FISCAL FEDERALISM AND BORROWING OPPORTUNITIES OF LOCAL COMMUNITIES

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Abstract

The principles of the European Charter of Local Self-Government were accepted and incorporated in the legislation of Bosnia and Herzegovina. Fiscal federalism is classified in the area of public finance theory that studies the system of collection and distribution of resources in the public sector with two or more levels of government. In practice, in the public sector we have an increasing presence of a trend of decentralization of powers and jurisdictions of the state through: the transfer of political power and the transfer of influence from higher to lower levels of government. Decentralization achieves some of the following goals: reducing the share of public sector in the overall economy, mobilization of public revenues while reducing the cost of public services, harmonization of responsibilities for local public expenditures and the available financial resources, boosting of own revenues of local authorities, promotion of cooperation between different levels of fiscal government in provision of public services.

Characteristic of the mechanisms of financing of local government units in Bosnia and Herzegovina are different levels of development, which is why there is a need to find financing models that would meet the needs of local population and achieve the highest possible level of harmonization of standards, as well as a higher degree of fiscal decentralization. The theory and practice developed the forms of financial equalization: vertical financial equalization and horizontal financial equalization. According to the principles of the European Charter on Local Self-Government, local authorities have the right to adequate sources of financing which they shall freely use within the framework of their powers. Funding sources should be appropriate to their powers. Objectification of allocation of public revenues by levels of state organization is achieved through harmonized policy for allocation of public revenue and fiscal equalization policy at all levels of government.

A significant part of the local units’ budget is quite meagre and strict. This is particularly true in local units in which most of the revenues are non-tax revenues. These non-tax revenues

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have established intended use (mostly for the cost of maintenance functions of the local community and large constructions). Such tying of revenue with precisely set use prevents local governments to be more flexible in allocation of budgetary resources. Based on the analysis of debt and borrowing of local government units, as well as research, we came to an assessment that there are real conditions and opportunities for local government borrowing in Bosnia and Herzegovina. Local units mainly borrow from a bank (or banks) in which they have deposited funds and whose accounts are used for cash management. There are few incentives and initiatives for borrowing by issuing of municipal bonds. One limitation is the lack of interest or knowledge to present all the costs and benefits of planned capital investments and to assess the financial potential and ability to repay debt. Promising modalities of financing of local communities in Bosnia and Herzegovina are those of public-private partnerships and emissions of municipal bonds that would require reliable demonstration of justification of borrowing purposes at the time of approval.

**Keywords:** Fiscal federalism, Local communities, Fiscal equalization, Public debt, Budget, Public-private partnerships, Emission of municipal bonds.

**Introductory considerations – European Charter of Local Self-Government**

Three basic theoretical principles of local democracy in the world are:

- Freedom (autonomy) – local democracy implies the existence of the bodies of self-government that will limit the concentration of political power of the central government, which allows a different political choice in different local units;
- Participation (democracy) – the existence of local self-government bodies that allow a greater inclusion of citizens in matters of self-government;
- Efficiency – capacity of local authorities to provide different, efficient, services at the local level.

The European Charter of Local Self-Government (Council of Europe, Strasbourg, 15 October 1985) is the first multilateral legal instrument that defines and protects the principles of local autonomy incorporated in the concept of modern pluralist democracy, developed and promoted by the Council of Europe in order to safeguard the common values as a platform of uniting the European countries. It is a result of a number of initiatives that have preceded it, (for example, the Declaration of Local Autonomy, proposed for adoption in 1968 by the then Conference of Local and Regional Authorities (1), or the Resolution no. 126 of 1981, which provided the first draft of an internationally binding document, eventually adopted by the Committee of Ministers of the Council of Europe in June 1985).

The Charter has no pretensions to impose a model of local self-government which would apply to all member states, regardless their mutual major political and economic differences, and therefore it does not regulate in detail its structure and powers.
Its aim is to build standards in establishing, functioning, assessing and protecting the level of government closest to the citizens and thus to ensure effective participation of members of a specific local community in decision-making about what relates to their everyday lives.

