Local Government Finance and Bond Markets

Edited by Yun-Hwan Kim

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Foreword

The Asian financial crisis has underscored the need for both public and private sectors to diversify sources of funds to finance development projects. The domestic capital market is a fertile source that has not been successfully utilized for development financing, especially prior to the crisis. In particular, domestic bond markets are one of the instruments that could help put potential resources to more productive use, and are even a viable alternative source of financing for development projects.

Central governments of several developing member countries (DMCs) of the Asian Development Bank (ADB) have, in recent years, devolved to local governments the responsibility for delivering basic public services and providing physical infrastructure, both of which require substantial financial resources. Better known as political decentralization, the premise of this process is that a local government should assume the responsibility for delivering services to the residents within a given geographical area. Decentralization also aims to reduce large fiscal deficits among both central and local governments by raising their efficiency in mobilizing resources and generating revenues, and by helping promote subregional growth and poverty reduction. At the same time, the rapid urbanization that is taking place in most DMCs has prompted local governments to upgrade basic infrastructure in an attempt to meet increasing demands for public services.

DMC governments have made significant efforts to strengthen local government finance and to diversify financing methods by reforming revenue (particularly taxation) and expenditure systems, restructuring intergovernmental transfers, privatizing key development projects, and developing municipal credit markets. Nevertheless, local government finance in most DMCs remains weak and needs to tap new financial resources, particularly long-term private resources in domestic credit markets.

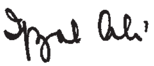
Against this background, in early 2002, the Economics and Research Department (ERD) of ADB initiated a study on Local Government Finance and Bond Markets under the regional technical assistance (RETA) 5809: Study on Development of Government Bond Markets in Selected Developing Member Countries. The study was conceptualized and supervised by Yun-Hwan Kim, ERD, with the assistance of Ludy Z. Pardo. I would like to extend my special gratitude to them. The bond markets of the following DMCs were analyzed: People's Republic of China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Sri Lanka; Taipei,China; and Thailand.

Besides these 10 country reports, the study included a comparative assessment of bond financing and bank financing by local governments in developing countries by George E. Peterson of the Urban Institute in Washington, DC. Roberto de Vera of the University of Asia and the Pacific and Yun-Hwan Kim prepared an overview paper synthesizing country experiences and lessons in building up local government finance.

The country research examined the present state of financing at the subnational (or local) government level, local governments' efforts to tap private resources, and the state of bond markets for local governments. It then proposed key policies with a view to developing and deepening the bond markets for local governments.

The research study benefited from valuable insights of experts in the field of government finance and bond markets who shared their professional knowledge and experience. All researchers provided significant contributions, having examined the feasibility of developing markets for local government bonds. An international conference was held at ADB from 19 to 21 November 2002 to discuss the research reports. These reports brought to the fore a wealth of relevant and significant information for mobilizing long-term private sources of financing at the local government level.

This volume contains edited versions of the papers presented at the conference. It is hoped that it will be of use to developing economies not only in the Asia and Pacific region, but also in other regions of the world, in formulating improved financial market policies and in channeling the efforts of both national and local governments toward innovative development finance mechanisms.



Ifzal Ali
Chief Economist

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Yun-Hwan Kim
Assistant Chief Economist
Development Indicators and Policy Research Division
Economics and Research Department

Contents

Foreword iii
Acknowledgments v

Banks or Bonds? Building a Municipal Credit Market 1
By George E. Peterson
Introduction 3
Bank Lending 4
Relationship Banking 4
Delegated Monitoring 5
Bundled Services and Bundled Pricing 6
Limitations to the Bank Lending Model for Newly Established Local Credit Systems 7
Short-Term Savings and Lending 7
Municipal Loans as Real Estate Lending 8
Municipal Bond Issuance 9
Limitations of the Bond Model for Countries Establishing New Local Credit Markets 10
Bond Ratings before Adequate Financial Disclosure? 10
Access to Long-Term Funds 11
Designing Transitional Credit Systems 11
Single-Purpose Infrastructure Financing Authority Insulated from Central Government 14
Competitive Unbundling 15
Financial Monitoring and Early Warning Capacity 16
Municipal Disclosure Rules 16
Accessing Long-Term, Cheap Capital 17
Banks or Bonds? 18

Overview: Local Government Finance, Private Resources, and Local Credit Markets in Asia 19
By Roberto de Vera and Yun-Hwan Kim
Introduction 21
State of Local Government Finance in Asia and Major Issues 22
India 22
Indonesia 23
Pakistan 25
Philippines 27

Other Countries 28
Major Issues and Challenges 29
Fiscal Reforms to Improve Local Government Finance 30
External Borrowing and Privatization Efforts by Local Governments 33
Developing Local and Municipal Credit Markets 39
Conclusions 43

People's Republic of China 59
By Jia Kang
Executive Summary 61
Introduction 62
Local Government Finance: General Profile and Trends 62
Local Government Financing Channels and Impediments to Bond Financing 67
Overseas Debt and Project Bonds, and Transfer Lending of Central Government Debts 67
Alternative Bond Financing by Local Governments: Transmuted Bond Flotation 68
Need for Local Bond Financing 70
Feasibility of Developing Local Bond Financing 72
Basic Principles and Policy Recommendations for Local Bond Financing 73
Possible Problems in Local Government Bond Flotation 75
Possible Initiatives for the Asian Development Bank 77

India 87
By Hemanta K. Pradhan
Executive Summary 89
Introduction 94
Forces Shaping Decentralization 95
Urbanization 96
Local Government Powers and Functions: Expenditure Assignment 99
Resource Base of Urban Local Bodies 100
Imbalances in State Government Finances 104
Fiscal Reforms in Recent Years 106
Guarantees 108
Financial Devolution 111
Framework for Financing Urban Infrastructure and Services 112
Major Urban Infrastructure Schemes 113
Recent Central Government Initiatives 114

External Financing 116
Capital Market Dependency of Local Government 117
Local Government Financing and Financial Markets 118
Commercialization and Private Sector Participation 122
Financing Innovations in Urban Infrastructure 122
Bond Markets and Local Government Financing 124
State Government Bonds 125
State-Sponsored Institutions 126
Municipal Bonds 126
Urban Development Funds 127
Enabling Environment for Subnational Bond Market Development 133
Vibrant National Bond Market 133
Investors 134
Creating Secondary Markets 135
Regulatory Design for Local Debt Markets 137
Private Placement 139
Credit Rating 139
Borrowing Powers 143
Municipal Bankruptcy 144
Fiscal Incentives for Bond Issuance 145
Capacity Building 146
Local Bond Market Development: A Roadmap 149
Areas of Technical Assistance 150

Indonesia 167
By Carunia Mulya Firdausy
Executive Summary 169
Fiscal Decentralization and its Impact on Local Government Finance 171
Fiscal Trends and Budget Structures 171
Developments in Local Government 175
Patterns of Local Government Revenue and Expenditure 180
Regional Budget Revenue and Expenditure 180
Sources of Revenue 183
Expenditure Categories and Uses 189
Strengthening Local Government Financial Sources 190
Bond Market Financing 195
Existing Regulatory and Institutional Framework for Local Government Bond Markets 205
Major Impediments to Bond Financing by Local Governments 206

Summary and Conclusions 207
Policy Recommendations 208
Areas of Technical Assistance 211

Republic of Korea 225
By Junghun Kim
Executive Summary 227
Local Public Finance 230
Structure of Government 230
Expenditure Assignment 233
Revenue Assignment 235
Intergovernmental Grants 241
Recent Developments in Local Public Finance 247
Institutional Changes 247
Fiscal Trends 250
Long-Term Financing of Local Governments 252
Institutional Framework of Local Debt 252
Size and Structure of Local Debt 259
Local Debt Issues 263
Policy Issues to Improve Local Public Finance 271
Improving Accountability in Local Government 271
Asymmetric Decentralization 272
Expenditure Reassignment 273
Policy Issues in Local Bond Market Development 274
Central Government Loans and Compulsory Bonds 274
Intergovernmental Grants and Infrastructure Investment 276
Soft Budget Constraints 276

Malaysia 283
By Azmi Setapa and Elayne Yee Siew Lin
Executive Summary 285
Introduction 287
Overview of Local Government 287
Sources of Revenue 290
Assessment Tax 290
Licenses and Permits 291
Rentals 292
Car Parking 292
Grants 293

Loans 298
Other Types of Revenue 298
Revenue and Expenditure Trends 298
Increasing Local Government Revenue 302
Challenges to Local Governments 302
Sources of Revenue 303
Recommendations for Local Government Revenue Sources 304
Financial Constraints on Local Government 304
Possible Avenues of Local Government Financing 304
Taxation and Constitutional Bias 306
Improving the System of Revenue Administration 308
The Importance of Bond Financing 309
Recent Developments in the Bond Market 311
Viability of Bond Financing for Local Government 316
Impact on Monetary and Fiscal Policy 316
Constitutional Restrictions on Borrowing 317
Inadequacy of Financial Reporting and Transparency 318
Bond Market Infrastructure 318
Guidelines for Private Debt Securities Issuance 322
Options for Local Government Bond Financing 323
Conclusions 326

Pakistan 331
By Shahid H. Kardar
Executive Summary 333
Institutional Framework 337
Constitutional Provisions 337
Federal Government Functions 337
Provincial Government Functions 337
Local Governments and the Constitution 338
Revenue-Sharing Arrangements 339
Limitations of Current Fiscal and Borrowing Powers and Tax Systems 340
Financial Position of Subnational Governments 342
Provincial Finances 342
City District Government of Karachi 344
City District Government of Lahore 346
Limitations of City District Government Accounts 347
Debt-Carrying Ability of Subnational Governments 348
Borrowing Powers of Subnational Governments 349

Investment in Infrastructure 349
Importance of Infrastructure 349
Private Sector Provision of Infrastructure and International Experience 350
Sources of Funding for Infrastructure Investment 351
Experience with Government and Corporate Debt Instruments 352
Money Market and Government Debt Instruments 352
Corporate Debt Instruments 353
Factors Hindering Subnational Government Bond Issuance 353
Low Rate of Domestic Savings and Weak Intermediary Systems 353
Legislative Constraints 354
Regulatory and Tax Constraints 354
Lack of Financial Information on Subnational Governments 354
Weak Financial Management and Accountability Systems 355
Recommendations 356
Strategy for Issuing Subnational Government Bonds 356
Recommendations for Resource Mobilization 360
Enhancement of Institutional Capability 361
Transparency to Facilitate Investment Decisions 361
Conclusions 362
Scope of Local Government Reform 367

Philippines 385
By Lydia N. Orial
Executive Summary 387
Introduction 390
Local Government Structure and Powers 391
Structure 391
Powers 391
Economic and Political Trends since 1995 391
Major Economic and Political Changes 391
Devolution of Functions from National to Local Government 392
Impact of Devolution on Local Government Finance 394
Local Government Fiscal Management 396
Local Government Fiscal Patterns 396
Strategies to Strengthen Local Government Finance 398
Financing Alternatives and Local Government Financing Trends 401
Financing Alternatives 401
Local Government Financing Trends 405

Current Local Government Bond Market Situation 405
Low Level of Local Bond Issuance 405
Regulatory and Institutional Framework for Local Government Bonds 408
Market Players 409
Impediments to Local Government Bond Market Development 409
Regulatory Constraints 409
Legislative Constraints 411
Administrative Constraints 411
Structural Constraints 412
Conclusions and Recommendations 412
Overall Status of the Local Government Bond Market 412
Proposed Reforms 412
Some Considerations for Successful Local Government Credit Financing 414
Potential Areas for Asian Development Bank Assistance 415

Sri Lanka 429
By Amarakoon Bandara
Executive Summary 431
Local Government Finance and Bond Financing 433
Socioeconomic Responsibilities, Economic and Political Changes, and Fiscal Trends 434
Local Government Structure 434
Socioeconomic Responsibilities 434
Economic and Political Changes 438
Fiscal Trends 441
Strengthening the Financial Situation of Local Governments 444
Fiscal Reforms 445
New Revenue Generation 447
Financial and Debt Management 448
Raising Funds in the Market 449
Law Enforcement 450
Introducing a Retirement Scheme 451
Improved Project Implementation 451
Improved Infrastructure Maintenance 451
Conducting Awareness Campaigns 452

Tapping Domestic and International Markets 452
Sri Lanka's Bond Market 452
Legislative Provisions to Borrow 453
Past Practice 455
Alternative Financing 455
Impediments to Bond Financing 458
Policy Recommendations 464
Recommendations for Bond Market Development 465
Recommendations for Local Bond Market Development 466
Assistance from the Asian Development Bank 470

Taipei,China 487
By Steve Waicho Tsui
Executive Summary 489
Basic Economic and Government Structure 492
Economic Trends 492
Government Functions 493
Responsibility and Expenditure Assignments 494
Tax Assignment 496
Revenue and Expenditure Structure 499
Problems in Local Government Finance 504
Intergovernmental Transfer System 506
Public Debt and Bond Issuance 510
Underdevelopment of the Local Government Bond Market 516
Feasibility of a Local Bond Market 519
Legal, Regulatory, and Institutional Conditions 519
Major Impediments to the Development of a General Local Bond Market 520

Thailand 525
By Sakon Varanyuwatana
Executive Summary 527
Introduction 530
Development of Local Government 531
Local Fiscal Development before the New Constitution 534
Early Attempts to Improve Local Financing 535
Local Government Reform under the New Constitution 536

Local Finance System 540
Structure of Locally Levied Tax for Local Government 542
Impact of Decentralization on Local Government Finance 543
Local Revenue Capacity-Building Schemes 545
Local Government Finance 547
Local Government Revenue 547
Local Government Expenditure 551
Regulatory and Institutional Framework for Bond Market Development 554
Impediments to Local Bond Market Development 559
Roadmap for Local Bond Financing Development 561
Recommendations 563
Assistance from the Asian Development Bank 564

Tables

Overview: Local Government Finance, Private Resources, and Local Credit Markets in Asia **19**
Table 1. Financing of State Governments' Gross Fiscal Deficits, India (%) 23
Table 2. Outstanding Guarantees by Governments, India (% of GDP) 23
Table 3. Estimated Local Government Revenues, Indonesia, FY2001 (Rp billion) 24
Table 4. Provincial Budget Operations, Pakistan, 1993/94–1999/2000 (PRs million) 26
Table 5. Refunding Plan of Seoul Subway Debt through Samurai Bonds 35
Table 6. Details of First ¥48.5 Billion Samurai Bond Issue by the City of Seoul 35
Table 7. Comparison of Debt Retirement (¥ billion) 35
Table 8. Benefits of Bond Bank Issuance 42

People's Republic of China **59**
Table 1. Fiscal Revenue and Expenditure at Local Level (CNY 100 million) 64
Table 2. Structure of Tax Revenue of Local Governments (CNY 100 million) 67

India **87**
Table 1. Trends in Urbanization 96
Table 2. Towns or Urban Agglomerations by Class 97
Table 3. Cities with a Population of Over 1 Million, 2001 97
Table 4. Structure of Urban Bodies 98
Table 5. Status of the Functions as per the 74th Constitutional Amendment 100
Table 6. All-India Revenue and Expenditure of Local Bodies (%) 102
Table 7. Revenue-Raising Powers of Corporations 103
Table 8. Selected Fiscal Indicators of State Governments (%) 105
Table 9. Financing of State Governments' Gross Fiscal Deficits (Rs10 million) 106
Table 10. Outstanding Government Guarantees (Rs10 million) 108
Table 11. Ceilings on Guarantees as Promulgated by State Governments 110
Table 12. Transfer of Resources from the Center to the States (Rs10 million) 111
Table 13. Use of External Aid by Sector, 1998–2000 116
Table 14. Estimate of Resource Requirement for Urban Infrastructure 117
Table 15. Commercial Bank Lending to the Infrastructure Sector (Rs million) 119
Table 16. Funding of Urban Infrastructure by the Housing and Urban Development Corporation Ltd., 2001/02 120
Table 17. Disbursements by the Infrastructure Development Finance Company, 2000/01 121
Table 18. Structure of Bond Markets: Issuers and Instruments 125
Table 19. Resources Raised from Debt Markets (Rs10 million) 125

Table 20. Market Borrowings of States through Auction 126
Table 21. Private Placements of Bond Issuance (Rs10 million) 127
Table 22. Features of Municipal Bond Issuance, 1997–2002 128
Table 23. Ownership of State Government Securities, end-March (Rs10 million) 135
Table 24. Investments by Banks in Local Securities (Rs100,000) 136
Table 25. Savings of Household Sector in Financial Assets (%) 137
Table 26. Secondary Market Distribution in Turnover in the Wholesale Debt Market Segment (Rs10 million) 138
Table 27. Local Bond Market Development: A Roadmap 151

Indonesia 167
Table 1. District/Municipal Revenues and Expenditures, Various Years (Rp billion) 171
Table 2. Ratio of Regional Budget Revenue to Gross Regional Product 182
Table 3. Provincial Budgets, FY2000 (Rp billion) 183
Table 4. District/Municipal Budget, FY2000 (Rp billion) 184
Table 5. Shares of Local Revenue and Revenue from Central Government in Total Revenue in the Provincial Budget, FY2000 (%) 185
Table 6. Local Revenue Sources in Six Provinces, FY2000 (%) 186
Table 7. Local Revenue Sources in Six Districts and Municipalities, FY2000 (%) 186
Table 8. Incomes from Higher-Level Government in Six Provinces, FY2000 (%) 186
Table 9. Income from Higher-Level Government in Six Districts and Municipalities, FY2000 (%) 187
Table 10. External Loans before 1988 (Rp billion) 195
Table 11. Total Loan Disbursement to Provinces and Municipalities in Indonesia by Investment Fund Account and Subsidiary Loan Account, 1982–2000 (Rp million) 196
Table 12. Investment Fund Account Loan Disbursement to Four Provinces (Rp million) 197
Table 13. Bond Emissions of Local Government Banks 198
Table 14. Trading Transaction between Government and Corporate Bonds (via Over-the-Counter Fixed-Income Service), 2000–2001 (Rp billion) 204

Republic of Korea 225
Table 1. Structure and Size of Local Government, 2001 231
Table 2. Expenditure Responsibilities of Local Government 233
Table 3. Fiscal Independence Index of Local Governments, 2002 (%) 236
Table 4. Distribution of the Fiscal Independence Index of Local Governments, 2002 236
Table 5. Local Government Revenue Trends (W billion) 250
Table 6. Local Government Tax Revenue (W billion) 251
Table 7. Local Government Expenditure (W billion) 251

Table 8. Central Government Funds Available for Local Borrowings, 2002 257
Table 9. Local Government-Managed Funds for Local Borrowing, 2002 258
Table 10. Size of Central and Local Government Debt, 1995–2001 (W billion) 260
Table 11. Local Debt and Revenue, December 2001 (W billion) 261
Table 12. Source of Local Debt, December 2001 (W100 million) 262
Table 13. Interest Rates of Local Debts 262
Table 14. Target Projects of Local Debts 262
Table 15. Source of Debt Retirement 263
Table 16. Share of Local Debt among Local Governments 263
Table 17. Debt Composition of Subway Companies in Seoul, December 2002 267
Table 18. Comparison of Debt Retirement (¥ billion) 268

Malaysia **283**
Table 1. Local Government by State, April 2002 289
Table 2. Ratio of Urban to Total Population 289
Table 3. Major Sources of Local Revenue, 2000 (%) 292
Table 4. Outstanding Assessment Taxes (RM million) 293
Table 5. Local Government Consolidated Finances, 1995–2001 (RM million) 299
Table 6. Various Statistics for Local Government, 1995–2001 (RM million) 299
Table 7. Local Government Annual Revenue and Expenditure Changes, 1996–2001 (%) 300
Table 8. Petaling Jaya Town Council Revenue and Expenditure (RM million) 300
Table 9. Ampang Jaya Municipal Council Revenue and Expenditure (RM million) 301
Table 10. Klang Town Council Revenue and Expenditure (RM million) 301
Table 11. Shah Alam City Council Revenue and Expenditure (RM million) 302
Table 12. Funds Raised in the Bond Market (RM million) 312
Table 13. New Issues of Private Debt Securities by Sector (RM million) 314

Philippines **385**
Table 1. Financing Alternatives for Local Government Units 401

Sri Lanka **429**
Table 1. Revenue Sources of Provincial Councils 442
Table 2. Resource Gap of Provincial Councils, 2001 (SLRs million) 445
Table 3. Borrowing by Municipal Councils (SLRs million) 455
Table 4. Outstanding Central Government Debt by Institution 462

Taipei,China **487**
Table 1. Classification of Taxes, 2002 500
Table 2. Size of Public Sector, FY1980–1999 (%) 501
Table 3. Net Expenditures by Government (%) 502
Table 4. Revenue Structure of Different Tiers of Government (%) 503
Table 5. Comparison of Fiscal Transfer to Local Governments: Before and After the Downsizing of Taiwan Provincial Government (NT$ million) 509
Table 6. Outstanding Debts, All Levels of Government, 1986–2002 (NT$100 million; %) 511
Table 7. Outstanding Debts in FY2002, All Levels of Government (NT$100 million) 512
Table 8. Issues, Redemptions, and Amounts Outstanding of Government Bonds (NT$ million) 514
Table 9. Issues, Redemptions, and Amounts Outstanding of Local Government Bonds (NT$ million) 515
Table 10. Taipei City Government Bond Issuance (NT$ million) 515
Table 11. Kao-hsiung City Government Bond Issuance (NT$ million) 516

Thailand **525**
Table 1. Functions of Local Government after the 1997 Constitution 539
Table 2. Sources of Local Government Revenue after the 1997 Constitution 540
Table 3. Types of Grants Allocated to Local Government 544
Table 4. Total Local Government Revenue, 1996–2001 (B million) 548
Table 5. Local Government Revenue by Entity (B million) 549
Table 6. Local Revenue from Trust Fund and Loans, FY1999 (B million) 550
Table 7. Total Local Expenditure, 1996–2000 (B million) 552
Table 8. Local Government Expenditure by Entity, 1994–2000 (B million) 553
Table 9. Size of Financial Market (B billion) 555

Figures

India **87**

Figure 1. Political Governance in India 94
Figure 2. Resource Base of Urban Local Bodies in India 101
Figure 3. Framework of Financing Urban Infrastructure 114
Figure 4. Bond Issuance Structure by Urban Local Bodies 130
Figure 5. Municipal Bonds with Asset Management Company as an Intermediary 132

Indonesia **167**

Figure 1. Government Revenues and Expenditures at the Provincial Level, FY1996–2000 172
Figure 2. Revenues and Expenditures at the District/Municipal Level, FY1996–1999 173
Figure 3. Revenue Shares of Local Budget for All Provinces, FY2000 188
Figure 4. Revenue Shares of Local Budget for All Districts and Municipalities, FY2000 188
Figure 5. Growth in Number of Corporate Bond Issuers, 1983–2001 199
Figure 6. Growth in Value of Corporate Bonds Issued, 1983–2001 (Rp trillion) 199
Figure 7. Process of Issuing Bonds 201
Figure 8. Bond Trading through Over-the-Counter Fixed-Income Service 201
Figure 9. Secondary Market Mechanisms of Corporate Bonds 202
Figure 10. An Example of Bond Trading through Stock Markets 203
Figure 11. Composition of Corporate Bonds Based on Rating 203

Republic of Korea **225**

Figure 1. Local Government System, 2001 230
Figure 2. Concentration of Population around Metropolitan Areas, 2002 (%) 232
Figure 4. Ratio of Local Tax to National Tax 238
Figure 3. Ratio of Central Government to Local Government Expenditure 238
Figure 5. Tax System 240
Figure 6. Local Debt Issuance 254
Figure 7. Types of Local Debt 255
Figure 8. Interest Rate Trends, 1990–2002 259
Figure 9. Local Government Foreign Debt (W billion) 266
Figure 10. Won-Dollar and Won-Yen Exchange Rates (Won/$1, Won/¥100) 270
Figure 11. Relationship between per Capita Local Shared Tax and Population of Local Government 274

Malaysia **283**
Figure 1. Organizational Chart for City, Municipal, and District Councils 290
Figure 2. Ratio of Bonds Outstanding to Gross Domestic Product 313
Figure 3. Private Debt Securities Issued in 2001 by Type of Instrument (%) 313
Figure 4. Utilization of Proceeds from Private Debt Securities (%) 315
Figure 5. Trading of Ringgit Bonds (RM billion) 316
Figure 6. Rating Distribution of Outstanding Private Debt Securities (December 2001) 321

Philippines **385**
Figure 1. Bond Issuance Process and Institutional Framework 410

Sri Lanka **429**
Figure 1. Structure of Local Government 435
Figure 2. Provincial Council Revenue 442
Figure 3. Composition of Tradable Government Debt, 2001 453
Figure 4. Secondary Market Yield Curve for Government Securities 459
Figure 5. Roadmap of Recommended Reforms 467

Thailand **525**
Figure 1. Revenue Structure of Local Government 541

Boxes

Overview: Local Government Finance, Private Resources, and Local Credit Markets in Asia **19**

Box 1. Tamil Nadu Urban Development Fund 36

Box 2. Limiting Credit Risk in the United States Municipal Bond Market 40

India **87**

Box 1. Press Reports on Bond Financing 109

Box 2. Ministry of Urban Development and Poverty Alleviation Guidelines for the Issue of Tax-Free Municipal Bonds 140

Box 3. Credit Rating Information Services of India Ltd.: Rating Indicators for State and Municipal Governments 142

Philippines **385**

Box 1. Case Study of Municipal Government of Anda, Pangasinan: Philippine National Bank Loan for a Public Market and Bus Terminal 403

Box 2. Case Study of Pulilan, Bulacan: Municipal Development Fund Loan for a Public Market 404

Box 3. Case Study of Urdaneta City: Municipal Bonds for Abattoir Upgrading 406

Box 4. Case Study of Tagaytay City: Local Government Bonds for a Convention Center and Lodging Facilities 407

Sri Lanka **429**

Box 1. Policy Changes since 1977 439

Box 2. Floating Rate Note Issued by DFCC Bank 457

Thailand **525**

Box 1. Local Government Reform in 1994 535

Box 2. Regional Urban Development Fund 554

Box 3. Thailand Bond Market Development 557

Box 4. Thai Rating and Information Services 560

Banks or Bonds?
Building a Municipal Credit Market

George E. Peterson
Senior Fellow
The Urban Institute
Washington, DC

Acronyms

CNY	yuan
Inca	Infrastructure Finance Corporation Ltd.
MDF	municipal development fund
PRC	People's Republic of China
Rs	Indian rupees
TNUDF	Tamil Nadu Urban Development Fund

Introduction

Asian cities cannot finance the infrastructure investments they need without accessing private domestic savings. Urban growth has multiplied demand for investment in water systems, wastewater collection and treatment, roads, and other facilities. At the same time, decentralization strategies have shifted much of the responsibility for this investment to local governments. Private financing can be attracted to urban infrastructure in different ways—including direct private investment in income-earning facilities—but perhaps the most critical avenue will be the local credit market. In a world of decentralized governance, domestic credit markets must be capable of generating long-term financing for cities and their infrastructure agencies.

Two models of municipal credit markets are considered here: (i) bank lending, which financed municipal investment in western Europe throughout most of the 20th century and is still the primary source of local credit financing there; and (ii) municipal bonds, which have been the foundation of municipal borrowing in North America. In designing local credit initiatives for Asia or other parts of the developing world, policy makers do not have to choose between these two systems, which are converging in their regions of origin. Countries now building or strengthening local credit markets would do well to select characteristics from both models and, even more, to encourage competition on a level playing field between bank lending and bond issuance.

Comparing the two models is instructive. Building reliable local credit markets where they did not exist before has proven more difficult than foreseen. The experience of multilateral institutions is filled with apparent paradoxes. Large-scale use of municipal development funds (MDFs), for example, began in Brazil 30 years ago. Several states in Brazil have subsequently instituted MDFs, with a record of success that is enviable, with very low rates of nonperforming municipal loans and successful completion of local investment projects. Yet Brazil today is as far away as ever from having a functioning local credit market. Municipal bond issues are prohibited. Municipalities must obtain case-by-case approval from the central bank and national Senate for other types of borrowing. No private banks will make intermediate or long-term loans to municipalities, even when it is legally permissible, because of the perceived riskiness of such lending.

The frequent failure of international onlending initiatives to build sustainable local credit markets stems in part from lack of clarity as to what elements a subnational credit market should possess. The precedents established by the initial institutions involved in local lending can as readily retard or jeopardize local credit market development as encourage it.

Bank Lending

The banking approach to municipal lending is well illustrated by the specialty municipal banks established to provide capital and affiliated services to local governments. Worldwide, the largest of the specialty municipal banks is Credit Local de France, now the core of the Dexia Group. Dexia has recently merged with, or taken equity positions in, other municipal banks throughout Europe, including Belgium, Italy, and Spain, establishing itself as a pan-European specialized municipal lender. Dexia has also advocated municipal banking in eastern Europe, purchased an equity position in a new specialized municipal lending institution in the Republic of South Africa, and advised Pudong Development Bank of Shanghai, People's Republic of China (PRC). Variants of municipal banks can be found in many other countries.

The municipal bank philosophy can be summarized in three principles: (i) relationship banking, (ii) delegated monitoring, and (iii) bundled services and bundled pricing.

Relationship Banking

A municipal bank strives to establish permanent partnership relations with its local clients. Most European banks have a history of specialized collaboration that dates back a century or more. They provide a breadth of services to complement their lending activity. A typical municipal bank helps municipalities prepare and structure their budgets, design investment projects, and conduct financial analysis of cost recovery strategies. The bank may manage the municipality's financial accounts and maintain the municipality's deposits in addition to providing long-term lending. Municipal banks provide 15–30-year loans to finance municipal investment projects. Municipal banks may extend their relationship beyond their municipal clients to serve as the designated intermediary between the central government and municipalities by handling tax-sharing arrangements or administering local government grant allocations on behalf of the central government.

Initially, the municipal banks' special relationship was protected by legal rights. Some banks such as the Municipal Bank of the Netherlands enjoyed a legal monopoly on local government lending. All municipal banks enjoyed preferential and exclusive access to certain types of below-market, long-term savings that made it possible for the banks to provide low-cost, long-term loans to local governments. Credit Local de France, for example, had access to the long-term, below-market funds accumulated through the postal system's savings plan for small savers. Many municipal banks require, by law, that municipalities maintain their accounts and deposits with the bank. Municipal accounts of this kind typically carry below-market interest rates.

This gives municipal banks some of the character of credit unions, where members receive below-market returns on deposits in return for gaining access to below-market borrowing opportunities.

Relationship banking is also common in certain sectors of the economy, such as small-business lending, and is most valuable during a borrower's start-up stage or when an institution is first entering the credit market. A relationship bank that is protected from competition can take a long-run view of its partnership with clients. Empirical studies have found that development banks sheltered from competition tend to subsidize clients' borrowing in their early stages of development, then later recover these costs by charging more than market rates once the clients have become better established.

One argument for establishing municipal banks is that only they can afford to support municipalities in the early stages of their learning about the credit market. The learning curve applies at least as much to ancillary activities, such as preparing financial information for loan applications and project preparation, as to borrowing and loan repayment. A bank can afford to nurture communities through the learning process only if the bank is subsidized by central government policy or enjoys partial protection from competition so that it can create a long-term client.

As borrowers grow in economic strength, relationship banking becomes less important to them (Himmelberg and Morgan 1995). They no longer require the same kinds of close financial monitoring or help. In competitive markets, experienced borrowers that have established a reputation for good financial management and have compiled a record of prompt debt repayment will find other institutions willing to lend to them, often at lower cost. Such borrowers' loans will require less intensive monitoring and involve less credit risk. This maturation of borrowers can strain a closed credit system. Divergence of municipalities' interests is most likely when loans to local governments are made at a uniform interest rate, regardless of credit history.

Delegated Monitoring

The differences between bonds and bank loans are rooted in financial sector intermediation. In modern intermediation theory, banks perform what is called "delegated monitoring" (Diamond 1984). Municipalities and other borrowers can, in principle, deal directly with individual lenders by borrowing investment funds from large financial institutions, such as pension funds or insurance companies, and even from individual savers. However, unless the loan is large, it is inefficient for each saver to try to monitor financial conditions and all other factors affecting loan payment. A bank performs these intermediation and monitoring functions. It gathers savings from numerous sources, assembles specialized professionals capable of loan appraisal and loan oversight, allocates capital, and then monitors loans and borrowers' financial conditions.

Monitoring is facilitated by the partner relationship that gives the municipal bank special knowledge of the municipality's budget and finances. Where the bank handles all accounts of a municipality, its security interest can be protected by loan agreements that give the bank, as lender, automatic access to the municipality's accounts for repayment purposes. As a corollary to active monitoring, a well-functioning municipal bank will initiate loan-restructuring discussions with a borrower when the client encounters serious financial difficulty. A proactive program of loan restructuring is preferable to accumulating nonperforming loans. In the early 1990s, for example, when French cities found themselves confronted with declining revenues and large, high-interest debts when interest rates were falling, Credit Local de France negotiated workouts with some of the more financially distressed borrowers to keep its loan repayment record intact.

