach to municipal borrowing is desirable, and that markets are better, and more flexible, at judging risk than government policy makers. So long as it is clear that lenders will reap the rewards and bear the losses associated with their lending decisions, they would expect lenders to price credit according to perceived risk (a salutary phenomenon that has been largely lacking from lending in Bosnia and Herzegovina) and to forego lending altogether where they do not think there is a reasonable chance they will be paid. Notwithstanding this argument, policy-makers in most countries have placed limitations on the

---

bond covenants; and they could arrange for both paying agents and registration agents to pay bondholders and keep track of them, thereby increasing bondholders' confidence.

use of both short-term debt (intended to be paid off within the current budget year) and long-term debt.

Short term borrowing policy options

Formulating a policy regarding short-term debt requires that policy-makers address the following questions:

- Should the purpose of short-term borrow, and the use of proceeds is restricted?
- Should the amount of short-term debt be restricted?
- Should short term debt be required to be paid off periodically?
- Should there be limits on where money may be borrowed?

It is not clear why the current legislation restricts the use of short term borrowing to fund "investment expenditures," nor why borrowing is limited to 20% of budgetary revenues. These provisions are likely both intended to avoid dangerous patterns of rolling over and accumulating short term debt, particularly when it is used to finance operating deficits – there are many instructive examples from international experience. The use of short-term debt to avoid cutting municipal operating expenses often leads to larger deficits and thus larger debts from year to year, or even quarter to quarter. When the debt service finally becomes untenable, the pain of drastic adjustments is inevitably much greater than it would have been if the municipal budget had been balanced all along.

The limit on total short term borrowing to 20% of budgetary revenues is not unreasonable as part of a plan to protect against accumulating debt to finance recurring deficits. However, the current legislation may go too far in limiting borrowing to financing only investments. Financing operating cash shortfalls is accepted as good practice internationally, where it is done in anticipation of specific and realistic future income streams to be realized within the current period. Bridging capital requirements in anticipation of specific and realistic grants to be received or debt to be issued within the current period is also common and considered prudent. In each case, the test should be whether the municipality can point to the specific revenue that it expects to use to retire the short-term debt.

As provided in Article 38, it is wise to require that short-term debt be paid off annually, and perhaps to add that it must remain paid off for some reasonable period of time, with both borrower and lender responsible for enforcement. This addition could limit superficial compliance with the repayment requirement, followed by fresh borrowing the morning the new fiscal year begins.

The reason for restricting the source of borrowed funds is also not completely clear. Most likely, this provision is intended to protect municipalities from getting into more short-term debt than they can handle. By restricting the sources of financing, the government may hope to keep an eye on the amount of borrowing by each municipality. Unfortunately, municipalities seem to ignore this provision, as both municipalities and bankers reported instances of short-term bank borrowing. This suggests that the current provision has the dual vices of being unenforceable (or

at least unenforced) while also burdening each entity's government the burden of financing the cash flow needs of their municipalities. The debt limitations suggested in the preceding paragraph may be more effective, particularly if responsible officials of both borrowers and lenders are made liable for violations.

Long term borrowing policy options

The essential questions to be decided in formulating a policy regarding long-term borrowing are the following:

- Should the purpose of long-term borrowing and the use of proceeds be restricted?
- Should the amount of long-term debt be restricted?

As to the purpose of long term borrowing, it is generally accepted in Bosnia and Herzegovina, as elsewhere, that long-term debt is appropriate for capital investment. It is desirable for the term of the borrowing to relate to the useful life of the capital asset being built or acquired, within the limits of the marketplace. A more difficult policy issue is whether multi-year debt should be allowed for purposes other than physical infrastructure, e.g. workouts as part of a municipal recovery package, or extraordinary expenses related to the post-conflict reconstruction now under way in Bosnia and Herzegovina. Currently, Article 39 limits long-term borrowing to financing capital investment. There is certainly no urgency about broadening that authorization, and borrowing for other investments, however sound in theory, could be a distraction to the primary objective of providing financing for infrastructure. However, if there is good experience with municipal borrowing, the list of permitted investments could well be expanded in future to include such items as funding accumulated operating deficits in a work-out situation or funding retrenchment programs which have demonstrable long-term benefits.

More problematic is the restriction in Article 39 to "special criteria" which have not yet been promulgated in either entity. Until these criteria are established, the authority granted purportedly for long-term borrowing is largely theoretical. It is not clear what those criteria might be, or whether they might imply a case by case review by entity-level authorities. If the entities intend to facilitate municipal borrowing, these criteria should be established as soon as possible, or the reference to them deleted from the existing (Federation) or draft (RS) legislation.

As to the amount of long-term borrowing, Article 39's current limit on the principal amount of borrowing to 20% of revenues seems likely to prevent borrowing for infrastructure from becoming a significant factor in municipalities' financial strategies. A more usual limit would be to limit annual debt service to a portion (e.g. 15-20%) of revenues. Several observers believe that this was what was intended, notwithstanding the wording of the law. To see how big a difference this issue makes, let's assume a municipality has annual revenues of one million marks. The law as written would only allow that municipality to borrow 200,000 marks total. Assuming a 10-year term, a level principal and interest structure, and 10% simple interest, the debt service on that 200,000 marks would be less than 33,000 marks per year, or 3.3% of revenues. A limit on debt service at 20% would allow the municipality to borrow over 1.2 million marks; i.e. over 6 times more. Whether a municipality should borrow at the higher level another matter, and one that would require careful consideration by the municipality in each case. Debt finance for

infrastructure always involves trading future flexibility for current infrastructure -- the question of how much of the former to trade for the latter can perhaps best be made by those most directly affected, i.e. at the municipal level. But a national policy setting the permissible outer limits is not unusual.

3. Authorization of Borrowing

This group of issues deals with the question of what authorizations (internal to the municipality) and approvals (by other levels of government) should be required for a municipality to incur debt.

Within the municipality

As reported previously in this note, in the RS, the draft budget law provides that the city assembly is authorized to take borrowing decisions. The Federation budget law provides that the cantonal parliament is authorized to take borrowing decisions for cantonal and municipal borrowing.[28]

Within a community, broader participation in the community's decision to borrow is better. Internationally, it is not unknown for a mayor or chief executive officer to borrow to fund some pet project and for his successor to renege, or threaten to renege on the debt. Where the city council and the chief executive have both endorsed the borrowing decision, the chances that it has been well thought out and has broad community support are greater than if only the executive or mayor makes the borrowing decision. Most American states go much further, requiring an election to approve the issuance of general obligation debt. There is a tradition of similar referenda in Bosnia and Herzegovina – the former Yugoslav practice of self-contribution. Because debt of the municipality could well affect the tax burden on citizens, there is some reason to consider requiring a referendum to authorize general debt, although the situation of Bosnia's refugees and displaced persons creates special problems for such referenda. There is less reason to require an election for project-finance debt, where creditors' are limited to project revenues as the source of repayment, though even project-finance debt can affect citizens' utility rates.

Pre-conditions and external approvals

In this section, we discuss the following questions, which should be resolved by policy-makers in connection with any new legislation:

- what pre-conditions or tests, if any, a municipality or canton should meet before it is authorized to borrow?
- What approvals (by other levels of government) should be required before a municipality or canton may borrow?
- If approvals by other levels of government are required, on what basis would other levels of government review and approve municipal borrowing decisions?

[28] See footnotes 11 and 14 *supra*.

In both entities, there is palpable nervousness at the entity level about local government borrowing. It is a new phenomenon, and one with which policy-makers are not completely comfortable. Government officials are concerned that local administrations, councils, or mayors may be irresponsible, and borrow irresponsibly.

Despite this nervousness, no clear policies have been arrived at in either entity. Ministry of Finance officials in Banja Luka felt that all municipal borrowing should perhaps be reviewed by the ministry to be sure they are viable. Part of the expressed rationale for this approach was a concern that if the municipality does not pay, the debt would automatically become that of the RS government. Similarly, many canton officials in the Federation intend to, and feel obligated to, review municipal borrowing to protect both the municipality and the canton (even without cantonal guarantees).

Currently, the only formal preconditions at the moment are found in the budget laws, as described above -- in both entities, there is a limit on municipal borrowing to 20% of revenues.

The only formal approval required, i.e. the Federation's requirement for the canton parliament to make decisions as to municipal borrowing (Article 39 of the Federation's budget law), may be a policy choice, but most of those interviewed felt that the mention of the canton parliament was intended to apply only to canton borrowing, and the failure to mention municipal assembly approval for municipal borrowing was an oversight.[29]

Preconditions

Preconditions that might be considered, in addition to the borrowing limits discussed in section 2 above, include:

- A requirement that the municipality or canton have analyzed the impact that debt service and operating costs associated with any infrastructure being financed will have on its operating and capital budgets.
- A requirement that the municipality or canton have a written debt policy in place, identifying how much debt it plans to issue, and for what purposes.
- A requirement that the municipality or canton have a capital spending strategy in place, identifying its capital investment priorities and how it intends to finance them. This strategy could be subjected to public hearing requirements.