“Local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population.

This right shall be exercised by councils or assemblies, composed of members freely elected by secret ballot on the basis of direct, equal, universal suffrage, and which may possess executive organs responsible to them. This provision shall in no way affect recourse to assemblies of citizens, referendums or any other form of direct citizen participation where it is permitted by statute.

Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.

Local authorities’ financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.

Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of the statute, they have the power to determine the rate.

The financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.” (Council of Europe 1985)

The need to protect financially weak local authorities requires the establishment of appropriate procedures or measures of financial equalization, in order to rectify the consequences of unequal distribution of financing sources, or financial burden of local authorities. Such procedures or measures cannot narrow the rights of local authorities that they have within their jurisdiction.

The principles of the European Charter of Local Self-Government have been accepted and incorporated into:
• The Law on Principles of Local Self-Government in FBIH (Official Gazette of FBIH, 49/06; 51/06)
• The Law on Local Self-Government of the Republic of Srpska (Official Gazette of the Republic of Srpska, 101/04, 42/05 and 118/05)
Fiscal federalism and the position of local communities in the financing system

In a broader sense, fiscal federalism includes the relations between the central government and regional and local collectives. Uncoordinated definition and collection of public revenues has a number of negative economic, social, political and financial repercussions since all observed public and legal entities of different levels of government claim the same fiscal potential. Disharmony in the collection and disposal of public revenues by different levels of state organization on purely financial plan has a negative reflection on the rational use of public revenues and harmonious satisfying of public needs. Therefore, a fiscal agreement is necessary as a system of norms that delimitate and coordinate the relations in the financing of public expenditures by levels. The most significant components of the fiscal agreement are contained in the domains of delimitation of powers in defining the duties, the regime of allocation of public revenues and disposal of funds. “Fiscal federalism is part of the theory of public finance which deals with the problems of decision-making, possibilities of tax apportionment and the use of funds collected in the public sector with two levels or more levels of government” (Bajo and Alibegović 2008 : 42).

In the world, and so in the region, an increasingly present trend is the trend toward decentralization of powers and jurisdiction of the state through:
• Transfer of political power, and
• Transfer of effects from higher to lower levels of government.

Such decentralization achieves many goals:
• Reduction of the share of public sector in the overall enterprise,
• Mobilization of public revenues while reducing the costs of public services,
• Ensuring that the responsibilities for local public expenditure are in line with available funds,
• Strengthening of own revenues of local authorities, and
• Promotion of joint cooperation between different levels of fiscal authorities in the provision of public services.

The sources of revenues of local communities consist of:
• Tax revenues allocated from higher levels;
• Own financial resources;
• Grants and subsidies (fiscal equalization).

**Tax revenues that are allocated from higher levels:**
• Revenues from VAT and other indirect taxes (since 2006) which, despite the relatively low participation of municipalities in these revenues (approximately 8%) constitute a very important source of funds (on average between 20-30%);
• Revenues from income tax and other direct taxes;
Funds collected from taxes and contributions that fully or partially belong to local communities as own source revenues.

**Own financial sources:**

The structure of public revenues allocated to LSUs consists of:
- Taxes,
- Charges,
- Fees.

*Taxes* are a form of compulsory levies imposed by the state, but without specific use and have no direct consideration by the state or the level of authority that imposes them.

*Charges* are cash income of the state or LSUs, depending on who imposes them. The obligations payment thereof is not limited to citizens of the country that imposes this obligation, but the territorial principle applies to the payment of charges. Revenues from charges are used to finance public needs and are declarative state revenues. In some of their characteristics, the charges significantly differ from taxes because they are a consideration for the service that the state provides to a taxpayer. As tax, charges also have elements of compulsion, which can be seen in the following: (a) the obligation of charge and the amount of the obligation is unilaterally established by the state authority, (b) some of the rights or actions can be realized only after the payer has initiated the due procedure, or done a specific action, and (c) unsettled obligations will be charged by force. For a paid charge, the payer gets a particular consideration. Therefore, the closest definition is that the charges are “partial payment by a user of the costs of a public service that he has voluntarily requested either on his own behalf or which he was imposed in the name of the use”.

