

## MUNICIPAL BONDS AS NEW INSTRUMENT FOR ENHANCING LOCAL ECONOMIC DEVELOPMENT IN REPUBLIC OF SERBIA

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**Abstract.** *In 2007 local economic development became a new function of Serbian local governments. According to Article 20 (paragraph 1, item 9) of the Local Government Act ("Official Gazette of RS", no. 129/2007) which defines the self-governed competences of Serbian decentralized units, local self-governments, in accordance with the Constitution and the special Acts: "adopt programs and projects of local economic development and ensure an improvement of the overall framework for economic activity in local government unit." This Act shifted paradigm of local government from a socially-oriented concept of local government to the economically oriented local government whose task is to promote local economic development and create a favourable and enabling environment for investments. One of the local economic development instruments, fully neglected until recently, is municipal bonds. The authors examine recent changes in the legal regime of municipal bonds and practical possibility for the use of this instrument in Serbia. The paper gives a contemporary analysis of the notion and characteristics of municipal bonds, and also of a process of issuing, legal framework and economic feasibility of their use in the Republic of Serbia. The authors examine the problem of rating this type of debt securities and, based on the research, identify what would be the optimum yield of this type of securities in the Serbian market.*

**Key Words:** *decentralization, local government, local economic development, municipal bonds.*

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## 1. THE MAIN FEATURES OF THE LOCAL GOVERNMENT SYSTEM IN SERBIA

### 1.1. General characteristics of serbian territorial organization

The right to provincial autonomy and local self-government of the Serbian citizens has been guaranteed by the constitution (Article 176/1 of the Constitution). There are two autonomous provinces, Vojvodina and Kosovo and Metohia, but the possibility of establishing new autonomies has been provided as well (Articles 182/2 and 182/3 of the Constitution). However, in 2008, Kosovo declared its independence from Serbia.

The autonomous provinces should be distinguished from statistical territorial units established in 2009. According to the below mentioned documents, the establishment of statistical regions comprising one or more districts is provided. Under the Regional Development Act and the Decree on Statistical Territorial Units Nomenclature the state territory has been divided into one NUTS 1 statistical units, five NUTS 2 units (regions) and 30 NUTS 3 units (districts). However, these entities are neither administrative nor political units, nor do they have legal personality due to their special purpose or function which differs from that of autonomous provinces and local self-government units (Lilić, 2009). In the past several years, there has been a strong pressure for regionalization, i.e. introduction of regions as the medium, second tier of governance, but at that time the ruling Democratic Party has not clearly expressed its consent on this issue (see the Party Programme, <http://dss.rs>).

Serbia is divided into 29 administrative districts which are not local self-governing units due to their status of deconcentrated state administrative bodies. In the course of their future position, there have been some proposals that they should be replaced by regions as forms of second-tier territorial self-government units, but without success (Šević, 2001: 429).

The local self-government system consists of 150 municipalities, 23 towns and the City of Belgrade as a special local government unit. According to the Statute of the City of Belgrade, one or more urban municipalities (as a form of sub-city-municipal autonomy) may be established on its territory.

### 1.2. The legal framework of the process of decentralization

Serbia has a long-standing tradition of local self-government (Guzina, 1976), which may be traced back to the times after the Ottoman rule; it was maintained even during the dictatorship of King Aleksandar I and it was discontinued only for a short while after the end of World War II. A strong autonomy of local units was maintained during the socialist period. However, in the first decade after the collapse of the SFRY, local autonomy was undermined by the strong centralistic state politics which considered the local level issues to be unimportant (Lilić, 2002: 49), or even threaten centrally defined policies.

The process of decentralization, based on a significant extension of the self-governing competences, was continued in 2002 by adopting the Act on Establishing Certain Competences of Autonomous Provinces and the Local Self-government Act (LSG). The former was afterwards replaced by the Act on Establishing Competences of the Autonomous Province of Vojvodina (2009).

However, the full capacity of decentralized units could not be fully achieved without additional conditions: fiscal decentralization, subsequent changes of the sector laws,

creation of a stable base of well-educated, professional local civil servants, etc. An unequal development of Serbian municipalities and towns required a gradual transfer of public competences to the local level. The weak local units were not able to carry the burden of the extended scope of activities, which had an adverse effect and resulted in strengthening the centralization process (GRS, 2004: 30). However, an analysis has shown that most towns and the City of Belgrade have sufficient capacities to perform the new functions they are to be delegated during the process (Milosavljević and Jerinić, 2010: 31).

