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MUNICIPAL DEBT FINANCING IN ARMENIA THROUGH BORROWING AND ISSUANCE OF BONDS

AN INTERNSHIP POLICY PAPER SUBMITTED TO THE FACULTY OF THE GRADUATE SCHOOL OF POLITICAL SCIENCE AND INTERNATIONAL AFFAIRS FOR PARTIAL FULFILLMENT OF THE DEGREE OF MASTER OF ARTS

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Abstract

This paper is based on the results of the Policy Internship Project conducted at the USAID funded Local Government Project, Phase 3 (LGP 3) implemented in Armenia by Research Triangle Institute (RTI).

Armenian local governments, like in most post-Communist countries, face with the challenge of remedying years of under-investment and under-maintenance in basic infrastructure like water supply, sewage, roads, housing stock etc. Local governments today have severe budget constraints preventing them to sufficiently invest into development of mentioned infrastructure. Therefore prudent borrowing can augment investment capacity with the expectation that local government can later repay the incurred debt either from the future earnings of the facilities built or repaired over their useful life or from local government general revenues. According to the RoA "Law on Local Self-Government" and "Law on Budgetary System" local governments have the right to issue bonds and take commercial bank loans, however, the exact procedures and techniques seem to be not in place yet and therefore there has been no precedent so far.

The purpose of this paper is to review the possibilities of introducing municipal borrowing from commercial banks and issuing bonds in the RoA as widespread municipal debt financing instruments. In many countries these are used by subnational governments or public authorities under their jurisdiction to raise funds for capital construction, repair of public infrastructure and thus improve the quality of public services.

The results of the research have revealed that the legal and institutional environment in Armenia does not support the development of these instruments, financial and administrative capacities of local governments are not sufficient for borrowing as well as paying back bank credits on time: we also have found that the market is not prepared yet for issuing and circulating municipal bonds. Finally, policy recommendations are made on how to improve the legal framework, administrative and financial mechanisms in order to promote and encourage the development of the system.

List of Abbreviations

AMD	Armenian Drams
CBA	Central Bank of Armenia
CEE	Central and Eastern Europe
EBRD	European Bank for Reconstruction and Development
EU	European Union
LBS	Law on Budgetary System
LG	Local Government
LGP	Local Government Project
LGU	Local Government Unit
LLSG	Law on Local Self-Government
MOC	Municipally-Owned Companies
MoF	Ministry of Finance
MoTA	Ministry of Territorial Administration
RoA	Republic of Armenia
RTI	Research Triangle Institute
USAID	United States Agency of International Development

Introduction

Extensive political and fiscal decentralization is now under way in many countries in Central and Eastern Europe (CEE) and the former Soviet Union where new institutions and economic infrastructures are being created to provide the foundation for a pluralist and democratic society. Decentralization as granting the authority of policy-making, decision-making and transfer of sufficient financial resources to Local Government Units (LGUs) is to be followed by elaboration of the most efficient mechanisms of successful implementation. This ongoing process in subnational and intergovernmental level is of considerable importance as the creation of legislative bases and transfer of more power to local self-government bodies is crucial for the establishment of real democracy and development of local self-governance (Henig 1985).

The course of decentralization and formation of local self-government system in the RoA started in 1996 together with required political, legislative, institutional, financial and economic modifications. In parallel with a number of achievements there still exist multifarious problems in need of conceptual, political and legislative responses. The experience of the past periods comes to evidence that theoretically, legislation on local self-government has already been introduced; however actually, the legislation affirms decentralization, local financial autonomy and administrative independence of the subnational level from central control. The language of the laws differs, but the general intent appears to free subnational governments from centralized control and allow local democracy to flourish. Hence, local self-government bodies of Armenia are still very weak.

Today there is a huge investment need at the local level to improve public services that suffer from delayed investments in the past and from the lack of basic infrastructure in some parts of Armenia (water supply networks, wastewater treatment plants). Primarily, own-source revenues from property tax, other local taxes, user charges and central government grants (subsidies) are the major factors determining the amount of funds that can be delivered for capital needs. On the other hand, alternative sources of funds such as grants and donations from international organizations, sister-cities, Diaspora, etc., also determine how much the local government should wish to borrow from the capital market. Such revenues have somewhat crowded out credit from the financing of investment, perhaps locking the local governments into the routine practice, although the mentioned sources of funding are far not sufficient to satisfy the capital needs of municipalities. The inequality in the amount and value of municipal property and further inequalities in the local tax base between large and small municipalities exclude most of the local governments from the credit market, especially the small ones. The remaining few are the potential borrowers. Nonetheless, the final decision on borrowing is to be taken by local politicians and there is a significant fear of indebtedness among the decision-makers that limits the scope of local borrowing (Tumanyan 2005).

This paper has been set forth on the basis of the above fundamental problems taking into consideration the urgent importance of enhancing local government financial capacity through launching the instruments of municipal debt financing with regard to further progress in local self-government systems.

The focus of the policy paper is to review the possibilities of introducing commercial bank borrowing and municipal bonds issuance in the RoA as widespread financial instruments of municipal debt financing in many countries and reliable tools for attracting private investments into the public sector. These debt financing instruments are widely used by subnational governments or public authorities under their jurisdiction to raise capital for building public infrastructure and income generating projects thus improving the quality of public services and promoting economic development. The underlying principle is that since the projects are supposed to benefit the public over extended period of time, these financial instruments spread the payments between generations. In this context, the possibilities of introducing commercial bank borrowings and bonds as mechanisms for financing municipal capital projects in Armenia remain unexplored. According to the RoA Law "On Local Self-Government" (LLSG) and RA "Law on Budgetary System" (LBS) the local governments have the right to issue bonds and take commercial loans in order to finance long-term capital projects. However, the exact procedures and techniques seem to be not in place yet and therefore there has been no precedent so far.[1]