*Fees* are public revenue, and in its purpose are basically very similar to charges and are introduced as compensation for consideration of a particular organ or institution that provides the service. The difference in relation to the charges is based on the entity that is authorized to prescribe it. The right to introduce fees belongs to institutions that perform the tasks of wider interest, not only those of the state.

*Fines*, according to the meaning of the word, are prescribed sanctions in criminal and misdemeanour law that obliges the offender to pay to the state/entity/municipality a specific amount of money.

It follows from the above that LSUs independently or within the set limits determine the amount of administrative, utility fees and fines that are in the jurisdiction of municipalities, while special water charges and fees, income from games of chance and municipal fees for the use of natural and other resources of general interest are in the jurisdiction of other organs.
According to the structure of revenues that (according to the Law on the Budget System of the Republika Srpska) belong to towns and municipalities, we can conclude that they are based on the principle of the territory where they are exercised, or where the property or a form of organization of games of chance is located and on which the services are provided by a public authority or institution.

Thus determined public revenues are intended to compensate for the costs of providing certain services by a public authority or institution (charges) and to compensate for the costs of maintaining a certain function (fees, real estate tax). The public revenues allocated to LSUs only partially have a social component, redistribution of income (tax on winnings from games of chance, real estate tax, fines).

Bearing this in mind, the rates (taxes), amount of charges, fees and fines are calculated on a cost basis; the costs of collection and maintenance costs. To the extent to which the policy of charges and fees could provide compensation for material costs and personal income of employees, then the part of distributed public revenues provided from the distribution from the single account on the basis of indirect taxes and income taxes would contain the development component.

Grants and subsidies (mainly with a specific purpose):
- Grants and subsidies from higher levels of government,
- Grants and subsidies from other sources.

In all political systems, there is an increasing sense of justification of fiscal decentralization and increased participation of local communities in public funds, which has its base in the following facts:
- Transfer of political power and influence from higher to lower levels of government,
- More efficient public sector,
- Mobilization of public revenues while reducing the costs of public services,
- Satisfying different local interests and needs for public resources and services,
- Better access to public services required by the local population,
- Ensuring that the responsibilities for local public spending are in line with available funds.

In the current system of financing the public expenditure, units of territorial autonomy and local self-government have an ultimately narrowed degree of fiscal authority. The system of related separation has been abandoned; it was a system in which the local self-government units were able to introduce taxes from the legally stipulated circle, to determine the amount of tax rates of these taxes within the limits of the agreed policy, to use the incentives through giving tax reliefs and exemptions and to collect not only from taxes that belong to them but also from the taxes that belong to the Entities through decentralized (municipal) services of public revenues. This is a regime of shared revenues from ordinary taxes by which local self-government units
have the right to generate revenue from certain taxes without any impact whatsoever on its amount and collection. This also means the exclusion of the option to create local “tax oases” on the basis of tax incentive measures of local fiscal authorities, primarily in taxation of revenues from independent activity, which, in addition to certain weaknesses, have a positive function primarily in the economic sphere. In fact, a sort of competitive relationship between the local self-government units has a positive impact on felling of fiscal pressure on a broader scale and on the development of economic activities that are related to local conditions.

In states organised as federation, as well as in unitary states, with respect to the presence of territorial autonomy and local self-government, there is not only a problem of jurisdiction and powers in respect of the establishment, implementation and determining the amount of public revenues and their collection, but also a problem of distribution or allocation of given types and forms of public revenues by the levels of political and territorial organization.

Various models and their variants are possible in the application.

In theory, certain criteria have been clearly specified, which should be taken into account in the constitution of the relationship in the distribution of public revenues vertically so to comply to the maximum extent with the requirements of functionality and rationality, and in the operationalization to adjust to the specifics of socio-political organization, the capacities of fiscal resources and their structure.