The main directives for continuing the process of decentralization were identified by the PAR Strategy. The conditions thereof were established in 2006, after the constitutional changes had taken place. The new Local Self-government Act (2007), the Local Elections Act (2007), the Territorial Organization Act (2007) and the Capital City Act (2007), which altogether comprise, the so-called, legal regime of Serbian local government, have all been adopted. Taking primarily into account the legislative reform undertaken in the field of decentralization, Serbia has been ranked as an 'advanced intermediate decentralized' state (Cohen, 2010: 37), along with the majority of the Western Balkan countries. However, the creation of a stable legislative basis was just the initial part of the reform, insufficient for the completion of the decentralization process (Vučetić, 2007:40).

### **1.3. The scope of competences and financial autonomy of local self-government units**

The first significant extension of municipal competences (which are the competences of towns and the City of Belgrade) was made by the 2002 Local Self-government Act. The total number of 39 competences to be exercised by municipalities (the so-called self-government scope of authority) has been defined in the Local Self-government Act (2007). One should bear in mind, that the possibility of establishing a local police force is earmarked for towns and the City of Belgrade, but not for municipalities (Article 24). In addition, the City of Belgrade has been given wider competences regarding particular functions such as: water management, construction and reconstruction of streets and roads, city police and fire fighting, and establishment of television and radio stations (Article 8 of the Capital City Act). The possibility of delegation of a particular state administrative function to municipalities (transferred scope) has been stipulated in Article 137/1 of the Constitution and Article 21/1 of the LSG Act.

The Local Self-Government Financing Act, which is the legal basis for fiscal decentralization, was adopted in 2006 and came into effect in the budgets of 2007. The National Assembly has ratified the European Charter of Local Self-government whereby it has assumed the obligation to provide resources for the execution of the self-government scope of functions. But the devolution of tax collection and tax administrative competences to local government units has yielded poor results because of the lack of quality political and technical management (Sigma, 2009: 22).

### **1.4. Political bodies at the local self-government level**

The Serbian citizens exercise their right to local self-government directly or through elected representatives. There are three main political bodies at the local level: the assembly (as a representative body), the (city) mayor and the council (as executive bodies). The

assembly councilors are elected on the basis of a free, general and equal right to stand for election and be elected by direct and secret ballot.

In 2002, there was an attempt to strengthen the political legitimacy by introducing the institute of a direct election of mayors. Even though the first direct elections for mayor were held in 2004, the 2006 Constitution prescribed that municipal mayor shall, after all, be elected by municipal assemblies, and not directly by citizens (Article 191/4). In the next local elections held in 2008 and 2012, the citizens voted only for assembly councilors, not for municipal presidents and town mayors. Unfortunately the direct election of mayors only lasted for one mandate before it was abolished. It is yet to be proven whether this form of municipal organization showed signs of superiority or serious disadvantages to currently running.

## 2. LOCAL ECONOMIC DEVELOPMENT

The number of registered companies and small businesses in Serbia is about three times lower than the average in the European Union. Entrepreneurs in Serbia are obliged to pay more than twenty different types of taxes and fees, and every single entrepreneur spends nearly 80% of the total revenues in the local community where the company operates, either through salaries or the payment for goods and services to the suppliers from local communities. This triples the effects on the local economic activity and has both direct and indirect effect on increasing the local government revenue (Bojović, 2010:6). In addition to these tangible financial effects that business entities have in the community, their contribution to the local economic growth is also reflected through reduction of the number of people receiving social assistance, lowering young people migration, increasing the number of people who regularly pay utility fees, improving the economic picture of a local community, generating new revenues by means of local government taxation which ensures further investments in infrastructure, education and utilities, providing secure customers of local materials and services and ensuring that employees of local enterprises will be buying goods and services in the local community. But, it is not enough to only declare that local economic development is the number one priority for local government leaders. A true commitment of the local political elite to local economic development means that more revenues are directed towards its economic development on a long-term basis. This is possible only if long-term benefits of investing in local community development programs, such as programs supporting the economy, or human resources are clearly explained. For example, by investing two million Serbian Dinars in a project or program that opens or maintains a hundred jobs, the investment becomes profitable within four months.

