Local Government Borrowing Issues in Central and Eastern Europe. The case of Albania.

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Abstract : During the last two decades the process of decentralization has been extended worldwide. This process has taken place in developed countries. Nowadays, this process is also being applied in developing countries in order to challenge the monopoly of centralized decision making of governments. The decentralization process has had different objectives in different countries, depending on the democratic tradition and the level of socio-economic development.

In addition the recent financial crisis has make policy makers more sensitive regarding the stock of public debt. Under this framework local borrowing is becoming increasingly important as Central and Eastern Europe consider the legal and institutional restrictions on local borrowing as part of the restrictions on total public debt.

This paper argues about the major issues central and Eastern European countries are facing regarding local borrowing with a focus on the current situation in Albania where the local borrowing law is recent.

Keywords: public debt, decentralization, local loan.

1. Introduction

One of the major topics in many discussions in economics and finance in Europe is the rising stock of public debt; the volatility of economic growth, reforms to counter the global financial crisis, the new challenges of local government with regard to their financial capabilities, and the actions taken by the central government under the decentralization process.

In general, under the framework of managing public debts, countries of Central and Eastern Europe consider the legal and institutional restrictions on local borrowing as part of the restrictions on total public debt. In these countries, central government is considered as the main responsible actor in the management process of the total public debt, whereas local government and its performance are seen as highly dependant on central financial and fiscal policies.

In many discussions taken place, the instrument of local government financed through loans from the financial system/banking has it difficult to attract the attention of, and find appropriate implementation among stakeholders and regulatory authorities. In Albania the local borrowing law, which was approved on February 2008, and the law of October 2009 on the municipal obligations have a little awareness in the banking market; meanwhile the local units see their importance as the key to implementing strategic investment.

Compliance with the legal framework and bank rating are necessary, however not the only conditions that a local unit should fulfill in order to borrow. Successful financial management requires a proactive approach, where local policy-makers will have to conduct cost-benefit analysis for each project and respectively adjust their investment policy with their current debt capacity.

2. Major issues in the management of domestic debt in countries of Central and Eastern Europe

Fiscal decentralization, as one of the main components of the whole decentralization process, has advanced in parallel with economic development, economic and political reforms, organization of financial and monetary institutions, regional economic differences and certain income groups of population.

Borrowing is a big responsibility because local managers take decisions in this case not only for the current taxpayers of their units, but also for those who will pay in the future. The data shows that the average level of debt of local governments in Central and Eastern Europe remains quite below the level of other European countries. The European Union average is more modest, with a local government debt at only 5% of GDP and 9.5% of total public debt. Total local debt rarely reaches 2% of GDP in the new member states, the economic performance of which is comparable with that of other Western European countries of average incomes. Countries in transition outside the EU (Balkans and the former Soviet Union), also show low levels of local debt (Swianiewicz 2004: pg 399). The main reasons behind these low levels of domestic debt in countries of Central and Eastern Europe have been identified as follows:

- Lack of technical and administrative capacity for debt management;
- Inaccurate forecasts of current income flows (due to macroeconomic and institutional reasons);
- Revenue from privatization, and intergovernmental grants as an alternative way to fund the liquidation of debt;

- Not favorable standpoints towards debt (debt is seen as a sign of financial instability, a risky way for financing, and a heavy burden for future generations);
- Policies that do not favor borrowing and debt;
- Discrepancies and changes in local tax base and property value, thereby reducing the chances and opportunities for small municipalities to borrow.
- Lack of mature financial markets;
- High interest rates due to inflation;
- The limited role of local governments in public sector investments

In some cases, countries of Central and Eastern Europe do not really try to solve the complexity of the problems identified above, because the obstacles of debt financing are often accumulated and seriously affecting local governments which have a low financial and administrative capacity. Therefore, even in those areas where local government debt would be convenient as a financial tool the local authorities of these countries would rather use the following:

- Conditional transfers and investment grants from central government budget
- Income from the privatization of assets, or
- Revenues from their own sources (tariffs and local taxes)

Grants and assistance from international organizations (like the EU) and the partnerships between public and private sector play a limited role, which however should not be overlooked in the local government finance.

