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THE DEBT OF MUNICIPALITIES IN BULGARIA - THREAT OR OPPORTUNITY

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Abstract

In times of high liquidity in the credit markets and low interest rates, debt financing is an attractive opportunity both for expanding the municipal investment program and for meeting short-term temporary current needs. The purpose of this article is to review the debt financing of local authorities in Bulgaria for the period 2008-2018, to assess whether the macroeconomic risk is currently present on municipal debt in Bulgaria, to analyze the potential risks of rising local debt levels. The change in the municipal debt of EU countries is presented, the examples of the implementation of local debt control and monitoring systems are given.

Keywords: *debt financing, local governments, Bulgaria, financial situation*
JEL Codes: *E62, H63, H74*

1. Introduction

In recent years, we have seen an unprecedented situation of low interest rates, both within the European Union and in the United States. Analyzes and forecasts of experts from OECD the World Bank and the IMF show that low interest rates and high liquidity in banking institutions will continue over the next few years. This brings up issues related to the benefits and risks of debt financing of local authorities. In what situations is it useful to use debt and what are the risks involved in attracted funds? This article has discussed the case of Bulgaria. The development of municipal debt financing over the last ten years has been assessed, and the access of small and medium-sized municipalities to attracted finance has been examined. We are looking for an answer to the question of whether municipal debt carries macroeconomic risk currently. Potential risks and threats related to increased use of attracted funds were assessed. Examples of countries with municipalities with liquidity problems are reviewed. Municipal debt control systems introduced by different countries are presented. The dynamics of EU Member States' sub-national debt financing over the last ten years has been assessed. Recommendations for limitation of the risks in connection with municipal debt financing have been formulated.

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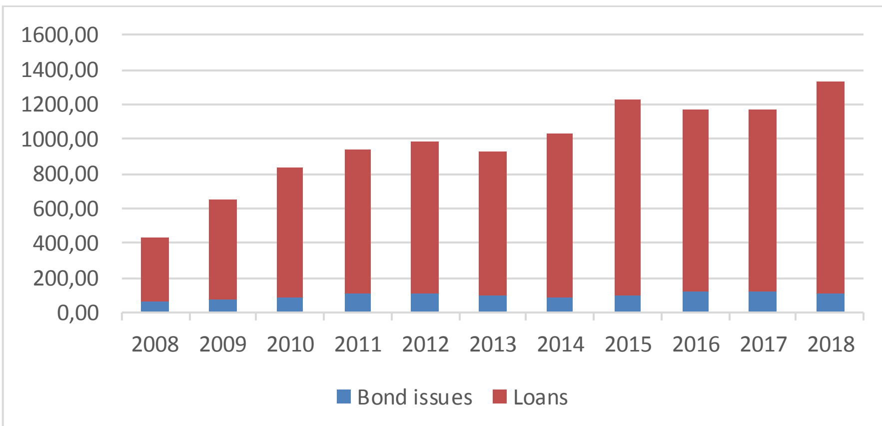
2. Overview of the municipal debt financing in Bulgaria in 2008-2018

Over the last ten years, Bulgarian municipalities have been gradually expanding their access to debt markets. Based on increase of own revenue and development of administrative capacity, large and medium-sized municipalities are increasing their creditworthiness.The process of local debt financing is regulated by the Municipal Debt Act and the Public Finance Act. Figure 1 shows the change of the municipal debt in 2008-2018.

Figure no.1 Debt of Local Government sub-sector 2008-2018 (mill. BGN)



Source: Ministry of Finance, own calculation

For the period, municipal debt increased from BGN 437 million in 2008 to BGN 1334 million at the end of 2018. Loans remain the most actively used instrument by Bulgarian municipalities. Bond issues represent 8-14% from total amount of debt financing of the municipalities for the period. It should be stress that only, the largest municipalities with good level of creditworthiness can use bond issues financing.

