

Municipal bonds – an instrument to develop local communities

Authors:

Adrian Lupușor

Dumitru Pîntea

Sergiu Gaibu

Stas Madan

Tatiana Savva

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Disclaimer

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Introduction

This study aims at exploring one of the main viable instruments that could be used by the Local Public Authorities (LPA) for developing the localities and to fortify the local autonomy – the local bonds. In the international practice, these are also called municipal bonds that represent securities issued by cities or other forms of local authorities. Based on these instruments, the LPAs can borrow financial means in order to obtain financing, usually for capital investments.

In the Republic of Moldova, although the legislation foresees the possibility for local authorities to issue bonds by local authorities of all levels, however, up to this moment, no such entity has engaged in such activities. The causes are multiple, both legal, investment and even financial infrastructure ones. On the one hand, interacting with the capital market requires that the LPA have special financial and economic forecast competencies. On the other hand, the legal framework does not seem to be favourable both in terms of municipal bonds issuance as much as investing in them. As well, the national capital market remains shadowed by the banking system, the possibilities allowed by the latter being limited and also, little known.

The first chapter offers an overview of the current legislative and normative framework provisions in order to reflect the mechanism on issuing municipal bonds. This refers to the conditions in which the municipal bonds can be issued, the purpose of issuing, the Ministry of Finance endorsement, the stages of the issuing process and reimbursing the loans attracted as a result of issuing the bonds. The emphasis is made on the aspects that limit somehow the possibility to implement this instrument, particularly: (i) the inequitable fiscal regime of investments in municipal bonds, (ii) the indebtedness cap set at 20% from revenues excluding the special destination transfers and (iii) the impossibility to issue bonds in foreign currency.

The second chapter analyses the international practice, because in the majority of states from the region, issuing municipal bonds is the simplest way to attract a pool of investors from outside of the banking sector. Particularly, the chapter analysed in detail the evolution of the local bonds market from 3 states in the region, an experience which is relevant for the Republic of Moldova. The analysed states are Romania, Bulgaria and Serbia.

The third chapter analyses the LPAs revenues, particularly if they allow real financial autonomy and how financially sustainable they are to issue bonds. The analysis of local budgets is crucial in the context of discussions regarding the local bonds, in light of respecting prudential norms and avoiding the transformation of this instrument in financial and electoral adventures. The chapter analyses the local tax base, the indebtedness level of the LPA and the local financial autonomy degree of the LPA, especially from the perspective of issuing local bonds.

The fourth chapter presents the opportunities related to issuing municipal bonds. Aside from the advantages and opportunities presented by the municipal bonds, certain criteria that must be respected for ensuring success in using this instrument are specified.

Overall, this study emphasises the legal, fiscal, financial and institutional barriers that prevent the LPAs to issue bonds, as well as presents a set of policy recommendations based on the experience of other states comparable, in terms of valuing this instrument, by respecting prudential and good governance norms.

Executive summary

Next to the classic loan instruments as bank loans, the state, companies etc., the local authorities have other possibilities, less known ones. This concerns the possibility to issue securities, here referring to bonds, which can be used to attract the needed capital for implementing certain investment projects under circumstances that are far more favourable than bank loans. Even if this may be the case, the Republic of Moldova does not register for the time being any bond issuing mechanism, except for the ones issued by the Government for financing the budget deficit. Thus, the local companies or authorities do not use this instrument, particularly due to different legal, investment or even financial infrastructure causes. Moreover, the interaction with the capital market requires special financial and economic forecast competencies that very few authorities have.

At the international level, the term „municipal bonds” is a generic term referring to the securities issued by cities or other types of local authorities. According to the national legislation, the municipal bonds are loan instruments that can be issued by local public administration authorities. The LPAs in Moldova are first-level local authorities – village town governments and second level – rayons and autonomous territorial units. Based on these instruments, the local authorities can take out loans in order to obtain financing, usually for capital investments (road infrastructure, water and sanitation, renovating public buildings or purchasing long term equipment) or refinancing a long term debt previously contracted, also in order to make capital investments.

Although theoretically, the national legislation allows the local authorities to contract loan through the issuance of bonds, up to this moment, such operations were not registered. This is due specifically to a legal framework that is both unfavourable for issuing as much as for investing in municipal bonds. Particularly, referring to the following:

- i. **Unfavourable fiscal treatment that the foreign investors are facing** – currently, the tax legislation foresees the distinct taxing of investments in different financial instruments. Thus, the sources obtained from investments in bonds are not taxed by the state, while the revenues obtained from investments in municipal bonds by local authorities do not benefit from any tax exemption;
- ii. **The caps on long terms indebtedness of LPAs** – the local authorities can contract a long-term loan only if the total amount of annual payments will not exceed 20% from the total own revenues of the local authority. An exception is made for the Chisinau and Balti municipalities, where this cap is set at 30%. Under the circumstances that the annual revenues of some LPAs are relatively low, the gradual limitation of the indebtedness level at 20% from the total own revenues create a disadvantage for the LPAs to actually start issuing bonds. This constraint is relevant especially for the medium to large municipalities, except for Chisinau and Balti, for the firsts having a 20% cap set, despite their solvency.
- iii. **The process of issuing municipal bonds is a different and a more complex one, as opposed to issuing state securities.** As opposed to state securities, issuing municipal bonds can be carried out only according to provisions of Law no.171/2012¹ on capital market, respectively, the issuing must be based on a prospectus, be intermediated by an investment society and must

¹ The Law on the capital market no. 171/2012, https://www.legis.md/cautare/getResults?doc_id=121171&lang=ro#

be implemented based on an endorsement from the Ministry of Finance. Obtaining this endorsement involves fulfilling other conditions, especially conditions that regard the reimbursement financial capacity and also on how the money will be allocated.

- iv. **The impossibility to issue bonds in foreign currency.** Even if the local authorities can access loans in foreign currency from international financial institutions, the same does not apply to bonds, that can be issued only in the national currency. This limits the group of potential investors by making the respective investment unfavourable for foreign investors, representatives of the diaspora or the ones who want to make placements in foreign currency.

In international practice, issuing municipal bonds represents the simplest way to attract a pool of investors from outside the banking sector. The success stories regarding issuing municipal bonds are associated with a series of preconditions as the existence of tax facilities adjacent to these loan instruments, a well-established investment plan as well as the existence of certain filters in order to maintain the management of the local debt in optimum parameters. Another attribute of the success of municipal bonds is a robust capital market, although there are examples that show that municipal bonds can constitute themselves an incentive for developing the capital market, as it could happen also in the case of the Republic of Moldova.

The experience of more states reflects more opportunities provided by the municipal bonds for local development. The most common advantages for the local communities when using the municipal bonds stand in the flexibility of establishing reimbursement terms and conditions, the equitable burden of costs and the access to benefits, avoiding additional costs through finalising more rapidly the projects, access to non-reimbursable resources from European funds and other development funds and the increase of visibility and investors' trusts.

In the case of Moldova, the municipal bonds can become viable financial instruments, an alternative to the classic loan method, that could be used for local investment projects. Provided that the respective bonds constitute a financing instrument, not an investment one, it needs, on a mandatory basis, to indicate in the project the revenue sources for managing and paying back the bonds. For this reason, the most suitable financing projects are as follows:

1. Community investment project that will provide direct revenues to the LPA (connecting new areas to water and sanitation, renovating the service networks provided to the community)
2. Infrastructure projects that will increase the number of investors and the volume of investments, that will indirectly lead to an increase in LPA revenues by enhancing the tax base and the mandatory taxes (industrial platforms, new residential neighbourhoods etc.)
3. Co-financing grant projects, in case the LPA will not have their own resources available so that due to the bonds issued by the LPA, they will be able to benefit from enhanced financial leverage that is made available only if a co-financing mechanism is implemented.
4. Re-financing more expensive previously contracted loans.

The main recommendations in regards to promoting municipal bonds in the Republic of Moldova:

- Standardizing the tax regime related to investments in bonds (providing fiscal facilities similar to the ones available for state bonds).
- Extending the indebtedness cap to 30% for all the cities with municipality status, as well as for the ones with a budget registering strong own revenues.

- Establishing the possibility to issue bonds in foreign currency, and ensuring that all prudential provisions are respected (the indebtedness cap, in this case, should be 15% from own revenues).
- Developing a program on promoting and financing municipal bonds.
- Simplifying the procedures for issuing municipal bonds.
- In the process of promoting municipal bonds, aside from the aspects related to solvency, foreseen by the legislation, it is important to ensure the integrity of utilising this instrument. In particular:
 - The process to identify the financing needs and investment field need to be transparent and consulted with representatives of the local communities.
 - Selecting the intermediary for issuing bonds needs to be a transparent process and in line with the public procurement process.
 - Managing the attracted resources must be in line with the public procurement requirements and be applied by using the public procurement electronic platform.
 - It is necessary to make public the information regarding the final beneficiary of the investor that purchases municipal bonds (this information doesn't need to be public, but it must be made available to the competent authorities in light of preventing conflict of interest, arranged investments or any other type of corruption).
 - Issuing bonds must be a process open for participation to anyone interested in investing. At the same time, in case the process is made as a private one, this action must be preceded by a transparent and competitive process on identifying the private investor/s.