- Abundance of sources from which the duties are paid. Less abundant resources would belong to only one level of financing, public expenditure. However, the most generous sources of income, such as the taxation of trade, should be used by the immediate and wider political and territorial units, i.e. a system of separation and shared revenues should apply.

- The nature and importance of the sources and objects of duties. Those sources that are of importance to the overall flows of social reproduction should be covered with fiscalities belonging to the state and Entities, and those duties that include objects and sources of regional and local importance should belong to the units of territorial autonomy and local self-government;

- Position of individual administrative-territorial units observed by levels in the socio-political system. A pronounced degree of fiscal sovereignty of the Entities and local government in municipalities and towns require the application of a combination of related separation and shared sources, so that the local collectives would have available both separate revenues and participation in shared sources.

Of course, it is not possible to satisfy each of these and other possible criteria. They are often contradictory, so that they have a cumulative instead of an alternative character. In order to achieve the global optimum, their combination is necessary.
Sometimes one of them should be given the priority, and some should not even be taken into consideration, depending on the present situation. Objectification of the distribution of public revenues by levels of state organization is achieved by agreements at all levels of government.

Needs (expenses) and means (income) should be determined by each other, and should be a reflection of the principle of harmonization, application of which achieves the main goals of an allocative, redistributive and stabilization policy.

The realization of the principle of harmonization should be a reflection of the application of the basic principles of fiscal federalism:

• principle of efficiency,
• principle of fairness,
• principle of low administrative costs and
• principle of meeting the fiscal needs.

System of fiscal equalization and the position of Local Self-Government Units (LSUs) in Bosnia and Herzegovina

The basic characteristics of mechanisms of financing of LSUs in Bosnia and Herzegovina are:

• The degree of development of LSUs is different in general,
• The need to find financing models that would meet the local needs of the population and harmonize standards as much as possible,
• It is necessary to achieve the greatest possible degree of fiscal decentralization (measured by the LSUs’ share of revenues in GDP).

Under active financial equalization or financial equalization in the narrower sense, we imply the regulation of the distribution of public revenues. Therefore, the object of observation is now the tax system, i.e. a single consistent whole of tax forms.

In theory and practice, there are forms of financial equalization, namely:

• vertical active financial equalization,
• horizontal financial equalization.

Certain forms of active financial equalization have a very important practical significance for public revenues.

In vertical active financial equalization, there is so-called mixed system that combines the system of its own (source) revenues and the system of shared revenues.
Mixed system of public revenues allocation is actually a variant of both forms, which practically means that certain administrative-territorial units, in order to finance expenditures under their jurisdiction, partly dispose the revenues, and earn one part by participation in other territorial units. This practically means that sovereignty is divided into a number of territorial units. In the practical terms of the model development, this would mean that the customs own source revenues, which are allocated upwards (state level), should also be distributed downwards (cantons); that revenues from special taxes, so-called excise taxes, that are the revenues of Entity budgets, should be directed toward the cantons. Also general taxes on turnover of goods and services would have to be distributed upwards (Entity), as are allocated downwards (municipality). These rules could be valid partially with other tax forms, such as profit tax and income tax, as expressed representatives of direct taxes. Tying these taxes to the economic power of companies and citizens should have a significant redistributive and regressive role. The existing model of allocation of profit tax ignores both of these criteria, which is particularly negatively reflected on the economically developed regions that are losing financial strength through the classic form of “spillover” of income and creation of greater consumer power in the administrative-territorial units with the seats of companies in the field of energy, postal services (ptt), as well as with the head offices of commercial banks, insurance companies and funds.

Since we have a constant tendency to the development of administrative-territorial structure, two approaches are objectively confronted:

• First, in the stressed centralization,
• Second, in the stressed decentralization.