Bundled Services and Bundled Pricing

In a sheltered market, the bundled services that municipal banks offer rarely are broken out or priced to correspond with incremental costs for a particular service. The price of a bundle of services may be combined into the interest-rate spread between the bank's cost of funds and lending rate, or some of the costs may be subsidized by the central government as a type of public good. Price differentiation of any kind by municipal banks in developing countries is unusual, even in lending. Municipal banks lend to all municipal clients at the same interest rate. Credit assessments are used to determine whether a loan should be made at all or the amount of debt that a municipal borrower can afford to assume, but rarely to establish the risk premium that ought to be charged to a particular borrower. The reluctance of municipal banks and internationally supported onlending arrangements to differentiate interest rates according to credit risk is one factor that has made it difficult to construct self-sustaining local credit markets. Where credit risk is associated with low-income communities, the reluctance to add a risk surcharge is understandable. However, in systems with the highest rates of nonperforming loans, repayment risk appears to be primarily a matter of willingness rather than ability to pay.[1] Adding a risk premium to interest costs for local governments with a poor credit history (as well as denying new loans to local governments that are in arrears on existing loans) might well have a desirable demonstration effect.

Limitations to the Bank Lending Model for Newly Established Local Credit Systems

Municipal banks have been severely challenged by financial sector deregulation. Most have lost their legal monopolies, opening their municipal lending to competition from other financial institutions. Most have also lost their preferential access to sources of long-term savings, forcing them to compete with other financial institutions for savings. Some of the municipal banks, such as Dexia, have been able to survive competition because of their reputation as efficient providers to municipalities of a bundle of financial services and technical assistance. Dexia, formerly government controlled, has been fully privatized. It competes throughout Europe with commercial banks and bond markets as an alternative municipal capital supplier.

In countries where specialty municipal banks do not have a long history of partner relationships or a reputation to draw on, the effect of financial deregulation has been to force bank lending to municipalities within the framework of standard commercial banking, exposing municipalities to short-term savings horizons. Municipal lending is a small share of most commercial banks' total lending activity. As a result, commercial banks have subsumed municipal lending under other operations, eroding the special understanding of municipal finances found in relationship banking. Both these changes have made bank lending less attractive as a source of municipal infrastructure finance. They account in part for the growth of interest in bond financing.

Short-Term Savings and Lending

The PRC illustrates the consequences of heavy reliance on commercial bank lending. In the PRC, the bulk of municipal lending for infrastructure finance now comes from the China Construction Bank and other commercial banks. Most of these loans carry 3-year terms or less, and sometimes 5-year terms. Local governments cannot repay these loans from infrastructure project revenues. In a period of greatly accelerating urban investment, local governments cannot repay the loans at all according to their scheduled terms.[2] As borrower and lender know, the loans will have to be rolled over into new, short-term loans on maturity. In a banking system as fragile as the PRC's, and as burdened with nonperforming loans, the reliance of local infrastructure financing on the continuing ability to roll over short-term bank borrowing places future market conditions and banking reform at significant risk.

A similar changeover is occurring in India. Its special infrastructure financing intermediaries have lost their exclusive access to long-term savings and have been subjected to competition as a result of market reforms. The institutions have had to react: Industrial Credit and Investment Corporation of India Ltd. (ICICI), for example, has shifted from long-term infrastructure financing to retail banking and short-term investments. It carried out a reverse merger with its retail banking arm. Most of ICICI's new loans carry 3-year terms or less, corresponding to the short-term savings it now commands through the retail banking system. This kind of financing is unsuitable for urban infrastructure investment. ICICI, which only a few years ago was a substantial source of financing for urban infrastructure investment, has largely withdrawn from such activity.

Municipal Loans as Real Estate Lending

Commercial banks frequently treat municipal lending as a subset of an existing class of larger lending activity, such as enterprise lending or real estate lending. Many of the first-generation municipal loans of commercial banks are, in effect, real estate loans, secured by real property collateral. Sometimes the real estate is expected to provide not only back-up security but also the primary source of cash flow to repay the loan. In a typical bank loan of this kind, the Ring Road Corporation, responsible for building a ring road around Changsha, capital of Hunan Province, was given 12 square kilometers of land. The corporation will borrow CNY3 billion against this asset, and use the proceeds from long-term land leasing to repay the principal value of the loan. Similar structures of real estate-based municipal lending have been used in the Philippines, Thailand, and elsewhere in the region.

The principle of recapturing infrastructure costs through increases in land values and using borrowing to cover the advance costs of road construction is valid. However, real estate lending introduces its own risks into municipal infrastructure finance by spreading the volatility of land markets to the municipal credit market. Borrowers typically incorporate aggressive assumptions about future land market demand into their financing plans. Changsha was able to obtain an intermediate-term loan from the China Development Bank for its ring-road project. Problems are most acute when land leasing is expected to generate the revenue to repay short-term commercial bank borrowing, and when the investment projects, such as sewage treatment plants, do not directly add to land values.

The risks of commercial bank lending are only partly financial. Short-term commercial bank lending severs the nexus between project-level finances, service fees, and loan structure. In a well-functioning credit market, municipal lending should reinforce efficient service pricing by municipalities. Municipal authorities generally will plan to recover at least a portion of debt service costs from project-specific revenues, even when general obligation security is offered. This arrangement requires the lender and borrower to carefully investigate the infrastructure capacity to be financed. Reliance on land and property sales for unrelated debt service payments can undermine the discipline of project analysis, as can the use of short-term borrowing to finance long-term investment projects. For efficient service pricing, borrowing periods should approximate to the useful lives of the financed infrastructure.

Municipal Bond Issuance

Local capital financing through bond issuance offers a different approach to the three principles underlying municipal bank lending:

Competition, Not Relationship Banking. Municipal bond underwriters try to achieve a long-term working relationship with their municipal clients. However, the essence of a bond issue is (or should be) that it is freshly competed for on each occasion. Neither institutional nor individual purchasers of bonds need have a long-term relationship with the issuer. For seasoned and sizable issuers, market competition of this kind, focused on the cost of capital, is likely to produce savings. However, this kind of competition leaves an unfilled niche for smaller and less experienced local governments. This niche can be partly filled by pooling arrangements, such as bond banks, which allow smaller cities to join in combined bond issuance through an experienced intermediary. A bond bank can provide the relationship stability for infrequent issuers that otherwise would be missing from the bond model.

Public, Not Proprietary, Monitoring. Whereas banks typically seek to build loan departments that possess proprietary information and proprietary methods of analyzing creditworthiness, in a municipal bond market, information on local financial conditions is provided by issuers to the market. Bond markets rely on public disclosure of municipal financial information to function effectively. Most financial systems utilizing bond issues have extensive public disclosure requirements that issuers must comply with, as well as requirements specifying accounting standards and independent audits of financial statements. Credit-rating firms have developed a presence in every municipal bond market of significant size. They report the content of their credit analyses publicly, and exert considerable influence over the market, including the risk premium that municipalities have to pay for borrowing, based on their financial condition and credit history.

Unbundling. A municipal bond market unbundles the various support functions that a municipality can receive from a municipal bank. Local governments can make separate decisions about where to maintain their liquid deposits and where to obtain financial advisory services or technical assistance on project design. Bidding for each of these support activities can be competed for separately in their submarkets. Unbundling services and subjecting them to competition is likely to lower total costs. However, unbundling may deprive municipalities of the benefits of having a comprehensive partner familiar with how a municipality's financial activities fit together.

Limitations of the Bond Model for Countries Establishing New Local Credit Markets

The basic features of a municipal bond market are now well known as municipal bonds have become a more common instrument for raising capital for local infrastructure. It is appropriate, therefore, to focus directly on the difficulties and special requirements of transferring a credit market model that has worked well in North America and elsewhere to countries where local credit markets are just being established.

Bond Ratings before Adequate Financial Disclosure?

Almost all countries that have introduced municipal bond financing have also introduced, or supported the introduction of, credit-rating agencies. However, the role of credit ratings in newly formed local credit markets is significantly different from the public monitoring function that is so critical to efficient bond market operations over the long run. The differences lie in rating agencies' access to reliable financial information, their role in public disclosure, and the incentives that market participants have to assign importance to ratings.

Lack of reliable information on local budgets, local balance sheets, local debt service obligations, and intergovernmental fiscal flows vastly limits credit-rating agencies' ability to carry out analyses and the usefulness of those analyses to determine credit risk. Credit-rating agencies are the gatekeepers in developing countries' local credit markets. Typically, bonds can be issued in the domestic market only if they attain a minimum credit rating from an authorized credit-rating agency. This arrangement has several shortcomings as a precedent for a self-sustaining bond market. First, the arrangement substitutes a quasi-private rating process for full public disclosure. In some countries, such as the PRC, the credit-rating agency releases to the public only a one-page summary of its credit rating. Detailed information, including any adverse commentary on the issuer's financial situation, is sent as a private communication only to the issuer.

Second, the underlying information necessary for an adequate credit assessment may not be provided to the credit-rating agency and is very rarely the subject of public disclosure requirements. Inherent in the public monitoring model is the ability of multiple participants in the bond market—competing credit-rating agencies, institutional bond buyers, and individuals—to carry out independent credit analyses using reliable data. Public disclosure guidelines for financial reporting, therefore, must logically be in place prior to credit ratings. The public monitoring system should not be short-circuited by efforts to allow individual credit-rating agencies to vouch for the creditworthiness of issuers, without public access to the data from which such conclusions are drawn.

Third, the business dynamics of credit ratings mandated by government regulation need to be examined. In a typical case, a prospective bond issuer must obtain a minimum credit rating to issue its bond. The issuer hires a credit-rating agency. The credit-rating agency is almost always paid by the issuer. The business pressure to assign at least a threshold credit rating is immense. As credit-rating agencies often acknowledge, they will lose the issuer as a client if they assign a poor rating. In many transitional bond systems, institutional relationships reemerge in the triangle of underwriter, credit-rating agency, and issuer, who all share a business interest in successful bond issuance. The proper antidote to any temptation to short-cut the objectivity of credit ratings is to require public disclosure of the financial and other data that should serve as a basis for the rating, as well as public disclosure of the full rating report.

Access to Long-Term Funds

Because urban infrastructure in mature bond markets is financed through bond issues of 20–30-year maturities or even longer, bond issues are assumed to open access to longer-term sources of funds than bank loans. This is not necessarily the case. The initial rounds of bond issues frequently have terms similar to those of bank loans. In India, the initial Ahmadabad and Tamil Nadu Urban Development Bonds were 5-year bonds, with significantly shorter durations, given the annual requirements for amortization of principal. Introducing municipal bonds does not solve the problem of accessing long-term capital but provides an instrument that may make feasible tapping institutions and individuals with long-term savings. Designing a strategy to use bonds to access long-term financing is a major part of policy design.

Designing Transitional Credit Systems

Attempts by international organizations to help build sustainable local credit markets have so far had inconsistent results. For almost 30 years, Brazil has been using central government-administered municipal development funds to channel World Bank and Inter-American Development Bank funds to local governments to finance infrastructure. Loan repayment rates have been excellent—none of the central government MDFs has had nonperforming loan rates in excess of 5%, and most have nonperforming loan levels of around 1% or even less. Yet, private sector financial institutions continue to regard municipal lending as extremely risky and will not lend to local governments. The central Government views municipal borrowing as risky and potentially excessive, prohibits municipal bonds issuance, and requires case-by-case authorization for other types of municipal borrowing.

The explanation for this paradox reveals why internationally supported municipal onlending systems have not, with greater regularity, helped introduce true local credit markets. The credit security mechanisms available to central government MDFs are not available to the rest of the market. MDFs and central government finance ministries utilize an offset system, which subtracts debt service from municipalities' transfer entitlements and automatically credits the MDF account. This mechanism is not available to private market lenders. As a result, the decades of experience with municipal onlending, while financing useful projects at the local level, have contributed little to the development of a sustainable local credit market. Because of the presence of the offset system and the resultant high loan repayment rates, MDFs have had little incentive to address underlying municipal credit risk.

Internationally supported municipal onlending programs should be viewed as public experiments. The administering institutions themselves are a type of public good. Their successes in municipal lending should be generalized to the rest of the market as swiftly as possible. This is a difficult lesson to apply, for it often means deliberately helping or even creating competition that may undercut the onlending program. However, when the objective is to create a sustainable domestic credit market, easing the entry into the market of competitive lenders and competitive lending arrangements should be viewed as the highest sign of programmatic success.

One of the most successful institutions in abetting municipal credit growth, by leveraging its own positive experience, is the Tamil Nadu Urban Development Fund (TNUDF). It is a worldwide leader in designing systems to attract new financing sources and introducing instruments that are consistent with a deregulated financial sector and nascent domestic capital market. TNUDF has been able to attract domestic private financing to the urban sector through several fundamental innovations, including the following:

- A 15-year bond issue (30 crore, equivalent to $300 million) sold on the domestic capital market to finance the credit component of the Madurai ring road. The bond issue was marketed to a variety of financial institutions. The security mechanisms introduced serve as a precedent for future similar financings: procedures for earmarking toll revenues into an escrow account, establishment of an independent trustee to represent the bondholders' legal interests, and provision of a back-up guarantee from the government of Tamil Nadu to cover any shortfall in the escrow account. This government guarantee includes the guarantee on TNUDF's own bond issue extended to other lenders.

- Equity investment by a private sector firm in India's first build-operate-transfer undertaking for wastewater collection and treatment. This arrangement gives similar types of local escrow account and other protection for project revenue to a direct private investor. The TNUDF financing package also requires an up-front contribution of Rs5,000 from each household connected to the wastewater system.
- Pooled financing. Twelve municipalities that have completed water and sanitation projects, with tariff mechanisms in place, issued a pooled bond backed by (i) a debt service reserve fund, (ii) a central government security back-up to replenish the fund, and (iii) an external guarantee covering 50% of principal repayments. The arrangement allowed the borrowers to refinance TNUDF loans at lower cost by taking advantage of the decline in interest rates and by avoiding the 3 percentage point spread built into TNUDF's onlending. This financing was expressly designed to compete favorably with TNUDF's own onlending and to serve as a precedent for future similar financings by others.

Other examples of international success in introducing local credit markets include the Municipal Finance Company of the Czech Republic, which introduced a system of municipal onlending through commercial banks, which, in turn, introduced the commercial banking system to a new set of highly creditworthy clients. Commercial banks assumed all credit risk from the outset. Once the initial lending succeeded, the banks quickly began lending to municipalities from their own funds. It is now routine for Czech commercial banks, which have access to long-term savings, to make intermediate-term (8–12-year) infrastructure loans from their own funds, and to do so under competitive conditions. All the largest banks make infrastructure loans to local governments. All cities with a population of over 100,000 have also issued municipal bonds. The potential for raising funds from both sources has helped restrain interest rates and lengthened the maturities for all types of municipal credit.

One of the most impressive local credit intermediaries of the developing world is the Infrastructure Finance Corporation Ltd. (Inca) of South Africa. It was formed by a private financial group as a specialized municipal lender and now finances more than half the municipal credit in South Africa. The corporation consistently earns returns on equity in excess of 20% while charging spreads of 50–100 basis points between its own cost of capital, raised primarily through bond issues, and its municipal onlending rate.

What lessons can be learned from these and other successes in building credit markets, as well as from the failures? One clearly is the importance of the stage of development of the overall credit market. Local government borrowing will always be a relatively modest share of total credit. Successful development of the local credit market is most likely to occur when local government borrowing can advance along with the rest of the credit market, following the same basic set of legal procedures and similar disclosure guidelines, credit-rating systems, and sources of long-term funds. However, some lessons are specific to the development of the local credit market as well, and are described in the following paragraphs.

Single-Purpose Infrastructure Financing Authority Insulated from Central Government

Infrastructure finance is a sufficiently specialized subject to merit quasi-independent institutions having the mandate to operate international onlending programs and charged with furthering the development of a domestic credit market. Institutions housed within the ministry of finance or other government ministry have difficulty giving weight to this extragovernmental objective of market building. A stand-alone institution also has the opportunity to establish a stable partner relationship with the private financial sector, which can be expanded over time, as with a municipal bank.

A variety of institutional models should be adequately insulated from the central government and its pressures, budgetary and political. TNUDF solved this design problem by handing over management and partial equity ownership to a special company formed by three of the major, quasi-private financial institutions in the country. On a localized scale, the Shanghai municipal government has announced its intention to utilize the Shanghai Water Assets Operations and Development Company, a specialized holder of local water and wastewater assets, as a sector infrastructure financing agent that will issue its own development bonds, attract direct private sector investment to the metropolitan water and wastewater sector, and sell off mature water distribution systems to private investors so that proceeds may be recycled in new investments. This type of sector-wide development objective should underlie financing efforts.

Infrastructure financing agencies housed within the national ministries of finance or otherwise directly reportable to the central government have had the least success in establishing local credit markets. Such agencies necessarily aim for central government control of municipal borrowing, which, if beyond that necessary to protect aggregate debt levels, runs counter to the spirit of decentralization and of financial experimentation that animates a successful infrastructure financing authority.

Competitive Unbundling

Many MDFs and similar institutions have deterred market development by concentrating too much authority within themselves. MDFs that prepare (or sponsor preparation of) development projects approve them for financing, make loans, oversee construction, collect loan repayments, and assume credit risk, acting almost as institutional monopolies and internalizing most of the market's operations. It is unsurprising that such institutions find it difficult to step outside their own management responsibilities and work to develop competitive markets, some of whose elements may compete directly with their own.

A broad institutional mandate for MDFs may be necessary. However, one of the first acts of an MDF should be to prepare an action plan for unbundling. It should identify responsibilities that can be spun off to the market or to local governments and establish a timetable for doing so. It is remarkable that in the more than 50 countries that have received international help in setting up MDFs, no MDF has voluntarily gone out of business by declaring itself unneeded in light of overall credit market development. An unbundling action plan will identify straightforward measures, such as encouraging the development of independent consultants for project preparation so that municipalities can competitively procure technical assistance without going through the MDF or securing MDF approval.

More ambitious unbundling will involve the essentials of a local credit market. In countries strongly committed to decentralization, project review at the MDF level can be simplified to focus on health, safety, and environmental issues, while such matters as discretionary design options and project costs, below some threshold, can be left to the local decision-making and political process. The Czech system was designed in this fashion from the outset. Municipal engineers were good enough to oversee local project designs. Accountability to local constituents was considered to be a good measure for assessing whether local political authorities had made the right investment choices and carried out construction efficiently. Commercial banks were charged with assessing credit risk, since they were assuming that risk. The infrastructure financing agency, or onlending fund, was left with the simple task of determining whether all planning approvals were in place, whether the projects complied with program rules, and how the onlending mechanics would work. In this unbundled onlending model, the onlending agent was able to approve a project and deliver funds to the commercial bank within an average of 31 days from receipt of project application. The speed of action had as much impact as anything else on the willingness of commercial banks to expand into the local credit market through this vehicle.

Financial Monitoring and Early Warning Capacity

The basic measure of a municipal financial intermediary's success in building a local credit market is its own loan repayment record. A good repayment record does not guarantee market development. However, a poor loan repayment record, which signals high credit risk to other potential lenders, will always set back market development. Some MDFs have set back local credit market development by introducing a new class of risk—political risk—into municipal lending. Inca, for example, will not lend jointly with government, however much its subsidized lending rates might lower the costs of capital to municipal borrowers. Inca justifies this stance on the ground that once government is involved, loan repayment becomes a matter of political negotiation that will inevitably carry over to repayments to the private lending partner.

Aggressive monitoring of local borrowers' financial and other conditions is a prerequisite to maintaining strong repayment rates in the absence of special mechanisms, such as offset or intercept arrangements. MDF performance in this respect has been weakest. Aggressive monitoring implies constant personal contact with municipal authorities to identify early warning signs of financial difficulty or reluctance to pay. Such monitoring needs to be complemented by swift action to enforce security arrangements and, when necessary, a willingness to restructure loan agreements to avoid defaults. Inca enjoys no government-supported loan security and has a small staff, but contacts each borrower weekly. Most repayment problems are headed off at this early stage. If a problem persists, Inca obtains within days of any missed or late loan payments a court order authorizing the seizure of loan collateral. With the court order in hand, Inca then negotiates with the municipality a specific loan workout that will avoid the seizure of collateral. The possibilities for applying this precise approach elsewhere are limited because it depends on the willingness and ability of the courts to act swiftly in enforcing security pledges. Constant and aggressive monitoring establishes the expectation that municipalities must make loan repayments on time, and that if extreme circumstances arise, a municipality must identify the situation at an early stage and agree to a voluntary workout.

Municipal Disclosure Rules

Full, prompt, and continuing disclosure of municipal budgets and of municipal financial conditions is essential to the operation of credit markets, especially a bond market that relies on public monitoring. The implementation of financial reporting and disclosure guidelines is a prerequisite for the effective operation of credit-rating agencies. International organizations sometimes have been remiss in not prioritizing financial reporting and disclosure reforms in designing the framework for a transparent credit market.

Accessing Long-Term, Cheap Capital

An infrastructure financing authority must raise capital as efficiently as possible, which involves accessing long-term savings. The largest and fastest-growing holders of long-term savings in most countries are pension funds. Priority should, therefore, be given to strategies to tap pension funds for municipal lending. The first step is often to modify the legal rules governing investment possibilities of pension funds. When Poland changed its regulations to allow pension funds to invest up to 5% of their assets in municipal bonds, the local bond market exploded, in volume and in bond maturities. Even though pension funds in much of Asia are modestly funded compared to other sources of capital, pension funds are growing at an exceptional pace. A forward-looking plan to increase capital flows to local infrastructure must connect with this special source of long-term savings.

Creating a secondary market for bond trading is another means of tapping into long-term savings. The existence of a secondary market allows households or institutions whose circumstances have changed to sell their long-term bonds even before maturity. Such flexibility increases market demand for long-term securities. Bonds are the best instrument for this kind of trading. In many countries, transferring one bank's municipal loan to another buyer is extremely cumbersome.

An equal challenge to accessing long-term savings is efficiently connecting borrowing from the private market with government subsidies to bring down the cost of capital for investments possessing strong externalities. Virtually no government in the world requires users to pay the full cost of wastewater collection and treatment, in view of the widely shared public health benefits. Such facilities should, therefore, be subsidized at the investment stage. The bond market offers an efficient vehicle for blending below-market capital with market-rate capital. The Government of India recently announced two initiatives to create substantial opportunities for state infrastructure development funds. One large national initiative is the National River Conservation program, aimed at cleaning urban rivers through investments in wastewater collection and treatment, before returning treated water to the rivers. The financing plan contemplates blending government grants with beneficiary contributions, urban local body contributions, and market-rate borrowing. A second national program, announced in September 2002 for fast tracking, is a pooled financing program modeled after the state environmental revolving funds in the United States. This program will combine 5% financing from government-supported sources with commercial-rate loans from private sector financial institutions and bond issues to finance underground sanitation projects. Both programs offer infrastructure financing agencies, such as TNUDF, the chance to greatly magnify the scale of their financing by assembling financing packages that take advantage of these terms.

Banks or Bonds?

There is no need to choose a single instrument as the "right" way to handle local government credit. Many countries simultaneously use bank lending to municipalities and local bond issuance. The policy rationale, however, justifies emphasizing development of local bond markets. The public monitoring and public disclosure required for efficient bond market operation are consistent with greater transparency for all public financial transactions. Financial sector deregulation has eliminated the possibility of having quasi-monopoly municipal banks draw on especially protected government allocations of low-cost, long-term savings to finance local infrastructure. In a competitive world, bonds have more ways to tap institutional and household long-term savings. Even when the ultimate credit extended to a local government continues to be a loan from a bank or other financial institution, the financial intermediary will increasingly raise its own capital for onlending from bond issues. That is the direction of change for the most successful intermediation vehicles. Even Credit Local de France, the original municipal bank, now raises the bulk of its financing on the bond market.

Footnotes

[1] For example, analyses of the 51% of arrears (at the end of 2001) in Indonesia's regional development account and subsidiary loan agreement reveal no correlation between arrears and fiscal capacity.

[2] For example, the annual debt service of Guiyang, the capital of Guizhou, a poor province, is projected to rise from CNY20 million in 2000 to more than CNY1.2 billion within the next 5 years, given the investment projects approved by the Municipal Planning Commission and the sources of financing projected by the Finance Bureau.

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Overview: Local Government Finance, Private Resources, and Local Credit Markets in Asia

Roberto de Vera
Director
Regional Strategies Group and
Assistant Professor
School of Economics
University of Asia and the Pacific
Manila

Yun-Hwan Kim
Assistant Chief Economist
Development Indicators and
Policy Research Division
Economics and Research Department
Asian Development Bank
Manila

Acronyms

ADB	Asian Development Bank
B	Thai baht
BOT	build-operate-transfer
CARE	Credit Analysis & Research Ltd.
CDS	city development strategy
CNY	yuan
DMC	developing member country
GDP	gross domestic product
ICICI	Industrial Credit and Investment Corporation of India Ltd.
IDBI	Industrial Development Bank of India
IDFC	Infrastructure Development Finance Company
IL&FS	Infrastructure Leasing and Financial Services Ltd.
Inca	Infrastructure Finance Corporation Ltd.
IRA	internal revenue allotment
km	kilometer
LGC	Local Government Code
LGU	local government unit
MDF	municipal development fund
NFC	National Finance Commission
NTADCL	New Tirupur Area Development Corporation Ltd.
O&M	operation and maintenance
OECF	Overseas Economic Cooperation Fund
PFDS	pooled finance development scheme
PRs	Pakistan rupees
Rp	Indonesian rupiah
Rs	Indian rupees
SFI	specialized financial intermediary
SMRTC	Seoul Metropolitan Rapid Transit Corporation
SPV	special-purpose vehicle
SRF	state revolving fund
SAO	subdistrict administrative organization
TNUDF	Tamil Nadu Urban Development Fund
ULB	urban local body
US	United States
USAID	United States Agency for International Development
W	Korean won
WSPF	Water and Sanitation Pooled Fund

Introduction

Sound local government finance is becoming more important in Asia, largely for two reasons. First, in recent years a number of developing countries have been undergoing political decentralization, with central governments devolving to local governments the responsibilities for delivering local public services and developing the key infrastructure that requires large financial resources.[1] This trend demands that local governments strengthen their financial capacity. Decentralization is based on the recognition that participation of key local stakeholders, including local governments and communities, is critical for economic growth and poverty reduction.[2] By enabling local governments to efficiently allocate resources for public service delivery, decentralization reforms aim to reduce the large fiscal deficits of central and local governments.[3]

Second, the rapid urbanization seen in most developing countries reinforces the need both to improve existing, often poorly maintained, infrastructure and to meet new demand for housing, education, water supply, sanitation, sewerage treatment and disposal, solid waste management, and public transport. This requires massive investments, much of which should be financed, cofinanced, or guaranteed by local and/or municipal governments. An Asian Development Bank (ADB) report (Brockman and Williams 1996) expected Asia's urban population to more than double to almost 2.5 billion by 2020, making up more than half the total Asian population.

Asian governments have made significant efforts to strengthen local government finance and diversify financing methods by reforming taxation and expenditure systems, reshaping intergovernmental transfers, privatizing key projects, accessing long-term credit markets, and developing municipal credit markets. This paper summarizes the efforts made in 10 ADB developing member countries (DMCs) to improve local government finance and recommends some policies to reinforce these efforts.[4]

State of Local Government Finance in Asia and Major Issues

Local government resources consist mainly of tax and nontax revenues, grants-in-aid, loans from central governments, and own-market borrowings. Tax revenues include those from taxes on agricultural income, property, stamp duty and registration, sales, roads, and motor vehicles. Nontax revenues include interest receipts, cost recovery charges for various services provided by the local government, and profits and dividends from state-owned enterprises. Central governments also make transfers to local governments by way of grants and loans for general and specific purposes.

India

The financial health of local governments in India has deteriorated, along with that in several other countries, including Pakistan, Philippines, and Sri Lanka. India faces fiscal imbalances in the form of large budgetary deficits, a rising debt service burden, very slow growth in nontax revenues, a rising share of nondevelopment expenditures, and increasing financial losses of state-owned enterprises. The gross fiscal deficit of state governments has remained high at 3–5% of gross domestic product (GDP) since the 1990s, although with considerable variations among them. Growing deficits over the years have significantly increased debt and debt service. Total liabilities of state governments were 19.4% of GDP in 1990/91 and 23.9% in 2001/02. Interest payments account for about a quarter of the revenue receipts of all states, and the percentage continues to increase, depriving them of resources that could be spent for other purposes, such as development projects.

States' deficits are financed largely by (i) loans from the central Government; (ii) issuance of bonds through the Reserve Bank of India; and (iii) loans from small-savings schemes and other financial institutions, including insurance companies and provident funds. As seen in Table 1, the sum of (i) and (iii) finances 83–89% of the deficits, while bond issuance finances the rest. An important development in recent years was the change in the relative importance of (i) and (iii). In the early 1990s, central government loans had a higher share than borrowings from financial institutions. This was reversed during the last few years due to deterioration in the financial state of the central Government.

Besides direct borrowing, state governments also provide guarantees for the borrowings of other subnational entities such as state housing boards, urban development authorities, municipalities, electricity boards, and road transport corporations. Outstanding guarantees extended by the state governments amounted to Rs1.69 trillion at the end of March 2001, or 8.1% of GDP (Table 2). Five large states (Gujarat, Maharashtra, Karnataka, Andhra Pradesh, and Tamil Nadu) account for over 50%

Table 1. Financing of State Governments' Gross Fiscal Deficits, India (%)

	1990–1999[a]	1999/2000	2000/01	2001/02
Loans from Central Gov't.	48.3	36.0	33.8	35.8
Net Market Borrowing	16.3	13.9	13.3	11.3
Others[b]	35.4	50.1	53.0	52.9

[a] Average. [b] Loans drawn from small-savings schemes and other financial institutions, including insurance companies and provident funds.
Source: Table 9, Pradhan (this volume).

Table 2. Outstanding Guarantees by Governments, India (% of GDP)

	Central Government	State Government	Total
1993	7.8	5.7	13.4
1994	7.3	5.7	13.0
1995	6.2	4.8	11.0
1996	5.5	4.4	9.6
1997	5.1	4.6	9.7
1998	4.9	4.8	9.7
1999	4.3	5.6	9.9
2000	4.4	6.8	11.2
2001	4.2	8.1	12.3

Source: Table 10, Pradhan (this volume).

of total state guarantees. Although they have financed state investments, guaranteed borrowings have also added to state governments' fiscal risks.

Decentralization has brought significant financial pressure on state governments due to increased expenditures for infrastructure, social sectors, and operation and maintenance (O&M) of facilities. State finances have deteriorated in recent years due to imbalances between large expenditure requirements for development and nondevelopment items, and poor revenue collections. Recognizing the substantial need to engage the participation of the private sector and financial institutions in social and development infrastructure, Gujarat and Karnataka have established specialized funds for infrastructure development.

Indonesia

Indonesia's ambitious decentralization program started in 1998,[5] when a special session of the People's Consultative Assembly decreed the implementation of regional autonomy, which led to the promulgation of two laws in May 1999: Law 22 on Local Government Autonomy, and Law 25 on Central-Local Balance Financial Fund.[6] A large number of regulations and presidential and ministerial decrees have been issued to implement these laws. Starting in FY2001, local governments have assumed new expenditure responsibilities.

The two laws highlight 11 areas of local government responsibility: public works, health, education and culture, agriculture, communications, industry and trade, capital investment, environment, land, cooperatives, and labor. Thus, regional expenditure responsibilities have become greater. In FY2001, local government expenditures accounted for about one quarter of total public expenditures. A major concern is that local governments have not been awarded new authority over major tax bases, retaining only the right to levy essentially the same taxes and charges as before decentralization. Tax systems remain highly centralized, and the subnational government share of total revenue is estimated at only about 4% (Lewis 2002).

Data for FY2001 show that central government transfers accounted for as much as 89% of total local government revenues (Table 3). Local governments may not have been given sufficient access to resources to meet expenditure requirements. Table 3 details the relative importance of the various transfers in FY2001. The general-purpose fund is the single most important source of revenue for regional governments, funding nearly two thirds of subnational government budgets. Shared revenue is the next in importance, taking up 22.4% in 2001. It is composed of revenues from natural resources (13% of total regional revenue), property-related taxes (7%), and personal income tax (2.4%). However, the relative significance of each item varies across local governments. Revenues are distributed highly unevenly among regions. Over 50% of the personal income tax share is allocated to Jakarta alone. About 75% of the total natural resources revenue share is distributed to three provinces (Aceh, Riau, and East Kalimantan). The revenue inequality arising from this is mitigated by Indonesia's main equalization tool, the general-purpose fund.

Own-source revenues are the least important, accounting for only 11.4% of total

Table 3. Estimated Local Government Revenues, Indonesia, FY2001 (Rp billion)

	Provinces	%	Districts/ Municipalities	%	Total	%
Own-Source Revenues	6,400	34.5	4,100	5.6	10,500	11.4
Total Transfers	12,166	65.5	69,772	94.4	81,938	88.6
General-Purpose Fund	(6,238)	(33.6)	(54,729)	(73.5)	(60,517)	(65.5)
Special-Purpose Fund	—	—	(701)	(0.9)	(701)	(0.8)
Revenue Sharing[a]	(5,928)	(31.9)	(14,792)	(20.0)	(20,720)	(22.4)
Total Revenues	**18,566**	**100.0**	**73,872**	**100.0**	**92,438**	**100.0**

— = data not available.

[a] Natural resource revenues, property-related taxes, and personal income tax.

Source: Lewis (2002).

revenues of local governments in 2001. Estimates of potential own-source revenues should be improved and revenue capacity from these sources strengthened.