Part of the municipalities that use attracted resources under bond issues are Plovdiv, Burgas, Varna, Sliven, Pomorie and Pazardzhik. It should be noted that a significant part of the small municipalities in Bulgaria do not have access to or do not use debt financing. Another part of the small and medium-sized municipalities use debt in moderate size.

For example, the number of **municipalities without debt financing** in recent years is as follows: 2014 - 82 municipalities, 2015 - 81 municipalities, 2016 - 83 municipalities, 2017 - 82 municipalities, 2018 - 84 municipalities (MoF 2020). At the end of 2018, distributed municipal debt has the following structure: 84 municipalities with no credit obligations, 58 municipalities with debt up to BGN 500,000, 38 municipalities with debt between BGN 500,000 and BGN 2 million. , 75 municipalities between BGN 2 million -

BGN 15 million and 10 municipalities with debt over BGN 14 million. **It can be concluded that at this stage a limited number of municipalities have access to large loans.**

The reasons for this are the high dependence on state transfers - the national average is about 58% of municipal revenues (Kalcheva, 2019), low tax revenues and limited sources of own revenues. It should be noted that unlike many countries in the European Union, Bulgarian municipalities do not receive revenue from shared taxes. According EUROSTAT, municipal debt in Bulgaria is 1.2% of GDP for 2018, with EU averages of 5.5% (Annex 1).

2. Municipal debt - threats and opportunities

As it became clear from the analysis, currently we do not identify significant risks and threats arising from the municipal debt in Bulgaria. However, it is not advisable to allow high indebtedness of local authorities in the country. **The main risks** associated with increasing the debt of the municipalities are: the risk of additional imposition of a tax burden on citizens, the manifestation of permanent budget deficits, debt servicing at the expense of municipal services, interest rate risk.

Extremely low interest rates and record lows of the Euribor Index have characterized the debt markets in recent years. Practice shows that some banks even provide loans with negative interest rates. (EURIBOR Interest Reference Site). However, the economic cycle implies a period during which interest rates will gradually rise and return to pre-2011 levels. **This risk should be considered when drafting the long-term projections on debt service, particularly with regard to loans over 5 years.**

In the hypothesis that the municipality is experiencing liquidity problems, there is a risk of an increase in tax rates. It should be borne in mind, that municipal fees are targeted revenue and can only be used to repay debt if those fees originate from the debt financed project. Regarding the transfers, the only general equalizing grants are the source of debt repayment. This defines tax revenue as one of the main sources of debt repayment, it is a major tool for raising own revenues.

Permanent budget deficits can occur when borrowing is inconsistent with the creditworthiness of the municipality and the timing of own source revenues and running costs do not match. *A sharp rise in interest rates not foreseen in the debt repayments projections can also lead to large deficits.* Based on the current conditions on the credit market, it can be assumed that there is also interest rate risk.

Last but not least, inappropriately high debt service costs can lead to a decrease in the volume and quality of goods and services provided by the municipality. At the risk of locking up accounts and activating collateral, borrowers often choose to minimize the cost of services for the citizens. This leads to frustration among the local population. To minimize the risks arising from debt financing, different debt control systems are in place. These will be discussed in point 4.

The main opportunities that debt financing includes are: first and foremost, expanding the municipality's investment program, achieving a fair distribution of benefits and costs between generations, equitable burden of cost and access to benefits ("inter-temporal equity") reducing operating costs, promoting the economic development of the municipality, applying basic methods for analyzing and evaluating investments, securing and improving access to European and international funds, optimal allocation of resources (Swianiewicz, 2004).

Due to the structure of municipal revenues and low tax autonomy, Bulgarian municipalities find it difficult to raise sufficient funds to make public investments. *European funds have been a major source of local investment in recent years*. When implementing European projects, the municipality should ensure its own participation in the project. Often the amount is beyond the budget of the local authorities. Municipalities often use debt financing to ensure their own contribution in the projects.