1. Legal aspects regarding the issuance of municipal bonds

Although, theoretically, there is the possibility that LPAs issue bonds as debt instruments (municipal bonds), up to now, no LPA has implemented this mechanism. The causes are different: legal, investment, or even those related to the financial infrastructure. On the one hand, interacting with the capital market requires specific financial and economic forecast competencies. On the other hand, the legal framework does not seem to be favourable both in terms of issuing municipal bonds as much as investing in them. As well, the national capital market remains shadowed by the banking system, the possibilities allowed by the latter being limited and also, little known. This provided, this chapter will describe the main normative and legal framework provisions in order to explain the mechanism for municipal bonds issuance with an emphasis on those aspects that somehow limit the possibility to put this instrument into practice.

1.1 What are the municipal bonds?

On the international level „municipal bonds” is a generic term referring to bonds issued by cities or other forms of local authorities. From the national legislation point of view, the municipal bonds are financial instruments that can be issued by level I local public authorities (village and commune town governments) as well as level II LPAs (rayons and autonomous territorial units)². At the same time, even if these bonds would be issued by state authorities, the issuing mechanism would differ from the one on government securities, being similar to the mechanism applied in issuing corporate bonds (issued by private entities).

Many LPAs can borrow from banks, but the current situation in which the banking sector is at the moment shows that it is a good time to develop new instruments. The interest rates are at historical minimums supported by a surplus of liquidity in the banking system. The agents who need capital, including the LPAs, encounter difficulties to finance their long-term investments due to the low maturity offered by banks. Under these circumstances, the municipal bonds may be the solutions through which the cities can attract long-term capital for implementing investment projects, whether referring to an own contribution to projects financed by budget funds³ or projects funded by external partners, or an individual investment project that is needed for the locality.

Next to the proper financial circumstances, the development of the national financial system and new financial instruments is a priority for the state authorities as well. Thus, the *Non-banking financial market development Strategy for 2018 - 2022*⁴ seeks to enhance the capital market activity through bond issuance, including municipal bonds, which would ensure optimum conditions for financing investment programs implemented by LPAs. Next to this, for a few years now there have been discussions on decentralization and increasing local autonomy in order to provide better quality services to the citizens. In this regard, the municipal bonds can be that instrument that will generate alternative financing sources to ensure sustainable development of the local communities in the Republic of Moldova.

² The Law on local public finances no. 397/2003, https://www.legis.md/cautare/getResults?doc_id=16325&lang=ro

³ Usually, the projects financed from the National Ecology Fund, the National Regional Development Fund, the Energy Efficiency Fund require a contribution from budgets of at least 15% from the total project value.

⁴ Law no.129/20018 for approving the Non-banking financial market development Strategy for 2018 – 2022 and the Action Plan for its implementation, https://www.legis.md/cautare/getResults?doc_id=105492&lang=ro

1.2 The issuance process

The issuance process of municipal bonds is a different and more complex one, as compared with the issuance of state securities. As opposed to state securities (treasury bills and bonds), issuing municipal bonds can be realised only in line with provisions of the Law on capital market no.171/2021⁵, respectively, the process needs to be based on a prospectus, intermediated by an investment company and only with an endorsement of the Ministry of Finance. Obtaining this endorsement also foresees the accomplishment of preliminary conditions, especially conditions concerning the financial capacity to reimburse the loan and the allocation of the funds. Table no.1 presents the legal framework related to the issuance of municipal bonds. Following this, the main elements related to the issuance process are presented, both from the perspective of local public finances management, as well as from the perspective of the issuing mechanism.

Table no. 1. The legal framework related to municipal bonds issuance

	Document title	Provisions on issuing municipal bonds
1.	Law on local public finances no. 397/2003	• The possibility of LPAs to issue municipal bonds • The purpose for which the obtained resources can be used • Level of indebtedness
2.	Law on the public sector debt, state guarantees, and state recrediting no. 419/2006	• Endorsement from the Ministry of Finance • Debt reimbursement • Debt management
3.	Law on the capital market no. 171/2012	• Issuing entities, including LPAs • The issuing mechanism • Requirements on the issuing process
4.	Instruction on the mechanism on registering bonds issued by local public administration authorities, Decision of the National Commission of the Financial Market no. 18/1/2018	• Registration and placement of municipal bonds • Requirements of the issuance prospectus • Carrying out the public offering
5.	Government Decision no. 1136/2007 on the measures to implement Law on the public sector debt, state guarantees, and state recrediting no. 419/2006	• Debt approval committee • The procedure for evaluating the expression of interest on the loan by the Ministry of Finance

Source: Compilation elaborated by the authors based on the national legislation provisions

1.2.1 Conditions under which municipal bonds can be issued

The Law on local public finances foresees the conditions under which the municipal bonds can be issued, from public finances sustainability perspective, as well as how can such decisions be taken by the local authorities. Thus, article 15 from the law foresees the following key aspects:

- a) The municipal bonds can be issued with the purpose to implement certain capital investments;
- b) The executing authorities can issue bonds only after the decision was approved by representative and deliberative authorities that authorize the debt;
- c) Issuing bonds can be carried out in line with the provisions of Law no.171/2012 on the capital market;
- d) The payments and transfers in what concerns buying and reimbursing municipal bonds are carried out only in national currency;

⁵Law on the capital market no. 171/2012, https://www.legis.md/cautare/getResults?doc_id=121171&lang=ro#

- e) The total amounts of annual payments (reimbursing the loan, paying the interest rate, and other adjacent payments) is established at a 20% cap from the total annual revenues of the respective budgets, except for special destination transfers⁶ (exemptions are made for the Chisinau and Balti municipalities, where this cap is established at 30%).

1.2.2 The purpose of issuing municipal bonds – financing capital investments

The local public administration authorities can contract, by issuing bonds, long term loans strictly for the following purposes: (i) financing capital investments and (ii) refinancing previously contracted long term debt (also subject to capital investments). In fiscal terms⁷, in what concerns „capital investments” expenditures made in regards to purchasing and/or improving long-term assets that are not attributed to current results but must be capitalised, meaning, attributed to enhancing the value of long terms assets. The most frequent investments at the local level are the ones made in road infrastructure, water and sanitation, renovating public buildings, or purchasing equipment that has a long-term exploitation period. On the other hand, in case there is a refinancing of a previously contracted loan, it should be contracted at more advantageous conditions than the one that is planned to be refinanced.

1.2.3 The Ministry of Finance endorsement on issuing bonds

The LPA decision on contracting any debt, including through the issuance of municipal bonds, is previously coordinated with the Ministry of Finance. This is a common international practice and it seeks to ensure the sustainability of the public finances in general. In this regard, within the Ministry of Finance, the Commission for authorising actions regarding contracting long-term loans/providing guarantees for long term loans is instituted, responsible for evaluating the set of documents presented by the LPAs, in light of a series of objective criteria that aim to ensure the following:

- Capacity to reimburse the debt;
- Compatibility between the financial conditions to attract money and the objectives of the local administration debt managing objectives;
- Alignment of the projects planned to be financed from resources attracted with the annual and multiannual development plans;
- Alignment of contracting the debt/providing the mentioned guarantees with the restrictions established in Law no. 397/2003 on local public finances.

The Commission deliberations are reflected in the minutes, based on which the endorsement is issued. It has a mandatory character, based on which the LPAs can continue the loan contracting/bonds issuance or guarantees providing procedures. Obviously, the result can be also negative (negative endorsement). In this case, the endorsement will reflect the reasons for rejecting to authorise the contracting of loan or issuing bonds.

⁶ Special destination transfers are conditionally allocated financial means, according to legal provisions, in absolute amounts, from the state budgets in order to ensure exercising public attributions or in other special purposes.

⁷ Art. 93, pnt. 18, from the Fiscal Code of Moldova, No. 1163/1997, https://www.legis.md/cautare/getResults?doc_id=120958&lang=ro

1.2.4 The mechanism for issuance of municipal bonds

After all the preliminary financial and non-financial conditions are met, the local authority may proceed to the issuing procedure. As opposed to the state securities, issuing municipal bonds is performed according to the *Law on the capital market*, meaning it implies a mechanism that involves more parties. Thus, the public offering can be initiated by the issuing authority (the LPA) only after the prospectus⁸ is published and approved by the National Commission on Financial Market (NCFM) and only via an *investment society*⁹ (a professional participant on the financial market, licensed as an investment society, usually a bank or a different financial intermediary). For each stage related to the prospectus, there are a series of clear terms foreseen so that the process is realised in a reasonable amount of time. As well, the prospectus of the public proposal must provide an accessible and easy to analyse form, the information that allows investors to make a well-informed assessment of the issuing authority and its offer (prospectus). At the same time, there are no restrictions on investors in bonds, they can either be institutional investors (for example – banks, insurance companies, retirement funds) or natural individuals or legal entities, based on an individual purchasing decision.

