Decentralization, Local Government Capacity and Creditworthiness: Macroeconomic Aspects

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Decentralization, Local Government Capacity and Creditworthiness: Macroeconomic Aspects

Paul Bernd Spahn

Executive Summary

Introduction

1. In many transition economies of Europe and Central Asia, responsibility for the provision and financing of services is being decentralized. Yet, the national policy dimensions of decentralization can have a crucial impact on local governments' spending decisions (unfunded mandates) and on their ability to mobilize resources (constraints on tax rate/base or unpredictability of the grants system). Moreover, the expanded local government role in delivering services remains constrained by weak institutional capacity and limited financial resources and know-how. Within the increasingly decentralized environment, this strategy note reviews the broad range of issues/parameters relevant to building a sound local government finance framework and enhancing creditworthiness and access to private capital/credit markets in a way consistent with macroeconomic stability and policy objectives.

2. The note covers the macroeconomic and public finance aspects of a sound decentralization strategy with improved intergovernmental fiscal relations and strengthened capacity for stable own-source revenue generation by local governments. It covers more specifically issues of expenditure and revenue assignment, intergovernmental transfers, stability of municipal budgets, municipal deficits and indebtedness and some macroeconomic indicators of municipal creditworthiness.

Macroeconomic and Public Finance Aspects of Decentralization

3. The decentralization of government functions raises problems for macroeconomic control at the national level. This is because local accountability involves the transfer of financial competencies as well—together with the municipalities' right to borrow. Uncontrolled access to capital markets and mismanagement of budgets by local governments could jeopardize efforts to stabilize the economy. For these reasons, local budgets are typically subject to central control and/or monitoring. Such rules can enhance municipal creditworthiness, yet they can render local budgets inflexible or create negative incentives which lower municipal borrowing capacity. In particular, municipal creditworthiness may be adversely affected if the central government can discharge its own responsibilities by transferring them to lower tiers without proper co-funding, or if it establishes or varies regulations for macroeconomic, social or other purposes.

4. There are two distinct approaches to stabilizing municipal budget behavior depending on revenues and expenditures assignment. Either 'steadily flowing' revenue sources and cyclically

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invariant outlay functions are assigned to municipal governments—which facilitates budget planning and avoids a procyclical conduct of budgetary policies. Or the Constitution assigns elastic output functions and volatile taxes to the municipal tier, then local budget flexibility is needed and borrowing is required to compensate for cyclical variations. Under such conditions regional governments must have sufficient ‘own sources’ of revenue, in order to minimize pressures for national bail-outs. Decentralization and municipal creditworthiness are conflicting in that municipal creditworthiness is highest where the central government bears the full costs (and risks) of local borrowing, and it is typically lower where municipal governments act without sovereign participation or guarantee. The dilemma is that explicit or implicit bail-outs of local governments appear to strengthen local creditworthiness, but leads to inefficiencies, moral hazard, and greater macroeconomic instability.

**Expenditure and Revenue Assignment**

5. Since there is a case in favor of decentralizing the allocation function of government, there is an argument for assigning revenue and outlay responsibilities to local governments in such a way as to avoid conflicts with the objectives of macroeconomic stabilization. The financing of local budgets must then be based on stable local revenue sources and on intergovernmental transfers ideally immune to the whims of the business cycle. Municipal creditworthiness is then more easy to assess on the basis of resources and needs, for which benchmarks could be established. Under these conditions, municipal creditworthiness would depend both on expenditure and revenue assignment.

6. (a) - Expenditure assignment. It is important to assess the overall budgetary dimension of municipalities first on the basis of outlay responsibilities including: outlay budget based on financial flows, sustainability of expenditure levels and ability to adjust expenditures to revenue levels, composition of outlays in terms of share of income-generating expenditures and investments that enhance the tax base, inflexible budget items such as existing debt service, share of personnel expenditures and longer-term commitments resulting from social and environmental policies imposed by the central government, and other financial commitments (such as those related to public ownership of local banks and the risk of ‘connected borrowings’).

7. (b) - Revenue assignment. The needs to cover outlay responsibilities will have to be confronted with local own resources and the ability of municipalities to mobilize funds. Own resources can be defined in a narrow sense (the independent local tax base, including the potential of legally permitted piggy-back charges on higher-level taxes) or in a broader sense to include revenue sharing and grant entitlements. As to own source revenue, municipal creditworthiness is affected by the availability of finance of a significant proportion of the municipal budget through stable and predictable local revenues and significant competencies in raising local revenues, sufficient ‘tax room’ which is not occupied by higher level jurisdictions, political discretion to vary the local tax rate and mobilize additional resources, good governance (political commitment, accountability and transparency), good local tax administration (management, collection, and audit), and robustness of local tax against macroeconomic shocks. Caution would be needed where there is a lack of diversity of local economic activities, heavy reliance on price-sensitive taxes (such as on natural resources), or local monopolies which raise consumer prices and reduce purchasing power and local tax potential.
Intergovernmental Transfers

8. Whatever local tax system is established, there will be a need for grants or revenue sharing because local expenditure needs tend to outstrip local resources. The design of the grants system is therefore of prime importance, and intergovernmental fiscal relations should be based on stable, transparent, universal and non-negotiable rules which should not interfere with the principle of accountability. Criteria relevant in assessing the grants system's impact on municipal creditworthiness include: the amount/proportion of financial transfers available in the form of unconditional revenue grants or revenue sharing with the central authority that could qualify as 'own revenue'; the character of grants and revenue sharing which represent constitutional or legal 'entitlements' so they entail stable rules for revenue distribution and reduce the volatility of transfers. This allows local activities to evolve within a stable-financial framework and local policy makers to focus on those budget elements -- local taxation, expenditures and borrowing -- under their control. The variety of conditions that govern specific purpose transfers to municipal governments -- social assistance transfers to persons based on national legislation, transfers fostering municipal programs along national priorities, and matching grants that correct for regional spillovers -- warrants a differentiated approach in assessing their implications for local budgets. (It would be useful to assess whether an increase in local tax potential would automatically be followed by a reduction in grant entitlements.)

Stabilizing Municipal Budgets and the Working of the Transfer System

9. If local governments are to provide services that are sensitive to the business cycle—such as social assistance—budget flexibility is needed for both revenues and expenditures. Budget flexibility is reduced when: budget structure cannot react to a changing business environment; outlays and revenues are 'captured' in funds, and transfers across budget chapters are constrained; revenue and expenditure functions are subject to changing central government policies; transfers are unpredictable; revenues earmarked to certain functions are volatile (oil revenues tied to a road fund); and local borrowing is restricted or disallowed. The evaluation of local budget risks emanating from macroeconomic policies should also address situations where: the local tax base or local spending directly respond to macroeconomic stabilization policies; local activities are poorly diversified (vulnerable tax base) or depend highly on foreign trade (exchange rate exposure); local governments have limited access to seigniorage (in high inflation environment) where ordinary tax revenues decline ('Tanzi-effect') while expenditures follow the general price trend; central bank attempts to stabilize price levels by restricting money supply, which may freeze municipal budgets at unsustainable levels or imposes budgetary risks through high real interest rates. It would thus become important to assess the risks of structural and macroeconomic policies changes on local budgets in terms of sensitivity to interest and exchange rate variations. The grants/revenue-sharing system can be rendered more stable and predictable through a stabilization scheme including: sharing the tax base rather than tax proceeds from joint taxes; neutralizing volatile elements of the tax system (e.g., the progressive part); capping periodic increments of the transfers; calculating transfers on moving-average bases; and setting up stabilization funds to sterilize (or release) revenues in the case of buoyancy (or recession).
Municipal Budget Deficits, Indebtedness and Creditworthiness

10. Although institutional restrictions on local borrowing could reduce budget flexibility and affect the stabilizers of the fiscal system, many countries limit local borrowing ability. This is motivated by concerns that local governments could incur an unsustainable level of debt, calling for national government bail-out. The smaller the share of own resources at lower government levels, the less trustworthy is central government commitment to a ‘no bail-out’ policy -- essential for capital markets to assess specific lending risks. Restrictions on local borrowing may be softer than they appear—as in the case of outright bans on local borrowing—as municipal governments sometimes can circumvent restrictions by borrowing through publicly owned enterprises. The financial deficit of municipal governments relative to their resource flow is an important creditworthiness indicator. Relevant parameters for determining municipal debt levels and assessing creditworthiness should cover: total public borrowing requirements; structure of debt, maturities, and other considerations such as the existence of a municipal bond market; relationship between own source revenues and current debt service; scope of current budget to cover operating costs; sensitivity of debt service to interest rate movements; liquidity risks such as access to short-term financing; and record of debt repayment. Other elements of creditworthiness assessment cover: political risks (incoming administration challenging previous financial commitments); spillover effect of one local government’s problems on the perceived creditworthiness of the municipal sector; discounted value of budgetary commitments resulting from social and environmental legislation; tax-induced distortions in the structure of local debentures; share of external debt vulnerable to exchange rate variations; and contingent liabilities such as guarantees.