Imposing these preconditions does not necessarily require that any higher level of government review the borrowing decision. Requirements such as those just enumerated could be made self-enforcing, by requiring that the mayor and municipal assembly certify that the conditions had been met.

The municipal assembly of any municipality planning to issue municipal debt could adopt a written debt policy. This policy would help establish limits and provide general direction to municipal executive officials in the planning and issuance of debt. The assembly should specifically approve

[29] See footnotes 11 and 14 *supra.*

each actual long-term debt issue, but developing an overall debt policy would ensure that relevant policy questions were considered from a broader perspective. In addition, a debt policy would let municipal policy makers integrate debt planning with other long-term planning and financial objectives. A carefully crafted and consistently applied debt policy would signal to lenders and rating agencies that the municipality was committed to controlling its borrowing. Some of the items that could be spelled out as a matter of municipal policy are shown in Appendix 2. These are local issues, which are probably best addressed by each municipal assembly, within the overall national policy framework.

A capital improvement strategy could also be adopted by the municipal assembly, prior to consideration of particular debt issues. The strategy would reflect the outcome of a capital investment planning process. The goal of such a process is to consider and prioritize a municipality's capital needs, ideally in an open, participatory process that maximizes the chances that the resulting capital improvements plan will: (1) represent a community consensus that is sustainable over the long term and over any change in leadership, (2) target the available resources on the most urgent needs, and (3) avoid the need to evaluate individual projects in a vacuum. Wise planning would include specific consideration of how various capital improvements would be financed, how the borrowing capacity of the municipality should be used to that end, and what effect borrowing (and facilities built with borrowed funds) would have on future operating budgets, taxes, rates, and utility tariffs. Some of the items to be considered in a municipal capital improvement strategy are identified in Appendix 2.

External Approvals

Currently, there is no clear policy as to whether review of approval by some level of government above the municipality should be required. Both the draft RS legislation and the existing Federation legislation refer to criteria that have not yet been specified. If any approval by other levels of government were to be required, it would be critical to specify the scope and effect of the approval. Conceptually, entity level approval, and canton approval within the Federation, could be predicated on a variety of conditions, including:

- the financial capacity of the municipality to pay the debt, as measured either by analysis or by the application of a formula or ratio specified by law or regulation
- consistency with national economic policy
- acceptability of the purpose of the borrowing
- the form or formalities of the borrowing.

Although financial capacity reviews could control irresponsible borrowing at the local level, such reviews would take time and would require the creation of review capacity at the entity or canton level. Ultimately, the marketplace, aided by accounting rules, rating agencies as and when they develop, and individual investor reviews, are likely to do a better job of testing the financial capacity of borrowers to repay debt. We doubt the need to spend scarce resources to develop the requisite analytic capacity in the public sector. Moreover, once the entity or canton becomes involved in assessing the capacity of a municipality to pay debt, investors may view that process as some sort of endorsement or guarantee, thus exposing the canton or entity to risk that it need not assume. If the purpose of a review is simply to test compliance with some specified debt ratio,

a certification that the required limit has not been exceeded can presumably be provided by a certified public accountant as well as by a governmental agency, and with less liability to the government.

National or entity economy policy could require some form of temporary restraint on the cumulative volume of municipal loans. State or entity-level ministers of finance could implement this type of restraint if it were needed, but the fact of the matter is that national economic health is much more likely to be threatened by national government borrowing than by municipal borrowing. This is especially true if steps are taken to effectively eliminate the perception that local debt becomes national debt if unpaid. Laws, policy statements, and even language on debt instruments could all play a role in conveying the message that municipalities borrow in their own name only, and on the strength of their own ability to pay only.

Canton or entity-level reviews of the purpose of each municipal borrowing would seem inconsistent with the basic principles of democratic decentralization reflected in the organic documents of Bosnia and Herzegovina and the entities. As a policy matter, it seems undesirable for judgments of entity or canton level officials to replace the deliberations of the elected municipal council when it comes to deciding the priorities for which the local community is willing to borrow. In countries where governmental review of the wisdom of local borrowing is required, very little local government borrowing happens. The process creates obstacles that can easily become insurmountable and hinder legitimate local borrowing. Lenders can, and should be encouraged to, protect their own interests by avoiding lending where they are not convinced of the local will and capacity to repay. Institutional lenders will not need government looking over their shoulders and second-guessing their lending decisions.

Approval by entity or canton authorities regarding the formalities of the borrowing is a less onerous burden. In the U.S. state of Texas, for example, local government issuers must obtain approval from the Office of the Attorney General. That office reviews proposed bonds and their supporting documentation, certifies their validity, and issues an opinion. This opinion is needed for the bonds to be legally binding, and relieves individual purchasers of the necessity to inquire into the process by which the bonds were issued. This kind of certification can help build investor confidence, and relieve individual investors of some of the “due diligence” that would otherwise be required. However, it is not clear that under current conditions in Bosnia and Herzegovina, there is meaningful capacity at the entity or canton level to devote to this task. Imposing any review requirement that cannot be quickly fulfilled will limit the development of any market more than would leaving the “due diligence” inquiry with the lender/investor and private counsel.

The ultimate policy question that will guide resolution of all of the issues addressed in this section is the extent to which municipalities can and should be separate operating entities conducting their own relations with the capital markets.

4. Disclosure and Market Regulation

Forms of borrowing and the need for regulation

Municipal borrowing takes different forms in different countries. In many countries, including much of Europe, most municipal borrowing is from banks or special-purpose municipal lending institutions, and the original lender usually intends to hold the debt until maturity. In other countries, including the U.S., municipal borrowing is more broad-based, attracting funds from individuals, investment funds, non-bank financial institutions, and others. In the latter case, municipal debt takes the form of securities or bonds, which are typically sold by the municipality to an underwriter, and can then be bought and sold on the open market.

Philosophically, a single loan agreement by which a municipality promises to repay one million marks with interest is no different from 200 separate loan agreements under which a municipality promises to pay 5,000 marks to each investor at the same rate of interest. The former is essentially a bank lending model, and the latter a municipal bond model. The larger pool of smaller investors can mean more competition for municipal debt as an investment vehicle, and can result in lower interest rates. Municipal bonds can also be popular with local investors, allowing them a concrete way to invest in their community. But municipal bond issues are more administratively complex than bank loans, so that any savings in interest cost need to be weighed against the increased administrative cost. And under-subscribed municipal bond issues[30] can create special problems – e.g. where a fixed sum is needed to construct an important public facility and the municipality cannot sell all of the intended bonds to investors. This problem is solved in sophisticated markets through an underwriter function[31] – given the weakness in Bosnia and Herzegovina's financial sector, the emergence of that function is no doubt many years off.

While bank lenders may be able to look out for their own interests effectively, individual investors often lack the knowledge (and the leverage) to protect their interests vis-à-vis municipal borrowers. Accordingly, governments often regulate the sale and trading of municipal securities for the protection of the average citizen. And rating agencies often evaluate municipal debt issues to help individual and institutional investors make judgments about credit quality without the burden of investigating and analyzing each issue.

The regulation of debt markets, including requirements for public disclosure by municipal borrowers, is especially important for the eventual development of municipal securities markets.

---

[30] When a municipality negotiates a loan with a bank, it can borrow the full amount it needs to build an object of capital infrastructure. If the bank is unwilling to lend the full amount needed, the money is taken from other resources, or the project is pared down. By contrast, the incremental nature of bond issues can create problems, in the absence of an underwriter who makes a firm commitment to buy the entire bond issue. The problem is easily illustrated by an example that is typical of experience in emerging markets: 100 million marks may be needed to build the object, and only 60 million worth of bonds can be sold. The municipality is left with too little money to build the object, but must service the debt, financially and administratively. Human nature leads the municipality to search for some other project(s) to do, as long as it has the 60 million marks, but the originally intended improvement is not built, and the municipality has used up its borrowing capacity.

[31] An underwriter promises to buy the full issue, either for its own account or to re-sell to investors. In developed markets, an underwriter often pre-sells most or all of the bond issue. Underwriting syndicates involving many investors are not uncommon, and allow underwriting firms to pool their resources and share the risks.

Such regulation has far less relevance to a bank-lending model. The most important policy issues concerning disclosure are listed in Appendix 3, and should eventually be addressed by policy-makers in Bosnia and Herzegovina. An important underlying policy issue is whether the development of a municipal securities market is considered a priority, whether the bank lending model is preferred, or whether market evolution should be allowed to play out in whichever form seems most appropriate to borrowers and lenders.