Introducing new local taxes and user charges will not be easy and might adversely impact consumption and investment. Efforts to develop and collect new types of taxes are hampered by lack of good databases on actual and potential taxpayers, inefficient tax administration, lack of experts, an underdeveloped legal and accounting system, and general reluctance of people to pay more taxes. Intensifying collection of old taxes, including those on vehicles, land, construction, entertainment, hotels and other accommodation facilities, advertisements, and roads, would thus be more effective. Corporate income tax may not be a desirable source of local revenue because corporate income cyclically fluctuates and is not, therefore, suitable to finance essential local services.

Pakistan

In 2000, the Government launched a program to radically alter governance structures by devolving authority and granting autonomy to lower-level government, which now not just provide but also plan, finance, regulate, and supervise public services and infrastructure projects. The division of responsibilities between federal and provincial governments is specified in the Constitution. The exclusive responsibilities of provinces include highways, urban transport, irrigation, and mineral resources. Legislation also gave provincial governments certain responsibilities for primary education, curative health, local roads, and farm-to-market roads.

However, a key concern is how to improve the financial strength of local governments, whose fiscal health has steadily deteriorated. Large overall deficits of the provinces have resulted in accumulated debt, which is now serviced by 18–20% of recurrent expenditures. This has led to unplanned cuts in spending, resulting in deferral of expenditures, especially those required to maintain critical physical infrastructure. Provinces receive a share of federally levied and collected taxes in the form of transfers, constituting over 80% of provincial revenues. At least once every 5 years, the National Finance Commission (NFC) reviews and approves the rules on formation and allocation of the divisible revenue pool, such as the list of taxes that constitute the pool, federal and provincial shares in the pool, and formula for horizontal distribution of resources between provinces. NFC members include the federal finance minister, the four provincial finance ministers, and other members selected by the President. The provinces have a 37.5% share in the divisible pool. The pool consists of sales tax, customs revenues, income tax, and federal excise duty. Provinces also receive other tax transfers and grants from the federal Government.

Historically, local government tax bases have been narrow because of the highly centralized tax structure. The federal Government still holds exclusive collecting power over major and buoyant taxes and duties, i.e., import duties, sales tax, income tax, and excise duty. The provinces are empowered to collect stamp duties on financial and property-related transactions, motor vehicle tax, agricultural income tax, land revenue tax, registration fees, and other user charges. The bulk of provincial nontax revenues comes from irrigation charges and various user charges and fees. However, the taxes or shares do not match the additional expenditure responsibilities of provincial governments, creating fiscal difficulties.

Table 4 shows provincial budget operations in 1993/94–1999/2000. Despite fluctuations, the share of the budget deficit to total expenditure increased from 5.5% in 1993/94, to 7.7% in 1999/2000. One reason for this is the fast increase in current expenditure, which doubled in absolute terms over this period, and its share to total expenditure has been increasing, implying that more and more fiscal expenditure of provincial governments is being allocated to nondevelopment spending such as salaries, wages, and debt servicing. Investments in development infrastructure or long-term economic facilities have received low priority.

On the revenue side, the contribution of the divisible pool has significantly

Table 4. Provincial Budget Operations, Pakistan, 1993/94–1999/2000 (PRs million)

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000
Total Revenue	98,821 (100.0)	127,226 (100.0)	147,819 (100.0)	157,170 (100.0)	148,920 (100.0)	157,725 (100.0)	199,151 (100.0)
Share in Divisible Pool	79,875 (80.8)	104,273 (82.0)	120,446 (81.5)	131,555 (83.7)	114,078 (76.6)	115,573 (73.3)	143,231 (71.9)
Provincial Taxes	7,939 (8.0)	9,351 (7.3)	11,614 (7.9)	13,964 (8.9)	13,908 (9.3)	15,494 (9.8)	18,774 (9.4)
Provincial Nontax	6,391 (6.5)	6,356 (5.0)	5,923 (4.0)	7,149 (4.5)	10,053 (6.8)	14,574 (9.2)	16,144 (8.1)
Federal Grants	4,616 (4.7)	7,246 (5.7)	9,836 (6.7)	4,502 (2.9)	10,881 (7.3)	12,084 (7.7)	21,002 (10.5)
Total Expenditure	104,607 (100.0)	131,550 (100.0)	156,004 (100.0)	153,700 (100.0)	157,817 (100.0)	161,087 (100.0)	215,858 (100.0)
Current Expenditure	84,948 (81.2)	100,302 (76.2)	125,950 (80.7)	134,401 (87.4)	133,607 (84.7)	137,512 (85.4)	179,605 (83.2)
Development Expenditure	19,659 (18.8)	31,248 (23.8)	30,054 (19.3)	19,299 (12.6)	24,210 (15.3)	23,575 (14.6)	36,253 (16.8)
Overall Balance	**-5,786**	**-4,324**	**-8,185**	**3,470**	**-8,897**	**-3,362**	**-16,707**

Note: Figures in parentheses are percentages of total revenue or expenditure.
Source: Kardar (2002).

decreased. Its share, which stood at 80.8% of total revenue in 1993/94, increased to 83.7% in 1996/97, but has since fallen rapidly. By contrast, provinces' own revenue (tax and nontax) has slightly increased. This trend is closely related to fiscal decentralization, although the share of federal grants has sharply increased.

Philippines[7]

The Constitution identifies provinces, cities, municipalities, and *barangays*[8] as subnational divisions. The province is the highest unit of local government, followed by the city or municipality, then the *barangay*. The Local Government Code (LGC) of 1991 empowers the province to exercise general supervision over its component cities and municipalities. However, highly urbanized and independent noncomponent cities are not under the supervision of any province.

The LGC caused a major paradigm shift in local government finance and introduced far-reaching changes in political and fiscal governance, redirecting development thrusts and encouraging a shift in development strategies from being nationally to locally driven. The LGC mandated the devolution of functions of national government agencies to local government units (LGUs) and provided for a higher LGU share in internal revenue and national wealth taxes. The LGC granted more autonomy to LGUs not only to mobilize resources but also to allocate them. The LGC empowered LGUs to create their own sources of revenue; levy taxes, fees, and other charges; and access nontraditional LGU financing, including through the issuance of bonds, securities, and other obligations. The LGC also increased the LGU share in national taxes from 20% before 1991 to 30% in 1992, 35% in 1993, and 40% from 1994.

Since the Asian financial crisis in 1997, local government finance has grown in importance since transfers and aid from the national Government have become less feasible under the soaring national budget deficit. Important infrastructure projects have been left unattended, hampering development and poverty reduction, and decreasing long-term growth potential. Thus, pressure on local governments to deliver basic services devolved to them has become more intense.

Outcomes of decentralization over the last decade indicate that many LGUs are unable to meet devolved and new expenditure responsibilities, largely due to budget constraints. LGU revenues as a share of GDP averaged 3.0% in 1992–1995 and 3.9% in 1996–2000. LGU expenditures as a share of GDP, however, averaged 2.8% in 1992–1995 and 3.7% in 1996–2000. This apparent fiscal surplus is due to the regulation prohibiting LGUs from registering fiscal deficits. Many LGUs face severe resource constraints that prevent them from making long-term investments in development projects.

The main sources of local government income are taxes, nontax revenues, and income from external sources. Of the levels of local government, provinces are most dependent on revenues from external sources, followed by municipalities, then cities. The internal revenue allotment (IRA) from the national Government is the major external source of LGU income. IRA has never been lower than 95% of total externally sourced income of all levels of LGUs under the LGC. Provinces are the most dependent government level on IRA. The average share of IRA to their total externally sourced income was 99% in 1992–2000, followed by 98% for municipalities, and 97% for cities. The average share of IRA to total revenues was 75% for provinces, 45% for cities, and 66% for municipalities. High dependence of LGUs on IRA may be part of the reason why few have fully exploited their own sources of revenue.

Local taxation is the second-largest source of revenue for all levels of LGUs. In the 1990s and in 2000, the average share of local taxation in total local sources was 45% for provinces, 67% for cities, and 59% for municipalities. LGUs have not fully tapped nontax revenue sources such as receipts from economic enterprises, fees and charges, and loan borrowings.

Other Countries

In other DMCs, local government finance has also become an important policy matter despite much slower decentralization.

People's Republic of China

In 1994, the Government adopted the tax-separation system, in which the central Government and the local governments have separate taxing powers over certain categories of taxes. The result has been the rapid increase in tax revenue collections at both levels. However, the fiscal gap between expenditure and revenue of local governments has been increasing, partly due to the disparity between their revenue-raising powers and their expenditure responsibilities. From 1993 to 2001, the share of local government to central government expenditures hovered around 70% (71.7% in 1993, 72.9% in 1996, and 69.5% in 2001) while their corresponding revenue share decreased (78% in 1993, 50.6% in 1996, and 47.6% in 2001). Fiscal deficits of local governments stood at CNY172.7 billion in 1994, CNY203.9 billion in 1996, and CNY529.7 billion in 2001. Portions of the deficits were financed through borrowings from state-owned commercial banks and government nonbank financial institutions, but most of the gaps were filled by central government transfers.

Sri Lanka

Provincial revenue collection has covered only about 30% of recurrent expenditures while provincial development expenditures have been entirely financed by central transfers. Local government activities are financed by funds received mainly from two sources: local own revenue and central government transfers. As the scope for generating local revenue is limited, the bulk of financing for local projects and local government expenditure has been provided by the central Government, particularly for development projects and social services. The main source of local government revenue has traditionally been taxes on production and expenditure—turnover taxes, property assessment rates, license fees, and stamp duty. Total revenue collection of provincial councils, which supervise all local governments, declined from 0.66% of GDP in 1995 to 0.62% in 2001.

Thailand

Decentralization is under way to increase the capability of local governments to finance their own public services. Thailand made several initiatives to decentralize governance in the 1990s, but the most concrete effort was initiated by the 1997 Constitution, which, for the first time, clearly promotes decentralization. Among the Constitution's objectives is to increase the share of local government expenditures through transfer of responsibilities from the central Government, assigning more revenue sources to local governments, and promoting local accountability. However, central government agencies and local governments duplicate functions, as do local governments themselves.

Under the Plan and Procedure of Decentralization Law of 1999, the first task is to clarify functional assignments within and between central and local governments. Perhaps the most important features of the law are the mandate to devolve a portion of central government revenues to local governments (from 20% to at least 35% in 2006), the reclassification of revenue sources for each local government, and reform of intergovernmental transfers. Besides their traditional tax and shared revenues, local governments receive general and specific grants from the central Government. The unpredictability of the amount available for transfer each year makes it difficult for local governments to formulate a stable expenditure plan.

Major Issues and Challenges

The major issues and challenges of local government finance across DMCs are the following:

- Local government finance has become an increasingly important issue due to decentralization in the region, but in some countries such as India and Pakistan, the fiscal health of local governments has been deteriorating in recent years.
- Decentralization has limited the capability of some local governments to deliver newly devolved services largely because they were not matched by corresponding revenue-generating authority and capability to carry out these services.
- Local governments continue to rely heavily on central government transfers, but discretionary elements in the computation and disbursement of intergovernmental transfers make them unstable as a source of local government revenue.
- Excessive reliance of local governments on central government transfers for their development expenditures restricts active and voluntary development of essential infrastructure demanded by local communities.
- Local projects that the central Government is willing to finance wholly or jointly through grants or subsidized credits are not clearly defined, which may lead to the financing of commercially viable development projects through subsidized credits.
- An external financing strategy for local governments should be developed to encourage them to tap long-term private sector resources and to privatize development projects without worsening local government finances.

Fiscal Reforms to Improve Local Government Finance

Driven by the need to close the fiscal gap and to finance public infrastructure demand, local governments in DMCs implemented fiscal reforms. In several DMCs, central governments instituted fiscal decentralization reforms, devolving to local governments the responsibility for delivering local public services and the authority to generate revenues needed to sustain these services.[9] In varying degrees, these decentralization reforms limited the ability of local governments to deliver the newly devolved services and dampened their desire to improve their financial management skills.

In India, decentralization took longer to take root. Only a few states implemented fiscal reforms to strengthen local government finance. The Tamil Nadu and Uttar Pradesh state finance commissions rationalized the property tax procedures to increase real estate tax revenues that had long been stagnating, despite appreciating property values. The Rent Control Act should be amended and the 1999 Repeal of the Urban Land Ceiling Act universally accepted. Other states, such as Andhra Pradesh, began to tap unexploited user charges as a revenue source by imposing a betterment levy, impact fees, and valorization charges. A couple of municipalities leased out roads and bridges to private entities through privatization schemes and by modifying their state toll acts.

Several states in India complemented these fiscal reforms with medium-term structural reforms in their finances, which included the following:

- preparing annual budgets guided by a medium-term expenditure plan that yields better results for infrastructure and social development projects, as in Andhra Pradesh and Karnataka, which use a rolling multiyear fiscal plan to assess available resources to finance new programs, thus avoiding the inclusion of new programs in the annual budget that have no corresponding source of financing;
- signing memorandums of agreement with the central Government to set up the state regulatory commission and reform the power sector to reduce the huge losses of state electricity boards, which have been adversely affecting state finances;
- conducting a comprehensive review of the performance of state public service units for possible restructuring and identifying ways to increase user charges to finance the rapidly growing costs of providing urban infrastructure;
- disseminating state financial information, including guarantees and the performance of state-owned enterprises; and
- establishing guidelines on state guarantees and debt ceilings, implemented by several states, including Rajasthan, West Bengal, Assam, Gujarat, and Sikkim, to minimize the moral hazard caused by unrestrained use of state guarantees for subnational borrowings.

The 2002/03 Union Budget proposes three initiatives to encourage urban sector reforms to bolster fiscal reforms:

Infrastructure Equity Fund. This will be managed by the Infrastructure Development Finance Company (IDFC) to provide the equity portion of infrastructure projects. A seed fund of Rs10 billion will be raised from the combined contributions of public sector companies, insurance companies, financial institutions, and commercial banks. An institutional mechanism, still to be developed and set up, will coordinate debt financing in infrastructure projects that cost more than Rs2.5 billion. As the coordinating agency, IDFC will work with India's two major financial institutions—the Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India Ltd. (ICICI)—to use this fund to develop and implement projects in various infrastructure sectors.[10]

Urban Reform Incentive Fund. With a seed fund of Rs5 billion, the fund will help states implement urban sector reforms, including rationalizing high stamp duty regimes, levying realistic user charges, mobilizing resources by urban local bodies, and initiating public-private partnerships in public service provision.

City Challenge Fund. This will help cities fund the costs of attaining sustainable and creditworthy systems of municipal management and service delivery, and partly finance the efforts of urban local bodies to develop both an economic reform program and financially viable projects.

The Philippines implemented decentralization at about same time as India. Fiscal reforms to strengthen local government finance have begun to take place in a few cities. For instance, the formula for calculating intergovernmental transfers results in the distribution of a bigger IRA, and thus bigger development benefits, to larger LGUs, while the smaller ones with limited capacity to increase revenue stagnate fiscally year after year. This impasse in strengthening local government finance is being broken by a group of Philippine cities that completed the first phase of the City Development Strategies Program sponsored by the World Bank and Cities Alliance in 2000. This program helps each participating city formulate a city development strategy (CDS)—described as an "urban version of corporate strategy"—through a process designed and owned by the city's stakeholders. The CDS is intended to help the city achieve a targeted level of livability and competitiveness by improving urban governance and fiscal balance (Cities Alliance 2002). (For the rationale and phases of a CDS exercise, see Appendixes 1 and 2, respectively.)

After identifying the priority projects that support their CDS, the cities of San Fernando (La Union), Olongapo, Lapu-Lapu, and Dapitan in the Philippines strengthened their financial management skills and prepared an investment framework including funding sources, feasibility studies, 3 years of financial statements, and other documents required for project funding. The first three cities were able to secure funding for their urban infrastructure and poverty reduction projects. The fourth city is negotiating with an international agency to fund its cultural tourism initiatives.[11]

Three DMCs have begun reforms to strengthen local government finance. The impact of these reforms may be limited due to rapid urbanization and the need for substantial investment. In Thailand, the 1994 law instituting changes at the village level and the 1999 decentralization law are important foundations to improve local governments' financial management. All subdistrict councils are now juridical bodies, and subdistrict administrative organizations (SAOs) have been created. Subdistrict councils and SAOs have political and revenue-raising powers, including those to issue regulations and develop local area development plans, to fulfill their devolved expenditure assignments. The subdistrict chief and village head are now mere representatives of the central Government as they have relinquished their executive role to SAO members, who are elected by the people (Appendix 3).

In Thailand, central and local governments work together to implement the decentralization law and seek ways to consolidate small LGUs to meet the minimum scale for cost-effective governance.[12]

Indonesia and the Republic of Korea are finding ways to implement decentralization. Indonesia began to implement Laws 22 and 25 on 1 January 2001 (see endnote 6). The Republic of Korea, after 34 years of economic development driven by the central Government, passed the 1995 Local Autonomy Act, which brought back local elections. Indonesia and the Republic of Korea face a common challenge, however: their system of intergovernmental transfers worsens income disparities between the rich cities of Jakarta and Seoul and the poor regions.[13]

External Borrowing and Privatization Efforts by Local Governments

Local infrastructure projects in DMCs have been traditionally financed by central governments and by onlending of high-level governments. Since demand for local infrastructure finance is growing faster than supply of these traditional sources, local governments should examine various innovations such as foreign borrowings and privatization schemes. The policy and cultural milieus in these DMCs have set up prohibitive barriers for local governments to access foreign borrowings and initiate privatization. Local governments, however, have introduced innovations to overcome them.

The Republic of Korea and India have pioneered special-purpose vehicles (SPVs), creative debt conversion and credit pooling, and infrastructure bonds to overcome restrictive regulations on bond financing and limited creditworthiness of local governments. In the Republic of Korea, several city governments introduced Samurai bonds to finance local development. For example, the construction of Daejeon Riverside Expressway is partly financed by a ¥13 billion Samurai bond issued in 2001, which was considered a record-setting transaction in infrastructure finance because it was (i) the first structured Samurai bond issue,[14] (ii) the first 10-year private sector Korean Samurai bond issue, and (iii) the first Korean private participation in infrastructure with foreign equity. A French company and a Singapore company formed a consortium with a Korean company, and each contributed one third of the equity to the project entity, Daejeon Riverside Expressway Company Ltd.

This bond issue introduced an innovation to satisfy a clause in Korean commercial law, which requires the amount of corporate bonds to be less than 400% of the net assets. An SPV,[15] the Daejeon Riverside Expressway Funding plc, was created in Ireland to satisfy this clause and to take advantage of the low tax rates in Ireland and the double-tax treatment between the Republic of Korea and Ireland.[16] This Irish SPV issued the limited-recourse[17] bonds, and the proceeds from selling the bonds were loaned to Daejeon Riverside Expressway Company Ltd. via Macquarie Bank.

This path-breaking bond financing of a toll road project suggests three things in the development of local government bond markets and infrastructure investment. First, many sectors consider this to be the first successful demonstration of how a public-private partnership can use foreign equity to finance an infrastructure project. Second, Daejeon City took advantage of the low capital rates in the Japanese capital markets amid local governments' common practice of not tapping these markets. Third, the formation of a joint venture that involved the issuance of Samurai bonds by a foreign SPV to meet the requirements of a clause in Korean commercial law should encourage other Korean companies to resort to similar innovations to finance future infrastructure projects.

Seoul provides another example of innovative Samurai bond financing. To reduce the burden arising from subway company debts, the Seoul Metropolitan Rapid Transit Corporation (SMRTC) decided to convert the W450 billion loan from the Overseas Economic Cooperation Fund (OECF) of Japan—comprising 22.7% of the total debt of SMRTC as of December 2001—into Samurai bonds beginning in 2002. The OECF loan was borrowed during 1984–1997 at interest rates of 4.00–4.75%, and will be fully retired by 2015. According to the debt-refunding plan, Seoul will issue ¥77.5 billion worth of Samurai bonds in 2002–2007. Seoul issued its first Samurai bonds worth ¥48.5 billion in December 2002 and received a credit rating of A- from Standard and Poor's and Japan Rating and Investment Information Inc. The Samurai bonds will be retired by 2013, 2 years earlier than the OECF loan. Seoul expects to save about ¥7 billion in interest payments (Tables 5, 6, and 7).

Recognizing Seoul's systematic efforts to reduce its debt burden, Standard and Poor's upgraded the city's domestic bond credit rating to A- in July 2002 and to A+ in October 2002. Moody's also upgraded the city's foreign bond credit rating from Baa2 to A3 in October 2002. Standard and Poor's noted that the city's efforts to establish medium- and long-term plans to manage its debts—arising from the construction of its subway and World Cup stadium—send positive signals to the market.

India implemented various innovations to overcome the limited creditworthiness of small local governments. One innovation was credit pooling, which was partly successful. One example of successful credit pooling is the state bond banks in the United States (US). Here, a special state intermediary with a superior credit rating raises funds through bond issuance and onlending to local governments by purchasing their bonds. (US state bond banks will be discussed further in the next section.) There are two types of credit pooling. The "blind pool" consists of a bond bank raising sufficient funds based on its own credit rating and then onlending to local governments. The project-specific pool gathers and lumps several projects together in a bond issuance, reducing transaction costs and improving pricing significantly.

While working with Tamil Nadu Urban Development Fund (TNUDF) on the

Table 5. Refunding Plan of Seoul Subway Debt through Samurai Bonds

Year of Issue	Size of Issue (¥ billion)	Tranche (¥ billion)		Maturity (years)
2002	48.5	1st	12.5	1
		2nd	11	2
		3rd	10	3
		4th	10	4
		5th	5	5
2003	8	1st	4	3
		2nd	4	4
2004	6		6	4
2005	5		5	5
2007	10	1st	5	5
		2nd	5	6

Source: Kim (2002).

Table 6. Details of First ¥48.5 Billion Samurai Bond Issue by the City of Seoul

Issued	Size of Issue (¥ billion)	Tranche (¥ billion)		Maturity (years)	Coupon (%)	Equal to an STSL[a] (basis points)
December 2002	48.5	1st	12.5	1	0.39	27
		2nd	11	2	0.60	44
		3rd	10	3	0.77	55
		4th	10	5	1.06	70
		5th	5	7	1.37	79

[a] STSL = spread to swap level.
Source: Lord (2002).

Table 7. Comparison of Debt Retirement (¥ billion)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
OECF	6.1	11.9	17.7	23.2	28.6	33.8	38.4	42.3	46.1	49.8	53.3	56.7	60.1
Samurai	4.9	10.4	15.8	20.3	24.7	31.3	36.7	42.1	42.3	47.6	52.8		

OECF = Overseas Economic Cooperation Fund.
Source: Table 18, Kim (this volume).

Financial Institutions Reform and Expansion Project, the United States Agency for International Development (USAID) formulated a project-specific pooling initiative called the Water and Sanitation Pooled Fund (WSPF) (Box 1). The first pooled fund in India, it was created through a Development Credit Authority guarantee of

Box 1. Tamil Nadu Urban Development Fund

Under the Indian Trusts Act, the government of Tamil Nadu established the Tamil Nadu Urban Development Fund (TNUDF) in 1996, with a line of credit from the World Bank. Participating in its establishment were Industrial Credit and Investment Corporation of India Ltd. (ICICI), Infrastructure Development Finance Company (IDFC), and Infrastructure Leasing and Financial Services Ltd. (IL&FS). The government owns 49% of TNUDF, 21% of ICICI, 15% of IDFC, and 15% of IL&FS.

Created as a trust fund and managed by the asset management company Tamil Nadu Urban Infrastructure Financial Services Ltd., TNUDF develops urban infrastructure in Tamil Nadu. Eligible borrowers are urban local bodies (ULBs), statutory boards, public sector undertakings, private corporations, and joint sector projects. Loan tenor ranges from 12 to 15 years, depending on the type of project funded. Special recovery mechanisms such as escrow accounts of property tax and water charges are generally used. In certain cases, debts are blended with grants to reduce the interest cost for ULBs.

TNUDF also conducts capacity-building activities such as computerization of accounts and training development.

Source: Pradhan (this volume).

$3.2 million. This guarantee serves as a credit enhancement for pooled financing of water and sanitation projects in Tamil Nadu's 14 small and medium-sized local bodies, which have few or no credit ratings. USAID's partial credit guarantee enabled the bonds to extend maturities from 7 to 15 years. Tamil Nadu Urban Infrastructure Financial Services Ltd., acting as the asset management company for TNUDF, purchased the bonds of municipalities and funded them by issuing its own bonds with the usual credit enhancements (Appendix 4).[18]

Two developments in India support its first pooled finance initiative. If successful, they can spread this pooling initiative to other states. First is the proposal of the 2002/03 Union Budget to create a pooled finance development scheme (PFDS) that will promote bond issues with credit enhancements to help small urban local bodies (ULBs) access capital markets. Pooled financing mechanisms such as TNUDF and WSPF are not limited to commercial lending of funds but also provide market loans blended with grants and concessionary funds. The mechanisms also give technical assistance in project preparation and financial management to local governments.

The second development is the growing popularity of infrastructure bonds as a source of funds for infrastructure projects. Investors with surplus funds from canceled placements in small-savings certificates, which have lower returns, are putting these funds into infrastructure bonds, which have become more attractive due to their improved tax advantage. For instance, beginning in 2001/02, the maximum amount of investments that can be deducted from a person's taxable salary income has been raised to Rs80,000, subject to a minimum investment of Rs20,000 in infrastructure bonds issued by IDBI and ICICI.

Several successful innovations (build-operate-transfer [BOT] and similar mechanisms, SPVs, equity contributions from state governments, power purchase agreements, etc.) have enabled local governments in Taipei,China and in India to encourage private sector participation in local infrastructure projects. An example of the successful use of a BOT mechanism was the Taipei 101 project. The Taipei city government sought to compete with Hong Kong, China; Shanghai; and Singapore as a regional financial center. The city government announced a BOT investment project for a 101-story, 508-meter tower. It will be the tallest building in the world and will host the Taiwan Security Exchange. The BOT project, with a 70-year contract on land-use rights and a lump-sum payment and annual land rent to be collected by the city government, received a winning bid of NT$20.67 billion, double the city's request. Excluding the lump-sum payment and annual land rent, the project cost was estimated at NT$56.8 billion.

India has also utilized BOT and its variations—build-own-operate, build-operate-lease-transfer—to finance infrastructure projects. These arrangements have been complemented by government support in the form of equity participation, concessions in land or water supply, dedicated revenue streams for loan repayments, and a transparent regulatory framework. Many states have created SPVs to finance their urban infrastructure projects through private-public partnerships. SPVs are formed with seed capital from equity contributions from state governments or sponsors. Project financing through SPVs has certain advantages: (i) liabilities of the promoter are limited to the specific project, (ii) lending is done without guarantees from the sponsors, and (iii) one of the sponsors is usually assigned to oversee day-to-day operations. In this sense, SPVs are similar to US state revolving funds (SRFs). (A discussion on SRFs is in the next section.)

The Noida-Delhi toll bridge project is an example of how an SPV was created to implement a project using build-own-operate-transfer. In this case, the Infrastructure Leasing and Financial Services Ltd. (IL&FS) and Noida, an agency of the Uttar Pradesh government, created the Noida Toll Bridge Company Ltd. to build the eight-lane, 7.5-kilometer (km) Noida-Delhi Expressway, which was completed 4 months ahead of schedule and started commercial operations on 7 February 2001. It cuts down travel time between south Delhi and Noida from 30 to 8 minutes. The first of its kind to be funded by foreign equity, the expressway cost Rs4.1 billion, with funds from the World Bank, IL&FS, Noida, and 12 domestic banks and financial institutions. South Africa's Intertoll, the O&M contractor for the project, will receive 11% of the toll revenues collected by Noida Toll Bridge Company

Ltd. in the first 10 years of operation. The revenue-sharing agreement is intended to encourage Intertoll to attract more traffic. After 10 years, Intertoll will be paid Rs0.725 per vehicle and Rs31.9 million per annum to cover fixed and variable costs, both of which will be indexed to inflation. Investment funds placed in the project are guaranteed a return of 20%, and promoters expect to fully recover their investments in 25 years. After 30 years, the project will be transferred to Noida without charge. It will administer toll collections, which will be indexed to the consumer price index (*Business Line* 2001).

The water supply and sewerage project of the New Tirupur Area Development Corporation Ltd. (NTADCL) is the first build-own-operate-transfer scheme in India, with a total cost of Rs11.6 billion.[19] The project will build a 55 km pipeline from the Cauvery River; a water distribution network of about 350 km; raw water and sewerage treatment plants; pumping stations; and conveyance facilities. The water component was completed in April 2002; the sewer component will be completed in 2006. When fully operational, this water supply and sewerage system will supply 185 million liters of water per day to about 1,000 textile firms and over 1.6 million residents in Tirupur, Tamil Nadu, and surrounding areas. IL&FS developed this project with USAID. The project is considered the first public-private sector partnership in the country. In January 1999, NTADCL signed an agreement with a consortium for a private integrated water and sewerage project in Tirupur. The consortium is composed of Mahindra Realty and Infrastructure Developers Ltd., a subsidiary of Mahindra and Mahindra Ltd.; Bechtel Enterprises Inc.; and United Utilities International of the United Kingdom. Debt and equity funds will finance the project. Equity will come from the state government, Tirupur Exporters Association, financial institutions, international funding agencies, and convertible debentures. Deep-discount bonds and loans from international funding agencies will contribute to the debt component. USAID has provided $25 million in loan guarantees. When operational, the water and sewerage system will be handed over to NTADCL and United Utilities, which have formed a joint venture that will handle O&M in the next 30 years for a fixed fee (Water Technology 2002).

Power purchasing agreements have been successfully used by Indian state electricity boards to develop electric power projects. For example, these boards and independent power producers have entered into an agreement on the boards' minimum power purchase and electricity tariff rates. This agreement allows 100% foreign direct investment in exchange for a central government guarantee to implement several fast-track projects. This kind of arrangement has made investments in the power sector attractive to lenders, prompting the major financial institutions to take considerable exposure. As customers are willing to pay user charges for value-added services, privatization initiatives with similar arrangements were made in telecommunications. Success of these privatization initiatives was also assured by establishing independent regulatory agencies that guarantee a minimum level of demand for services and set a competition policy to make investments viable.

Developing Local and Municipal Credit Markets

Developing local credit markets is imperative for local governments in Asia because of the need to access private domestic savings to finance infrastructure investments for urban services. Local governments should consider two models of municipal credit market—the bank lending model used in Western Europe, and the municipal bond model used in North America—and select from each model various elements appropriate for the countries' sociocultural and political milieu. Local governments may start with either model but will typically end up with both models serving different segments of the local credit markets (Peterson, this volume).

Municipal bank lending, characterized by the principles of "relationship banking," "delegated monitoring," and "bundled services and bundled pricing," is suitable for less creditworthy city governments that need to be assisted at each phase of project implementation. An example of how this model was used successfully to build a local credit market was the Czech Municipal Finance Corporation (CMFC). It had a system that matched creditworthy borrowers with commercial banks and let them assume all the credit risk. After their successful experience in using funds from CMFC, the banks used their own funds to lend to municipalities. Building a local credit market using this model in countries that have little or no history of relationship banking will be difficult because financial deregulation usually forces municipal finance corporations to act like commercial banks. Municipalities will be limited to issuing short-term loans and resort to real estate-based lending due to the staff's unfamiliarity with local government operations (Peterson 2002).

In contrast, municipal bond markets, which thrive on the principles of "competition," "public monitoring," and "unbundled services," can be accessed directly by local governments that have strong local financial management capabilities. The US municipal bond market is the most vibrant form of this model. It introduced credit-rating agencies, public disclosure of financial information, and private bond insurance to limit credit risk (Box 2). Developing countries may find it difficult to adopt the US model to their infant local credit markets. First, the benefits of credit-rating agencies may be watered down when the model is introduced in a regime of restricted access to financial information. Second, most policy makers wrongly assume that bond issues immediately open the doors to long-term financing, thus failing to craft the policies that will make long-term finance possible. Third, this

Box 2. Limiting Credit Risk in the United States Municipal Bond Market

Three important mechanisms have emerged to reduce credit risk in the United States bond market:

- Credit-rating agencies now rate virtually all publicly issued bonds. Credit rating has become a large and sophisticated business. However, in its early years, credit rating was much more haphazard. Of the municipal bonds that defaulted during the Great Depression of the 1930s, 48% were rated AAA, the highest safety classification, by Moody's, the principal bond-rating agency at that time. Almost 80% of defaulting bonds were rated AAA or AA, the two highest safety categories. The current sophistication of the United States credit-rating system does not imply that start-up institutions in developing countries will be able to successfully detect municipal credit risks at the beginning.
- Public disclosure of municipal financial conditions has greatly improved the information from which risk assessments are made. In the wake of New York City's financial crisis in the mid-1970s, the Municipal Finance Officers Association and the Public Securities Association adopted voluntary disclosure guidelines. These comprehensively identified the kind of municipal financial information that should be made available to the public before a bond issue can be sold. They also recommended standardized formats for presentation. Later, the disclosure guidelines became mandatory and regulated by governments. Municipalities are also now required to report any significant changes in their financial or legal condition, as long as bonds are outstanding.
- Private bond insurance has further reduced purchasers' risks. Almost half the municipal bonds issued today are insured by private insurance companies for timely payment of interest and principal. Unlike free government guarantees, private bond insurance does not create perverse efficiency incentives. Municipalities must pay a premium for insurance coverage. The insurance companies have specialized staff that assess the risks involved in a municipality's finances or in a project financed by revenue bonds. The greater the credit risk, the greater the premium a municipality must pay to obtain insurance. Often, the insurance company advises a municipal borrower on how it can restructure a project to reduce economic risk.

Source: Peterson 2000.

model is deficient in serving the needs of smaller and less creditworthy local governments.

