Local authorities need to meet future challenges with their "affairs" in order

- What is creditworthiness and how do municipalities achieve it?

Desislava Kalcheva & Lars M Andersson

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The authors:

Desislava Kalcheva has worked for more than 10 years in the local finance field. She was a Director at the Fund for Local Authorities and Governments in Bulgaria, responsible for the assessment of fiscal conditions and debt profile of Bulgarian municipalities. Desislava holds a PhD in finance, and her PhD thesis is: Fiscal Decentralization and Investment Capacity of Bulgarian Municipalities. Currently she is doing research with the University of National and World Economy, Sofia on a project: "Systems for Financial Stability and Fiscal Discipline of Municipalities in Bulgaria."

Desislava has written a number of papers on the subject of local finance: Municipal capital investments in Bulgaria - a way of development (2013) Impact of the structural funds on the capital investments of the Bulgarian municipalities (2013), Decentralization in Bulgaria - from here to where? (2013) Form and organization of municipal funds for development, opportunities for implementation and management in Bulgaria (2013) Assessment of investment opportunities of municipalities in Bulgaria (2016) Access to debt financing - opportunities for improvement of the investment capacity of Bulgarian municipalities (for the period 2003-2015) (2016) Interrelationship between public investments and economic development in the EU countries (2017). She has participated in various conferences on public finance and public administration in Bulgaria and abroad. Desislava is an individual member of the Network of Institutes and Schools of Public Administration in Central and Eastern Europe**.**

Lars M Andersson has worked for more than 40 years with public sector finance. He started his professional carrier in municipalities and in 1986 he took the initiative to create Kommuninvest, the local government funding agency of Sweden. There he, as CEO, developed the activities during the first 15 years. In 2001 he joined the Swedish Export Corporation as the head of public sector activities and overall communication. In parallel with these positions, Lars has done a number of international advisory missions over the last twenty or more years. He has done a number of advisory assignments in many parts of the world, as, for example, South Africa, Senegal, Bulgaria, Romania, Colombia and Peru. Lars has been an advisor in the processes to create local government funding agencies in the UK and France. Agence France Locale was funding in 2013 and Lars is now serving as a member of the Supervisory Board and as chairman of the Strategy Committee. Lars is also a board member of the Fonds Mondial pour le développement des villes (FMDV), an organisation created by United Cities and Local Government (UCLG) and Metropolis. Furthermore, Lars is a member of the City Finance Lab Committee.

Lars is the author of two books (in Swedish) about the future of Swedish local authorities and has recently co-written a chapter in UN Habitats Finance for City Leaders Handbook. Lars has also written a number of papers on the subject of local finance, as for example "Local Government Finance in Europe – Trends to create Local Government Funding Agencies" (2014), "Finance cooperation between local authorities in developing countries" (2014), "What the world needs now…is local infrastructure investments" (2014) and "Overview of municipal pooled financing practices" (2015).

Local authorities need to meet future challenges with their "affairs" in order - What is creditworthiness and how do municipalities achieve it?

Cities and other local authorities play an essential role in our societies. This role is projected to substantially grow in importance, according to, for example, United Nations[1], UN-Habitat[2], OECD[3] and many others. This development comes with many challenges for the cities of tomorrow. The most pressing challenge is most certainly **finance**. This is true for all types of municipalities and the ongoing urbanisation has further emphasised this. Growing cities will face urgent needs to invest in infrastructure and to provide services to more and more people. Also, municipalities with shrinking population have to keep up the basic services, at the same time as the local tax-base is diluted. The question of finance is a huge one and it could be divided into two major issues: own-source revenues and state transfers. Within the category of own-source revenues there are local taxes and fees. Real-estate taxes in different forms and shapes are common. It is, however, important to realise that in order to tap this source the municipality has to have proper and up-to-date registers of the ownership of land and houses. The registers have to form the foundation for taxing. Even other local taxes need the proper information gathered by the municipality. Then it is, of course, a question of what local authorities are allowed to make use of in order to get income, within the national legal framework. Here we again come to the question of decentralisation, which needs to happen, first of all, because it is here that the public sector meets the citizens. Without proper local services, the national growth is inhibited, but, equally importantly, poor local services increase inequalities and give rise to conflicts and populist movements.