11. The quantitative or qualitative measure of municipal creditworthiness is rather complex and covers the broad national and local context in which municipal governments operate. Macroeconomic conditions enter both the sovereign context and the analysis of specific elements relating to local governments. The sovereign context focuses on an assessment of the national legal, economic and political conditions that directly affect local government operations. The local context evaluates the local (economic, financial, political, institutional and administrative) characteristics, particularly when local governments act without higher-level guarantees. If there is a sovereign guarantee, the credit rating would reflect that guarantee, not the borrower’s fundamentals.

12. A crude approach to evaluating creditworthiness based on economic and financial position, and debt profile was adopted in the Maastricht Treaty as to the fiscal performance of national governments forming the European Monetary Union where two budget indicators have been singled out: financial deficit and level of debt outstanding. An analogy of this approach for municipal governments could be the financial deficit and the level of debt as percent of some revenue measure. Despite strong conceptual shortcomings, such crude methodology could serve as a first step toward assessing local governments’ creditworthiness—provided it would be complemented by a more appropriate monitoring of local debt exposure on a case-by-case basis. The IMF is advising to shift to a debt stock to revenue ratio of 60 per cent for the ECA region. This figure might provide a practical average guideline (wealthier cities with greater infrastructure needs may want to achieve higher ratios of debt stock to revenue), although there
would be a need to monitor local debt exposure effectively on a case-by-case basis (or by city 'clusters') through criteria beyond a pure ceiling approach.

13. The paper elaborates the Maastricht approach on monitoring public sector indebtedness, and hence creditworthiness, on the basis of operational indicators with special regard to macroeconomic stability. It focuses in particular on the municipal sector and includes a number of additional criteria to be observed closely. In the ECA region, information required to obtain a full set of such operational indicators of municipal creditworthiness may be hard to come by. However, the criteria might form a benchmark for further refinement and the collection of conforming statistical and other information.

Decentralization, Local Government Capacity, and Creditworthiness: Macroeconomic Aspects

1. In many transition economies of Europe and Central Asia, responsibility for the provision and financing of services is being decentralized. On the one hand, the national policy dimensions of decentralization can have a crucial impact on local governments’ spending decisions (e.g., unfunded mandates) and on their ability to mobilize resources (constraints on tax rate/base or unpredictability of the grants system). On the other hand, local government behavior can also imperil the central government’s effort to stabilize the economy. Moreover, the expanded role of local governments in delivering services is constrained by weak institutional capacity and limited financial resources and know-how. Within an increasingly decentralized environment, this strategy paper reviews the broad range of issues/parameters relevant to building a sound local government finance framework and enhancing local creditworthiness and access to private capital/credit markets in a way consistent with macroeconomic stability and policy objectives. The paper covers the macroeconomic and public finance aspects of a sound decentralization strategy with improved intergovernmental fiscal relations and strengthened capacity for stable own-source revenue generation by local governments. It covers more specifically issues of expenditure and revenue assignment, intergovernmental transfers, stability of municipal budgets, municipal deficits and indebtedness and some macroeconomic indicators of municipal creditworthiness.

I. Decentralization and Macroeconomic Control

2. The decentralization of government functions raises substantial problems for macroeconomic control at the national level. This is because local accountability calls not only for decentralized decision-making; it typically involves the transfer of financial competencies as well—together with the municipalities’ right to borrow. Uncontrolled access to capital markets and mismanagement of budgets by local governments could, however, jeopardize efforts to stabilize the economy. For these reasons, local budgets are typically subject to central government control and/or monitoring. Such rules can enhance the creditworthiness of municipal governments, yet they can also render local budgets inflexible and/or create negative incentives which lower the capacity of municipal governments to borrow. In particular, municipal governments’ creditworthiness may be adversely affected if the central government can discharge its own responsibilities by transferring them to lower tiers without proper co-
funding ("unfunded mandates"), or if it establishes and/or varies regulations and standards for macroeconomic, social, environmental, and other purposes. The national policy and regulatory dimensions of decentralization are therefore crucial for evaluating municipal creditworthiness because they can have an impact on local governments' spending decisions (e.g., through constraints on wages and salaries; restrictions on the hiring and firing of staff; labor standards; regulation of services; unfunded outlay functions), on their ability to mobilize resources (e.g., through caps on tax rates; constraints on the municipal tax base; restrictions on fees for services and prices; arbitrariness as to the working of the grants system), and on local governments' access to capital markets (including restrictions on property rights).

3. Inasmuch as local budget behavior can affect macro stability, so can macroeconomic developments affect local budgets—and hence municipal creditworthiness. There are essentially two distinct approaches to stabilizing municipal budget behavior depending on the philosophy that governs the assignment of revenues and expenditures to the local tier.

- Either 'steadily flowing' revenue sources and cyclically invariant outlay functions are assigned to municipal governments—which facilitates their budget planning and avoids a procyclical conduct of budgetary policies. This facilitates the evaluation of borrowing requirements which are then assessed exclusively on the basis of local resources (including grants) and the need for infrastructure investment.

- Or, the Constitution assigns elastic output functions and volatile taxes to the municipal tier, then local budget flexibility is needed and borrowing is also required to compensate for cyclical variations of the budget. Such fluctuations increase credit risks and may call for some form of national 'insurance' (such as a stabilization fund) which could eventually have negative effects on local government behavior and repudiate the objectives of decentralization. Under such conditions regional governments must have sufficient 'own sources' of revenue, in order to minimize pressures for national bail-outs. Own resources are also a prerequisite for the creditworthiness of local governments in both cases, but its evaluation is more difficult in the second case.

4. Decentralization and municipal creditworthiness are conflicting in that creditworthiness of local governments is highest where the central government bears the full costs of local borrowing (including risks), and it is typically lower where municipal governments act on their own behalf without participation or guarantee of the national sovereign. The dilemma is that explicit or implicit bail-outs of (or the intercept of intergovernmental transfers to) local governments appears to strengthen the local sector’s creditworthiness, but it leads to

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2 National guarantees—whether implicit or explicit—have the character of supra-regional insurance of local economies. This implies the risk of 'moral hazard' behavior of the latter. Local authorities could then be encouraged to inflict economic shocks upon their economies (e.g., through their budgets by bending to unrealistic wage claims) because they can hope to be eventually 'bailed out' by the insurer—the central government. Equally, national insurance tends to honor excessive consumption on the part of regional economies and governments whereby budget constraints are softened through the implicit or explicit guarantees of the insurance 'contract'. Even where regional shocks are exogenous, insurance may be counterproductive if shocks are permanent rather than transitory. Insurance may then deepen a recession by 'easing' hard budget constraints and by postponing the necessary structural reforms. Conversely, borrowing by regional governments is likely to encourage more rapid adjustment policies because of the need to convince capital markets (and parliaments), and because the costs of non-adjustment are unfettered and more poignant.
inefficiencies, moral hazard, and greater macroeconomic instability—which invalidates the positive effects of decentralization. This is because implicit bail-outs (such as intercepts) often divert lenders from a thorough risk analysis, constitute an "easy solution" for local governments in the very short run, and commit resources of future budgets that may be necessary to finance operational costs of the investment and even basic communal services. This must lead to pressures on the central government to soften a hard budget constraint on local governments that has become unsustainable. In order to get the incentives right, both lenders and borrowers have to be prepared to assume risks—which is the only way to let them assess such risks accurately. This requires sound procedures to assess subsovereign credit risks per se.