Surveys conducted in the area of public finance point to certain aspects of the problems that need to be borne in mind in Bosnia and Herzegovina’s practice, namely:

• territorial organisation or building the state structure of Bosnia and Herzegovina,
• functions and distribution of responsibilities of certain levels of the state structure (separation of functions of the state and of the local communities: cantons and municipalities),
• system of financial equalization and fiscal capacity,
• tax sharing,
• non-tax forms at the local level,
• budgetary balance and borrowing opportunities,
• preparation of consolidated balance according to the government levels and forms of demand (current and capital),
• planning and financing capital projects (water supply, road communication, etc.),
• planning, execution, control, internal monitoring and auditing (internal and external),
• organization and development of the tax administration,
• professional training for all participants in the process of budgetary and extra-budgetary financing.
Financing Local Economic and Infrastructural Development

According to the principles of the European Charter of Local Self-Government, local authorities have the right to adequate funding sources, which they dispose freely within their powers. Sources of funding should be appropriate to their prescribed responsibilities.

Local authorities should be consulted regarding the methods on the basis of which they will be allocated the redistributed funding sources. As much as possible, the funds that are transferred to local authorities should be consistent with the volume of assumed responsibilities and subject to the system of public control. Allocating these funds may not jeopardize the discretion right of local authorities to conduct policy in the framework of their powers.

To allow the borrowing for capital investment, it is necessary to allow the local authorities to access the national capital market.

Diversity and resilience of the municipal revenues are provided through the structure of municipal revenues:
- From indirect taxes,
- From direct taxes,
- Fees and charges,
- Fines and other penalties,
- Income from property,
- Donations.

Financial equalization has been built-in through the model of the distribution of revenues from the Treasury Single Account – TSA – BIH.

The distribution is made on the basis of the following formula (Anon. 2006):
- 68% based on the population of the local government unit;
- 5% based on the surface of the local government;
- 20% based on the number of pupils in primary education;
- 7% based on the level of development of municipalities, defined through the development index.

For the first time, the system based on the derivation has been replaced with a system based on a clear and simple formula, which has ensured that municipalities and cantons can make a safer planning of public revenue and expenditure.

Although it is very difficult to predict how the political situation in the country will develop in the future, there is a possibility that in the same way as a unique system of equalization for the FBIH has been established we develop such a system for the whole country in the future. Only in this way it is possible to reduce the existing differences between the Entities, and thus to strengthen the integrative forces in the state.
During 2012, the generated public revenues of municipalities and towns in the FBIH amounted to:

Table 1: Overview of the total realized and distributed public revenues for the period January – December 2012

<table>
<thead>
<tr>
<th>Type of revenue</th>
<th>Total public revenues 31/12/2012</th>
<th>Total public revenues of municipalities 31/12/2012</th>
<th>% of total public revenues in FBIH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax revenues</td>
<td>2,778,252,232</td>
<td>321,176,881</td>
<td>11.6</td>
</tr>
<tr>
<td>Non-tax revenues</td>
<td>944,664,801</td>
<td>271,019,983</td>
<td>28.7</td>
</tr>
<tr>
<td>Extra-budgetary funds</td>
<td>2,650,467,398</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>6,373,384,431</td>
<td>592,196,864</td>
<td>9.3</td>
</tr>
</tbody>
</table>

Source: Federal Ministry of Finance, archives

In the Republika Srpska, the sources of funding for local communities are:
- Tax revenues,
- Non-tax revenues,
- Grants,
- Transfers,
- Proceeds from assets,
- Proceeds from borrowings.

Revenues from indirect taxes
- The main source of revenues for all levels / part is used for servicing foreign debt
- Revenues from indirect taxes, paid in the budget of Republika Srpska from the Single Account of the Indirect Tax Authority, which, after the allocation of a part of funds for servicing of foreign debt of Republika Srpska, are distributed as follows:
  - The remainder is divided as follows:
    - RS 72%
    - Municipalities and towns 24%
    - JP Putevi RS (PE Roads of the RS) 4%

Revenues from income tax
- RS 75%, municipalities and towns 25%

Revenues from the change of use of agricultural land
- RS 30%, municipalities and towns 70%

Revenues from the concession fees for use of mineral resources
- RS 30%, municipalities and towns 70%
Financing Local Economic and Infrastructure Development

Revenues from special water fee
- RS 55%, municipalities and towns 30%, Fund for Environmental Protection of the RS 15%

Revenues from confiscated proceeds and funds from the sale of seized items under the jurisdiction of the Republic Administration for Inspection Activities
- RS 70%, municipalities and towns 30%

Distribution of revenues collected on the previously mentioned bases
- The share of municipalities and towns in these revenues is determined according to the following criteria:
  - 75% based on the population
  - 15% based on the surface
  - 10% based on the number of students in secondary schools
- The system of distribution is determined by a formula that considers the period of ten years
- Coefficients of distribution in accordance with this formula are established by the Government of Republika Srpska (Anon. 2003).