After approving the prospectus, the issuing authority, in a 5-day timeline, will publish the announcement on the proposal, which will encompass the main information on the conditions of the public proposal, including the ones referring to how the prospectus is available for the public. The public proposal is considered closed on the same date when the implementing period, foreseen in the add and the proposal, expires, or on the date of the early closure, according to the provisions laid out in the prospectus (it will be possible to close the public proposal early if all the bonds foreseen in the proposal were subscribed up to the expiring of the term foreseen in the offer). After the closure, the bondholder obtains the right to sell the bonds on the secondary market, and the issuing authority, to realise all commitments mentioned in the prospectus. In order to specify all the steps that need to be implemented, the NCFM approved *the Instruction on the mechanism for registering bonds issued by local public administration authorities*¹⁰. Figure 1 presents, in consecutive order, the main steps in the process of issuing municipal bonds.

⁸ A document that contains information on the issuing authority and the bonds made publicly available, that will be approved for transitioning on a regulated market, respectively, all information that would allow investors to make an informed decision of assets and liabilities, on the financial market, on the financial situation, on profit or loss, on the issuer's perspective or on the guaranteed of the issuing procedure, in case such guarantees exist, as well as on the rights associated with these bonds.

⁹ Legal entity that mainly provide professional investment services and/or professional services regarding how to carry out investment activities, in line with the Law on capital market no.171/2012.

¹⁰ Instruction on registering local public authorities bonds, NCFM Decision No.18/1/2018, https://www.legis.md/cautare/getResults?doc_id=111166&lang=ro

Figure 1. The main stages of the issuance process of municipal bonds



Source: Data drafted by authors, based on the current normative and legislative framework provisions.

1.2.5 Reimbursing loans attracted as a result of bonds issuing

The resources attracted via bonds issuance are regulated according to the norms of any type of capital investment loans, either from national financial institutions or from international ones. The documents needed for issuing bonds should foresee clauses through which the local authority is obliged to reimburse the loan and to pay the adjacent interest rates strictly from the budget revenues. The Government does have any obligations to cover payments according to loan contracts signed between local authorities, respectively, the Government cannot be invoked as an authority that guarantees to reimburse the debt.

Returning the debt from bonds issuance stands as a priority from other monetary obligations of the local budget, respectively, the allocations for labour retribution, the functioning of the municipality office, etc. The payments for returning the debt are performed according to the commitments made, indifferently from the amount approved in the budget for this purpose. In case sufficient resources are not available, the

authority may contract short term debts for covering temporary gaps or they may choose to refinance the long-term debt previously contracted. Even under these circumstances, refinancing a long-term debt may take place only if the debt destined for refinancing will be contracted under more advantageous conditions¹¹.

1.3 Legal constraints related to issuing municipal bonds

Although theoretically, the national legislation allows the LPAs to contract debts by issuing municipal bonds, there are a series of fiscal and legal constraints that reduce the perspectives of this instrument.

First of all, we refer here to the unfavourable treatment of investors, as opposed to other investment instruments (for example, banking deposits or state bonds). Secondly, the caps established for the amount of annual repayments seem quite reduced, compared to the necessary capital for financing larger investments in the long run. Finally, the impossibility to issue bonds in foreign currency narrows the target group of potential investors, basically, excluding the diaspora and foreign investors.

1.3.1. *Different tax regime for investments*

The fiscal legislation foresees different taxation applied for investments made in different financial instruments. Thus, now, the resources provided by investments in government securities are not taxed, while the investments in municipal bonds (or corporative bonds) do not benefit from such exemptions. Even if the legislation on implementing the Tax Code foresees a provisory exemption until January 1, 2021, it does not provide clear predictability to investors and, thus, to create fair conditions on taxing municipal bonds, it is necessary to revise the non-taxable income sources through an amendment and completion of article 20 from the Tax Code. The respective amendment would not have a financial impact on the state budget because, up to this moment, no actions on issuing municipal bonds on the financial market have been operated. The Romanian practice in this regard, presented in chapter 3, provided clarity and an incentive for investors to focus their attention on such instruments.

1.3.2. *The 20% indebtedness cap*

The local authorities can contract a long-term debt only if the total amount of annual payments for repaying this debt will not overcome 20% of the total annual revenues, except the special destination transfers. An exception is foreseen for the Chisinau and Balti municipalities, where this cap is set at 30%. Under the circumstances that the own revenues of certain municipalities are relatively low, the current capping of indebtedness levels (20%, not including the special destination transfers) disadvantage the LPAs in the process of issuing municipal bonds. This is because, the amounts that could be potentially contracted through this mechanism, when limited, may turn out to be insufficient for financing significant local investment projects. At the same time, the international practice analysed in chapter 2 foresees a maximum indebtedness cap of 30%, but it must be taken into account that the level of local financial autonomy is more extended, respectively, the own revenues have a higher share.

In order to create favourable conditions for issuing municipal bonds, the 20% cap could be increased for a series of LPAs, for example, for all municipalities or local budgets that have solid own revenues. Thus, different capping can be foreseen, for example, the LPAs for which the own revenues average share in the

¹¹ According to art. 45, par. (1) from the Law no. 419-XVI/2006 on the public sector debt, state guarantees and state recrediting.

past 5 years was above 50% from the total revenues, or for the ones that have own revenues exceeding 50 mil. MDL. In this regard, it would be necessary to amend article 5, par. (4) from the Law on Local Public Finances, taking into account the above-mentioned facts. As in the previous example, such amendments will not generate an impact that could affect the fiscal-budgetary balance at the level of the national budget system. The analyses on local budgets, presented at chapter 3, confirms a rather reduced level of indebtedness of local authorities although there is space for contracting additional loan for some of them. Moreover, for some cities, the own revenues have registered a significant increase in the past few years, a fact which could support the implementation of certain investment projects that are so much needed by the respective localities.

1.3.3. The impossibility to issue municipal bonds in foreign currency

Even if local authorities can access loans from international financial institutions in foreign currency, this is not the case for bonds, that can be issued strictly in national currency. This reduces the potential group of investors since the investment will be unfavourable for foreign ones, diaspora representatives, or those who wish to make placement in foreign currency. The propensity to save in a foreign currency is obvious when, for example, looking at banking deposits, where the foreign currency deposits are at 45% of the total. As well, migrants usually have a special affection for their home localities. Because of their will to contribute to the development of their home locality, they could represent an important group of investors in municipal bonds (issued by the LPA), except for, investments in a foreign currency will be much more attractive for them. This can be noticed in states like Romania, Bulgaria, and Serbia, where issuing municipal bonds in foreign currency shows an enhanced interest from a series of foreign investors or the citizens of these countries that are living abroad and want to reduce their monetary risk.

In order to remove the barriers on issuing municipal bonds in foreign currency, it is necessary to update the legal framework on currency regulation – Law no.62/2008. As well, some provisions from the legislation that governs the local public finances and the framework law on the capital market must be synchronised with the above mentioned. The respective proposals derive from the need to provide fair conditions for capital offers as well as for the practices applied in the banking sectors, particularly loans in foreign currency. According to the legislation, the banks can provide loans for companies or place deposits in foreign currency, while such infusions/investments in the capital market are prohibited.

1.4 Conclusions and recommendations

A series of legal constraints undermine the potential of LPAs to issue municipal bonds. In order to eliminate the previously mentioned barriers, a series of legal amendments are proposed, as follows:

- i. Standardising the tax regime for investments in bonds – completing the non-taxable income sources mentioned at art.20 from the Tax Code no.1163/1997 by adding letter u², foreseeing the following provisions: „u²) *interest rate from bonds issued by local public authorities*”;
- ii. extending the indebtedness cap to 30% for all municipalities, as well as for the budgets that have solid own revenues – reformulating art.15, par.(4) from the Law on local public finances no.397/2003, as follows: „*by derogation from par.(4) provisions, for municipality budgets as well as for budget with revenues exceeding 50 million lei, from which at least 50% represent own revenues, the cap of annual payments for repaying the loans of these budgets, contracted or guaranteed and/or that are planned to be contracted or guaranteed shall not*

exceed 30% from the total annual revenues of these budgets, except for the special destination transfers”;

- iii. enforcing the possibility to issue bonds in foreign currency – amending art.17, par.(8) from the Law no.171/2012 on the capital market, as follows: „*The bonds regulated by this article can be issued both in national and in foreign international circulation currency*”. In light of diminishing the monetary risk as well as an excess of savings in foreign currency, the bonds issued in foreign currency can be purchased only by non-residents (for example, diaspora representatives), and the cap on indebtedness for these loans should not exceed 15% from own revenues.

