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Topic:

THE IDEA OF LOCAL BORROWING IN TIME OF FINANCIAL CRYSES: LOGICAL STEP AHEAD OR POTENTIAL RISK FOR MUNICIPAL OVERDEBT

ABSTRACT

There is worldwide debate "*to let the local governments to borrow, in order to gain financial assets for successful accomplishment of local assignments in the area of local infrastructure*". At this point, when financial crises still asks for its share, there are many related questions, among which the most important is the limitation of the local borrowing imposed by the central government. In particular, in every debate of the municipal borrowing there is always a little query that local government borrowing often creates, or at least contributed to, significant problems. One of them is the potential risk of being *over borrowed.* On the other hand, experts from countries that implemented local borrowing system, see the idea as logical step ahead in order to satisfy the need for additional financial assets, especially in the area of local infrastructure.

The Republic of Macedonia has legally adopted system for local borrowing, but in practice, there is a "gap" between local government's financial capacities and bank's conditions and rules. This paper offers a proposal model for local borrowing (Local Self-Government Units-Development Fund -LSGU-DF) in the situation of lower local financial capacities and present economic downturn.

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Introduction: According to the well-known “principle of subsidiary”, the responsibility for the provision of government services should be at the lowest level of government compatible with the benefit area of the service, since decisions made by a level of government that is closer to its constituency are likely to reflect more closely the wishes of the voters[3]. This principle applies equally to capital expenditures, as well as to current expenditures: local governments should take full responsibility for planning, financing, and executing all capital projects whose benefit area corresponds with the geographic area of the jurisdiction.

Therefore, loan financing of capital investment project is regarded as one of the feasible options to keep the local government infrastructure development afloat. Nowadays, we have worldwide situation where local government systems with higher degree of fiscal decentralization have significant power to mobilize financial resources, by their empowerment of local taxation in combination with local financial management; and financial crises that had hit both central and local economics.

The advantages of higher fiscal decentralization are their revenue potential and financial stability. But in the practice, local government authorities face increased number of responsibilities for providing services in different fields such as education, culture, communal affairs, but also in the infrastructures areas. In that sense, there is international expert debate "*to let the local governments to borrow, in order to gain financial assets for successful accomplishment of local assignments in the area of local infrastructure, or not?*" At this point, when financial crises still asks for its share, there are many related questions, among which the most important is the limitation of the borrowing. In particular, in every debate of the municipal borrowing there is always a little query that local government borrowing often creates, or at least contributed to, significant problems.

In general, in the literature there are two main views: the skeptics who claim that the local borrowing bears higher potential risk of being *over borrowed*, versus other group of experts who see the idea of local borrowing as logical step ahead in order to satisfy the need for additional financial assets.

This paper will examine the second approach.

One of the primary arguments for "yes" to the local borrowing is the derivation of local authorities for better activity, responsively and accountability in the area of local infrastructure, and by that means to enable local development. So, the local government access to capital markets can provide significant benefits. As second, local governments can use borrowing to better match current expenditures with current tax revenues, allowing temporary and unexpected swings in revenues to be smoothed without undue disruption in service provision. As third, but not less important, local governments can use borrowing to finance public capital projects that are lumpy in nature; finance of investment projects via current revenues is likely to be inefficient, and, since future

[3] Vito Tanzi, Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects, 1996, In *Annual World Bank Conference on Development Economics*, Michael Bruno and Boris Pleskovic, eds. (Washington, D.C.: The World Bank).

generations will benefit from long-lived projects, finance via current revenues collected from current generations is likely to be inequitable as well[4].

From central government point, there are three important components related to local borrowing: regulatory frame, limitations and control mechanism. The credit providers (banks or other financial institutions) have other important points in view, such as the financial discipline of the participants of the capital market and law provisions for treatment of the local units at the market (special treatment of local units as borrowers). Also, the efficiency of the judiciary system has huge impact on this issue, especially in view of eventual indebt of the local units. Therefore, as long as the local borrowing can be seen as attractive instrument for raising local revenues, there are very delicate conditions and settings for its use.

1. Local borrowing in the overall frame

Positive impact of every kind of credit (including all commercial credits) is that the possibility for entrance on the capital markets could significantly speed the infrastructural expansion on local level. As supplementary argument, the capital market regulative requires from the local authorities to be extremely transparent, giving in the same time an opportunity for the creditors to control local government finances. This link is established through four processes: external assessments such as ratings, the tender process, reporting and monitoring.