Even with decentralisation happening, the national government should, of course, have a say on the overall strategies of the country. Transfers to local authorities are useful tools for this, but these transfers have to be stable and foreseeable. A local authority cannot carry out efficient activities without having a fairly good view of what the transfers would look like in one, two and three years from now. It is virtually impossible to do adequate budget prognosis when there is no clear vision about annual transfers.

The question of municipal finance is the responsibility of both the local authority itself and the national government. The municipality has to put in place proper administrative processes, including budgeting, accounting, physical planning, public procurements etc. The national government should build sustainable systems for transfers, including equalisation grants. The latter is of outmost importance, since the success of a country depends on equal possibilities for all of its local authorities to produce public services of good quality.

When a local authority approaches, for example, a bank to apply for a loan, the overall financial status is often referred to as creditworthiness. Basically, creditworthiness is about having the local authority's "affairs" in order, which is, to say the least, desirable even when you do not intend to borrow money from anyone. For this reason, creditworthiness could in certain circumstances be renamed to "operational worthiness". But, what is creditworthiness more precisely? The narrow definition is that the entity in question should be able to repay its debt in time and in full, which is not an unreasonable demand. The road to achieving this run through sound financial management, including fully functional routines for budgeting, accounting, reporting and auditing. There has to be also a possibility to predict future income, not only from own-source revenues, but also from central government transfers.

Financial analysis is the most important part of the process of determining the level of creditworthiness of a local authority. It should encompass the following:

Revenue streams
The stability and predictability of local revenue, revenue diversification, tendencies, system of tax-collection and possibility to impose taxes and fees have to be assessed.
Assessment of creditworthiness includes an analysis of different revenues of the local authorities. High level of creditworthiness suggests significant and stable own revenues and good level of tax collection.

The revenue from shared taxes is a part of the local budgets in many countries. Local and regional authorities in twenty countries of the European Union receive revenue from shared taxes. The sum represents around 43% of the local and regional revenue and 20% of the total local and regional revenue[4]. These revenues significantly increase the total own revenue base and imply fiscal autonomy and a higher level of access to the debt market.

During the assessment of income flows the local fees and taxes policy has to be analysed, including the amendments and trends as regards the amount of local taxes. In some countries, sub-national authorities have a right to introduce new fees and taxes (Austria, Belgium, France). For instance, in Bulgaria, the municipalities determine the amount of local taxes within the limits set by the law and may determine the amount of local fees and to introduce new ones at their discretion.

Cost-structure
The costs for separate functions (education, healthcare, residential construction etc.) and according to intended use (for wages, for current maintenance) are analysed. Their distribution and dynamics are assessed. Costs-flow studies assess and analyse which expenditures are made with funds from own revenues and which are made with funds from transfers.

It is important to consider capital and operating costs separately. Equal treatment of costs is achieved when capital and operating costs are considered separately, in particular investment costs are reported specifically, financial stability is maintained.

Often, in the event of financial crises and temporary financial instability, local authorities give priority to current expenditures. It is important to maintain the balance between different types of expenditures and not give priority to the current expenditures.

Balance
The net operational balance represents a difference between current revenue (own revenue from local taxes and fees and total equalization subsidy) and current/operational costs (costs for employee's salaries, social costs, interest costs and others). Under good financial management, favourable economic conditions, and a stable revenue base, local authorities should be able to achieve a positive net operational balance each year.

The net operational balance can be used for financing of local public investments as well as for repayment of debt liabilities. The ability of local authorities to generate operational surplus influences considerably both the investment capacity and the debt financing opportunities.
The operational balance can be negative (deficit) when the local spending exceeds local revenue. If local authorities report deficit annually, it is possible to observe substantial under-financing of local costs. The deficits show a deteriorated financial condition and a risk of delay of the debt payments.

Regarding local budgets, the theory recommends that a balanced operating budget be maintained, and the financing of current/operating costs is done from local revenue sources. Balanced budget recommendations are associated with the so called "Golden Rule". The "Golden Rule" of the balanced budget prescribes that local authorities should never take on debt to cover current costs, but it allows and, in some formulations, even promotes prudent borrowing for capital purposes[5].