2. International practices on issuing municipal bonds

In the international experience, issuing municipal bonds is the simplest way to attract a pool of investors from outside the banking sector. On one hand, the municipal bonds market is the most developed in the USA, where the active issued bonds create a market of a total of 3,8 trillion USD¹² and where individuals are the main investment category, due to the low risk and the tax exemptions on this financial instrument. In the Central and Eastern European Countries (CEE) and the former USSR republics, the possibility to issue bonds became a reality once the political and fiscal decentralisation has started after 1990. Placed before the challenge to remedy years of sub investment and insufficient maintenance in the main infrastructure, as well as a series of significant budgetary constraints, in more communities from the region prudential loans have enhanced the investment capacity and have led to the development of local self-governance. Generally speaking, success stories on issuing municipal bonds are associated with a series of preconditions as the existence of fiscal facilities related to this loan instrument, a well-defined investment plan and the existence of a series of filter aimed at maintaining the local debt management at optimum parameters. Another attribute of the success of local bonds is a robust capital market, although there are also examples that show that the municipal bonds can themselves represent an incentive for developing the capital market, as it could be the case for the Republic of Moldova. Following below is a detailed analysis of the evolution of the municipal bonds market in 3 states from the region – Romania, Bulgaria and Serbia, because they have an advanced level of development in this regard and can serve as examples in what concerns the steps we must follow in effectively implementing the municipal bonds instrument in the Republic of Moldova.

2.1 Romania – the advantage in developing a robust capital market

Romania has a wide experience in the past 20 years in financing local authorities through municipal bonds. Following the first issuing of bonds, operated in 2001, a multitude of local authorities have used this instrument, the capital market development and the timely adjustment and updating the legal framework being the most important elements in maintaining the viability of this instrument.

In 2019, the Bucharest Stock Market have 37 municipal bonds issuing operations available for investors, bonds issued by local authorities, valued at 3,3 billion RON with terms ranging from 5 to 20 years¹³. The structure of the bonds issued by authorities' portfolio shows that Bucharest is the city with most loans from bonds, totalling about 2/3 from the total value of municipal bonds. The four issuing operations were launched by the Bucharest municipality (the last one in the first quarter of 2018 with a 10-year maturity and an interest rate at 5,6%), each of 555 million RON, with annual interest rates ranging between 3,58 and 5,6% and a term ranging from 5 to 10 years. The value of these operations represents over half of the 4,2 billion RON revenues of the Bucharest municipality in 2018. The second municipality most indebted is Timisoara. The five issuing operations of 30 million RON each had an annual interest rate of 3,02%, being the lowest one and the maturity expiring in 2026. Generally speaking, we can conclude that most frequently, the municipal bonds are used as instruments to finance investment for larger cities with a more enhanced fiscal space and more complex managing competencies. The most important investors in municipal bonds are banks and Open Investment Funds, consisting mainly of individuals. According to the data of the Financial

¹² <https://www.cnbc.com/2020/04/28/the-3point8-trillion-municipal-bond-market-rocked-by-the-coronavirus-downturn-is-facing-a-key-test.html>

¹³ <https://www.zf.ro/burse-fonduri-mutuale/ce-bonduri-au-primariile-din-romania-3-3-mld-lei-municipiul-bucuresti-cel-mai-indatorat-prin-obligatiuni-18463152>

Supervising Authority (FSA)¹⁴, at the end of 2019 there were 38 active municipal bonds issuing operation, resulting that there is one single case when this financial instrument is not available on the secondary market.

The stages that the local authorities must undertake in order to obtain financing through the capital market are as follows¹⁵:

1. **The decision of the local or county authority** on issuing bonds;
2. **Contracting the intermediary authorised by the Financial Supervising Authority (FSA)** that will be in charge of the needed procedures on the capital market;
3. **Establishing the issuing characteristics** (total loan value, nominal value and the number of bonds, interest rate, maturity and frequency of payments, the offer validity as well as the guarantee modality);
4. **Drafting the proposal prospectus**, carried out by the intermediary, based on the information provided by the issuing authority, that will be approved by the FSA;
5. **Notifying and obtaining a positive endorsement from the Ministry of Public Finance** through the Commission on authorising local loans;
6. **Publishing the proposal** on selling bonds based on the proposal prospectus;
7. **Obtaining confirmation from the FSA on closing the proposal**, followed by the bonds being registered at the FSA;
8. **Signing the contract with the central depository**;
9. **Submitting the necessary documentation at the BSM (Bucharest Stock Market)** in order to obtain the approval on transactions with municipal bonds;
10. **Approval for undertaking transactions** within the systems administered by the BSM.

The Law on local public finances in Romania foresees that the local authorities (local and county councils and the general council of Bucharest) can approve the contracting or guaranteeing of internal or external short, medium- and long-term loans, for making local interest public investments, as well as for refinancing the local public debt. The instruments of local public debt can be: municipal bonds, loans contracted from banks or other loan institutions, supplier loans, financial leasing and local guarantee, and the source for their reimbursement is the own revenues, made up of: taxes, contribution, other payments, other income and shares deducted from the income tax).

In order to be able to issue municipal bonds, the authorities must go through two filters associated with public oversight of managing local public debt, as follows:

- Received an endorsement of the commission for authorising local loans established in the Ministry of Public Finances¹⁶, which activity is approved by Government resolution;
- The total annual debts, representing the due dates on contracted and/or guaranteed loans, interest rates and commissions related to them, including those of the loan planned to be contracted and/or guaranteed in the same year cannot surpass the 30% cap from the arithmetic average of the own revenues foreseen, diminished by revenues from capitalised certain assets, for the 3 years prior to the year in which the reimbursable financing is requested.

¹⁴ https://asfromania.ro/files/analize/Evolutie_piata_de_capital_in_%202019_02042020.pdf

¹⁵ <https://btcapitalpartners.ro/solutions/finantare-autoritati-locale/>

¹⁶ <https://www.mfinante.gov.ro/pagina.html?categoriebunuri=datoria-guvernamentala,datoria-locala,creante-externe&menu=Trezorerie&tab=2>

A significant aspect for ensuring the attractiveness and functionality of municipal bonds is an adequate fiscal and legal framework. In this order of ideas, the revenues obtained from holding and transferrin financial instruments that attest the state or territorial administrative units' public debt are not subject to income tax, including repo and reverse/repo operations carried out with these instruments, indifferently from the market/place where the transaction operation is carried out.

From the perspective of the safety of investors in municipal bonds in what concerns reimbursing the invested amount and remnants related to them, they bear at most the risk of late payment: because of the following:

- In Romania there is a Law on municipalities insolvency¹⁷ and, as the municipalities cannot declare bankruptcy and cannot be liquidated, there are recovery Plans drafted, that include financial support provided by the state budget and/or compensations and rescheduling schemes;
- Reimbursing the principal and remnants is guaranteed in accordance to the Guarantee Agreement by establishing a guarantee on all own revenues of the Issuing authority in line with the period for which the bonds are reimbursed.

2.2 Bulgaria – evolutions supported through private placements

In Bulgaria, issuing municipal bonds was most popular during 1999 – 2008, while after 2010 this trend if more moderate. Giving up of bonds issuing in the previous years by municipalities is mainly due to the low interest rates provided by traditional financial institutions – banks.

At the end of 2018, 9 municipalities had active bonds: Shumen, Pernik, Plovdiv, Kavarna, Smolyan, Pomorie, Kyustendil, Dupnitsa, Sliven, Peshtera and Varna. The analysis of the active bonds issued in Bulgaria and the reasons behind these commitments reflect the following distinctive elements¹⁸:

- All the issuing operations were carried out through private placements;
- The largest municipal bonds owners are institutional investors – Bulgarian pension funds, local and international banks;
- The purpose of issuing bonds in Bulgaria in the past 10 years can be divided into 4 categories (i) financing infrastructure projects (roads, water and sanitation), (ii) renovating municipal buildings (schools, hospitals, kindergartens, playgrounds, sidewalks etc.), (iii) refinancing current debt and (iv) necessary municipal co-financing for future UE projects;
- Both can be issued in national and foreign currency (Euro);
- Interest rates for national currency issued bonds are related to the base rate of the National Bank of Bulgaria, and the ones in Euro to the EURIBOR rate for 6 months. As well, there are cases when issuing bonds was carried out on fixed interest rate;
- There isn't a direct correlation between the financial capacity/stability of the municipality and the reached interest rate. Even so, some municipalities with a poorer financial situation, reduced population and lack of constant own revenues have obtained better interest rates as compared to larger municipalities;
- The majority of issuing authorities are medium and large municipalities form the country;

¹⁷ <http://legislatie.just.ro/Public/DetaliuDocumentAfis/148391>

¹⁸ Municipal Bonds: Comparative Study about the Best Practices in three Countries and Lessons for North Macedonia, UNDP, 2019

- Currently, none of the issuing operations of municipal bonds is listed at the Bulgarian stock market, because bonds investors are institutional ones, that stated from the beginning that they prefer private placement, having a long term investment horizon and preferring to maintain the remnants until their expiry date instead of carrying out transactions with them. The Bulgarian experience has shown that in order for a municipality to make use of the municipal bonds instrument for the first time, without experience and a debatable financial base, they should initially look at private placement¹⁹ and eventually, in the second stage, may continue to make the issuing public and introduce it on the regulated market.