In many countries, mostly in parts of Asia and Latin America, the first generation of municipal loans (credits) - most often backed by central state guarantees or financed by governmental financial institutions have been not sustainable[5]. Municipalities became so used to avoiding repayment of loans that in Latina America the paradox term “prestamo no reembolsable” (a non repayable loan) was created. As a result, most middle income countries have strictly regulated municipal access to credit by introducing: (a) Principle of rigidity and (b) applying indicators to assess the debt potential. Implementation of this approach, enable at least 25 developing countries to allow local borrowing (JAR, India, Philippines and other countries with needed degree of political and administrative decentralization along with relatively satisfactory level of economical development)[6].

In Europe, most of the regulations allow the local governments to borrow, either from commercial banks or from central government financial institutions. But, there are countries where this possibility does not exist. Somewhere, the state or the regional authority apply credit boundaries for local authorities, such as limitations on strictly infrastructural projects making limitations by so called “revenue anticipation“(the credit annuity is related with anticipated local budget revenue).

4 James Alm, Sri Mulyani, Decentralization and local government borrowing in Indonesia, Andrew Young School of Policy Studies, Georgia State University, Institute for Economic and Social research, 2003.

5 Niña Boschmann, Fiscal Decentralization and Options for Donor Harmonization, Development Partners Working Group on Local Governance and Decentralization, DPWG-LGD, Berlin 2009,pg.84.

6 Ibid.86.

For all those reasons, some countries have established a system to provide grants to decrease the borrowing costs for municipalities but let the private banks lend at market rates using their own rules and procedures. From an economic point of view, this is totally justifiable. Also, in many countries the national guarantees for the local government debts are revoked, in order to improve the local accountability and autonomy[7].

2. Economic downturn and local government debt

No matter the state when the municipalities face limited financial potential in time of economic downturn, the parallel process of fiscal decentralization is taking place. Fiscal decentralization requires assigned revenues for providing services at local level, while local government across Europe is bound to suffer from prevailing economic crises. The question is for how long, and what can be done to lessen the harm of the public services it needed to be perform.

The situation is the following: massive fall of foreign investment; raising unemployment; large government budget deficits (for example 14.4 Of GDP in United Kingdom, 10.6 in Spain), and all that caused increases in public sector debt[8]. That increased cost of servicing debt, partly to banking failures, partly to raises in bank lending rates, and devaluation of national currency against euro. The burden is particularly severe for those municipalities which were poor or indebt before the economic downturn in 2009. Broadly speaking, the analysis from various research studies confirms that the impact of the financial crises on local budgets has been very individual respecting different countries and local authorities within countries. There fore we may say that every local government is facing economic downturn, in some cases just slowdown in growth rates, or a real contraction. Economic and social distress may lead to wider threats to public order with their own consequences of public budgets at all levels of local government. So the solutions for the recovery include all kind of possibilities and remedies that are legally approved. Most of the studies showed that the possible way to recover from the economic crises include local borrowing. This solution is applicable in countries with low public debt. Therefore, municipal borrowing might be a fast response with high multiplier affect for stimulating economic growth trough fiscal expansion. Subsidized loans might further help specific investments (for example for energy savings, as well). [9]

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[7] Chuong Phung, Aleksandra Maksimovska Veljanovski, Second Report for the project "Technical Assistance for the Fiscal Decentralization in Republic of Macedonia", Ministry of finance and European Agency for Reconstruction, Brussels, September, 2008.

[8] Report by OSI/LGI to the Council of Europe," The Impact of the economic downturn on the Local Government", Local Government and Public Sector Reform initiative, 2010, pg.10.

[9] http:// econ.worldbank.org/wbsite/external

3. Facilitating local government access to bank credit in domestic surrounding

Municipal bonds are the preferred local governments' financing modality in the developed world such as the US, Japan and Western Europe because the risk is spread among millions of bond holders. However, most developing countries and emerging economies at the same income level as Republic of Macedonia must still rely on credit from commercial banks or specialized development banks to fund their investment needs because their financial system is not developed enough and because there are few bond takers, beside banks and a few institutional investors, such as pension funds and insurance companies.

Discussions with banks seem to indicate that the most important obstacle to bank lending is the municipalities' lack of adequate repayment guarantee. Banks work with collateral and municipalities cannot offer their assets which are public goods as loan guarantee. There are other obstacles, such as the quality of municipalities' financial reports and accounts, lack of long-term planning (which could be improved with technical assistance), but banks would be willing to lend to municipalities if they have adequate assurance of repayment.

On the other side, municipalities appear ready to borrow from banks, if credit terms are adequate. Many claim their financial situation does not able them to pay the on-going interest rate of about 7%-8% p.a. Also, the maturity of bank loans, typically less than 10 years, is too short for long-term gestation projects, such as sewerage or solid waste management and control.