The World Bank defines local economic development as "a set of activities that aim to build the capacity of local communities to improve their economic future and quality of life for all" (Goga and Murphy, 2006:1). Similarly, Bryant and Cofski understand local economic development as "activities that are conducted in a particular area in order to achieve sustainable socio-economic development" (Bryant and Cofsky, 2004:19). Both definitions state that the modern concept of a good local economic development is not restricted to economic issues, but that development is placed in the context of the overall quality of life, sustainability and socio-economic development.

Local economic development of municipalities implies that local leaders (from the private and public sector) identify real opportunities, development priorities and define mechanisms for change. First, it is necessary to learn about the available resources, to define development priorities and the mechanisms to be used to raise the competitiveness of the local community, to direct these limited financial and human resources to proper goals and, finally, to monitor results of those decisions. The commitment includes the creation of a clear policy which is not subject to frequent change as well as the local community support to implementing the adopted policies.

Serbian municipalities have diametrically different resources and their development prerequisites are different. For example, according to the Republican Bureau of Statistics, the average monthly earnings in 2008 ranged from 13,000 RSD in the Municipality of Bela Palanka (approximately 150 USD) up to 50,000 RSD in the Municipality of Novi Beograd. On the other hand, the City of Kraljevo, for example, covers five hundred times larger area than the Municipality of Stari Grad (in Belgrade), and the capital city of Belgrade has eight hundred times more inhabitants than the Municipality of Crna Trava (in the south-east of Serbia). These large differences between local government units show that some local governments need to rely on different mechanisms and have to find different solutions for their economic development.

### **2.1. The beginnings of local economic development in Serbia**

The beginnings of local economic development in Serbia date to 2001, six years before the formal legal introduction of the obligation of "local economic development" envisaged in the Local Self-Government Act. The City of Indija was the first city in Europe to introduce "System 48", which was originally developed in Baltimore, USA, under the name City Stat. On the other hand, Zrenjanin recognized the value and started using one of the greatest resources for all municipalities in the Serbian autonomous province of Vojvodina - acres of land. Today, many municipalities in Serbia may be proud of a number of successful economic development projects, although direct economic effects of these projects remain hard to measure. Institutional reforms, structural changes in the organization, strategy adoption and introduction of new codes of conduct are just some examples of these programs.

A survey of investors in Serbia (USAID, 2008) showed that economic development is closely connected with other elements of social development, such as: quality of workforce, political stability, quality and accessibility of infrastructure, quality of life and simplicity of administrative procedures.

And, on the other hand, according to the Republic of Serbia Bureau of Statistics, despite the overall trend of rising unemployment, some municipalities in Serbia have increased the number of employees in 2008 (as compared to 2006) by as much as 17%. So, in the same macro-environment, some municipalities are more successful than others (Republic of Serbia Bureau of Statistics, 2008).

### **2.2. Concepts of local economic development**

The macroeconomic and monetary policy created by the central state certainly affects local communities. State regulations, taxes and other legal policies affect the environment for businesses; they can either help or make local business more difficult (Blakely and

Leigh, 2010: 31). However, local government and local policies are affected by availability of, or lack of water, sewerage, telecommunications, infrastructure, and developed construction land. Local governments create procedures on the city level affecting housing, health and education services, availability of labor, safety, opportunities for training and education, and public transport.

The traditional central policy relies on financial incentives and a general approach to the economy, while the local territorial approach is interactive and has a horizontal cooperation with industry. In fact, all investments are actually local, which means that they get to a certain territory, a city or a municipality. The premises of every business and company are located in the territory of a certain local government unit and they employ workers from the territory of that local unit.

The process of managing the economic development begins with the infrastructure, but not only at the local level. Interstate roads are essential for the development of the local economy. One of the first axioms of economic development at the national as well as at the local level is to invest in the so-called "hard" infrastructure. Positive effects were reflected primarily in the number of employees. Today, a shift has been made towards investing in the overall quality of life, particularly given the fact that the developing countries have met the basic conditions concerning developed infrastructure during the 1970s.

On the other note, there is a discrepancy in Serbia. Although experience shows that all economic activities and economic development begin with infrastructure, it seems that only local governments have understood that fact and began investing in infrastructure. Unfortunately, without international roads and good inter-municipal infrastructure, investing in infrastructure at the local level is pointless for those who are not located on major roads.

The survey conducted among the business people of the City of Novi Sad in 2009 (the main question being: "What do you think should be the key issue in the development of Novi Sad?") showed that 67% of the respondents bring up the development of small and medium enterprises as the first-priority issue, and the development of communal infrastructure as the second most important issue, with 49% positive answers (Bojović, 2010:20).

