

---

**FINANCING LOCAL ECONOMIC DEVELOPMENT THROUGH THE FINANCIAL MARKET - SITUATION AND PERSPECTIVES IN REPUBLIC OF NORTH MACEDONIA****Florije Miftari**Faculty of Economics, AAB University, Prishtina, Kosovo, [florije.miftari@universitetiaab.com](mailto:florije.miftari@universitetiaab.com)

**Abstract:** The process of reform and fiscal decentralization in the Republic of North Macedonia is already in the second decade of implementation, the legal deadline of which was 2007. However, local government units are still lagging behind in the realization of many of their functions and legal competencies, mainly as a result of lack of financial means, lack of knowledge or lack of capacities to access on alternative sources of funding. An important instrument of financing, especially for financing local and regional economic development are municipal bonds, which are considered the most used financial instruments for financing local and regional capital projects in almost all developed countries of the World, but still in Republic of North Macedonia, no municipality has used this funding source. It is reasonable and necessary that this practice to be developed also in North Macedonia that would result in the realization of strategic municipal projects and at the same time will have an impact on the development of the capital market. Therefore, the purpose of this paper is to analyze the factors, causes and barriers of non-application of municipal bonds in North Macedonia as a financing instrument by the municipalities. Also in this paper are analyzed and evaluated the opportunities and constraints, benefits and risks, criteria and budget constraints of municipal bonds as an additional or alternative source of financial resources for financing local and regional economic development.

**Keywords:** municipal bonds, local government, financing, local economic development.

**1. INTRODUCTION**

Asset collection through the municipal bonds instrument, local government units will enable timely and sufficient provision of funds for realization of local capital projects with more acceptable cost compared to other borrowing sources, a source that would enable acceleration of development of capital projects and at the same time local economic development. In developed market countries, investors prefer to invest their savings in municipal bonds since municipal bonds have the lowest level of risk, debt payment is guaranteed with all municipal property and tax potential of the self-government unit. Another motive for purchasing is that insurance companies and banks can be the guarantor for debt repayment, which is often the biggest buyer of these bonds. In addition, in many countries income derived from interest is exempt from taxation. In terms of investment, interest rate is attractive to investors and the risk of investing in municipal bonds is smaller by the fact that the issuer is the local or regional government. In the Republic of North Macedonia, the partial implementation of the decentralization process as well as the realization of functional decentralization in the absence of sufficient fiscal decentralization influenced that almost all municipalities, in the fulfillment of their legal competencies, on one hand face the need for delivery many municipal services, while on the other hand faced serious financial shortages, creating huge debt burdens.

The financing system of the units of local self-government in the Republic of North Macedonia, based on the law on the financing of local self-government units<sup>42</sup>, mainly supports these main sources: its own source revenues and revenues from state budget funds. The legal regulation also allows municipalities to create financial resources from other sources, from borrowing and issuing bonds but under certain conditions set by law. Although this possibility exists since 2004, until nowadays, no municipality in the Republic of North Macedonia has secured funding sources from this instrument, the reasons for not using the municipal bonds are numerous such as the possibility of issuing municipal bonds also limited by incomplete legal regulation and conditional on the transition of municipalities to the second phase of decentralization, i.e the legal right to use this financial instrument dates back to June 2007; the underdeveloped financial market; lack of tradition and experience in the realization of the bond issuance process; lack of relevant professional staff in municipal administrative bodies to carry out the emission process; failure to inform potential investors for this form and investment opportunities, etc. Unfortunately, until today, this financial instrument has not yet been utilized by municipalities, although some municipalities have recently attempted to meet the conditions for issuing municipal bonds, but no municipality has yet realized any issue. In addition to the above mentioned conditions, municipalities should obtain or secure a credit rating from an international rating agency.

---

<sup>42</sup> Official Gazette no. 61/2004, 96/2004, 67/2007, 156/2009, 47/2011

---

Thus, the municipality of Kumanovo, Gostivar, Gevgelija and Stip, from the international credit rating agency Moodys, received the rating "B1", while the municipality of Skopje, Ilinden received the mark "B2".