However, the use of debt by local governments in some countries of Central and Eastern Europe has increased significantly during the last decade. Although the volume of loans and bonds remains small in absolute terms, there is a general tendency towards borrowing which means a major qualitative progress in this direction (Wetzel 2001: pg 40).

There are a number of factors that lead to an increased level of local government debt. In countries like Hungary, Poland, Czech Republic, Slovakia, and Estonia, there is a rapid development in the local authority skills and capacity in domestic debt management (due also to technical assistance provided by bilateral donors and international organizations), as well as in the strengthening of local economies, an essential precondition for the development of strong fundamentals in the local source income.

Moreover, the stock generated from privatization revenues and the assets still on auction are gradually being reduced. This tendency however is being offset by conditional grants, which have become very important for the growing demand for infrastructure related to EU membership. Improved overall macroeconomic conditions have led to lower interest rates in these countries and financial markets have finally begun to open up for many creditworthy municipalities.

Even though local units in countries of Central and Eastern Europe in general follow the national regulatory framework on borrowing and domestic debt, and even though cases of not settling off debts are rather rare, it does not necessarily mean that the budget management policies that they implement are absolutely the best. This is mainly due to the lack of skills and experience during the preparation of the budget and programming of capital investments. However, there are cases of reckless fiscal behavior even in rich and powerful regions and municipalities with good management skills.

The major identified issues are lack of planning and monitoring capacity, not full feasibility study assessments of the project, old information systems, not suitable accounting policies and other shortcomings at the local level. It is important to emphasize that not all errors occur systematically in all countries. Some errors can only be typical in some countries of the region, while others may occur more often in other countries. Errors can be divided into two groups, errors related to i) the economic management of investment programs and errors related to ii) the policy management.

Typical errors in economic management of investment programs include poor feasibility assessment of projects and an ongoing resistance to cooperation between jurisdictions. Distinguishably, the municipalities of smaller size are the ones that demonstrate deficits in these areas, mainly due to lack of professional expertise and capacity planning. According to (Jokay et al. (2004), all local governments in Hungary went bankrupt during the first five years after the adoption of the law on Municipal Debt Adjustment (No. XXV of 1996). Rural villages were included in to big infrastructure programs (gas supply, the pipes waste of water) which were not real from a technical and financial point of view.

A conclusion on the non-professional assessment of costs and public services is that local governments do not fully make use of tariffs on public services, which could be a potential source of revenue to them. Reports from neighboring countries indicate that these local tariffs/rates remain below the level of full cost recovery and that state treasury in local governments prefers simpler solutions based on community generated revenue to finance their current expenditure on maintenance and asset operation.

Finally, the error of economic management is the persistence of local governments regarding the implementation of programs for which funding is available (assistance grants, state loans), however not at expected levels. Local governments usually do not give up on these investments due to fear of losing the financial support from state budget or other foreign sources of aid they have gained so far on competitive basis (with other local governments). They prefer to stick to their plans and complete these projects with their own revenues, bonds or bank loans, and therefore putting their liquidity position in difficulty.

Mistakes in policy management of investment programs are mainly related to prioritizing.

First of all, it is important that the community itself and inhabitants support the project and that they are also willing to make use of public services the project would offer after completion.

Secondly, investment priorities must be clearly defined and should be the result of a democratic process.

The third mistake in political management is the pursuit of prestige driven motives in investment policies. This can happen at any time when the local politicians’ goal is to draw new businesses and taxpayers into its own jurisdiction. This is more than a usual practice in the local election period.

The classic theory of federalism and fiscal decentralization has traditionally promoted the case for "the golden rule”, rules that force local governments to maintain their current account balance (every year or during the business cycle) and allowing deficit only in their capital account, in order to prevent serious fiscal distortions and increasing debt in local government units