### 3. MAIN INSTRUMENTS FOR LOCAL ECONOMIC DEVELOPMENT

The basic Laws related to local economic development in Serbia are:

- The Local Self-Government Act ("Off. Gazette of RS", no. 129/2007),
- The Local Government Funding Act ("Off. Gazette of RS", no. 62/2006 and 47/2011),
- The Construction Act ("Off. Gazette of RS", no. 72/2009, 81/2009, 64/2010 and 24/2011),
- The Privatization Act ("Off. Gazette of RS", no. 38/2001, 18/2003, 45/2005, 123/2007, 123/2007 and 30/2010),
- The Innovations Act ("Off. Gazette of RS", no. 110/2005 and 18/2010),
- The Act on the Budget of the Republic of Serbia ("Off. Gazette of RS", no. 101/2011),

- The Act on the Development Fund of the Republic of Serbia ("Off. Gazette of RS", no. 36/2009 and 88/2010),
- The Public Debt Act ("Off. Gazette of RS", no. 61/2005, 107/2009 and 78/2011),
- The Company Act ("Off. Gazette of RS", no. 125/2004, 36/2011 and 99/2011),
- The Value Added Tax Act ("Off. Gazette of RS", no. 84/2004, 86/2004, 61/2005 and 61/2007),
- The Act on the Agency for Business Registers ("Off. Gazette of RS", no. 55/2004, 111/2009 and 99/2011),
- The Act on the Registration Procedure in the Agency for Business Registers ("Off. Gazette of RS", no. 99/2011)
- The Public Revenue and Expenditure Act ("Off. Gazette of RS", no. 76/91, 41/92, 18/93, 22/93, 37/93, 67/93, 45/94, 42/98, 54/99, 22/2001, 9/2002, 87/2002, 33/2004 and 135/2004),
- The Public Procurement Act ("Off. Gazette of RS", no. 116/2008),
- The Budget System Act ("Off. Gazette of RS", no. 54/2009, 73/2010, 101/2010 and 101/2011),
- The Act on Public-Private Partnership and Concessions ("Off. Gazette of RS", no. 88/2011).

These Acts have established some very important institutions for local economic development.

There are different types of instruments for enhancing local economic development but the ones used in the Serbian local governance system, in accordance with the aforementioned Acts are as follows:

1. Improvement of administrative procedures and reduction of bureaucracy,
2. Investing in the basic infrastructure, locations building and construction of business premises,
3. Support to existing businesses,
4. Support to establishment of new businesses,
5. Marketing and promotion of investments,
6. Stimulating attraction of investments,
7. Support to associations, development of industrial sectors and clusters,
8. Restoration of municipal space,

Municipal bonds, on the other note, have proven to be a great tool for enhancing capital investments and other types of investments categorized under "investing in the basic infrastructure, locations building and construction of business premises", and that is why the rest of the paper is going to analyze possibilities of their greater use in Serbian municipalities.

#### 4. MUNICIPAL BONDS AS AN INSTRUMENT OF LOCAL ECONOMIC DEVELOPMENT

There are several methods a municipality can use to provide essential funding for local economic development, and researches conducted in other states have shown that traditional methods of collecting revenues are insufficient. One method of financing local development projects is funding based on currently generated municipal revenues or "Pay as

you go" system. However, if local governments rely exclusively on this type of financing, capital investment is then limited to the municipal revenues generated in a given time period. This type of financing is basically more expensive than debt financing, primarily due to the extension of the investment completion period which involves excessive costs (Levitas, 2006:7).

Another, not so common, method of financing local projects is the method based on past revenues i.e. local self-government's earnings achieved with higher inflows over expenditures in a given time period.

The third and most common type of financing is through local authorities borrowing from banks on the basis of their future income.

Transfers to municipalities from the state budget represent the fourth and very common type of financing capital local projects.

The partnership between the private and the public sector (municipality) is being increasingly included in the international practice when the implementation of certain projects is concerned, primarily the development of community services, reconstruction and improvement of local infrastructure, solely with the aim of providing better customer service, and at much lower costs than it would have been the case with public investments.

In many ways, according to some authors, credit debt is economically most efficient. This instrument of financing investment projects is socially justified because of the fact that several generations support financing of the project bringing certain future benefits for them all.