This last deficiency has been overcome in India by credit pooling as implemented by specialized financial intermediaries such as TNUDF, which has also used various mechanisms to help local government access long-term funds for infrastructure projects. Two examples are (i) the 15-year bond issue (Rs300 million) sold on the domestic capital market to finance the credit component of the Madurai Ring Road, and (ii) the equity investment by a private sector firm in India's first BOT for wastewater collection and treatment. In the first example, the bond included credit enhancement measures such as escrow accounts for earmarked revenues, independent trustees representing bondholders' interests, and back-up guarantees similar to those used by US state bond banks. These measures have been combined in the Philippines with a careful assessment of the municipality's willingness to pay in the successful bond issues of a few cities in that country in recent years. In the second example, a direct investor enjoys similar credit enhancement schemes to those used in the above bond issue. The financing package assembled by TNUDF also requires an up-front contribution of Rs5,000 from each household connecting to the wastewater collection system.

Another special financial intermediary (SFI) worth examining is the Infrastructure Finance Corporation Ltd. (Inca) of South Africa. It was formed by a private financial group as a specialized municipal lender and now finances more than half the municipal credits in South Africa. Inca has been able to consistently earn returns on equity in excess of 20% while charging spreads of 50–100 basis points between its own cost of capital, raised primarily through bond issues, and its municipal lending rate. Inca's high repayment rate hinges on an aggressive monitoring system. For example, Inca staff call borrowers every week to monitor their financial condition. Whenever a borrower is overdue on its loan payment, Inca secures a court order within several days, which enables it to foreclose the borrower's assets. It can use this "stick," but has not yet, to persuade delinquent borrowers to update their loan payments. Inca also never takes the government as a cofinancier, to ensure the necessary independence and credibility to enforce prompt loan payments.

Since credit pooling appears to have a great potential for enabling small local governments in DMCs to finance infrastructure projects through bond issuance, the lessons learned from the credit pooling experience of US bond banks and SRFs should be considered. A state bond bank is "a state-sponsored entity that makes local infrastructure projects feasible by providing access to the municipal bond market and by providing direct and indirect financial subsidies to localities primarily through debt issuance" (Government Finance Group Inc. 1997, p.1). The first US general-purpose bond banks were created in Vermont in 1969 and Maine in 1972. Special-purpose bond banks usually catered to the needs of educational institutions. The oldest educational-purpose bond bank, Virginia Public School Authority, was created in 1962 to provide low-cost financing to Virginia school systems (Government Finance Group Inc. 1997).

In 1987, the Federal Clean Water Act created special-purpose state borrowing entities through SRFs. The act aimed to shift the financing of water and wastewater treatment programs from direct federal grants to a revolving loan fund. With seed capital from the federal Government, SRFs, usually housed in state bond banks, used funds from loan repayments to make new loans. The SRF program operates in all 50 states in different forms, but in all cases the federal grant of 80% and the state-matching share of 20% must remain in the corpus of the fund. Most SRFs are rated from A to AAA (Government Finance Group Inc. 1997).

The financing program of a bond bank could be in the form of a long-term bond pool, cash-flow financing, or equipment-lease financing. Bond banks enjoy good credit ratings, with most given a minimum of A for being able to pool a large number of small loans and provide a variety of state credit enhancements. (Appendixes 5 and 6 discuss the nature of these financing programs and the state credit enhancements, respectively.) An analysis survey of 17 state bond banks (Government Finance Group Inc. 1997) provides a list of their advantages and disadvantages, which designers of future credit-pooling funds in developing countries should note. Table 8 shows that localities valued bond bank issuance due to lower cost of capital (lower interest and issuance cost) and improved access to capital markets, particularly for projects that are too small to sell bonds on a stand-alone basis.

Table 8. Benefits of Bond Bank Issuance

Reason	Average Ranking	Mentioned in Top 3 Reasons[a]	Not Mentioned or in Bottom 3 Reasons
Lower interest cost	1.2	16	0
Lower issuance cost	2.9	15	0
Improved market access	3.4	9	0
Borrower too small for direct sale	4.9	5	3
Administrative burden less	7.4	8	1
No credit rating required	7.5	1	6
Lessens disclosure burdens	8.4	0	1
Avoidance of voter approval	9.1	1	16

[a] Out of a maximum of 17.

Source: Government Finance Group Inc. (1997).

In the analysis survey, bond banks cite two disadvantages that are useful for fund designers of credit pooling. First is the lack of flexibility experienced by local borrowers due to rigid financing schedules and terms. Due to the complexity of organizing a pooled bond issue, bond banks designed fixed or relatively inflexible financing schedules. Borrowings could have been made inflexible to keep the high credit quality of the pool and to satisfy statutory restrictions on bond banks. Moreover, local borrowers had no hand in selecting the financing team and other consultants. The second disadvantage is that borrowers with good credit standing are better off issuing bonds on their own because they can take advantage of lower interest and issuance costs. Large borrowers with weak credit ratings may also overwhelm the capacity of a bond bank structured on a portfolio basis and, therefore, be unable to access capital through this route.

SRFs are able to minimize these disadvantages by lending to small borrowers with poor credit ratings. SRF loan programs are either direct, which use only seed capital and subsequent loan repayments to generate a supply of loans, or leveraged, which combine seed capital with borrowed funds to raise a supply of loans upfront. A leveraged SRF program with reserve fund is useful to developing countries looking for a pooled fund arrangement, because like the states that were starting a leveraged SRF program in the early 1990s, they do not have a seasoned portfolio and need to quickly raise a large loan upfront. In a reserve fund program, seed capital and borrowed funds are deposited into a reserve fund and are not used to make loans. Interest earnings on the reserve fund are used to pay shortfalls on loan repayments. In most programs, the reserve fund is a constant percentage of the outstanding loan balance. As the loan principal is paid, a part of the reserve is freed and used to leverage more loans (Neil Flanagan, Bear, Stearns & Co. Inc. 2002).

Conclusions

Fiscal reforms, innovations to tap commercial capital, and initiatives to develop local credit markets in DMCs during the past 10 years have made modest incremental gains in closing the local fiscal gap. This confirms the conclusion of Bahl and Linn (1999, p.74): "The lesson from the history of urban fiscal reform is that major proposals rarely have a chance for adoption and implementation. Gradual and stepwise adjustments of the existing structure toward a more desirable state is perhaps the best that can be hoped for."

Country experiences in building local credit markets offer several lessons that can serve as basis for "gradual and stepwise adjustments" to building new local credit markets in developing countries (Peterson 2002):

- Since local government borrowing will always be a small portion of a country's credit market, development of local credit markets will be successful when SFIs and commercial institutions face similar sets of incentives, disclosure guidelines, credit ratings, and legal procedures. Otherwise, development of credit markets will be delayed. In some countries, for instance, municipal development funds (MDFs) have benefited from being able to intercept state aid when the state is

unable to meet its debt obligations, but their commercial counterparts cannot avail themselves of this mechanism. Being unable to resort to state aid intercepts when faced with delinquent state borrowers discourages commercial financial institutions from lending to local governments, stunting the growth of local credit markets. Another instance is what Peterson (2000) calls "the businesslike collection of taxes and fees." Unless they learn to levy user charges for services, cities and states will never acquire the credit discipline needed to repay their loans. Local governments will also need standard and sound procedures in accounting, auditing, and disclosure of municipal financial conditions to help local governments prepare the documents needed to access commercial capital.
- A single-purpose infrastructure financing authority (IFA) that has the political independence to operate international onlending programs and develop the domestic credit market is desirable. Good examples of this are TNUDF and the Shanghai Water Assets Operations and Development Company. Both have instituted mechanisms to ensure operation without undue government interference.
- IFAs, similar to MDFs, should have a concrete plan to unbundle their services so that their authority and functions can be devolved to other providers and allow new players to enter the local credit market.[20]
- IFAs should design and implement an aggressive monitoring system to ensure a high repayment rate, the most basic measure of a local intermediary's success in building a local credit market. The innovations of Inca in this area should be studied.
- Full, prompt, and continuing disclosure of municipal budgets and financial conditions is essential to the operation of credit markets, especially bond markets, which rely on public monitoring.
- In the long run, an IFA's job is to raise capital efficiently. Options to examine are the design of legal provisions allowing the tapping of pension funds as a source of local government finance, ways of developing a secondary market for bond trading, and ways of blending cheap capital with capital priced at market rates.

Previous discussions have shown the need to explore country experiences in the following areas:

- The mechanisms for mitigating the risks involved in subnational borrowing must be studied by comparing the experiences of centralized versus decentralized regimes.[21]
- Efforts to gather the best practices in minimizing disincentives (such as large intergovernmental transfers) to strengthen local government finance can begin

by looking at the World Bank-initiated CDS (see, e.g., Appendixes 1 and 2) and its experience in the Philippines (Philippines LGU Assistance Portal 2002).
- Encouraging private sector participation in infrastructure financing can benefit from a study of New Zealand's experience in implementing "contractualism," which involves "establishing more explicit, contract-like relationships at all levels of government and making a concerted attempt to replicate market-type mechanisms within the public sector" (Boston 1999).

Country experiences and lessons in building up local government finance show that the real issue in financing local infrastructure projects is not choosing between bonds and banks but rather the ability of public policy makers to create a milieu that will encourage the private sector to build a vibrant local credit market.

Endnotes

[1] Decentralization reforms were based on laws passed in the last decade. For example, the Philippines' Local Government Code in 1991; India's Decentralization Acts in 1992; Thailand's law giving subdistrict councils juridical status in 1994; the Republic of Korea's Local Autonomy Act in 1995; and Indonesia's laws on local government and central-local financial fund in 1999.

[2] The premise of decentralization reforms was that the responsibility for delivering a service within an area should be assigned to the government with jurisdiction over it. Local governments, being closer than central governments to their constituents, would be more sensitive and accountable to their needs and thus efficiently allocate the necessary resources to deliver services.

[3] Recognition is also growing of the need for close partnerships between local governments and other stakeholders—the private sector, civil society, and international development agencies—in promoting sustainable development under a decentralized regime.

[4] In 2002, ADB initiated a study on local government finance and bond market financing in 10 DMCs—People's Republic of China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Sri Lanka; Taipei,China; and Thailand—and held an international conference on 19–21 November 2002 to discuss country reports and special research papers. Unless otherwise indicated, the observations and figures for these DMCs are taken from the country reports by Bandara (2002), Firdausy (2002), Kang (2002), Kardar (2002), Kim (2002), Orial (2002), Pradhan (2002), Setapa and Yee Siew Lin (2002), Tsui (2002), and Varanyuwatana (2002), edited versions of which appear in this volume.

[5] Indonesia's modern administrative and fiscal decentralization program dates back to Law 5 of 1974, which provided the basis for greater involvement of decentralized subnational governments in the provision of public services. However, little progress has been made in the intervening 25 years to implement the general principles outlined in the legislation (Lewis 2002).

[6] Law 22 defines the functions that the central Government will devolve to local governments, and stipulates that these functions will be accompanied by revenue-generating authority for local governments. Law 25 describes the system of intergovernmental transfers.

[7] This section is based on Capuno (2002) and Orial (2002).

[8] The lowest unit of government.

[9] While several DMCs enacted decentralization laws, in other DMCs, decentralization occurred in other forms. For example, Sri Lanka passed the 13th amendment to the Constitution in 1988, which introduced provincial councils and made local governments subject to them. In Taipei,China, a constitutional amendment simplified the government system. The Taiwan provincial government became a ministerial agency directly under the Cabinet, and the centrally appointed Taiwan Provincial Advisory Committee replaced the Taiwan Provincial Assembly.

[10] Recently, the National Highways Authority of India discussed a proposal with IDFC to set up a mutual fund—the Indian Road Fund—with seed capital coming from the Infrastructure Equity Fund, and the rest from banks, financial institutions, and multilateral agencies such as ADB and the World Bank. The fund will be governed by a professional board and will be used to leverage more funds from the public for road development projects (*Business Line* 2002).

[11] For examples of how improved governance in local governments improves the pride and participation of constituents, which in turn strengthen local government finance, see the cases of Ahmadabad, India, and Naga City, Philippines, in Hamid and Martin (1999).

[12] Suwanmala (2002, Table 3) shows that 75.7% of the 6,395 SAOs, and 67.7% of the 1,028 town municipalities had populations of 8,000 and below in 1999.

[13] Kim (this volume) suggests asymmetric decentralization as a possible solution to this problem: "Decentralization can be enhanced without transferring national resources to local governments that already have resources through asymmetric decentralization: local governments are given a menu of public services that can be provided at the local level if the local governments opt for it. Normally, transferring resources needed to provide such public services is subject to heated debate. Under the asymmetric decentralization scheme, however, local governments may opt not to participate in the local provision of public services if the amount of transferred resources is unsatisfactory.

However, some local governments might prefer independent decision making even with little financial support. When Spain initiated decentralization in the late 1970s, local governments had the option of providing education and health care at the local level, without being guaranteed sufficient financial transfers from the central Government. Rich cities such as Madrid and Barcelona opted for the independent provision of those services since it meant greater political independence for them. Other local governments gradually followed suit."

[14] A financial instrument is said to be structured when it funds a project based on identifiable assets rather than on the entity's credit standing. A structured financial instrument includes various forms of lending where the entity's cash flows are intercepted to pay off the lender.

[15] The definition here refers to an SPV as a special-purpose entity (SPE): "While there is no precise definition either in the law or accounting rules, the basic idea is that an SPE is an entity with a limited purpose that is expressed in its charter or in the contracts in which it engages. Unlike normal firms, SPEs do not have significant ongoing control issues, because their decision-making follows a predetermined path. SPEs often have no or tiny equity claims, with owners of record bearing little risk and return. Instead, the main bearers of the risk and return on SPE assets are often the (potentially numerous) contractual counterparties of the SPE. In such cases, it is better to think of an SPE as the conduit for a set of contracts rather than as a firm in the usual sense" (Ryan 2002).

[16] Control of the local bond market by the Ministry of Government and Home Affairs included the case of foreign SPVs issuing Samurai bonds. Thus, this arrangement allowed the project company to satisfy the relevant clause in Korean commercial law.

[17] Limited recourse is a type of financing more commonly known as project finance, "where the creditors share much of the venture's business risk and, second, that funding is obtained strictly for the project itself without an expectation that the corporate or government sponsor will co-insure the project's debt—at least not fully" (Kleimeier and Megginson 1999, p.3).

[18] Bond investors can have the option of either calling (or retiring) the bonds after 7 years at a predetermined price or receiving a specified cash payment each year through an annuity repayment mechanism.

[19] The project used a "take-out" financing arrangement. The mechanism, pioneered in India, typically involves a specialized financial intermediary (SFI), such as IDFC. The SFI commits to take out (or assume financing of) the project when it becomes operational, and banks take up the earlier maturities. This way, banks are able to use their short-term maturity deposits by pulling out their investments at the end of a specified period.

[20] See discussion of key issues on MDFs in Peterson (1996) and Phelps (1997).

[21] The papers of Freire et al. (1998), Magrassi (2000), and Prud'homme and Shah (2002) form a subset of the studies in this area.

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Appendix 1. What are City Development Strategies?

The city development strategy (CDS) is a new tool of the World Bank's Strategy for Urban Development and Governance to focus the analytical expertise of the World Bank and its partners on the city as a unit of analysis. CDS helps countries, cities, and funding agencies improve the contribution of cities to national development.

CDS helps a city take stock of its opportunities and endowments, gauge its future place, and improve competitiveness in, for instance, producing tradable instruments, identifying critical investments, mobilizing private sector partnerships, and reducing poverty. The World Bank and its partners, with the help of Cities Alliance, are engaged in more than 50 cities preparing CDS. Past efforts to produce this broad, integrated approach have been fraught with confusion and wasted resources due to problems of coordination and efforts of too many agencies. Past plans such as city master plans were excessively technical and unresponsive to citizens' inputs and demand. CDS is different from master planning as it considers cities to be open to outside influences in a global economy, and able to act on growth opportunities. Decentralization is giving cities more scope for action, and democratization is opening the planning and political processes to greater participation and accountability. CDS is geared to respond to these new circumstances.

CDS is not intended as a substitute for integrated master plans, general land-use plans, or even investment plans, all of which may be an important complement to CDS. It is a strategic visioning exercise that helps identify a city's goals and directions and guide policy decisions and resource allocation so that cities can plan for land use, transport, and other sector needs with a clear notion about priorities and sequence of investments. Cities such as Bilbao, Rio de Janeiro, Sydney, Bangalore, and Yokohama have successfully guided their growth with strategic plans. Each used an open process of participatory planning for urban development so that the public and private sectors could expect to achieve an efficient mix of public and private resource allocation.

Source: World Bank (2002).

Appendix 2. Phases of a City Development Strategy Exercise

A city development strategy (CDS) starts with the commitment of a city, backed by regional and central governments, to take stock of how it will confront the major challenges in economic and social development. CDS proceeds with participatory processes, involving and engaging stakeholders (local government, community groups, private business sector, and civil society) in analyzing the city's problems, exploring their vision for the city, identifying opportunities for development, agreeing on priorities, and developing strategic action plans.

Process in a Typical CDS
The various phases of a CDS exercise are the following:
Preparatory phase: identification of key partners, base-line information, and consensus building for a common understanding of the city's priorities;
Consultative phase: holding stakeholder group meetings to arrive at a formal political commitment, and agree on the vision and on strategic framework;
Strategy formulation: evaluation of options, analysis of strengths and weaknesses, identification of stakeholder roles, development of action plans within a realistic financing framework;
Implementation: establishment of demonstration projects, resource mobilization by stakeholders, investment plans, and donor negotiations;
Regeneration: taking stock of and strategic visioning for the future.

Participation of all key stakeholders is crucial. A locally based institution (anchor institution) is best suited to coordinate this process for and in behalf of the stakeholders, to anchor the process outside of the political realm, and to ensure the sustainability of the participatory processes.

Source: Cities Alliance (2002).

Appendix 3. Local Government Reform in Thailand

A major change in local government occurred through the 1994 law that gave juridical status to all subdistrict councils and created the subdistrict administrative organizations (SAOs). A subdistrict council consists of one elected member from each village, plus ex officio members: subdistrict chief and village chief. In the event of a council's dissolution, only the ex officio members will remain until new elections are held. A subdistrict council that collects more than B150,000 (roughly $3,500 at March 2003 exchange rates) for 3 consecutive years is eligible for upgrading to a SAO. A juridical body has the right to (i) enter into contracts, (ii) levy taxes and collect fees and fines, (iii) borrow from commercial sources, and (iv) receive subsidies from the central Government.

The purpose of the law is to loosen the administrative control of the Ministry of Interior, give more administrative freedom to SAOs, and generate more local participation. Before the changes, the administrative line of power came directly from the Ministry of Interior to the villages. Every decision was made centrally, and people had little say in local affairs. Therefore, many public services provided by the village headman and subdistrict leader do not necessarily meet local demand.

Change occurred mainly in the wake of empowerment of local areas and growing recognition that overcentralization was causing a heavy national fiscal burden and questionable local performance. The new Constitution ignited public demand for more decentralization. One crucial constitutional provision is the trimming of the local administrative and executive functions of the village headman and subdistrict leader, and making them mere representatives of the national Government in the subdistrict council, enhancing people's participation in local affairs.

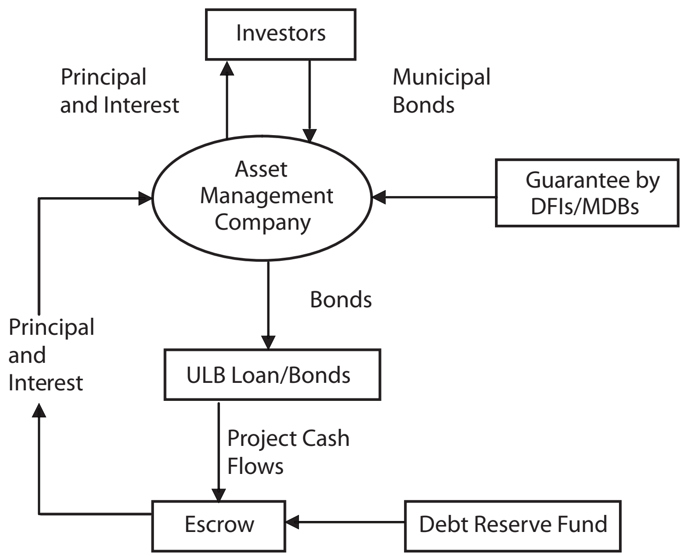
A number of measures have been taken to increase the role of elected officials in local political and economic affairs:

- Provincial administrative organizations, formerly headed by the provincial governor (a ministry of interior appointee), are now headed by a directly elected official.
- The subdistrict and village headmen, formerly appointed as members of various local development committees, must now be elected directly.

The roles of central government agents (e.g., village headman, subdistrict leader) and of local representatives are clear. If the village headman and subdistrict leader desire to participate in local government administration, they must resign their position and enter the election process.

Source: Varanyuwatana (this volume).

Appendix 4. Asset Management Company as Intermediary



DFI = development finance institution, MDB = multilateral development bank,
ULB = urban local body.

Source: Figure 5, Pradhan (this volume).

Appendix 5. State Bond Banks in the United States

Long-Term Bond Pool. Of the bond banks surveyed, all but the Virginia Resources Authority operate a long-term bond pool. In nearly two thirds of the bond banks, a long-term bond pool was the only program offered. The mechanics of a long-term bond pool are fairly standard. Typically, a bond bank issues bonds under a master legal indenture and uses the bond proceeds to purchase local debt obligations. Bondholders generally are secured by loan repayments from the pool of borrowers from many localities. Some bondholders have additional credit enhancement from the state. Because of diversification offered in the pool, investors generally require lower interest rates than if they were purchasing a single obligation from one locality. The pooling concept also provides economies of scale by spreading the fixed costs of issuance (e.g., rating fees, official statement printing) across several borrowers. Economies of scale can also be gained by negotiating lower fees for bond insurance, and by getting coverage for smaller loans that would not be insured on a stand-alone basis.

Cash-Flow Financing. Localities in many states face operating cash-flow shortfalls because of differences in the schedule of revenue receipts and of operating expenditures. Certain bond banks issue short-term pooled bonds to provide interim funding for localities until they receive the operating revenues. Cash-flow financing is similar to a long-term bond pool's structure and ability to provide economies of scale and interest savings, but varies in maturity length (generally 1 year or less) and purpose of issuance. Typically, short-term issues are secured by the operating revenues pledged to the bond bank by the locality and, in some cases, by the ability of the bond bank to intercept state aid in the event of the locality's nonpayment. The Indiana Bond Bank and Michigan Municipal Bond Authority offer popular cash-flow financing programs, with average issuance in excess of $200 million–300 million per year.

Equipment Lease Financing. Vendor financing or conventional debt financing for small equipment purchases is often prohibitively expensive for small entities, while up-front purchases deplete needed cash reserves. Although financing programs vary from state to state, bond banks generally act as a placement agent or pass-through entity by placing the loans with one or several banks. The bond bank typically provides the standardized loan and security documentation to streamline the process and allow banks to bid aggressively on the loans because of increased comfort with the credit of the local borrower. The loans can be pooled or placed on a stand-alone basis. Bond banks that offer these types of programs include the New Mexico Finance Authority and Indiana Bond Bank. The Michigan Municipal Bond Authority also offers a monthly competitive sale of pooled loans for equipment purchases, enabling local governments to finance small equipment purchases in a timely and cost-effective manner.

Source: Government Finance Group Inc. (1997).

Appendix 6. Types of State Credit Enhancements for State Bond Banks in the United States

State Moral Obligation on Debt Service Reserve Fund. Many bond bank debt issues include a debt service reserve fund equal to the maximum annual debt service that can be drawn from in case of default on debt service payments. When payment is drawn from the reserve fund due to a default, the bond bank (or appropriate state executive branch official) requests the state legislature to appropriate funds to restore the reserve fund to its required level. Investors then look to the state as the ultimate credit support, although they still face the risk that the legislature will not appropriate funds to replenish the debt service reserve. Generally, a moral obligation pledge to replenish the reserve fund gets a rating from Standard & Poor's and/or Fitch Investors Service of one category lower than the state's general obligation rating. Moody's Investors Service does not recognize moral obligation pledges, and instead rates bond bank issues primarily on the legal structure of the issue and the bond bank, and on the credit quality of the borrowers.

State Appropriation Support. In this structure, bond bank issues are backed by state legislative appropriation of debt service every year (or every 2 years, depending on the state's budget cycle). The annual appropriation pledge of the state mitigates the risk of local borrower' defaults, but investors still bear the risk of nonappropriation by the state.

State General Obligation Support. A few states have pledged full faith and credit to either the underlying issues of local governments purchased by the bond bank or the pooled issue sold by the bond bank itself. Most states do not pledge full faith and credit as they have statutory limitations on the amount of general obligation debt they can issue, or they need the debt capacity for state-wide projects.

State Aid Intercept Provision. Many bond banks have the statutory authority to intercept state aid to local governments if these default on their obligations to the bond bank. This intercept mechanism is viewed most favorably when local governments depend on state aid for a large portion of their revenues, and when state aid can be redirected immediately from the bond bank to investors.

A bond bank may use combinations of state credit enhancements, which may differ from one program to the next.

Source: Government Finance Group Inc. (1997)

People's Republic of China

Jia Kang
President and Senior Research Fellow
Institute of Fiscal Science
Ministry of Finance
Beijing

Acronyms

ADB	Asian Development Bank
CNY	yuan
GDP	gross domestic product
PRC	People's Republic of China
SAR	Special Administrative Region
US	United States

Executive Summary

This chapter analyzes the feasibility of developing local government bond financing in the People's Republic of China (PRC). It also recommends policies, as well as local and Asian Development Bank (ADB) initiatives, that can develop such financing.

Reforms in 1994 in the PRC provided a framework for the "tax-separation" fiscal system, but problems remain in deepening the reforms and in improving financial relations among different levels of government. Besides the existing channels for raising funds, local governments need bond financing for economic development. However, institutional impediments prevent formal operations via this channel. Some local governments carry out "transmuted" bond financing, but it is inefficient, chaotic, and full of risks.

Local government bond financing in the PRC is feasible. First, enough funds exist for significant bond issuance, and there are many potential subscribers. Second, the central Government has gained experience in bond issuance and management. Third, market interest rates are currently low. The following initiatives may be undertaken to develop local government bonds:

- Clear the legal obstacles to local government bond flotation through either (i) amendment by the National Congress of the Budgetary Law to include provisions that will define the autonomous power of local governments to issue bonds; or, if it is too early to amend the law, (ii) promulgation of special ordinances allowing the issuance and management of certain kinds of local government bonds, subject to limitations by the State Council.
- Design and launch trial programs and pilot projects, such as construction projects for the Beijing Olympic Games. The People's Congress of the city government can act as the approving authority.
- Closely monitor the trial programs, draw conclusions and lessons from the experience, and solve technical and managerial problems.
- Establish a special entity to coordinate and supervise the flotation and scale of central and local bonds. Expand the flotation of local bonds to more localities and increase the types of bonds. Foster the development of bond-rating agencies and other intermediary entities, and complete all the necessary support (including legal and regulatory) facilities.
- As the trial programs progress, build a consensus on the development of local government bonds among government authorities and the business sector. As a sound bond flotation mechanism is formed and financial markets operate successfully, build a national legal framework to regulate the flotation of central and local government bonds and to extend public debt-financing channels to all localities, and set up a formal institution to coordinate the annual amount of bonds issued.

Introduction

With the development of the market economy and the deepening of fiscal reforms in the PRC, whether or not local governments should have the right to issue bonds has become a major topic in financial, academic, and policy-making circles due to the constrained finances of local governments and rapid regional economic development.

This report (i) describes the status and problems of local government finance, and reviews and appraises the local financing channels; (ii) recommends that under the current tax-separation system, local governments should have legitimate and standardized channels for financing; and (iii) emphasizes the need for local government bond financing and lays down the basic principles for local bond flotation.

The critical point in local bond financing is how to ensure that the bonds will be fully repaid on time. Problems such as the inclination of local governments to overborrow should, therefore, be addressed. Tentative solutions are discussed here, but many problems can only be solved in the actual practice of bond financing. Technical assistance from ADB—including policy initiatives, project planning, training, etc.—will greatly help the PRC develop local bond financing.

The Constitution divides local administrative units into four tiers: (i) provinces, autonomous regions, and municipalities directly under the central Government; (ii) prefectures, autonomous prefectures, and cities, all under the provinces and autonomous regions; (iii) counties, autonomous counties, county-level cities, and districts, under the prefectures, autonomous prefectures, and cities; and (iv) towns, townships, and minority nationality townships under the counties and autonomous counties (Appendix 1).

The PRC has 31 provinces, autonomous regions, and municipalities directly under the central Government, in addition to Hong Kong Special Administrative Region (SAR) and Macao SAR (Appendix 2). Under the provinces are 333 prefectures, 659 cities (with 259 cities at the prefecture level and 400 at the county level) and 2,074 counties. The PRC has an area of about 9.6 million square kilometers and a population of 1.27 billion, unevenly distributed among regions (Appendix 3).

Local Government Finance: General Profile and Trends

Problems of Local Government Finance after 1994

Up to the early 1970s, government finance planning was highly centralized. All revenues and expenditures of local governments were under the state budget, in accordance with the principles of the centrally planned economy. The sharing of annual revenue and expenditure was settled by bargaining between the central and local governments. There was little room for regional autonomy or for local governments to expand revenue sources.

The fiscal decentralization reforms at the beginning of the 1980s brought changes, such as a contract system for revenues, and division of expenditure responsibility between the central and local governments. However, this system retained many of the characteristics of bargaining. Although they had 5-year fiscal contracts, the central and local governments were always negotiating for their shares, which varied frequently, in aggregate fiscal revenue. If local governments increased their revenue collection, then they might get a higher share. Eventually, local governments received more incentives to develop the local economy under this overall rationing system, but it had serious consequences. The ratio of central government fiscal revenue to total fiscal revenue declined between 1984 and 1993 (Appendix 4). The contract system also lacked stability. Since the formula for revenue sharing between central and local governments was renegotiated only every 5 years, it induced many negative short-term activities, such as predatory exploitation of resources, duplication of economic structures, and distortion of government-enterprise relations. These acted against the tenets of sustainable development and market-oriented reform.

The PRC thus introduced the tax-separation system in 1994, establishing a rudimentary framework for power division in fiscal administration. The central and local governments have separate powers to collect certain categories of taxes. The current tax structure of the PRC is presented in Appendix 5. For nearly a decade, this system has been important in defining the fiscal relationship between central and local governments and has contributed greatly to the rapid increase in tax revenues.

Since the 1980s, however, the decentralizing economic reforms have resulted in the severe decline of two ratios—that of total fiscal revenue to gross domestic product (GDP), and (until 1993) that of central government fiscal revenue to total fiscal revenue (Appendix 4). To reverse this decline and strengthen the central Government's control over the macroeconomy, large portions of tax revenues were assigned to the central level while more fiscal spending responsibilities were devolved to the local level. This kind of asymmetry, along with an unsound central-local transfer payment system, became the major cause of financial difficulty in some local governments. County and township levels could not even guarantee the payrolls of public school teachers or deliver basic services to the public, let alone provide the infrastructure for economic development.

Local revenue and spending statistics show that, in spite of the rapid increase in fiscal revenues, the gap between local revenue and expenditure is expanding, partly due to the lack of stable tax resources and partly to the asymmetry between fiscal power and spending responsibilities (Table 1). Since 1993, the proportion

Table 1. Fiscal Revenue and Expenditure at Local Level (CNY 100 million)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Local Fiscal Revenue	3,391.4	2,311.6	2,985.6	3,746.9	4,424.2	4,984.0	5,594.9	6,394.0	7,793.0
Annual Change (%)		-31.8	29.2	25.5	18.1	12.7	12.3	14.3	21.9
Share in State Total (%)	78.0	44.3	47.8	50.6	51.1	50.5	48.9	47.8	47.6
Local Fiscal Expenditure	3,330.2	4,038.2	4,828.3	5,786.3	6,701.1	7,672.6	9,035.3	10,365.1	13,090.0
Annual Change (%)		21.3	19.6	19.8	15.8	14.5	17.8	14.7	26.3
Share in State Total (%)	71.7	69.7	70.8	72.9	72.6	71.1	68.5	65.3	69.5
Local Revenue and Expenditure, (Deficit)/Surplus	61.2	(1,726.6)	(1,842.8)	(2,039.4)	(2,276.8)	(2,688.6)	(3,440.5)	(3,971.1)	(5,297.0)

Note: The revenue of local governments refers to revenue actually collected by local governments.
Sources: *China Statistical Yearbook 2001*; *China Financial Yearbook 2000*; and Budgetary Reports 2001 and 2002 to the People's Congress from the Finance Minister.

of local fiscal revenue to total state fiscal revenue has declined, while that of local fiscal expenditure to total state expenditure has remained at around 70% (Table 1 and Appendixes 4 and 6).

The gap between revenue and expenditure of local governments grew larger every year and was mainly filled by transfer payments (or internal revenue allotments, such as tax refunds and systematic subsidies) from the central Government. In 1999, for example, local governments had a deficit of CNY344.1 billion. This gap was filled by allotments from the central Government amounting to CNY408.7 billion, resulting in a minor surplus of CNY4.8 billion.

Some local governments, however, especially at the county and township levels, had huge fiscal deficits. A portion of the deficits was financed by borrowings from state-owned commercial banks and government financial institutions (trust and investment companies), but a larger portion was simply not filled but recorded in book accounts as, for example, deferred payments for payrolls of public school teachers and for contractors of some construction projects. This situation threatened local fiscal sustainability and local governments' credit standing and has become one of the biggest challenges for the PRC.