## 2. CHARACTERISTICS AND TYPES OF MUNICIPAL BONDS

Communal bonds are debt securities issued by federal states, regions, and cities. The purpose of which is the financing of local infrastructure projects such as: construction of roads, sewers, water supply, schools and other public projects. During issuance, local government (issuer) borrows from buyers of municipal bonds (investors) by promising return on principal and interest over a specified time period and at a certain value. The ever-increasing need for capital infrastructure projects to provide better and better living conditions on the one hand, and the lack and limitation of fiscal revenues of local and regional budgets have led local authorities to seek alternative sources of additional resources for the realization of investment projects. In countries with a higher level of democratization and decentralization, characterized by advanced economies and developed financial markets, in recent years, there is an attempt for the central government to offer more opportunities and freedom to local self-government units to spend funds and create additional financial means. Many developed cities and federal states in the US and Europe solve the problem of financing capital infrastructure projects by issuing bonds, ie issuing municipal bonds. For example the first municipal bonds were issued in New York City in 1812 and by the end of 2010 the cumulative value of the bonds (bonds) issued in the US amounted to \$ 2.9 trillion<sup>43</sup>. According to the Federal Reports, the size of the bond market communes issued by states and local government of the US amounted to \$ 4.26 trillion in 2017<sup>44</sup>. The treasury bills were issued for the realization of numerous infrastructure projects such as: construction of primary, secondary school buildings, and universities; roads; government administrative buildings; research institutes; transport infrastructure such as roads, airports, railways, bridges, ports, etc; electrical capacity; hospitals, houses for low-income families; etc. Municipal bonds were also issued by local self-government units of European countries such as France, Germany, Great Britain, Sweden, Belgium, etc. Several municipalities in Croatia, Montenegro, Serbia, Bulgaria and others have also realized some of the capital projects with the help of issuing municipal bonds.

## 3. MUNICIPAL OBLIGATIONS NEW TOPIC AND NEW CHALLENGE FOR REPUBLIC OF NORTH MACEDONIA

Despite the fiscal decentralization reforms, the Republic of North Macedonia still remains a country with very low fiscal decentralization rates compared with transition countries and with EU member states. According to the data of Ministry of Finance, the share of local government revenues in the GDP of Republic of North Macedonia in 2006 is 3%, whereas in 2007 as a result of the transfer of competencies and the increase of the block grants, the share of revenues of total communes reaches 4% of GDP.

The permanent lack of financial resources compared to decentralized municipal functions and competencies has caused the municipalities in the Republic of North Macedonia to generate huge obligations. Thus allowing the public debt of municipalities in 2008 to reach the value 0.4 million euros, in 2009 it amounts reach to 0.3 million euro<sup>45</sup>. According to the report of the National Bank of North Macedonia, 355 million denars are the requirements of the depository financial institutions to local government units for eligible loans (334 credits in denars and 22 million credit in foreign currency). The amount of reported and unpaid obligations of municipalities and user units, finally in September 2018 amounts reach to 5.9 billion denars. (96,680,474.00 Euro, according to the average exchange rate of National Bank of North Macedonia)<sup>46</sup>. According to the structure of debts almost all municipal obligations are towards suppliers and a very small part are in the form of borrowings received by financial institutions. Municipalities in Macedonia have the right to generate income from borrowing even that of short-term borrowings, covering the temporary lack of cash in the municipality, but not for the payment of penalties and interest rates. The total amount of short-term debt withheld during the fiscal year can not exceed 30% of the total realized revenues from the municipal budget in the previous fiscal year. With long-term debt the municipality may be charged for financing capital investments, for refinancing debts created on the basis of capital investment and investment, for the protection and elimination of consequences from elementary disasters. The total amount of the annual debt payment

---

<sup>43</sup> Neil O'Hara (2011) "*The fundamentals of municipal bonds*" sixth edition, John Wiley & Sons, Inc New Jersey.