As already mentioned above, Armenian local governments face with the challenge of remedying years of under-investment and under-maintenance in basic infrastructure and housing stock. The underlying purpose of municipal credit market development is to increase the volume of local capital investment in support of essential municipal services. At a time when governments at both levels in Armenia face severe budget constraints, prudent borrowing can augment investment capacity. Consequently, well-designed investment and borrowing plans often can finance needed capital investments today. This assumes that local government which incurs debt will repay it either from the future earnings of the facilities built/rehabilitated over their useful life or from local government general revenues. But municipal borrowing needs not only capacity and willingness of the local governments to incur debt. A municipality has to prove its creditworthiness and clearly identify investment priorities, otherwise it is likely to drain local budget resources and add risk to the fiscal system. Thus, the creditworthiness analysis of the communities is a necessary and an important step for including the loan capital of the community or implementing management reforms. However, before a local government floats a bond issue to incur debt or takes a credit, a great deal of analysis should be performed by financial experts in the investment banking industry to check the financial health of the community selling the bonds as well as

[1] Source: (Webpage: http://parliament.am)

the capacity of the borrowing unit to manage and spend the funds. Certain measures are to be calculated that enable analysts to rate a particular local government in terms of financial risk, in order to be able to set the true value of the bonds. Public administrators should be able to do the same things on the regular basis so that they can provide advice to their governing bodies regarding policies of a long-term as well as a short-term effect on the local government. These skills and capacities also are not in place yet and need to be developed.

The project is going to examine the legal framework of the RoA, financial resources, administrative structure and institutional capacity of local governments, capital markets and potential lenders of capital market in RoA. The paper has the purpose to study some of the best international practices in this area, particularly municipal borrowing in different CEE countries. Based on the review the project will present the current status of the problem and give recommendations on how to improve the legal framework, administrative and financial mechanisms in order to promote and encourage the development of the system.

Based on the above-mentioned considerations this paper addresses the following Research Questions:

1. Does the legal and institutional environment in Armenia support the development of commercial bank borrowings and bonds issuance?

a. Is it sufficient to operationalize the introduction of these financial instruments?

b. What steps can be taken to introduce the system and make it operational?

c. Is there a need for further development or harmonization of the acting legislation?

2. Is the financial and institutional capacity of local governments in Armenia sufficient for borrowing and issuing bonds as well as paying them back on time?

3. Are the Armenian financial and banking sectors ready to support municipalities?

4. Why municipal borrowings and bonds have never been used in Armenia so far?

Literature review

Introduction to Municipal Borrowing[2]

Local government borrowing is a relatively new phenomenon in CEE. With few exceptions, cities and communities were not permitted to borrow before 1990, nor did they have any communal property separate from state-owned property that could be used as collateral. In some countries this situation continued beyond 1990 as the possibility of using credit instruments came during the period which was rather difficult from the macroeconomic perspective. The banking sector was weak; the institutional setting for local government finance was far from stable; understanding the nature of local governments was quite low on the list of priorities of banking specialists, in addition, local administrators and politicians had to learn how to function in market conditions. They usually had little experience in management and financial planning (Struyk et al. 2000). But there was also a psychological factor when local governments found that they had inherited high budget deficit from the communist administration without having any statistical data describing the extent of the phenomenon. The deficit was not related to banking credits but to unpaid invoices or other financial liabilities that could not be covered by current revenues. Coping with that deficit was a test for local authorities (Bird et al. 1996).

Local governments around the world continually face the age-old question whether or not to borrow. Even when elected representatives understand intuitively that borrowing is essential, they still need to be able to explain that interpretation to their constituents (Swianiewicz 2004). Before there was borrowing, all projects have been built with the resources at hand. Even today, many projects are still paid on a pay-as-you-go basis “save every year and then invest what they are able to save”. Other sources of pay-as-you-go

[2] "Borrowing" comes in different forms. Bank credits, municipal bonds and others are various forms of borrowing to be discussed later. Here we generally discuss issues of municipal borrowing without distinguishing its types.

financing are grants, as the government does not have to pay back the money given; however, they are rare (Mikesell 2003). At the same time debt financing through borrowing also has advantages. Borrowing over time is an effective way to overcome the problem of inequitable burden of costs among tax payers. Moreover, benefits from accelerated local development can overshadow the cost of the borrowing. Intergenerational equity is an important argument against pay-as-you-go financing and in favor of borrowing. The principle involved is that those who benefit from project should generally pay for it (Vogt 2004).

But along with these clear benefits there are also potential hazards in borrowing, both of a microeconomic and a macroeconomic nature. The microeconomic danger lies in the potential for excessive indebtedness of some local governments, which may lead to serious difficulties in repayment of loans and may jeopardize the provision of vital public services. At the macroeconomic level, local governments contribute to the overall level of public debt. Local government indebtedness may thus have a negative effect on inflation and other important parameters of the national economy (Swianiewicz 2004).

International Experience

The position of individual countries towards borrowing is highly diversified, however it is important to highlight that bank credits and bond issues have gradually become significant financial resources for projects development in several countries (Poland, Hungary, the Czech Republic and Slovakia). In some other countries (Russia, Romania, Estonia) borrowing has remained a secondary source of funds used by innovators rather than by typical local governments (Swianiewicz 2004). Regardless of the initial boom for bonds (Czech Republic, Slovakia and Estonia) and external conditions for bond issues being sometimes more favorable (Poland), bank credits have remained the main source of capital. This puts CEE countries closer to the European than the American model of financing for local investments where bond type financing is more frequently used. Also, most lending is offered by banks rather than by special institutions established to finance local government projects. The degree of competition among banks varies from one country to another, but usually one or two banks have a dominant position on the credit market (Bird et al. 1996).

The analysis of international experience demonstrated that in Poland, it was very unusual for local governments to take loans in the first half of the 1990s. In 1992 only 2% of rural and about 5% of urban local governments decided to take loans. In 1994 the proportion of municipalities taking commercial loans increased to over 10%. In 2000 it was almost 40% of rural and 60% of urban local governments, and almost 90% in the case of big cities. In Estonia local borrowing started in 1993. The market gradually expanded, and currently there is no local government that has not taken a loan. Hungary, where local borrowing developed relatively early, is an exceptional case as it has decreased during last few years. In Romania local borrowing began only in 1999, and since then a slow but constant increase in the scale of borrowing has been observed; clear increase in 2000–2001, with two bond issues in 2001 and eight in 2002, and a slowly growing number of bank credits (Swianiewicz 2002). In Russia, fluctuations in the emerging local borrowing market have shown a significant correlation with macroeconomic changes, especially with phases of the 1998 financial crisis.