5. The rules that guide the assessment of credit risks should focus on good municipal governance and policies, local resource endowment, the soundness of municipal finance, an evaluation of political and economic incentives, and on principles that are consistent with macro stability. This does not preclude that the Bank and other lenders would try to hedge such risks through appropriate security collateral. But it also requires a reliable legal framework for debt issuance, settlement, repayment and custody; transparent and reliable regulations on municipal governments' bankruptcy; and the protection of creditors' rights. For any country, the full benefits of decentralization may only be captured if there is an effective regulatory framework that provides for rational and unambiguous relations between central and local levels of government. This framework includes the clarification and recording of property rights, a transparent system of land use control, open and competitive procedures for sale or lease of municipally owned property, and effective municipal management. This includes institutional capacity for effective service delivery, improving budgetary and control systems for local governments and affiliated entities, and strengthening local government financial management and capacity to mobilize private resources for local infrastructure finance. In this context, a sound strategy for local government capacity building is predicated upon a rational assignment of revenues and expenditures between tiers of government and would allow for an effective role and competitive participation of the private sector in the provision of local infrastructure. It would also set clear regulations on borrowing authority and access to credit by local governments, including regulations on municipal collateral (legal issues and risks related to pledging intergovernmental transfers), municipal bankruptcy and credit workouts for over-indebted municipalities.

6. The following criteria for evaluating the creditworthiness of municipal governments under macroeconomic considerations represent an attempt to establish a comprehensive view on the most important relevant issues. It is recognized, however, that some of the criteria are highly demanding in terms of information requirements which cannot always be met under the conditions prevailing in the ECA region at present. Therefore the strategy will consist in tying some of the key elements back into an elementary toolkit for credit rating of municipalities which respects actual data limitations in the ECA region, and accepting a gradual transition to a more sophisticated approach in assessing municipal creditworthiness in the medium term. The final objective of this exercise should be to establish quantitative and qualitative benchmarks for the more important criteria, and to monitor discrepancies from these benchmarks in a compound fashion (with the aid of a weighting scheme) and/or with regard to some of the more decisive criteria. It goes without saying that this approach must be supported by an upgrading of technical and accounting expertise as well as the establishment of reliable budgetary records, legal documentation, local statistics, and other relevant information for assessing the
creditworthiness of municipal governments in the ECA region. It also requires financial disclosure and budget management practices that conform with international standards. However, in the ECA region, institutional capacity at the local level is generally weak, accounting systems are poor and they lack the capacity to conduct sound financial planning. There is also need to develop, at the central level, supervisory capacity to monitor sub-national borrowing and to prevent destabilizing effects of local financial management.

7. In this paper, municipal creditworthiness is understood to reflect the general conditions that govern a local jurisdiction’s overall credit status in the market, not in the sense of a cost-benefit analysis of a particular municipal project or program. However, there may be specific policy risks associated with certain projects such as those that damage the local environment. They often entail potential disruptions through voters’ resistance and this may collide with good governance and could also lower the local tax potential. In this particular case, the overall credit rating of a local government may fall although only indirectly related to a particular project. Certain project-specific risks associated with municipal policies may thus go into the overall assessment of creditworthiness. Where municipal projects or programs are sourced outside the general budget—for instance, are assigned to a separate, independent, and self-financing legal entity under municipal supervision—this would typically be neutral to the assessment of municipal creditworthiness unless there are implicit obligations of municipal governments connected with this entity’s operations. It should also be stressed that the focus of this paper is on greater municipalities such as cities and metropolitan areas. Smaller jurisdictions often lack the capability to access capital markets directly and/or to administer a capital budget of their own. Their creditworthiness is often enhanced through specific pooling arrangements at the supply side (such as the Municipal Development Agency, the Environmental Fund in Poland or the National Savings Bank (OTP) in Hungary) and at the demand side (e.g., through the forming of associations of municipalities or Specific Purpose Districts). More recently, the ECA region has experimented with such forms, in particular with Municipal Development Funds, to help meet urgent municipal investment needs where the local capital market is currently unable to provide such finance. The Funds examine projects within the context of the overall budgets of municipalities applying for support. A Bank loan to Georgia approved in 1997 focuses entirely on the creation of such a Fund (see Box 1). Again, such forms of local finance and cofinancing arrangements are not considered in this paper although they may form an important segment of the market.

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3 Such management practices must respect general budget principles (such as gross estimates, comprehensiveness, unity, clarity, efficiency and cost effectiveness, authorization to spend and to commit resources), as well as more specific rules as to the preparation of the budget, accounting and the rendering of accounts (including the classification of the budget), auditing and discharge.

4 In the bond market, the overall credit status would determine the rating of so-called General Obligation bonds, which are debt instruments issued against the full faith and credit of local governments. The financing of Specific Purpose Districts (such as a school district) and specific local amenities or utilities (such as toll roads, airports, water, power plants) can be secured by user fees or dedicated taxes rather than the general taxing power of local governments. In the bond market, this would typically be effected through Revenue Bonds which exhibit a different risk structure compared to General Obligation bonds. These specific risks are not considered in this paper.
II. Expenditure and Revenue Assignment

8. There is a clear case in favor of decentralizing the allocation function of government such as the provision of public goods (basic education and health). These services are by their very nature steadfast and continuous. This makes a strong case for assigning revenue and outlay responsibilities to local governments in a steadily flowing fashion, which also avoids conflicts with the objectives of macroeconomic stabilization. The financing of local budgets must then be based on stable local revenue sources and on intergovernmental transfers that are ideally immune to the whims of the business cycle. Creditworthiness is then more easy to assess on the basis of resources and needs, which allows to establish a norm or benchmark for assessing municipal creditworthiness. Loans would essentially be reserved to the financing of local investment (school buildings, local infrastructure such as transportation, water, sewerage, and urban development). Current revenue of the municipality would have to be sufficient to serve this debt, bear the operation costs of local investments (such as teachers' salaries), and finance other current outlays (such as general administration). The exclusive use of borrowing for financing public investment is generally known as the 'golden rule'. This rule has the drawback, however, that it does not allow to determine a “cap” on public sector borrowing: in principle, all capital spending could qualify to be financed with borrowing without limitation.6

9. As far as the assignment of outlay functions is concerned, municipal creditworthiness will essentially depend on:

- Expenditure assignment. It is important to assess the overall budgetary dimension of municipalities—both in absolute and relative terms—first on the basis of outlay responsibilities. The correct assessment of expenditure responsibilities requires:

  - A comprehensive view of the outlay budget based on financial flows, including non-neutral3, ‘extra-budgetary’ functions and unfunded mandates.

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6 There is an additional complication which relates to the difficulty of drawing a clear line between current and capital spending. Of course, the definition of capital spending has to be as narrow as possible. The delineation is further blurred by the fact that capital spending could also be converted into current outlays, e.g., through leasing contracts. This is, again, an ‘easy way out’ for current administrations that commit resources of future public budgets that constrain future administrations.

7 Some extra-budgetary funds that operate on the basis of independent resource assignments, such as a specific tax or fee, might be considered ‘neutral’ to the municipal budget. Yet even such funds may fall onto the
• The ability of municipal governments to adjust expenditures to their revenue levels and thus avoid structural deficits; the latter appear whenever the level of outlay functions is consistently higher than the level of current resource flows.

• The sustainability of the level of local expenditures and stable proportions of operating and capital expenditures.

• A view of the composition of outlays, in particular the share of income-generating expenditures such as services financed by user charges, and infrastructure investments that enhance the local tax base.

• An assessment of inflexible budgetary items such as the servicing of existing debt.

• An assessment of expenditures with restricted flexibility such as the share of personnel expenditures with due account of constraints imposed by national legislation.

• An audit of longer term commitments of local authorities that may result from economic, social, and environmental policies and/or legislation—whether local or imposed by the central government.

• A scrutiny of “visible” pending financial commitments (such as arrears payable to public servants or suppliers of goods and services).

• A scrutiny of more “invisible” pending medium-term financial commitments (such as financial contingencies relating to grace periods of incurred debt, leasing contracts, or zero-bond financing).

• A correct view of budgetary commitments resulting from municipal ownership of public enterprises and/or the housing stock.

• A specific examination of public ownership of local banks and the risk of ‘connected borrowing’ without proper evaluation of credit risks.

municipality where there are legal commitments or political pressure. In the ECA region, most existing extra-budgetary funds are likely to constitute commitments of some government, whether municipal, regional, or central. In Russia, for instance, local governments in depressed regions have avoided budget deficits by simply reducing expenditures, which is not sustainable in the longer run.

Often the central government has the right to name key staff, establish staffing levels, impose bans on the firing of staff, and set wages centrally.

‘Entrepreneurial municipalities’—local governments that assume entrepreneurial functions that are better left to private agents—were typical for the socialist economy and often remain as a legacy in the ECA region. Such ‘municipal enterprises’ may be seen to generate additional revenue, provided they are profitable, and at least create employment, even if not profitable. But the legal and political commitments from the ownership of public enterprises may be substantial especially where the municipal enterprise is a local monopsonist in the labor market which risks to generate mass-unemployment in the case of bankruptcy.