The Golden Rule implies that the operating and capital budgets are differentiated and separated. It is recommended that debt financing be used for financing of investment costs only.
Debt financing of operating costs hides a number of risks, incl. an uncontrollable increase in debt burden; and the likelihood of a "Rollover Effect" and the creation of a fiscal illusion.
The Golden Rule is observed in a number of Western European countries such as Austria, Denmark, France, Germany, Norway, Italy, Spain, Switzerland and the United Kingdom[6]. In these countries, the assumption of debt to finance current expenses is only possible in the short term.

In Sweden, it is also a legal requirement to balance the budget, but it is a general view that this is not enough. The vast majority of municipalities comply with the principle of having a 2% surplus. It is viewed that a mere balance is not sufficient for two reasons: a surplus is needed for the self-financing part of local investments and, also, to have a leeway to cope with cyclical fluctuations. There is a debate as to whether the surplus should be not 2% but 3 or 4%.

The separation of capital and operating budgets is lacking in some countries of Central and Eastern Europe, for instance, in Bulgaria. Revenue and expenditure of local authorities in Bulgaria are reported as such for local activities, state activities and for financing of state activities with local revenues. A one-year capital program is set up and presented for capital expenditure; yet often it is not implemented due to a shortage of funds. There is no stability regarding long-term investment programs.

At the same time, we should note that the Golden Rule is breached in Bulgaria. It is formally allowed to take on long-term debt to finance operational costs according to the amendments to the Municipal Debt Act of 2018. According to the changes, long-term debt can be assumed for payment of arrears and for payment of temporary interest-free loans at the expense of the central budget under the Public Finance Act (Article 4, item 8 and item 9 of the Municipal Debt Act). Arrears' structure analysis shows that most of them are arrears for operating costs. Pursuant to the Public Finance Act, temporary non-interest-bearing loans are provided to finance cash disruptions (Article 103 of the PFA).

Amendments to the Act imply creation of a fiscal illusion and prerequisites for a Rollover Effect and debt overhang. The municipalities' budgets may be burdened with deferred payments of current costs through debt for a long-term period. This limits the financial opportunities for implementation of debt financing of investment costs.

However, the law only allows for the possibility of long-term financing of current costs. The Municipal Councils decide whether they will use this option and whether they will burden the municipal budgets with debt financing of current costs.

Assets
The municipal assets have to be analysed in the assessment of the creditworthiness of a municipality. The assets can be used as collateral for debt financing and substantially reduce credit risk. In some countries like Sweden, using assets as collateral is not possible. This legal restriction derives from the thesis that municipal property should not be put at risk. Furthermore,

it is viewed that creditworthiness will not be compromised by this, since other legal features ensure a secure financial situation to be upheld.
The composition of assets, the trends related to increase or decrease, incl. sale or purchase of new assets, depreciation method, market and book prices have to be assessed.

Liabilities
Short-term and long-term liabilities have to be assessed. The overdue liabilities have to be analysed, attention should be paid to the composition of the arrears. Historically, overdue liabilities are assessed and the causes for delayed payments are explored. Current arrears suggest a deteriorating financial condition and reduced liquidity.

Debt
The debt exposure and the annual debt payments are an important element of the financial assessment. In practice, there are different indicators assessing the debt profile of local authorities, but the most significant of them is the total debt value at year-end compared to annual municipal revenues, annual debt servicing costs compared to annual own revenues and debt per inhabitant. The central government often imposes limits on annual debt payments or on the total debt exposure at the end of the fiscal year concerned.

For instance, in Bulgaria, annual debt servicing costs should not exceed 15% of the average annual amount of own revenues and the total equalizing subsidy for the last 3 years. In the event of a breach of the rule, the Ministry of Finance sends letters with instructions to cease the assumption of new debt. The National Audit Office and the State Financial Control Agency also monitor the municipal debt.

In the analysis of the debt profile, account is taken of the diversification of the debt, annual interest payments, fees, commissions and principals, interest, currency and operational risks are assessed, and the maturity of individual loans is examined.

It should be said that debt in itself is neither good nor bad; whether it is one or the other depends on the purpose of taking on the debt. Three categories can be envisaged:

- Taking on debt for the purpose of financing investments that will lower the expenditure of the city in the future. Investments in this category should be encouraged even if it gives rise to increased debt, but, of course, the result related to expenditures has to be beyond doubt.