Particularly, issuing bonds is an attribution of the municipal councils. The municipal councils adopt the independent budget of the municipality based on their own revenues sources and the state transfers, allocated between municipalities according to the criteria foreseen in the Law on public finances. Therefore, any potential bonds' issuing operation must be integrated in the draft municipal budget, that must be proposed by the mayor and voted by the municipal council. The Law on the state budget for the relevant year may establish a maximum amount of debt that a municipality is allow to contract throughout one budgetary year.

The Law on public financed establishes as well the caps in what concerns the allowed indebtedness levels of Bulgarian municipalities. The annual amount of local debt for each municipality cannot be above 15% from the annual average of own revenues and balancing transfers from the past 3 years. The annual amount of payments on debts will include the principal, the interest rates, owned commissions as well as other obligations related to the debt contracted by the municipality.

The fiscal legislation is also an attractive one. According to the Law on income tax, the interest rates and the capital gains, as well as losses from bonds issuing transactions are part of the calculations of the taxable elements – profit from selling financial instruments is deducted, while the losses from selling financial instruments are added. Individual investors (according to the Law on personal income) are, as well, exempt from the income tax in case of interest rate and discount applied to Bulgarian government, municipal and corporate bonds^{20, 21}.

2.3 Serbia – varied instrument for bonds, but also public control

A precondition for the possibility to issue bonds in Serbia was decentralisation, that was launched in 2006, by dividing the country in autonomous provinces and local units – cities and municipalities. Next to this, the Serbian cities and municipalities have supported the need for additional financing for capital investment, and a few of these have also considered and used municipal bonds as an instrument for financing their projects.

¹⁹ Private placements refers to selling local bonds to investors and preselected institutions, instead of on the open market. This represents an alternative to the initial public offer. The investors invited to participate in private include wealthy individual investors, banks and other financial institutions, mutual funds, insurance companies and retirement funds.

²⁰ <https://investbg.government.bg/en/pages/4-income-taxation-of-individuals-140.html>

Starting with 2010, in Serbia, 4 municipalities have issued bonds: Novi Sad, Panchevo, Shabac and Stara Pazova. The synthesised data on the bonds issued by these municipalities have allowed us to emphasize their main characteristics²²:

- resources borrowed for a long term – the maturity term varies between 5 to 12 years. Usually, a grace period of 1-2 years is applied when paying the principal after which it is distributed in equal rates together with the remnant payments for the bond;
- attractive financial instruments, both for incomes from interest rates (usually, a higher interest rates than on bank deposits), as well as for the risk which is close to zero;
- bonds were issued in national currency (RSD) and indexed in Euro. The interest rates were either fixed, wither related to the EURIBOR rate for 3 months. The Serbian legislation allows for local bonds to be issued both in national as well as in foreign currency;
- the destination of investments from municipal bonds were aimed at building sewerage networks, road rehabilitation, kindergartens, pools and preparing the constructions of a series of industrial zones;
- from the 4 operations for issuing municipal bonds, two were made through private placements of a previously known buyer and two – through public proposals and respectively, regulated by the capital market;
- the Novi Sad region operated the municipal bonds issuing at a nominal rate of 6.2%, and the underwriting costs have increase the effective rate to 6.25%;
- the issuing authorities were the cities and municipalities that are amongst the most developed ones from Serbia. This confirms the situation when the communities from developing markets, with the best economic results become the municipal bond issuing authorities. Moreover, the personnel capacities of these entities are at a higher level than that of other ones.

The most important laws from the legal framework are the ones regulating the loans contracted by local authorities through issuing municipal bonds are as follows: Law on the capital market and the Law on the public debt. According to the law on the public debt, autonomous provinces and local territorial units (cities and municipalities) are allowed to contract debts in Serbia or abroad, in national or foreign currency, for obtaining long term financing or to refinance capital investments that are planned by the local authorities in the local budget. They can lend money from financial institutions (by contracting bank loans through public procurement procedure) or directly from investors on the capital market by issuing bonds. The representative body of the local authority (the Council) makes the decision regarding the loans of the respective local authority, after obtaining a legal endorsement from the Ministry of Finance. In what concerns the oversight of local public authority loans, the tasks regarding loans monitoring is placed with the Ministry of Finance.

Potential investors are both individual as well as legal entities, national or foreign. After the legal amendments operated in 2011, next to the private issuing of bonds, accessible only for institutional investors, issuing local (municipal) bonds can be performed also through public proposals through financial intermediaries and capital market mechanisms.

²² Municipal Bonds: Comparative Study about the Best Practices in Three Countries and Lessons for North Macedonia, UNDP, 2019

Indebtedness caps for long term debts for financing capital investments adopted by Law on public debt are as follows:

- The amount of long-term debt cannot overcome 50% from the total current budgetary revenues of the local authority from the previous year;
- The value of the principal and of interest rates that mature each year for all the debt does not overcome 15% from the total current budgetary revenues generated by the local authority in the previous year.

Similarly, in other countries, an important element that makes the municipal bonds instrument a competitive one is the tax framework, these instruments being exempt from taxation. The income from interest rates and the capital gains are exempt from income tax when the investor is an individual, and, in case the investor is a legal entity, the income is exempt from profit tax.

2.4 Advantages of local bonds for communities

As it results from the international practice, a proper and well-managed process on issuing local (municipal) bonds can generate a series of important advantages for the community, as for example^{23 24 25 26}:

1. **Flexibility in establishing the reimbursement terms and conditions** reflected in the issuing prospectus (proposal),
2. **The fair burden of costs and access to benefits „intertemporal equity”**. The long-term loan is an efficient means for overcoming the issue on inequitable costs burden amongst the taxpayers. When the capital project is financed from current revenues, the ones who have financed this project through paying the local taxes may not always benefit from the project in the future, if, for example, they will change their place of residence in another city.
3. **Optimum allocation of resources**. A close relationship between the beneficiaries and the taxpayers (for a project) encourages an optimum allocation of resources.
4. **The benefits of an accelerated local development cover the costs of the loans**. For example, ensuring that form municipal bonds, the connection to utilities and the needed infrastructure for creating an interesting zone for investors for developing an industrial park may enhance the investments and thus, generate new jobs, which, in the end will result in a more rapid economic development with higher revenues for the budget that will eventually be above the costs related to managing the bonds.
5. **Reducing operational costs**. For example, buying new buses to replace old ones, through issuing municipal bonds, will significantly reduce the maintenance costs and fuel consumption, providing, simultaneously a higher level of comfort for the community. Such cuts to current expenditures can actually be a lot higher than the costs related to loans;
6. **Long term projects are more expensive**. Financing obtained from current revenues usually delays the finalisation of the project for a longer period of time. This leads to higher constant costs and to a total higher volume of spent resources;

²³ Report on Funding Opportunities for local administrations for the implementation of (parts of) their Local Economic Development Plans, Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine, 1/29/2018, MAYORS FOR ECONOMIC GROWTH

²⁴ Municipal Debt Financing in Armenia through Borrowing and Issuance of Bonds, American University of Armenia, 2008

²⁵ Municipal Finances : A Handbook for Local Governments, <https://openknowledge.worldbank.org/handle/10986/18725>

²⁶ Municipal Bonds: Comparative Study about the Best Practices in Three Countries and Lessons for North Macedonia, UNDP, 2019

7. **Stabilising necessary budgetary resources.** The amount of capital expenditures in local public administrative units fluctuate on a yearly basis. If the capital projects are financed from current revenues, the resources demand also changes over time. In countries where a large part of the local revenues is increased through local taxes, this can result in an irrational fluctuation of local taxes rates;
8. **Access to non-reimbursable resources from European funds as well as other development funds.** This reasons appears more frequently in CEE countries and can be similarly valid and viable in the case of the Republic of Moldova, where often local communities have the opportunity to attract resources from European fund or even national funds, but the necessary co-financing contribution is usually at 10% to 30%, which is a factor that may lead to missing out on potential significant investments for localities and by using the municipal bonds instrument in such situations may have a much stronger multiplier effect on the socio-economic development of the localities;
9. **Increasing the visibility and trust in investors** – because the process on issuing bonds is a transparent one and created visible effects for the communities, the local administrations that operate this process in the proper way can cultivate higher trust from the population as well as for investors, to attract new public and private cities development projects.