Another interesting observation related to the development in local borrowing concerns the influence of elections. In the Czech, Estonian and Hungarian cases, it was reported that borrowing had usually been expanded immediately before local elections (e.g., in Hungary in 1994 and 1998 and in Estonia in 1996 and 1999). This suggests that young local democracies in CEE are vulnerable, because shortly before elections local politicians try to increase budget spending and that increase of capital expenditures is especially welcomed by their potential electorates. At the same time it is too risky to increase the rate of local fees or taxes. Consequently, taking loans for which repayment would not be a problem after the elections seems an ideal solution (DeAngelis et al. 2002).

Municipal Borrowing Forms

The forms of municipal borrowings have evolved along different paths in various countries. Below are offered the most typical forms of municipal debt financing instruments:

1. Intergovernmental loans (provided by central budget, usually free of any interest and sometimes with a real chance of being transformed into non-returnable aid);

2. Loans from special governmental programs and funds directed by ministries or by state off-budget funds; here environmental protection funds are among the most distinctive (with interest rates lower than commercial loans); (Swianiewicz 2004)

3. Commercial bank loans - taken from local and foreign banks;

4. Municipal Bonds (Mikesell 2003).

Intergovernmental loans are mostly given in response to applications filed by the specific LG, consolidated requests made by associations of LGs or by high merit of so-called political will. The MoF evaluates the loan requests together with the representatives of the municipalities, agreeing on the amount of the loan, interest rate and the time as well as loan guarantees. Generally the state government decides upon the loans, allowing the MoF to conclude the loan agreement. The extension of the loan period is based on the request of the LG or the state government who finds that it is appropriate to increase the borrowing agreement. As has been mentioned, in most cases the interest rates of these loans are lower, could be even 0%, as the state government has absolute freedom to settle on, the rate depends on political will (Swianiewicz 2004).

Governments also lend money received from international organizations to LGs - second-hand loans (Sub-loans) which involve repayment of the loans after the projects financed by the loan have been completed. Likewise, the banks recommend adding a margin to cover the costs of bank transfers and loan administration (Swianiewicz 2002).

This form of funding has been perhaps the foremost in Russia, during 2000 and 2001 when loans from other governments were over two thirds of borrowed resources. Similarly in Ukraine loans from rayons (countries) to siolo (village) are widespread but rarely repaid. In other countries intergovernmental loans do not exist as in Poland, Slovakia or Hungary. In Estonia, lending central government funds is not permitted, although sometimes it can be made indirectly through state-controlled agencies. From 1992 to 1999, in Estonia the MoF had Sub-loans from 12 foreign loans (2.7 billion kroons) - black oil loan from the World Bank, energy loan from the World Bank, energy loan from the EBRD and heating loan from the EU (Swianiewicz 2004).

Loans from Special Governmental Programs and Funds involve mainly housing, environmental protection and water management special loans' programs. The role of these loans is significant in Poland, the Czech Republic and Slovakia. In these countries environmental protection and housing development loans has been offered either as grants or preferential loans from state funds. In Hungary both the housing and water management programs have been offered. In Estonia preferential environmental loans for energy-saving programs have been given (Bird et al. 1996).

Commercial Bank Loans, being flexible and familiar in many countries, are designed to cover expenditures of reconstruction projects in the educational, cultural or social fields. The LGs become more and more active in taking loans from commercial banks as these loans are favorable for many reasons. First of all, today LGs realize that it is difficult to make investments without borrowing, besides local banks are interested in lending to LGs regarded as secure clients; what is more important the economy is developing (Kenneth 1988).

Most countries in Western Europe also have well-known central institutions that channel investment credit to local governments: the Belgium Municipal Credit Bank, the Danish Municipal Credit Association. In Belgium these institutions financed 80% of local investment (DeAngelis et al. 2002).

Bank loans remain the main source of borrowing in most of the countries analyzed. In countries like Poland, Romania and Slovakia discussions take place on the creation of a special bank specialized in lending to local governments. Likewise, the communal bank was established in Slovakia in 1993 by several municipalities. In the Czech Republic there is no clear domination by one bank, but there are three banks with the strongest position on the market: Česka spořitelna, Komerčni banka and Raiff eisenbank. In Poland there is no similar domination of any bank. The Bank of Environmental Protection (BOŚ) is the most active in channeling loans from environmental protection funds, but most of the major commercial banks are very active on the local market (Swianiewicz 2004).

In general, in spite of insolvency cases, local governments are considered by commercial banks to be among the most attractive and desired clients. Sometimes their approach is even too liberal - so they use less demanding criteria than they do with private investors (Epstein et al. 2000).

A significant shift from physical collateral to general obligation and revenue-based financing is a vivid progress for sustained growth in the volume of private sector lending to local governments, as when debt repayment is based on revenues or cost savings generated from the project, both the borrower and the lender tend to focus on the economic costs and benefits of project (Swianiewicz 2004). The analysis prove that in many CEE economies in transition (Czech Republic, Hungary, Poland) the municipal capital market initially has been built around collateralized municipal lending. Later, as municipal budgets became regularize, and the credit market became aware of assessing municipal credit risk, collateral requirements were reduced (Onofrei et al. 2002).

The alternatives for collaterals are revenues of the municipalities and state guarantee letters carried out by a separate governmental decree but none were ever issued in Armenia. However, here investors would be more focused on the quality of the guarantee and would not pay attention to the ability of municipality to pay by its own resources and consequently, calm down municipalities of using self-assessing mechanism. Other possible inaccuracies can be occurred in the estimation of the investment's profitability, the solvency of the consumers and of course, the economic situation (Swianiewicz 2004).

Municipal Bonds are structured differently from commercial loans. The significance of loans and bonds is not the same; as in the countries of Western Europe municipalities rely mainly on loans, unlike the North American (United States or Canadian) model. In France in 1997 banks provided loans over 70 billion francs, while the issued bonds were just about 5 billion francs. Bonds are considered by French local governments more costly than bank credits; however it should be stressed that during the last 15–20 years issuing bonds has become more "fashionable" (DeAngelis et al. 2002).

The bonds issued by municipal governments can be of two types: general bonds and bonds issued for financing purpose-oriented investment programs. General bonds require the same mechanisms for the issuance as registered securities issued in a documentary or non-documentary form and placed in series by auction or on exchanges (Mikesell 2003). For financing investment projects local self-governments issue purpose-oriented bonds which can be of different subtypes, like housing bonds, agribonds, energy bonds etc. The most common are housing bonds which confirm that their holders have invested their funds for construction of a particular housing project. Agribonds are for improving the existing agri-industrial practices. “Energy” bonds are for the restructuring of debt to the federal government in the fuel and energy composite (Swianiewicz 2004).