- Taking on debt for the purpose of financing investments that improve the conditions for the local economy. Here again, the certainty of the outcome is of outmost importance. The clear aim should be to make local companies flourish and the local tax base grow.

- Taking on debt for other purposes. Prudence is recommended!

But, also additional factors play a role when it comes to creditworthiness. These are:

Sound long-term planning
Long-term planning can be conducted on the basis of a trend analysis. The analysis includes tax-base research and assessment, diversification of individual revenue streams, possibility of raising tax revenues, assessment of average annual change in the individual budget items in previous years, assessment and forecasting of costs and transfers. It is advisable to avoid unrealistic predictions.

Often, in order to balance the budget, local authorities plan significant revenues from sale of assets. In a number of cases, these sales transactions do not take place and the forecasts have to be updated. It is recommended to prepare a conservative long-term prognosis.

Institutional and structural issues at national and regional level
This factor implies assessment of central government policy regarding the revenues and expenditure responsibilities and obligations of sub-national authorities. Here we can also include the transfer relations between local and central government, state decisions on additional financial support and special transfers, decisions on investment policy, etc. A number of countries have institutionalist recurrent talks between the central government and local authorities, often represented by their associations. This provides a good platform for resolving outstanding questions.

Capacity development of local authorities
Demographic trends, local economic and business development, future prospects, income level of the local inhabitant's solvency of the local population, natural resources, efficiency and productivity of municipal investments are assessed and analysed. Well-built and maintained public infrastructure is a very important prerequisite for attracting new inhabitants and investors to the region.

Institutional issues
The organization of local government, system of accounting and audit, reputation of the municipal leaders, composition and role of staff and its level of preparedness are very important points for an overall assessment of creditworthiness.

Management
The elements for assessment and analysis are the continuity and stability of governance and local government decisions, the transparency of local decisions and local spending, the publicity of local policies and decisions, the quality of local administration, investment policies, development plans, indicators for the implementation of development plans, etc.

Lately, another area that should be added to the list is **IT security**. More and more local authorities have computerised systems for their service provisions. Moody's Investor Service has discussed cyber risks in two reports[7]. "Cyber risks encompasses a broad range of threats, from web-based denial of service to data theft and disruption of critical infrastructure services" according to Moody's. The rating agency notes the following: "As providers of critical infrastructure services, a cyber attack on one or more utilities would cause major disruptions to these companies' service territory and result in material economic costs to the region and the affected companies". It should be noted that many local authorities provide utility services themselves or are the owners of utility companies.

The cornerstone of a well-functioning local administration

A good financial situation is reliant on a well-functioning local administration. This requires **well-educated and well-trained employees**. Now, we can see at least two problems in this regard and these are more or less common in most countries, at different stages of development.

Problem N°1: Most countries lack specific education and training for future employees of local authorities. Few countries have designated schools and universities for future civil servants. It is totally necessary to acknowledge that the skills needed to work in a local administration are very different from what is required in many private companies producing goods or offering services. The fundamental flaw of the neoliberal view is not seeing that a democratically governed authority is driven by altogether different principles than a private profit-maximising company and therefore requires a different set of skills.

There are, nevertheless, some countries that have created their own education facilities for future high-position civil servants. In France, the Institut National des Études Territoriales (INET) has provided a university-level education for over 25 years. Students are admitted to INET after very competitive exams and only a small part of the applicants are accepted. This is an example worth studying for a vast majority of countries around the world.

Problem N°2: Local authorities have a hard time retaining their high-quality administrators. Working in the public sector means in most countries lower wages than working in the private sector, especially for people in high positions in, for example, a city administration. In smaller municipalities this is even more accentuated, and the private sector is constantly looking for bright people. Brain drain from local authorities to private companies is a fact in most countries. If local authorities are to properly assume their important role for the future, the people working there must be paid accordingly.

Creditworthiness and corruption

Corruption can be classified as grand, petty and political, depending on the amounts of money lost and the sector where it occurs. Grand corruption consists of acts committed at a high level of government that distort policies or the central functioning of the state, enabling leaders to benefit at the expense of the public good. Petty corruption refers to everyday abuse of entrusted power by low and mid-level public officials in their interactions with ordinary citizens, who often are trying to access basic goods or services in places like hospitals, schools, police departments and other agencies.