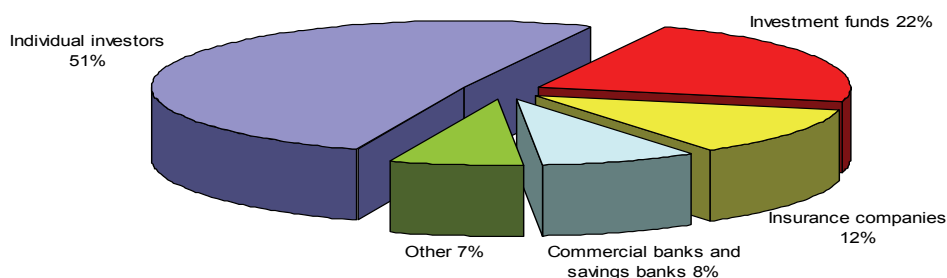
However, as initially stated, all the above listed traditional methods of financing local economic development are insufficient, which has also become evident in the practice of the developed countries.

The example of the U.S. municipal bond market (the tradition that lasts for over two hundred years) suggests to the countries in transition that this type of borrowing enables local governments to fund their growing needs. On the other note, creation of an active municipal bond market in the transitional economies is largely dependent on the capital markets development. The development of capital market institutions such as investment and pension funds has to come first, as well as of life insurance institutions, since these investors are interested in this kind of long-term investment in the first place. Municipal bonds should primarily be used by the local governments at the capital market for financing capital projects. In that way a local self-government obtains a cost-effective source of funding in comparison with a bank loan, and on the other hand, the investors get a more conservative i.e. less risky investments which is considered as a relatively safe investment. This is confirmed by the fact that municipal bonds are among the most secure investments from an investor's (bond buyer's) point of view – nowadays a 50% of the newly issued municipal bonds at the U.S. market are additionally secured from insurance companies and usually have an AAA credit rating given by reputable rating agencies. The intended usage of municipal bonds may be very wide and the collected money is mainly used for the construction of local infrastructure such as roads, schools, hospitals, utilities. It is also used to fund environmental and renewable resource projects, and alike.

Alongside banks, investment and pension funds, and insurance companies, the practice has shown that citizens are most numerous among investors in municipal bonds. Individual investors like these securities because that brings them income in the form of interest, which is generally higher than yield on term deposits from banks, and it is also tax-



free. The fact that this way their invested funds would be used to encourage the development and resolution of local problems of which they themselves will benefit is highly motivating.



**Graph 1.** Investors in Municipal Bond Market

Source: Federal Reserve System, 2011

Even though the countries belonging to the SEE region have been familiar with the above mentioned instrument of local economic development for quite some time, it has taken the Republic of Serbia dozen of years to create an adequate legal and institutional environment for it. Most of the obstacles that had stood in the way of the development of the municipal bond market in Serbia were eliminated in late 2011 (Bucic, 2011:3).

Amendments to the Public Debt Act ("Off. Gazette of RS", no. 61/2005, 107/2009 and 78/2011) now allowed to - beside exclusively financial institutions - all domestic and foreign, individual, private and corporate investors to buy municipal bonds on capital markets. That move opened a door for a larger population of citizens to invest in this market, because citizens worldwide are the largest buyers of Munis as is shown by Graph 1. For Serbia, this represents an additional financial potential of 7.5 billion Euros which equals the foreign exchange savings of the population, and additional 3 billion Euros, which represents unofficially estimated funds of the population apart from regular cash flows. Amendments to the Public Property Act ("Off. Gazette of RS", no. 72/2011) gave back property rights to local governments, strengthened their position in terms of securities for the settlement of liabilities for issued municipal bonds. New Capital Market Act ("Off. Gazette of RS", no. 31/2011) specially defines the complete procedure for issuing municipal bonds, primary as well as secondary bond trading, thereby creating the conditions for this financial instrument to be marketable and therefore more attractive to investors. The standards in terms of data disclosure of issued bonds, the investment project being financed, and the creditworthiness of the issuer are also defined by the Act.

#### 4.1. Effects achieved by issuing municipal bonds in Serbia

Bank loans as a capital investment financing instrument is a procedurally much simpler since these arrangements contain only one contract and one investor that needs to be convinced of the creditworthiness of a local self-government (Levitas, 2006:10). For municipal bonds, especially the public issuance of bonds offered to a broader investment public, the issuer is required to provide a large number of investors with the necessary information, and to convince them of the issuer's ability to settle all the liabilities on time,

resulting in much bigger information and transaction costs that are absent when borrowing from banks. Due to these higher information, transaction and representation costs in many countries there exists the rule that states that the volume of publicly issued municipal bonds must be over 5 million Euros in order to present an economically profitable form of borrowing to local self-governments (Levitas, 2008:3).

