

# **RESOURCE TRANSFERS & LOCAL GOVERNMENT DEBT FINANCING**



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# RESOURCE TRANSFERS



# Purpose

- **ECONOMIC**
  - Allocative Efficiency
  - Tax Efficiency
- **SOCIAL**
  - Horizontal Equity
  - Income Redistribution
- **POLITICAL/INSTITUTIONAL**
  - Good Governance
  - National Stability

# **Resource Allocation Options**

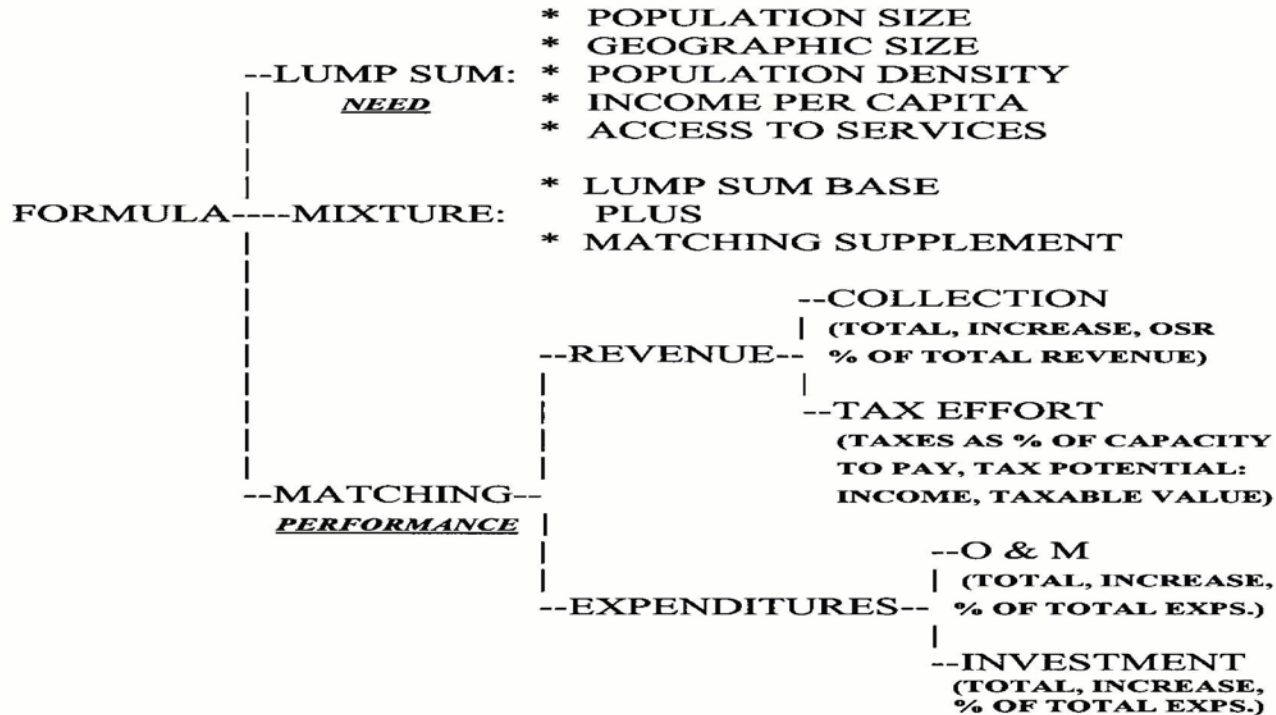
- **Independent Local Taxation:  
Revenue Base Assignment**
- **Centrally Assisted Local Taxation:  
Co-Administration**
- **Surcharges:  
Piggy-Backing**
- **Tax Sharing:  
Off-Budget Transfer**
- **Revenue Sharing:  
On-Budget Transfer**

# TYPES OF GRANTS

## I. CONDITIONS ON USE:

CATEGORICAL (EARMARKED) (SPECIFIC) (TIED)	<----- BLOCK -----> DISCRETION WITHIN BROAD RESTRICTIONS	UNRESTRICTED (GENERAL PURPOSE) (GENERAL USE) (DISCRETIONARY)
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## II. ALLOCATION METHOD:



## III. CEILING:

CLOSE-ENDED (LIMITED) VS. OPEN-ENDED (UNLIMITED)