<sup>44</sup> <https://www.federalreserve.gov/data/govsecure/current.htm>, watched on March 12, 2019

<sup>45</sup> Ministry of Finance of the Republic of Macedonia "Annual Report 2009 for implementation of the public debt management strategy of R. e. Macedonia ", Skopje. March 2010

<sup>46</sup> Law on Financial Support to Local Self-Government Units and Local Authorities of Local Authorities to finance outstanding and unpaid obligations. Official Gazette of RM, no. 209 and 15.11.2018.

(principal, intrinsic rate and other expenses) can not exceed 30% of the total municipal budget revenues in the previous fiscal year. The value of total uncollected debt including all guarantees can not exceed the total amount of municipal operating budget revenues realized in the previous fiscal year. The municipality may also borrow in the international financial market but only with prior consent of the Government.

Based on the Law on Financing of Local Self-Government Units, and with the recent changes to the legal regulation on public lending and securities law, and the adoption of regulations on securities issuance procedures, we can say that, a legal basis for issuing municipal bonds was created. However, in practice, the municipalities in the Republic of North Macedonia, so far has failed to issue municipal bonds. According to the results of the respondents, the reasons for not using this instrument are numerous and different, which can be summarized as follows:

- ✓ lack of knowledge and experience for the realization of the emission process; even in somecases, lack of interest and impartiality for the application of this instrument.
- ✓ Failure to comply with the legal conditions for issuing.
- ✓ The need for training and education of administrative workers for municipal bond issuance procedures.
- ✓ An underdeveloped financial market, the bond market structure in Republic of North Macedonia is comprised of state bonds, bonds for devaluated foreign exchange bonds and bonds for denationalization and very few corporate bonds;
- ✓ Municipalities do not possess property in their ownership in order to guarantee the return of principal and interest rate;
- ✓ lack of transparency, ie investor information on the possibility, advantages and benefits of investing their capital in this type of securities.

Recently, some municipalities have come up with the first signals of their interest and readiness to provide funds for infrastructure projects using this non-fiscal resource, and not only that, municipalities have made concrete activities to meet the conditions for issuing bonds utility. One of the many conditions is also the definition of a credit rating by an international agency for credit rating. Thus, municipalities of Kumanovo, Gostivar, Gevgelija and Stip from the international agency for credit rating Moodys have received the rating "B1", while the municipality of Skopje, Ilinden has received the rating "B2". According to estimates, Moodys considers investment in these municipalities as "high speculation" investment, meaning that bonds issued by enterprises, state and municipalities that have this estimate are buying by investors who want more risky investments. Macedonia as a state by Standard & Poor's has a credit rating "BB", which means that the bonds issued by the state are also non-investment and speculative, but have a higher level than the one for the five rated municipalities "High level of speculation". According to Moodys, the factors that limit the credit rating of municipalities are the inflexible budget structure, the large infrastructure needs and generally the poor quality of management and management in these municipalities.

Thus, for the time being, the above-mentioned municipalities are in the preparatory phase but have not yet begun issuing communal bonds.

### **3.1 Issue of municipal bonds**

The Law on Securities stipulates that municipalities must initiate a procedure for issuing municipal bonds to have an estimate of credit rating by an international agency. Further, the debt burden procedure continues with the submission of a debt claim to the finance ministry. The necessary data that the municipality attaches to the request are: Decision of the Municipal Council for debt relief; the purpose of the debt load; proposal the conditions under which the municipality wishes to be owed; completed forms for debt relief; information on the source of funds; Mayor's statement whether there are unexecuted obligations toward suppliers within 90 days from the day of delivery. The Ministry of Finance will provide a positive opinion on the debt burden of the municipality through issuance of bonds, if it finds: reconciliation of the debt value in compliance with the limits set out in the Law on Financing of Local Self Government Units; harmonization of the value of debt with the public loan targets and the fiscal deficit<sup>47</sup>. Under the Securities and Exchange Regulatory Law, securities can be issued in two ways:

**Public offering.** The Public Offering of Securities under the Law presents a public call for the purchase and registration of securities through public information media. For the issuance of bonds through public offering it is necessary: decision by the municipal council for issuance of bonds; the selection of external consultants and the conclusion of a contract with the bond issuing agent; permission from the Securities Commission to issue bonds through public offering.