**Table 1.** Comparative analysis between bank loans and municipal bonds

<b>Bank loan</b>	
<b>STRENGTHS</b>	<b>WEAKNESSES</b>
ready sources of funding based on bank competition	Interest rates are generally higher compared to other debt instruments
simple procedure of applying for a loan	
financial analysis conducted by creditors	less suitable for large investment projects that require long-term financing
obtaining a credit rating by the rating agency is not required	collateral requirements are higher than the loan amount
credit terms are subject to negotiation	The bank may change the business policies and money supply
<b>Municipal bonds</b>	
<b>STRENGTHS</b>	<b>WEAKNESSES</b>
lower rates of borrowing	complex procedure of issuing bonds
greater transparency of local government borrowing	local government must make its own study and evaluation of credit worthiness prior to issue procedure
long-term financing	necessity of rating agencies
increased competition in the money supply	the risk of failure of the public issue
secondary market trading	undeveloped financial instrument

Source: Guide to a local government borrowing and the latest developments in the NALAS countries, NALAS, 2011

Despite certain advantages, there is a number of limiting factors for the financing of local self-governments through the banking sector. In every country there is a limited number of banks willing to finance local self-governments (Serbia currently has 33 licensed banks) and each bank's business policy limits the level of its credit exposure to local self-governments. Another problem faced by local governments is the unwillingness of banks to finance long-term infrastructure projects. Unlike pension and investment funds as well as insurance companies, banks, especially in Serbia, are characterized by short-term liabilities, which as such have to be aligned with their assets, and this is the reason for the unwillingness of banks to grant long-term loans. On the other hand, concerning local self-governments, long-term financing is necessary when great investment projects are in question, and they can be funded only in the long term from the current budget revenues in order not to compromise the local budget and normal functioning of local self-governments. A great advantage of borrowing through the issuance of municipal

bonds and not through a bank loan is that a local self-government itself determines the issued amount, debt time limit, grace period duration, type and level of interest rates, payment structure and dynamics of the face value (principal) and the coupons (interest rate).

Modest experience of local authorities in Serbia in borrowing through municipal bonds has shown that it is best for a local self-government to simultaneously attempt to issue bonds and to obtain the loan, because with an increased investor competition, it can only profit in a form of reduced borrowing costs (Avakumović, <http://www.krediti.rs/vesti/obveznice-jeftinije-od-kredita/8603>).

In the late 2011, the City of Novi Sad issued its first municipal bonds, first time in financial history of Serbia, after several decades,<sup>1</sup> and saved three million Euros compared with the identical bank offer received for funding the local infrastructure. Parallely with the implementation of the issuance process, the town of Uzice was collecting financial offers from banks. At the end, although bond issuing procedure had been effectively brought to an end, the town of Uzice opted for a bank loan since the conditions were more favourable than any previously given to any local self-government by any bank in Serbia. The town of Pancevo also issued municipal bonds, while Arandjelovac and Kikinda are undergoing the final phase of the program of municipal bond issuance.

#### 4.2. Limitations

In order to get greater use of this instrument in Serbia, what is needed are more transparent operations of local self-governments, transparent management of local public finances and reduction of corruption. It is essential that all municipal financial statements and documents are presented with valid data so that potential investors could have a more realistic picture of the actual operations of a certain local self-government. Up to now, only three cities in Serbia (Kraljevo, Novi Sad and Valjevo) have received the international credit rating. By obtaining the international credit rating, a local self-government signal to investors that its economic environment has become less risky, more transparent, thus allowing it to be a new investment option for international investors (Belkić, Hrnjaz, 2010:37).

Another limiting factor of municipal (local self-government) borrowing is the price and level of current debt of the Republic of Serbia. The Ministry of Finance regularly issues republic bonds which are generally safer and more attractive to investors than the bonds of local authorities, and thereby it borrows at higher rates than municipalities do. In the late 2011, the State was indebted through ten-year bonds in dollars at the rate of 7.25%, while in the same period, the city of Novi Sad issued bonds in Euros with the maturity of twelve years and the interest rate of 6.25%. It is certain that in such situations, the investors (insurance companies, pension funds) are less interested in investing in municipal bonds.