Such fiscal problems are critical and need urgent attention. Among other measures, the following reform strategies are indispensable to strengthen the financial situation of local governments:

- Explore the potential of traditional revenue sources, such as business tax and real estate tax.

  Business tax is the main fiscal revenue source for local governments and is levied on the sale of taxable services, intangible asset transactions, and sales of real estate. Tax levies range from 3% to 20%. As the tertiary sector booms, business tax can be explored as a source of increased revenue.

Real estate tax has great potential to increase revenue as the PRC rapidly urbanizes. As long as local governments improve their territories' investment environment, real estate values are bound to appreciate. Local governments should regularly appraise real estate values through tax mapping.

- Establish a rational fiscal system under the provincial government and increase transfer payments from provincial governments to subordinate cities, counties, and towns.

  Fiscal difficulty among provincial government units, especially townships, is largely due to institutional problems. The system of division of fiscal power and responsibility is far from perfect. While lower-level local governments usually have the onerous tasks of providing infrastructure for economic development and delivering basic services to the growing populace, they have few and unstable sources of fixed revenue. Statistics show, however, that provincial governments (and some city governments at the prefecture level) have generated substantial fiscal revenues in recent years. In 2000, the ratio of provincial government fiscal revenues to aggregate national fiscal revenues increased to 28.8% from 16.8% in 1994, yet they have few fiscal responsibilities and an insufficient and inefficient downward transfer payment formula. These are the critical factors in the fiscal deficits of county and township governments. A rational and scientific fiscal division of power under the provincial government is needed, and the downward transfer payment should be enhanced.
- Increase transfer payments from the central Government.

  The central Government should be more active in achieving equitable fiscal revenue distribution among regions by increasing its portion of shared revenues and using it to increase the transfer payment to less developed and poorer regions.

Redefining the Fiscal Responsibilities of Local Governments

With the PRC's transformation to a market economy, local governments' social and economic responsibilities were redefined, and now include: (i) social services, such as elementary education, medical care and sanitation, weather forecasting, and fire prevention; (ii) construction of infrastructure such as roads, power plants, water supply systems, sewage treatment and garbage collection facilities, ports, and airports; (iii) social administration, including public affairs and public security and order; and (iv) local public information through radio, TV, newspapers, libraries, museums, and preservation of cultural artifacts.

The division of social and economic responsibilities is not permanently fixed under the local fiscal system. Regions and provinces vary significantly, especially in construction expenditure. Generally, however, more responsibilities (elementary education, infrastructure, maintenance, sanitation, health care, community security, and other basic services) are being devolved to the city and county levels, although provincial governments are largely responsible for expenditures of larger geographical infrastructure projects (i.e., those that cross city or county borders), besides daily administration and social welfare activities. Government functions and responsibilities should be divided more rationally and clearly at the provincial level.

Since 2002, the central and local governments have shared income taxes of enterprises regardless of which level has jurisdiction over them, thereby cutting off the "paternal" relationship between local governments and local enterprises, and helping local governments focus on providing local public goods and services.

Tax Revenue Structure of Local Governments

The official documents relating to the institutional reforms of 1994 provide that revenues of central and local governments are to come from different sources (Appendix 5). Central government revenue includes the following:

- tariffs;
- consumption and value-added taxes levied by customs;
- taxes on domestic consumption; income of central government enterprises; income of local banks, foreign-funded banks, and nonbank financial institutions; centralized profits (i.e., delivered to central Government) of railways, head offices of banks, and head offices of insurance companies; and ocean petroleum resources;
- 75% of value-added tax; and
- 50% of the tax on stock dealing (stamp tax).

Local government revenue includes the following:

- taxes on business, income of local government enterprises, personal income, use of urban lands, adjustment on investments in fixed assets, city maintenance and construction, real estate, use of vehicles and ships, slaughter, agricultural products, occupancy of cultivated land, contracts, and resources other than the ocean petroleum resources;
- stamp tax;
- 25% of value-added tax; and
- 50% of tax on stock dealing (stamp tax).

Business tax makes up the largest part of local government revenue (Table 2), consistently accounting for 30% of the total tax revenue in 1994–1999. In the long run, real estate tax should be developed as the main source of city and county revenue. Provided that local authorities upgrade their investment environment, the value of real estate is bound to appreciate and the tax base expand accordingly. Governments, therefore, should more actively foster market and fiscal resources.

Table 2. Structure of Tax Revenue of Local Governments (CNY 100 million)

	1994	1995	1996	1997	1998	1999
Value-Added Tax	579.98	654.41	742.82	824.28	908.44	974.32
Business Tax	647.36	828.24	1,006.32	1,160.97	1,340.50	1,453.71
Income Tax of Enterprises	291.51	350.86	402.84	538.44	528.60	624.43
Tax on Resources	45.45	54.96	57.33	56.52	61.93	62.86
Tax on Use of Urban Land	32.51	33.58	39.33	44.05	54.09	59.06
Tax on Stock Dealing (stamp tax)	22.66	0.00	60.83	35.12	24.58	67.06
Other Taxes	226.02	369.19	465.98	598.14	721.97	827.31
Tax on Town Maintenance and Construction	174.63	209.81	241.86	268.87	292.00	312.57
Tax on Adjustment of Investment in Fixed Assets[a]	43.30	53.63	62.22	78.37	107.55	130.11
Tax on Agricultural Products	195.02	243.55	338.26	364.99	365.44	390.47
Tax on Occupancy of Cultivated Land	36.47	34.54	31.20	32.49	33.35	33.03
Total Tax Revenue	**2,294.91**	**2,832.77**	**3,448.99**	**4,002.04**	**4,438.45**	**4,934.93**

[a] Stopped in 2000.
Source: *China Financial Yearbook 2000*, p.431.

Local Government Financing Channels and Impediments to Bond Financing

Overseas Debt and Project Bonds, and Transfer Lending of Central Government Debts

The PRC issued local government bonds shortly after it was founded, but this was stopped for various reasons. The major reason was the start of the centralized system of control over the economy and government finance at all levels. Even flotation of state treasury bonds was stopped in the mid-1950s. For decades, the PRC thus faced an extreme scarcity of financial resources.

Major financing channels of local governments now include borrowings from international financial institutions and the issuing of project bonds through special entities to raise construction funds. However, the amount of foreign debt arranged by the central Government cannot satisfy the huge financial demand of regional economic development.

The central Government recently set aside part of the proceeds from long-term treasury debt every year for transfer lending to local governments. The loans, used to support the construction of local infrastructure and public works, amounted to CNY50 billion in 1998, CNY30 billion in 1999, CNY50 billion in 2000, CNY40 billion in 2001, and CNY25 billion in 2002 (as projected in the budget). Logically, local governments should be allowed to raise funds through bond flotation under the revenue and power division system or else continue to suffer tight financing, which will defeat the aim of spreading debt risk and dispersing the debt burden of the central Government.

Alternative Bond Financing by Local Governments: Transmuted Bond Flotation

Transmuted bond flotation refers to an evasion of the prohibition clause of the law. For example, a local government (solely or jointly with other entities) sets up a special economic entity (investment company, investment and trust corporation, etc.) with close but ambiguous ties to the local authority, and is empowered to issue corporate bonds. The proceeds will be lent to the local government or to its affiliated state-owned economic entity. Repayment of the bonds sometimes comes from the loans, or from project investment returns, but eventually will come from fiscal funds.

Some bonds are issued through local trust and investment companies, and some through urban construction companies. Some capital is borrowed from the public. The loan is guaranteed by the local financial authorities. These borrowings add up to the pool of contingent liabilities of local governments, and amplify the embedded financial risk of local municipalities because the borrowings are outside the supervision and governance of the financial system.

From 1992 to October 2001, for example, Qingyang district in Chengdu, issued CNY375 million worth of bonds. In 1999 the value of the bonds issued amounted to CNY41 million and accounted for about one fifth of total district revenue (CNY255 million). Almost all these bonds were retailed to individual subscribers. An investigation overseen by the Finance Ministry in 1992 found that the bonds were issued directly by the local financial bureau, with repayment guarantee. The bond subscribers received a debenture or a certificate. When the Budgetary Law took effect in 1995, the local financial bureau was replaced by investment companies as the bond-issuing entity. Part of the proceeds from bond issues was used to pay previous debts and interest. The rest was invested in projects or lent to enterprises. This bond-issuing business was kept in extrabudgetary accounts by the district financial bureau. The proceeds were booked as "construction promotional funds," and the repayments for debt principal and interest were booked as "current budgetary expenditure—enterprise renovation expenditures."

Because of the lack of a legal basis, and lax management, the transmuted bond flotation was not covered by the standard decision-making process and supervision mechanism, and had no permission from the People's Congress, which was bound to increase local governments' financial risk. This low-level financing also hampered financial market development. With the expensive issuing cost (Qingyang bond interest rates were 5.1–22.0%) under the transmuted flotation, the possibility of local government insolvency and financial disorder was high. Such covert flotation also encouraged corruption because of the absence of strict supervision.

Obstacles to Local Bond Flotation

The need to allow local governments to use bond financing is more and more urgent. An estimated CNY300 billion is required for the 2008 Beijing Olympic Games, but Beijing's fiscal revenue was only about CNY45 billion in 2001. Issuance of special Olympic bonds was once expected, but the 1 July 2002 editorial of *21st Economic Report* states that the initiative was rejected by the central Government. Sponsoring the Olympic Games needs full investment in advance and returns come only during or after the Games. Issuing the special bonds is rational and viable but not enforceable because of the prohibition in the Budgetary Law. The Beijing Olympic Games will, therefore, likely turn out to be the PRC Olympic Games. Debts owed or guaranteed by local governments in the past decades were all illegal and invalid, and the central Government did not acknowledge them.

An alternative suggestion has emerged. The *Guangming Daily* (13 June 2002) reported that a research team of the National Party Revolutionary Committee in Beijing suggested financing through corporate bonds, as follows: "In 1997 Beijing utilized only CNY600 million of the total of CNY26 billion of corporate bonds, indicating that corporate bonds have great development potential. Bond financing should be considered in raising funds for infrastructure and big projects such as the Zhongguancun Science District and Olympic facilities."

Another research team at Beijing University suggested utilizing asset-backed securitization to finance the Olympic Games. Beijing would set up a special entity to finance infrastructure construction by issuing equity securities. Some of these could be listed on the exchanges; others could be traded on the kerb market. For infrastructure projects unable to generate enough cash to back up the securities, the Beijing municipal government would fill the fiscal gap.

This example shows how local government inability to issue bonds results in economic turmoil.

Institutional Impediments to Local Bond Financing

Provision 28 of the Budgetary Law stipulates the following: "All local government budgets should be planned strictly to assign expenditures by income and match the two. Without permission from the law or the State Council, no local government should issue bonds." This obstacle can be overcome by (i) appealing to the National Congress to amend the Budgetary Law; or (ii) asking the State Council to promulgate special ordinances defining rules for local government bond flotation, including the qualifications of issuing bodies, scrutiny and approval of bonds-issuing applications, and ways of flotation and debt repayments.

Standardized Channel of Financing for Local Governments

In most market economies, local government finance is independent of central government, with the budget planned separately. Local governments thus commonly issue bonds. Countries such as the United States (US), Japan, France, Germany, and United Kingdom have full-blown municipal bond markets. They are integral to the capital market and play an important role in promoting regional economic development. The US has one of the most developed municipal bond markets in the world, with municipal, mortgage loan, and corporate bonds issued by state and local governments. In contrast, the PRC has few bond varieties and growth of the bond market is slow compared to that of the stock market and investment funds. Transmuted bond flotation is risky and bond markets should be standardized and legitimized to increase their transparency and accountability.

Need for Local Bond Financing

Improving the Tax-Separation System and Giving Local Governments Financial Powers

Countries with tax-separation systems recognize the importance of local public debt financing through local government bond issuance. The PRC has established a rudimentary framework for revenue and power division among government levels. The next step is to give bond-financing rights to local governments. Local governments do not have the financial power to build infrastructure and either leave it to market forces or do not do it at all.

Expediting Economic Development and Infrastructure Construction

Although urban infrastructure has made significant progress since the reform and opening of the economy in 1979, such progress has been outpaced by rapid urban population growth and huge demand for urban facilities. The PRC must step up infrastructure development to build the momentum for long-term economic development. Some estimates foresee that a 1.0% growth in infrastructure construction in developing countries will bring about 1.5–1.7% growth in GDP.

Funds for infrastructure construction come mainly from central and local fiscal revenues, commercial banks, policy-based financing banks (special state-owned banks that offer favorable loans to some selected sectors), and the capital market. However, the central and local governments cannot afford to set aside enough funds for infrastructure. Commercial bank loans have many limitations in financing infrastructure projects because the funds for the loans mostly come from short-term deposits or savings, which can hardly match the long-term cash return and low profit level of infrastructure projects. Capital from policy-based financing banks is also limited as it is mainly used for national infrastructure projects. Equity markets can finance infrastructure, but the domestic equity market is still in its infancy. Governments must radically revise their economic concepts and establish a multichannel, multitier financing system.

Some municipalities allow foreign investors to participate in infrastructure projects with good prospects of investment returns on a license-management basis, guaranteeing very high capital return rates of 14–18% annually. This is appealing not only to foreign capital but also to domestic funds, especially savings accounts. A yield of 8–10% would be enough to attract domestic investors to invest in public utilities or public goods and thus not only bring down the financing cost of public utilities and infrastructure, but also give the public a variety of investing options.

The PRC is an emerging power, and sponsoring special events can promote its international status and economic development. In 2001, Beijing won the bid to host the 2008 Olympic Games. Huge demand for urban construction (including gymnasiums, traffic systems, hotels, information facilities, and environment protection projects) will come with it, entailing substantial capital demands. Therefore, financing the Olympic Games has recently become the biggest issue for the Beijing authorities. In the next few years, the total investment requirement for the Olympic Games will reach CNY300 billion. After deducting financial support from the central Government, Beijing must shoulder CNY180 billion, or at least CNY30 billion each year for the next 6 years. However, Beijing's fiscal revenue was only around CNY45 billion in 2001. Experts suggested the issuance of special Olympic bonds (see above).

Construction of sports facilities takes up only a small proportion of total investment. For the 1992 Barcelona Olympics, for example, more than 90% of capital went to construction of urban roads, housing, telecommunications upgrading, environmental improvement, and other support projects, while only 9.1% went to building sports facilities and infrastructure. All these investments improve the profile of the host and upgrade its economic structure (through more capital-intensive businesses, increased service industries, enhanced international reputation, and greater competitiveness). In the long run, the special Olympic bonds are expected to yield good economic returns. Redemption funds will come from the revenue of the Olympic Games (exclusive TV broadcasting fees, etc.), operation earnings of gymnasiums during and after the games, and indirect accrual of government revenue.

Local Government Bonds as a Solution to Volatile Government Revenue

When fiscal revenue is unstable, surpluses may occur in some years and deficits in others. In case of natural disasters, or when starting projects of vital and lasting importance, sudden spending demand might not be covered by fiscal revenue for that year. Bond financing is a way to meet unexpected spending demand, in conformity with the principle of matching costs with benefits, because some benefits will last a long time, and those who enjoy them can be expected to pay for them through taxes.

Enhancing Financial Market Development and Improving the Macroeconomic Regulation System

Sound development of the financial market cannot be divorced from development of the local bond market. The financial market consists of the stock, bond, and money markets. The stock market offers high returns; the bond market, a high degree of safety; and the money market, liquidity. Local government bonds are less safe than treasury bonds but safer than corporate bonds. However, local government bonds may have better returns than treasury bonds but less than corporate bonds. Local government bonds offer relatively high return without much risk.

Feasibility of Developing Local Bond Financing

Fund Supply, Bond Issuance, and Subscriber Response

The PRC has a very high savings rate of 35–40%, and the savings balance has been growing since the 1990s at an average rate of 27% per year. In mid-2002, total savings reached CNY8 trillion. However, investment channels are limited and many people consider the capital market risky, preferring instead bank savings and government bonds, which have lower risks and less volatile earnings. Bonds held by individuals including treasury voucher bonds, tradable treasury bonds, and corporate bonds amount to about CNY800 billion, and with individual savings of over CNY8 trillion, the bond market seems to have great potential. Local government bonds held by individuals can stop money from resting idle in banks and facilitate the conversion of bank savings into investments.

Institutional investors' security investment funds (closed- and open-end funds), insurance funds, social security funds, commercial banks, etc. have huge demand and purchasing power for local government bonds. Because they will want to diffuse risks and create opportunities to attain stable returns, these institutional investors and individuals will be the main subscribers of local government bonds.

Government Experience in Bond Issuance and Management

The PRC has gained experience in issuing treasury, corporate, and financial institutional bonds during the last two decades. It is familiar with bond flotation, structure, variety, duration, and interest rates. Local government bond issuance will be successful if supported and guaranteed by the systematic integration of various kinds of bonds (long, medium, and short term, general and special, tradable and nontradable, voucher and registered) and by the market participants (institutional investors and professionals) skilled in issuing and circulating bonds.

The securities trading network, however, including the Shanghai and Shenzhen stock exchanges, interbank bond trading market, and over-the-counter trading system (on trial operation), will provide substructures for possible local government bond circulation. Intermediary agencies (investment banks, credit-rating agencies, accounting and auditing firms, and law firms) are developing rapidly. They can provide services in issuing, underwriting, rating, and circulating local government bonds and supervise bond-issuing bodies.

Basic Principles and Policy Recommendations for Local Bond Financing

Basic Principles in Local Government Bond Flotation

Developed market economies' practices in flotation of local government bonds cannot be replicated in the PRC. The specific conditions of the PRC must be considered and some basic principles observed.

Repayment Capacity. The scale of local government bonds must be in line with repayment capacity, which requires local governments to predict revenue and repayment capacities and achieve a balance between current needs and future repayment capacity. Legislative bodies should approve the scale of bond issuance at corresponding government levels.

Prudence and Efficiency. Local governments must consider the returns on bond funds. To avoid risk, bond proceeds should only be used for capital expenditures, not for balancing current account deficits, which should be solved through adjustment of revenue and expenditure. Returns are direct and indirect. Direct returns refer to the revenue from the project itself, such as the toll revenue of an expressway built with bond funds. Indirect returns refer to the calculable increase in government revenue through expenditure on projects that do not generate revenue themselves, such as an improved investment environment and better transportation through free roads. Local governments must ensure that the proceeds from bond issuance go to revenue-generating projects.

Central Government Regulation and Coordination. To avoid the risk of local government overborrowing due to decentralized decisions, the central Government should coordinate and control the aggregate scale of government bonds. A clear and effective system of central approval should be established, including the creation of a government bond management committee to plan the aggregate scale of central and local government bonds, chart the progress of bond issuance, and coordinate and supervise local government bonds. The committee can also check local operations at the issuing, using, and repayment stages. Credit of local government bonds should be rated and the results publicized so that local governments will strictly abide by the relevant laws and regulations and keep accurate records.

Determining Fund Modalities

Issuer Qualifications. Not all cities are qualified to issue government bonds. Local governments applying for bond issuance should be strictly examined. Certain large and medium-sized cities may be allowed to issue government bonds first. Other cities may be allowed later. Issuers may include cities under direct central administration and state planning, cities administered by provinces, cities along coasts and rivers, famous tourist cities, and other development zone cities above a certain size. Specific conditions may be set. For example, a local government applying for issuance must have a balanced budget or surplus, no fiscal deficit within the last 3 years, and sound credit with no record of default.

Bond Tenors. Local government bonds should be medium and long term because bond-issuing proceeds are mainly diverted into infrastructure projects, which take a long time to build and to produce a return. Medium- or long-term bonds can allow governments to arrange their budget revenue and expenditure and ensure repayment of debts upon maturity.

Fields of Fund Use. Bond proceeds should mainly be put into transportation, communication, public facilities, residential housing, energy, environmental protection, and other infrastructure. Duplicative construction and commercial projects should be avoided. Based on reality and feasibility studies, priority should be given to projects that are most urgently needed and can contribute most to regional economic growth.

Mode of Placement. Local government bonds are suitable for private placement.

For governments of developed areas with a sound credit background, a national public offering can be considered. Placement would mainly cover local residents and financial institutions.

Interest Rates. Interest rates are not yet determined by market forces, and the new financial instruments (e.g., derivatives) to avoid risks once interest rates are determined by the market are lacking. Most residents prefer fixed interest rates on investments. Fixed interest rates can help local governments plan cost repayment (especially at the current low interest rates, which are favorable to issuing long-term fixed-rate bonds), which will make it more convenient to use bond revenues for infrastructure. Therefore, fixed interest rates should be the general choice for local government bonds, which should have lower interest rates than corporate bonds but higher than treasury bonds.

Negotiability. As the market for local government bonds is far from mature, these bonds are unsuitable to be listed on the securities market. However, the over-the-counter market should be developed to provide liquidity for investors. When conditions mature, some local government bonds with a high credit rating should be considered for listing on the securities market.

Bond Types. Based on different repayment guarantees, local government bonds can be classified as general obligation bonds or revenue bonds. General obligation bonds are issued on the guarantee of the local government's right to levy taxes and, thus, need to be repaid from tax revenues. Revenue bonds are issued on the guarantee of government revenue from public utilities. For example, water supply bonds are repaid with revenues generated from the water supply system. As local governments may not incur budget deficits, they should mainly issue revenue bonds. However, revenues generated by some public projects are insufficient for bond repayment. In this case, tax revenues can be used to supplement bond repayment.

Possible Problems in Local Government Bond Flotation

Overborrowing and Debt Control. Local governments in countries undergoing economic transformation are commonly under budgetary constraints. Due to unsound decision mechanisms and lack of a clear legal framework, local governments in the PRC sometimes do not limit their expenditures. Laws and regulations should be issued quickly once local governments are allowed to issue bonds. Local parliaments should examine and supervise the bond flotation to avoid short-term behavior, which is usually related to the time the local leaders are in position (commonly no longer than 5 years) in the local government. The central Government should inspect local government bond issuance and coordinate scale planning and allocation of local bonds. Intermediary agencies should oversee and rate the bonds' credit.

To guarantee repayment of principal and interest, local financial authorities should set up a redemption or sinking fund, to come mainly from the proceeds of bond-funded projects. The central Government can use the arrangement of redemption funds to determine the creditworthiness of local governments.

Bond Flotation and Macro Money Supply. There is no direct correlation between flotation of local government bonds and money supply. The central Government can decide the scale of local government bond flotation after considering money supply control. Rational scale control and strict scrutiny and approval of local government bond flotation will minimize the risk of losing control over the money supply and strengthen the effectiveness of monetary policies. With sound coordination between fiscal and monetary policies, local government bonds and treasury bonds will be effective tools to regulate the macroeconomy.

Interregional Development Gap. Uneven regional development is a serious problem in the PRC. Only some economically sound large and medium-sized cities and east coast cities can meet the qualifications for issuing local government bonds. Most cities in the western region do not, and thus cannot use a financing approach that could benefit them. Funds moving between regions as a result of local bond flotation can widen the development gap. One solution to this problem is to strengthen the transfer payment arrangements between regions. For some transregional projects, part of the bond revenues of developed regions can be transferred to underdeveloped regions for use in counterpart projects. Although some mid-western cities (Guilin, Lhasa, etc.) are not developing quickly, they have huge development potential. Under the strategy to develop the western PRC, their advantage in natural resources will gradually appear. Giving these cities the right to issue local government bonds to speed up infrastructure and public works construction will undoubtedly expedite their economic development and narrow the gap between east and west.

Local Government Bonds and Treasury Bonds. Local government bonds and treasury bonds should be interrelated and complementary, but sometimes there are mismatches. Unless rules are set, conflicts may arise in bond issuance in terms of time, market, and interest rate. Treasury bonds should be given priority over local government bonds; treasury bonds should be offered publicly, and local government bonds, privately.

Local bonds are less creditworthy than treasury bonds and should have higher interest rates, as in Japan. In the US, municipal bonds are tax-exempt. The PRC can follow suit.

Initiatives to Develop Local Government Bonds

A tentative roadmap of initiatives to develop local government bonds might appear as follows:

- Clear the legal obstacles to local government bond flotation through either (i) amendment by the National Congress of the Budgetary Law to include provisions that will define the autonomous power of local governments to issue bonds; or, if it is too early to amend the law, (ii) promulgation of special ordinances allowing the issuance and management of certain kinds of local government bonds, subject to limitations by the State Council.
- Design and launch trial programs and pilot projects, such as construction projects for the Beijing Olympic Games. In the process, the People's Congress of the city government should act as the approving authority to secure legislative support.
- Closely monitor the trial programs, draw conclusions and lessons from the experience, and solve technical and managerial problems.
- Establish a special entity to coordinate and supervise the flotation and scale of central and local bonds. Expand the flotation of local bonds to more localities and increase the types of bonds. Foster the development of bond-rating agencies and other intermediary entities, and complete all the necessary support (including legal and regulatory) facilities.
- As the trial programs progress, build a consensus on the development of local government bonds among government authorities and the business sector. As a sound bond flotation mechanism is formed and financial markets operate successfully, build a national legal framework to regulate the flotation of central and local government bonds and to extend public debt-financing channels to all localities and set up a formal institution to coordinate the annual amount of bonds issued.

Possible Initiatives for the Asian Development Bank

The central Government requires more technical assistance from ADB to develop local bond financing. The paragraphs below discuss the areas where ADB support would be the most useful.

Policy Studies

ADB can undertake the following:

- Fund studies on policy initiatives that cite the experiences of developed market economies and the newly industrialized economies in promoting urban construction and in mobilizing resources (especially private capital) for infrastructure.
- Guide classification of municipal construction projects. Which projects can be financed by revenue from bonds? Which projects can be included for bond financing? Which projects can be given more conventional fiscal funds? Which projects can be financed by private capital?

- Support research on how to harmonize the relationship between central and local governments, how to deepen the reform of the provincial revenue-sharing system, and how to control local government debt risk, including suggestions on improving local administrative system and governance.
- Help develop schemes to set the scale of government bonds and allocate bond financing, and support studies on how to improve the legal system, including bankruptcy procedures for local governments.

Consultation and Design
ADB can undertake the following:

- Conduct feasibility studies of selected development projects to help the PRC design bond flotation mechanisms.
- Offer schemes or conduct consultations to standardize the relationship among participants (the local government as the issuing entity, law offices, and bond underwriters, subscribers, and investors).
- Gather and share the successful experiences of other countries in planning local government bond flotation, bond circulation, mode of flotation, and interest rate formation.
- Help corresponding departments in the PRC establish a risk control system for local debts in terms of designing the risk warning indicator system, holding consultations on how to avoid debt risk, and other specific measures.
- Initiate consultations on local government bond underwriting, trusteeship, and rating, etc.

Training
ADB can undertake the following:

- Help the central Government train people to issue and manage local government bonds.
- Help organize groups to visit and train in developed countries. Members of visiting groups may come from local administrative offices, financial bureaus, planning departments, and project construction and operation teams. Members can learn from successful municipal bond projects such as bond-funded harbor construction in New York and New Jersey, US.
- Send specialists to participate in a program for local government bond flotation and trading. They can formulate the underwriting rules of bond flotation, design the trading system of municipal bonds, and establish the kerb (or over-the-counter) market.

- Organize various seminars to discuss solutions for specific problems.
- Train professionals in credit rating.

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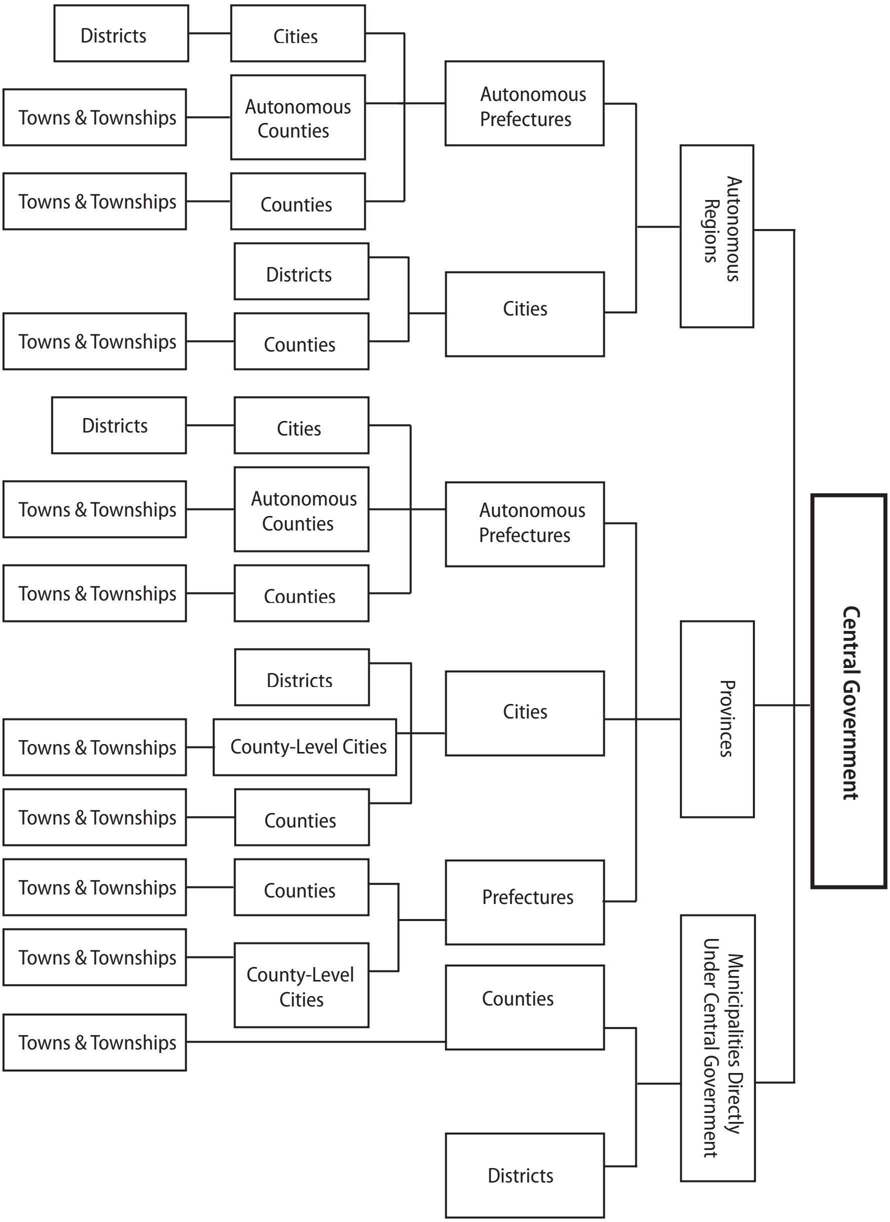
Appendix 1. The Structure of Local Governments Units



Appendix 2. Divisions of Administrative Areas (end-2000)

Provinces, Municipalities, and Autonomous Regions	Number of Prefectures	Cities at Prefecture Level	Number of Counties	Cities at County Level	Number of Cities at All Levels	Districts under Jurisdiction of Cities
Beijing			5			13
Tianjin			4			14
Hebei	11	11	138	23	34	35
Shanxi	11	10	97	12	22	22
Inner Mongolia	12	5	84	15	20	17
Liaoning	14	14	44	17	31	56
Jilin	9	8	41	20	28	19
Heilongjiang	13	12	66	19	31	64
Shanghai			3			16
Jiangsu	13	13	58	28	41	51
Zhejiang	11	11	62	24	35	26
Anhui	17	17	61	5	22	45
Fujian	9	9	60	14	23	25
Jiangxi	11	11	80	10	21	19
Shandong	17	17	92	31	48	47
Henan	17	17	110	21	38	48
Hubei	13	12	66	24	36	35
Hunan	14	13	88	16	29	34
Guangdong	21	21	77	31	52	45
Guangxi	14	9	81	10	19	29
Hainan	2	2	17	7	9	3
Chongqing			26	4	4	14
Sichuan	21	18	140	14	32	40
Guizhou	9	4	78	9	13	9
Yunnan	16	4	120	11	15	8
Tibet	7	1	72	1	2	1
Shaanxi	10	9	87	4	13	20
Gansu	14	5	76	9	14	10
Qinghai	8	1	39	2	3	4
Ningxia	4	3	17	2	5	7
Xinjiang	15	2	85	17	19	11
National Total	**333**	**259**	**2,074**	**400**	**659**	**787**

Source: *China Statistical Yearbook 2001.*

Appendix 3. Population Distribution by Region and by Urban or Rural Residence (10,000 persons)

Region	Total	Urban	Rural	% of Total	
				Urban	Rural
Beijing	1,382	1,072	310	77.54	22.46
Tianjin	1,001	721	280	71.99	28.01
Hebei	6,744	1,759	4,985	26.08	73.92
Shanxi	3,297	1,151	2,146	34.91	65.09
Inner Mongolia	2,376	1,014	1,362	42.68	57.32
Liaoning	4,238	2,299	1,939	54.24	45.76
Jilin	2,728	1,355	1,373	49.68	50.32
Heilongjiang	3,689	1,901	1,788	51.54	48.46
Shanghai	1,674	1,478	196	88.31	11.69
Jiangsu	7,438	3,086	4,352	41.49	58.51
Zhejiang	4,677	2,277	2,400	48.67	51.33
Anhui	5,986	1,665	4,321	27.81	72.19
Fujian	3,471	1,443	2,028	41.57	58.43
Jiangxi	4,140	1,146	2,994	27.67	72.33
Shandong	9,079	3,450	5,629	38.00	62.00
Henan	9,256	2,147	7,109	23.20	76.80
Hubei	6,028	2,424	3,604	40.22	59.78
Hunan	6,440	1,916	4,524	29.75	70.25
Guangdong	8,642	4,753	3,889	55.00	45.00
Guangxi	4,489	1,264	3,225	28.15	71.85
Hainan	787	316	471	40.11	59.89
Chongqing	3,090	1,023	2,067	33.09	66.91
Sichuan	8,329	2,223	6,106	26.69	73.31
Guizhou	3,525	841	2,684	23.87	76.13
Yunnan	4,288	1,002	3,286	23.36	76.64
Tibet	262	50	212	18.93	81.07
Shaanxi	3,605	1,163	2,442	32.26	67.74
Gansu	2,562	615	1,947	24.01	75.99
Qinghai	518	180	338	34.76	65.24
Ningxia	562	182	380	32.43	67.57
Xinjiang	1,925	651	1,274	33.82	66.18
National Total	**126,583**	**45,844**	**80,739**	**36.22**	**63.78**

Note: The national total population and urban population include the Chinese People's Liberation Army, but population by region excludes that.