‘Connected borrowing’ is typically responsible for financial crises as they were and are prevalent in Latin America and South-East Asia in the last years, although the borrower could even be a private agent. In Latin America, for instance, ownership of banks by regional and local governments provided easy access to central bank financing, which destabilized the macro economy. In the case of private borrowers/lenders, connected borrowing
• An evaluation of potential expenditures related to non-exerted constitutional expenditure responsibilities (which could be, or would have to be, exerted eventually).

• Other criteria relating to local expenditures. There is a number of further criteria that affect local creditworthiness and have to be monitored closely in relation with local expenditure, such as:
  
  • Expenditure items that represent mandated functions and are fully or predominantly financed by higher-level governments; such items do not reflect full outlay competencies of local governments and municipal budgets, and should therefore be ‘eliminated’ (also on the revenue side of the budget).
  
  • The payroll of local governments which has to be examined in order to identify overstaffing, ‘ghost workers’, and excessive pay.
  
  • The human resources and financial management expertise required at the local level to implement, administer and control efficient expenditure programs.
  
  • The relation between certain expenditure programs and regulations imposed on the use of land and zoning\textsuperscript{12} and an examination of related risks.
  
  • Where there is significant inflation: the importance of inflation-indexed expenditures.

10. As far as the assignment of revenue functions is concerned, municipal creditworthiness will essentially depend on:

• Revenue assignment. The needs to cover outlay responsibilities will have to be confronted with local own resources and the ability of municipalities to mobilize funds. Own resources can be defined in a narrow sense (the independent local tax base, including the potential of legally permitted piggy-back charges on higher-level taxes or tax bases) or in a broader sense which includes revenue sharing and/or grant entitlements. The latter should only be considered to the extent that intergovernmental fiscal relations are based on stable, transparent, non-arbitrary, universal, and non-negotiable rules, and are flowing on a continuous basis without the risk of major systemic disruptions.\textsuperscript{13} As to own source revenue, municipal creditworthiness is affected through the following conditions:

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\textsuperscript{12} Some municipalities are developing land in anticipation of higher profits or by using land as equity in commercial joint ventures with speculative intentions. This may impose budgetary risks in the case of failures of such ventures (as, for instance, in Albania).

\textsuperscript{13} Intergovernmental transfers are discussed in the next section.
- Finance of a significant proportion of the municipal budget through stable and predictable own local revenue\textsuperscript{14} (like a property tax or local fees for services) and significant competencies in raising local revenue.

- Sufficient 'tax room' which is not occupied by higher level jurisdictions;\textsuperscript{15} too much intrusiveness of the central government must crowd out local taxing powers.

- A structure of taxation that fosters accountability (use of a local personal income tax or a property tax) and limits 'tax exporting' to other jurisdictions (the latter reduces accountability and renders the local budget vulnerable to 'external' factors).

- A mix of taxes that avoids a too heavy reliance on singular revenue sources and is immune to horizontal tax competition (the latter tending to reduce tax potentials over time).

- Political discretion to vary the local tax rate in order to mobilize additional resources (often the competence of local governments to vary their tax rates is restricted by higher-level legislation).

- Full use and exploitation of the local tax base and an effort to develop the local tax base further; this hinges mainly on good governance (political commitment, accountability, transparency, contention of corruption and fraud) and on local tax administration (management, collection, and audit).

- The existence of monopolies at the local level which tend to raise consumer prices, reduce purchasing power, and hence local tax potential. In these cases, local economic rents are typically appropriated by private agents without necessarily strengthening the local tax base.

- The existence of price controls of taxable goods, leading—when enforced—to backwards-shifting of the tax onto producers who find their rate of return reduced. It will restrain local economic activities—and hence reduce the local tax potential\textsuperscript{16}.

- Robustness of the local tax potential against macroeconomic shocks. This is put in jeopardy by
  - heavy reliance on price-sensitive taxes (such as those on natural resources, mineral oil);
  - a lack of diversity of local economic activities, and hence vulnerability of the local tax base.

\textsuperscript{14} In the ECA region, there is often structural unpredictability of revenues due to endemic non-payment of taxes, especially business taxes.

\textsuperscript{15} Where the national government exploits a tax base (say, income) heavily, the room for municipal income taxation is restricted although local governments may have the constitutional right to exploit such tax bases.

\textsuperscript{16} In particular, rent controls may negatively affect the potential of the local property tax.
Box 2: Criteria for local taxation

Local accountability. Local politicians should be responsive to the expressed preferences of their local citizens, or encounter defeat in local elections. This is the basic principle of accountability of local policy makers, and it is essential both for economic efficiency and democratic representation. The principle calls for own tax bases of local governments, and it works against the financing through grants or tax sharing with higher levels of government. The principle also supports the quest for policy discretion of local politicians and parliaments, and it entails the right to determine their own tax rates. Accountability also implies that local taxes be borne by local citizens. There must be an equivalence between the provision of local public goods and the tax carried by local voter-citizens.

Benefit-tax link. The benefit-tax-link principle emphasizes efficiency aspects of local taxation as to the provision of public goods. If a link can be established between a tax and the willingness to pay for a public service, the tax plays a role similar to a price in a *quid-pro-quo* market transaction. This would enhance individual (and/or collective) welfare in the provision of public goods.

Non-distortion. Taxes should be non-distortive in that they do not affect allocation decisions in the private sector; taxation should ideally be "neutral" in that sense. At the municipal level, the criterion has a particular importance since taxpayers can always avoid a high level of local tax by shifting the tax base to low-tax jurisdictions. This leads to horizontal tax competition among local government with potentially ruinous consequences for the municipalities' ability to raise tax revenue at all.

Regional equity and long-term efficiency. Local taxation should ideally reflect a regionally equitable revenue pattern for reasons of distributional justice among jurisdictions. On these grounds, taxes on bases that are unevenly distributed across jurisdictions (like natural resources) are not suited for local use because they usually entail large regional inequities. The regional-fairness principle is difficult to realize in practice since the distribution of most tax bases can be expected to be regionally inequitable to some degree.

Reliability and stability of tax bases. Local governments have to provide services on a continuous and reliable basis; local infrastructure should also expand incessantly with larger, bulky investments being financed either through borrowing or with the assistance of higher level governments. While borrowing must, in principle, be available for local governments to bridge emerging revenue gaps, this should neither be used, at that level, on a recurrent basis, nor for macroeconomic stabilization purposes.

Administrative simplicity. Local taxes have to be administered by all municipalities alike, large or small. Since smaller jurisdictions face potentially higher administrative costs per unit of revenue raised than larger ones, the local tax system as a whole is constrained by the former's ability to administer the taxes. Otherwise, regional inequities would result from the effective variance in taxes collected.

- **Other criteria relating to local revenue.** There is a number of further criteria that affect local creditworthiness and have to be monitored closely in relation with local revenue such as:
  - The amount of revenue that is earmarked to specific purposes and cannot be used freely for all budgetary purposes.
  - Extraordinary revenue (such as the sale of assets) and its use (whether it is utilized to redeem outstanding debt, to finance infrastructure capital formation, or to pay for current outlays).
  - Excess funds (such as cash balances) and possible restrictions on their use (they may be seized by the central government, which entails inefficiencies in local spending and revenue raising behavior) as well as negative cash balances (arrears) which indicate strain on short-term financing of local budgets (and, eventually, structural deficits).
• Where there is significant inflation: the importance of revenue that is not indexed for inflation and tends to erode over time.

III. Intergovernmental Transfers

11. Own local revenue is the cornerstone of fiscal decentralization because it installs an efficiency-enhancing tax-benefit link and it fosters local accountability. But whatever local tax system is established in a country, there will be need for grants or revenue sharing because local expenditure needs typically tend to outstrip local resources. The design of the grants system is therefore of prime importance. Independent from the solution adopted, intergovernmental fiscal relations should be based on stable, transparent, non-arbitrary, universal, and non-negotiable rules. These rules should avoid destabilizing incentives and must not interfere with the principle of accountability.

12. The following criteria are important in assessing the impact of the grants system on the creditworthiness of municipal governments. There should be:

• A view on the amount and the proportion of financial transfers that are available in the form of unconditional revenue grants or revenue sharing with the central authority. No strings should be attached to these funds in order to fully qualify as ‘own revenue’.