As the municipal bond market grows and requires professionalism, all the procedures for the issuance of municipal securities are regulated by the Law on the Issuance and Circulation of the Government and Municipal Securities. Moreover, with the emergence of professional underwriters and secondary-market agents, the financial market infrastructure and legal framework start developing (DeAngelis et al. 2002).

In the United States, the bond market has grown out of a banking sector providing loans from depositors’ assets, while in CEE issuing of municipal bonds has developed together with American advisers from USAID or the World Bank. Two issues influencing development of local bond markets in CEE are of great importance. First is that opposite to the situation in the United States, in the CEE countries there is typically no tax freedom related to purchase of bonds issued by local governments which restricts the interest of individual citizen. Second, the future development of the bond market may be stimulated by the pension reform (currently being introduced in several countries) which is for the establishment of well-capitalized pension funds and accordingly, can become a significant investor in municipal bonds market (Swianiewicz 2004).

In the Czech Republic the first issue took place in Ostrava in 1992, and there were altogether 23 issues by the end of 2001. The picture in Slovakia is quite similar as there have been 37 issues in 28 cities since 1993. Unlike the Slovak model, Hungarian local bonds are exclusively private issues, with no secondary market for municipal bonds. In Poland the role of bonds is still very limited, but it has been the most dynamically growing part of the borrowing sector during the last few years. In Romania there have been no issues until the end of 2000, but there were two issues in 2001 and eight in 2002. In Russia the first issues were organized in 1992. The financial crisis of 1998 was a reason for cases of default in municipal bonds and the decline of the market for a short time. But since 1999 it has been possible to detect a dynamic growth again (DeAngelis 2002).

Thus, to summarize the development of the municipal bonds market it should be stressed that there are two models of development: in Hungary, Poland, Romania and Russia the market has been gradually growing (with a break in 1997–98 in Russia due to the financial crisis), while in the Czech Republic, Slovakia and Estonia disillusionment with bonds brought a decrease in their importance after the boom in the mid-nineties.

It is worth mentioning here that although bank credits remain more popular since banking procedures are better known to local governments, bonds allow for lower interest rates and the procedures are easier than for bank credits.

Moreover, big cities are the most active in the bond market, although in several countries small local governments try issues as well. Big cities are also often active on the international market applying for ratings from well-known international agencies. As a result, local rating agencies have been created in some countries, in addition to the activity of international ones. This has been the case in the Czech Republic, Slovakia and Poland. In most of the countries (except Slovakia) private issues that are usually bought by an underwriting bank are dominant. In many cases a bond is simply a specific form of bank credit, denoted that way for bureaucratic reasons (Struyk et al. 2000).

Based on the above, it can be concluded that the revival of municipal bond market is likely to begin in the near future.

Methodology

The methodology applied for this Policy Internship Project is based on the primary and secondary analyses of legal acts and documents, reports, researches as well as relevant literature concerning municipal borrowing in the RoA and other countries. Key concerns are identified based on preliminary information obtained from seventeen Municipalities, MoF, different governmental and non-governmental organizations dealing with local government finance issues and four commercial banks as potential lenders. Sources for analysis were also the laws of the RoA, various reports produced by different organizations (USAID projects). In order to analyze and explore the legal and financial environment in Armenia, purposive sampling method was used for the selection of interviewees to get better understanding on existing situation in Armenia.

Current State of the Municipal Credit Market in Armenia

Today Armenia cannot be said to have a fully functioning municipal credit market where local governments can apply to finance investment needs and where primary lenders can liquidate, buy and sell municipal credit instruments. Local government borrowings play limited role in Armenian local government system. From the very beginning of the 1990s citizens and elected representatives applied great pressure at repairing local thoroughfares, constructing wastewater treatment plants, providing gas and sewage for more municipalities, repairing school and theatre buildings, sports grounds and so on. Although the list of urgent needs is formidable and almost endless, the prevailing option of financing in most municipalities is the subsidy system of granting sources instead of one's own revenues for infrastructure investment projects (Tumanyan 2005).

Basically, the issue is that operating costs of municipalities are rising while revenues are not increasing significantly. Moreover, revenues of capital budget are mostly due to sales of municipal property that cannot continue forever. The huge need of investments is mostly satisfied by grants and subsidies from the central government (subventions or shares of environmental fees for municipalities under the negative impact of polluting industries). The demand for municipal credit depends not only on investment needs, but also on the readiness and ability of local governments to take and repay the debt. By this measure, effective demand over the largest number of local governments is near nil, as most local governments cannot afford to borrow under the present institutional and legislative system. These limitations, however, do not exclude those municipalities with strong economic base and high revenue to take the lead for initiating successful municipal credit and establishing a record of financing investments with loans and bonds (Peterson 1998).

Current Institutional Environment

In order for a local government to receive a commercial loan or issue bonds, a serious and voluminous preparatory work and analyses must be performed by city financial department and banking specialists to check the financial health of the community for acquiring a loan or selling bonds. If local governments do not have the ability to steadily generate revenues and repay over the course of years the eligibility for a credit will diminish. Hence, the financial health of local governments is a directly linked to their creditworthiness which allows ascertaining the impact of future revenue and expenditure scenarios on the capacity of an LGU to balance its recurrent budget and provide sufficient operating surplus for infrastructure investments. In an ideal case the municipality should be able to cover its debt obligations through this surplus as the capital budget doesn't have recurring revenues (Onofrei et al. 2002). In Armenia very few municipalities are able to generate surplus in their operating budgets, thus redirecting it to capital investments. So if there is a surplus in operating part it can be considered as a positive indicator for taking the loan.

Armenian municipalities are required by the legislation to separate operating and capital revenues and expenditures.[3] This separation is essential, as operating expenditures cannot be covered by capital budget revenues; hence, municipal borrowing for operating purposes is prohibited in Armenia. Accordingly, real revenues and expenditures are not balanced, and it is necessary to increase the revenues or reduce expenditures. In contrast, if a municipality is able to fund its operating expenses from operating revenues then the municipality can use the operating result for investments by paying back debts and capital expenditures. On the other hand if the municipality is able to fund its operating expenses, but not debt service, from operating revenues, it still means unsuccessful management of the municipality, as in this case the municipality has to use capital revenues for that purpose.