2.5 Conclusions and recommendations

The experience of the analysed states regarding issuing local (municipal) bonds shows that they have ensured a favourable fiscal treatment, similar to that on state bonds, and this is one of the key precondition for the viability of this instrument. The Republic of Moldova must implement this practice, largely applied at international level if it wants the country to register success stories in operating local bonds and, respectively, make the capital market a more dynamic one.

The indebtedness caps allowed, calculated as the total annual amount for repaying debts, compared to the local own revenues varies between 15% to 30%, while that cap in the Republic of Moldova is set at 20%, except for the Chisinau and Balti municipalities, where it is set at 30%. On the other hand, in the analysed states, the level of local financial autonomy is much higher compared in terms of the share of own revenues in the total revenues (for example: Bucharest – 87%, Timisoara – 72%), which allows for a much larger indebtedness space.

Obtaining the Endorsement from the Ministry of Finance represents a step mandatory for each of the three states analysed, being one of the filters associated to the public control, existent in Moldova as well, and is aimed at ensuring the sustainability of the local public finances.

The method chosen for placing municipal bonds (private or through public proposal) most often correlates to the level of development of the capital market. In the case of the Republic of Moldova, that has an underdeveloped capital market and a lack of experience in issuing bonds, in order to ensure the success of the process, it would be recommended to start with private placements through a prior agreement with the potential buyers of the bonds (banks, insurance companies).

The practice of Romania, Bulgaria and Serbia shows that, most frequently, the municipal bonds are used as an instrument to finance investment by more developed cities and/or larger cities that have a larger fiscal space and competencies in managing more complex administrative issues.

In more states like Serbia or Bulgaria, issuing bonds can be made both in national and in foreign currency (Euro), this provision enhancing the pool of potential investors in the respective financing instrument. In the case of the Republic of Moldova, such a provision could facilitate the access of the Diaspora, as potential investors, however, the risks levels would be rather high for the issuing authorities.

3. Analysis of local public finances and local autonomy

One of the most important questions, in the context of assessing the bonds issuing options, from the local public finances' perspective relates to understanding the degree of autonomy of the LPAs, in order for them to be able to borrow under current conditions, foreseen by the legal framework. As mentioned at chapter 1, the local public authorities can contract a long-term loan only if the total amount of annual payments for repaying this loan does not exceed a total of 20% from the LPA own revenues. An exception is made for the Chisinau and Balti municipalities, where this cap is set at 30%. This cap was established by the Ministry of Finance and is considered to be a measure that ensures the sustainability of the budgetary-fiscal system. When it comes to the degree of financial autonomy, the conclusion in a recent report on this matter referred more to the lack of autonomy, or, more specifically, the fact that it is only a formal autonomy. Below we will continue to analyse what are the revenues of the LPAs, if they allow a true financial autonomy and how financially sustainable are they if they should want to issue municipal bonds.

3.1 What are the local public revenues?

The LPA revenues can be conventionally separated in 4 categories, based on their source: (i) revenues from payments, (ii) transfers), (iii) donations and grants, (iv) revenues from own sources. The revenues from own sources constitute the local taxable base, that has constantly diminished in the past few years. This mainly relates to the local authorities' oversight: (i) property tax; ii) administrative and services payments, (iii) entrepreneur patent, individuals' income tax on independent activities in retail, licencing tax for certain activities paid in the level II local authorities budget (iv) local taxes and (v) natural resources, (vi) property revenues, and (vii) other revenues (fines, unique taxes, other revenues). In 2019, the revenues from own resources constituted a mere 10,4% from the consolidated local budgets, with a slight descendent evolution registered in the previous years, with an exception for 2019, which registers a small increase in this regard. The property tax, the local taxes and the revenues from services and administrative taxes cover approximately 87% from own revenues. The biggest contribution for the rural areas in increasing the consolidated local budget constitute revenues from administrative services and taxes, and, for the urban areas – property tax.

The local budgets are strongly dependent on State Budget transfers, over 70% from the revenues of Local Budgets during 2017 – 2019 come from these transfers. This dependence has registered an ascendant trend, especially after the reform of the local public finances from 2013, fully implemented as of 2015. Both level of the LPAs are strongly dependent on these transfers. Thus, the amount of transfers exceeds the revenues without transfers of the first level LPAs by 2,05 times and for the second level LPAs – by 2,8 times in 2019.

In terms of territorial aspects, it can be mentioned that the general trend for the great majority of second level LPAs during 2016 – 2019 was an increase of their dependence from the state budget transfers. Thus, in 2019, the great majority of second level LPAs have a dependence of 80% on the state budget transfers, with the exception of the TAU Gagauzia and the Chisinau municipality. As well, in 2019, compared to 2017, it is noticed that a part of the second level LPAs have registered an enhancement on the share of transfers, and another part – its diminishing, the latter exceeding the first (60% for total transfers and 65,7% for special destination transfers). As a consequence, in 2019, compared to 2017, a slight diminishing of the share of special destination transfers and total transfers from the state budget to the local consolidated budget was registered. The budget revenues of the first level LPAs (excluding the transfers from the second level LPAs) in 2019, for the great majority of the administrative territorial units, a share situated between 40% - 51%

from total revenues was registered, although for the local consolidated budget this share is approximately 32%.

3.2 How autonomous are the LPAs?

Throughout the previous years, the dependence of the LPAs on transfers from the state budget has increased. The share of the revenues of the local authorities on which the LPAs have full decision-making power on during 2016 – 2018 has registered a general decreasing trend, reaching 40,2% compared to 42% in 2014, from the total revenues accumulated to the local budget. An exception was the year 2019, where this share has reached 47,5%, as a follow up to the amendment of the Law on local public finances.²⁷ Provided this exception, for this period of time we can see a trend in the increase of the share of special destination transfers, that have increased more rapidly compared to the rest of revenues. Thus, in 2019, for all the groups of territorial administrative units of level II (rayons, the Chisinau and Balti municipalities, Gagauzia), the share of special destination transfers has overcome 50% from their consolidated revenues. At the same time, the territorial administrative unit Gagauzia is the only one that had a reverse general trend, meaning the decrease of the share of special destination transfers, in 2019 reaching the lowest share, 50,1%. The highest level of special destination transfers from the state budget, and, respectively the most restrained space on decisions regarding the resource allocation was registered by rayons – 65,7%, followed by the Balti municipality, at 62,6%.

From the 20,9% growth of the local consolidated budget for 2016 – 2019, the contribution of own revenues to the local budget is only 2,6%. The contribution of own revenues (total) at rayon level is even lower – 0,9% and quite close to that from the TAU Gagauzia (1,7%), while in the Chisinau and Balti municipalities, these are considerably higher, at 4,5% and, respectively, 3,7%. The most obvious difference on own revenues is noted on the property and local taxes, which have a much more important contribution in Chisinau and Balti, compared to the rayons and Gagauzia. Even if we were to consider the hypothesis that the growth rate of own revenues would significantly surpass the average of revenues from the state budget, this would not significantly change the situation of the LPAs' financial autonomy situation. Under these circumstances, only including other sources of revenues for the LPAs would be a solution for increasing the local autonomy.²⁸

A first step in this regard was including income tax of the legal entities from the territorial administrative units in the structure of the revenues. Thus, in 2019, the share of LPAs' revenues on which the local public authorities have decision making power has increased from 40,2% to 47,5% in 2018. At the same time, this measure is only temporary, because, as of 2021, once the amendment on establishing the share on the income tax at 12%, the amount of general destination transfers will decrease, provided the amendment on the base calculation of the Fund for financial support of the administrative territorial units.

3.3 Statistic data on the LPA debt in 2019

At the end of 2019, the balance of the public debt sector diminished by 0,28 million MDL or, by 0,5%, compared to the end of 2018 and constituted 57,60 billion MDL, out of which only 1,1 billion MDL constituted the direct debt of the LPAs. The share of the public sector in the GDP, constituted 27,4%, out

²⁷ Introducing in the revenue sources of the Administrative Territorial Unit the income tax of legal entities from the respective ATU, except for Chisinau and Balti.

²⁸ <https://www.expert-grup.org/ro/biblioteca/item/1835-autonomia-financiara-in-republica-moldova-evolutia-veniturilor-bugetelor-locale>

of which 0,52% was the direct debt of the LPAs, or, 6,5% from the total LPA revenues in 2019. In the LPA structure, the major share of the debt was in foreign currency – 85,8%, by 4,2 % less than in 2018 and by 8,4% less compared to 2017. More than 73% of the direct LPA debt is the fluctuating interest rate debt, with 0,4% less than at the end of 2018 and 0,5% less compared to the end of 2017. Moreover, 21,3% from the total direct debt of the LPA will reach maturity in 2020. The amount of guarantees issued by LPAs for contracted direct debt, at the end of 2019 was 336,6 million MDL. The internal guarantees issued by LPAs on non-contracted loans constituted 252,2 million MDL.