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>* INSTITUTIONAL</li> <li>* SECTORAL</li> </ul> | <ul style="list-style-type: none"> <li>* INDIVIDUAL</li> <li>* SOCIAL SAFETY NET/ENTITLEMENTS</li> </ul> |
|---|--|

# Effective Grant Formulas

- Simple and transparent
- Predictable and stable
- Fit needs and objectives
- Administratively feasible
- Adequate revenue
- Minimal ancillary effects

# General Guidelines

**Increase expenditures on specific functions →**

*Categorical, Matching, Open-Ended Grant*

**Redistribute resources among subnational jurisdictions →**

*General, Lump-Sum, Close-Ended Grant*

# LOCAL GOVERNMENT DEBT FINANCING





# Why Borrow?

- Capital investment:  
Schools, roads, water & sewerage
- Support/subsidize private activities:  
Mortgages, student loans, developers
- Smooth short-term cash flow:  
Spend before income received
- Refinance:  
Replace expensive debt with lower-cost debt

# How to Borrow?

- **Municipal Development Funds**
  - Pooled resources at a level above individual municipalities/LGUs
  - Disbursed as grant, loan, or mixture
  - Purpose to wholesale capital investment
  - Capital from budget, donors, reflows
  - Most W. European countries, Japan
- **Municipal Bonds**
  - Interest bearing obligations issues by state/local governmental entities
  - Public debt
  - Purpose usually to finance investments
  - Individual and institutional investors
  - Primarily in the United States

# MDF Institutional Forms

- Government managed
  - Funds for local authorities managed by MoF or MoLG
  - Usually revolving
  - Common in Anglophone Africa, RDA in Indonesia
- Autonomous
  - Banking institution
  - Rediscount facility
  - Loan fund
  - Windows for grants/loans via state-controlled pension, insurance, and savings funds

# INTERNATIONAL COMPARISON OF MUNICIPAL DEVELOPMENT FUNDS

ITEM	BELGIUM: Credit Communal de Belgique (BMC)	COLOMBIA: Financiera de Desarrollo Territorial S.A. (FINDETER)	UNITED STATES: New York State Environmental Facilities Corporation (EFC)	INDONESIA: Regional Development Account (RDA)
1. Year Established	1860	1989	1970	1991
2. Legal Basis	Belgium Limited Company Law	Colombia Congressional Law 57 of 1989	Chapter 744 of the New York Laws of 1970	Ministry of Finance Decree No. 1021/KMK.013/1991
3. Ownership	9 Provinces 589 Municipalities 1 Wateringue	Ministry of Finance All Departments (Provinces)	State of New York	Ministry of Finance
4. Supervision	Banking and Finance Commission; Min. of Finance; Min. of Interior	Min. of Fin.; Min. of Dev.; Natl. Planning Dept.; Office of the Pres.; 2 Departments	State of New York	Ministry of Finance
5. Resources				
a. Main Sources of Funds	Private Savings; Local Government Deposits	Natl. Budget; Intl. Donors; Mandatory Bond Purchases	Federal Grants; N.Y. State Grants; Bond Issues	National Budget; International Donors
b. Key Figures	Savings Bonds: \$36.4 b Customer Deposits: \$19.9 b Credit Institution Deposits: \$12.5 b Shareholder's Equity: \$1.7 b	Bank Loans: \$135.7 m Compulsory Bonds: \$13.6 m Paid-Up Capital: \$65.9 m Revalued Equity: \$29.8 m	Federal Grants: \$652 m State Grants: \$130 m Bonds Receivable: \$1.1 b	National Budget: \$227.3 m Donor Funds: \$39.1 m
6. Loans				
a. Client Base	Provinces, Municipalities, Other Local Authorities; Private Borrowers; National Government	Municipalities Via Intermediary Banks	Local Governments	Provinces, Municipalities, Districts, Local Enterprises
b. Loan Uses	Any Local Investment	Feasible Local Investments	Feasible Wastewater Investments	Cost Recovery Local Investments
c. Loan Terms	Up to 30 Years	Up to 12 Years	Up to 20 Years	Up to 20 Years
d. Loan Interest	Market Rates	DTF + 2.5% (To Banks) DTF + 5.0% (To Endusers) [DTF = Ave. 90-Day Rate]	Subsidized Long-Term Municipal Bond Rate	Inflation + Adm. Cost (Adjusted Annually by Ministry of Finance)
e. Loan Security	Own Source Revenue; Government Transfers	Own Source Revenue; Government Transfers	Own Source Revenue; Government Transfers; Bond Security	Local Government Guarantee (No Pledges)
f. Other Conditions	Project in Local Budget and Approved Locally	FINDETER Appraisal and Approval	EFC Appraisal and Approval	Approval by Dir. Gen. of Financial Insts., Dir. Gen. of Budget, and Bappenas
g. Credit Outstanding	Public Authorities: \$30 b Private Customers: \$8 b Public Bonds and Securities: \$19 b	Total: \$225 m	Leveraged Loans: \$2.1 b Direct Loans: \$23.5 m Short-Term Loans: \$100.3 m	Total: \$300 m
7. Number of Employees	3,675	200	70	16
8. Number of Branches	988	10	None	None
9. Quality of Service	Competitive With Other Commercial Banks	Long, Complicated Approval and Disbursement Process	Long, Complicated Approval and Disbursement Process	Funds Uncertain and Limited Due to Budget and Interdepartmental Links
10. Miscellaneous	Conduit for Central Transfers; Local Government Treasurer	Technical Assistance Provided	Technical Assistance Provided	RDA Not An Institution (Special Account at BI)