However, at the moment, there is little interest in municipal bonds, and it is unlikely that the lack of sophisticated regulation in this area will retard growth of the securities market. In fact, it is entirely possible that over-regulation or mis-regulation could be more significant problems. By "over-regulation" we mean the adoption of detailed regulations that, though appropriate for a highly developed municipal securities market, place such a burden on potential issuers or underwriters that they create an effective entry barrier that discourages securities-based borrowing. By "mis-regulation," we mean the application of regulations developed primarily for the corporate securities market to municipal securities. Experience in Poland, e.g., suggests that many disclosure requirements that are appropriate for corporate borrowing simply make no sense in the municipal context. The risks associated with investing in municipal debt are different from those associated with investing in corporate debt. Municipal ability and willingness to pay has to do with tax and fee revenues, and with political decisions, while corporate ability and willingness to pay may have to do with sales revenue, business strategy, and the competitive environment. At the end of the day, a business can declare bankruptcy and cease operations, while municipalities typically have continued existence, and must continue to provide services.

Phased regulation of disclosure

As noted, Appendix 3 presents a list of the issues to be considered in developing disclosure regulations. How well the municipal credit market will function, in terms of trading, clearing, settlement, and supporting operations, will determine the attractiveness of municipal securities as opposed to direct bank lending. If transaction costs are high, investors will charge more, or will avoid securitized lending altogether. The more easily debt instruments can be sold, the greater the amount of private capital the markets are likely to attract.

Liquidity is important, especially for holders of long-term debt. Investors are more likely to lend for the long term if they know there is a ready market (usually referred to as a secondary market) in which they can sell their holdings should they want to do so. Most or all of the factors that will strengthen primary municipal credit markets will also be important for increasing liquidity in the secondary market.

The theory driving disclosure requirements for municipal securities, as for corporate securities, is that better information will make capital markets operate more efficiently, and enable investors to distinguish good credits from bad. Clear and full disclosure will be critical to developing a municipal securities market in Bosnia and Herzegovina. A market for municipal credit will be information-driven.

Developing disclosure policy requires that one specify who is responsible for disclosure, to whom, what information is to be provided, how frequently it is to be provided, and what will be the

means of information distribution. In general, disclosure should be originated by the borrowers themselves (municipalities), who can be assisted (in many cases substantially) by underwriters and brokers. Ultimately the burden of disclosure should fall on the party that is responsible for paying the principal and interest. Violation of disclosure and registration requirements should be criminal violations, with liability imposed on all market participants. Elected representatives and appointed officials alike should have a duty of reasonable inquiry in respect of compliance.

Disclosure to "the market," i.e. to all potential investors, requires some readily accessible depository for the information, which is envisioned for the final phase of regulation. Disclosure to individual investors is envisioned for the intermediate phase of regulation. Some countries provide less complete disclosure rules where the offering is not to the whole market, but to some special class of investors, typically financial institutions and wealthier individuals who can understand and bear the risks involved.[32]

Disclosure is important before a municipality borrows money, for those who lend money to the municipality by buying its debt instruments (notes or bonds) at the time they are issued. And if one looks forward to an active secondary market for municipal securities (which will lower borrowing costs and bring more capital into the municipal credit market), then it will eventually be appropriate to require continuing disclosure by the municipality, after it has borrowed the money. This continuing disclosure will allow secondary purchasers to make informed investment decisions. Accordingly, an appropriate policy might be to require initial disclosure followed by continuing disclosure of pertinent financial information at least annually, and disclosure on the occurrence of a "material event" that could affect an investment decision.[33]

Bosnia and Herzegovina currently has a relatively unsophisticated financial sector. Because the burdens of developing a regulatory system and compliance capacity could present significant entry barriers, slowing or preventing the development a securities-based municipal credit system, it may be desirable to consider a phased approach to regulations and institutions to support municipal securities disclosure. While basic disclosure of information and protection against fraud is critical from the outset, it is important not to burden the market with overly stringent disclosure regulations too early in its development. As the volume of municipal securities issues increases, more sophisticated regulations and institutions can be pursued. Such a phased approach might be implemented as follows:

<u>Initial phase of disclosure regulation:</u>

- Required registration of debts, defaults, and security interests
- Creation of central registry, either in each entity or for the State as a whole[34]

---

[32] Qualifying individuals are referred to as "sophisticated investors," and must typically meet minimum net worth requirements and show they have investment experience and be able to show they have the knowledge necessary to make sophisticated investment decisions.

[33] An event is "material" if there is a substantial likelihood that, under all the circumstances, it would assume significance in the deliberations of a reasonable investor. Examples include: principal and interest payment delinquencies; non-payment defaults; unscheduled draws on debt service reserves reflecting financial difficulties; unscheduled draws on credit enhancements reflecting financial difficulties; bond calls; and rating changes.

[34] This registration is a function that could well be established on a State level, which might help facilitate inter-entity municipal lending. It could also be done on an entity basis, and could be based in the Ministry of Finance, Ministry of Local

- Borrower and lender both required to report
- Legal prohibition on fraud

Intermediate phase regulatory additions:
- Legal requirement for prospectus or equivalent
- Borrower and dealers distributing securities commercially required to provide prospectus or offering memorandum to purchasers
- Government regulations specifying minimum contents of prospectus

Final phase regulatory additions:
- Industry standards and guidelines for prospectus, developed by government finance officers, bond dealers, and consumer protection advocates
- Requirements for continuing, post issuance disclosure
- Creation of self-funded repository/distribution system[35]

Violations of legal or regulatory requirements would subject the violator to criminal sanctions, and could be the basis for private legal actions as well. While legislation would be relatively permanent, government regulations could evolve over time to increase minimum disclosure requirements as the capacity to develop and present information evolves and as particular practices requiring regulation are identified.

There would be no criminal penalty for non-compliance with industry standards and guidelines. These standards would exist primarily to establish the expectations of those who must deal with disclosure documentation in the trade, i.e. its merchantability. These standards could provide model formats for disclosure, and describe particular information deemed appropriate for particular types and structures of financing. They would likely be developed and revised constantly, in a way that government legislation and regulation could not and should not be.

5. Assisting in the municipal debt sector

This group of issues deals with policy issues that are somewhat collateral to the basic regulatory framework for municipal debt, but which nevertheless relate to the objective of attracting private debt capital to help build municipal infrastructure.

Government, or an independent agency. The registry should start simply, with just debts (principal amount and term, borrower, lender), payment defaults (date and amount), and associated security interests (the asset or revenue pledged). It would be an inquiry notice system, and interested parties could find relevant details by contacting the municipality in question. Later, the registry could include non-payment defaults, and more information about the debts.

To be effective, the registration requirement must be enforceable, as to both local governments and lenders. The registry could easily be electronic, with internet access to potential lenders and to the public.

[35] Because borrowers, potential investors, the news media, and others will benefit from the system, fees can be charged for filing and accessing information, and these fees can support the operational costs of the system.

Direct assistance

Direct lending, guarantees, and insurance by the entity or state government have all been suggested as ways to support the development of municipal borrowing. Each of these approaches would likely accelerate municipal borrowing, and make long-term borrowing possible sooner than would otherwise be the case. However, each of these approaches has costs, and these must be carefully weighed against the advantages to be expected.

The biggest drawback to direct government **lending** is that it diverts limited resources from other priorities. Even if local infrastructure could be prioritized over all other demands on the national and entity budgets, direct government lending is likely to be inadequate. Government resources are scarce. If an environment can be created which attracts private investment, government resources can be used elsewhere. This is all the more true in the case of concessional lending, which implies a budget subsidy.[36]

Guarantees by the state or the entities pose the problems always associated with contingent liability. First, they are difficult to value and when they must be honored, they divert resources in the same way as direct government lending, though even more unpredictably. If there are a number guarantees outstanding and there is an economic downturn, cutting off the flow of claims can be considerably harder than stopping further direct lending. Second, guarantees can lead to moral hazard problems, i.e. they can increase the risk that municipalities will not repay their debts and instead let the government pick up the tab.

Government-sponsored **insurance** can have the same risks as guarantees, or it can be more limited, and can even have positive incentives. Although similar to a guarantee if government insures against all risks, insurance may be an appropriate response where the risk to be insured against is in fact in the government's control, and not in the municipality's. We do not believe enhancement mechanisms for municipal debt are necessary or desirable. However, if the government wanted to explore some form of enhancement for municipal debt (given the perception of national and economic instability in Bosnia and Herzegovina), policy-makers in Bosnia and Herzegovina could consider the creation of a sovereign risk fund for municipal debt. Payments from such a fund would be triggered by actions of the sovereign, which make municipal payment of debt obligations impossible. Carefully defining the risks that would be covered would be essential. The insured risks should be those of greatest concern to potential investors and most under control of the state or entity providing the insurance.

As noted above, some entity-level officials believe (without a legal basis, so far as can be determined), that if municipal debt is not paid, it becomes a debt of the national government. This perception is not healthy, and should be addressed directly, through public education, legislation (including legislation clearly defining creditors' remedies and addressing municipal insolvency), policy pronouncements, and even caveats on debt instruments.