Transparency International is an organization that works with governments, businesses and citizens with the purpose to stop abuse of power, bribes and secret transactions. The organization prepares and presents annual indexes of the level of corruption in a given context. The index, which ranks 180 countries and territories by their perceived levels of public sector corruption according to experts and businesspeople, uses a scale of 0 to 100, where 0 is highly corrupt and 100 is very clean.

Review of the ratings for 2017 shows that the countries of the Balkans and Central and Eastern Europe have more significant corruption indices than Western European countries.
For example, Romania' index is 48, Bulgaria's - 43, Macedonia's - 35. Countries with an index of corruption at the opposite end are Germany - 81, France - 70, Sweden - 84, Switzerland -85. There is a correlation between the level of corruption and the level of well-being in the country concerned. A higher level of corruption is reported in poor countries with low wages for public sector employees[8].

Corruption can have a major negative impact on public spending, including in the implementation of European projects and access to the debt market. Lack of transparency and accountability can seriously undermine the confidence of investors and creditors and therefore central, local and regional authorities can reduce dramatically their creditworthiness.

Implementing a monitoring system and corresponding strict penalties when irregularities are detected can limit corruption. Increasing the remuneration of public sector employees can also be used as a measure against corruption. Anti-corruption measures can lead to increased creditworthiness and to the gradual growth in confidence in public institutions.

How is creditworthiness analysed?

What first comes to mind is of course the worldwide operating rating agencies such as S&P, Moody's, Fitch. Apart from these there are a number of regional and national rating agencies. Just to mention a couple of examples: BCRA, in Bulgaria and Bloomfield Ratings, located in Abidjan, have both rated local authorities and related entities. The rating agencies' ways of analysing local authorities is fairly well known, so we want to look into how some other entities are working, that is to say central governments and local government funding agencies.

Local authorities are an integral part of the public sector, for which the central government bears the main responsibility. For that reason, a government authority, usually the Ministry of Finance, supervises the local public sector. This supervision could consist in all from very elementary estimates to elaborate analyses. It is very difficult to get precise information about the details of these systems, but a few examples could be mentioned. In France, the Treasury has an updated list of local authorities that have a vulnerable financial situation (le réseau d'alerte) and in Sweden the Ministry of Finance has done specific studies of which financial information helps to detect future problems in individual local authorities.

In Bulgaria, Ministry of Finance assesses and publishes on a quarterly basis, basic financial indicators on the fiscal condition~~s~~ of municipalities, including information about municipal debt by a municipality[9]. There are regulatory constraints on maintaining sound public finances in the Public Finance Act. The Ministry of Finance contacts the specific municipalities when they deviate from the legal restrictions, sends recommendations and monitors their financial status/ municipal debt. There is a procedure in Bulgaria for financial rehabilitation of municipalities. In case of violation of fiscal rules, municipalities should improve their financial position. In certain cases, interest-free loans for financial rehabilitation are offered.

Since the local government funding agencies are conducting their operations based on the creditworthiness of their members/customers, it is essential that they have an updated and comprehensive view of the same. Let us take two examples: Kommuninvest of Sweden and the French Agence France Locale. Both have systems for supervising the financial situation of the local authorities that are involved in their financial activities. These systems have to be viewed in relation to the general financial situation of local authorities in Sweden and France. This means that questions related to, for example, tax collections are not addressed since this is not a responsibility for local authorities in these two countries.

In the 1990s, Kommuninvest introduced a system of risk analysis of new members and semi-annual checks on each of the existing members. The following areas are analysed by this system[10]:

Liquidity: the flow of revenues and the ability to cover payments, both taking short and long-term views.
Balance: the result of the profit-and-loss-account over time. Analysis of trends, the ability to adjust costs to revenues in order to reach a satisfactory result.
Capacity: long-term financial resilience. Analysis of solvency, debt, assets, tax-levels and the local authority's finance policy.

Commitments: activities with inherent financial risks. This could be, for example, entities owned by and/or guaranteed by the local authority.
Internal and external factors: internal factors include questions regarding governance, organisation and staff. Population development, local economy, unemployment etc., are among the external factors.