• An assessment of the character of grants and revenue sharing (respectively, piggy-backing). Such revenue should represent constitutional or legal ‘entitlements’. Stable, transparent, non-arbitrary, universal, and non-negotiable rules for the distribution of such revenue means are needed to render these resources equivalent to steady unconditional flows of funds—like own local taxes—and they serve to contain budgetary risks.

• An affirmation of the immunity of unconditional transfers against strategic behavior of recipient governments. Entitlements should ideally be based on standard criteria of fiscal capacity or expenditure needs (not effective deficits), based on statistics that cannot be manipulated; gap-filling transfers should be viewed with suspicion (because they distort the fiscal behavior of municipal governments and encourage moral hazard).

• The containment of the volatility of intergovernmental transfers. This allows local activities to evolve steadfastly within a stable-financial framework and to focus their attention on those budget elements that are under their own control: local taxation, expenditures and borrowing.

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17 See Box 2 for a description of the more important criteria. For a further discussion, see Spahn (1995).
18 Negotiated coverage of budget costs encourages inefficient spending at lower levels of government. It is thus wasteful in economic terms. Moreover, it is not transparent and it is likely to lead to regional inequities.
19 This—together with the municipal tiers’ ability to pursue an independent tax policy—guarantees that the latter can freely respond to variations in demand for local public services without penalty in the form of reduced transfers to the jurisdiction.
• An assessment of specific purpose grants and their impact on budget flexibility of local
governments. Such grants can be:

• transfers to persons which are administered by municipal governments and channeled
through their budgets, but are based on national legislation (such as social assistance);
these transfers should be neutralized on both sides of the budget, but any residual risk
remaining through partial funding must be retained;

• specific-purpose transfers which are given to foster municipal programs according to the
priorities of the national government; such transfers may be equivalent to general revenue
in that national priorities may be identical (or lower) than local priorities in the respective
policy domain (i.e., municipal governments would have undertaken these functions
anyway); this frees general revenue funds for other purposes;

• matching grants that correct for regional spillovers; conditional grants of the matching
type and cofinancing models can be useful to improve public sector management, and
there may be a case for vertical (among the center and municipalities) and horizontal
(among municipalities) cooperation and specialized development programs.

The variety of conditions that govern specific purpose transfers to municipal governments
warrants a differentiated approach in assessing their implications for the budgets of
municipal governments. Some guidance may be found in the procedures established by the
Commonwealth Grants Commission in appraising the needs of the Australian states for
general purpose grants. These may also be relevant in assessing the creditworthiness of
municipal governments.

• A thorough analysis of the criteria that govern the distribution of grants at the horizontal
level. It is important, in particular, whether an increase in local tax potential would

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20 Where the priorities of municipal governments are lower than the central government’s, such funding may
encourage ‘wasteful’ spending in the respective policy domain without regard to local preferences. Moreover,
spending is different from output. Municipal governments may find ways to spend the specific-purpose grants and
still fail to meet a given output goal. This is why general revenue is preferable to specific-purpose grants as
municipal budgets remain responsive to local demand.

21 However, the functional division of government with its vertically segmented funds and the earmarking of
taxes—as found in some Latin American countries—is highly inflexible and inefficient and should be avoided. All
such funds should be transferred into a general budgeting framework of the central government whereby some
programs may be suitable for administration at lower levels of government.

22 The Commonwealth Grants Commission’s methodology takes four different approaches to dealing with
specific purpose payments: (1) Inclusion is used for those grants which are considered to meet in part state
expenditures needs (e.g., government schools). In these cases special purpose funding is a full substitute of general
revenue assistance. (2) Absorption is a variant of the inclusion method. Specific purposes payments are added to the
pool of financial assistance grants and per capita relativities recommended by the Commission are determined with
regard to that pool (e.g., for unquarantined hospital funding grants). (3) Deduction is used when specific purpose
grants are considered to finance expenditure in addition to what the states would otherwise have undertaken. In these
cases, only the state-funded portion of expenditure is included in the Commission’s assessment for general revenue
grants (e.g., a number of health grants). (4) Exclusion is used where the Commonwealth has largely accepted
financial responsibility (most grants “through” the states). In this case, all expenditure in the particular area is
automatically be followed by a reduction in grant entitlements. Some grant distribution mechanism, often found in former socialist countries, suffer from the fact that they tend to ‘fill gaps’, even though in part. This entails a negative incentive to exploit own resources more fully, because this would reduce or close the gap and be automatically penalized by a reduction of the grant.

IV. Stabilizing Municipal Budgets and the Working of the Transfer System

13. If local governments are to provide services that are sensitive to the business cycle—as for instance social assistance in the case of the states in the United States—flexibility is needed on both the revenue and expenditure sides of local budgets. These provisions should not encourage local governments to pursue an activist macroeconomic stabilization policy. They should however secure the full workings of built-in stabilizers at lower levels of government under these conditions.

14. Budget flexibility is reduced:

- when the budgeting process is rigid, i.e., when volume and structure of the budget are hampered in reacting to a changing business environment;

- when outlays and revenues are ‘captured’ in funds, or if a transfer of means across chapters of a budget is difficult or impossible;

- when revenue and expenditure functions are subject to errant policy behavior of the national government;

- when transfers are arbitrary and unpredictable;

- when revenue is earmarked to certain functions, in particular if the revenue is volatile (e.g., oil revenue tied to a road fund);

- when local borrowing is restricted or disallowed.

15. The assignment of revenue and expenditure functions is crucial for the stability of municipal governments’ budgets. It forms the basis for assessing credit risks at the municipal level. In addition, there are the risks of ‘structural change’ whereby the assignment of responsibilities is altered through national legislation (often without corresponding co-funding),

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23 This also depends on the degree to which the grants system is equalizing among jurisdictions. If there is a given pool of grant money to be distributed to municipalities on the basis of their effective financial status, any improvement of their relative position will lead to financial sanctions through a reduction of equalizing grants. Too much equalization may reduce the willingness of municipal governments to exploit their tax base in full, and it may entail inefficiencies as well as a reduction in local growth potentials. This is the reason why financial capacity of sub-national governments must be measured in a standardized fashion in order to allow municipalities to retain additional taxes which they raise by increasing their ‘tax effort’.

24 As an example, the share of personal income tax entitlements of Hungarian municipalities has been varying widely over the years. Moreover, decisions on tax sharing and grants entitlements are often made too late to allow a sound budgeting process at the municipal level.
or where there is ample discretion in assessing the volume of transfers to municipalities. Some relevant criteria for assessing credit risks under these aspects have been mentioned above.

16. More difficult is the evaluation of budgetary risks for local budgets that emanate from macroeconomic policies at the national level—given a constant structure of intergovernmental fiscal relations. A few examples of the more important transmission channels are given in the following. Macroeconomic policies may entail risks for local budgets:

- when either the local tax base or local spending (e.g., unemployment-related outlays) directly respond to macroeconomic stabilization policies; there is some evidence from industrialized countries that industrial regions (especially with a great number of smaller manufacturers) and the housing industry are more strongly affected by variations in interest rates than other economic activities;

- when local governments effect a high proportion of public investment; these tend to be a ‘residual’ budget activity which is more volatile by definition; they are also highly responsive to interest rate variations;

- when local activities are poorly diversified which renders the tax base narrow and vulnerable;

- when local activities depend highly on foreign trade and there are significant exchange rate changes;

- when there is high inflation and local governments have only limited access to seigniorage (the ‘inflation tax’); ordinary tax revenue tends to decline under such circumstances (‘Tanzi-effect’), while expenditures tend to follow the general price trend;

- when the central bank attempts to stabilize the price level through orthodox measures (e.g., a price and wage freeze) or through external constraints on the money supply (e.g., a ‘currency board’); this may either freeze municipal budgets at unsustainable levels of revenue and expenditures; or it imposes budgetary risks through high real interest rates with unsustainable levels of servicing the existing debt;\(^{25}\)

- when macroeconomic policies lead to capital inflows/outflows which would typically have a varying impact on regional activities and local budget performance.

17. For these (and other) reasons, it is important to assess not only the workings of an existing structure of revenue and expenditure assignment, but also the risks associated with structural change and those that derive from macroeconomic policies. In particular, local government budgets may be highly sensitive to variations in interest rates, prices, and foreign exchange rates. This sensitivity can, however, be tested and evaluated empirically by standard procedures.