While the "golden rule" is the key to control of local debt in some countries of Western Europe and is reported as an effective instrument to control the debt, in the entire region of Central and Eastern Europe, this rule does not exist or does not work. In Bulgaria, Croatia, Czech Republic, Hungary, Poland and Romania, these rules do not exist and borrowing is allowed for operational and investment purposes. In Albania and Estonia the right of local borrowing is limited to investment purposes. However, local authorities in Estonia are not required to formally divide their current budget expenditure from their capital budget expenditure (though encouraged to do this distinction). Slovakia (since 2001) is the only country in the region where the current and capital budgetary expenditures are formally separated, and equilibrium is required with regard to the current expenditure. However, "in extraordinary situations, when the autonomy of the municipality is at risk" local management council can request a reallocation of funds from capital budgetary expenditures to finance their current expenditures, up to 25% of their budgetary revenues (Kling and Nizansky 2004: 187)

An important pre-condition for the effective implementation of the "golden rule" is a clear definition of key terms like "investment" (i.e. what should be reflected in the capital account), "debt service" or "loan amortization", and the division of current and capital budgetary expenditures. Nevertheless, it should be mentioned that the "golden rule" and the division current and capital budgetary expenses are opposed in the current debate of fiscal federalism by the argument of inflexibility during periodical/seasonal falls.

Even if national legislation does not support the application of the "golden rule" or the division of current and capital budget expenses, nothing prevents local governments from voluntarily adopting these measures in the internal financial management systems as required.

3. The process of local decentralization and local finance in Albania

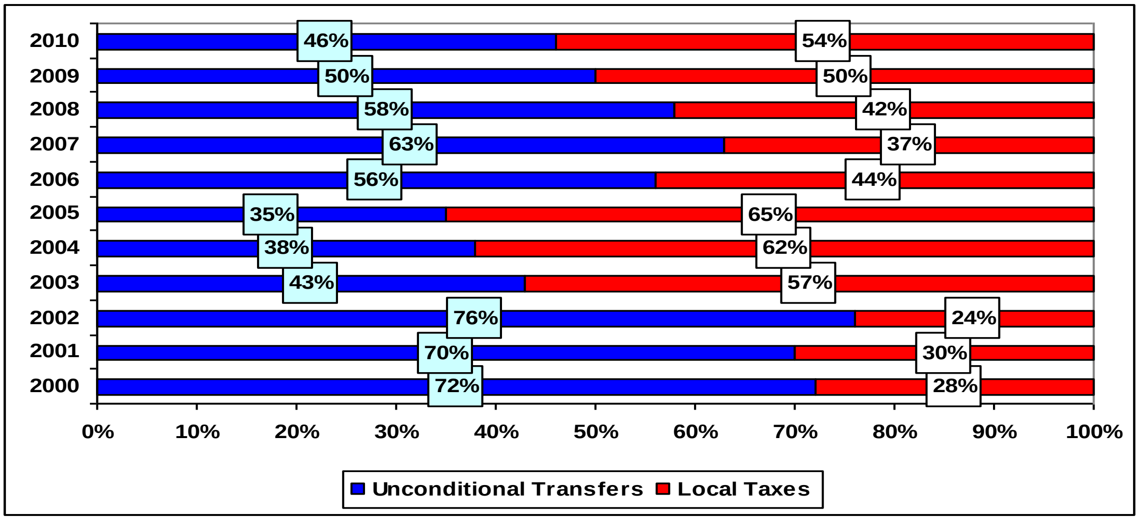
Albania has made a range of institutional and economic reforms under the process of economic reorganization and steady decentralization. To mention here is the decentralization reform, which is based on four main pillars:

- Transfer of functions, competences and relevant legislation, as well as empowerment of local government.
- Strengthening the financial capacity of local government.
- Transfer of the public properties for own functions of local government.
- Institutional reforms and human resource capacity building

The above pillars are built gradually to ensure a successful process of decentralization. Nonetheless, the most important out of the three and the absence of which would make all the pillars fall, is the enhancement of financial capacities in local governance.

Year 2000 was very significant in the whole decentralization process in Albania, as it was the starting point of the local decentralization and financial reforms. Since then, local entities have essentially increased their financial autonomy through the transfer of financial and fiscal instruments. The organic law on organization and function of local government defined the organization and functioning of local government entities, structural and institutional reforms, the independence of these entities, and also their own financial resources.