Thus, two issues: (i) Lack of collateral from municipalities; and (ii) Adequate borrowing terms must be solved for municipalities borrowing from banks to actually happen.

With regard to the first issue (lack of collateral), many countries have solved it by agreeing to use the central government grant transfer system as guarantee for loan repayment. In the Philippines, it's called "block grant intercept". In a nutshell, the borrowing municipality agrees to open an account in the lending bank (if it does not have one yet) where its grants from the central government would be deposited and allows the lending bank to repay itself first using funds in the municipality's account.

In Republic of Macedonia where municipalities must have their accounts with the central bank, the matter can be solved by the borrowing municipality giving an irrevocable order to the central government (or central bank branch where the municipality has its account) to repay the lending bank first. The central government, which must be informed of all municipalities' bank borrowing, can also get involved by agreeing to repay the lending bank with the grants it regularly transfers to municipalities. In countries applying this system, bank lending to municipalities have increased two or three folds. Experience has also showed that lending to municipalities is no more risky than lending to private enterprises, the commercial banks' core client base.

With regard to the second issue (adequate borrowing terms), it must be recognized that some municipalities, because of their economic base or small size and small population, can never be creditworthy for bank credit and need central government's assistance if they were to borrow from private banks. There is also very strong economic justification for central government's involvement when the municipal projects have important externalities and a strong impact on public health, such as sewerage or solid waste management projects.

For all those reasons, some countries subsidize borrowing from municipalities by creating a special window with concessionary rates or forcing commercial banks to give preferential treatment to municipalities. However, government intervention in the functioning of the financial system has substantial costs down the line, delays the development of the sector and should be avoided.

Thus, instead of subsidizing local government borrowing, more and more countries give grants to decrease the borrowing costs for municipalities but let the private banks lend at market rates using their own rules and procedures. The proportion of the grant in the total financing package depends on the economic base and financial capacity of the municipality as measured by the poverty mapping discussed in the previous section. From an economic point of view, this is totally justifiable, particularly when the projects have externalities and strong impact on public health.

3. A proposal model for local borrowing in time of economic downturn

An illustrative cost sharing is provided below and is based on an actual situation of a country using the system a few years ago (Philippines). The proportion of grant increases with the perceived weak financial capacity of the municipality. The richest local government unit is receiving no grant at all, and the poorest ones is receiving almost all the financing in grant. However, for sound financial practice, they are still asked to contribute at least 10% to the total cost of the project.

Table 1: Financing of local government unit investments – Illustrative Cost Sharing[10]

(%)

	Class 1	Class 2	Class 3	Class 4	Class 5	Class 6
LSGU own funds	30	30	30	20	20	10
Gov. grant	--	10	20	40	70	80
Bank loan	70	60	50	40	10	10
Total	100	100	100	100	100	100

A similar system could be established in Republic of Macedonia. The grant element can come from the capital grant transfers foreseen in the Law on Financing the Units of Self-Government (LFUSG) which has been used only parsimoniously. Or better, it could come from equalization transfer.

Therefore, instead of transferring the totality of the equalization funds, a portion, say 20%, would be retained for distributing to those municipalities which invest in long-term gestation, non-generating

[10] Chuong Phung, "Technical Assistance for the Fiscal Decentralization in Republic of Macedonia", European Agency for Reconstruction, Brussels, September, 2008

revenue projects with strong impact on public health. The capital grants foreseen in LFUSG could be eliminated as they are no longer needed. In the proposed new system, capital grants would go to municipalities which invest and distributed according to a well-established and transparent cost sharing system.

The system discussed above takes care of the cost of borrowing for weak municipalities. However, there is still another issue remaining: the maturity of bank credit, which typically is less than 10 years, while some municipal projects, such as sewerage, need much longer terms (between 20 to 30 years) to be financially viable for municipalities.

To solve this issue, a new financing mechanism should be put into place. It could be a window in the country's development bank or at the central bank or a new municipal development fund.

This Local Self-Government Units-Development Fund (LSGU-DF) would receive grants or concessionary long-term loans (up to 30 years) from aid donors (all aid donors finance municipalities through a local financial intermediary) and would pass on the resources to private (and public) banks for lending to municipalities. LSGU-DF could also issue bonds in Republic of Macedonia or in international markets. Being back by the Government, it should appeal to local and international investors and would be able to get good rating for its bond issues.