Large municipalities and medium-sized municipalities with high local revenues rely on attracted resources to implement important infrastructure projects out of EU funding projects. The debt may allow a substantial expansion of the municipality's investment program. However, this must be accompanied by realistic and long-term forecasts that take into account all risks arising from debt financing.

4. Municipal debt control and monitoring systems

According to Teresa Ter-Minassian and Jon Craig, local debt control systems can be conditionally divided into four groups. The authors placed **Market Discipline** at first place. However, in order for this system to work, several prerequisites must be met, namely: the market must be free and open, municipalities should not be perceived as privileged customers of banking institutions, information on residual debt should be available, a publicly available assessment of the creditworthiness of local authorities, there should be no option for financial support from the central government in the event that a municipality is in financial difficulty. According to an OECD report, this approach is rarely used by countries. An example of a country that applies it is Canada.

At the second place, the authors point out the so-called **Cooperative Approach to Debt Controls**. This approach is identified as being closest to market discipline. The restrictions are not determined by law or by the regulations of the central government, but they are the result of negotiations between sub-national authorities and the central government. The scope of the negotiations includes the formulation of macroeconomic objectives and key fiscal parameters to be followed by subnational governments. Countries agree on specific funding limits based on creditworthiness of individual municipalities. The approach is applied in some of the Scandinavian countries and Australia.

The next model to limit the debt is **Direct Controls of the Central Government over Subnational Borrowing**. In direct control, central government explicitly approves local government lending. The approval may be in relation to the maximum amount of the debt, the purpose of the loan or it may involve approval of all parameters of the transaction. Control powers generally encompass not only the ex ante authorization of proposed borrowing, but also the ex post monitoring, on a more or less detailed and timely basis, of the subnational governments' financial operations. (Ter-Minassian and Craig).

Next comes **Rule-Based Approaches to the Control of Subnational Borrowing**. In this approach, the limits and rules for assuming municipal debt are contained in the Constitution or laws. The limits may be to set a ceiling on the maximum amount of debt, to introduce a rule on the purposeful spending of a loan or a rule to comply with certain ratios associated with annual debt service costs. Most countries rely on this approach.

In many countries allowed assumption of debt only for investment purposes etc. the golden rule. It is considered that debt incurred to finance running costs can only be covered exceptionally and for a short period of time.

Regarding Golden rule, it is worthwhile to consider the **example of Bulgaria**. The Municipal Debt Act states that a municipality may incur long-term debt to: finance investment projects for the benefit of the local community; refinance existing debt; prevention and elimination of the consequences of force majeure; securing payments on required municipal guarantees.

However, in 2018, the new options were added as follows: funding for municipal projects for concessions for construction or concessions for services with payments from the grantor; financing in case of temporary cash gaps in the budget of the municipality under art. 103, para. 1 of the Public Finance Act; payment of arrears; financing of projects through financial instruments; payment of arrears; securing payments on temporary non-interest loans at the expense of the central budget under the Public Finance Act.

We can identify as more risky the possibilities for financing temporary cash gaps and financing arrears. Temporary cash gaps arise in the divergence of revenue streams and expenses incurred. Often current costs are underfunded. A substantial part of arrears are current cost also. The texts in the law create a prerequisite for violating the Golden Rule, which in turn can lead to financial difficulties for municipalities. At the same time, the practice has shown that a number of European countries impose additional restrictions on long-term municipal financing. Examples are the ban on financing from abroad (Slovakia and Slovenia), financing only certain types of investments (Denmark and Turkey), etc. (OECD, 2016).

It should be noted that in some countries a combined control system is used, subject to government approval for certain types of credit and the legal definition of limits on annual debt payments, for example. Table 1 shows sample restrictions that apply in EU countries.