Borrowing opportunities and constraints of local units in Bosnia and Herzegovina

Based on the analysis of debt and borrowing of local units, as well as on surveys, we can say that there are objective conditions and opportunities for borrowing of local units in Bosnia and Herzegovina.

A significant part of the budget of local units is quite stiff. This is particularly true for the local units where most of the revenues are non-tax revenues. These non-tax revenues have a specified purpose and established intended use (mostly for costs of maintenance and capital construction). Such tying of revenues to concretely set use prevents local units in a more flexible distribution of budgetary resources. In addition, the financial position of local units can be improved because on the revenue side there is a problem of fiscal discipline or collection of non-tax revenues (revenues under special regulations).

Competition of local units for borrowing in financial market also affects the strengthening of criteria for borrowing. There is often the question of quality of the financial management of local units. Poor quality of financial management of local units results from the lack of vision in using financial resources. Local units mostly borrow from banks (or a bank) in which they deposit the funds and whose accounts they use for cash management. There are few incentives and initiatives for borrowing by issuing municipal bonds. One of the constraints is the lack of interest or knowledge
to present all the costs and benefits of planned capital investments and to assess the financial potential and ability to repay the debt.

Undeveloped market and public debt management is one of the constraints that does not encourage local units to use municipal bonds more actively. The state has not yet defined the criteria or conditions for borrowing by issuing bonds. The fact is that the government has not initiated an organized management, and the market of domestic public debt is transferred directly to local units that show no deeper interest in the use of local government bonds.

For banks and financial institutions that lend to local units there is still a problem of assessing the credit risk of local units. Specifically, comprehensive information on local units that would encompass financial business is still missing. The impetus for the publication of information may be indirectly given by commercial banks.

The question of borrowing by institutions and enterprises owned by local communities is related to their prior approval in the capacity of a majority shareholder or founder. Granting warranties/guaranties to shareholder companies, limited liability companies (d.d. and d.o.o.) or to institutions by the local communities creates additional risk, which has the character of a potential credit risk which, in principle, in total creates additional financial risks and potentially increases non-tax burden of citizens. Institutions and utilities owned by local communities may borrow in short and long term. Short-term borrowing is related, mostly, to business with the bank. The framework of short-term borrowing should be monitored at the level of the local community when it comes to financing of current expenditure. To finance capital projects, local companies and institutions borrow long-term loans from banks or by issuing bonds. Corporate bonds are debt securities that may be listed on a stock exchange. The procedure of borrowing and issuing guarantees of local communities (municipality, town, Canton) is provided by the Entity Law on Debt, Borrowing and Guarantees and on the basis of the Law on Borrowing, Debt and Guarantees of Bosnia and Herzegovina (Anon. 2005; Anon. 2007; Anon. 2012). The decision on borrowing of utilities should be based on the calculation of the obligations and ways of their settlement (annuities or instalments), as well as their impact on non-tax burden and increasing of utility charges and contributions. Therefore it is essential to make an assessment of financial capability to repay the debt per given guarantees which may cause an increase in the total debt of local communities and an additional fiscal burden on citizens. Thus, the debt of local community could be presented as the sum of all accumulated obligations based on loans, issued guarantees on debts of utility companies and institutions as well as due to unpaid obligations.