[3] Law of RoA on Budgetary System

According to the RoA legislation municipality has to cover interest expenses from operating budget while principal expenses from capital budget, municipality can also transfer money from operating budget to capital budget using operation budget contingency fund.

Here, one of the issues is that as a result of the problems with tax collection, current budget revenues are rather low and mostly depend on state subsidies. Armenia is not in a good situation with the aspect of tax administration. Citizens mostly don't pay taxes, as tax payment is connected with corruption and shadow economy level in the country. This situation puts the financial stability of the community in a rather complicated condition by preventing even the smallest needed capital investments.

Under the LLSG some of the municipal services are: garbage collection, heating, per-school education, local public transportation, local roads and public parks etc. This means that a community can improve its services and advance its revenues by rendering these and some other services that imply service charges by the purchase of new equipment or rehabilitation of infrastructure, As a result the consumer of these services will be more willing to pay (Municipal Creditworthiness Assessment Training Source Material 2008).

Another important source of funding according to the RoA legislation is borrowing (LLSG, Article 59 and LBS, Article 30). The communities may take loans for capital investments in development of the social infrastructure of the communities. Financing these through loans or bonds will allow improving collection of fees for services and additional savings. The later are usually increased by improving efficiencies and savings of resources (eliminating water line leakages, illegal connections, installing meters). In addition, improvements will lead to an increase in revenue stream in order to repay the loan.

Borrowing practices are also a matter of local politics as elected officials refrain from borrowing regardless of the fact that the city would benefit. There are number of reasons, why this instrument is not applied in Armenia yet, although the two major laws regulating municipal finance enable this important type of funding. One of the reasons of not using these financial instruments is in the lack of experience in developing capital-investment projects. The capacity of long-term capital planning is crucial because of the necessity to prove the paying-back aptitude which is possible only if the municipality has an enduring strategy and is able to predict its revenue (Municipal Credit Market Development in Bulgaria 2000).

Another important factor is the necessity to have financial institutions that will do a creditworthiness analysis of the borrower. It must be taken into consideration that if a bank is financing the project, it will carefully analyze the viability of the project, creditworthiness and economic stability of local administration. Thus, municipal administration must clearly formulate its debt policy objectives and repayment of its obligations. In Armenia the municipal council must adopt a written debt policy which establishes limits and provides directions to municipal officials in the issuance of debt (Tumanyan 2004).

Assessing the probability of default and predicting the severity of loss, creditworthiness analysis is an essential tool in developing the capacity of local governments to borrow or to issue bonds. An important aspect of this analysis done by the commercial banks or bond underwriters is to assess the risk of default and set the interest rate accordingly (Struyk et al. 2000). In Armenia there is a problem with banking system in assessing the creditworthiness of municipalities. Rating, as an important form of assessing municipalities' creditworthiness, does not exist and hence, lack of experience prevents financial institutions to step in this potentially profitable area (Municipal Creditworthiness Assessment Training Source Material 2008).

Thus, though Armenia has quite a stable banking system open to increasing its lending activities, due to the large number of small local governments, only the largest ones can take loans. The reasons are in the absence of adequate own source-revenues and capacity to manage municipal credits. On the other hand, local governments have difficulties in predicting future revenue flows. Therefore, there must be continued efforts to improve the planning skills of local governments' with sensible rules as well as imposed regulations to maximize their revenues on the securities market (Municipal Creditworthiness Assessment Toolkit Manual 2008).

Current Legal Environment

For the decentralized system to be fully implemented and for the municipal credit market to be developed, local authorities need to have flexibility in decision-making power and financing responsibilities. Although Armenia has established laws regulating the preparation and execution of local budgets, there are still a number of important limitations in ensuring adequate budget management and promoting good financial procedures. Therefore, Armenia will be mistaken to rush ahead with preparations for LGU borrowing, without simultaneously improving the legal framework that enlarges LGUs' role and revenue resources, within the bounds of fiscal discipline. By supporting to the development of local credit market, local government regulations can strongly assist municipalities to provide better public services as well as execute balanced operating budgets (Municipal Credit Market Development in Bulgaria 2000).

According to the law there are no direct limits on borrowing by local governments, but an indirect limit is based on the permissible deficit – total amount of principal and interest to be paid annually should not exceed 20 percent of capital budget revenues (the latter is more properly viewed as an advantage to the local governments, rather than as a form of control) [4]. Without regulations the banks would be unwilling to provide loans or would demand higher interest from those municipalities that borrow more than they are able to pay. The same would happen if local governments tried to issue bonds—the rating would be low and the market

[4] Article 59, Law of RoA on Local Self-Government and Article 30 part 2, Law of RA on Budgetary System

would refuse to buy bonds or would demand high interest. Moreover, along with the MoF Order 1631/1999 the LGUs may only issue bonds subject to the prior approval of the MoF General Department of Public Debt. This condition gives a preference to bank loans over bonds that can result in market distortion and is contrary to the legal direction.

This debt limitation in the law has excluded most of local governments from the market because they do not have adequate revenues. On the one hand this control has a positive effect, by protecting small municipalities from default, on the other hand, it is a real barrier for large municipalities that can use loans for financing their investments, as they are required to borrow less than needed.

According to the LLSG[5] and LBS[6] the borrowed funds are considered as a source for covering capital budget deficit and the maximum net amount of the loan (receivables less payables) annually cannot exceed 30% of average size of the capital budget actual revenues in the 2nd and 3rd fiscal years proceeding the current year.[7] However, investment projects in the public infrastructure financed by borrowed funds are often rather large. Consequently, as the key condition of successful execution of a project is the fast introduction of infrastructure facilities, such tight restrictions on the amount of borrowing at a given time within a fiscal year can bring a harmful impact on the efficiency of the investment policy employed by municipal administrations.