**Private placement.** Private placement represents a direct offer of bonds to a limited number of investors, with which the municipality has previously created an agreement for the purchase of bonds. Issuance of bonds by this method

<sup>47</sup> Public Debt Law , (Official Gazette of the Republic of Macedonia No. 62/2005 and 88/2008) and The Instruction on the manner and procedure of debt burden of municipalities and public enterprises in the Republic of Macedonia

by issuers is needed: decision by the municipal council for issuing bonds through private placement; finding an institutional investor interested in bonds (banks, insurance companies, investment funds or institutional funds); and permission from the Securities Commission for issuing private placement bonds. According to this method, it is not necessary to compile and declare the prospectus. When issuing municipal bonds, the following facts should be taken into account: the current financial situation of the municipality, current solvency, debt loads, long-term financial situation, municipality's ability to determine additional revenues through new taxes, etc. For the assessment of the quality of the debt, the analysis of some coefficients is needed as: eg. debt per capita; coefficient of debt (cost) cost as a percentage of the total municipal budget; In addition to these coefficients, social and demographic trends that may endanger the ability to pay off debt in the future are taken into account.

**3.2 Why do municipalities use municipal bonds rather than bank loans to finance capital projects?**

Emission and placement of municipal bonds is a democratic financing method, local government is the one who independently decides on the terms of issuance as: the manner and purpose of the utilization of the funds, the amount of the issue, the interest rate, the grace period, the type of bonds, the dynamics of principal and interest rate, which is an absolute precedent in comparison to the terms of the loans standards that are determined and conditioned by the financial institutions.

Issuance of municipal bonds increases the financial responsibility and transparency of local authorities, whereby potential financial and development performance is presented to potential investors and to the wider public. Local self-government units, their creditors should present transparent, accurate, clear information about their income and expenses and their ability to generate debt servicing surplus. Investing in the savings of citizens in municipal securities, besides generating income for investors, at the same time increases the contribution of citizens through their investment to influence the construction and improvement of municipal infrastructure by creating better conditions for living in the community which live and operate, in a way link citizens financially with the district in which they live and operate. The interest rate of municipal securities is usually lower than the interest rate on loans provided by financial institutions.

**Table 1: SWOT analysis of municipal bonds**

	<i>STRENGTHS</i>	<i>WEAKNESSES</i>
	<ul style="list-style-type: none"> <li>✓ Lower interest rates unlike classic borrowing through credit lines;</li> <li>✓ Increased transparency of the issuer, financial stability that enables the access to the capital market;</li> <li>✓ Simultaneous collection of the necessary financial funds;</li> <li>✓ Faster realization of capital projects.</li> </ul>	<ul style="list-style-type: none"> <li>✓ An underdeveloped financial market with a small number of participants;</li> <li>✓ Absence of full financial transparency for municipal activities;</li> <li>✓ Uncontrolled debt loads through this instrument may increase the level of public debt of the country;</li> <li>✓ Municipalities do not own a real estate property that would reinforce investor safety;</li> <li>✓ The fiscal autonomy of municipalities in determining municipal taxes and fees is limited;</li> <li>✓ Municipal bonds in the Republic of North Macedonia are a very small segment of financial instruments;</li> </ul>
	<i>OPPORTUNITIES</i>	<i>THREATS</i>
	<ul style="list-style-type: none"> <li>✓ Faster mobilization of financial funds;</li> <li>✓ Supplementary financing that will not come from the central government budget;;</li> <li>✓ Financial independence from the central government; realization of capital projects of economic, social and municipal infrastructure;</li> <li>✓ Local and regional economic development; improvement of living conditions and standards;</li> <li>✓ Increasing investment, production, employment;</li> <li>✓ Improving local economic conditions</li> </ul>	<ul style="list-style-type: none"> <li>✓ Risk of changing the interest rate,</li> <li>✓ Risk of early payment of the bond (call and repayment risk)</li> <li>✓ Credit risk,</li> <li>✓ Liquidity risk, appears</li> <li>✓ Inflation risk</li> <li>✓ Risk of investors' lack of interest in this instrument</li> </ul>