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<sup>1</sup> The City of Belgrade was using bonds as a source of financing more than 30 years ago. In December 1977, medium-term bonds were issued with the maturity of seven years and the nominal value of 16.4 million U.S. dollars. The bond was guaranteed by the Belgrade bank and the sponsors of the issuance were four foreign banks. This bond issuance was used to finish "Sava center".

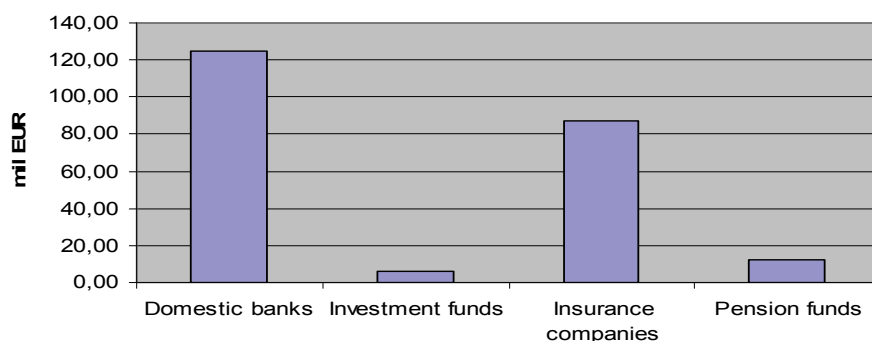
**Table 2.** Average interest rate trends in the financial market in Serbia (period 2009-2013)

Year	NBS key policy rate	The average interest rate on treasury bills in RSD	The average interest rate on treasury bills denominated in EUR	The interest rates of commercial banks to non-financial legal entities in RSD	The interest rates of commercial banks, non-financial corporate customers in EUR	Interest rates on savings deposits in RSD	Interest rates on foreign currency savings deposits
2009	9.50%	12.63%	–	–	–	17.00%	6.83%
2010	11.50%	11.20%	5.25%	16.40%	8.55%	11.79%	5.65%
2011	9.75%	13.06%	5.32%	17.36%	8.50%	11.23%	5.25%
2012	11.25%	13.48%	6.01%	16.55%	8.05%	10.73%	4.35%
2013*	11.50%	11.79%	–	–	–	10.50%	4.05%

\* including January 2013

Source: National Bank of Serbia, the Ministry of Finance-Treasury

A much bigger issue for future municipal borrowing in Serbia presents a total public debt of the Republic of Serbia, which in the late 2011 exceeded the legal limit of 45% GDP and by the end of 2012 it reached 61.5% of GDP. Although the local self-government's participation in the total public debt is low and equal to only 2% (note that the City of Belgrade participates here with almost 70%), any additional borrowing by the local authorities, including municipal bonds, may further undermine the public finances of the state. Therefore, a local self-governments issuance of bonds, is in danger of postponing, since it is necessary to obtain a positive opinion of the Ministry of Finance for the issuance of bonds, which is not exactly easy when one takes into account all the above mentioned and a potential public debt crisis in Serbia, entailing an uncontrollable decline of the Serbian dinar, inflation, decline in employment and a significant drop in living standards.

**Graph 2.** Potential local investors and their investment capacity

Source: National Bank of Serbia, www.nbs.rs

### **4.3. Process of issuing municipal bonds**

The first step is that the local self-government must be provided with an opinion of the Ministry of Finance, regardless of the type of financing source to be used. The Ministry delivers its opinion within 15 days and afterwards the competent authority issues a decision on borrowing.

Second, owing to the fact that the employees of a local self-government generally do not have enough experience with the bond issuance, the local self-government hires a financial advisor (an experienced guide through the complex and extensive process of issuance) upon the issuance of the decision on borrowing. The complexity of this process is evident in the fact that it is not uncommon for local authorities to sometimes employ several financial advisers. The services of a financial advisor include:

- 1) Assessment of the current level of indebtedness of the issuer;
- 2) Preparation of requests for proposals by potential sponsors of bond issuance;
- 3) Evaluation of sponsor offers;
- 4) Advising the issuer when negotiating with insurance companies (in case of insured bonds);
- 5) Conducting informational interviews with potential investors;
- 6) Development of the bond offering formal memorandum;
- 7) Review of key documentation;
- 8) Independent analysis of the issuer's financial status;
- 9) Making estimates on the price of bonds (Naić, 2011:6).