Likewise, Article 56 of LLSG states: *"Should the Community budget be in deficit, and as such balanced by borrowings, the chief of Community, in collaboration with the state authorized agency, shall elaborate the program of gradual repayment of the borrowings in accordance with the procedure defined by the state authorized agency. In such a case, the state authorized agency, in addition to the legal surveillance, shall carry out permanent supervision over the implementation of the agreed program, including repayment of the*

[5] Article 57, Law of RoA on Local Self-Government
[6] Article 28.2 part 2, Law of RoA on Budgetary System
[7] Article 12, Law of RoA on Budgetary System

borrowings." In reality LGs in Armenia are allowed to apply and receive loans and issue bonds only with the approval of MoTA and MoF. At the same time, even if MoF approves, there is little reason to believe that the monitoring agency will do a better job of assessing credit risk than the lenders. Also, it is interesting to note that in many countries, local governments are required to ask for voters' approval for long-term debt. Such requirements ensure public reaction is case if tax rates are going to be raised for debt repayment (Belcher et al.1997) Armenian legislation does not require a referendum for loan approval.

The oversight over local budget completion is realized by Municipal Council through his members, audit companies, National Assembly and Government of the RoA.[8] The oversight also includes regulation of LGs borrowing activities connected with financial crisis (bankruptcy) procedures. There is not a law or established remedial procedures for dealing with insolvent LGs.

With respect to limitations on municipal borrowing, an important factor is the assessment of the risk of lending to a local government. Hence, the problems arise from the accounting system of the LGs as, even though municipalities are allowed to have commercial bank accounts, the restriction requiring to deposit their funds at the treasury[9], diminishes the chances of municipalities as potential clients, hampers banks' control and monitoring over the bank transactions of municipality and makes it hard to use the cash and other budget revenues as collateral.

Investment guidelines for municipal deposits must be established. The MoF sets strict requirements even to borrowing from central government treasury by allowing loans for operating budget expenses and for no more than six months. One community can borrow from the operating surplus of another, but again only through the MoF treasury department

[8] Article 12, Law of RoA on Budgetary System
[9] Law of RoA on Treasury System

which acts as a master service of municipal budgets. Under the LBS, Article 33[10], *"...the treasury departments act as the financial liaisons between financial institutions and municipalities. Loan proceeds and payments for loans are made through the MoF treasury department for all local governments. MoF also establishes the methodology for municipal budgeting and other related processes."* However, while applying for loan it is essential to be able to open a bank account.

Legislative modifications for municipal credit market development are also required in laws regulating financial institutions. All financial institutions focus on to the liquidity and risk weights of the loans. Central Bank of Armenia (CBA) regulations for private banking sectors are rather strict and result in high liquidity - little money is loaned.11 Consequently, changes in regulations can serve as an incentive for financial institutions to enter new and possibly promising municipal credit market. Simultaneously, changes favoring municipalities can be realized by gradually building a successful credit history, which can lead to the decreases of loan interest rates as well.

A shift away from physical collateral and toward general obligation and revenue-based financing may be a significant precondition for the growth of lending to LGs. For lenders, potential attractiveness of LGUs as borrowers is linked with their predictable future revenue streams which in addition to local taxes, fees and revenues include user charges for public services. Types of collateral according to Armenian legislation are only budget revenues and government guarantees. In many CEE countries (Czech Republic, Hungary, Poland) the municipal market initially has been built by using property as collateral for bank loans or municipal bonds. Afterward, as municipal budgets became more stable and the municipal credit market became more familiar with assessing the risk, collateral requirements have been removed (Municipal Credit Market Development in Romania 2000).

[10] Article 33, part 5, Law of RoA on Budgetary System
[11] Law of RoA on Banks and Banking

The present legal framework prohibits LGs to use municipal assets as collateral. This limitation aims at immunizing LGs from enforced sales while a state guarantee is supposed to be issued by a separate government decree. For lenders a state guarantee is the most preferred term for approving a loan to a municipality. However, a state guarantee can also weaken the meaning of proposed loan or bond issue as investors focus more on this guarantee and do not pay attention to the ability of municipality to pay. To get the state guarantee for a loan, LGs must file applications to the MoF describing the exact purpose of the loan and their obligations. If the MoF agrees to provide a state guarantee, it presents the corresponding documents to the state government for authorization to conclude the guarantee contract and issue the guarantee letter. However, the procedure is a theoretical opportunity, since the central government so far has not issued a guarantee to the loans of LGs.

Additionally, the LLSG provides legal authority for LGUs to finance and operate projects also on regional bases. Yet, there is a need for the improvement of a legal contractual framework for joint associations of municipalities not only work together on projects but also to access financing for projects. Here a great role can play Municipally-Owned Companies (MOC) which deliver the basic municipal public services and operate as commercial entities. These companies can easily use financing for infrastructure investments by issuing corporate bonds. Registered under commercial law MOCs can access debt financing without putting municipal budget at risk. So, MOCs are to be strengthened as they have their own assets, the power to borrow money and separated debt as a commercial company. The law must set up a clear legal basis for the pledging of the future revenues of MOCs as loan security (Municipal Credit Market Development in Bulgaria 2000).

According to the analysis, Armenia is in a position to develop the legal and institutional framework first. The poor quality of financial management in municipal sector is the result of the absence of any vision on the use of credit market. There is no incentive for borrowing by issuing of municipal bonds. One of the constraints is lack of interest, and lack of knowledge on how to display all the costs and benefits as well as how to assess financial potential of municipality. In Armenia there is no knowledge on what to do with LGUs bankruptcy regardless of real chance that LGUs would have financial difficulties. For this reason bankruptcy law for LGUs can lay down their rights and obligations. Summing up, among the major problems to be overcome are the absence of defined procedures of getting approval of state authorities as well as adjustment of CBA regulations for municipal loans.

Summary of Interviews and Findings

As it was mentioned above, with the purpose of getting necessary information for the internship policy paper, in-depth interviews with the experts from relevant fields were conducted. In order to have a variety of opinions, it was decided to conduct interviews with representatives from seventeen urban communities recommended by RTI, MoF and four commercial banks interested in municipal credit market development.

The interviews with seventeen communities showed that due to last years' economic decline, the physical condition of communities' assets worsened. Today public utilities systems are in the worst condition, majority of municipal buildings and constructions are subject to repair, municipal offices are not heated; there is a need for expansion and renovation of the road infrastructure. Though there are centralized systems of water supply and sewage, the levels of servicing are far to be satisfactory due to the depreciation of the infrastructure (for example: most of the water supply and wastewater infrastructures are transferred by municipalities to large water utilities to manage them and supply residents with water in a centralized way). Housing stock operations and maintenance are serious issues during the present financial deficit. There are dilapidated buildings in the communities that require urgent rehabilitation as well as depreciated infrastructures.