[36] Of course, to the extent government provides technical assistance and training at its expense, it is also a form of subsidy, but one which helps borrowers and private lenders reach common ground, and by making private capital available, has the potential to offer tremendous return on the investment.

Guarantees and insurance should be approached with great caution. Even limited guarantees (e.g. of longer maturities or against specific risks), carry significant contingent risk and costs which are difficult to quantify. If government or government financed entities provide such guarantees, they should consider doing so at full cost, to avoid distortions and disincentives. One way to assure that the full cost is covered is to ensure that guarantees or insurance are funded through a self-financed mechanism, with no potential for additional capital infusions. This will tend to keep the costing "honest."

Indirect assistance for potential borrowers

Besides direct assistance, government can do many things to assist municipalities in the responsible use of borrowing for infrastructure. Some of these things are important for other reasons besides enabling municipal borrowing. Here we highlight some of the policy choices that can help create a positive environment for municipal borrowing.

Reliable and adequate revenues

There is both a demand-side and a supply-side to capital markets. To establish the demand side of the market – i.e. the demand of municipal borrowers for loans – reliability and adequacy of local revenues is paramount. Municipalities will not borrow, and should not borrow, without confidence in the future flow of adequate revenues with which to repay their debts. If they did borrow, they could not meet their long-term debt obligations without reliable and adequate revenues. Reliable and adequate revenues can be based on taxes, fees and charges, intergovernmental transfers, or any combination of these.

Taxes:

Locally set or shared taxes can include: personal income taxes, corporate income taxes, and taxes on sales and services. International experience shows that almost any combination of these taxes can form a solid tax base, but not if local shares change from year to year. Taxes on sales and services, along with personal income taxes, appear to be the most important sources of revenue for municipalities in both entities. Although real property taxes have potential, and are an important source of local revenues in some countries,[37] *ad valorem* property taxation in Bosnia and Herzegovina will likely not be implemented soon, especially given property ownership concerns in much of the country. Other local taxes can be important contributors to the tax base, but for at least the next decade, the most important municipal taxes in Bosnia and Herzegovina probably will be the existing taxes on sales and services. While tax shares appear stable in the Republika Srpska, it is not clear that they are adequate to municipal responsibilities.[38] In the Federation, stabilizing municipal tax shares at a reasonable level is probably the single most helpful thing government can do to make responsible local borrowing possible.[39]

---

[37] Particularly Holland and the Anglophone countries.

[38] It is not possible to generalize about how much municipal revenue is enough. That depends on a careful analysis of municipal responsibilities. If additional responsibilities are devolved to the municipal level, then additional revenues or revenue authority (i.e. authority to set meaningful taxes and fees) should be provided.

[39] Footnote 13 discusses some recent changes in municipal revenue shares.

Fees and charges:

Fees and charges for services are also critical to the local revenue picture, and thus to the demand-side of capital markets. Municipalities and their communal service enterprises (whether public or private) must be allowed and encouraged to charge the full cost of services to users, including an allowance for capital recovery.[40] Tariff setting and tariff regulation are complex issues, and require institutional and regulatory support that effectively balances the public interest with the financing needs of communal service enterprises. Such framework issues are well beyond the scope of this note, except to note the importance of a stable environment for establishing tariffs in making possible revenue-based project borrowing.

Intergovernmental transfers:

Many countries use intergovernmental transfers for a variety of purposes, including revenue equalization. In structuring intergovernmental transfers, it is important to keep an eye on possibilities for leveraging of such transfers with private capital, by providing that they will be pledgeable and interceptable by creditors, subject to appropriate penalties and administrative fees (in order to encourage municipalities to responsibly manage and pay their debts rather than abandoning creditors to their remedies).

Technical assistance and training

It is important for the government, donors and multilateral institutions to help municipalities access private capital through technical assistance and training, geared to building skills and capacity. A significant amount of such technical assistance and training has been provided, and the Local Development Program will provide more, but much remains to be done if municipalities are to use municipal debt wisely and participate fully in the eventual credit markets. Technical assistance at the municipal level can help with:

- Operating and capital budget skills
- Project and investment analysis
- Development of local debt policies describing how a municipality intends to use debt, and up to what limits
- Development of capital improvement strategies that identify the various needs of the community, prioritize them, and consider how to finance each of the priorities.[41]

In municipalities, training should be directed to elected representatives and appointed officials alike.

[40] No investigation has been made of communal service pricing legislation or practices in Bosnia and Herzegovina. In many countries in the region, explicit national regulation or interference by anti-monopoly or consumer protection offices has resulted in the barriers to municipalities and their enterprises pricing services at appropriate levels.

[41] It appears that most capital improvement planning is still done by sectoral ministries, and there is little or no effort to integrate the desires of each sector or department into a unified strategic development plan for the municipality.

Appeals to civic pride have been successful in attracting private capital in many parts of the world. All things being equal, many citizens would like to invest their capital in municipal debt instruments if they can see that the money will be used for improvements that benefit the community. An organized program for attracting local private capital, even in very small increments, can be an effective part of municipal borrowing programs.[42]

The World Bank's Local Development Project includes a technical assistance component that will offer targeted assistance to municipalities. In order to assist in pre-selecting the municipalities that would receive such assistance, we have prepared a suggested municipal assessment protocol, which is attached to this note as Appendix 4. It should be noted that this protocol does not purport to assess municipal creditworthiness, since the detailed financial data for such an assessment is largely lacking. It does identify many of the factors that would tend to make a municipality more creditworthy (e.g. leadership, public participation, and financial capacity), because it is these factors that will tend to make a municipality a better candidate for technical assistance.

In view of the needs of Bosnia and Herzegovina as a whole, the technical assistance being offered in connection with the Local Development Project must be seen as only a part of the solution. It is to be hoped that further bilateral assistance to municipalities will be forthcoming, and that the government of Bosnia and Herzegovina will continue to support the development of local skills and capacity.

Indirect assistance for potential lenders

Building capital

One reason the supply side is weak is the simple lack of capital. To help create aggregations of capital that could be invested in municipal debt, government can pursue policies that increase savings. Deposit insurance is already being pursued. Tax incentives, discussed below, are another possibility. The more capital that is available to banks, insurance companies, mutual funds, and pension funds, the more potential investors there will be in any given debt issue. The lack of legitimate capital concentrations in Bosnia and Herzegovina is a real barrier to market development. Although Bosnia and Herzegovina is in a post-war environment, some residents have savings that might be attracted to help finance municipal infrastructure. And some Bosnians living abroad have money that could be attracted to help re-build the country. Anything that can be done to attract domestic or foreign sources of capital to safe, secure financial institutions in Bosnia and Herzegovina will benefit municipal, commercial, and individual borrowers alike.

Among the most important structural adjustments to encourage capital aggregations will be the introduction of domestic competition and international practices in banking, and more broadly in

[42] The Local Development Program will provide banks with funds to lend to municipalities, but these funds have ultimately been borrowed by Bosnia and Herzegovina from the World Bank. Another step in the evolution of banking capacity and credit markets will be when the banks are strong enough, and involved enough in the market place to find their own capital, from domestic deposits or international sources. In several emerging economies, municipalities have bypassed the banking system altogether, attracting local, small-scale individual savings through micro-bond issues.

the financial sector. Banks controlling the most assets are still largely state-owned or controlled, though there is continued movement toward privatization. There is little competition for investor deposits.[43] The investment banker's art of raising and investing money is largely lacking, and banks have relatively little capital.

Economic incentives to invest in municipal debt exist in many parts of the world, most notably the United States. Tax incentives to encourage investment in municipal infrastructure could be applied (1) to municipal debt, (2) to debt incurred to provide municipal services (whether of a public or private entity), or (3) to savings and investment generally. Proponents of tax incentives argue that they can stimulate investments by the private sector. Tax exemptions have proven remarkably effective in stimulating private investment in municipal infrastructure in the United States. However, many fiscal experts are skeptical about tax incentives. In fact, both the Organization for Economic Cooperation and Development (OECD) and the European Commission have taken the position that tax incentives erode tax bases. An argument against tax incentives is that in granting preferential treatment to a few sectors, they burden other sectors with higher tax rates. For example, if municipal debt for infrastructure were tax-advantaged, but not private debt for municipal infrastructure, the public sector would have a competitive advantage in providing services to citizens.

Technical assistance and training

Bankers and other potential investors in the municipal sector can also benefit from training in municipal budget analysis, project analysis, debt underwriting and syndication, and the practices and functions of more evolved municipal debt markets. Various bilateral aid programs are already providing technical assistance and training to the banking sector. The Local Development Program will also be providing technical assistance and training, focusing on municipal credit analysis. Sharing experiences from other CEE transition economies may be especially helpful to investors in Bosnia and Herzegovina. Poland, Hungary, and the Czech Republic all offer instructive and sometimes cautionary examples.