Therefore the debt management requires the following information:
• conditions of borrowing of institutions and utilities at the local level;
• establishing the credit rating for local units and utility companies owned by local communities;
• determining the value of assets and liabilities of enterprises and institutions owned by local communities;
• procedures for approval of guarantees based on assessments of the effects of borrowing on the budget of local communities;
• conducting the performance audit procedures on the basis of borrowing of enterprises and institutions owned by local communities (Bajo 2006).

Final assessment and recommendations: Possible modalities of financing of local communities in Bosnia and Herzegovina

Public-Private Partnership (PPP) – the basis for generation of revenues of LSUs (local self-government units)

Public-private partnership (PPP) is a long-term contractual relationship between public authorities and private partners/entrepreneurs, in which for the purpose of building the public infrastructure and/or providing a public service, the private partner assumes the obligation of financing, design, construction and/or upgrading, and possibly the provision of public services, while the public sector sets standards of services and reserves the right to perform monitoring for the entire duration of the contract.

PPP is between the traditional public procurement and the privatization. It is important to identify the circumstances under which the PPP model may be the best way to deliver certain services or construction of infrastructure in comparison with the traditional methods of public procurement.

In the scheme of PPP, the private partner bears partial or full costs of the project implementation, as well as a key part of the risk associated with the construction and operation. The public partner determines the output specifications for the design and the technical and operational characteristics of the project, and determines the payment mechanism either through regular payments (e.g., in annual instalments) that are associated with the availability of facilities and compliance with the output specifications, or through direct payments by end users in the form of charges (e.g. tolls).

The objective of the PPP is to include private partners in the implementation of projects or in the provision of services in order to ensure not only additional financial resources, but also the use of their knowledge, human resources, innovative approach and ability to effectively manage complex projects in the public interest.

The main advantages of PPP are the following:
Financing of multiple projects

Due to the growing demand for public services, which the state administration is more and more unable to satisfy alone, there is a need for support from the private sector. During periods of slow growth, state revenues are often insufficient to cover the necessary expenses, which results in sharp costs cutting or tax raise. Partnerships allow unimpeded continuation or even higher level of services even at lower costs. By developing partnerships with the private sector, the state can maintain quality of services despite limitations in budget and offer its citizens a wider range of works and faster and more efficient services.

Risk distribution

A key principle of PPP is the distribution of risks to the party that will best manage those risks at the lowest cost. To ensure the achievement of the best value, the goal is to optimize rather than maximize risk transfer, resulting in a significant reduction in costs and in exceeding of deadlines. Moreover, the fact that the private partner is also responsible for the project implementation results in better services with greater functionality throughout the duration of the project.

Improvement of the investment environment

PPP model mobilizes greater investments than those that the public sector alone could provide, and thus offers a possibility to various representatives of the private sector and investors to participate in infrastructure projects, develop innovations and develop new activities. The long-term nature of PPP projects results in the establishment of financially stable trade companies with predictable cash flows that contribute to market and promote the growth of the economy.

Greater benefit and satisfied citizens – value for money

This is a result of the application of knowledge of private companies in the respective areas of work and their motivation that stems from the possibility of long-term revenues meeting all requirements of contracts relating to the quality of provided services, which the public sector assesses and controls for the entire duration of the contract.

In PPP projects, the private partner is selected through an appropriate public procurement procedure. PPP is implemented through contracts which clearly agree and define all aspects of a project, not only during the construction phase, but also in the operational period of the building, or in the period of service provision – also including the obligations of both contractual partners. After the end of pre-agreed period of duration of a project implemented according to the PPP model, the building is transferred from the private to the public partner.
Project financing and cost reimbursement

After the completion of the public procurement procedure, the selected private partner as a rule establishes a joint business entity for completing the project

- Construction of the project, and
- Operation and exploitation of the project or maintenance under the provisions of the contract.

In general, a smaller part of the funds come from the private partner or from its capital and the bigger part of these are bank loans. Joint business entity is responsible for the construction of the project infrastructure (construction, rehabilitation of the existing infrastructure, installation of equipment, etc.) and for the provision of pre-agreed services during the contract period, using either its own resources or subcontractors’ services to satisfy the criteria set by the public partner. During the project duration, the private partner is paid either by the public partner who pays to the joint business entity the regular payment by instalments (payments for availability) or by payment by the end user. In return, the joint business entity repays loans and, if it generates profit, it pays dividends to its investors on the basis of return on equity.