4.1. Implementation of the model in Republic of Macedonia

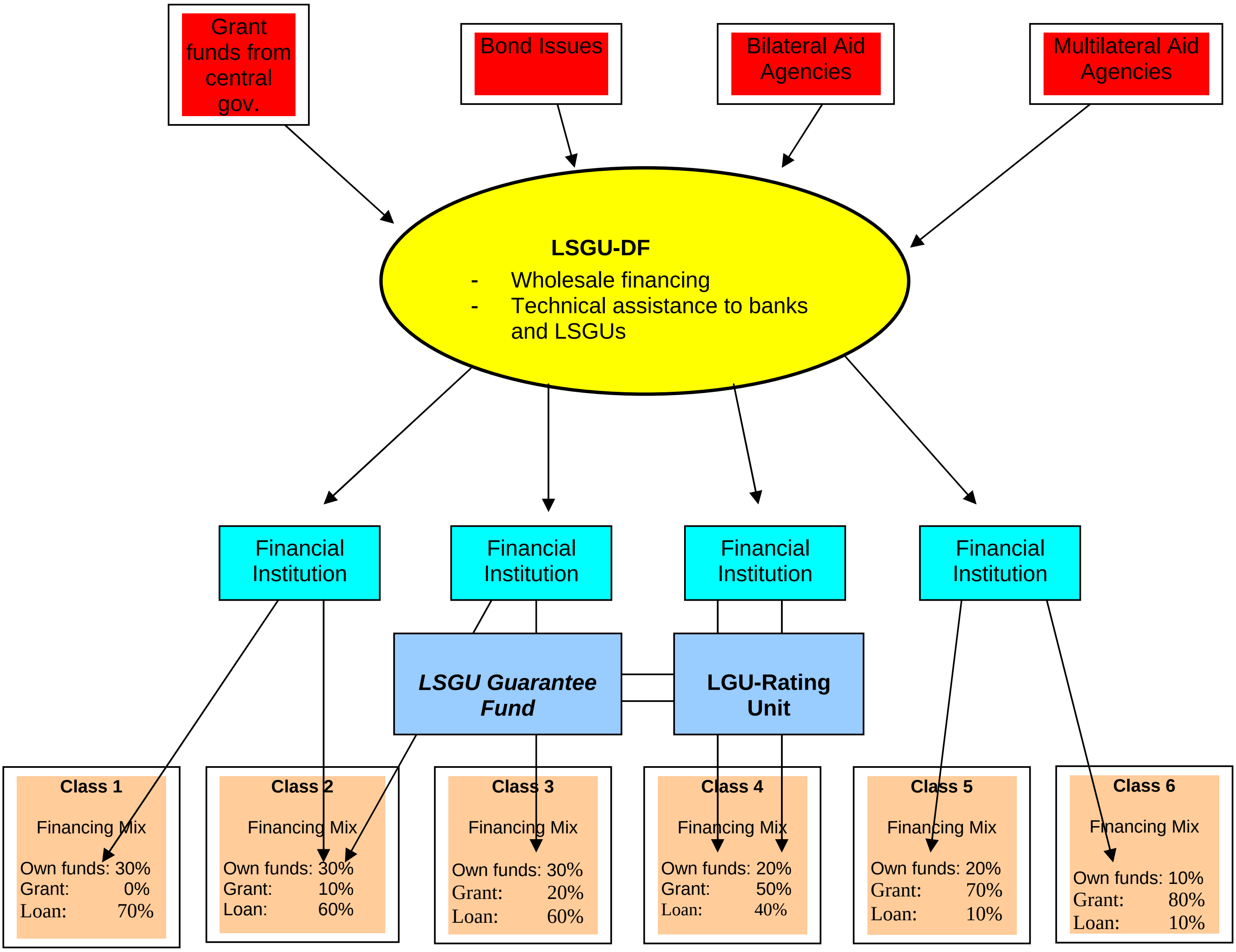
The LSGU-DF would not be lending directly. It would only discount loans made by banks to the local governments and provides technical assistance to both local governments and the participating banks. Indeed, while local banks are competent in assessing the merits of private promoters' projects, they may not be familiar with long-term gestation projects with important externalities submitted for financing by municipalities. Municipalities may also not be familiar with the banks' information and data requirements for loan applications. There is thus a need for technical assistance to both the lending banks and the borrowing municipalities, which the LSGU-DF should provide with donors' assistance.

LSGU-DF would also manage the cost sharing system, including grant funds from the central government.