The third stage in the process of issuing bonds is due diligence on both the investor and the sponsor. If it has been estimated that there will not be a sufficient number of interested investors, an option for the local authorities is borrowing through bank loans. For the bond issuer, the best solution is the engagement of a bond issuance sponsor to guarantee the purchase of unsold bonds.

The fourth step is the preparation of information memorandum. It is a standard document the issuer uses to present themselves to potential bond investors. They have to provide a brief report on the financial position and operations of a particular town or city, data on liabilities, assets, profits or potential losses in business. The purpose of this document is to create a realistic picture of the issuer which helps the investors make their decisions on investing or not investing in a particular bond.

Further steps are conducting interviews with potential investors and presenting the planned activities of a local self-government, simultaneously examining the possibilities of obtaining bank loans and reviewing bank offers in order to evaluate which type of borrowing is cheaper and more acceptable and choosing the type of borrowing, and making decision on the issuance of municipal bonds.

## **5. CONCLUSION**

Until recently, one of the biggest obstacles regarding new and innovative instruments for financing of local governments in Serbia was national legislation. Until recently (2005) Serbian municipalities were simply not allowed to borrow money on credit markets. Even today credit market is still largely limited to larger municipalities with good

financial and fiscal capacity, and therefore fiscal decentralization remains a necessity in order to strengthen the capacity of small local governments.

Decades of experience in using municipal bonds as an instrument for local economic development in neighboring countries, unfortunately, did not contribute to its faster implementation in the Serbian system. But, even modest experiences of Serbian local governments in borrowing through municipal bonds, have clearly shown that this is the most effective and cheapest instrument of borrowing for local government. However, in addition to limits set out by Serbian legal system additional constraints are market conditions and financial market development. The level of public debt, bank-centric financial system, and transparency of local government operations, personnel and technical equipment are limiting factors for development of a new instrument of local economic development in Serbia.

Serbian financial system is bank-centric, because banks play a dominant role in mobilizing savings and capital allocation. Corporate and public sector relies heavily on bank loans to finance development projects but also for maintenance of liquidity. Encouraging local governments to finance their development by issuing municipal bonds enhances competition in capital and loan markets, which results in lowering of interest rates.

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## **MUNICIPALNE OBVEZNICE KAO INSTRUMENT ZA UNAPREĐENJE LOKALNOG EKONOMSKOG RAZVOJA U REPUBLICI SRBIJI**

**Dejan Vučetić, Miloš Jovanović**

*Od 2007. godine lokalni ekonomski razvoj postao je nova izvorna nadležnost srpskih jedinica lokalne samouprave. Prema članu 20 (stav 1 tačka 9) Zakona o lokalnoj samoupravi ("Službeni glasnik RS", broj 129/2007) koji reguliše izvorne nadležnosti jedinica proste decentralizacije u Srbiji, jedinica lokalne samouprave: "donosi programe i sprovodi projekte lokalnog ekonomskog razvoja i stara se o unapređenju opšteg okvira za privređivanje u jedinici lokalne samouprave." Ovaj zakon je napravio značajnu promenu u odnosu na prethodni, socijalno orijentisani koncept lokalne samouprave (pružanje raznih javnih usluga, socijalna zaštita i bezbednost stanovništva sa prebivalištem na teritoriji lokalne jedinice) ka ekonomski orijentisanoj lokalnoj samoupravi čiji je zadatak da podstakne lokalni ekonomski razvoj i stvori povoljno i podsticajno okruženje za investicije. Jedan od instrumenata lokalnog ekonomskog razvoja, potpuno zanemaren sve do nedavno, je izdavanje municipalnih obveznica. Autori u radu ispituju nedavne promene u pravnom režimu opštinskih obveznica i praktične mogućnosti korišćenja ovog instrumenta u Srbiji. Rad daje savremenu analizu pojma i karakteristika opštinskih obveznica, kao i procesa njihovog izdavanja, zakonskog okvira i ekonomske opravdanosti njihove upotrebe u Republici Srbiji. Autori ispituju problem "rejtinga" ovog tipa dužničkih hartija od vrednosti i, na osnovu istraživanja, identifikuju koji bi bilo optimalan prinos ove vrste hartija od vrednosti na tržištu Srbije.*

**Ključne reči:** decentralizacija, lokalna samouprava, lokalni ekonomski razvoj, opštinske obveznice