INTRODUCTION

1. In many countries, the responsibilities for the provision and financing of public services are being increasingly decentralized. In transition and developing economies, the expanded local government role in service delivery is often hindered by limited financial resources, as well as weak institutional capacity particularly in terms of inadequate financial, practices, management and know-how. In this context, this note reviews the broad range of parameters pertaining to a sound local government finance system, including local government capacity and potential to access private capital markets in a way consistent with macroeconomic stability and policy objectives.

2. To this effect, the note identifies the building blocks for a resilient local government finance structure and the crucial elements on which local government creditworthiness is predicated and is likely to be assessed by relevant market players. The main issues in this regard relate to: enhancing the local regulatory framework and institutional capacity for effective service delivery; improving inter-governmental fiscal relations, and budgetary and control systems; and strengthening local financial management and capacity to mobilize private capital markets in a way consistent with macroeconomic stability and policy objectives.

LEGAL, REGULATORY AND INSTITUTIONAL ENVIRONMENT FOR LOCAL SERVICE DELIVERY

3. The full benefits of decentralization may only be captured if there is an effective legal and regulatory framework that provides for rational and unambiguous relations between central and local levels of government in terms of responsibility for services. Moreover, the effectiveness of local service delivery is linked to the soundness of the institutional environment within which investment responsibilities are allocated, infrastructure investments planned, public utilities operated and tariffs set. An effective local government finance system is underpinned by a sound local institutional capacity which would call for strengthening the local setting for service delivery and easing resource constraints through revenue generation from services. This would inter alia be predicated upon:

   (i) Rationalizing expenditure assignments between tiers of government in allocating clear planning, investment and operating responsibilities for service delivery.

   (ii) Allowing for an effective role and competitive participation of the private sector in the provision of local infrastructure.

   (iii) Strengthening the organizational setting for local service delivery in terms of autonomy, accountability and planning and operating capabilities of local public entities.

   (iv) Setting clear performance criteria and other regulatory mechanisms for monopoly services.

   (v) Improving the efficiency of municipal asset management and use.

   (vi) Building local government staff capabilities.

   (vii) Developing rational pricing policies for local services differentiating between revenue generating services and public goods, and improving the collection levels of user fees.

FISCAL DECENTRALIZATION AND PUBLIC FINANCE

4. A sound strategy for effective decentralization requires improved capacity for stable own-source generation by local governments. Building such a capacity is predicated upon the existence of an effective
public finance and fiscal framework that could be strengthened through such measures focusing on:

(i) Rationalizing local tax bases and rates and improving tax administration and collection levels.

(ii) Rationalizing inter-governmental fiscal relations and streamlining revenue sharing policies and arrangements between tiers of government.

(iii) Setting predictable rules for central government transfers and grants.

(iv) Removing disincentives from transfer rules and reducing moral hazard.

**BUDGETARY AND CONTROL SYSTEMS**

5. A sound strategy for local capacity building aimed at a strong local government finance structure would require effective and reliable budgetary and control systems for local governments and affiliated entities. Implementing such a strategy would involve such measures as:

(i) Strengthening and updating local government current and capital budgeting processes.

(ii) Developing credible accounting systems and implementing independent audits.

(iii) Improving local government cash management, payment and financial control systems.

(iv) Developing indicators on local government finance—such as ratios of debt service to revenues, current revenues to current expenditures, local taxes to local revenues, local taxes to total revenues, etc.—that allow standard comparisons between, and ranking of, local government entities.

(v) Setting financial disclosure standards that provide investors and creditors with relevant information on local government entities and provide a reliable basis for credit ratings.

**LOCAL GOVERNMENT FINANCIAL PLANNING AND MANAGEMENT**

6. A sound strategy for effective decentralized policies should seek to strengthen local government financial management capability, and—as an essential medium-term objective—to improve local government creditworthiness, which would call for measures aimed, *inter alia*, at:

(i) Improving local government financial planning (including a reliable capital budgeting system).

(ii) Improving local government assets/liabilities management.

(iii) Improving local government liquidity management.

(iv) Improving local government financial risk management.

**INFRASTRUCTURE FINANCING AND ACCESS TO PRIVATE CAPITAL MARKETS**

7. A decentralized strategy for effective service provision and local government capacity building might have to reassess the selection and financing criteria for local government programs and projects. In this regards, it should carefully consider alternative funding schemes, including where feasible privatization and concession of services, that enhance local government potential to mobilize private resources including domestic credit in ways that create no contingent liabilities at higher government levels. This would in particular involve:

(i) Strengthening the review process of local public investment programs with sound selection criteria for investment projects.

(ii) Establishing project risk/return benchmarks and profiles against which infrastructure financing proposals could be assessed

(iii) Developing budget-neutral funding schemes including non-recourse corporate and project finance options that could reduce claims on fiscal resources.

(iv) Assessing the potentials and conditions for mobilizing debt funding backed by local government taxing powers (general obligation bonds).

(v) Assessing the potentials and conditions for mobilizing debt funding secured by user fees and other dedicated streams of income (revenue bonds).

(vi) Assessing the potentials and conditions for mobilizing debt funding on a corporate finance basis (balance sheet finance).

(vii) Assessing the potentials and conditions for using short-term municipal instruments (municipal notes, commercial paper and other special instruments) to manage cash-flows and mismatches between expenditures and revenues.

(viii) Assessing the potentials and conditions for establishing "special purpose districts" to provide
services such as water and sanitation to residential or commercial developing areas.

