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COMMENTARY



FINANCING OF THE LOCAL GOVERNMENT
CAPITAL INVESTMENTS - CURRENT
REVENUES OR DEBT FINANCING

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When considering what resources are available to fund capital investments, the most important is to consider all possible financial alternatives. On one side, borrowing results in additional costs related to bank charges, interest, etc. For sure it would be better to wait until the investment project could be financed from current revenues, thus avoiding additional and unnecessary costs of borrowing. However, in general, financial capabilities of the local governments are smaller than the figures needed for investments. This is normal because the local government budgets are still very modest to take on important projects. One way to satisfy the needs for finances in order to complete the projects is by borrowing long term funds domestically or from abroad as well as combination of their own resources of revenues with borrowing.

Infrastructure services like electricity, roads, water, and sanitation are main drivers of economic activity. Social infrastructure, such as health and education, but also access to

Table 1. Sources of Financing of Infrastructure Projects

Source	Pros	Cons
Own resources	Cheap	Less predictable, rarely sufficient
Grants from EU and central governments	Cheap	Restriction on the use of funds, slow pace of approval, strict control
MFO loans	Long-term, grace periods, amortizing repayment	Foreign currency risk, restrictions on the use of funds
Domestic bank loans	Local currency	Short-term, restricted capacity
Bonds	Diversity of investors, liquidity, depth of markets	Expensive depending on size, bullet repayments
Own sources or borrowings of enterprises	No direct costs	Contingent liabilities and more expensive
PFI/PPP deals	No direct costs, more effective private sector provision of services	Long-term agreement with concessionaires, off-balance sheet risks
Investment banks and funds for local government unit	Deposit risk attenuation, lower interest rate, possibility of contributing to capitalization of the bank, local government unit could provide guarantee with their current revenues as well, the Bank can provide consulting services to the local government unit as an auxiliary service	Possible mix between having a role in the capitalization process and possibility of being granted a loan i.e. political interference, Local development fund could prove counter-productive to the objectives of sound, private credit market development.

Source: Nikolov, M. USAID Assistance to the Center for Economic Analyses (2007, July). Report on the Process of Decentralization in Macedonia CEA/USAID, p.13. Table 2

clean water and sanitation, lead to direct positive impacts on the quality of life and reduce mortality and morbidity. The rationale of a positive impact of all kinds

of loans (including commercial ones) is that the exposure of local governments to capital markets can significantly speed up infrastructure development

and in addition requires local governments to be transparent and leads to lenders exerting a certain control function on local government finances.¹

Local governments rarely maintain cash surpluses large enough to pay for the entire cost of big capital projects. They can either finance a capital project from own resources, by accumulating savings in their current account budget (pay-as-you-go financing) or by tapping credit markets (pay-as-you-use financing). Pay-as-you-go financing is paying for capital projects and acquisitions from sources other than debt such as current taxes and revenue, funds from capital reserves, special assessments or impact fees and grant revenue from federal, state, or foundation sources. Pay-as-you-use financing - every long-term improvement or expenditure is financed by serial debt issues with maturities arranged so that retirement of debt coincides with depreciation of the project. Most of the local govern-

¹ Fiscal Decentralization and Options for Donor Harmonization, Development Partners Working Group on Local Governance and Decentralization, Berlin, (2009, December)

ments practice a combination of Pay-as-you-use and Pay-as-you-go policies.²

There has been a remarkable growth in local government revenues as both a share of GDP and total public expenditures through the years. Both have more than tripled since the beginning of Macedonia's decentralization process, while the per capita revenues of local governments have more than quadrupled. The progress with decentralization in Macedonia has proceeded quite rapidly and successfully.³

Borrowing allows a local government to carry out more ambitious investments than otherwise would not be possible. It also promotes intergenerational equity by having the future generations of citizens which will benefit from a facility's services pay for its construction. However, borrowing is not always an appropriate financing strategy. Borrowing to cover current ex-

penditures or account deficits has just the opposite effects. It shifts the costs to future generations, while today's taxpayers enjoy the benefits.⁴ There is also the value of exposing local governments' development plans to public and expert analysis and the "discipline of the market". Local government taxpayers and national government officials can take some comfort from the knowledge that a local government's proposed infrastructure capital expenditure programmes will be subject to review by financial and technical experts before they are financed. These experts check that the proposed capital expenditures are appropriate and affordable for the local government. They assess whether they are willing to invest in that

local government and determine what level of return they would require for their investment.⁵

Local governments need to compare the need for funds (the estimate for the investment project) with the amount of loan they expect to receive in accordance with the legal limit for borrowing as well as to plan how much annual debt service they can make in order to repay the due amount.

The most important arguments for borrowing by local governments are as follows: equitable burden of cost and access to benefits, optimal allocation of resources, benefits from accelerated local development overshadow the cost of borrowing, reduction of operational costs, longer projects cost more, stabilization of required budget resources, access to grants from Euro-

pean and other development funds.⁶

For most local governments in developing countries a rapid increase in spending on infrastructure projects is needed as soon as possible, not only to build new infrastructure but to refurbish existing infrastructure. Borrowing for capital expenditure can make this possible. Borrowing can provide large capital sums for immediate use, and the resulting longer term debt can be serviced from a regular stream of local government income, whether directly from revenues resulting from the investment or indirectly through increased tax revenues. Additionally, there is a growing trend toward the decentralisation of service delivery, where locally elected councils decide on capital expenditure priorities and are expected to raise some or all of the funds to meet them.⁷

However, there are also potential hazards in borrowing, both of a microeconomic and a

² Guidelines on local government borrowing and recent developments in NALAS countries, (2011)

³ Local Government Finances and the Status of Fiscal Decentralization in Macedonia: Statistical Review 2008-2011 Skopje: Macedonia Local Government Activity / USAID

⁴ Guidelines on local government borrowing and recent developments in NALAS countries, (2011)

⁵ Obtaining a Municipal Credit Rating: a brief overview, (2007, March)

⁶ Local Government Borrowing: Risks and Rewards, A Report on Central and Eastern Europe (2004)

⁷ Commonwealth Local Government Forum, Obtaining a Municipal Credit Rating: a brief overview (2007)

macroeconomic nature. The microeconomic danger lies in the potential for excessive indebtedness of some local governments, which may lead to serious difficulties in repayment of loans and may jeopardize the provision of vital public services. At the macroeconomic level, local governments contribute to the overall level of public debt. Local government indebtedness may thus have a negative effect on inflation and other important parameters of the national economy.⁸

When considering what resources are available to fund capital investments, it is the most important for local governments to consider all possible financial alternatives. A wide range of sources are possible, for example current revenues, grants from central government, funds from donors, private sector investments (PPP). Some local governments have high share of special revenues and are thus less dependent on transfers

from the central government. This provides them a more stable budget to finance capital investments. Such local governments meet the preconditions to obtain a credit rating that will enable them to choose in future whether their borrowing is cheaper in the form of credit or securities (municipal bonds). The rest of the local governments have limited capacity to perform their main functions stipulated by law. Due to high insecurity and risk, these local governments do

not meet the requirements for borrowing, considering their fiscal stability and the question of debt sustainability. One way to satisfy the needs for finances in order to complete the investment projects is by combination of their own sources of revenues with external financing (borrowing). However, each local government should understand its capabilities and on this basis to define its medium-term development policy. ●



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⁸ Local Government Borrowing: Risks and Rewards, A Report on Central and Eastern Europe (2004)