Figure 1: Unconditional transfers and local taxes in Albania



Today, local government revenues (generated from taxes, tariffs and local asset management) contribute with more than 50% on the total unconditional budget; meanwhile the unconditional transfer to local government is distributed based on a consolidated formula, which increases the unconditional funds to local entities on a yearly basis. The above chart clearly defines the quality of a growing financial capacity in local units. Figures indicate that the composition of own revenues and unconditional transfer in local government entities will move from 28%/72% to 54%/46%, which represents increased autonomy in these units.

Certainly, this enhanced autonomy in the financial capacity of local governance units is the result of an increased number of financial and fiscal instruments from one year to another, and the continuous improvement in the collection of local taxes and tariffs.

Other important sources of local finance and fiscal instruments, in addition to central government transfers (conditional or unconditional), are local asset management and loans from banks and/or other financial institutions. Both these sources of revenue have attracted the attention of local government, as the basis for the establishment of schemes such as public-private partnerships. The some of the loan applications in the Albanian banking system have already been implemented with the help of foreign assistance.

The decentralization reform and especially the financial and fiscal autonomy have brought by innovation in the local governance, reflected also in improved public services for the community.

The first decade of the local decentralization until year 2000, was characterized by a local government that offers minimum level of services for the community and a budget that mainly covers the salaries, road maintenances and local government institutions. Therefore, if local investments in year 2000 constituted about 20% of the local budget, in the end of this decade (2010) they will reach 40%. Changes have also occurred in the budget with regard to the current expenditure, where there is a general decrease in expenditure for salaries and an increase in the expenditure for maintenance.

In small size municipalities investments constitute for almost 30% of their total unconditional budget; in municipalities of middle size they constitute for almost 40%; and in municipalities of considerable size (which are very few in Albania) investment portfolio consists of 55% of their total budget.

By the management of the budgetary system in Albania is obligatory for the local government to develop medium-term budget programs. This legal obligation (which was approved in 2008) has given space to local managers in implementing larger projects while making sure the continuity of funding beyond one annual budgetary year.

As mentioned above, the opportunities for attracting investment resources are borrowing from the banking system, and public asset management for economic activity or the creation of public private partnerships. The borrowing is a very useful instrument matching the current conditions of the local budgets. The public asset management continues to remain an underutilized area among the local entities, partly due to a lack of sufficient assets that can be used for economic activity, partly due to a vague legal framework regarding the establishment of PPPs, and partly due to social issues. For these reasons, local borrowing is a very powerful tool that will serve as leverage to local managers in implementing priority investments in their respective communities.

3.1. The local borrowing as an important funding opportunity in Albania

Incentives that local governments need to initiate borrowing from commercial banks is one of the main objectives of the National Strategy for Local Decentralization (compiled in 1999-2000 and the last revision in 2007), established with the aim of "enhancing local fiscal autonomy and empowering local governance, ensuring effective exercise of the government in power, improving service delivery and enhancing access by local units to loans from the financial/banking sector" would significantly strengthen the financial and economic capacities of local government units.

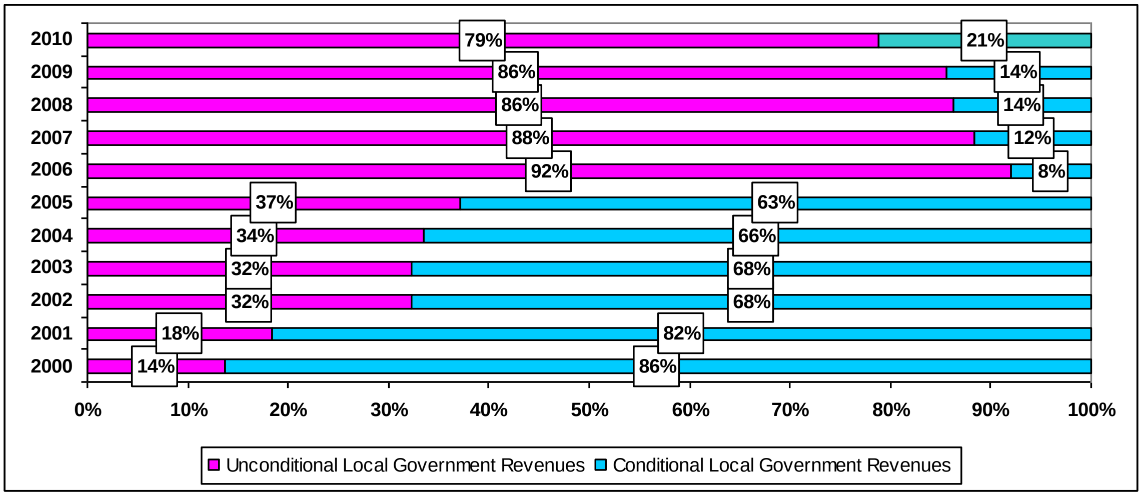
The Albania parliament has approved the law no. 9869, date 4.02.2008 "Local Government Borrowing in Albania", and law no. 10158 date 15.10.2009, on "Bonds of joint stock companies and local governance", which grants to local units the possibility of issuing bonds. Even though the legal basis on local borrowing has often been called "too ambitious" for the current human and financial capacity of the local budgets, the newness that this law brings is considered rather conservative, in the sense that there are no potential forecasted gaps in the local financial administration.