\(^{25}\) In the latter case there is typically a ‘negative Tanzi effect’ which eases the budget constraint by raising local tax revenue in relative terms, but this revenue performance risks being misinterpreted and giving rise to unsustainable expenditure decisions (e.g., wage concessions or the hiring of new staff).
18. The workings of the grants/revenue-sharing system can also be sensitive to variations in the business cycle which imperil the orderly planning of the budget and its execution—with obvious consequences for the creditworthiness of municipal governments. In fact, tax sharing of highly price-elastic taxes may exhibit a much higher degree of volatility than own local taxes (e.g., the property tax). Volatility of unconditional untied grants and revenue-sharing means can even become excessive if there is an intercept for debt servicing or if parts of the transfers are earmarked for other specific purposes. This must affect the operation of budgets, may impose severe liquidity constraints, and reduce the local sector's ability to service its debt.

19. The grants/revenue-sharing system can be rendered more stable and predictable through some form of a stabilization scheme. More stable performance of the grants/revenue-sharing system is achieved:

- when the tax base is shared rather than the tax proceeds from joint taxes (variations of the base being normally smaller than of the tax yield, especially for progressive taxes);
- when volatile elements of the tax system (e.g., the progressive part) are eliminated through a conforming formula;
- when the periodic increment of the transfer is capped in absolute or relative terms;
- when transfers are time-lagged or are calculated on the basis of moving averages;
- when there is an explicit stabilization fund which sterilizes revenue in the case of buoyancy, and releases it in the case of revenue shortfalls or recession.

All such stabilization schemes—to the extent that they are transparent and predictable—contribute to avoiding 'false signaling' for policy makers and budget authorities, and they thus enhance the creditworthiness of municipal governments.

V. Municipal Budget Deficits and the Level of Municipal Debt

20. In spite of the fact that institutional restrictions on local borrowing will reduce budget flexibility and hence jeopardize the full workings of built-in stabilizers of the fiscal system, many countries limit such ability in some way or another. The European Union attempts to restrain even the borrowing of national governments through standard budget criteria and the onus of financial sanctions in the case of leniency. This is motivated essentially by concerns that local governments could—either through moral hazard or a misinterpretation of cyclical developments—incur a level of debt that proves to be unsustainable in the long run, and the national government would then have to bail them out. It is therefore important to insist on a sufficiently high level of own resources for lower levels of government because this is a corollary of a credible pledge of the central government to let regional governments go bust.

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26 If \( x_t \) is the volume of grants in period \( t \), and \( e_t \) is the volume of earmarked revenue from these grants (or the intercept for debt service), with \( \text{var}(x_t) \) typically greater than \( \text{var}(e_t) \), then \( \text{var}(x_t) \) must be lower than \( \text{var}(x_t - e_t) \) in percentage terms (relative to their mean).
eventually. The smaller the relative importance of own resources at lower levels of government, the less trustworthy is a 'no bail-out' commitment of the central government. However, the 'no bail-out' predicament is essential for private capital markets to assess specific lending risks correctly—which could then discipline regional governments implicitly through higher risk premia on interest rates. With full bail-out guarantee of the central government, the creditworthiness of municipal governments would be tantamount to the sovereign risk.

21. Even where restrictions on local borrowing seem to be strict—as in the case of outright bans on local borrowing—these constraints may in fact be softer than they appear. In some formerly socialist countries, municipal governments are accustomed to circumvent such restrictions by borrowing through quasi-fiscal institutions or publicly-owned enterprises which they control. This renders the financial situation of municipalities opaque and requires specific attention to the relationship between municipal budgets and 'hidden' commitments through local government guarantees. However, the Bank and other lenders should refrain from lending to municipal governments under such premises which render the examination of their creditworthiness superfluous.

22. The level of the financial deficit of municipal governments relative to their resource flow is an important indicator of their creditworthiness, but it would be simplistic to examine only the actual budget outcome. Ideally the budget would have to be corrected for all pre-committed resource flows—both at the revenue and expenditure sides. Moreover, borrowing for current expenditures should normally be avoided which would require the separation of an operational from a capital budget. One would expect the operational budget to exhibit an uncommitted surplus (savings) that contributes to financing a part of capital expenditures.

23. The view that borrowing should be related only to capital formation, but not current outlays (‘golden rule’), is found in many constitutions that govern municipal finance. It should be noted, however, that this rule does not restrict the level of public sector borrowing as such (the level of public investment being open-ended), and it does not eliminate the need to examine municipal governments’ creditworthiness in detail. This is all the more true as public infrastructure financed through borrowing is seldom suitable to serve as collateral of public sector debt. Moreover, the definition of public investment should be narrow and controllable, and borrowing be confined to financing public investment that generates revenue or enhances the local tax base.

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27 This is why the Maastricht budget criteria are neither needed to contain moral hazard, nor are they imperative for limiting debt exposure of European national governments as long as these governments control sufficiently large public resources of their own jurisdictions, and capital markets are allowed to adapt freely.  
28 It also requires an institutional framework for dealing with effective bankruptcies of municipal governments.  
29 For instance, Chinese municipal governments often use the borrowing power of state firms (of which they are the owners) to access capital markets indirectly. This behavior is not confined to socialist countries alone. In Argentina and Brazil, the states have typically used the borrowing power of the provincial/state banks (which they often own) to tap central bank finance—especially under inflationary conditions.  
30 Some countries, such as Colombia, have chosen a wider definition of public capital formation which includes human capital formation (education, health). This may be defensible on economic grounds, but this should be avoided at the local level because the relationship between human capital formation and the local tax base is extremely weak due to potential migration.
24. Additional factors that should be taken into consideration—beyond a thorough analysis of municipal budgets and their financial resources—are the following:

- The total of public borrowing requirements, including the rescheduling of existing debt;
- The structure of debt, maturities, interest payment mechanisms, and structural considerations such as the existence of a municipal bond market (which are all relevant for the process of rescheduling existing debt);\(^{31}\)
- The relationship between own sources and the current debt service\(^{32}\) as well as between uncommitted savings and capital spending;
- The scope of current budget to cover the operating and maintenance costs of services related to capital formation (preferably through user fees);
- The volatility of current debt service relative to variations of interest rates (also with regard to policy risks where non-market interest rates are being employed);
- Potential liquidity risk factors of municipal governments (access to short-term financing);
- The sensitivity of local borrowing to the ‘political cycle’;\(^{33}\)
- The record of repayment experience.

25. With regard to the stock of municipal debt, the following appear to be important for assessing creditworthiness:

- The relationship between the level of debt and the net worth of municipal governments (excluding extra-budgetary funds and public enterprises);
- The discounted (net) value of pending non-financial budgetary commitments that result from social and environmental legislation—both at the national and the local level;
- Pending liabilities through financial operations such as zero-bond financing or put options;

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\(^{31}\) A trend toward short-term financing and refinancing of public budgets and debt indicates increasing budgetary risks.

\(^{32}\) Where debt service is secured through an intercept on transfer entitlements of the municipal government, this should, of course, be neutral with regard to this criterion. It is preferable, however, to avoid such intercepts as a regular device under normal circumstances because it distorts the incentives, may limit the operational budget unnecessarily, and conveys the impression of an automatic bail-out with its negative consequences from moral hazard. An intercept should only be used as a collateral in the case of effective default of a municipality where its budget would then operate under a specific bankruptcy regime with its intervention procedures (debt adjustment, reorganization, etc.). Such bankruptcy provisions for local government exist in Hungary, for instance (Law on Municipal Debt Adjustment of 1996). The necessity of a bankruptcy regime for municipalities is an obvious corollary of the decentralized approach to public sector borrowing.

\(^{33}\) Municipal decision makers tend to launch capital projects late in their term in order to enhance their chance of being reelected, or—when reelection is not possible—they tend to operate with ‘grace periods’ the impact of which on future obligations has to be thoroughly evaluated.
• The amount of concessional loans to municipal governments and their impact on local finance;

• The structure of existing debt as to public and private ownership;

• The ratio between internal and external debt (foreign debt and its service are particularly vulnerable to variations of exchange rates);

• Distortions in the structure of local debentures induced through special tax treatment of interest income (exemptions or tax credits);

• The transparency of planning, engineering and procurement of local infrastructure investment;

• A risk factor that indicates potential liabilities from local government guarantees and bad loans;

• Other political risks such as those related to a fragmentation of political parties, or a change in the city’s administration where this may lead to a challenge of financial operations undertaken by the previous administration;

• Potential risk ‘contamination’—that is, the spillover effect of one local government’s troubles or of one negative credit event to the perceived creditworthiness of the whole municipal sector;

• Priority (‘protection’) of debt repayment in the local budget;

• The investor’s lien position in the case of default, non-payment, and/or bankruptcy.