In countries where this system (or a variance of) is applied, participating banks sign a participating agreement with LSGU-DF, which guarantees them that their loans to municipalities are eligible for discounting with the LSGU-DF whenever needed. The banks then lend to municipalities using their own resources and appraise the project and credit risk using their own policies and procedures without any interference from the government. They can keep the loans as long as they wish and discount them with LSGU-DF when they need resources. Like in the Philippines, banks may also have their own guarantee fund to mitigate the credit risk or use credit rating agencies (often set up with foreign assistance) to help evaluate the borrowing municipalities' creditworthiness.

As can be noticed, the main idea behind the proposed model is to use financial institutions, which are best placed to prepare and finance investment projects and to promote greater and more effective private sector participation in the financing of LGU investment projects.

Figure 1: proposed LSGU-DF[11]



[11] Chuong Phung, Aleksandra Maksimovska Veljanovski, Second Report for the project "Technical Assistance for the Fiscal Decentralization in Republic of Macedonia", Ministry of finance and European Agency for Reconstruction, Brussels, September, 2008

4. Benefits of the proposed model for Republic of Macedonia

The main advantages of the proposed system are as follows:

a) Consistency with Law on Financing of Self-Government Units

Traditionally, the central government has been the main provider and/or financier of infrastructure in the country. However, over the last decade, several factors have conjured to make it necessary to rethink the role of the Government in that area:

- Central government's resources are insufficient to meet the basic infrastructure needs of an expanding population (particularly in urban areas);
- Decentralization has assigned to local governments the responsibility of delivering the basic goods and services, such as water supply and sanitation at the local level;
- Necessity for local governments to meet the EU infrastructure standards as part of the member ship accession process; and
- The Law on Financing of Self-Government Units encourages municipalities to borrow from banks and capital markets.

Thus, the role of the central Government is gradually shifting from being a major provider of goods and services to playing a coordinating and enabling role to help the markets provide as much financing and delivery of urban infrastructure as possible.

b) Equitable System

The proposed model puts the emphasis on equity and gives all local governments, regardless of income levels, equal access to financing. A system solely based on efficiency would leave out many fiscally weaker municipalities[12]. The model's financing mix also makes it unnecessary to have recourse to interest rate subsidies, which introduce distortions in the credit system and discourages banks from lending to local governments.

c) Simple and Transparent System

Under the proposed model, all municipalities are eligible to present their investment projects to participating financial institutions (FIs). The decision to submit a project for financing is made by the municipalities themselves, which is how it should be since they know best what the priorities of their communities are. The FI will analyze the project and, based on the financial and economic merits of the proposal, will decide whether or not to finance it. The burden of project screening and selection is passed on to the FIs, which will apply their own project appraisal criteria, which are generally sound. Since FIs are lending and taking the project and credit risks, project evaluation and monitoring will also be done by the financing institutions.

[12] If a municipality wants to borrow for a revenue-generating project, such as construction of a market or slaughterhouse, it should ensure that the project generates sufficient revenues to pay off the bank loan because, in this case, it should bear the full cost of bank credit.

d) Development of a Long-Term Capital Market

Under the proposed model, banks can discount their loans to municipalities with the LSGU-DF any time they need resources. This guarantee of resource availability should encourage banks to keep the loans as long as they could (because they earn more money), thus encouraging the development of a long-term capital market in the country.

Summary

In every debate of local borrowing there is also little question that local government borrowing has sometimes created, or at least contributed to, significant problems. When local governments are given preferential access to capital markets, they may be encouraged to undertake capital projects whose economic justification is weak. More importantly, when local governments are unable to repay their loans, the central government may be forced to assume responsibility for the debt service. If widely anticipated, this may in turn lead lenders to act imprudently by lending to local governments that are not creditworthy, it may encourage local governments to borrow excessively, and it may create unplanned and uncontrollable fiscal liabilities for the central government.

This paper explains the necessity of local borrowing as logical step further in time of financial crisis and economic downturn in domestic and comparative surrounding. As second, the paper includes a proposal- model of crediting municipalities. The idea is taken from comparative legislative in different countries such as Filipinas and JAR, but also some European experiences are considered. Very important parts of the paper are findings of couple of research projects were the authors participated.

At the start the authors explains the idea of local borrowing, the impact of economic downturn on municipal development and focus on the necessity for local financing, both by bank credit and local bonds in order to satisfy local infrastructural needs such as waste management, water supply etc. The introduction is followed by an overview of local crediting in some countries with similar GDP and local development as Republic of Macedonia.

In the main text, there are several related parts: local borrowing in the comparative legislative; credit versus bonds; open questions for municipal crediting; proposal for implementation of the new crediting model in Republic of Macedonia; obstacles and perspectives of the proposed model and conclusion as closing part.

The final conclusion is establishing a Fund for Local Development that will have interactive part in municipal borrowing for long-range capital investments.

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