From the explanations of the legal provisions regarding the public-private partnership, it is clear that LSUs can play an active role in initiating the procedures of contracting of the public-private partnership, which represents a quality basis for generating new revenues for LSUs (Anon. 2010).

Issuance of municipal bonds

Municipal bonds (bonds of LSUs) are debt securities by which the local government as the issuer commits to repay the borrowed funds with a certain interest until a certain date. They have an identical purpose as government bonds, with proviso that the funds collected are invested in projects of local and regional importance, while government bonds finance the projects of general national and state interests.

Many public facilities that are located in the area of LSUs are funded by municipal bonds of LSUs, which are repaid from the collected tax revenues.

Interest on municipal bonds may be paid exactly in the same way as the government bonds:
- at once
- together with the principal at the time of maturity of the bond,
- periodically, i.e. in instalments.

Municipal bonds may be:
- long-term,
Municipal bonds are primarily a lending instrument, but they can also serve as a means of payment to the local government (e.g. for the payment of taxes).

Municipal bonds are one of the safest securities, because the state (LSUs) guarantees for their payment and they are therefore regularly traded on the secondary market of securities.

Municipal bonds are transferable securities. An investor in municipal bonds has two basic options:
• to hold the municipal bonds to maturity with the regular payment of interest and principal, and thus to achieve a return that he has bought; or
• to sell the municipal bonds at any time prior to maturity to any other interested investor with an opportunity to generate a capital gain or loss thereby.

Issued bonds are used for different purposes, such as renovation of roads, construction of residential and office building with garages and parking lots, and investment in sports facilities and playgrounds and so on.

Municipal bonds are issued in non-material form, in the form of electronic records in the series; they are personal, freely transferable and uninsured. Municipal bonds are uninsured, direct and unconditional obligations of the issuer, which are mutually equal and have the same rank with all other present and future uninsured obligations of the issuer, other than obligations that may take precedence under the law.

It is evident that LSUs in the region underuse the opportunity to obtain additional funds by borrowing through the issuance of municipal bonds. Issuance of municipal bonds offers possibility of obtaining large amounts of capital at a time, with a lower interest rate compared to other borrowing instruments. The conditions under which municipal bonds are issued prove the mutual profitability for both the issuers and the investors.

The use of municipal bonds may be very wide. Basically the collected money is used for the construction of local infrastructure such as sports facilities, roads, schools, hospitals, utilities, etc. They are significant also because they enable local population to invest their money in their own town or municipality, obtaining favourable interest rates. In addition, the return that the municipal bonds bear is attractive not only for small, but also for institutional investors (funds, insurance companies, banks). They can also be issued to cover the budget deficit of LSUs or for financing of specific
projects, the cash flow of which will cover the bonds. Revenue municipal bonds generally carry a higher risk, so they are often insured by large insurance companies.

The advantage of borrowing through the issuance of municipal bonds is a lower interest rate compared to borrowings, the tax reliefs and an increased accountability of government representatives due to the expressed transparency of the whole process. By building better infrastructure, LSUs increase the standard of living at the local level and create the conditions for more rapid development of the real sector through greater inflow of foreign investment. In addition to real effects, bonds of LSUs can have positive marketing effects on the LSUs.

Municipal bonds usually have a high nominal value, which is why they are not affordable for small investors. Most often, institutional investors such as banks, insurance companies and investment funds invest in them. Through investment funds, municipal bonds may be available to small investors as well. Investment units of funds of municipal bonds will be bought by investors aiming at income from investment for which the fund does not pay tax, so that the resulting return is higher.

References

Anon. (2003) Law on the Budget System of RS, *Official Gazette of the Republic of Srpska*, No. 96/03; 14/04; 67/05; 34/06; 128/06, 117/07, No. 54/08 – Consolidated text, 126/08, 92/09.