26. When evaluating local governments’ creditworthiness, the Bank and other potential lenders should invariably pose the question whether there is a need for financing public infrastructure through a local budget and/or whether “public goods” functions at the municipal level could (and should) not also be fulfilled via private service delivery with municipal regulatory control. Also, public and private sector financing can be combined in joint ventures or in matching funds for urban infrastructure and its operation. In such instances, private capital is used as a leverage which often improves the efficiency and targeting of municipal investments.\(^3^4\)

VI. Operational Indicators for Assessing Municipal Creditworthiness with Special Emphasis on Macroeconomic Aspects

27. The various criteria influencing the credit rating of municipal governments under macroeconomic aspects have to be brought together in an operational framework for assessing and comparing local government creditworthiness. The rating should reflect the risk to lenders

\(^3^4\) BOT (build-operate-transfer) schemes where municipal governments work together with private businesses (contractors and operators)—as in Hungary—are a pertinent case.
of receiving full payment as scheduled. However, the criteria could also serve as an indicator to monitor progress in decentralizing the government sector and thus the enhancement of welfare and efficiency through a better response of public service delivery to local demand.

28. The analytical process of achieving a quantitative or qualitative measure of municipal governments' creditworthiness is rather complex. Rating agencies—such as Moody's—describe their rating methodology for regional and local issuers of debt as a 'pyramid'.

“At the base, forming the foundation of the review, is the broadest context in which the regional or local government operates. The sovereign context focuses on an assessment of the national legal, economic and political conditions that directly affect the local government operations. Moving up the pyramid, (the) review evaluates local conditions. Here, both quantitative and qualitative considerations are incorporated. Factors such as the locality's economy, financial performance, debt profile, and management capabilities of the local administrations are all reviewed. These provide further indications about the entity's ability as well as the administrative 'willingness' to meet debt obligations.”

29. Macroeconomic conditions enter both the sovereign context and the analysis of specific elements relating to municipal governments. If there are sovereign guarantees, the rating reflects that guarantee and not the fundamentals of the borrower. Where local governments act on their own behalf without guarantees of higher-level governments, the overall macro and institutional framework becomes decisive whereby creditworthiness is the higher the more stable and transparent this framework becomes. As to specific local characteristics, these are evaluated both in relative terms—comparing them with other municipalities operating in the same sovereign context—and in terms of their trends (both historical and prospective). The key elements are the local economic base, the financial position, political, institutional and administrative aspects, the debt profile, risks related to an eventual systemic frailty of intergovernmental relations, and the vulnerability of local finance to macroeconomic shocks (structural and cyclical).

30. A crude approach to evaluating creditworthiness on the basis of an economic base, financial position, and debt profile was adopted in the Maastricht Treaty as to the fiscal performance of national governments that will form the Monetary Union. Two budget indicators have been singled out: the financial deficit and the level of debt outstanding (3 per cent and 60 percent of GDP, respectively). An analogy of this approach for municipal governments could be the financial deficit and the level of debt in per cent of some revenue measure. (The International Monetary Fund is indeed advising to shift to a debt stock to revenue ratio of 60 per cent for the ECA region.)

31. However, the Maastricht budget criteria exhibit severe conceptual shortcomings. They disregard the facts that

- the overall operational deficit is a poor indicator of the change in financial commitments, especially of accruing obligations and the change of pending liabilities;

---

• the operational deficit is distorted (and can be manipulated) through variations in the timing of expenditures and revenues, the inclusion of singular extrabudgetary revenue (such as the proceeds from the sale of assets), financial operations (such as the avoidance of interest payments through the issuance of zero bonds), the transformation of bulky investment expenditures into periodic (and hence smaller) current outlays through leasing contracts, or through outsourcing and/or lease-back or purchase-back agreements with the private sector;

• tax resources may be underexploited and effective revenues are lower than tax potentials (particularly in countries with a low tax pressure or weak administration);

• there may be varying scope for reducing expenditures through simple legislation;

• the deficit could be (negatively or positively) affected by the vagaries of the business cycle;

• the deficit may be subject to variations in the level of interest rates and/or of exchange rates;

• a high debt ratio in terms of GDP may appear low in terms of net assets and the level of infrastructure development; or

• the nature of debt (internal/external; private/public sector lending) may vary across regions. However—crude as this methodology may be—it could well serve as a first step toward assessing local governments' creditworthiness—provided it would be complemented by a more appropriate monitoring of local debt exposure case by case.

32. If the debt stock to revenue ratio of 60 per cent for local governments proposed by the International Monetary Fund were simply derived from the 60 per cent of GDP debt criterion of the Maastricht Treaty (for total government and national GDP), this benchmark is conceptually far off the mark. GDP is a measure of total economic activity, not of total government revenue. If, for reasons of simplicity, the average total tax rate of the public sector in the EMU region is assumed to be 50 per cent, then the Maastricht criterion would have to be doubled to 120 per cent with respect to public revenue. However, as a practical guideline, this figure seems to be agreeable. To offer an empirical benchmark by comparison to German municipal governments: the average debt stock to revenue ratio (including transfers) was 66 per cent for West Germany, and 62 per cent for East Germany (accumulated over only 8 years) in 1998. Of course, wealthier cities with a greater need of infrastructure may want to achieve higher debt stock to revenue ratios than these averages. It is therefore appropriate to monitor local debt exposure effectively on a case by case basis (or by ‘clusters’ of cities) through criteria that go beyond a pure ceiling approach.

33. It is possible to develop the Maastricht approach to monitoring public sector borrowing and debt for the municipal sector by simple elementary corrections of budget results and/or by incorporating the value of (marketable) local assets or net wealth. However, this requires additional information which may not be readily at hand for municipal governments in the ECA

36 The ratio for the city of Frankfurt am Main, for instance, was 103 per cent in 1996. It must be noted, however, that the figures for individual cities are highly distorted in the case of Germany—because of its excessive horizontal equalization payments which unduly reduce the fiscal outcome of the wealthier cities.
region. A more sophisticated model does not seem to be warranted at this stage. However, the following elements should be (and could be) used to establish a benchmark for municipal creditworthiness based on budgetary information (which should become available):

Comprehensive deficit criterion (all budgetary resource flows):

\[
\frac{[E_c + E_t + E_i + E_e] - [T + F + Gu + Gs + \pi + Yo + Ye]}{[T + F + Gu + Gs + \pi + Yo + Ye]}
\]

Corrected deficit criterion (only regular budgetary resource flows):

\[
\frac{[E_c + E_s + E_t - Em] - [T + F + Gu + \alpha Gs - Gm + \pi + Yo]}{[T + F + Gu + \alpha Gs - Gm + \pi + Yo]}
\]

Cyclically-neutral deficit criterion (regular resource flows neutral of cyclical variations):

\[
\frac{[E_c^* + E_s^* + E_i - Em] - [T^* + F^* + Gu^* + \alpha Gs^* - Gm + \pi + Yo]}{[T^* + F^* + Gu^* + \alpha Gs^* - Gm + \pi + Yo]}
\]

Auto-financing criterion (municipal saving relative to capital formation):

\[
\frac{[E_c + E_s] - [T + F + Gu + Gs + \pi + Yo]}{E_i}
\]

Comprehensive debt stock criterion (all budgetary resource flows):

\[
\frac{D}{[T + F + Gu + Gs + \pi + Yo + Ye]}
\]

Corrected and neutralized debt stock criterion (cyclically-neutral resource flows):

\[
\frac{D - A}{[T^* + F^* + Gu^* + \alpha Gs^* - Gm + \pi + Yo]}
\]

where:

- \(E_c\) Current local expenditures
- \(E_s\) Local expenditure related to servicing existing debt
- \(E_i\) Local capital expenditure (net investment)
- \(E_e\) Extrabudgetary/exceptional expenditures of municipalities
Em | Mandated expenditures of municipalities (on behalf of central government)
T  | Own local taxes
F  | Local fees for services
Gs | Unconditional grants to municipal governments
Gs | Specific-purpose grants to municipal governments
Gm | Reimbursement grants received by municipal governments
    | (the funding of mandated functions)
\( \pi \) | Business income of municipal governments
Yo | Other ordinary income received by municipal governments
Ye | Extra-budgetary/exceptional income received by municipal governments
\( \alpha \) | the degree of earmarking of specific purpose grants
D  | Level of net debt (corrected for financial assets) at the end of previous period
A  | Value of marketable assets such as land, buildings (using conservative valuation)
*  | An asterisk signifies that the variable has been corrected for cyclical variations
    | (e.g., through a simple moving average)