6. Monitoring, Intervention, and Remedies

Monitoring

Important policy questions arise concerning the monitoring of municipal debt:

- What is the purpose of monitoring?
- By whom should monitoring be done, and should it be on the state level or entity level?
- Should the information gathered during the monitoring process be publicly available?

Purpose:

[43] One banker noted that he would have no trouble attracting millions of marks in deposits if he emulated the practices of some other banks in paying interest on savings.

Most entity officials interviewed feel that municipalities will need to at least inform the national government about local borrowing, even if no prior approval is required. In part, this is to assure compliance with IMF and other loan conditions that limit total public sector borrowing. In part, there seems to be a sense that if municipal borrowing gets out of hand, Ministry of Finance officials may need to step in and limit or ban local borrowing.

The government has a justifiable interest in both municipal debt and municipal finances generally. The information needed to understand municipal debt, and to identify potential triggers for intervention in cases of borrowing-related troubles, is related to but less than the information needed to understand municipal finances more broadly. Actual or anticipated failure to pay current expenses, including debt service, is the area of commonality. Municipal debt monitoring (as is done, e.g., in Poland and in the U.S. states of North Carolina and Pennsylvania) relates only to borrowing municipalities, while municipal finance monitoring (e.g., Philippines, Russia, and Australia) relates to all municipalities, and may include budget and expenditure review.

Before adopting monitoring requirements, policy makers should be clear about what they want to monitor and why. Would monitoring be to inform macro-economic policy and assure compliance with external financing conditionality? Or would it be to provide data so that policy-makers can analyze developing municipal debt practices, and the use and application of debt proceeds, so as to adjust borrowing policy? Different purposes require different information, though some information can serve multiple goals.

Responsible agency:

It seems likely, given the current situation in Bosnia and Herzegovina, that separate monitoring is likely do be desired by each entity. It would be useful if a common approach were taken, so that data is comparable, and capable of being integrated to provide an overall picture. Within the RS, either the Ministry of Finance or the Ministry of Local Government could be the monitoring agency. Within the Federation, there appears to be no ministry charged with local government issues, and therefore the Ministry of Finance is the logical choice. It makes sense to make the monitoring agency in each entity the same as the agency for registration of municipal debts, defaults, and security interests, as described in Section 4 above.

The government will need to consider the costs and benefits of any new programs or institutions created to monitor municipal borrowing. Recent accounting reforms, once implemented, may in fact ultimately limit the need for other information-gathering systems. Publicly disclosed annual reports can be an excellent source of data, and may obviate the need for special-purpose bureaucracies and systems. Until such systems are in place, some other measures may be useful, but care should be given not to create expensive systems to avoid problems that may never exist.

Public information:

An important policy question for decision-makers is whether the information gathered during the monitoring process should be publicly available. Disclosure would increase transparency and accountability. It would allow for benchmarking, and would provide a valuable base of data for

commentators and policy advocates. The argument for disclosure is essentially the same for municipal borrowing and for municipal finances generally -- experience around the world is compelling that the quality of the data and the incentives for good management will both improve if municipal financial information is subjected to public scrutiny.

Intervention

Among the basic policy questions to be decided by policy-makers developing a regulatory framework are those related to the potential for, and mechanics of, any intervention in municipal financial affairs by other levels of government. Among the policy questions to be decided will be the following:

- Are special intervention rules and procedures needed for intervention due to borrowing problems?
- Who should be authorized to intervene in the event of financial problems?
- What conditions should trigger an intervention process?
- How much intervention is likely to be needed, and of what kind?
- What would be the potential powers and duties of an intervenor?
- Should the intervention process be an executive process or a judicial process?
- When should an intervention end?

There will always be instances where municipalities get into significant fiscal imbalance, in Bosnia and Herzegovina as in other countries. These imbalances can occur as a result of borrowing, but they can also occur through overspending, as a consequence of natural or man-made emergencies, or because potential revenues are simply inadequate to the tasks being undertaken. In each case, some intervention by other levels of government may be necessary to bring about a balance between revenues and expenditures. Intervention processes can be defined either by law or by contract. For a viable regulatory framework for municipal debt alone, there may not be a need for a detailed, legislatively prescribed intervention process. Absent such a detailed process, the parties can define intervention and receivership processes contractually. However, for national policy reasons beyond the municipal borrowing framework, policy makers may want to spell out an intervention process legislatively. Any intervention process must be as clear and simple as possible. This section briefly identifies the policy issues that will need to be decided before legislation can be drafted.

Some Federation cantons have authorized themselves to dissolve local councils and appoint commissioners to run municipalities under certain conditions.[44] An important policy question for the Federation is whether intervention is properly a canton function, or rather an entity function. If it is determined by policy-makers to be an entity-level function, what ministry or agency should

[44] For example, Article 45 of the Canton of Herzegbosna's Law on Local Self-government provides that the Cantonal Parliament can, on the proposal of the Government of the Canton, dissolve the Municipal Assembly if :

- general acts have been issued frequently in contradictory to the Constitution, Law and other regulation or because of frequent heavy violating of the Law and other regulations,
- the municipal Head was not elected in the period of 90 days from the day of the constituting of the municipal council,
- the Statute was not established in the term determined by this Law,
- the budget of the municipality was not established in the term determined by the law.

be charged with initiating an intervention? Within the Republika Srpska, should it be the Ministry of Finance or the Ministry of Local Self-Government that would supervise and initiate the intervention process?

Once initiated, should the intervention process be an executive process or should it be judicial? A court-appointed receiver can perhaps cut across local political issues more effective than an intervention by a ministry, but such an approach would require confidence in the courts' capacity to act effectively.

How long should a municipality stay under administration or intervention? Only until the immediate problem is solved, or until some other point? In the Federation, some cantons have provided that an appointed commissioner serves until the next election.[45]

How would an intervention be triggered? It could conceptually occur at the request of the municipal council or some official of the municipality, at the request of a creditor whose bills have not been paid, or at the instance of a supervisory entity (or canton) ministry. Intervention mechanisms which drag the intervening authority into local battles without the will and power to solve problems should be avoided.

An important policy question is how specific to be in describing the intervention process, and how much leeway to leave the intervening authority to decide on the most appropriate measures in the actual event. Broad and flexible powers allow the remedies to be shaped to address the actual problems, but can offer less predictability. Should there be multiple levels of intervention, e.g. a light intervention consisting of expenditure controls, to be followed by more substantial intervention where lighter measures fail to resolve the situation?

A final question in the event of intervention in municipal affairs is what degree of protection should be afforded to essential public services, however essentiality may be defined. Whether the intervention is by the government or by the courts, it may be important to protect "minimum essential" municipal services. In general, these should be narrowly defined if they are not to take away the investors' perception of security.

Creditor remedies, insolvency, and disincorporation

Notwithstanding any government intervention process designed to protect citizens and governance issues, general creditors will want clear, simple remedies against a defaulting municipality, as discussed in Section 1 above. As a policy matter, it is important to consider how legal and contractual creditor remedies may be affected or limited by an intervention process, and whether creditors should be among those entitled to trigger an intervention.

For the occasional case where a municipality cannot conceivably pay all of its debts, it may be wise to provide clear legislation governing municipal **insolvency**. Such legislation would address

[45] This procedure does not appear to require a default "trigger," and may not have been specifically intended to address financial issues, but does reflect a recognition that intervention is sometimes necessary

creditors' rights and priorities between them when assets and revenues are not sufficient to satisfy all creditors. In advance of any insolvency, it should be clear when and under what conditions debts and other municipal contractual obligations could be dischargeable.

The next step beyond insolvency and discharge of debts is potential disincorporation. If a municipality is simply not viable, and cannot conceivably be made viable because of a fundamental and permanent imbalance between revenues and expenditures, provisions for **dissolving the municipality** as a legal entity, and transferring its assets and responsibilities to another entity are necessary.

THE WAY FORWARD

The challenge of describing a way forward is to satisfy the immediate needs of the Local Development Project in a way that is consistent with medium and long-term actions that will help support the development of a market for municipal borrowing.

Local Development Project

The most pressing need for the Local Development Project (LDP) is to clarify the authority of municipalities to borrow, and to assure that municipal revenues will be there to support repayment. As currently envisioned, the LDP will provide funding which municipalities will be able to borrow in their own name and on the strength of their own finances.

For the purposes of the LDP, clarifying the authority of municipalities in the RS requires the adoption of authorizing legislation, either the draft budget law or otherwise. See the discussion in section 1 above. If the budget law is to be the vehicle for authorization, then:

- the "special criteria" mentioned in Article 39 should be developed or the requirement for them deleted from the legislation
- Article 39's limitation of borrowing to 20% of revenues will likely need to be eliminated or modified to limit debt service to 20% of revenues[46]

For the purposes of the LDP, clarifying the authority of municipalities in the Federation will require amendments to the Federation's existing budget law. Again, please see the discussion in section 1 above. At a minimum the two issues mentioned immediately above with regard to the RS will need to be addressed. In addition:

- Article 39's requirement that the canton parliament take the borrowing decision should be amended to authorize the municipal assembly to take that decision.
- The cantonal law on local self-government in each canton where LDP lending will occur should be scrutinized to establish that the municipal assembly has the authority to enter into debt on its own decision, and that the decision cannot be undone by the canton.