Table no. 1 – Debt limitation rules in EU countries – sub-national level

Country	Debt limitation
Czech Republic	Subnational debt services should not exceed 30% of their revenue
Greece	Debt repayment should not exceed 20% of regular revenue
Italian local governments	Interest payments should not exceed 12% of current revenue
Slovak Republic	Loan instalments and interest should not exceed 25% of current revenue from the previous year
Poland	Local governments` debt service has not been allowed to exceed the three-year average sum of their operating surpluses and privatisation receipts

Source: Organization for Economic Co-operation and Development

5. Cases of countries with municipalities with liquidity problems

Italy

In 1999, explicit fiscal rules for regions and municipalities were introduced in Italy in the form of the Internal Stability Pact. The pact is subject to annual changes, incl. topics, objectives, sanctions, monitoring procedures and incentives. This creates tremendous uncertainty for municipalities, regions and governments. The targets are usually set for a predetermined reduction in their deficit, with the exception of 2005 and 2006, where there is a system of annual increase ceilings. Then nominal local values are introduced. The aim is to limit debt and improve the fiscal position of local authorities.

Monitoring is also an important part of the Pact: since 2007, local authorities are required to submit to the Ministry of Economy and Finance information on cash and accrued accounts every three months. The financial and economic crisis of 2008-2009 has a major impact on public finances in Italy. The debt-to-GDP ratio reached the 100% threshold before the crisis, and in 2013 it registered values of 133%. At the same time, according to statistics, local government debt to GDP has fallen over the period as a result of fiscal consolidation measures during the crisis. However, the problem lies in *Off budget debts and arrears*. In the Italian legal framework, off budget debts are defined as debts originated by practices not in compliance with accounting rules. Thus, these debts are not recorded and undermine budget truthfulness and transparency; in addition, part of these debts are not formally recognized. According to Corte dei Conti's estimates, this problem concerns about a quarter of Italian municipalities; and in the time period between

2010 and 2012, off budget debts of municipalities have increased to about EURO 1.265 millions (Ambrosanio M. et all, 2014, p. 24).

In connection with liquidity problems, the Italian Government adopted two decrees in 2012 and 2013 and paid a large part of the overdue obligations to subnational governments. Repayment of the commercial debts in 2013-14 represented perhaps the only counter cyclical fiscal measure that Italy could adopt since the beginning of the crisis while still complying with European rules. It is hard to estimate the impact of these payments on growth. The Bank of Italy (2013) estimates fiscal multipliers which depend on how firms use the amount they receive (close to unity in the case of investment in machinery and working capital, and close to zero for the amounts that firms hold for precautionary purposes); in particular the effects of the measures to unblock general government commercial debts (total EURO 47 billion in the two years 2013-14) on GDP is estimated to be a little over half a percentage point in the three years 2013-15. (Ambrosanio M. et all, 2014, p. 26).

The Italian law has provided the prohibition for sub-national governments to borrow money to finance expenses not related to investments but, in fact, long term debt has been used to cover financial imbalances (not caused by investments) in case of off-balance debt until August 2001. Article 119 of Constitution now provides the constitutional relevance of the so-called “golden rule” for regions and LGs, i.e. the possibility to take on loans exclusively for investments. The Constitution has further been recently modified in 2012 in answer to the EU “fiscal compact” rule that provides a strict control over public finances. (Du Boys, 2014). Returning to the debt control systems, it should be noted that debt approval is being introduced in Italy after negotiations between local, regional and central authorities. At the same time, annual debt ceiling limits and debt payment limits are being introduced. The measures aim at improving and maintaining sound financial stability.

Hungary

After joining the European Union by 2004 Hungarian local authorities gradually began to take on more debt. The aim is to provide funding for the co-financing of European projects implemented by subnational governments. Resources in local budgets are insufficient to ensure their participation in municipal projects. Although municipalities take loans for investment projects, most of the investments do not generate revenue. Meanwhile, on the part of the investments are accrued depreciation and maintenance costs increase over time. *During the 2008-2009 crisis, municipalities are required to pay their loan principals, charge depreciation and pay off loans taken to finance projects. This puts a heavy burden on the municipal budgets.*

In addition, municipalities in Hungary are owners of a number of public companies. These enterprises generate significant debt, which is not recorded in the municipal balance sheet but is stated off-balance sheet. In the event of liquidity problems for businesses, municipalities are committed to providing financial support to their enterprises. At the same time, the interest payments on the loans of the municipalities are increasing, the investment needs are expanding, and lack of working capital to carry out the usual activities of local authorities is starting to be reported.