34. Further improvements could be achieved by considering the following additional indicators that may be available partially. They must be assessed against a benchmark value, and eventually be compared with an average of the indicator's value for a more comprehensive set of municipalities that operate in the same sovereign environment. These indicators are derived from the criteria discussed above, and they fall into two categories:

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<th>POSITIVE INDICATORS</th>
<th>NEGATIVE INDICATORS</th>
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<td><strong>Expenditure related:</strong></td>
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<tr>
<td>1. The ability of municipal governments to adjust the level of outlays</td>
<td>1. Inflexibility of the wage level, restrictions on the hiring and firing of staff at the local level</td>
</tr>
<tr>
<td>2. The sustainability of local expenditures</td>
<td>2. High proportion of inflexible budget items in local budgets (debt service)</td>
</tr>
<tr>
<td>3. Stable proportions of local government outlays over time</td>
<td>3. A rigid regulatory framework set by national legislation</td>
</tr>
<tr>
<td>4. A high proportion of local expenditures that are self-financing (fees)</td>
<td>4. Commitments of municipal governments through social and environmental legislation</td>
</tr>
<tr>
<td>5. Mandated outlays in the budgets of local governments that are fully funded</td>
<td>5. “Invisible” financial commitments at the local level (zero bonds)</td>
</tr>
<tr>
<td></td>
<td>6. Local government commitments through ownership of public enterprises and housing</td>
</tr>
<tr>
<td></td>
<td>7. Lack of human resources and financial management expertise at the local level</td>
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<td></td>
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<tr>
<td><strong>Revenue related:</strong></td>
<td><strong>Revenue related:</strong></td>
</tr>
<tr>
<td>1. Stable and predictable revenue sources of municipal governments</td>
<td>1. Heavy reliance of municipal governments on a singular revenue source</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>POSITIVE INDICATORS</th>
<th>NEGATIVE INDICATORS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. High proportion of own resources of total local revenue</td>
<td></td>
</tr>
<tr>
<td>3. Sufficient ‘tax room’ at the local level</td>
<td></td>
</tr>
<tr>
<td>4. Efficient local taxation and accountability</td>
<td></td>
</tr>
<tr>
<td>5. Discretion of municipal governments to exploit local tax bases by varying rates</td>
<td></td>
</tr>
<tr>
<td>6. Political commitment to develop the local tax base</td>
<td></td>
</tr>
<tr>
<td>7. Low cyclical sensitivity of local taxes</td>
<td></td>
</tr>
<tr>
<td>8. Diversity of local economic activities and tax bases</td>
<td></td>
</tr>
<tr>
<td>2. High degree of tax competition among governments</td>
<td></td>
</tr>
<tr>
<td>3. Legal restrictions of local tax policy</td>
<td></td>
</tr>
<tr>
<td>4. Underexploitation of a given local tax base</td>
<td></td>
</tr>
<tr>
<td>5. Existence of local monopolies</td>
<td></td>
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<tr>
<td>6. Price controls that affect the local revenue base (e.g., rent controls on the property tax)</td>
<td></td>
</tr>
<tr>
<td>7. High level of earmarked tax revenue at the local level</td>
<td></td>
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<tr>
<td>8. Non-indexed local taxation in the case of inflation</td>
<td></td>
</tr>
</tbody>
</table>

Transfer related:

<table>
<thead>
<tr>
<th>Positive Indicators</th>
<th>Negative Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. High proportion of unconditional revenue grants or revenue sharing as legal ‘entitlements’ of municipal governments</td>
<td></td>
</tr>
<tr>
<td>2. Stable, transparent, non-arbitrary, universal, and non-negotiable rules for the distribution of transfers to local governments</td>
<td></td>
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<tr>
<td>3. Immunity of unconditional transfers against strategic behavior of recipient local governments</td>
<td></td>
</tr>
<tr>
<td>1. High volatility of intergovernmental transfers</td>
<td></td>
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<tr>
<td>2. Reduced budget flexibility at the local level through specific purpose grants (incorporated, to some extent, in the formulae above)</td>
<td></td>
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<tr>
<td>3. High degree of equalization that may undermine local tax capacity</td>
<td></td>
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</tbody>
</table>

Management related:

<table>
<thead>
<tr>
<th>Positive Indicators</th>
<th>Negative Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Good local governance, and soundness of municipal finance</td>
<td></td>
</tr>
<tr>
<td>2. High degree of accountability of local officials</td>
<td></td>
</tr>
<tr>
<td>3. Correct political and economic incentives in the local fiscal system</td>
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<tr>
<td>4. Competent management expertise at the local level</td>
<td></td>
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<tr>
<td>5. Political stability and commitment of local officials</td>
<td></td>
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<tr>
<td>6. Sound institutional framework for handling cases of default, non-payment, and/or bankruptcy</td>
<td></td>
</tr>
<tr>
<td>1. Rigid budgetary process at the local level</td>
<td></td>
</tr>
<tr>
<td>2. Proliferation of ‘captured’ funding</td>
<td></td>
</tr>
<tr>
<td>3. Local budgets subject to errant behavior of the central government</td>
<td></td>
</tr>
<tr>
<td>4. Restrictions on local borrowing</td>
<td></td>
</tr>
<tr>
<td>5. Structural or ‘systemic’ risks through frequent changes in intergovernmental relations</td>
<td></td>
</tr>
<tr>
<td>6. Fragmentation of political parties at the municipal level, and/or frequent changes in the city’s administration</td>
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</tbody>
</table>
## Cyclical aspects
### (if not accounted for in the formula)

1. Stable and independent tax revenue of local governments
2. Highly diversified local economy
3. Regional immunity to international capital inflows/outflows

## Issues relating to local borrowing and debt

### (if not accounted for in the formula)

1. Tax base and/or expenditures fluctuations in response to variations of interest rate, prices, and/or exchange rates
2. Price- and interest-sensitivity of local investment expenditures
3. High dependency of the local economy on foreign trade
4. Vulnerability of local budgets to inflation
5. Vulnerability of local budgets to central stabilization policies

## Cyclical aspects

1. Stable and independent tax revenue of local governments
2. Highly diversified local economy
3. Regional immunity to international capital inflows/outflows

## Issues relating to local borrowing and debt

1. Full sovereign guarantee of local debt or intercept of intergovernmental transfers (enhances creditworthiness, but contradicts the principle of decentralization)
2. Long-term maturities, fixed interest and amortization for local debentures
3. Access to a local bond market
4. Low degree of uncommitted local savings
5. Good record of repayment experience by municipal authorities
6. High proportion of private ownership of local debentures
7. Low degree of external debt of municipal governments
8. Transparency of planning, engineering and procurement of local infrastructure investment
9. Priority (‘protection’) of local debt repayment

## Issues relating to local borrowing and debt

1. Uncertainties as to the financing of operating and maintenance costs of local capital
2. Volatility of local debt service in relation to variations of interest rates
3. Potential liquidity risks of local budgets
4. Sensitivity of local borrowing to the local ‘political cycles’
5. Pending local liabilities through specific financial operations
6. High degree of concessional loans to municipal governments
7. Potential liabilities from local government guarantees and bad loans
8. Potential risk ‘contamination’ from default by other municipal governments
VI. Summary

35. The set of criteria that is relevant for assessing the creditworthiness of municipal governments in general, and in the ECA region in particular, under institutional and macroeconomic aspects is rather vast and ambitious in terms of information requirements. It is recommended, however, to concentrate, at first, on a restricted set of budget criteria such as the operational deficit, the relationship of savings to capital formation, and the level of debt relative to the resources available at the local level—with certain adjustments for extraordinary budget events and, eventually, cyclical aspects. However, a number of key indicators should be considered in addition that reflect systemic risks, cyclical risks (including the political cycle), and risks associated with the institutional setting in which municipal governments operate (including the assignment of revenue and expenditure responsibilities, intergovernmental fiscal relations, and access to capital markets). Such additional information will be specific and is likely to be different for each of the ECA countries individually. A successful partnership between ECA municipalities and the Bank will highly depend on whether such information will become available and on the ongoing dialogue between the Bank's actual and potential customers as to the usefulness of monitoring creditworthiness on the basis of such indicators, and on the prospects for further decentralization of the public sector and the benefits that can be reaped from strengthening municipal governments.

References