Although the current indebtedness level of the LPAs is an insignificant one, the Ministry of Finance, in its operational acts mentions a series of challenges in managing the LPAs public debt. Amongst the main risks listed in this document, there is the low capacity of local public authorities to make short and medium term forecasts on the main budgetary-fiscal indicators, the low quality of budget and strategic development documents and the lack of budgetary discipline.²⁹ The Court of Accounts, in its annual reports³⁰, confirms these issues, for which a solution was not identified throughout the past 7 years: low budgetary-fiscal forecast capacity at local level, the lack of development vision at local level, including because of frequent political uncertainties, the lack of a regional development strategy and issues regarding the management of LPA revenues and expenditure. As a consequence, the level of execution of fixed assets in 2019 is at 65%, compared to the forecasts level and only at 50% on executing financial resources destined for capital investments, a trend which continued in 2020 (on 20 October 2019, at 60% compared to the forecasted level and only at 35% at the level of executing financial resources destined for capital investments). Under these circumstances, the LPAs prefer to not borrow, none of them reaching the 20% cap set for the total annual own revenues of the respective budgets. Even in the case of Chisinau, the total amount of budget debt adjacent to the already contracted or guaranteed loan (including reimbursing the principal and the interest rate), did not exceed 12%.

3.5 Conclusions and recommendations

Except for the Chisinau municipality, the current financing conditions do not allow local authorities to respond to priority local needs. Although the LPAs have the legal possibility to borrow, they do not perform such operations for various reasons, the main ones being the lack of a strategic development vision at local level and the lack of the capacity of town governments to identify the most adequate financial instruments for developing, in particular, infrastructure projects. A program on financing municipal bonds would allow, on one hand, a better anchoring of the local development objectives in the medium term budget framework as well as, inevitably, a higher responsibility level of the LPA, through a better budgetary-fiscal planning, under the circumstance of maximum budgetary-fiscal transparency and a transfer of knowledge and skills, including from the Ministry of Finance and the Court of Accounts.

²⁹ <https://mf.gov.md/sites/default/files/Raport%202019%20datoria%20publica.pdf>

³⁰ <http://ccrm.md/rapoarte-anuale-1-20>

4. Why municipal bonds?

The LPAs are at the starting point when it comes to assimilating good governance competencies, as well as capitalising on leverages that derive from reforms of increasing the local autonomy. The possibilities and administration options are expanding at local level, but, along them, the level of responsibility toward the citizens also increases. Decentralising public authority and enhancing local public authorities' autonomy implies the need of financial instruments in order to coherently manage both the current operational activities, as much as local investment projects. The only financing solution available currently are the bank loans. At this point in time, the LPAs have contracted bank loans worth approximately 140 million MDL, out of which about 75% are loans contracted by the Chisinau municipality. An alternative solution would be the issuing of municipal bonds for the investment needs of the municipality. Acquiring financing through different instruments is at its starting point in the Republic of Moldova. In mature economies like USA, the local authorities operate 2.5 times more investment projects than the federal authorities³¹. These investments are due to a spread use of municipal bonds for financing large projects. The municipal bonds are an investment instrument aimed at supporting the decentralised decision making process for infrastructure projects, decided upon and implemented together by local leaders and the citizens of those communities. This instrument allows the citizens to diversify their savings placement options in secure investments and provide them with the opportunity to invest in their communities. By using municipal bonds, the small rural communities as well as large urban communities finance essential infrastructure projects.

4.1 What can be financed through municipal bonds?

The Republic of Moldova communities need multiple financing sources for infrastructure projects, and municipal bonds can be one of those options. The available financial resources are limited at LPA levels and the investment needs are increasing. It is important to realise how and under which circumstances can municipal bonds be used to improve the capacity to implement local projects, maintaining, at the same time, a healthy state of the local public authority finances and to avoid situations of default. Thus, the most suitable projects that can be financed by municipal bonds are, as follows:

1. Co-financing or fully financing investment projects that will generate certain additional revenues. Such projects include water supply systems, sewerage systems and wastewater treatment stations, collecting solid household waste. This type of services can be quantified and paid for by the populations as bills for local services, that will be a direct source for repaying issued bonds.
2. Investment in infrastructure projects that will generate additional taxes collected to the local budget. For example, investments that will provide infrastructure for an industrial platform where private investors can be attracted, that will contribute subsequently to LPA fiscal revenue increase through property tax, taxes resulting from economic activity and through the creation of jobs; or investment in charged parking lots, thus using the collected revenues from parking services to repay municipal bonds issued for building the parking lots.
3. Co-financing grant applications when LPAs lacks sufficient resources to ensure own contribution quota. The LPAs can issue municipal bonds to cover the own contribution quota to access the grant scheme. Thus, the community can benefit of large investments with an excellent financial leverage

³¹ Municipal Bonds Build America: A County Perspective on Changing the Tax-Exempt Status of Municipal Bond Interest, NACo Policy research paper, 2013

ensured by the grant component. Even if investment project does not generate direct revenues, the financial leverage generated by the grant component make reasonable the repayment of the municipal bonds from future LPA's general revenues.

4. Refinancing more expensive loans or debts, thus, improving the overall financial and operational capacity of the LPAs.

Key criteria for performing bonds issuing and the implementation of a successful local investment project

1. The financed projects must be well defined, with a robust financial plan and realistic and clear sources to repay issued bonds and interest rates. Such projects must also reflect, in detail, the direct or indirect quantified revenues and a well-defined cash flow.
2. Investment projects are in line with community needs and are thoroughly consulted with community members. In some international practices, large investment projects are voted by inhabitants of the community. The voting mechanisms can be simple, as decided by the LPA Council, without having a legal enforcement, but this would guarantee the direct involvement of the citizens in the decision making process, would validate the assumptions of community leaders and would ensure that the project is very welcomed by the population of the locality.
3. The potential investors are preliminarily identified, they can be citizens, local businesses as well as portfolio investors that are ready to support investment projects managed by the LPA: banks, insurance institutions, companies with excess liquidities, other portfolio investors.
4. Full transparency is ensured both towards citizens, as well towards investors on how the investment projects implementation is carried out, how the revenues plans are implemented, risks evaluations and risk mitigation actions.

4.2 Simple procedures on issuing and managing bonds – a mandatory condition for the success of municipal bonds as a financial instrument

The procedure to issue bonds must be as simple as possible and the central authorities and the capital market regulator must invest maximum efforts and operate timely improvements to the normative framework, as soon as gaps and bottlenecks are identified in the process on issuing and selling bonds on the primary and secondary markets. Aside from the state (government) bonds issued by the Government of Moldova, in the capital market history of Moldova there were only a few tentatives to issue bonds. The National Commission for Financial Markets has put effort into describing the issuing municipal bonds procedure in the *Instruction on registering bonds issued by the local public administration authorities*, reflected in the NCFM decision no.18/1/2018, mentioned in the chapters above. At the same time, in order for this instrument to become an attractive one and comfortable to use, the procedure on operating both the issuing process as well as the operations that follow the issuing process, must meet a series of criteria:

1. The procedures are as simple as possible, strictly the ones absolutely needed to the process. Any non-necessary documents, stages, operations must be eliminated from the process.
2. Logistic costs must be kept to a minimum. It is imperative that the operations related to issuing municipal bonds are possible to be performed electronically and remotely.
3. All costs associated to issuing bonds should not exceed 1-1,5% from the total value of the issuance and to not overcome the costs associated to accessing a bank loan, otherwise the interest for this instrument will significantly decrease.
4. The option to make electronic transactions must be a key objective in drafting the policies in this field. Any bottleneck in reaching this objective must be eliminated.

5. It is necessary to facilitate the creation of a simple, electronic system for performing transactions with bonds on the secondary market, so that the local bond sparks interest in investors.
6. It would be good to have a buy back mechanisms for the municipal bonds, which would reduce the perception on the risks associated to investing in municipal bonds and would increase the investors' interest in them.
7. In order to attract portfolio investors, the interest rates for the municipal bonds must be slightly above the levels of the banking interest rates for the respective period.
8. If the local population and the economic agents of the community express a special interest in a project put forward by the municipality and have expressed their interest in investing in municipal bonds with reduced interest rates, the LPAs could issue bonds with interest rates below the commercial ones.

Piloting projects in this field will expose the gaps, uncomfortable processes, unnecessary documentation or too costly stages, which will need to be reviewed and optimised.

4.3 National municipal bonds procurement program

Implementing a new financial instrument will not be easily integrated in the current financial paradigm, particularly since such a process will overlap with the COVID-19 generated crisis, thus, a program of the central public authorities to support the financing of investment projects of the LPAs would be well suited. The investors are reluctant to accepting a new instrument, the associated risks of which are not tested on the market and the subsequent buy-sell mechanism is not clear. This reluctance and respectively, the non-execution of subscription objectives may discourage also the municipalities to use this new financing instrument.