These factors reinforce its impact on municipal budgets due to the financial crisis. This creates significant financial difficulties for local authorities in Hungary and creates the conditions for consolidation.

The measures taken by the state to stabilize the financial situation of local authorities are as follows:

- At the end of 2011, the debts of municipalities with county rights were settled with the central government having assumed their duties.
- At the end of 2012, a single, non-refundable transfer was granted to communities with less than five thousand inhabitants to settle their debts.
- In 2013, part of the debts incurred by communities with more than five thousand inhabitants was assumed.
- Finally, in 2014, the remainder of the debt of communities with more than five thousand inhabitants was also assumed.
- Two third of local governments took part in the consolidation, which amounted to approx. EUR 4.6 billion. The total debt assumed in the framework of consolidation was equivalent to 4.2 percent of GDP.

In the middle of 2013, Hungary was released from the European Commission’s excessive deficit procedure (Bethlendi and Lentner, 2018).

Conclusion

Debt financing provides significant opportunities for expanding the municipality's investment program and for economic growth in the individual regions. At the same time, the use of attracted funds poses significant risks, such as uncontrolled increase in the tax burden, the creation of liquidity problems and the deterioration of fiscal discipline.

The municipal debt in Bulgaria has been increasing in recent years. However, many local authorities do not have access to the debt markets due to limited own revenues. Municipalities with large debt exposures are subject to serious monitoring by the Ministry of Finance. Currently, municipal debt does not carry significant macroeconomic risk.

In order to minimize the risks arising from municipal debt, various debt control systems are in place. However, in times of economic crisis and recession, subnational governments are in financial difficulties. The practice has shown that most often the state financially supports local authorities in order to improve their fiscal position and due to the lack of bankruptcy or bankruptcy procedures for local authorities. Many countries have examples of this, and the study presents the examples of Italy and Hungary.

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Annex 1.

Government consolidated gross debt - local level (% of GDP)

GEO/TIME	2008	2010	2015	2018
European Union	**5.3**	**6.3**	**6.4**	**5.7**
Belgium	5	5.2	5.8	5.1
Bulgaria	**0.6**	**1.1**	**1.4**	**1.2**
Czechia	2.3	2.5	2.4	1.6
Denmark	6.4	6.9	7.2	6.7
Germany	5	6.5	5.9	5
Estonia	3.1	3.7	3.5	2.8
Ireland	2.9	3.3	1.7	1.4
Greece	0.7	0.9	0.9	0.7
Spain	2.9	3.3	3.3	2.1
France	7.5	8.2	9	8.7
Croatia	0.9	1.4	1.6	1.4
Italy	7.8	8.2	8.4	7.2
Cyprus	2.2	2.3	2	0.7
Latvia	3.9	6.6	6	5.6
Lithuania	1.2	1.6	1.9	1.1
Luxembourg	2.3	2.4	2.1	1.6
Hungary	3.8	4.6	0.2	0.5
Malta	0	0.1	0	0
Netherlands	7.2	8.2	8.1	7.3
Austria	2.5	3.6	4.2	4.2
Poland	2.3	3.8	4.4	3.9
Portugal	5	6.1	6	5
Romania	1.8	2.5	2.5	1.8
Slovenia	0.9	1.7	2.1	1.8
Slovakia	1.9	2.7	2.3	2.1
Finland	5.3	6.4	8.9	9.1
Sweden	6.2	6.4	10.3	11.4
United Kingdom	4.3	4.5	4.6	4.7
Norway	9	11.6	14.7	15.5

Source: EUROSTAT