The legal framework aims to expand the financial autonomy of local governance units by giving them the opportunity through this new instrument to take short and long term loans for investment purposes and/or to better face liquidity shortages. Local borrowing can be obtained from local capital markets/financial institutions and banks in the domestic market the same way as in the international market. Additionally, this legal framework aims to guarantee a risk-free market through the establishment of a system which identifies local units facing liquidity problems in debt obligations, by giving the right to the Ministry of Finance to take over the management in these units until they become financially stable.

The basis for assessing the legal capacity of local debt is the unconditional income of local governance units. There are two key components of unconditional income: i) revenues from taxes, fees and other local unit activities, and ii) the unconditional transfers of government, the weight of which differs among local units

The progress made in terms of increased financial resources of local governance is reflected in their revenues (taxes and fees) against the government grants to local units, from 28% in year 2000 to 54% in year 2010. In 2009 revenues and grants to local units were equal, whereas this year revenues are expected to exceed grants. On one hand, this progress increases the discretion to forecast and therefore to attract funds through borrowing, but on the other hand it imposes a more serious work and higher risk to achieve the long-term programs with regard to revenue collection, programs which are actually based on bank loan repayments. Moreover, the budget structure of unconditional transfers to local entities differs from one unit to another, a situation which causes the real absorption capacity of foreign funds and the risk of loan repayment to differ among local entities. Local taxes and tariffs are a whole competency of local government units, but up to the limits specified by the law on local tax system.

Figure 2: Local government revenue in Albania



The above graph shows the level of autonomy on the use of revenues come from central government transfers and from taxes and local fees. That part of the revenues that have full autonomy in their use has increased over the period 2000-2010 which shows the growing trend of the decentralization of functions, powers and the sources of funding for local government.

Despite the conservative approach that this instrument entails, it is considered a strong financial leverage when compared to local budget structures. Data from some local units in Albania (base year 2011), indicate that this borrowing instrument has significantly increased the annual investment portfolio starting from 2.6 times in Elbasan, 6 times higher in Korca, to 17 times higher in Gramsh.

To generalize the multiplying effect of this borrowing instrument, based on the fact that local governments are allowed to borrow up to 1.3 times of their collected revenues of the previous budgetary year, and based also on the fact that budgetary structure in Albania with regard to current/capital expenditure is 60/40% of the total expenditures, we can conclude that local government units can undertake investments up to 3.2 times higher than their capital expenditure of annual budgetary funds.

This multiplying effect is more visible in local government units of small and medium size due to their limited budgetary funds for capital expenditure, and less visible in local government units of bigger size. We could mention for instance the case of Municipality of Elbasan, which, in 2010 took borrow up to 800 ALL (Albania Leke) but the multiplier effect is only 2.6 times given that the budget for capital expenditure in 2010 for this local unit is less than 300 million ALL.