#### 4. CONCLUSION AND RECOMMENDATIONS

Despite regulating and defining the legal framework that provides the legal basis and opportunity to enable local self-government units in North Macedonia to issue municipal bonds, the low level of fiscal decentralization, financial dependence of municipalities from the state budget, poor management, lack of budget transparency, macroeconomic circumstances of the country. etc. will affect that in the future, municipal bonds as a financial instrument for providing funds for financing municipal investment projects will remain a new challenge and challenge for many municipalities, investors and the financial market in the Republic of North Macedonia. The main factors that have affected the application of municipal bonds remain in the preparatory phase are: budget deficit, debt loads, underdeveloped secondary market, credit rating of the country and poor municipalities, lack of transparency, lack of tradition, lack of professional skills and other factors. Considering the factors that hinder the use of municipal bonds in North Macedonia, we suggest to undertake these activities:

- Capacity building through the organization of workshops and seminars that will enable local self-government units through concrete examples and good practices to enable the issuing procedures of this financial instrument.
- Municipalities should be given clarification on the opportunities offered by municipal bond issuance as an important instrument for collecting financial resources and increasing the financial capacities of local self-government units especially in times of financial crisis where the provision of low-cost financial resources is increasingly difficult
- Raising investors' awareness that investing in municipal bonds will bring greater benefits than the proceeds from depositing funds to a financial institution. That by investing in these instruments contribute to the realization of capital projects that will improve the quality of the local public services of the community in which they live. That the income realized from this investment are exempt from tax, etc.
- Improving management and leadership with municipalities
- Increasing the transparency of municipal budget performance and financial stability
- Investigating investors' interest in investing in municipal bonds
- Encouraging municipalities to issue municipal bonds for infrastructure capital projects that will generate revenues from their use.

Municipal bonds are one of the most used financial instruments to finance local and regional capital projects in almost all developed countries of the world. It is reasonable and necessary that this practice to be started also in the Republic of North Macedonia that would significantly contribute to the realization of strategic municipal projects and at the same time will have an impact on the development of the capital market.

#### BIBLIOGRAFY

- Bubas Z. (1995) *“Municipalne obveznice”* Finansijska praksa 19(2), , Institut javnih finansij Zagreb
- Daniel Platz *“Infrastructure finance in developing countries-the potencial of sub-soverein bond”* DESA Working paper nr. 76, July 2009.
- Frank J. Fabozzi Series (2008) *“The handbook of the municipal bonds”*. John Willey& Sons, Inc New Jersey.
- Guidelines on the Manner and Procedure for Debt Burden of Municipalities and Public Enterprises in the Republic of Macedonia.
- Law on Financing of Local Self-Government Units (Official Gazette of the Republic of North Macedonia no:61/2004 ,96/2004, 67/2007, 156/2009, 47 /2011)
- Law on Local Self-Government (Official Gazette no. 52/2002)
- Law on Securities (Official Gazette of the Republic of Macedonia no:95/2005, 25/2007, 7/2008,57/2010,135/2011).
- Ministry of Finance of the Republic of Macedonia "Guide for issuing municipal bonds, February 2011.
- Neil O'Hara (2011) *“The fundamentals of municipla bonds”* sixth edition, John Willey& Sons, Inc New Jersey.
- OECD (2016), OECD Regions at a Glance 2016, OECD Publishing, Paris.[http://dx.doi.org/10.1787/reg\\_glance-2016-en](http://dx.doi.org/10.1787/reg_glance-2016-en)
- Public Debt Law, (Official Gazette of the Republic of Macedonia no:62/2005 dhe 88/2008)
- Rulebook on the Form and the Contents of the Request for Borrowing by Public Institutions Established by the Republic of Macedonia and the Municipalities, Municipalities in the City of Skopje and the City of Skopje ("Official Gazette of the Republic of Macedonia" no. 83/2011)
- [www.finance.gov.mk](http://www.finance.gov.mk)
- [www.nbrm.org.mk](http://www.nbrm.org.mk)
- [www.mse.mk](http://www.mse.mk)
- [www.zels.org.mk](http://www.zels.org.mk)