Analysis of communities' financial condition, creditworthiness and budget reports showed that the revenues were continuously increasing. Revenue growth was noticed almost in all articles: property tax, land tax, non-tax revenues and duties. The rate of financial independence also had a tendency to rise. However, in several communities the revenues from capital budget did not allow the municipality to take credit (Kapan, Vayk and Sisian). Thus, because the community-owned lands, un-useable buildings and other assets had been mainly sold, the revenues in the capital budget in future years would be low and not sufficient to address pressing capital needs. To solve aforesaid issues, it would require involving loans.

According to communities' 2007-2010 capital investment plans, there were a number of projects possible to accomplish through a long-term credit financing. Evaluating these plans it is worth mentioning that the major projects appeared to be: repair of flat and slope roofs of multi-apartment buildinds, reconstruction and improvement of streets and roads (Martuni, Hrazdan, Abovyan, Gavar), heating system, garbage collection system improvement (Vanadzor, Alaverdi), drinking water network renovation, wastewater treatment plants renovation, repair of kindergartens, cultural centers, libraries (in all communities) etc. What is more, in some communities the permitted credit amount was even not enough to be eligible for loan financing (Artik, Vayk).

The interviews also proved that although some communities were creditworthy at the moment they were abstained from submitting a proposal for credit. The main reasons for refusing were: legislative restrictions, high interest rates and municipality's inability to work with banks (Abovyan, Alaverdi, Masis, Kajaran, Vayk). It appeared that Hrazdan community was ready to apply for loan; however the needed credit amount was rather large. Moreover, there was an agreement with VTB Armenia bank due to which the bank had decided to give loan for five year period but legal restrictions were real barrier. The interviews also revealed that several communities were ready to apply for credit and complete all the required banking documents for the realization of the above mentioned projects (Vanadzor, Kapan, Ashtarak, Gavar, Martuni).

The studies demonstrated that the communities and banks had a problem of knowing each other in practice; so close collaboration with banking system and enhancement of professional capacities of the community would improve the existing situation. For example Kapan community with its proffesional staff had experience in applying for credit and accomplishing all the required application forms, however, application was rejected by the bank as the restrictions stipulated by the law did not allow involving necessary amount of loans for funding projects with big value.

Evaluating the communities' partnership with banking system, four commercial banks were chosen for interviews: Anelik (Susanna Beglaryan "Head of Loan Department"), AGBA (Arayik Asryan "Head of Business Loans Department"), Ardshininvest Bank and VTB Armenia Bank (Hayk Shekoyan "Head of Business Development Department"). The interview results showed that although Ardshininvest Bank had branches in 13 urban communities it was not interested to work with communities by saying that the bank did not have enough credit assessment tools for municipalities. The other three banks expressed readiness to co-operate with municipalities. The interview results illustrated that although Anelik Bank had experience of credit default in 1998 because of city's mayor fault; the bank still was ready to provide loans being hopeful that during the years the situation had changed. As for VTB Bank, it was found out that the bank had successful experience of working with municipalities in Russia. Likewise, AGBA had recently got consent from its headquarters in France to start lending to municipalities and now is working on legal regulations to facilitate the process. The main reasons of refusing to provide credit were the lack of any guarantee and mortgage permission, lack of trust towards municipal officials as well as creditworthiness assessment. Among the required documents all the banks stressed the permission from state and local authorities, previous year's budget reports and capital projects subject to crediting.

The interest rate that commercial banks were going to set for municipalities was 1-2% below market level (approximately 16-18%). The banks stated that their concerns were the absence of responsibilities among mayors and misappropriate credit spending, delayed payments etc. However, the banks looked forward to assist and open new opportunities for municipalities, which would enlarge their credit market as well. VTB bank representative stressed that the bank would give preference to the revenue-generating projects; yet others were ready to support any project that would be beneficial for the communities. As a starting point the banks were going to set from one to four year payment schedule in order to decrease the risk level but later the credit would have a long payback period. All the banks stated that after gaining confidence in municipalities the interest rate would have a tendency of being reduced.

At the final stage of interview, Armenuhi Harutyunyan from "Procurement Process Regulation and Budgeting Methodology Department" and Lala Ananikyan from "Budgeting Process Management Department" were the respondents from the MoF. The interview results showed there had not been any borrowing proposal yet; however, the MoF was ready to offer methodological information in order to assist municipalities. Lala Ananikyan highlighted that legal acts should be reviewed and municipalities should work more effectively to promote this process. She said that fiscal discipline and knowledge was needed to develop a good self-analysis in the ability to repay loans which was an instrument that goes beyond the mere preparation of a loan package. She said that the focus should be to increase the skill level and analysis of local government finance directors to be able to put possible commercial loans into perspective in terms of alternative claims on the city's resources as well as consensus about the importance of the capital investment. She also put emphasis on the laws being somewhat vague. Armenuhi Harutyunyan affirmed that MoF could become a loan guarantor only by a government decision. Additionally, they declared that in case of borrowing the MoF could control the credit payments through subsidies.

Summarizing results of the interviews it can be said that from municipalities' standpoints the problems are in the absence of defined procedures of getting approval from state authorities, lack of trust among lenders, small size of loan because of legal restrictions, problems with methodology on how to keep the debt records, lack of ability to design revenue-generating projects that have cost savings and high interest rate. However, out of seventeen urban communities seven refused to apply now and ten agreed to apply for credit. At the same interviews with four commercial banks and MoF demonstrated another viewpoint. The problems appeared to be in possible default of municipalities, lack of mechanisms of transferring funds, management of borrowed funds, auditing report, familiarity with municipal practices; nevertheless, commercial banks were still ready to work with municipalities.

The interview also showed that loans are more preferable for small amounts, do not need special skills, although interest rate is high there is no need for vibrant security market, and what is more important can be implemented now as compared to bonds which require greater expertise and adoption of additional regulations. The analyses prove that the legal and institutional environment in Armenia does not fully support the development of commercial bank borrowings and bonds. At last, based on the interview results financial and institutional capacity of several local governments is sufficient for borrowing as well as paying the loans back on time but for issuing bonds the market is not developed yet.