[46] It is possible that some LDP borrowing will be small enough to fit under the 20% limit as is, but borrowing at such a level seems trivial in terms of the infrastructure it could provide or the impact on services provided to citizens.

In addition to these minimum legal changes, prudent lenders will need to satisfy themselves that municipal revenues are as stable and adequate as possible within the existing intergovernmental and local revenue structure.

Beyond LDP: Toward a Regulatory Framework

We recommend the development of a more comprehensive and permanent framework to help move toward a market-based system for municipal debt. Developing this framework would require several steps. One possible path would be as described in Appendix 5. Such a process has been used successfully in other countries in the region. Whether or not that particular model is used, we recommend a conscious policy change process. Emphasis must be given to the development of a clear vision of the role of municipalities and the resources they will have to fulfill their role. On the basis of that vision, specific policies can be agreed for municipal borrowing, and those policies can then be enacted into law and written into regulation.

Vision

A common vision on the role of municipalities, especially in the Federation, is an essential pre-condition for a successful and coherent policy on municipal borrowing. If municipalities are to be the prime actors in providing local infrastructure, they must be authorized to borrow in their own name, with limited involvement by other levels of government, and without lender recourse to state, entity, or cantonal resources.

If any significant amount of municipal debt is part of the national strategy for financing infrastructure, then a flow of stable and adequate revenue is the *sine qua non*. Municipalities cannot and should not borrow if their revenues are variable and subject to dramatic change from year to year. Municipalities cannot borrow if there is a fundamental imbalance between their revenues and their expenditures. If it does not take place earlier, policy consensus on municipal roles and revenues is necessary before any formulation of municipal debt policies. The current trend in both entities seems to be toward increasing the responsibilities of municipalities while maintaining (in the RS) or decreasing (in many cantons of the Federation) their revenue shares. This does not bode well for municipal finances generally, nor for municipal borrowing specifically.

In order to come to policy consensus and move toward legislation and implementation, a series of steps such as is outlined in Appendix 5 might be pursued. The integrated system that might develop from such a process will have a variety of components, including legislation, regulations, and institutions.

Legislation

Both entities will need clear and detailed legislation on municipal borrowing. This could be created by amending local government laws, or through separate and comprehensive municipal borrowing legislation. As mentioned above, an *ad hoc* revision of the provisions of Article 39 of the draft (RS) and existing (Federation) budget laws could be considered as an interim measure for the purposes of the LDP. Drafting and adopting more comprehensive legislation would require decisions on the various policy issues identified in this note. The kind of process

described in Appendix 5 appears desirable before drafting of comprehensive legislation would begin. Such a policy formulation and consensus-building process would help assure that the legislative process would be relatively straightforward, and a significant head-start would have been gained on subsequent implementation steps.

Eventually, regulations will be needed to flesh out disclosure requirements for municipal securities. Detailed disclosure requirements should probably not be adopted by legislation, but rather by more flexible regulation, eventually supplemented by voluntary standards as described in the body of this note.

As this note has demonstrated, there are many policy issues to be decided. Initial discussions on these issues were had with many stakeholders in the preparation of this report. One inventory of issues to be decided is attached to this note as Appendix 6. Although we believe the government and stake-holders should come to policy decisions about these issues after discussing the pros and cons of various options, we take this opportunity to record our preliminary view that the following items should be addressed in legislation:

- Complete clarity that municipal or cantonal debt is not guaranteed by, nor the responsibility of, any entity other than the municipality or canton issuing the debt.
- Clear authorization for long- and short-term municipal borrowing, specifying which legal entities are authorized to borrow, and the purposes for which each type of borrowing is authorized.[47]
- Clarity about the procedures for authorizing and evidencing debt, and in the Federation clarification of whether the canton must approve municipal borrowing.
- Authorization for, and any limitations on, covenants and pledges in connection with municipal borrowing.
- Clear and specific remedies for lenders.
- Clear provisions regarding municipal insolvency.
- Requirements as to registration and disclosure.
- Prohibitions on fraud in connection with municipal borrowing.
- Any limitations on municipal borrowing, specifically including removal or clarification of the 20% limit on municipal borrowing.[48]

Institutions

A diverse and robust financial sector

Banks and other financial sector actors will need more financial capacity and more analytic capacity if they are to fulfill their roles in a municipal debt system. It is hoped that the financial capacity of the banking sector will improve as a result of policy reforms in that sector, and as a

[47] Because it would be permanent in nature, this authority might best be located in general municipal law or in a special municipal borrowing bill.

[48] Although most of those interviewed indicated this was intended to limit debt service to 20% of revenues, it reads as a limit on the principal amount of borrowing. This would limit borrowing to a trivial amount. Please see discussion in section 2 of this note.

consequence of increasing social and economic stability in Bosnia and Herzegovina. Insurance companies, pension funds, mutual funds, and individuals will all play a role in the healthy credit markets we hope will develop over time.

As mentioned above, additional technical assistance to banks and other potential investors in municipal debt could help increase their acceptance of, and analytic capacity with regard to municipal debt. Potential lenders and investors in Bosnia and Herzegovina have expressed interest in municipal debt, and in a future market for municipal securities. Lenders will need to become more knowledgeable about distinguishing municipal credits from other corporate entities and private enterprises. They will need to improve their analytic capacity in general, and with specific regard to municipal debt. Potential lenders must be able to evaluate municipal financing plans, but also municipal governance, demographic and income trends, and economic development potential.

Creditworthy municipalities

In addition to a sound policy environment, municipalities will need to become responsible borrowers that are attractive to the private sector. To be creditworthy, municipalities will need at least two things: (1) stable, predictable, and sufficient revenues to support borrowing for capital investment; and (2) the management capacity and experience to plan for and use debt responsibly. The former requires a system of local and intergovernmental finance that provides reliable funding for needy communities without creating perverse incentives. The latter requires generous amounts of training, technical assistance, mentoring, and time.

Municipalities particularly need to focus on the following issues in order to become more attractive to potential investors:

- Municipal accounting and compliance with accounting standards
- Operational and capital budgeting
- Capital improvement planning
- Local debt policies and strategy
- Project analysis
- Disclosure of information in connection with debt
- Marketing the debt
- Management of troubled finances.

Regulatory and supporting institutions

The Federation's Securities Commission will be adopting disclosure regulations for corporate securities. There and in the RS, care should be taken to address municipal securities separately, and perhaps even reserve municipal security regulation for a future date.

As described in Section 4, a registry for borrower- and lender supplied information on municipal debt, default, and security interests would be a good starting point in building a transparent and information driven municipal debt market. A possible step-wise evolution of disclosure regulation is also discussed in Section 4.

Professional associations/professional standards

Associations of finance professionals (e.g. JAFIS in the Federation), local government associations (which exist in both the Federation and the RS), bankers' associations (one has been established in at least the Federation) and ultimately municipal debt investors and dealers (these specialized associations do not yet exist) can all help improve standards of professionalism, develop guidelines and practices for the sector, and advocate for policy change. JAFIS and/or the municipal associations could play an immediate role in sponsoring the creation of a municipal finance database that would provide information about both revenues and expenditures. And would allow municipalities to benchmark themselves against comparable municipalities thriving municipal debt marketplace will depend on a multiplicity of actors and interests playing their roles effectively. Another appropriate role for these associations would be the development of standards and models to guide municipalities in adopting debt policies, capital improvement strategies, and in deciding whether and how to borrow.