A solution in this regard is to launch a national municipal bonds purchasing program. Even mature economies use such programs in order to support the local initiatives and investments. USA has one of the most developed capital market, however, the federal government launches recurrent municipal bonds purchasing programs. In April 2020 a 500 billion USD municipal bonds purchasing program was launched, with the main purpose to stimulate local investments and their financing at reasonable prices.

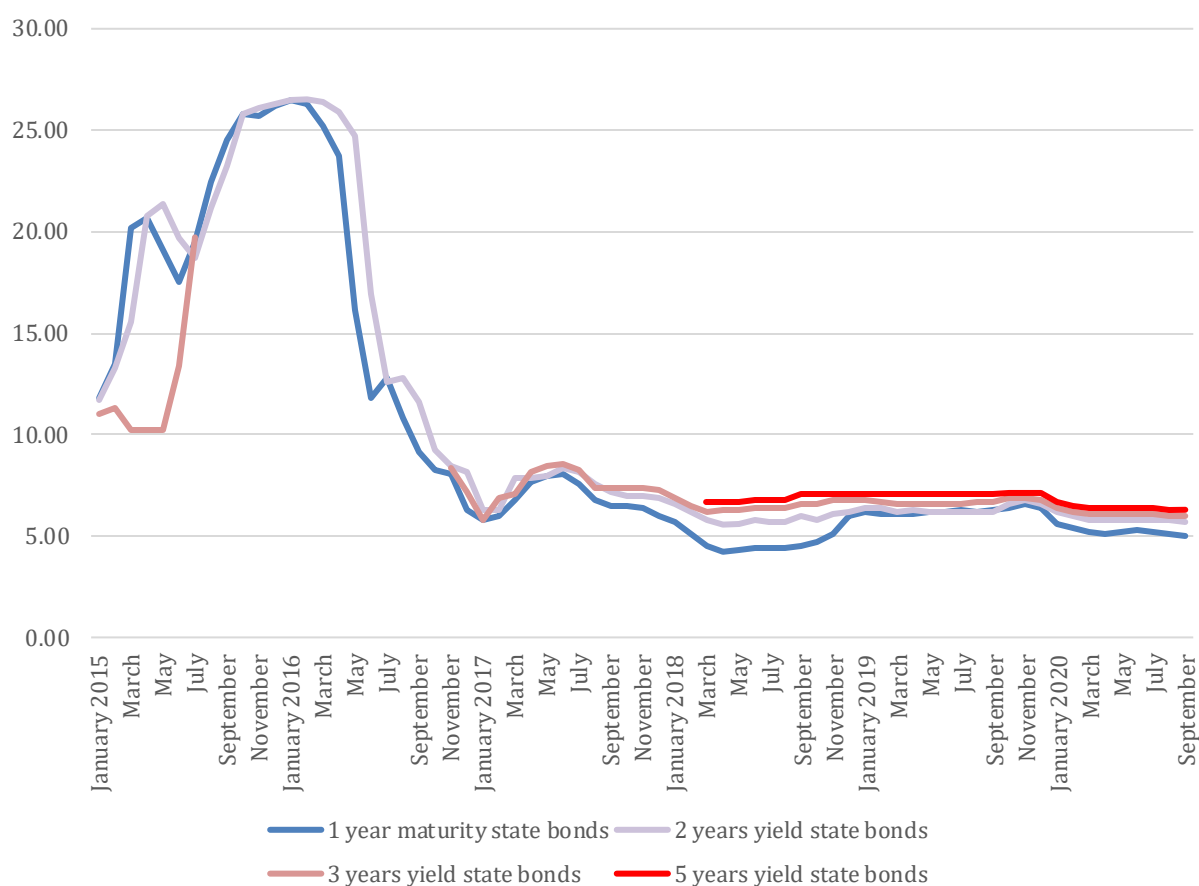
The key criteria for a potential National municipal bonds purchasing Program are as follows:

1. The Government (Ministry of Finance) commits to non-subscribed municipal bonds, if the city/town government is able to subscribe 10%/15%/20% from the planned municipal bonds package to the private market. The shares can vary, based on the destination of the investments.
2. The commitment of the Ministry of Finance can be performed in standard manner, at a fixed interest rate, equivalent to the interest rate on the Government bonds.
3. In order to stimulate and support local development initiative, for certain categories of investments, the Government could accept reduced interest rates, which would be equivalent to the average privately subscribed bonds' interest rate. Thus, the projects in which the individuals and the private sector are ready to accept a lower interest rate, compared to the commercial one, the Government, in turn, is ready to accept reduced interest rates for issued bonds. The Government will cover certain minor costs, but the financial leverage will be tens of times higher in what concerns the investments made in the local infrastructure.

Implementing a national municipal bonds procurement program would generate a series of socio-economic advantages with costs close to zero for the state budget:

1. Significant increase in the success of introducing the municipal bonds as a financial instrument for the local authorities
2. Increasing the certainty of town governments that through this instrument they will be able to collect the necessary financial means for their investment projects.
3. Decrease of the costs of municipal bonds in the proximity of state bonds costs and a certainty for local leaders on obtaining financing at adequate costs. *Please see the evolution of the state bonds costs in the figure below.*
4. Certainty for private investors that the projects will be financed and will generate the planned revenues for paying the interest rates and reimbursing the bond value in due time. The increase of participation of professional portfolio investors (insurance companies, holders of surplus liquidity, banks).
5. Market participants will have a stable reference regarding to the bonds' cost.
6. A dynamic of the municipal bonds market will be stimulated and could become the basis for creating a national capital market.

Figure 1. The evolution of the effective interest rate on state bonds, 2015-2020, %



Source: National Bank of Moldova

A municipal bonds financing program would be a simple efficient in the same time national instrument, which would significantly amplify the infrastructure investments at local level with an unprecedented financial leverage for the central authorities and that will, simultaneously, stimulates the local initiative and population participation in managing the development of their city or village. Such a program would be an excellent complementary instrument of the central authorities for the regional development of Moldova.

4.4. Advantages of the municipal bonds, compared to loans

Each instrument has its advantages and disadvantages and are suitable for certain financing needs and in specific circumstances. For sure each financial instrument has its role and place in the financing mix of each organisation. As the only way an LPA can finance its needs is contracting a bank loan or contracting international financial institutions loans, below we will examine the advantages of municipal bonds compared to loans:

1. The major and non-disputable advantages of bonds are the fact that the intermediary is removed from the LPA and investor relation. The investor provides directly the financial means for the LPA, benefitting from a full remuneration of the lent capital.
2. The LPA has the freedom to quantify and establish their own basis for calculating the bonds' interest rate, the repaying deadlines and thus, correlate the financing parameters as close as possible to the specific features of the financed projects and the associated risks. It is indisputable that these need to be anchored in the national financial market realities and to ensure a comfortable level of risk and benefits for future investors.
3. According to the international practice and investment alternatives of the investors, the LPAs can obtain a more advantageous cost of the accessed financial resources, compared to bank loans. Provided the Moldovan realities, they can be situated between the deposits interest rate and the annual effective interest rate of loans, most probable, in the proximity of the state bonds rates, operated for the respective debt terms.
4. Through a direct relation with the investor, the LPAs can raise awareness amongst investors and obtain reduced financing costs. In the case of the relation with professional operators from the financial market, the awareness margin is significantly lower.

4.5 Conclusions and recommendations

The municipal bonds have their role in the mix of financial instruments and are the most suitable for financing investment projects with direct or indirect revenues or for co-financing grant projects and obtaining the positive financial leverage. In spite of certain flexible aspect of the municipal bonds, the LPAs must treat issued bonds in a similar way they treat a bank loan. It is important that investment projects are properly quantified and complemented by a well formulated cash flow and reimbursement plan. The municipal bonds carry certain advantages compared to bank loans, but, in order to benefit at maximum level from this advantage, the LPAs must select well defined projects that matches best the interest of the community and ensure an active relation with the investors.

Simple issuing and transaction procedures in what concerns the municipal bonds, and reasonable costs, are fundamental criteria for the success of this instrument. The central authorities must be receptive to the proposals that come as a result of testing and piloting the process and issuing bonds in order to ensure simplification and bottlenecks elimination, so that this instrument is transformed into a comfortable one for both the LPAs as much as for the investors.

Even countries with mature financial markets develop and implement municipal bonds acquisition Programs. Particularly, under the crisis effect circumstances, the need to finance LPAs is increasing, but also makes the implementation of a new financial instrument more difficult. Provided that international good practices suggest to create a mechanism of support from the central authorities by approving national support programs, the drafting and implementation of a national municipal bonds acquisition program, is

more than welcome., A good concept of the programme with clear conditions and commitment to buy certain quota of issued bonds will ensure increasing the confidence of the LPAs in obtaining financing for planned investment projects and „normalising” of municipal bonds interest rates. Elaborating such a national program would imply minimum costs for the state budget with an excellent leverage for central authorities, by making financial resources available to the LPA, at costs that can be accessed by the Government of Moldova itself.