# Key Issues With MDFs

- Conflicting objectives
- Sources of funds
- Subsidies
- Risk management
- Role of private sector

# Results of MDFs

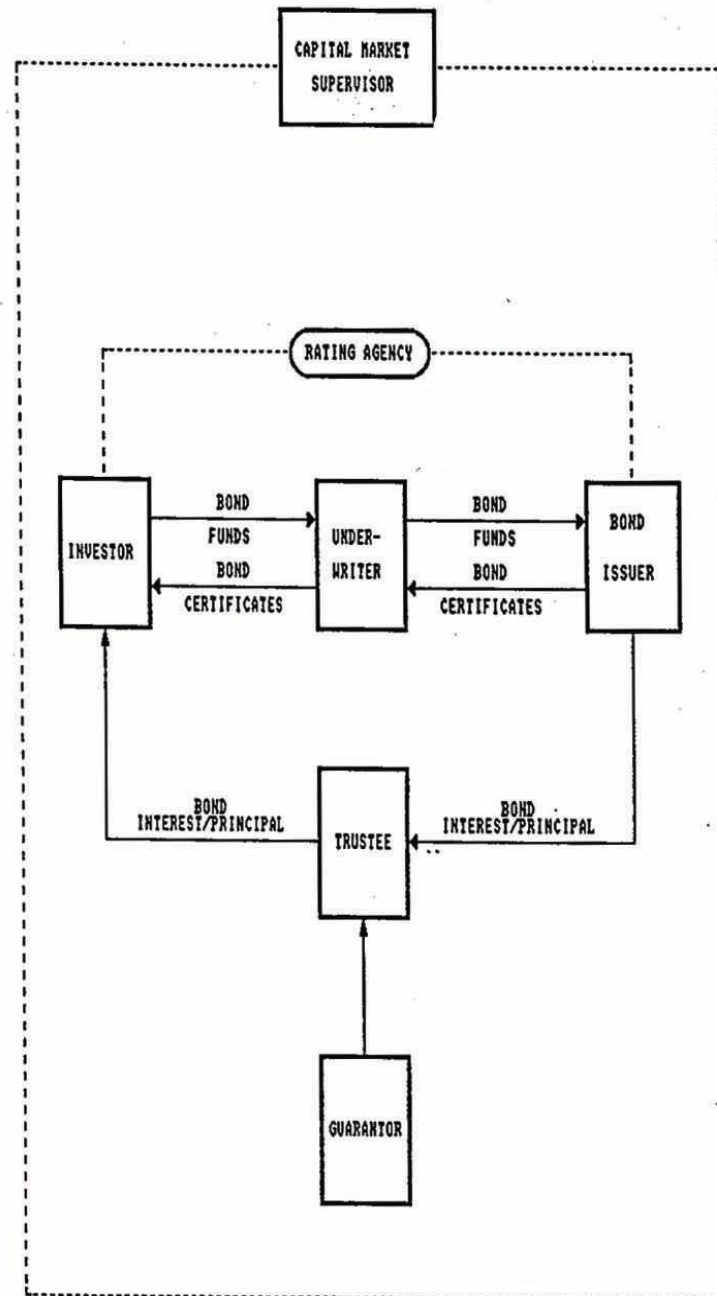
- Positive
  - Increased public capital investment
  - Improved equity, quality, accountability
- Negative
  - Drop in private sector investments
  - Bad projects
  - Failure to reflect local demand → failure to accept/repay and use/maintain
  - Not sustainable
- Success Factors
  - Politically neutral
  - Market driven
  - True financial intermediary
  - Strong municipal governments