APPENDIX 1 - INTERVIEWS

Republika Srpska

Ministry of Finance
Gordana Cenic Jotanovic, Deputy Minister
Zorica Mrdja, Manager of Foreign Debt

Ministry of Government and Local Self-government
Anto Nikolic, Deputy Minister

Crystal Bank
Ljubomir Klincov, General Manager

Agroprom Banka
Milenko Vracar, Director
Milos Marceta, Deputy Director
Vesna Grozdanic, Long-term Credit Manager

Laktasi Municipality
Ranko Karapetrovic, Mayor (Chairman of the Municipal Assembly)

Association of Municipalities in RS
Ranko Karapetrovic, Mayor, Laktasi Municipality
Mirko Lukic, Mayor, Samac Municipality
Mihailo Crnadak, Deputy Mayor, Banja Luka
Dorde Umicevic, Mayor, Banja Luka
Mrs. Dokic, Director Reconstruction and Renewal, Banja Luka Municipality

Federation of Bosnia and Herzegovina

Ministry of Finance
Sena Uzunović, Assistant Minister

Mira Bradara
Chief of International Finance Group

Securities Commission
Dr. Herbert Schmidt, Commissioner
Dr. Vjekoslav Domljan, Commissioner

Investment Bank of the Federation of Bosnia and Herzegovina
Azra Čolić, Executive Director of Project Assessment, Financing and Management Department
Adnan Topalović, Management of Funds Senior Officer

Central Profit Banka D.D. Sarajevo,
Sefket Teskeredzic, Director

JAFIS, Public Finance Association
Ljiljiana Simunovic, Director

Central Profit Banka D.D. Sarajevo
Sefket Teskeredzic, Director

Bosna Reassurance, Sarajevo
Zlatan Filipovic, Managing Director
Hasan Delic, Financial Director

Sarajevo Canton
Hasib Gibanica, Deputy Finance Minister

Tuzla Canton
Besim Durakovic, Minster of Trade and Tourism
Muhibija Delic, Minister of Finance
Zijo Kosovac, Deputy Minister of Finance

Zapadnohercegovacka Canton
Lucija Ramljak, Advisor, Ministry of Finance

Hercegbosanski Canton
Jozo Ursa

Ljubuski Municipality
Andrija Bradvica

Tuzla Municipality
Selim Beslagic, Mayor

Visoko Municipality
Kenan Jusufbašić, Mayor

Livno Municipality
Juze Kasalo, Budget and Finance
Tiko Lani, Budget and Finance

Centar Municipality, City of Sarajevo
Igor Gaon, Mayor

U.S. Department of Treasury

Anne Schwartz, Resident Advisor
Laura Trimble, Resident Advisor

APPENDIX 2 – MUNICIPAL DEBT POLICIES AND CAPITAL IMPROVEMENT STRATEGIES

Municipal-level debt policies

A municipality considering the use of debt would be well advised to consider a written debt policy, addressing the following issues:

- What are acceptable levels of short- and long-term debt? The municipality must decide to what extent it is willing to give up future flexibility. Debt issuance involves a trade-off. In exchange for funds for current capital improvements, future spending is limited. The degree to which a municipality is willing to make these trade-offs will depend on the urgency of its capital needs, its expected rate of growth, economic tends, and the stability of its overall finances.

- What are acceptable purposes for which debt can be issued? To what extent must there be a public benefit? Must the improvement have a useful life of at least the term of the debt? Is water and sewer debt acceptable, but not debt for infrastructure that does not generate revenue?

- To what extent, and for what purposes, will the municipality use general obligation debt vs. revenue debt? Where the municipality can use revenue debt, it is less limiting of future flexibility. However, not all important projects generate reliable revenue streams to repay debt.

- What covenants, pledges, or security interests is the council willing to consider in order to make borrowing possible and/or lower its cost of borrowing?

- For what purposes will the municipality use “pay-as-you-go” financing, and for what purposes will it consider debt financing? A municipality should not issue debt for ongoing operations and maintenance, nor for short-lived improvements or repairs. The municipality may want to shift infrastructure development costs to beneficiaries—through user fees, service charges, or developer financing—to the maximum extent possible.

- Will the municipality use variable-rate debt, or will it only issue fixed-rate obligations? In a highly inflationary economy, fixed-rate long-term issues are not viable.

- For what term will debt be issued? For the near term, the market may be more of a limiting factor than any policy the municipality might develop. However, the municipality will want to avoid issuing debt for longer than the useful life of the improvement to be financed. At the same time, it will want to spread the debt over a long enough period that the payments due in any given year are manageable in light of the anticipated revenues.

- Will debt be placed competitively, or by negotiation? If the latter, what safeguards will assure the municipality that it is borrowing at the lowest possible cost?

Municipal level capital improvement strategy

A capital improvement planning process can result in a sustainable, strategic approach to capital improvements that helps responsible local officials consider particular improvement proposals in context. Such a process should include analyses of capital needs, environmental considerations, financing considerations, project design and selection criteria, and the impact of planned improvements on annual costs for debt service, operations, and maintenance. The process is on-going, and the strategy should be updated periodically. Some of the items that could be included in a strategic capital planning process are:

- An assessment of the current social, economic, and environmental reality in the municipal area—the current reality
- A determination of community needs through close consultation with the affected citizens and businesses
- The development of a clear vision for development in the area
- An audit of the community's available resources, skills, and capacities
- A prioritization of community needs in order of urgency and long-term importance
- The formulation of strategies to meet these needs within specific time frames
- The implementation of projects and programs to meet these needs
- The use of monitoring tools to measure the impact and performance of the projects and programs implemented

APPENDIX 3 – DISCLOSURE -- POLICY ISSUES

1) What information should be required to be disclosed in connection with a municipal or canton borrowing?
   a) Information material to an investment decision?
   b) How should the "material information" be defined?
      i) By law?
      ii) By regulation?
      iii) By industry standard?
2) By whom should information be disclosed?
   a) By borrowers?
   b) By lenders?
   c) By underwriters or others distributing municipal securities?
   d) By others?
   e) What are the consequences of non-disclosure?

3) When should information be disclosed?
   a) At initial issuance of municipal debt?
   b) Should there be continuing disclosure requirements after a municipality borrows?

4) To whom should information be disclosed, or, for whose benefit should information be disclosed?
   a) All investors?
   b) Should there be a "sophisticated investor" exception?
   c) Should there be a "private placement" exception?

5) How should information be disclosed?
   a) By the preparation of disclosure statements?
   b) Where should disclosure documentation be filed?
   c) How should disclosure documentation be disseminated?

6) Should there be registration requirements in connection with municipal and canton debt?
   a) Registration of debts, defaults, security interests?
   b) Should registration be instead of, or in addition to, disclosure requirements?

7) Other than disclosure requirements, should trading in municipal securities be regulated or limited?
   a) Should OTC trading be permitted or encouraged?
   b) Is exchange-based trading desirable?
   c) Should municipal debt traders be licensed or regulated?
   d) Should municipal debt be reflected by physical instruments, dematerialized (i.e. a book-entry system), or some combination thereof?

APPENDIX 4 – COMMUNITY SCORING MATRIX

MUNICIPAL ASSESSMENT PROTOCOL

This preliminary assessment process is likely to take at least one day for each municipality interviewed. If 10 cities are done each month, 30 cities could be interviewed between October 1 and December 31, in each entity. This pool of 60 cities would give an excellent database for making a preliminary selection of cities to receive technical assistance.[49]

1. Initial Contact: Contact municipality at least 2 weeks before an intended visit, by telephone and by faxing an introductory letter.[50]

2. Introductory letter: This letter should:

   a. Explain that the purpose of the visit is to determine whether the city should be selected to receive TA designed to help it improve its creditworthiness, for consideration by banks participating in the LDF project and for other creditors.
   b. Explain that TA resources are limited and that the selection process will be competitive. No decision will likely be made on cities to receive TA until early in the year 2000.
   c. Include the adopted criteria for LDF projects
   d. Request the municipality to indicate within 7 days whether it wishes to be considered, so that travel arrangements can be made. If they are interested, they should provide with their response:
      1) a letter so indicating
      2) a copy of their budget
      3) any lists that may exist of priority infrastructure projects
      4) a proposed schedule for the day
      5) a key point of contact for the team
   e. Indicate that a series of separate meetings are requested, not a single group meeting, and that the interview team would like to meet with the mayor, members of council, relevant members of the city's executive structure, and members of any committees or task forces working on infrastructure issues. The door should be left open to any other meetings the municipality wants to suggest.
   f. Indicate that the TA process is likely to take at least a year (?), and to require a significant effort from the municipality, and that there is no guarantee that any loan will be awarded at the end of the process.
   g. Provide a contact person and coordinates for any questions or follow-up.

3. The interviews: On the day of the visit, indicate that no decision will be made until all of the interested municipalities have been interviewed. Use the scoring sheet that follows to record your impressions of

[49] December 31 is used as the hypothetical end date on the grounds that the TA team will start work January 1, 2000. If, in fact, that start is delayed, the assessment process could and should continue, generating at least 10 more assessments per month in each entity until all potential recipients had been screened.

[50] If 10 are to be interviewed in a given month, 20 could be contacted, and the 10 with the quickest and best responses could be visited.

the municipality's capacity with regard to each parameter. In addition, please consider, and record written comments on the following items:

a. Is each person well-prepared for the evaluation
b. Is each person interested in receiving the TA (as opposed to seeing it as a necessary evil to be endured in order to receive the financing)?
c. How well do they understand the need to repay? How carefully they have considered their ability to repay?
d. How well do they understand that taking a long-term loan will limit their current flexibility in future years?
e. How well do their priority projects correspond to the LDF project criteria?

4. Comparative evaluation: After all of the cities have been visited, transfer the scores to the scoring matrix, and consider whether any scores should be adjusted because of written comments. Provide the interview forms and comparative matrix to the TA team for their consideration.