Conclusion and Policy Recommendations

The present study has examined the opportunities and constraints for municipal credit market development in Armenia through municipal loans and bonds. Based on the analysis it can be said that all parties (LGUs, central government, banks, and other potential investors) express an opinion that the policy issues surrounding credit market development are to be better defined and appropriate legal framework need to be in place before the market springs into action. Regulations by central authorities have a significant impact on the evolution of the municipal borrowing sector in respect to achieving a meaningful level of lending activities over the near term. It is obvious that the financial position of the LGUs is improving, and an increasing number of them are now able to meet the basic conditions for borrowing. The municipalities will also issue bonds in the future; nevertheless, this process can be only expected after their competencies and related revenues have stabilized. Accordingly by increasing the capacity of municipalities to operate in credit market and raising the fiscal discipline to ensure repayment of loans or bonds will allow the community to execute capital projects, assess the budget potentials, predict revenues and expenses, determine the maximum rate of receiving a loan, and based on the priority of aforesaid projects receive long-term credits. Consequently, the ability to understand these concepts and apply them will provide greater financial capacity to meet capital investment goals as well as take advantage of municipal credit market.

Given the embryonic phase of the municipal credit market development in Armenia, the opportunities remain for systematic institutional and legal development in advance of significant volumes of borrowing materialized. Looking beyond technical assistance, large policy expansion course can assess the pros and cons of creating a specialized municipal credit agent (e.g. Municipal Development Fund) as an intermediary institution to assist the entry of private financial sector bodies into municipal lending for investment purposes. Such institution will be responsible for the entire scope of work, including the development of the securities placement and circulation plan, informational support of municipal loans and bond issues, preparation of all documents needed for the registration of an issue, organization of municipal bond placements with all major participants, introduction of meaningful, long term capital improvement planning etc.

In conjunction with all the issues discussed and the results of in-depth interviews this paper has allowed developing the following policy recommendations:

- Preparation of policy dialogue and legislative reform by the central government for changing the current policies related to municipal creditworthiness, making clear the procedures of loan applications (Ministry approval), and reducing the loan limitations.
- Enhancement of professional capacities of the municipal staff for active collaboration with banking system in order to gain the trust among lenders.
- Development of the law regulating the issues of insolvency in municipalities, their rights with regards to creditors, conditions under which to address municipal insolvency.
- Appointment of supervisor or trustee from the MoF for assisting the municipalities to prepare and implement all the procedures as well as financial remediation programs.
- Expansion of municipalities' financial capacities, financial management, capital investment planning and budgeting, improvement of municipal service revenue streams, creditworthiness assessment, operating of borrowed funds, internal control and audit.
- Development of methodology for communities' creditworthiness self-assessment.
- Increase of awareness of revenue-generating and cost-saving projects.
- Encourage issuance of limited liability debt by MOCs, review the legal system and identify possible loopholes that prevent them to borrow on commercial basis.

- Perpetuation of support for training and capacity building to key institutional participants in underwriting and managing municipal credits by international organizations.
- Establishment of specialized municipal credit rating organization to increase the volume of municipal securities by assuming the risk level.

It is worth, recapitulating, that the benefits for municipal credit market are intergenerational equity, optimal allocation of resources, reduction of operational costs, stabilization of required budget resources, efficient funding for capital needs, local economic development. So once several smaller loan transactions are successfully completed, the municipalities and banks could jointly work to lobby the state authorities to make appropriate changes in regulations which would enable further development of borrowing-lending opportunities in this field and contribute to the further social-economic development of Armenia and to the profitability of the banking sector as well.

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Review of interview results from seventeen urban communities

Table

Urban Communities	Creditworthiness assessment (maximum amount of loan in thousand AMD)	Willingness to apply for credit
1. Abovyan	2008 - 48 287,93 AMD 2009 - 119 869,20 AMD	Refuses (high interest rates and legislative restrictions)
2. Alaverdi	2008 - 6 233,21 AMD 2009 - 31 222,34 AMD	Refuses (high interest rates and legislative restrictions)
3. Armavir	2008 - 18 702,21 AMD 2009 - 48 000,71 AMD	Accepts (ready to start the crediting process)
4. Artashat	2008 - 20 737,55 AMD 2009 - 36 791,93 AMD	Accepts (ready to start the crediting process)
5. Artik	2008 - 2 500,00 AMD 2009 - 4 500,00 AMD	Refuses (high interest rates and legislative restrictions)
6. Ashtarak	2008 - 21 681,56 AMD 2009 - 45 018,20 AMD	Accepts (ready to start the crediting process)
7. Dilijan	2008 - 48 557,73 AMD 2009 - 260 480,24 AMD	Refuses (high interest rates and legislative restrictions)
8. Gavar	2008 - 1 447,14 AMD 2009 - 8 575,97 AMD	Accepts (ready to start the crediting process)
9. Hrazdan	2008 - 106 674,53 AMD 2009 - 90 105,74 AMD	Accepts (ready to start if legal restrictions permit)
10. Kajaran	2008 - 1 078,37 AMD 2009 - 12 128,21 AMD	Refuses (high interest rates and legislative restrictions)
11. Kapan	2008 - 12 468,87 AMD 2009 - 31 394,78 AMD	Accepts (ready to start the crediting process)
12. Martuni	2008 - 3 943,20 AMD 2009 - 14 168,21AMD	Accepts (ready to start the crediting process)
13. Masis	2008 - 21 732,57 AMD 2009 - 58 582,73 AMD	Refuses (high interest rates and legislative restrictions)
14. Sevan	2008 - 20 105,87 AMD 2009 - 40 693,53 AMD	Accepts (ready to start the crediting process)
15. Sisian	2008 - 3 000,00 AMD 2009 - 9 149,00 AMD	Accepts (ready to start the crediting process)
16. Vanadzor	2008 - 163 931,45 AMD 2009 - 493 494,86 AMD	Accepts (ready to start the crediting process)
17. Vayk	2008 - 1 800,00 AMD 2009 - 3 105,48 AMD	Refuses (high interest rates and legislative restrictions)

Out of 17 urban communities 7 refuse to apply now and 10 agree to apply for credit. According to the table the amount of permitted borrowing has an increasing tendency within communities.[12]

[12] Note: The creditworthiness assessment is done with the help of toolkit based on calculation of communities' revenues and expenditures which is prepared for urban communities by USAID RTI and LGP Phase 3.