Source: *China Statistical Yearbook 2001.*

Appendix 4. Total Revenue and Shares of Central and Local Governments, and Total Revenue as Share of GDP

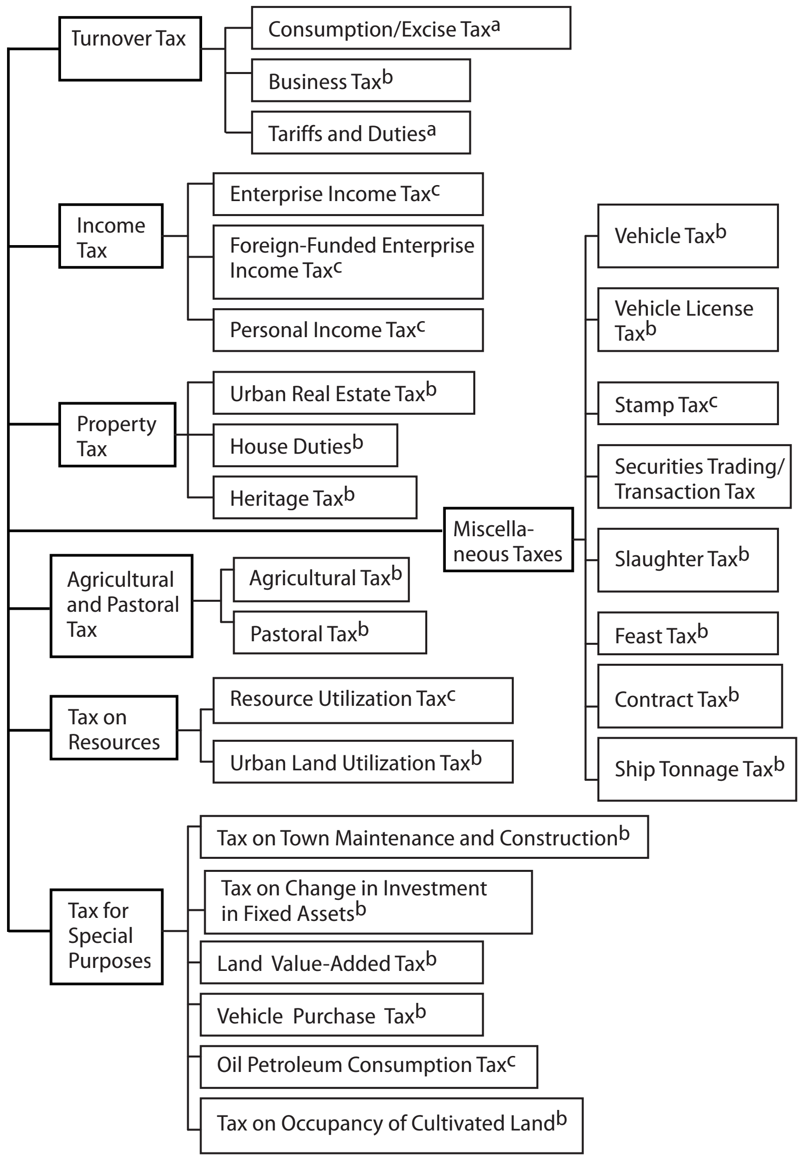
Year	Total Revenue (CNY100 million)				Share in Total Revenue (%)	
	Total	Total Rev./ GDP (%)	Central Government	Local Government	Central Government	Local Government
1953	213.24	25.9	177.02	36.22	83.0	17.0
1954	245.17	28.5	187.72	57.45	76.6	23.4
1955	249.27	27.4	193.44	55.83	77.6	22.4
1956	280.19	27.3	222.10	58.09	79.3	20.7
1957	303.20	28.4	222.94	80.26	73.5	26.5
1958	379.62	29.0	305.26	74.36	80.4	19.6
1959	487.12	33.9	118.78	368.34	24.4	75.6
1960	572.29	39.3	142.80	429.49	25.0	75.0
1961	356.06	29.2	76.65	279.41	21.5	78.5
1962	313.55	27.3	93.07	220.48	29.7	70.3
1963	342.25	27.8	78.92	263.33	23.1	76.9
1964	399.54	27.5	100.81	298.73	25.2	74.8
1965	473.32	27.6	156.07	317.25	33.0	67.0
1966	558.71	29.9	196.49	362.22	35.2	64.8
1967	419.36	23.6	132.44	286.92	31.6	68.4
1968	361.25	21.0	107.11	254.14	29.6	70.4
1969	526.76	27.2	171.10	355.66	32.5	67.5
1970	662.90	29.4	182.95	479.95	27.6	72.4
1971	744.73	30.7	119.36	625.37	16.0	84.0
1972	766.56	30.4	105.81	660.75	13.8	86.2
1973	809.67	29.8	119.86	689.81	14.8	85.2
1974	783.14	28.1	134.77	648.37	17.2	82.8
1975	815.61	27.2	96.63	718.98	11.8	88.2
1976	776.58	26.4	98.91	677.67	12.7	87.3
1977	874.46	27.3	113.85	760.61	13.0	87.0
1978	1,132.26	31.2	175.77	956.49	15.5	84.5
1979	1,146.38	28.4	231.34	915.04	20.2	79.8
1980	1,159.93	25.7	284.45	875.48	24.5	75.5
1981	1,175.79	24.2	311.07	864.72	26.5	73.5
1982	1,212.33	22.9	346.84	865.49	28.6	71.4
1983	1,366.95	23.0	490.01	876.94	35.8	64.2
1984	1,642.86	22.9	665.47	977.39	40.5	59.5
1985	2,004.82	22.4	769.63	1,235.19	38.4	61.6
1986	2,122.01	20.8	778.42	1,343.59	36.7	63.3
1987	2,199.35	18.4	736.29	1,463.06	33.5	66.5
1988	2,357.24	15.8	774.76	1,582.48	32.9	67.1
1989	2,664.90	15.8	822.52	1,842.38	30.9	69.1
1990	2,937.10	15.8	992.42	1,944.68	33.8	66.2
1991	3,149.48	14.6	938.25	2,211.23	29.8	70.2
1992	3,483.37	13.1	979.51	2,503.86	28.1	71.9
1993	4,348.95	12.6	957.51	3,391.44	22.0	78.0
1994	5,218.10	11.2	2,906.50	2,311.60	55.7	44.3
1995	6,242.20	10.7	3,256.62	2,985.58	52.2	47.8
1996	7,407.99	10.9	3,661.07	3,746.92	49.4	50.6
1997	8,651.14	11.6	4,226.92	4,424.22	48.9	51.1
1998	9,875.95	12.6	4,892.00	4,983.95	49.5	50.5
1999	11,444.08	13.9	5,849.21	5,594.87	51.1	48.9
2000	13,395.23	15.0	6,989.17	6,406.06	52.2	47.8

Notes:

1. The revenue of the central and local governments refers to revenue actually collected by them.
2. Revenue in this table does not include revenue from domestic and foreign borrowings.

Source: *China Statistical Yearbook 2001.*

Appendix 5. Tax Structure in the People's Republic of China



[a] Taxes collected only by the central Government. [b] Taxes collected only by local governments.
[c] Taxes shared by the central and local governments.
Note: Heritage tax, oil petroleum consumption tax, and securities trading/transaction tax are not yet authorized by law to be levied.

Appendix 6. Total Expenditure and Share of Central and Local Governments

Year	Total Expenditure (CNY100 million)			Ratio (%)	
	Total	Central Government	Local Governments	Central Government	Local Governments
1953	219.21	162.05	57.16	73.9	26.1
1954	244.11	183.70	60.41	75.3	24.7
1955	262.73	201.05	61.68	76.5	23.5
1956	298.52	210.02	88.50	70.4	29.6
1957	295.95	210.03	85.92	71.0	29.0
1958	400.36	177.22	223.14	44.3	55.7
1959	543.17	249.34	293.83	45.9	54.1
1960	643.68	278.63	365.05	43.3	56.7
1961	356.09	160.32	195.77	45.0	55.0
1962	294.88	181.64	113.24	61.6	38.4
1963	332.05	192.31	139.74	57.9	42.1
1964	393.79	224.86	168.93	57.1	42.9
1965	459.97	284.17	175.80	61.8	38.2
1966	537.65	339.11	198.54	63.1	36.9
1967	439.84	269.94	169.90	61.4	38.6
1968	357.84	219.49	138.35	61.3	38.7
1969	525.86	319.16	206.70	60.7	39.3
1970	649.41	382.37	267.04	58.9	41.1
1971	732.17	435.67	296.50	59.5	40.5
1972	765.86	431.40	334.46	56.3	43.7
1973	808.78	449.33	359.45	55.6	44.4
1974	790.25	397.84	392.41	50.3	49.7
1975	820.88	409.40	411.48	49.9	50.1
1976	806.20	377.63	428.57	46.8	53.2
1977	843.53	393.70	449.83	46.7	53.3
1978	1,122.09	532.12	589.97	47.4	52.6
1979	1,281.79	655.08	626.71	51.1	48.9
1980	1,228.83	666.81	562.02	54.3	45.7
1981	1,138.41	625.65	512.76	55.0	45.0
1982	1,229.98	651.81	578.17	53.0	47.0
1983	1,409.52	759.60	649.92	53.9	46.1
1984	1,701.02	893.33	807.69	52.5	47.5
1985	2,004.25	795.25	1,209.00	39.7	60.3
1986	2,204.91	836.36	1,368.55	37.9	62.1
1987	2,262.18	845.63	1,416.55	37.4	62.6
1988	2,491.21	845.04	1,646.17	33.9	66.1
1989	2,823.78	888.77	1,935.01	31.5	68.5
1990	3,083.59	1,004.47	2,079.12	32.6	67.4
1991	3,386.62	1,090.81	2,295.81	32.2	67.8
1992	3,742.20	1,170.44	2,571.76	31.3	68.7
1993	4,642.30	1,312.06	3,330.24	28.3	71.7
1994	5,792.62	1,754.43	4,038.19	30.3	69.7
1995	6,823.72	1,995.39	4,828.33	29.2	70.8
1996	7,937.55	2,151.27	5,786.28	27.1	72.9
1997	9,233.56	2,532.50	6,701.06	27.4	72.6
1998	10,798.18	3,125.60	7,672.58	28.9	71.1
1999	13,187.67	4,152.33	9,035.34	31.5	68.5
2000	15,886.50	5,519.85	10,366.65	34.7	65.3

Notes:

1. The expenditure of the central and local governments refers to expenditure actually collected by them. 2. Expenditure in this table does not include the payment of the principal and interest of domestic and foreign debts and the expenditure for capital construction using foreign loans.

Source: *China Statistical Yearbook 2001.*

India

Hemanta K. Pradhan
Professor of Finance and Economics
Xavier Labour Relations Institute
Jamshedpur

Acronyms

ADB	Asian Development Bank
AMC	Ahmadabad Municipal Corporation
CARE	Credit Analysis and Research Ltd.
Crisil	Credit Rating Information Services of India Ltd.
GDP	gross domestic product
HDFC	Housing Development Finance Corporation Ltd.
HUDCO	Housing and Urban Development Corporation Ltd.
ICICI	Industrial Credit and Investment Corporation of India Ltd.
ICRA	Investment Information and Credit Rating Agency of India Ltd.
IDFC	Infrastructure Development Finance Company
IL&FS	Infrastructure Leasing and Financial Services Ltd.
LIC	Life Insurance Corporation of India
NSE	National Stock Exchange of India Ltd.
O&M	operation and maintenance
PRC	People's Republic of China
RBI	Reserve Bank of India
Re/Rs	Indian rupee/s
SBI	State Bank of India
SEBI	Securities and Exchange Board of India
SFC	state finance commission
SPV	special-purpose vehicle
TNUDF	Tamil Nadu Urban Development Fund
ULB	urban local body
US	United States
USAID	United States Agency for International Development

Executive Summary

This chapter analyzes the fiscal and financial situations of local governments in India, and identifies areas of policy reform and technical assistance, focusing on developing local bond markets to facilitate subnational borrowing, and on reforming regulatory and institutional regimes. Local governments include the states and, more important, major urban bodies such as municipal corporations.

Sociopolitical developments during the last decade have significant implications for the powers and functions of local governments. Decentralization and improvement of local governance have been supported by (i) the 74th Constitutional Amendment Act (Decentralization Act) of 1992; (ii) the New Economic Policy pursued following the 1991 macroeconomic crisis; (iii) financial sector reforms, gradually introduced over the 1990s, to develop domestic bond markets; (iv) trends in urbanization; and (v) the emergence of regional political parties forming state governments and participating in central government coalitions.

The states and local bodies play a crucial role in delivery of social and economic services (public health, education, housing, and urban development), and in provision of infrastructure (power, irrigation, and transport). States and local bodies are responsible for implementing central government policies and programs, including those to reduce poverty and provide social security. The fiscal and financial situation of the state and local governments, therefore, is important for economic development in general and for subnational financial market development in particular.

The focus on decentralization and urban governance is an offshoot of the growing urban population and concentration of major economic activities in the cities. Urban centers have widely diverse economic structures. The larger urban areas have, in general, stronger institutional arrangements than smaller cities, and a better resource base as well as infrastructure. The large cities have attracted most of the emerging business and economic activity during the last decade of liberalization. The smaller towns have extremely limited financial and human resources and suffer lagging growth. Significant capacity building is needed to augment the fiscal capacity of local governments to make them self-reliant and able to directly access municipal bond markets to fund infrastructure.

The 74th amendment envisaged empowering urban local bodies (ULBs) functionally and financially to take on emerging social and economic development responsibilities without depending on higher levels of government. The 12th schedule of the Constitution directs state governments to decide the powers and functions to be devolved to their local bodies. Since the functions delegated to ULBs are concurrent, state governments act simultaneously within the framework of local bodies. Functions of states, state government departments, and local bodies must be clearly and permanently demarcated through legislation. Increased functional responsibility should be matched with increased revenue-raising powers.

Wide differences exist among ULBs in tax jurisdiction, degree of control exercised by state governments in fixing the tax base, tax rates and tax exemptions, and how efficiently taxes are administered and enforced. The revenue gap is widening in most ULBs due to low revenue generation, increasing expenditure, shrinking budgetary grants, and inefficient financial management.

Transparency in expenditure assignment and tax devolution is a prerequisite for decentralization. The mandate given to state finance commissions to devolve taxes from the state divisible pool to ULBs needs to be exercised in a rational and time-bound manner. Resource devolution mechanisms must take into account the regional pattern of growth and should be based on up-to-date information. Uniformity of ULB functions should be ensured, at least within a state. Central-level interventions may be needed to compel state governments to surrender their expenditure responsibilities to local bodies.

States are significant in providing basic economic and social services and ensuring an environment conducive to high levels of investment. The financial health of state governments, devolution of resources from states to local bodies, and provision of guarantees are important in state-local fiscal relations. The structural adjustment program pursued since the 1990s emphasizes mostly the restructuring of central government finances, until recently ignoring states' fiscal health. State finances have been deteriorating as demands on basic infrastructure and services increased, following reforms and the definition of new responsibilities emerging from decentralization.

States should provide an environment conducive to resource mobilization, build the foundation for high economic growth, and provide resources to improve social indicators of development. The emerging policy imperatives should focus on (i) public expenditure management; (ii) tax policy and administration; (iii) rightsizing the civil service and government; (iv) public enterprise reforms and private sector participation; (vi) financial management and accountability of their departments; and (vii) fiscal transparency, dealing with fiscal information at the state level as well as transparent intergovernmental fiscal relations. In recent years, several states have begun introducing medium-term structural financial reforms with assistance from multilateral organizations.

Apprehension is growing that guarantees issued by state governments to their local bodies and state-level enterprises might worsen state governments' fiscal problems. The guarantees also have a macroeconomic dimension: guaranteed debts of the state could become part of the public sector debt. Credit-rating agencies have shown increasing concern about these guarantees, and recent rating downgrades affect the borrowing programs of the states and local bodies. Guarantees given by financial institutions without risk assessment also increase the risk of moral hazard and adverse selection for the financial system. The guarantee system needs to be phased out gradually, by allowing ULBs to access bonds directly without such guarantees, particularly for commercially viable projects.

Provision of urban infrastructure and services will greatly determine growth and productivity. Investment of the scale and size required cannot be met from budgetary resources and will need multiple sources of financing, mainly financial markets and external sources. The contribution of financial markets to creating infrastructure, and particularly bond markets, has been impressive, and the trends and initiatives, especially in the urban sector, show great potential. The few enablers toward this are the increasing number of credit-rated ULBs, issuance of bonds by a few municipalities, and private-public participation of urban service delivery in a few states.

The financial sector should become an important provider of capital to the urban sector, with a risk mitigation mechanism in place. A policy framework with complementary arrangements between central and local governments is needed, supported by an enabling regulatory and institutional framework and multilateral assistance. Equally critical is the need to strengthen local institutional capacity to manage urban growth and development.

In many ways, financial sector reforms since the early 1990s have changed the operating environment of financial intermediaries. Resource mobilization by the corporate sector and development finance institutions from the capital markets and, most importantly, from the bond markets has substantially increased. The banking sector continues to be the primary financial intermediary. However, ULBs have little commercial relationship with the banking system; growth in bank lending for infrastructure, particularly urban infrastructure, has been low.

Recently, commercial banks have begun to participate in urban finance through innovative mechanisms such as “take-out” financing or cofinancing. Development finance institutions and specialized financial institutions set up specifically for infrastructure development have been able to raise substantial capital by issuing tax-exempt bonds and lending them for infrastructure projects. Contractual savings institutions also are best suited to finance infrastructure as their liabilities are long term.

The role of financial institutions needs to be enhanced as urban sectors are important in the national economy. Domestic financial institutions have contributed significantly to corporate sector resource mobilization, and, with a risk-mitigating mechanism in place, their contribution to the urban sector may increase as well. Their involvement in local government financing will enhance the confidence of domestic and foreign investors, and of multilateral development banks.

Private sector participation and commercialization of urban infrastructure is recent. The urban sector is highly suitable for private-public partnerships and commercialization in various forms such as build-operate-transfer contracts. Support from state governments in the form of equity participation, land or water supply concessions, dedicated revenue streams for loan repayments, and transparent regulatory frameworks has been encouraging. The thrust has to be on capacity to generate cash flow rather than government subsidies and guarantees. State laws should be deregulated, processing time for clearances reduced, and an independent regulator for tariff setting established.

Fiscal incentives in the form of tax exemption and deduction have been in vogue for several years for infrastructure investments. The definition of infrastructure has been expanded to include urban infrastructure, making it eligible for tax incentives. Income tax exemptions for interest, dividends, and capital gains have attracted primary investors to local infrastructure bonds.

The securities markets have witnessed significant growth and change during the last decade, emerging as the major provider of investment capital. The potential for local bond market development is substantial due to the large urban population and promotion of urban infrastructure development in policy. Cities need long-term capital for investment to create institutional and supporting mechanisms to develop an active local bond market, make local securities attractive, and reduce transaction costs and risks for investors.

Market participants also need other economic benefits such as liquidity, legal protection of investments, protection of return on investments, and a supportive subnational socioeconomic environment. Investors in subnational securities benefit as much from a fair and transparent market structure as do investors in national securities. Securities regulations are not designed in segments but should be viewed as part of an overall system existing alongside and complemented by established national systems of regulations.

An enabling environment includes a broad issuers' and investors' base; institutional infrastructure such as credit rating; market intermediaries such as underwriters, merchant bankers, and trustees; regulations with defined and enforceable debt contracts; protection of issuers' rights in the event of default; and an efficient judiciary overseeing the enforcement of investors' rights. Capacity building is needed to identify and structure credit enhancement mechanisms within a well-defined borrowing framework. Funding agencies should help develop more such pilot projects for municipal bond issuance, in collaboration with rating agencies, merchant bankers, regulatory agencies, and stock exchanges.

The experience of urban infrastructure financing and municipal bond issuance has lessons for local financing. The Tamil Nadu Urban Development Fund (TNUDF), and its success, should be replicated in other states. It provides technical assistance to build ULB capacity in project preparation and financial management. Built on the success of TNUDF, a pooled financing arrangement has been completed in the state of Tamil Nadu. The arrangement is promoted by the United States Agency for International Development, in collaboration with TNUDF, to cater to the financing needs of smaller municipalities, and to provide guarantees to lengthen municipal bond tenors and improve the pricing factor.

Institutional capability of ULBs has been weakened considerably due to withdrawal of their functions and powers and consequent shrinkage of the local resource base and fiscal capabilities. The problem stems mainly from the structure and functions of ULBs, their poor operation and financial management, inadequate revenue base, and inefficient collection. Significant capacity building is needed to augment the fiscal capability of local governments to access municipal bond markets. An awareness campaign is needed to make people understand the potential of private capital market access and, particularly, bond market access.

This chapter tackles issues of significant interest to the Asian Development Bank (ADB) in implementing its local lending programs in India, particularly in promoting local government financing and bond financing. ADB could do the following:

- Help achieve decentralization by improving the efficiency of local governments, such as states and ULBs, in delivering core services.
- Help make state and city governments' fiscal systems efficient and sustainable.
- Strengthen the role of the private sector in providing basic urban services by changing the legal and regulatory frameworks and supporting an enabling environment.
- Deepen the nascent bond market and spread its coverage to cities throughout India by providing access to the thousands of ULBs in need of funds for long-term investments.
- Strengthen the links and build synergies among stakeholders, such as state and central governments, private sector service providers, and financial institutions, some of which have not funded local governments, to float bonds for urban finance projects.
- Bring in international best practices that have been successful in many decentralized setups and facilitate innovative schemes for urban financing.

The proposed activities could be adapted by progressive and reform-minded states as well as those with great potential for reform and decentralization. Although the former are expected to be the main beneficiaries of any new initiative, the latter can be brought into dialogue with central and state governments, financial institutions, regulatory agencies, and funding agencies to equitably realize the benefits of decentralization and capital market access.

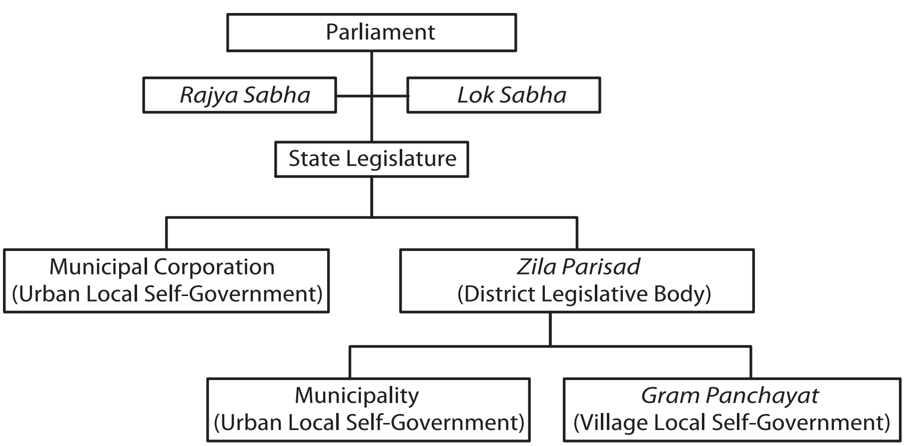
Introduction

India is a federation of 28 states and seven union territories.[1] Its population, 1.03 billion as of 2001, is next only to that of the People's Republic of China (PRC). With a gross domestic product (GDP) of $2,200 billion based on purchasing power parity, India is the fourth largest economy in the world, after the United States (US), PRC, and Japan. The states and union territories differ vastly in natural resource endowment, development capacity, and economic performance. India is a nation of enormous ethnic, linguistic, and cultural diversity.

The federation comprises a three-tier structure, with the central Government at the top, states and union territories in the second tier, and local self-governments—both urban and rural—in the third tier (Figure 1). The states remain important in all matters of national polity and economy in what has been called "cooperative federalism."

Although local governments are recognized and protected by the Constitution, states have de facto legislative powers over them. State governments are crucial to the provision of social and economic services (public health, education, housing, and urban development), and infrastructure (power, irrigation, and transport). The states are also responsible for executing central government policies and programs, including those to reduce poverty and provide social security. The mandates to the states are derived from the Indian Constitution to frame the necessary statutes, which vest the necessary controlling and supervisory powers with the state governments on their local bodies.

Figure 1. Political Governance in India



Forces Shaping Decentralization

The 1990s saw significant progress in local governance and decentralization. Factors that have furthered local governance include (i) the 74th Constitutional Amendment Act (Decentralization Act) in 1992; (ii) the New Economic Policy, pursued since the 1991 macroeconomic crisis; (iii) the financial sector reform program since the 1990s, to develop domestic bond markets; (iv) increasing trends in urbanization; and (v) the emergence of regional political parties forming state governments.

Institutional capacity of ULBs weakened considerably over the years due to the withdrawal of their functions and powers, which shrank the local resource base and ULBs' fiscal capability. The 74th Constitutional Amendment made a revolutionary change in ULBs' powers and functions by demarcating local government functions and financial powers, thus providing for the first time a legal basis to exercise them. ULBs became distinct from state governments, just as states are distinct from the central Government. The amendment provided for: (i) holding of regular elections, under the supervision of the state election commissions; (ii) protection against arbitrary dissolution of local elected bodies by higher levels of government; (iii) constitution of ward committees, ensuring greater proximity to citizens; (iv) gradual transfer of powers and authority of state legislatures to ULBs so that they function as institutions of self-government; (v) clear demarcation of ULBs' responsibilities under the 12th schedule of the Constitution; and (vi) formation of state finance commissions (SFCs), in line with the Central Finance Commission, to identify avenues for municipal finance and recommend criteria to devolve resources from states to local bodies. These provisions, although not fully implemented, provided functional and financial autonomy within the framework of a democratic government structure, and made local governments directly accountable to their citizens.

In many ways, the economic reform program pursued in the 1990s intensified the forces of decentralization. Fiscal reform measures at the center put considerable pressure on state government finances by reducing grants, subsidies, loans, and other forms of transfers to the states. At the same time, an expanding urban population has increased demands on city governments to provide infrastructure and civic amenities. Cities and towns were to perform a key role in economic growth and productivity and create an environment conducive to private investment. Decentralization, along with privatization, made local governments not only more responsive to their citizens but also to private sector demands as well, requiring amendment of regulations for private sector participation.

Financial sector reform has been gradually reducing the directed credit component of financial institutions. Most states have weak capacity to recover the costs of services from user charges. To mobilize substantial investment in infrastructure and services, local governments have to seek new sources of funding, including private sector participation in service delivery. These developments have intensified the need to access private capital markets, thereby giving impetus to raise local resources and issue bonds. The emergence of regional parties forming state governments, and the parties' presence at the center in successive coalition governments, have led to a shift of power—political and financial—to the states. These regional parties no doubt have brought greater autonomy to the states.

Urbanization

The focus on decentralization and urban governance is an offshoot of the increasing urban population and concentration of major activities in cities (Table 1). The 2001 census shows that of the total population of 1.03 billion, 285.4 million or 27.8% live in urban areas. In 1991–2001, the total population increased by 21.3%, and the urban population, by 31.2%. The Planning Commission on Urban Perspectives and Policies had projected the urban population at 38% of the total population by 2006/07. The increase in urban population has been due to natural population increase, reclassification of new towns, and rural-urban migration.

Table 1. Trends in Urbanization

Year	Urban Population (million)	Urban Population to Total Population (%)	Growth over Previous Decade (%)	Contribution of Urban Sector to GDP (%)
1981	159.5	23.3	46.1	47.0
1991	217.6	25.7	36.4	55.0
2001	285.4	27.8	31.2	60.0

GDP = gross domestic product.
Source: http://urbanindia.nic.in.

The level of urbanization is widely diverse across states. As of 2001, India had 4,378 towns and cities, with 393 class-I towns with a population of 100,000 or more (Table 2). Thirty-five towns or urban agglomerations have a population of over 1 million and account for about 37% of the total urban population (Table 3).

The National Capital Territory of Delhi is the most urbanized all the states and union territories, with 93% of its population living in urban areas. Tamil Nadu is the most urbanized state, with the urban population making up 43.9% of the total population, followed by Maharashtra (42.4%) and Gujarat (37.4%). The proportion of the urban population is the lowest in Himachal Pradesh (9.8%), followed by Bihar (10.5%), Assam (12.7%), and Orissa (14.9%).

Table 2. Towns or Urban Agglomerations by Class

Class	Population Size	Number
Class I	100,000 and above	393
Class II	50,000–99,999	401
Class III	20,000–49,999	1,151
Class IV	10,000–19,999	1,344
Class V	5,000–9,999	888
Class VI	Less than 5,000	191
Unclassified		10
All Classes		4,378

Source: http://urbanindia.nic.in.

Table 3. Cities with a Population of Over 1 Million, 2001

Rank	City	Population	Rank	City	Population
1	Greater Mumbai	16,368,084	19	Ludhiana	1,395,053
2	Kolkata	13,216,546	20	Kochi	1,355,406
3	Delhi	12,791,458	21	Visakhapatnam	1,329,472
4	Chennai	6,424,624	22	Agra	1,321,410
5	Bangalore	5,686,844	23	Varanasi	1,211,749
6	Hyderabad	5,533,640	24	Madurai	1,194,665
7	Ahmadabad	4,519,278	25	Meerut	1,167,399
8	Pune	3,755,525	26	Nashik	1,152,048
9	Surat	2,811,466	27	Jabalpur	1,117,200
10	Kanpur	2,690,486	28	Jamshedpur	1,101,804
11	Jaipur	2,324,319	29	Asansol	1,090,171
12	Lucknow	2,266,933	30	Dhanbad	1,064,357
13	Nagpur	2,122,965	31	Faridabad	1,054,981
14	Patna	1,707,429	32	Allahabad	1,049,579
15	Indore	1,639,044	33	Amritsar	1,011,327
16	Vadodara	1,492,398	34	Vijayawada	1,011,152
17	Bhopal	1,454,830	35	Rajkot	1,002,160
18	Coimbatore	1,446,034	**Total**		**107,881,836**

Source: Office of the Registrar General, New Delhi. *Census of India 2001.*

India has 3,682 ULBs, whose size, structure, and economic conditions vary so significantly that they are classified as (i) municipal corporations for larger urban areas, (ii) municipalities for smaller urban areas, and (iii) *nagar panchayats* for the rural-urban transition areas. "Others" includes smaller ULBs such as *nagar panchayats*, town *panchayats*, notified area committees, municipal councils, town area committees, city and town municipal councils, town committees, notified area councils, municipal boards, and notified area authorities (Table 4).

Urban centers are widely diverse in economic structure. The larger ones have generally stronger institutional arrangements, and a better resource base as well as

Table 4. Structure of Urban Bodies

State	Municipal Corporations	Municipalities	Others	Total
Andhra Pradesh	7	94	15	116
Arunachal Pradesh	—	—	—	—
Assam	1	28	50	79
Bihar	6	70	94	170
Goa		14		14
Gujarat	6	85	58	149
Haryana	1	81		82
Himachal Pradesh	1	19	28	48
Jammu and Kashmir		2	67	69
Karnataka	6	121	88	215
Kerala	3	55		58
Madhya Pradesh	18	103	283	404
Maharashtra	15	229		244
Manipur	7		21	28
Meghalaya		6	—	6
Mizoram	2	4	—	6
Nagaland	—	—	9	9
Orissa	2	30	70	102
Punjab	4	96	37	137
Rajasthan	3	11	169	183
Sikkim	—	—	—	—
Tamil Nadu	6	102	636	744
Tripura		1	12	13
Uttar Pradesh	11	226	447	684
West Bengal	6	112	4	122
Total	**96**	**1,494**	**2,092**	**3,682**

— = data not available.

Source: Ministry of Finance. 2000. *Report of the Eleventh Finance Commission.*

infrastructure. The larger cities have attracted most of the emerging business and economic activity during the last decade of liberalization. Some have the capacity to access capital markets from domestic as well as international sources. However, the smaller towns, with their limited financial and human resources and slow growth, cannot undertake the responsibilities outlined in the 74th Constitutional Amendment. Significant capacity building is needed to augment the fiscal capability of local governments to access municipal bond markets.

Provision of urban infrastructure and services will greatly determine growth and productivity. Deficient infrastructure and services will affect the quality of urban life and the environment, resulting in the proliferation of slums, shortage of water supply and sanitation facilities, and poor waste management. The urban housing shortage in 2001 was estimated at 41 million dwelling units. An average of 20%

of urban households do not have access to safe drinking water, and 50% of the population has no sanitation facilities.