Agence France Locale has, in turn, put in place a scoring system with a scale from 1 to 7 (1 being the best)[11]. Local authorities that apply for membership and have a financial scoring from 1 to 6 are admitted. The scoring is based on three criteria:

- Solvency
- Budget sustainability
- Indebtedness

For the purpose of loan provision, a socio-economic scoring is performed in addition to the financial scoring, complemented by a qualitative analysis if:

- The financial score is > 5
- The debt ratio is > 120%
- The local authority debt volume with AFL is > 50 M euro
- The requested loan maturity is > 26 years

The qualitative analysis includes governance stability, quality of management, off-balance sheet items and financial outlooks.

The supporters of local creditworthiness

In most countries, the national local government associations are crucial in developing standards for their members and for exchanging experiences between members. In conferences and written information "best practices" are shared.

As noted above, local government funding agencies, in the countries where they exist, could play an important role in keeping the local authorities financially healthy. Here it is most of all a question of peer-pressure since the success of the agency is based on the creditworthiness of its members. Indeed, peer-pressure seems to be one of the most efficient ways of pushing the local authorities in the right direction.

A special network operates in Central and Eastern Europe - The Network of Institutes and Schools of Public Administration in Central and Eastern Europe (NISPAcee). The network is a professional network of more than 120 institutions from almost 40 countries (from the NISPAcee region and beyond) and hundreds of individuals sharing the organisation's mission, established in 1995. The members of the organization may be individuals, associated and institutional representing the central, regional or local authorities. NISPAcee region involved new EU member countries (Czech Republic, Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia); non-EU member countries in Eastern Europe (Belarus, Ukraine, Republic of Moldova, Russian Federation, Turkey); countries in the West Balkans (Macedonia, Bosnia and Herzegovina, Serbia, Albania, Montenegro); countries of Central Asia (Kazakhstan, Kirghizstan, Uzbekistan, Turkmenistan, Tajikistan); countries in the Caucasus (Armenia, Georgia, Azerbaijan). Members of the organization are public institutions, associations and universities, as well as representatives of regional and local authorities[12].

NISPAcee activities are to promote the development of public administration disciplines and training programmes in post-Communist countries. This means increasing the quality of instruction and research and assisting in school/institute development on international, regional and national levels. Part of the mission is also to foster the development of civil service human resources by spreading the practices of good professional public management, public policy and governance and assisting in the overall political and economic transition through effective public service. Most important is the creation of conditions for increased professionalism of the civil service especially through the facilitation of contact between government representatives responsible for public service and representatives and consultants from member institutions. In addition to the advantage this will give the countries involved, it will also help strengthen the position of schools and institutes in these regions as well as NISPAcee as an organisation. NISPAcee unites experts from different countries, and the main activity is to strengthen and improve public administration, to promote the transparency of public decisions and to explore and incorporate good practices.

In post-Communist countries, we observe many universities with programs in Public Finance and Public Administration (Bulgaria, Greece, Romania). Nevertheless, in these countries we observe a high level of corruption and inefficient management of public resources.

The importance of self-diagnosis.

As noted above, the creditworthiness of local authorities is analysed by a number of different entities, but the responsibility for a well-functioning administration, whether it is about to take a loan or not, lies solely with the local authority itself. To be clear, this is the responsibility of the members of the local council and cannot be delegated to the staff of the local authority. To supply the elected local politicians with sufficient information to assume that responsibility, it is very important for the local authority to perform a self-diagnosis. This should be done at least semi-annually, in conjunction with the decision of the budget for next year and at the time when the annual report is being produced.

To conclude, it is always important for local authorities to have "their affairs in order". This is the responsibility of the local authority itself, but in order to take this responsibility the national government must provide appropriate conditions to do so.

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[7] Moody's Investor Services, Utilities remain vulnerable and attractive target of cyber attacks, a credit negative, 2017, and Cyber risks of growing importance to credit analysis, 2015

[8] https://www.transparency.org/news/feature/corruption_perceptions_index_2017

[9] http://www.minfin.bg/bg/810

[10] https://kommuninvest.se/en/

[11] http://www.agence-france-locale.fr

[12] http://www.nispa.org/