# Debt Financing via Capital Markets:

## Municipal Bonds

- Definition
  - Municipal bonds = municipal securities = munis
  - Interest bearing obligations issued by state/local governmental entities to finance operating or capital costs
- Types of Municipal Bonds
  - ***General Obligation (GO) Bonds***: Backed by full faith/credit of issuer, taxing power of state/local government
  - ***Revenue Bonds***: Issued to support/repaid from revenues of a particular project/investment
  - ***Double-Barreled Bonds***: Hybrid bonds backed by project revenue stream + specific local revenue
  - ***Other State/Local Capital Market Debt Instruments***: Short-term securities (notes), commercial paper (CP), short-term municipals

# BOND MARKET SCHEMATIC





# Characteristics of U.S. Munis

- Extremely large, liquid, diverse, and complex market

## *Large (2010)*

- \$2.9 tr outstanding (8% of \$35.3 tr; federal 56%, private 36%)

## *Liquid Primary and Secondary Markets (2010 and 2009)*

- \$433.0 b issued in 2010 (6% of \$6.9 tr total)
- \$12.5 b daily trading in 2009 (2% of \$815 b total; buy & hold)

## *Diverse and Complex (2009)*

- All : 62% REV/38% GO; 85% nego/14% competitive/1% PP
- L-T (> 13 mos): 88% fixed/11% var/1% other; 86% callable/ 14% non-call; 64% new capital/36% refunding; 16.7-yr ave. maturity

## *Individual and Institutional Investors (2010)*

- 70% households (individuals and mutual funds)
- 10% banks, 16% insurance companies, 4% other

- Federal and own-state income tax exemptions
- No explicit or implicit federal guarantees

# Municipal Bond Trends

- Major Defaults
  - New York City, 1975
  - Washington Public Power Supply System (WPPSS), 1983
  - Orange County, 1994
- Led to:
  - Bond insurance, credit guarantees, third-party credit enhancements; bond insurers grew to cover half of muni market, but now many have retrenched/gone bankrupt
  - Tighter regulations
  - Focus on voluntary disclosure

# Potential and Obstacles for Municipal Bonds

- Potential for municipal bonds
  - Local need for long-term financing
  - Local underutilization of debt financing
  - Accelerating accumulation of relatively idle long-term capital
  - Gradual development of capital markets
- Obstacles for municipal bonds
  - Weak capacity of local government
  - Limited development of capital markets
  - Unsynchronized capital financing instruments
  - Unclear institutional, legal, tax, and regulatory framework

# LOCAL GOVERNMENT BONDS

## ADVANTAGES AND DISADVANTAGES

<u>Category</u>	<u>Advantage</u>	<u>Disadvantage</u>
1. Preparation	Not Extremely Different From Normal Preparations To Borrow	A Bit More Rigorous Because Bonds Entail Borrowing From The Public At Large Rather Than The Government Or A Bank
2. Drawdown	Much Faster Than Traditional Loans (All At Once Rather Than In Tranches)	No Major Disadvantage
3. Repayment	Principal Can Be Amortized Or Paid Upon Maturity	Difficult To Renegotiate Repayment Terms
4. Interest Rate	The Effective Cost Of Borrowing Is Often Less Expensive Than Government Or Bank Loans	The Nominal Cost Of Borrowing Is Often More Expensive Than Government Or Bank Loans
5. General Terms & Conditions	Can Be Negotiated To Suit Issuer Needs	No Major Disadvantage
6. Decentralization	The Issuer Takes Primary Responsibility For Its Own Finances	With Additional Authority Comes Additional Accountability
7. Public Participation	The Public At Large Has A Direct Stake In Regional Economic Development	No Major Disadvantage
8. Capital Market Development	Increases Market Liquidity	No Major Disadvantage
9. Macroeconomics	Foreign Borrowing Is Replaced By Domestic Savings	No Major Disadvantage