Local Government Powers and Functions: Expenditure Assignment

The 12th schedule of the Constitution provides for 18 functions to be undertaken by ULBs:

1. urban planning, including town planning;
2. regulation of land-use and construction of buildings;
3. planning for economic and social development;
4. provision of roads and bridges;
5. provision of water supply for domestic, industrial, and commercial purposes;
6. provision of public health, sanitation conservancy, and solid waste management;
7. provision of fire services;
8. promotion of urban forestry, protection of the environment, and promotion of ecology;
9. safeguarding of the interests of weaker sections of society, including the handicapped and mentally retarded;
10. slum improvement and upgrading;
11. urban poverty reduction;
12. provision of urban amenities and facilities such as parks, gardens, and playgrounds;
13. promotion of culture, education, and aesthetics;
14. provision of burials and burial grounds, and cremations, cremation grounds, and electric crematoriums;
15. provision of cattle pounds, and prevention of cruelty to animals;
16. recording of vital statistics including registration of births and deaths;
17. provision of public amenities including street lighting, parking lots, bus stops, and public conveniences; and
18. regulation of slaughterhouses and tanneries.

While not mandatory, the provisions direct state governments to decide the powers and functions to be devolved to local bodies. Except for Kerala, West Bengal, Tamil Nadu, and Maharashtra, states have made few changes in the municipal laws. Table 5 presents the implementation status of the functions in 13 states.

The functional domain has been variable, depending on the discretion of the

Table 5. Status of the Functions as per the 74th Constitutional Amendment

State\Function	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Andhra Pradesh	N	N	N	Y	N	Y	N	Y	Y	N	N	Y	N	Y	N	Y	N	Y
Gujarat	N	N	N	Y	Y	Y	Y	Y	Y	N	N	Y	Y	Y	Y	Y	Y	Y
Haryana	N	N	N	Y	Y	Y	Y	N	N	Y	N	Y	N	Y	Y	Y	Y	Y
Himachal Pradesh	N	N	N	Y	Y	Y	Y	N	N	N	N	Y	N	Y	Y	N	Y	N
Karnataka	Y	Y	N	Y	Y	Y	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Kerala	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Madhya Pradesh	Y	Y	Y	Y	Y	Y	Y	Y	Y	N	Y	Y	N	Y	Y	Y	Y	Y
Maharashtra	N	N	N	Y	Y	Y	Y	N	N	N	Y	N	Y	Y	Y	Y	Y	Y
Rajasthan	N	N	N	Y	Y	Y	Y	N	N	N	Y	N	Y	Y	Y	Y	Y	Y
Tamil Nadu	Y	Y	Y	Y	Y	Y	Y	Y	N	N	N	N	N	Y	Y	Y	Y	Y
Uttar Pradesh	Y	N	N	N	Y	Y	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
West Bengal	Y	Y	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Delhi	N	N	Y	N	N	Y	N	N	N	N	N	Y	N	Y	Y	Y	Y	Y

N = function not assigned to municipalities by the state government, Y = function assigned to municipalities by the state government.

Note: See previous page for description of functions.

Source: National Commission to Review the Working of the Constitution. 2001.

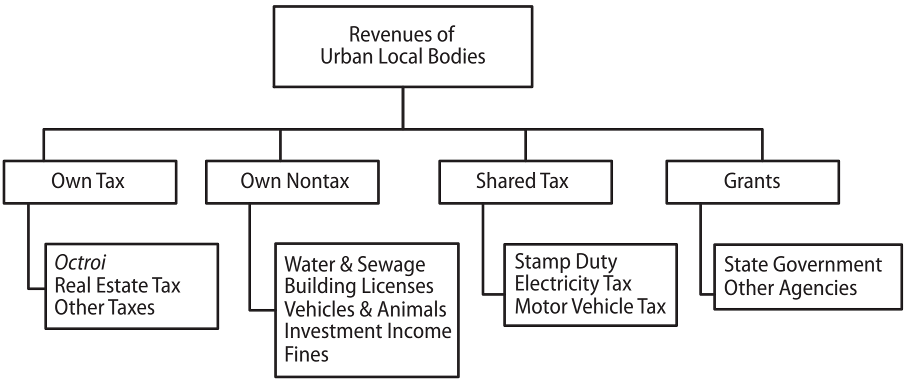
state government. Since the functions delegated to ULBs are concurrent, state governments act simultaneously within the framework of municipal functions. For example, functions such as primary education and health have been taken over by state government departments, and functions such as water supply and sewerage, housing, and land development have often been returned to state corporations and housing boards. In many cases, state governments and their parastatal bodies develop new infrastructure, which is then transferred to municipal bodies for operation and maintenance (O&M).

The 74th amendment envisaged empowering ULBs functionally and financially to undertake social and economic development responsibilities without depending on higher-level governments. Legislation should demarcate functions of the state, state government departments, and local bodies, and ensure that higher levels of government do not withdraw these functions.

Resource Base of Urban Local Bodies

The Constitution specifies the taxes to be divided between the central and state governments (chapter 1, part 12). Although the 74th amendment is not specific about the type of taxes ULBs should have, state government ULB statutes define the sources of tax revenue and methods of their mobilization, and SFCs define the functions and devolution mechanisms. The resource base of ULBs consists of their tax and nontax revenues, shared taxes, grants, and loans from state government, and market borrowings (Figure 2).

Figure 2. Resource Base of Urban Local Bodies in India



The database on ULBs' resource structure is not available in detail. The broad national trend of aggregate data from the *Report of the Eleventh Finance Commission* is provided here. Table 6 presents the share of revenue and expenditure, and the revenue-expenditure ratio at three levels of ULBs during 1990/91 to 1997/98, allowing for a comparison of local revenue and expenditure trends before and after the 74^{th} amendment. Appendix Tables A1.1–A1.5 present more data on selected ULBs in different states, as well as state-level data.

In 1997/98, the aggregate revenue of ULBs was Rs80.9 billion. Tax revenue accounted for over 50% of total revenue raised by municipal corporations. The most important sources of ULB taxes are the property tax and *octroi* (a levy on goods brought into the city). Although property values have gone up several times, the property tax has been near stagnant due to complicated valuation procedures, legal disputes, and ceilings imposed on rents, etc. Only the finance commissions of Tamil Nadu and Uttar Pradesh have rationalized property tax procedures.

Table 6 shows that user charges (own nontax revenues) are the lowest for all urban areas. States, which have started commercialization of, and private sector participation in, basic services with regulatory reforms, have generated higher revenue. Andhra Pradesh has successfully introduced user charges such as the betterment levy, impact fees, and valorization charges. Some municipalities have even leased out roads and bridges to the private sector under special schemes.

The broad pattern of aggregate expenditure shows that about two thirds was

Table 6. All-India Revenue and Expenditure of Local Bodies (%)

Category	Item	1990/91	1992/93	1994/95	1995/96	1996/97	1997/98
All Urban Local Bodies							
Revenue	Own Tax	49.22	51.12	50.74	51.01	49.40	48.38
	Own Nontax	20.38	18.55	17.13	17.00	16.92	17.47
	Other Revenue	30.40	30.34	26.83	26.84	28.86	29.63
Expenditure	Core Services	40.94	31.55	29.57	33.45	54.77	66.90
	Other	59.06	68.45	70.43	66.55	45.23	33.10
Revenue/Expenditure		16.11	20.59	18.81	18.52	13.03	8.05
Municipal Corporations							
Revenue	Tax Revenue	53.67	55.46	53.93	54.08	53.13	52.50
	Nontax Revenue	22.05	20.05	17.76	17.95	17.87	18.82
	Other Revenue	24.29	24.48	20.52	20.16	21.75	21.86
Expenditure	Core Services	47.23	32.49	29.81	36.00	60.59	74.49
	Other	52.77	67.51	70.19	64.00	39.41	25.51
Revenue/Expenditure		14.16	19.66	16.09	16.18	10.44	6.20
Municipalities							
Revenue	Own Tax	42.66	44.30	44.96	48.06	40.18	43.83
	Own Nontax	17.26	15.81	15.97	15.00	13.38	15.02
	Other Revenue	40.09	39.88	39.08	36.94	36.29	41.15
Expenditure	Core Services	22.00	28.59	27.67	24.36	24.95	17.75
	Other	78.00	71.41	72.33	75.64	75.05	82.25
Revenue/Expenditure		18.70	19.71	26.17	22.30	22.42	16.44
Nagar Panchayats							
Revenue	Own Tax	32.43	33.51	38.49	30.77	29.13	25.73
	Own Nontax	17.41	14.30	14.71	15.77	15.59	13.85
	Other Revenue	50.16	52.19	46.80	53.46	55.28	60.42
Expenditure	Core Services	48.28	48.50	48.04	49.45	49.83	51.62
	Other	51.72	51.50	51.96	50.55	50.17	48.38
Revenue/Expenditure		101.36	94.79	95.09	98.58	86.98	96.56

Source: Ministry of Finance. 2000. *Report of the Eleventh Finance Commission.*

spent on core services (water supply, sanitation, street lighting, roads, burials, and burial grounds) and the balance on noncore services, including general administration. Municipalities' per capita aggregate expenditure is increasing while per capita revenue receipts are, but not as much, thus widening the resource gap (Appendix Tables A1.4 and A1.5). Revenues as a proportion of expenditures are higher for smaller urban areas such as *nagar panchayats*, and revenues as a proportion of expenditures for municipalities are higher than for municipal corporations. This does not imply self-sufficiency, however, but the inability of smaller urban areas to expand their expenditure far beyond the revenue base.

The Tenth Five-Year Plan (2002–2007) envisages state and local governments as key in urban development:

Table 7. Revenue-Raising Powers of Corporations

Corporation	Own Taxes	Shared Taxes	Grants in Lieu of Tax
Hyderabad	Property, lighting, advertisement taxes	Tax on transfer of immovable property; profession or trade, and entertainment taxes	*Octroi*, vehicle and animal tax
Maharashtra and Gujarat (as per BPMC Act)	Property, vehicle and animal, theater, and water taxes; entry toll on vehicles/animals; *octroi*	Profession or trade, and entertainment taxes	
Karnataka	Property, advertisement, and lighting taxes; entry toll on vehicles/animals	Tax on transfer of immovable property; entertainment tax	*Octroi*, vehicle and animal tax
Ludhiana	Property, vehicle and animal, and advertisement taxes; *octroi*	Profession or trade, theater, and entertainment taxes	Tax on transfer of immovable property
Kolkata	Property and advertisement taxes; entry toll on vehicles and animals	Profession or trade tax	

BPMC Act = Bombay Provincial Municipal Act 1949.
Source: Credit Rating Information Services of India Ltd. 2001.

Urban governance today is characterized by fragmentation of responsibility, incomplete devolution of functions and funds to the elected bodies and ULBs, unwillingness to progress towards municipal autonomy, adherence to outmoded methods of property tax and reluctance to levy user charges. State governments continue to take decisions on such matters as rates of user charges, property tax, *octroi*, role of parastatals in water supply and sanitation services, etc., with little reference to the ULBs that are affected by these decisions. Far from strengthening the constitutional role of the elected ULBs, such developments only reinforce the perception that ULBs are subordinate entities under the day-to-day control of the state governments, beholden to them not only for the development of the cities but often for their very survival. There appears to be a lack of confidence that many of the ULBs are capable of meeting their obligations as institutions of local self-governance. In the present set up, initiatives for local development activities rarely come from the ULBs. Experience shows that functional autonomy becomes a reality only when it is accompanied by financial independence. State governments, therefore, need to strengthen the autonomous functioning of the ULBs through positive measures, and in particular, ensure their financial self-reliance (p.613).

The following are the major issues:

- The revenue gap is widening in most ULBs due to low revenue generation, enhanced expenditure responsibility, shrinking budgetary grants, and inefficient financial management.
- Wide differences exist among ULBs in tax jurisdiction and degree of control over fixing the tax base, rates, and exemptions, and in how efficiently taxes are administered and enforced.
- The expenditure function has to be linked to revenue-generating capacity. Central-level interventions are needed to make state governments surrender their expenditure responsibilities to local bodies, and make expenditure commensurate with the devolved revenues.
- Transparency in expenditure assignment and tax devolution is a prerequisite for decentralization. The mandate given to SFCs to devolve taxes from the state divisible pool to ULBs should be exercised in a rational and time-bound manner.
- The resource devolution mechanism should evolve, taking into account regional features, and should be based on up-to-date information. Uniformity of such functions among ULBs should be ensured, at least within a state.

Imbalances in State Government Finances

As second-tier entities in the federation, states are important in providing basic economic and social services, and ensuring an environment conducive to higher levels of investment. The financial health of state governments, devolution of resources from states to local bodies, and provision of guarantees are important in state-local fiscal relations.

Central and state government fiscal problems were the most important reasons for the 1991 macroeconomic crisis. The structural adjustment program of the 1990s and since has emphasized restructuring central government finances, until recently ignoring states' fiscal health. State finances have been deteriorating as demand for local infrastructure increased following economic reforms and new state responsibilities emerged from decentralization.

Table 8 presents the evolution of states' recent fiscal indicators. States' fiscal health has worsened considerably in recent years. Imbalances have emerged due to large revenue deficits, a rising debt service burden, very slow growth in nontax revenue, a rising share of nondevelopment expenditures, and increasing financial losses of state enterprises. The states' gross fiscal deficit remained consistently high over the 1990s, although a slight improvement has taken place during the last 2 years (4.6%

of GDP in 1999/2000, 3.8% in 2001/02). The revenue deficit accounted for over 50% of the gross fiscal deficit of the states in recent years. Interstate variation in fiscal performance is considerable (Appendix Table A1.6).

Table 8. Selected Fiscal Indicators of State Governments (%)

Item	1990–2000 (average)	1999/ 2000	2000/01	2001/02
Gross Fiscal Deficit/GDP	3.1	4.6	4.3	3.8
Primary Deficit/GDP	1.25	2.3	1.9	1.2
Revenue Deficit/GDP	1.17	2.7	2.4	2.0
Gross Fiscal Deficit /Total Expenditure (excluding recoveries)	21.4	30.7	27.7	25.2
Revenue Deficit/Revenue Expenditure	9.3	20.8	17.2	14.8
Conventional Deficit/Aggregate Disbursements	(0.1)	0.9	0.7	0.2
Revenue Deficit/Gross Fiscal Deficit	34.8	59.2	54.3	51.5
Nondevelopment Revenue Expenditure/ Revenue Receipts	39.6	50.9	48.7	50.4
Interest Payments/Revenue Receipts	16.5	21.9	21.7	22.8
Development Expenditure/GDP	10.2	9.5	10.2	9.3
Social Sector Expenditure/GDP	5.7	5.9	6.2	5.8
Nondevelopment Expenditure/GDP	4.6	5.6	5.6	5.8
States' Tax Revenue/GDP	5.3	5.2	5.5	5.8
States' Nontax Revenue/GDP	1.7	1.5	1.4	1.3

GDP = gross domestic product.
Note: Data cover 26 state governments and the national capital territory of Delhi.
Source: Reserve Bank of India.

States' market borrowings consist of bond issues through the Reserve Bank of India (RBI), loans from the central Government, loans drawn from small-savings schemes, and other financial institutions (Table 9). RBI extends short-term accommodation as methods advance to remedy any temporary mismatch between state government receipts and payments. Market borrowings constitute a tiny proportion of total deficit financing, most accounted for by loans from the central Government, and, most important, small-savings schemes, and loans from financial institutions such as insurance companies. Over 80% of net small-savings collections are available for investment in state government securities. State governments also borrow from state provident funds. Growing deficits over the years have resulted in a significant amount of debt, leading to a very high debt service ratio. Interest payments account for about a quarter of the revenue receipts for the states.

Table 9. Financing of State Governments' Gross Fiscal Deficits (Rs10 million)

Year	Loans from Central Government (net) (1)	Market Borrowings (net) (2)	Others[a] (3)	Gross Fiscal Deficit (1+2+3)	States' Outstanding Liabilities		Total Liabilities as % of GDP
					Total[b]	Market Loans	
1990/91	9,978	2,556	6,253	18,787	110,289	15,618	19.4
(%)	(53.1)	(13.6)	(33.3)	(100.0)			
1991/92	9,373	3,305	6,222	18,900	126,338	18,923	19.3
(%)	(49.6)	(17.5)	(32.9)	(100.0)			
1992/93	8,921	3,500	8,471	20,892	142,178	22,426	19.0
(%)	(42.7)	(16.8)	(40.5)	(100.0)			
1993/94	9,533	3,620	7,443	20,596	160,077	26,058	18.6
(%)	(46.3)	(17.6)	(36.1)	(100.0)			
1994/95	14,760	4,075	8,862	27,697	184,527	30,133	18.2
(%)	(53.3)	(14.7)	(32.0)	(100.0)			
1995/96	14,801	5,888	10,737	31,426	212,225	36,021	17.9
(%)	(47.1)	(18.7)	(34.2)	(100.0)			
1996/97	17,547	6,515	13,189	37,251	243,525	42,536	17.8
(%)	(47.1)	(17.5)	(35.4)	(100.0)			
1997/98	23,676	7,280	13,244	44,200	281,207	49,816	18.5
(%)	(53.6)	(16.5)	(30.0)	(100.0)			
1998/99	31,057	10,467	32,730	74,254	341,978	60,283	19.4
(%)	(41.8)	(14.1)	(44.1)	(100.0)			
1999/00	32,656	12,636	45,474	90,765	419,821	72,919	21.5
(%)	(36.0)	(13.9)	(50.1)	(100.0)			
2000/01	32,033	12,567	50,221	94,821	503,613	85,486	23.1
(%)	(33.8)	(13.3)	(53.0)	(100.0)			
2001/02	33,633	10,666	49,730	94,028	591,509	96,151	23.9
(%)	(35.8)	(11.3)	(52.9)	(100.0)			

GDP = gross domestic product.
[a] Includes loans from financial institutions, provident funds, reserve funds, deposits, and advances, etc.
[b] Includes internal debt, loans, and advances from the central Government and provident funds, etc.
Source: Reserve Bank of India.

Fiscal Reforms in Recent Years

States have to provide an environment for greater revenue generation and resource mobilization and thus build the foundation for higher economic growth, as well as provide greater resources for development. The emerging policy imperatives should focus on the following: (i) public expenditure management, (ii) tax policy and administration, (iii) rightsizing the civil service and government, (iv) public enterprise reforms and private sector participation, (vi) financial management and accountability of the state-level departments, and (vii) fiscal transparency (fiscal information at the state level as well as transparent intergovernmental fiscal relations).

In recent years, several states have begun to introduce medium-term financial structural reforms:

- Some states have begun to introduce expenditure management systems by setting up expenditure reform committees and identifying performance indicators to assess the quality of expenditure restructuring.
- States such as Karnataka and Andhra Pradesh have prepared a medium-term expenditure plan and placed the annual budget within it. For investments in infrastructure and social development, such a plan is seen to yield better results and ensure greater autonomy to state-level departments. RBI has been organizing conferences of state finance secretaries, thereby providing a forum for dialogue on state finance.
- Some states have comprehensively reviewed the functioning of state-level public sector enterprises and their restructuring.
- Gujarat and Karnataka have established specialized funds to encourage the private sector and financial institutions to develop infrastructure.
- Considering the enormous losses of the state electricity boards and the impact of such losses on state finances, some states have signed memorandums of understanding with the central Government to reform state power sectors and to set up state electricity regulatory commissions to determine electricity tariffs in 15 states.
- Following the recommendations of the Core Group on Voluntary Disclosure Norms for State Budgets (RBI 2001a) by the RBI, several states have begun disseminating comprehensive information on their finances, including information on guarantees, performance of state-owned enterprises, etc. The financial markets have started reacting to such financial disclosures and credit information.
- The recommendations of RBI's Technical Committee on State Government Guarantees, made in 1999, such as selectivity in the provision of guarantees, institution of ceilings, setting up guarantee redemption funds, etc., are being implemented at various stages. As a follow-up to the decisions taken in the conference of state finance secretaries held in May 2001, RBI constituted a group to examine fiscal risk under different types of guarantees issued by the states.
- Following the recommendations of the of the Eleventh Finance Commission, the central Government set up the Incentive Fund to encourage state-level fiscal reforms. Releases from the fund are based on a monitorable fiscal objective, thereby encouraging state governments to implement fiscal reforms.

State governments can enhance resource mobilization by making tax administration and compliance more efficient, increasing user charges from public utilities, and raising revenue from public sector divestiture programs and small savings. States' own-revenue generation from taxes has to be complemented by transfers through the policy recommendations of the Planning Commission as well as the Finance Commission, and by transfers from the center to the states for specified purposes and sponsored schemes.

Guarantees

State governments guarantee the borrowings of their local bodies and corporations. Outstanding guarantees extended by all state governments amounted to about 8% of GDP by the end of March 2001, or nearly twice the level of guarantees made by the central Government (Table 10). Gujarat, Maharashtra, Karnataka, Andhra Pradesh, and Tamil Nadu account for over 50% of total state guarantees, with sectors such as irrigation and power accounting for the largest proportion (Crisil 2002). State entities such as housing boards, urban development authorities, municipal corporations, state electricity boards, and state road transport corporations have all mobilized their borrowings and bond issues through such government guarantees, and various other forms of credit enhancements such as escrow accounts and pledging grants of higher levels of government.

Table 10. Outstanding Government Guarantees (Rs10 million)

Year	Central Government		State Governments		Total	
	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
1993	58,088	7.8	42,515	5.7	100,603	13.4
1994	62,834	7.3	48,866	5.7	111,700	13.0
1995	62,468	6.2	48,479	4.8	110,947	11.0
1996	65,573	5.5	52,631	4.4	118,204	9.6
1997	69,748	5.1	63,409	4.6	133,157	9.7
1998	73,877	4.9	73,751	4.8	147,628	9.7
1999	74,606	4.3	97,454	5.6	172,060	9.9
2000	83,954	4.4	132,029	6.8	215,983	11.2
2001	86,862	4.2	168,712	8.0	255,574	12.2

GDP = gross domestic product.
Source: Reserve Bank of India.

Although such guaranteed borrowings have financed investments in the states, the borrowings have also created significant fiscal risk for them. Apprehension is growing that such guarantees might subsequently devolve to the states, worsening state fiscal problems. Credit-rating agencies have shown increasing concern about these guarantees, and their rating downgrades are affecting states' borrowing programs and other undertakings. The guarantees could become part of the public debt.

Box 1. Press Reports on Bond Financing

Financial Institutions Move to Attach State Government Property

On 6 October 2002, Industrial Development Bank of India and Industrial Finance Corporation of India obtained a decree from the debt recovery tribunal to attach the property of the government of Maharashtra. The move followed failure of 19 state sugar cooperatives and spinning mills to repay their loans, guaranteed by the government. As the government failed to honor its commitment, the financial institutions approached the tribunal and obtained a decree.

Economic Times, 7 October 2002.

Credit Rating Information Services of India Downgrades State Government Rating

On 16 October 2002, the Credit Rating Information Services of India Ltd. (Crisil) downgraded the government of Maharashtra from "BB plus (so)" to "D (so)," signifying a default grade ('so' implying rating of structured obligations). The move followed a delay in meeting interest and principal obligations on bonds issued by the state government's special-purpose vehicle for irrigation. Maharashtra becomes the first state to be downgraded to a default grade.

Financial Express, 17 October 2002.

Guarantees extended by financial institutions without risk assessment increase the risk of moral hazard and adverse selection for the financial system. Management of state government debt levels and guarantees remains crucial to maintain financial and banking sector stability.

In 1999, RBI's Technical Committee on State Government Guarantees recommended eschewing such practices and providing credit enhancement only within an overall limit. Some states have introduced statutory and administrative ceilings on guarantees; some also charge a guarantee commission on the outstanding guaranteed amount (Table 11). Most public sector banks that had extended loans and subscribed to the bonds issued by such state entities are not willing to invoke state government guarantees, even when payments are overdue. The reason is, once invoked, the assets are classified as substandard or doubtful, depending on the overdue period, thus requiring significant provisioning on the part of banks.

States should aim to measure their consolidated debt position by taking into account the level of guarantees they offer. The guarantee system needs to be phased out gradually, by allowing ULBs to issue bonds directly without such guarantees,

Table 11. Ceilings on Guarantees as Promulgated by State Governments

State (Year)	Ceiling and Other Features
Assam (2000)	The administrative ceiling on government guarantee against loan principals is fixed at Rs15 billion.
Gujarat (1963)	The statutory ceiling, originally fixed at Rs600 million in 1963, was revised to Rs200 billion in March 2001.
Karnataka (1999)	Total outstanding government guarantees as of 1 April of any year will not exceed 80% of revenue receipts of the second preceding year (excluding additional borrowing to implement the Upper Krishna project). The state government will charge a minimum of 1% as guarantee commission.
Rajasthan (1999)	Total loans and guarantees of the state government on the last day of any financial year will not exceed double the amount of estimated receipts in the consolidated fund of the state for that financial year. Outstanding guarantees issued by the state government will not exceed the amount of receipts in the consolidated fund of the state.
Sikkim (2000)	The total outstanding government guarantees as of 1 April of any year will not exceed thrice the state's tax revenue receipts of the second preceding year.
West Bengal (2001)	The total outstanding government guarantees as of 1 April of any year will not exceed 90% of revenue receipts of the second preceding year (which will not apply to any loan raised by the West Bengal Infrastructure Development Finance Corporation Ltd. to fund different infrastructure projects). The state government will charge a minimum of 1% guarantee commission.

Source: Reserve Bank of India.

particularly for commercially viable projects. The Fiscal Responsibility and Budget Management Bill 2000 prescribes that the central Government will not guarantee any amount exceeding 1.5% of GDP during any financial year. This provision is yet to be implemented. In addition to the explicit credit guarantee, implicit guarantees are extended by state governments, such as letters of comfort and structured payment obligations, which also carry significant fiscal risks.[2]

Financial Devolution

Devolution of resources from the central Government to the states, and from the states to the local bodies, is an important feature of the federal finance system (Table 12). Article 280 of the Constitution calls for the setting up of a finance commission every 5 years at the state level. The Central Finance Commission and SFCs are responsible for assessing and advising the respective levels of government on the financial needs of local government. The Central Finance Commission also reviews the financial position of local bodies, and recommends devolution of taxes, user charges, shared revenues, and other intergovernmental transfers. States give local governments general and specific grants.

Table 12. Transfer of Resources from the Center to the States (Rs10 million)

Year	Resources Transferred to States and Union Territories					
	Share of States in Central Taxes (1)	Grants from the Center (2)	Loans (gross) from the Center (3)	Repayment of Loans by States (4)	Gross Transfers to States (1+2+3)	Net Transfers to States (1+2+3-4)
1970/71	755	612	1,028	658	2,395	1,737
1980/81	3,792	2,796	3,146	917	9,734	8,817
1990/91	14,535	13,293	14,522	4,653	42,350	37,697
1991/92	17,197	15,805	13,199	3,781	46,201	42,420
1992/93	20,522	17,943	13,335	4,639	51,800	47,161
1993/94	22,240	20,956	15,263	5,192	58,459	53,267
1994/95	24,843	20,297	18,807	4,494	63,947	59,453
1995/96	29,298	21,577	19,627	4,790	70,502	65,712
1996/97	35,061	23,545	24,031	6,459	82,637	76,178
1997/98	43,548	30,452	14,729	7,125	88,729	81,604
1998/99	39,145	25,844	15,935	9,475	80,924	71,449
1999/00 (RE)	43,510	30,240	21,912	11,923	95,662	83,739
2000/01 (RE)	54,079	41,424	21,534	12,687	117,037	104,350

RE = revised estimate.
Source: Reserve Bank of India.

Following the recommendations of the Eleventh Finance Commission, the central Government will provide financial assistance for local authorities to strengthen their capacity to manage their finances.

Most states have already set up SFCs and made recommendations. It is hoped that SFCs will both ensure sufficient transfer of funds to local bodies based on objective criteria and strengthen fiscal federalism. The divisible pool of taxes should be standardized to bring uniformity across states. SFCs need to focus on the emerging revenue-raising capabilities of ULBs.

The National Commission to Review the Working of the Constitution (2001) made the following suggestions:

- A distinct and separate tax domain for municipalities should be recognized. A list of taxes that come under municipal jurisdiction should be prepared and form part of the common schedule of functions and responsibilities for local bodies. If the 11^{th} and 12^{th} schedules are continued separately, the tax domain should figure in the relevant schedule.
- Articles 268–274 of the Constitution specify the distribution of tax revenues between the central and state governments. The concept of a divisible pool of taxes, which can be shared among the central Government, states, and municipalities, should also be recognized. Categories of taxes and levies that form part of the divisible pool, tax collection responsibility, and the share of the three tiers of governments should be specified.
- In case of taxes and levies, the proceeds of which are to be shared with municipalities, prior consultation will be required before any modification is made in the scope of tax or its rates.
- Article 276 on taxes on professions, trade, and employment should be amended as suggested by the Eleventh Finance Commission. Parliament should specify the ceiling from time to time rather than require amendments to the Constitution.
- State laws should provide for composition of SFCs and criteria for its membership, similar to the provisions set up by the President for the Central Finance Commission under Article 280.
- It is desirable to synchronize the formation of the Central Finance Commission and SFCs so that their recommendations are implemented on time.
- State laws should empower municipalities to borrow.
- State laws should provide for the preparation and adoption of municipal budgets in a transparent manner in keeping with the public's right to information.

Framework for Financing Urban Infrastructure and Services

Urban planning and development are state responsibilities. State governments and their local bodies are required to provide basic urban infrastructure and civic services such as water supply, sewerage and drainage facilities, solid waste management, street lighting, and road transport facilities. The sharing of responsibility between the state and local bodies depends to a great extent on organizational and policy regimes.

In most cases, state governments handle capital investments as well as O&M activities through departments such as housing development, public works, water supply and drainage, road transport, public health, and engineering. In other cases, state governments undertake capital investments through statutory boards (Chennai Metropolitan Water Supply and Sewerage Board in Tamil Nadu, Bangalore Water Supply and Sewerage Board in Karnataka, Delhi Jal Board in New Delhi, etc.), leaving O&M to local governments. In recent years, the municipal corporations of Ahmadabad, Mumbai, Nasik, and Pune have been undertaking capital investments and O&M.

The central Government also invests directly in urban infrastructure, and provides project-specific grants to state and local governments under centrally sponsored schemes. These projects may be sponsored by either the central or state governments. Urban infrastructure and civic services, therefore, are financed by pooling multiple sources: revenues from state and local governments are augmented by funds transferred from the central ministries, including external sources (Figure 3). Capital expenditure is generally met by state government revenue, loans from specialized financial institutions such as Life Insurance Corporation of India (LIC) and Housing and Urban Development Corporation (HUDCO), as well as market borrowings. Typically, such pooled financing arrangements have inherent flaws: transfer of funds from higher levels of government often depends on the matching resources of ULBs, making transfer amounts highly unreliable and greatly affecting project planning and implementation, resulting in inordinate delays.

Major Urban Infrastructure Schemes

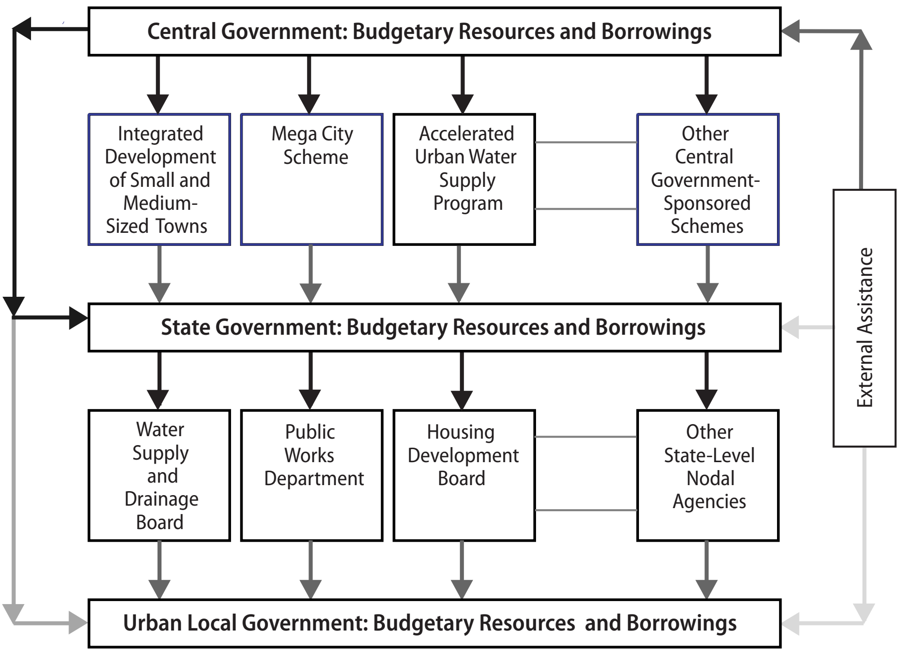
Some major schemes for urban infrastructure and services are as follows:

Integrated Development of Small and Medium-Sized Towns. The scheme aims to improve urban infrastructure. The central and state governments share the cost at 60:40, apart from other sources. This scheme was covering 1,058 out of 3,697 ULBs as of 31 March 2001.

Mega City Scheme. Initiated in 1993/94, it targets Bangalore, Chennai, Hyderabad, Kolkata, and Mumbai. Funds are channeled through specialized state institutions for water supply, drainage, sewerage, sanitation, city transport network, land development, and slum development projects.