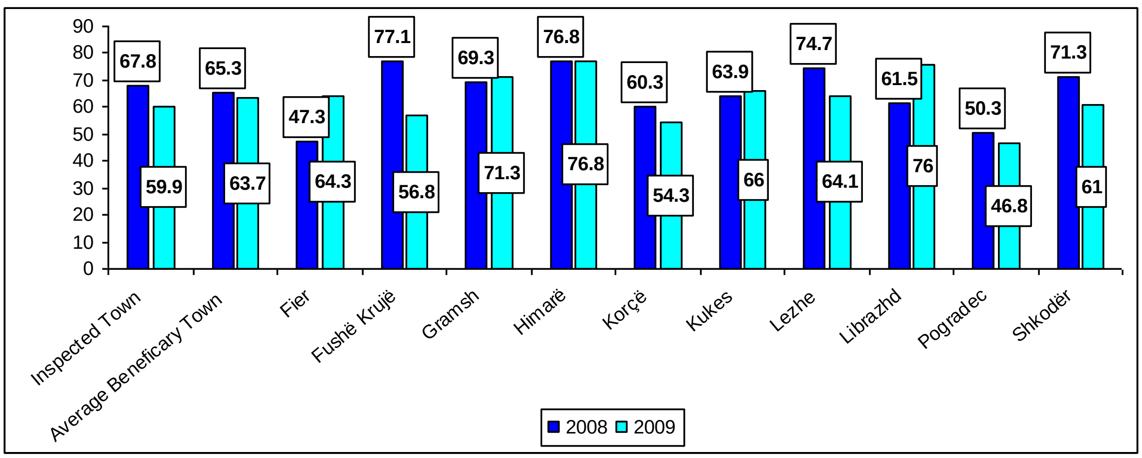
Experience so far has proved that the real borrowing capacity of local government entities, especially in units of small and medium size, is much smaller than the legal limit of stock that they can reach at a specific moment in time. In addition to the limitation criteria explained above, local government units should also fulfill other two criteria related to yearly debt service, i.e the ability to pay yearly debt obligations as they come due. These criteria are assessed and analyzed, to chose amongst many, the one with the lowest rating with regard to monetary obligations. In some cases, even though local units have had a stock limit of 94 million ALL in 2010, the maximum allowed annual debt service is too little, that a long period of time will be required to fully repay the obligations.

3.2 Previous experience in local borrowing in Albania

Althought four years have passed since the approval of the legal framework for local borrowing, its cases are still limited (or still there is a small number of the local borrowing cases). As stated above, this legal framework has certain criteria and restrictions that make it conservative and cautious with regard to lowering the risk of debt default.

The offer and the guarantee for local borrowing are one side of the problem; the other side is how the community and business see this instrument? In order to study the perception of the community and clients, if they would be willing to support the local government unit in using this new funding instrument, in the years 2008 and 2009, the USAID project Local Governance in Albania conducted polls for "The public services of local government" in 20 municipalities of the country.

Figure 3: For answers "Totally Agreed" and "Agreed"



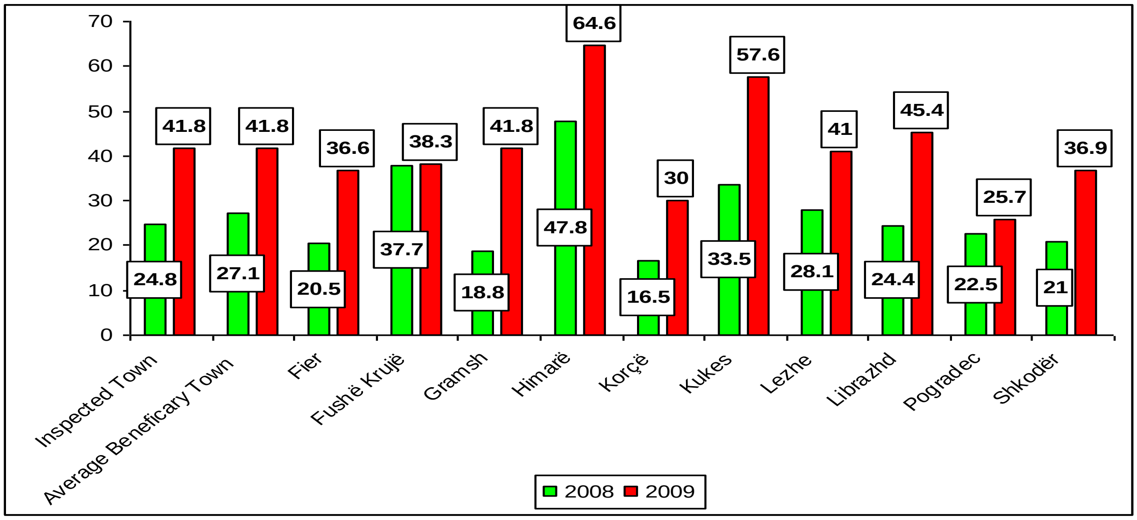
Members of the community and business have been asked:

- Would you agree that the Municipality borrows in order to improve public services?
- If yes, would you agree that the loan could be afforded by the increase in local fees?

Regarding the first question only answers of the interviewers "Totally Agreed" and "Agreed" were processed.

The survey showed that, except Pogradec Municipality where only about 50% of interviewers replied "Totally agreed" and "Agreed", in favor of receiving debt to improve services, in all other municipalities, this resulted in an average figure of over 65 percent, although they did not totally agree on the increase of the local fees to address debt repayment. This was clear from the replies of the interviewers in the second question, "If yes, would you agree that the loan could be afforded by the increase in local fees?

Figure 4: For answers "Yes"

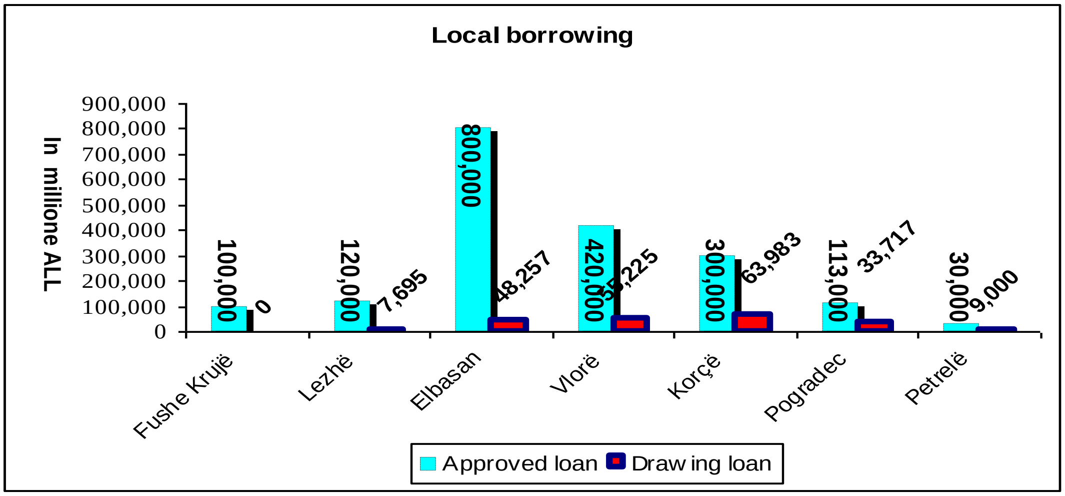


Judging from the data of the above graph, we conclude that in all municipalities, with no exception, the number of interviewers pronounced positively to an increase in local fees in order to meet the loan repayment in the year 2009, compared with a prior year, was greater. Thus, while in the year 2008, the variation width in percentage according to municipalities varied from 16.5 in Korca Municipality, to 47.3% in Himara Municipality, in the year 2009 it significantly increased, both, in the minimal and maximal limits and specifically in Pogradec Municipality it was increase to 25.7% and in Himara Municipality it increase to 64.6 %.

The rising awareness of the communities and management staff of the local government units regarding the positive effects of the local borrowing as a financing instrument, even in case of any increase in local fees to meet the loan repayment, it will serve as a driving factor towards increasing investments, expanding the production and service basis, furthermore improving the employment indicators, thereof the living standards.