(ix) Assessing the potentials and conditions for establishing "tax increment districts" to fund the development of run-down areas from additional tax receipts accruing from the growth in property values.

(x) Assessing the potentials and conditions for using financial/legal credit enhancement structures (e.g., securitization, guarantees, bond insurance, bank letters of credit, convertible debt, derivative products) which help diversify and transfer credit and market risks, and increase market acceptance of local government borrowings.

LINKS TO CAPITAL MARKET DEVELOPMENT ISSUES

8. Local government credit markets are a sub-set of the domestic capital markets. Therefore, the development of sound local government credit markets requires effective financial sector regulations—with which local governments need to comply—as well as sound institutions and instruments adapted to local government needs. Highlighting this inter-dependence, a strategy for capacity building to tap or expand the upstream long-term funding pool for local investments should assess the improvements and adjustments needed in the financial market infrastructure to serve local financing needs. It will be important that the linkages to capital market development issues remain focused on what is germane to local government financial markets and instruments, and in particular to:

(i) Setting clear regulations on borrowing authority and access to credit by local governments, including regulations on municipal collateral, municipal bankruptcy and credit workouts for over-indebted municipalities. This, *inter alia*, should address the legal issues and risks related to pledging inter-governmental transfers, municipal assets and non-tax recurrent own-source revenues.

(ii) Defining benchmarks for pricing debt obligations of local government entities.

(iii) Devising, from the debt issuers’ perspective, measures aimed at bridging the gap between demand for and supply of local government securities so as to increase the flow of long-term institutional funds into local infrastructure investments.

(iv) Defining, from the debt issuers’ perspective, the critical requirements related to the development of underwriting, distribution and secondary market-making capabilities for local government debt securities.

(v) Building local government capability to comply with prevailing regulations on the issuance, registration, settlement, and repayment of local government debt securities.

(vi) Developing approaches to building closer financial partnerships between local governments and providers of services and capital—commercial banks, securities firms, institutional investors, infrastructure funds, rating agencies, municipal bond insurers, utilities operators—that have complementary institutional and financial interests so as to expand the flows of domestic and foreign private finance into local infrastructure investments.

ROLE OF MARKET-BASED FINANCIAL INTERMEDIARIES FOR LOCAL INVESTMENTS

9. Market-based financial intermediaries involve pool-financing arrangements for local infrastructure investments. Lending to local governments for viable, revenue-generating, projects could be accomplished in establishing adequately capitalized financial intermediaries, and leveraging the intermediary’s equity capital through bond issuance in private credit markets without government guarantee. A sound strategy to finance local infrastructure investments through pool funding arrangements would focus on improving the conditions and developing the criteria necessary to establish commercially viable, self-sustaining financial intermediaries, and in particular in:

(i) Defining the legal, regulatory and institutional conditions required for the establishment of market-based financial intermediaries for local infrastructure finance.

(ii) Assessing the elements of public support (such as central capital grants) initially needed to assist such intermediaries in leveraging their equity resources through debt issuance on private credit markets.

(iii) Devising the sequences and steps by which existing, non market-based, intermediaries could be put onto the path of financial sustainability.

(iv) Defining the main parameters in terms of intermediaries' strategic objectives and institutional and management structure which are critical to financial viability.

(v) Defining the main operational features in terms of product range (loans, guarantees, equity participation) offered by the intermediary.
(vi) Defining the main operational parameters related to project financing criteria and portfolio management including diversification among sectors and borrowers.

(vii) Defining the main financial parameters related to the intermediary’s funding, lending and product pricing policies.

(viii) Defining the main parameters related to the intermediary’s market, credit and currency risk management policies.

CONCLUSION

10. The set of issues addressed and proposals outlined in the note pertains to the main determinants of local government financial capacity and creditworthiness. Within this broad range, however, there would be a need to assess, on a country-by-country basis, the priority and feasibility of specific actions and approaches that may be initiated as part of a decentralized strategy in the local government finance area. For instance, in some countries, it might be important to assess the potential for direct local government access to the domestic bond markets to finance local operations. In other countries, the priority might be to explore the role of financial intermediaries as a channel to raise private resources for local infrastructure investments. The links between local government finance and broader capital market development issues are likely to be relevant in most cases. The legal, regulatory and institutional framework for local service delivery, the inter-governmental fiscal relations, and the budgetary and control systems would have to be addressed in all cases. Finally, any sound strategy would entail building financial partnerships between local governments and providers of services and capital so as to expand the flows of private finance into local infrastructure investments.

TO LEARN MORE

“Inter-governmental Transfers in Developing and Transition Countries: Principles and Practice” by Roy Bahl

“Linkages between Local Governments and Financial Markets: A Toolkit to Developing Credit Markets in Emerging Economies” John E. Peterson and John B. Crisfield

“The National Framework for Local Credit Markets” by George E. Peterson

“Municipal Budgeting” by Michael Schaeffer

“User Charges for Public Services: Potential and Problems” by Richard M. Bahl and Thomas Tsiopoulos

Infrastructure Notes, FM-8a, “Municipal Bond Markets - Experience of the USA” by Samir El Daher

Infrastructure Notes, FM-8b, “Municipal Bond Markets - Prospects for Developing Countries” by Samir El Daher

Infrastructure Notes, FM-8d, “Specialized Financial Intermediaries for Local Governments - A Market-based Tool for Local Infrastructure Finance” by Samir El Daher

Urban Infrastructure Notes are available on-line at: http://www.worldbank.org/urban/publicat/publicat.htm