SCORING SHEET FOR

_____

(name of municipality)

	Potential Score	Actual Score
I. LEADERSHIP	***20***	
Management skills and practices	*(4)*	
Preparation for interview/selection visit	*(4)*	
Political support for management (from council, executive, mayor, and public)?	*(4)*	
Political leadership/visibility on proposed project(s)	*(4)*	
Leadership's commitment to proposed project(s) (mayor, executive, council)?	*(4)*	
II. PUBLIC PARTICIPATION	***20***	
Pro-active communication/ public meetings/ public relations department?	*(4)*	
Transparency of information and meetings?	*(4)*	
Public meetings on setting investment priorities? Broad-based infrastructure committee or task force?	*(4)*	
Public meetings on project(s) under consideration?	*(4)*	
Cooperation with public organizations (NGOs)	*(4)*	
III. FINANCIAL CAPACITY	***28***	
Fiscal competence (fiscal policies – council/mayor level)	*(4)*	
Financial Information/analysis and availability	*(4)*	
Budget management (execution – executive level): Is budget readily available, understood by all (mayor, council, executive)? • Revenues: broad tax base, effective tax and tariff collection, and other income? • Expenditures: arrears? Good control systems? Contingency planning/reserve? • Net: surpluses? Deficits?	*(8)*	
Predictable, stable, adequate revenues? At least 3 years of stability in tax retention percentages?	*(8)*	
Previous borrowing successes?	*(4)*	
IV. ECONOMIC AND INFRASTRUCTURE DEVELOPMENT	***21***	
Strategic Planning Process	*(4)*	
Project Planning and Implementation	*(4)*	
Appropriateness of project(s) in light of LDF project criteria	*(8)*	
Economic conditions and potential of community	*(5)*	
V. SERVICE DELIVERY ORIENTATION	***11***	
Priority Setting Process	*(3)*	
Results (customer service) orientation	*(3)*	
Cost recovery	*(5)*	
TOTAL	***100***	

WRITTEN COMMENTS OF INTERVIEWER(S):

NAME(S) OF INTERVIEWERS:

NAME(S) OF INTERVIEWEES:

DATE: _____

APPENDIX 5 – POLICY DEVELOPMENT PROCESS

STEP 1: Identify stakeholders and issues

Identify institutions and actors in each entity. These include at least the following:

- Municipalities
- Cantons (in the Federation only)
- Communal service enterprises
- Municipal associations (i.e. political/NGO associations for advocacy, communication, and training)
- Municipal service associations/authorities, if any exist
- Banks, insurance companies, pension funds and other potential lenders
- Any lending community associations
- Any investment intermediaries now operating (mutual funds, unit trusts)
- Securities Commission
- Stock exchange(s)
- Parliamentary committees with jurisdiction over local government issues
- Entity Ministries of Finance
- Any other cabinet departments with a local government portfolio
- Other key political actors

Research current laws and practices to frame the issues. It will be important to separate received wisdom from actual laws and regulations. Some issues include:

- Authority of authority of municipalities and communal service enterprises to pledge assets, revenue streams, and power to set fees and charges
- effect of accounting practices on rate setting, and of rate setting on available revenues
- effect of existing law on obligations

STEP 2: Form a working group

There could be one working group, or one for each entity. The group or groups will be most effective if:

- It has (or they have) an official mandate, e.g. from Cabinet or Parliament
- It includes (or they include) those stakeholders that care deeply and/or are in a position to block or facilitate change

Ideally, the group should be policy-oriented, not technical. Policy makers who feel strongly one way or the other about municipal autonomy and of market approaches should be included. Key representatives of the stakeholders should be included.

STEP 3: Policy Workshop(s)

A series of focused discussions to address the key issues related to the policy question

At this stage, there may also be a role for papers and further input from domestic and foreign experts.

STEP 4: Policy Framework

The working group(s) would hopefully come to policy consensus, and adopt a set of broad policy recommendations, identifying the institutions, laws, regulations, and interventions needed to implement the agreed policy. These recommendations can be developed during Step 3, and as a logical outcome thereof. They should be philosophical in approach, but should identify the laws, regulations, institutions, and interventions required for implementation.

STEP 5: Legislative Strategy

The key stakeholders, who will hopefully champions of the agreed policy framework, pursue a specific strategy to assure the necessary laws and regulations are adopted. This will include a media and public education component, a parliamentary education and advocacy component, and other efforts to gain broad support.

Step 6: Implementation

Once the necessary laws and regulations are enacted, and institutions created, the policy framework could be implemented, monitored for results, and fine-tuned as needed.

APPENDIX 6 – OUTLINE OF POLICY ISSUES

Group 1: Issuing debt

1) Which subsovereign institutions should be permitted to borrow?
   a) Should municipalities of all population and budget sizes be permitted to borrow?
   b) Should cantons (in the Federation) be permitted to borrow?
   c) Should communal service enterprises, e.g. those providing water and sewer services, solid waste collection and disposal, and district heating, be authorized to borrow?

2) Should special districts and intergovernmental authorities be envisioned?
   (e.g. for financing and providing specific services: water and sanitation districts, fire protection districts, business improvement districts)

3) What kind of borrowing?
   a) Should a municipal debt be an unconditional promise to pay from any and all available sources?
   b) Should/could it sometimes be something less?
   c) Something more?

4) What remedies at law?
   a) The right to intercept funds due to a municipality from other spheres of government
   b) The right to trigger the imposition of an additional tax within the defaulting municipality
   c) The right to trigger the appointment of a receiver or board to control expenditures and/or other operations of the municipality.

5) What remedies by contract?

   I.e. what leeway should the parties (municipal borrower and private sector lender) be allowed to craft security provisions that meet their needs?

6) What other special promises should municipal borrowers be authorized to make in connection with borrowing?
   a) Tariff and rate covenants.
   b) Initial or contingent assignments of revenue from other levels of government (i.e., contractual revenue intercepts)

Group 2: Restrictions on Issuance and Use of Municipal Debt

7) Restrictions on ST debt?
   a) Amount
   b) Use – cash flow only?
   c) term

8) Restrictions on LT debt?
   a) Amount
   b) Use – physical infrastructure only?
   c) term

9) If restrictions as to amount, how formulated?
   a) Absolutely?
   b) Some proportion of local revenues?
   c) Some proportion of GDP?

Group 3: Authorization of Borrowing

10) What authorizations (internal to the municipality)?
   a) Mayor?
   b) Executive?
   c) Council?
   d) Citizens?

11) What pre-conditions?
   a) Impact on operating and capital budgets analyzed?
   b) Capital spending strategy in place?
   c) Debt strategy in place?

12) What approvals (by other levels of government)?
   a) Canton?
   b) Entity?
   c) Other?

13) On what basis would other levels review and approve?
   a) Financial capacity of the borrower
      i) by analysis or
      ii) by the application of a formula
   b) Consistency with national policy, e.g., as to timing
   c) Purpose
   d) Form or formalities

Group 4: Disclosure and Market Regulation

14) What disclosure?
   a) Material to an investment decision?
   b) How defined?
      i) Law
      ii) Regulation
      iii) Industry standard

15) By whom?
    a) Borrowers?
    b) Lenders?
    c) Underwriters?
    d) Other?
    e) Consequences of non-compliance?

16) When?
    a) At initial issuance?
    b) Subsequent disclosure?

17) To whom?
    a) All investors?
    b) Sophisticated investor exception?
    c) Private placement exception?

18) How?
    a) Disclosure statements?
    b) Where filed?
    c) How disseminated?

19) Registration?
    a) Debts, defaults, security interests?
    b) Instead of, or in addition to disclosure?

20) Trading?
    a) OTC?
    b) Exchange-based?
    c) Other?
    d) Physical securities, or computerized system?

Group 5: Concessional Finance and Other Assistance

21) What direct assistance to borrowers?
    a) Direct lending?
        i) Concessional rates?
        ii) "market rates?"
    b) Insurance/guarantees?

22) What indirect assistance?
    a) Local revenue structure?
    b) Inter-governmental revenue structure?
    c) Incentives to invest in municipal debt?
    d) Ratings?

23) What TA and training?
    a) For whom?
        i) Municipalities?
            (1) Elected representatives?
            (2) Appointed officials?
        ii) Bankers?
        iii) Other investors?
    b) Provided how?
        i) Donors?
        ii) Government?
        iii) Private sector?

Group 6: Monitoring, Intervention, and Remedies

24) What monitoring, if any?
    a) By whom?
    b) For what purpose?
    c) How public?

25) What intervention in troubled municipalities?
    a) Whether or not debt-related?
    b) By whom?
    c) For how long?
    d) How?
        i) Direct government (or canton in Federation) control?
        ii) Court supervision?
        iii) What powers?
        iv) How triggered?

26) What creditor remedies?
    a) See above
    b) How do these relate to intervention process?