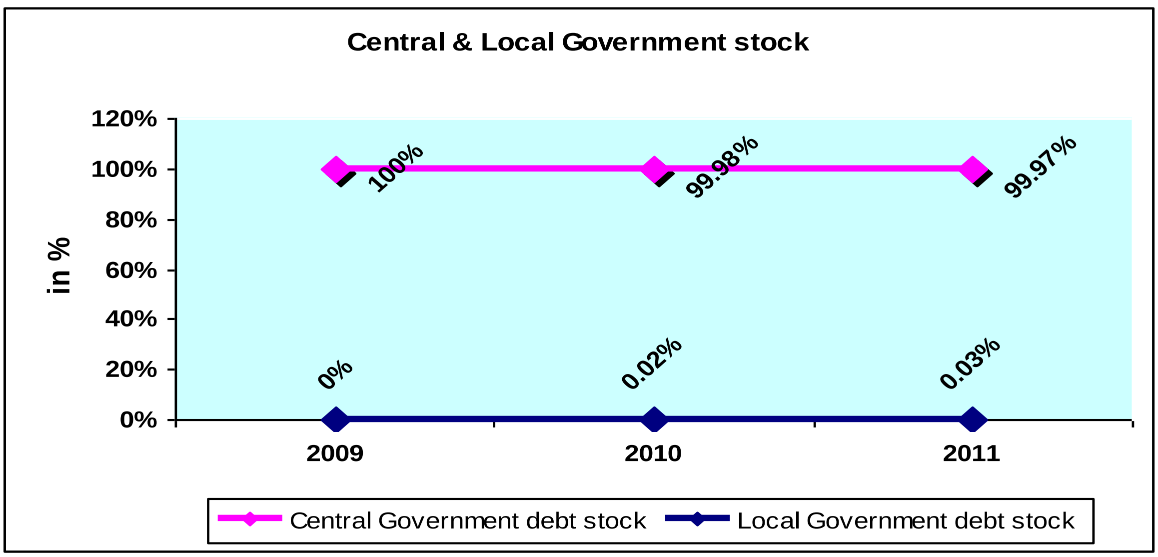
The period in which the legal framework concerning the local borrowing is approved coincides with the onset of the global financial crisis. Meanwhile in this period, in various countries appeared the first problems of public debt. Despite the abovementioned conditions and circumstances that effected even Albania, this financial instrument is not appropriately utilized in favor of investments financing at the local level. So far 16 local units have applied for borrowing, amounting to a sum of 3.823 million ALL, of which are approved from the Minister of Finance 7 local units resulting in an amount of 1.883 million ALL. According to the legal criteria and based on the fiscal performance of the local government during the last three years, the borrowing capacity of the local government has been 12 billion ALL, meanwhile it is approved from the Minister of Finance the sum of 13.3% of this capacity and is disbursed only 1.8% the capacity.

Figure 5: Local borrowing



As observed from the above chart, to the local units receiving loans is disbursed only the sum of 11.5% of the amount approved by the Ministry of Finance and of the contracts signed with creditors.

Figure 6: Central and local government stock



In the year 2010 only 0.02% of total debt stock is composed of the local government debt stock, and in the year 2011, it amounted to 0.03% of the total stock. If we analyze the annual disbursement of loans for the two years 2010 and 2011, it results in a low level concerning the local government. In the year 2010 there were disbursed 0.45% of the public loans, and in the year 2011 only 0.12%, thus in the two years the figures does not reach even 1% of the total disbursed amount of the public debt. The low level of these indicators has also been affected by the order issued by the Ministry of Finance to reduce the level of loans disbursement for the local government units. Under this order, in the year 2010 to the local units was disbursed the loan of only 5% of the amount of budget expenditures of the year 2009, regarding the year 2011 and onwards the restraint is deepened falling to 2.5% of the budget expenditures of the previous budgetary years.

Under these conditions the borrowing opportunity of the local government units is very limited.

4. Findings and recommendations

1. Increased financial and fiscal autonomy of local governments should be accompanied with a special program to increase managerial capacities of the municipalities and communes.
2. Projects that request funding through borrowings must be co-financed with local contributions.
3. A stable local government fiscal legal framework is indispensable in order to avoid the frequent legal interventions.
4. Stabilization and consolidation of the budgetary transfers from the central to the local government.
5. The establishment of objective criteria and transparency increase concerning the regions development fund, which finances investments at local level.
6. Separation of the local government debt limit from the central government debt limit.

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