National Capital Region Planning Board (NCRPB). Parliament created NCRPB to plan and promote development around Delhi. NCRPB's resource base includes budgetary allocation through plan provision and institutional borrowings and issuance of taxable and tax-free bonds. NCRPB promotes infrastructure for housing, industrial, and commercial plots, office space, and other urban infrastructure.

Figure 3. Framework of Financing Urban Infrastructure



Accelerated Urban Water Supply Program. Launched during 1993/94, the program aims to provide water to towns of less than 20,000 people as per the 1991 census. As of 31 December 2001, 601 towns (as against 2,151 eligible ones) had benefited under the scheme.

Low-Cost Sanitation. The scheme aims to convert dry latrines into low-cost pour-flush latrines, and thereby eliminate manual scavenging. A loan and a subsidy have been extended through HUDCO. So far, 836 schemes in 1,285 towns have been sanctioned, in addition to 3,966 community toilets.

Recent Central Government Initiatives

The central Government has introduced three reform tools as a follow-up to the 2002/03 Union Budget proposals.

Urban Reform Incentive Fund. With an initial contribution of Rs5 billion, the fund will provide reform-linked assistance to state governments to (i) reform the Rent Control Act, (ii) repeal the Urban Land Ceiling Act, (iii) rationalize stamp duties, (iv) pass enabling laws for speedy approval of contracts, (v) levy realistic user charges, (vi) revise municipal laws in line with the model laws prepared by the Ministry of Urban Development and Poverty Alleviation, (vii) introduce computerized registration of properties, (viii) introduce the double-entry accounting system in ULBs, and (ix) reform the property tax. The funds will be provided to states as additional central assistance when they sign the memorandum of agreement, which will provide activity milestones.

City Challenge Fund. This will help municipal corporations—cities with more than 500,000 people—by partly financing reforms. It is meant to catalyze institutional, fiscal, and financial reform of cities to make them creditworthy and improve their service delivery. Cities will have to submit an urban reform plan and show their commitment and capacity to implement reforms. Applications will be assessed by an independent evaluation committee followed by the execution of a memorandum of agreement and definition of activity milestones. Of the fund's requirements, 75% will be borne by the central Government and 25% by the state government. Guidelines are being finalized by the central Government. The reform areas are (i) improving financial capacity; (ii) reducing wasteful expenditure; (iii) improving the financial accounting system; (iv) forming a separate entity to deliver urban services; (v) capacity building and restructuring, including a voluntary retirement scheme; and (vi) initiatives for public-private partnership.

Pooled Finance Development Fund. This is meant to help small and medium-sized ULBs introduce reforms and access the capital market. A state-level intermediary (existing or to be created) will raise funds from the market by issuing bonds on behalf of a group of ULBs. Loan repayment will be by way of the escrowing of resources, the interception of state grants if necessary, and the setting up of a debt service reserve fund. The fund will enhance the credit rating of ULBs. The cost of making ULBs creditworthy, as in the case of the City Challenge Fund, will be borne by the central Government (75%) and the state (25%).

Infrastructure Equity Fund. The fund, to be managed by the Infrastructure Development Finance Company (IDFC) with an initial corpus of Rs10 billion, is proposed to provide equity investment in infrastructure projects. The initial contribution will come from public sector insurance companies, financial institutions, and commercial banks. An institutional mechanism will be set up to coordinate debt financing in infrastructure projects larger than Rs2.5 billion.

None of the states seems to have drawn from these funds, although some have already initiated urban sector reform programs. The policy regime facilitating urban infrastructure financing is evolving. The central Government is preparing sample municipal laws to facilitate amendments in states to reform accounting, improve municipalities' revenue base, and enable private sector participation as well as private-public partnership.

External Financing

Multilateral agencies such as the World Bank, ADB, Japan Exim Bank, and the Department for International Development of the United Kingdom have been funding urban infrastructure projects in India. Multilateral agencies offer lines of credit to financial institutions such as IDFC, Infrastructure Leasing and Financial Services Ltd. (IL&FS), and HUDCO, which are involved in urban infrastructure projects. Funds are often released to these financial institutions on the condition that they match the funds.

Tapping international capital markets has not yet been considered to finance urban infrastructure projects in India. (Several projects from emerging markets, such as toll roads in Mexico, have recently accessed foreign currency financing, although larger public sector utilities in India, particularly power and telecommunications, have directly accessed the global capital market.) One reason for this has been the increasing exchange risks of foreign currency loans due to the large depreciation of the rupee. Accessing international capital markets presupposes financially strong and viable ULBs. International investors often demand financial sophistication and project-specific covenants—stringent registration process with significant disclosure, credit enhancement such as letters of credit, credit rating from an international agency, etc.—which would add significantly to the cost of funds for ULBs.

Foreign direct investment has been permitted to develop integrated townships since 2001. Although inflows have progressively increased, they have not materialized in the urban sector due to numerous legal and procedural bottlenecks in the real estate sector, and lack of transparency in policy regimes (Table 13).

Table 13. Use of External Aid by Sector, 1998–2000

	Rs10 million	$ million
Energy	7,809	1,905
Social Sector	6,228	1,519
Agriculture	4,429	1,080
Infrastructure	2,906	709
Environment	1,927	470
Industry and Finance	1,197	292
Urban Sector	859	210
Others	1,694	413
Total	**27,049**	**6,597**

Note: $ total may not sum due to rounding.

Capital Market Dependency of Local Government

Resource requirements for investments in new infrastructure and its O&M will be substantial. The India Infrastructure Report (1996) estimated the investment needs for urban water supply, sanitation, and roads at about Rs1.25 trillion during 2000–2005. The Central Public Health and Environmental Engineering Organization has estimated the requirement for 100% coverage of the urban population under safe water supply and sanitation services during the Tenth Five-Year Plan at Rs537 billion (Table 14).

Table 14. Estimate of Resource Requirement for Urban Infrastructure

Source	Services and/or Infrastructure Covered	Period of Recommendation	Resource Requirements (Rs10 million)
Ninth Five-Year Plan	Urban water supply and sanitation	1997–2002	50,000
India Infrastructure Report (1996)	Various urban infrastructure, capital costs, O&M needs	2000–2005	125,000
Zakaria Committee Norms (1963) updated to 1997/98	Water supply, sewerage and sewerage disposal, storm water drainage, construction of roads and paths, street lighting, and electricity distribution O&M	2000–2005	72,099
Ministry of Urban Development	Revenue gap of O&M requirements relating to civic services	2000–2005	18,500
Central Public Health and Environmental Engineering Organization	Water supply	2002–2007	28,240
	Sanitation		23,157
	Solid waste management		2,323
	Total		53,720

O&M = operation and maintenance.

Sources: Ministry of Finance. 2000. *Report of the Eleventh Finance Commission*, p.72; and Planning Commission. 2003. *Tenth Five-Year Plan*, p.637.

Investment requirements will vary depending on the area's service levels and the cost of operation. The scale and size of investment requirements cannot be met from government budgetary resources, so multiple sources of financing are needed. A major chunk of resources would have to come from financial markets as well as external sources.

The contribution of financial markets to infrastructure creation has been impressive, and recent trends and initiatives show great potential due to the increasing number of ULBs becoming credit rated, issuance of bonds by a few municipalities, and private-public participation in urban service delivery in a few states. With a risk mitigation mechanism in place, the financial sector will become an important provider of capital to the urban sector. A policy framework reflecting complementary arrangements between central and local governments, supported by an enabling regulatory and institutional framework and multilateral assistance, is necessary. Equally critical is strengthened local institutional capacity to manage urban growth and development.

Suggestions of the Ninth Five-Year Plan (1997–2002) are as follows:

> Financing of urban infrastructure is bound to pose new challenges to the different constituents of the financing system. Innovative mechanisms and practices will have to be encouraged and supported to stimulate the flow of finances such as the municipal bond system, municipal financial reforms, fiscal and monetary incentives for the creation of environment-friendly environment, participation of cooperatives, community groups and NGOs etc.

Access to capital markets and, most important, to bond markets by local governments will:

- enable subnational bodies to leverage internal resources to access long-term capital for infrastructure investments;
- shift the focus from distorted financial resource allocation based on a cash subsidy program;
- enable the present generation to make large investments through bond issuance rather than limited pay-as-you-go financing of such investments;
- make investing and resource raising feasible, which is an objective of the 74th Constitutional Amendment; and
- impose a market-based credit discipline on city governments by promoting fair disclosure and accounting, and better management practices.

Local Government Financing and Financial Markets

India has a broad-based financial system, with a large network of commercial banks, development finance and insurance institutions, state-level financial corporations, national-level refinance institutions, and specialized financial intermediaries created for infrastructure development and financing. Around 12,500 nonbank finance companies in the private sector cater to the corporate sector. Financial sector reforms pursued since the early 1990s have changed in many ways the operating environment of these intermediaries.

Commercial Banks. The banking sector continues to be the primary form of financial intermediary, with 19 nationalized banks along with SBI and its 7 subsidiaries, and 34 Indian and 45 foreign private sector banks as of 31 March 2001. The banking sector is the largest conduit to mobilize domestic savings, and the main source of external credit for households and firms. Traditionally, ULBs have little commercial relationship with the banking system; their monetary operations are exclusively carried out by the government treasury. Bank lending to infrastructure is a tiny portion of total lending, and bank involvement in financing of urban infrastructure has been negligible (Table 15).

Table 15. Commercial Bank Lending to the Infrastructure Sector (Rs million)

Sector	Outstanding as of 26 March 1999	Outstanding as of 24 March 2000	Outstanding as of 23 March 2001
Power	21,090	32,890	52,460
Telecommunications	22,730	19,920	36,440
Roads and Ports	15,630	19,620	24,590
Total for Infrastructure	59,450	72,430	113,490
Total for All Sectors	**1,789,990**	**2,001,330**	**2,188,390**
Share of Infrastructure (%)	3.32	3.62	5.18

Source: Industrial Development Bank of India. *Development Banking Report, 2000–2001.* Mumbai.

In recent years, banks have begun to participate in urban infrastructure projects through cofinancing and some innovative financing schemes, such as:

- "take-out" financing, where a specialized financial intermediary, which takes up later maturities, involves commercial banks, which take up earlier ones. Commercial banks are thus able to use their short-maturity deposits by pulling out their investments after the end of a specified period; and
- the "mezzanine" structure, a hybrid of equity and debt, whereby the financing agency sets a low coupon for the loan component with an agreement to share a certain percentage of profits from the project revenues.

Development Finance Institutions. Industrial Development Bank of India and Industrial Credit and Investment Corporation of India Ltd. (ICICI)[3] are the two most important players in infrastructure finance. Three specialized financial institutions for infrastructure development are HUDCO, IDFC, and IL&FS, which have raised substantial capital by issuing tax-exempted bonds and invested in various urban development projects. With the increase in the exempted salary limit for investments and the fall in returns on tax-relieved small-savings certificates, infrastructure bonds have become popular among tax-saving individuals.

Housing and Urban Development Corporation Ltd. HUDCO is a central government institution mandated to provide long-term finance for housing and urban infrastructure (Table 16). By leveraging central government funds, and by raising resources directly from capital markets, HUDCO has increased its financing of environmental infrastructure projects. It operates mainly through the State Housing and Urban Development Board, development authorities, and municipal corporations for financing operations. HUDCO also subscribes to the bonds and debentures issued by these entities. Multilateral institutions such as the World Bank, ADB, United States Agency for International Development (USAID), Kreditanstalt für Wiederaufbau (KfW), and Japan Bank for International Cooperation (JBIC) have helped HUDCO fund housing and urban infrastructure.

Table 16. Funding of Urban Infrastructure by the Housing and Urban Development Corporation Ltd., 2001/02

Type of Scheme	No.	Loan Amount (Rs10 million)
Water Supply	341	6,866
Sewerage and Drainage	80	1,343
Transport and Roads	127	4,696
Area Development	100	1,313
Social Infrastructure	106	1,381
Commercial Infrastructure	121	3,352
Total	**875**	**18,952**

Infrastructure Leasing and Financial Services Ltd. IL&FS was set up in 1987 as a private entity to commercialize infrastructure projects in conjunction with public and private sector sponsors. The company has floated several special-purpose vehicles (SPVs) with state governments and the private sector as cosponsors. These SPVs enter into concession agreements with state and local governments to build and operate infrastructure projects commercially by collecting user charges. With lines of credit from multilateral lenders and resources raised through bond issuance, IL&FS has promoted urban infrastructure projects.

Infrastructure Development Finance Company. IDFC was formed as an exclusive funding agency for infrastructure projects, to bring in private sector initiatives (Table 17). The institution is expected to link public infrastructure projects and capital markets by enhancing credit, providing technical assistance, creating partnerships among a variety of financial institutions, and subscribing to shares and debentures of infrastructure companies. IDFC and the government of Karnataka recently created the Infrastructure Development Corporation of Karnataka, one of the first public-private partnerships of its kind, to promote and develop infrastructure projects. IDFC has the potential to expand and deepen the municipal debt market by increasing its participation in projects as well as providing appropriate risk-sharing avenues to financiers.

Table 17. Disbursements by the Infrastructure Development Finance Company, 2000/01

Sector	No. of Schemes	Amount (Rs10 million)
Power	6	222
Telecommunications and Information Technology	3	494
Transportation	3	42
Urban Infrastructure	3	4
Total	**15**	**762**

Insurance Companies. Life Insurance Corporation and General Insurance Corporation have found financing infrastructure projects feasible, given the long-term nature of their liabilities. These institutions extend term loans to urban infrastructure projects executed by state governments and parastatal agencies, often with a state government guarantee. These institutions also directly subscribe to the bonds issued by infrastructure companies. Public provident funds have restrictions for their investments and are allowed to invest only in government securities.

The role of financial institutions should be enhanced, considering the importance of the urban sectors in the national economy. Domestic financial institutions have contributed significantly to resource mobilization by the corporate sector and, with a suitable risk-mitigating mechanism in place, their contribution to the urban sector can be enlarged as well. Their involvement in local government financing will enhance the confidence not only of domestic investors but also of foreign investors as well as multilateral development banks.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, which deals with issues such as securitization, asset management companies, and enforcement of security interests on loan defaults to banks, is expected to strengthen creditor rights through foreclosure and enforcement of securities by banks and financial institutions. By conferring on lenders the right to invoke the physical asset cover or the guarantees, or both, in respect of overdue loans, the law is expected to allow lenders to recover their dues promptly without going through a costly and time-consuming legal process.

Commercialization and Private Sector Participation

Commercialization and private sector participation in infrastructure in sectors such as power, telecommunications, roads, and ports have made significant progress, attracting large investments and improving basic infrastructure. These sectors also offer attractive returns, supported by a regulatory framework as well as policy reforms to accommodate private players and commercialization. Independent regulatory agencies such as the Telecom Regulatory Authority of India and Central Electricity Authority have been set up. The central Government's comfort to the lenders and promoters in the form of guarantee for minimum demand, repayment by state government agencies, number of competitors, etc. has proved to be fruitful in these sectors.

Although commercialization and private sector participation in urban infrastructure are recent, they are suitable for private-public partnerships, and commercialization in various forms such as management contracts, lease contracts, and contracts such as build-own-operate and build-operate-lease-transfer. Support from state governments in the form of equity participation, land or water supply concessions, dedicated revenue streams for loan repayment, and a transparent regulatory framework has been encouraging.

Many state governments have been successful in urban infrastructure development through project finance routes by creating SPVs, which are formed under the Companies Act 1956, with equity contribution from state governments or sponsors as seed capital. Liabilities of promoters (usually government entities) are restricted only to a specific project and will not have an adverse impact on the promoters' original business. Lending for the project is done without any recourse to promoters. SPVs' advantages are not just in financing but also in their ability to execute projects. One of the promoters generally executes the project's day-to-day functions. SPVs have been successful in issuing bonds of 3–7-year maturity from the capital market.

Financing Innovations in Urban Infrastructure

Noida Toll Bridge Company Ltd. An SPV promoted by IL&FS for the Noida-Delhi toll bridge project, the company built a bridge, which became operational in February 2001, across the Yamuna River on a build-own-operate-transfer basis. The project cost about Rs4,082 million, with a debt-equity ratio of 70:30. The equity component came from several stakeholders, including IL&FS, Noida administration, and World Bank, with the debt financed by a consortium of financial institutions such as IDFC, IL&FS, Industrial Development Bank of India, SBI, Industrial Finance Corporation of India Ltd., and commercial banks. The credit enhancement mechanism involved an irrevocable and unconditional guarantee offered by IL&FS for interest payment on the bond component. The project had deep-discount bonds, fully convertible debentures, and a "take-out" offer to investors at the end of years 5 and 9 from the date of allotment.

New Tirupur Area Development Corporation Ltd. This is an SPV promoted in February 1995 by IL&FS and the government of Tamil Nadu, and was India's first commercially structured water supply and sewerage project developed with private-public participation. The equity participation and grant came from the central Government, IL&FS, Tamil Nadu Corporation for Industrial Infrastructure Development, Tirupur Exporters Association, and build-own-operate-transfer operators (consisting of engineering, procurement, and construction contractors such as the US firm Bechtel, the Indian firm Mahindra & Mahindra, and the United Kingdom-based United Utilities International). The total project cost of Rs11,530 million had a debt-equity ratio of 65:35. The debt component came from financial institution loans such as Industrial Development Bank of India, IDFC, and Small Industry Development Bank of India as well as commercial bank loans and loans from the World Bank and USAID. The credit enhancement mechanism involved a letter of credit for 1 month and escrow for 3 months' water revenues from the municipality.

Karur Bridge. This was undertaken by Karur municipality in Tamil Nadu for about Rs160 million and was initiated by the government of Tamil Nadu in collaboration with Tamil Nadu Urban Development Fund (TNUDF) via build-operate-transfer. The concession was awarded for 14 years to East Coast Constructions and Industries Ltd. on the basis of competitive bidding. The state amended its state toll act to allow ULBs to charge tolls.

Moradabad Bypass. This project involved the construction of a four-lane express highway along an 18-kilometer stretch on National Highway 24 (opened in July 2002), implemented by the National Highways Authority of India (NHAI) on a design-build-finance-operate basis. The financing mechanism involved the creation of an SPV: Moradabad Toll Road Company Ltd., set up by NHAI. The Rs1.03 billion project had a debt-equity ratio of 70:30, with equity provided by NHAI and the State Bridge Corporation in Uttar Pradesh, the latter being the engineering, procurement, and construction contractor, and the debt component through 15-year loans from IDFC and SBI. Revenues collected by tolls are used to service the loan, besides debt service support provided by NHAI until a debt reserve is built up.

The financing mix in the above cases reveals important lessons for local government financing. Equity contributions have generally come from promoters such as the state or local governments, project beneficiaries, or even specialized funds, such as TNUDF, Maharashtra Urban Development Fund, and Feedback First Infrastructure Fund, which is the only private sector fund in India. State government support through equity financing has made a significant difference, as promoters are one of the primary concerns of lenders. Domestic financial institutions have cofinanced projects when ULBs have undertaken considerable operational restructuring. Cofinancing requires a supportive political environment, and regulatory changes in user charges. Cofinancing from a financial institution with management support is vital.

Reforms must sustain and enhance cash flows that generate capacity, rather than subsidies and guarantees from higher levels of government. State laws should be deregulated, process time for clearances reduced, an independent regulator for tariff setting established, and initial equity participation by state and central bodies promoted to facilitate such financing.

Bond Markets and Local Government Financing

The bond market has witnessed significant growth and sophistication in recent years in terms of issuers and investors, instruments, trading volume, and market awareness. Table 18 gives the structure of issuers and instruments in bond markets, distinguishing between national and subnational levels. Central government issues, comprising treasury bills and dated securities, are the most important segment. Other active issuers at the national level are corporate, all-India financial institutions, commercial banks, and central public sector undertakings.

Financial institutions have progressively used bond markets to raise resources for lending to infrastructure. Infrastructure bonds have also been found attractive to primary investors due to beneficial fiscal regimes. During 2001/02, the central and state governments raised Rs152.5 billion, accounting for about 75% of total bond issues. Bonds and debentures issued by the private corporate sector made up another Rs52 billion or 25% of total issues (Table 19). As seen from Table 19, most of the bond issuances by the private corporate sector are in the form of private placement issues. Local bond markets will comprise issues by state governments, state financial institutions, state-level public sector undertakings, and municipal corporations. Bonds issued by state-level undertakings often carry a guarantee by state governments. During 1997–2002, eight municipal corporations raised funds by issuing bonds, securitized in some form or other by revenue receivables or grants.

Table 18. Structure of Bond Markets: Issuers and Instruments

Level of Government	Issuers	Instruments
National	Central Government	Treasury bills, dated securities, zero-coupon bonds, floating rate bonds, inflation indexed bonds
	Development finance institutions, commercial banks	Bank bonds, infrastructure bonds, zero-coupon bonds
	Public sector companies	Taxable and tax-free bonds
	Private sector companies	Bonds and debentures, zero-coupon bonds, floating rate bonds
Subnational	State governments	State government loans
	State-level public enterprises and financial institutions	Government-guaranteed bonds
	State-level special-purpose vehicles and statutory boards	Bonds, often with revenue dedication, with or without government guarantee
	Municipal corporations	Municipal bonds, with revenue dedication, with or without government guarantee

Table 19. Resources Raised from Debt Markets (Rs10 million)

	1999/2000	2000/01	2001/02
Government	113,336	128,483	152,508
Central Government	99,630	115,183	133,801
State Government	13,706	13,300	18,707
Corporate	59,399	56,578	51,561
Public Issues	4,698	4,144	5,341
Private Placements	54,701	52,434	46,220
Total	**172,735**	**185,061**	**204,069**

Sources: Reserve Bank of India; National Stock Exchange of India Ltd.

State Government Bonds

The volume of state government bonds depends on the extent of the state's deficit financing; the bonds are issued by RBI. These securities will serve as the benchmark for other state-level local bodies and entities. As of June 2002, 662 state government bonds were outstanding, maturing in 10 years. Until 1998/99, the states issued securities at pre-announced coupon rates and prices and were issued by RBI through common tranches. This implied that the better-off and the more creditworthy states could raise their loans at the same rates as not so creditworthy states. Since 1999, states have been given the option to raise 5–35% of their borrowings by way of competitive auctions. States with better fiscal and financial management have benefited from such auctions as they lower borrowing costs (Table 20).

Table 20. Market Borrowings of States through Auction

State	Date of Issue	Amount Rs10 million	Cut-Off Yield (%)	Central Government Securities 10-Year Yield (%)
West Bengal	8 Aug 2000	250	11.80	11.43
Maharashtra	8 Aug 2000	280	11.70	11.43
Andhra Pradesh	8 Aug 2000	400	11.80	11.43
Tamil Nadu	8 Aug 2000	290	11.70	11.43
Kerala	29 Aug 2000	200	11.75	11.42
Karnataka	5 Dec 2000	250	11.57	11.32
Kerala	17 Apr 2001	200	10.53	10.25
Gujarat	20 Jul 2001	190	9.50	9.35
Gujarat	6 Aug 2001	250	9.40	9.10
Andhra Pradesh	13 Aug 2001	475	9.53	9.25
Madhya Pradesh	13 Aug 2001	105	9.55	9.25
West Bengal	13 Aug 2001	250	9.72	9.25

Source: Reserve Bank of India.

State-Sponsored Institutions

State-sponsored institutions include state-level financial institutions, state-sponsored SPVs, and statutory agencies such as water supply and sewerage boards. Most of these state-level entities issue bonds through private placements, which are often guaranteed by state governments (Table 21). Bond issuance can be taxable or tax-free, often in the form of structured issues or carrying credit enhancement features such as revenue dedication. The instruments are usually known in India as structured obligations because they are structured to enhance credit rating. In recent years, these bond issues have increased significantly and carry significant fiscal risks for state governments.

Municipal Bonds

Municipal bond issuance is of recent origin, with the first occurring through private placement by Bangalore Mahanagara Palike in 1997. Ahmadabad was the first municipal corporation to make a public offering in January 1998, raising Rs1 billion. So far, eight municipal corporations have issued bonds worth Rs5.3 billion (Table 22). More and more ULBs are expected to enter the bond market to raise funds for

Table 21. Private Placements of Bond Issuance (Rs10 million)

	1998/99		1999/2000		2000/01	
	No.	Value	No.	Value	No.	Value
All-India Financial Institutions and Banks	28	18,603	44	14,359	43	21,672
Central Public Sector Undertakings	17	3,110	18	8,435	19	7,839
Private Corporations	127	7,425	117	12,594	100	9,169
State-Level Financial Institutions	2	313	6	2,605	4	2,286
State-Level Undertakings	30	9,479	48	16,526	48	11,426

Source: Prime Database.

infrastructure development. Over 30 major cities have obtained credit rating from agencies such as Credit Rating Information Services of India (Crisil), Investment Information and Credit Rating Agency of India Ltd. (ICRA), and Credit Analysis & Research Ltd. (CARE), with the intention of entering the bond market.

Municipal bonds generally are securitized debt instruments, providing future revenue flows from the project as collateral (Figure 4). ULBs offering the bonds will surrender their rights to future revenues to service the bonds. Revenue flows will comprise *octroi*, user charges collected from water supply and sewerage projects, state government grants and transfers, property tax, and tolls collected from vehicles, etc. When future revenues are considered insufficient to meet debt service obligations, a third-party guarantee from the state government will be obtained and/or a debt service reserve fund created to obtain an investment grade rating for an issuer with no track record in the capital markets.

Ministry of Urban Development and Poverty Alleviation guidelines stipulate that the issuers are to maintain a debt service coverage ratio of at least 1.25 throughout the tenor of the bond. This overcollateralization and the provision of a debt service reserve account serve as additional credit enhancement measures, intended to reduce the risk to investors.

Urban Development Funds

The initiative to set up an urban development loan fund can be traced to the World Bank's third Calcutta Urban Development Project in the early 1980s, to finance investment there. The West Bengal government was the sole manager of the fund, thereby preventing any private sector participation; the repayment performance of the fund was poor (Peterson 1996).

Table 22. Features of Municipal Bond Issuance, 1997–2002

December 1997	Bangalore Mahanagar Palika of Karnataka issued the first municipal bonds in India for Rs1 billion, with 7-year maturity and a coupon of 13% per annum. The purpose of bond flotation was to raise resources to develop roads, side drains, and street lighting in Bangalore City. The bond was issued through a private placement and guaranteed by the government of Karnataka. Crisil provided a rating of A (SO), indicating adequate safety. The principal and interest payments were secured by way of structured payment mechanisms—collection and deposit of property tax and government grants to a designated escrow account—which were used to pay bond holders, and supervised by a trustee: Karnataka State Financial Corporation. The issue was managed by State Bank of India Capital Markets Ltd.
January 1998	Ahmadabad Municipal Corporation (AMC) of Gujarat issued Rs1 billion at 14% payable semiannually. The bond was secured on a charge/mortgage on AMC's properties. Redemption was in three tranches of Rs333 per Rs1,000 at the end of year 5; Rs333 at the end of year 6; and Rs334 at the end of year 7. Designed as a structured obligation, the issue had a credit rating of AA (SO) from Crisil. *Octroi* collection from 10 designated collection points was earmarked to service the bond and kept in an escrow account; 75% (Rs750 million) was in the form of private placement (firm allotment basis), organized by Infrastructure Leasing and Financial Services Ltd., with co-lead managers such as Kotak Mahindra, SBI Caps, and ANZ Grindlays Bank; and 25% (Rs250 million) in the form of public issue, fully underwritten by the lead managers. (See also Appendix 2.)
May 1999	Nashik Municipal Corporation of Maharashtra raised Rs1 billion at 14.75%, to partly finance projects such as water supply and underground sewerage, and to build flyovers, bridges, and truck terminals. Crisil rated the bonds AA (SO). Lazard Credit Capital Ltd. served as the arranger of the issue, and Bank of Maharashtra acted as the agent and trustee. *Octroi* collection from four designated collection points was earmarked in an escrow account to service the bonds, which were to be done in three tranches after years 5, 6, and 7.
September 1999	Ludhiana Municipal Corporation of Punjab issued Rs100 million at 13.5–14.0%. With a credit rating by ICRA of LAA-(SO), the bond was issued as private placements without a state government guarantee. The escrow of the revenue streams from water and sewerage charges were the basis to enhance the rating. Property worth 1.25 times the size of the issue was pledged as security. Repayment was made in four equal installments payable from the end of year 7.

Table 22. Features of Municipal Bond Issuance, 1997–2002 (*cont'd.*)

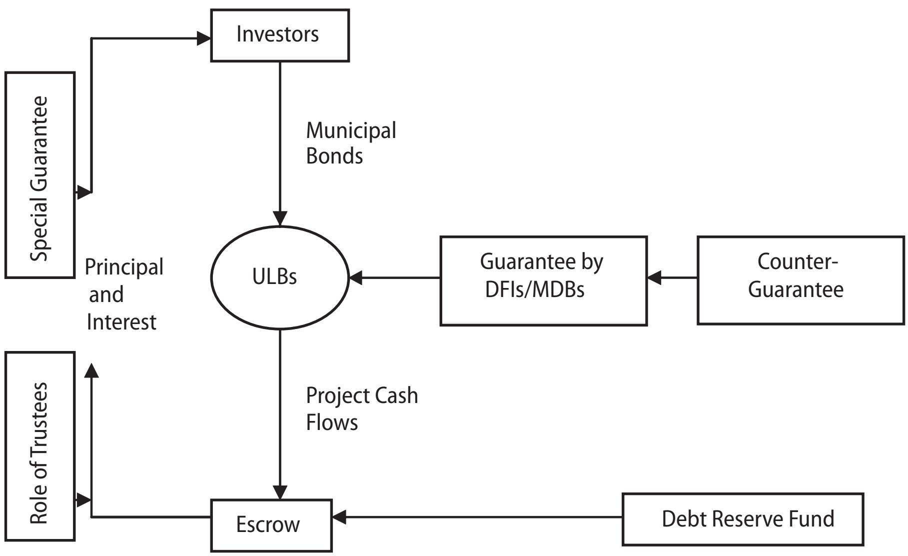
November 2000	Nagpur Municipal Corporation of Maharashtra issued bonds worth Rs500 million at 13% coupon, payable semiannually, through a private placement of secured nonconvertible debentures. Arranged by SBI Capital Markets Ltd., the maturity of the issue was 7 years, with a put-and-call option at the end of 5 years, and a redemption option at the end of years 5, 6, and 7. The issue carried a rating of LAA-(SO) by ICRA. The proceeds of the bond issue were to be used to fund the corporation's water supply projects.
April 2001	Madurai Municipal Corporation of Tamil Nadu issued Rs300 million by way of private placement at 12.25% without a government guarantee. The bonds were in the form of secured, redeemable, and nonconvertible debentures, and were taxable. The bond issue was assigned a credit rating of LA+(SO) by ICRA and was without a government guarantee. The issue was made to partly finance the requirement for the two-lane inner ring road between Kanyakumari and Melur roads, and also to refinance the then high-cost loan from the Tamil Nadu Urban Development Fund. The agent and trustee were Canara Bank, Bangalore. The bonds were securitized through a dedicated escrow account into which toll collections from the inner city ring road are deposited daily. With a maturity of 15 years, the bonds had a put-and-call option after 8 years.
July 2001	Indore Municipal Corporation of Madhya Pradesh issued nonconvertible redeemable bonds of Rs100 million at 11.5% payable annually. The bonds were issued through private placement with guarantee from the state government. The proceeds were to be utilized to improve city roads. The bonds were redeemable in three installments of 30%, 30%, and 40%, payable at the end of years 5, 6, and 7.
March 2002	Ahmadabad Municipal Corporation of Gujarat state issued for the second time tax-free bonds of Rs1 billion through private placement. With a rating of AA (SO) from Crisil, the coupon was 9% per annum, payable semiannually, for the first 5 years, and the rate beginning in year 6 at the prevailing bank rate +2.5%, payable semiannually until maturity. With a maturity of 10 years, the bonds have a put-and-call option at the end of year 5 from deemed date of allotment. The lead arranger of the issue was GSFS Capital and Securities Ltd. Other arrangers included Infrastructure Leasing and Financial Services Ltd., Merchant Banking Services Ltd., Industrial Credit and Investment Corporation of India Ltd., Securities and Finance Co. Ltd., and Centrum Finance Ltd. The trustee was the Central Bank of India. Credit enhancement for the bond issue was made through an escrow account of property tax revenues.

Table 22. Features of Municipal Bond Issuance, 1997–2002 (*cont'd.*)

March 2002	Hyderabad Municipal Corporation of Andhra Pradesh issued tax-free bonds of Rs825 million at 8.5%, payable semiannually and with a maturity of 7 years. The floating was backed by an escrow mechanism. The purpose was to partly fund the corporation's plans to invest Rs2,475 million in various development projects. Crisil gave the corporation a credit rating of AA+ (SO). The State Bank of Hyderabad has acted as the trustee. Escrow accounts of nonresidential property tax, professional tax, advertisement tax, entertainment tax, stamp duty, and town planning charges are earmarked to service the debt.

Crisil = Credit Rating Information Services of India Ltd., SO = structured obligation, ICRA = Investment Information and Credit Rating Agency of India Ltd.

Figure 4. Bond Issuance Structure by Urban Local Bodies



DFI = development finance institution, MDB = multilateral development bank, ULB = urban local body.

The most successful fund of recent origin is TNUDF, promoted by the government of Tamil Nadu with a line of credit from the World Bank. ADB is proposing to create an urban environmental infrastructure fund in Karnataka. The funds are often created in collaboration with an international counterpart and Indian financial institutions, along with the state government as equity participant, to attract private capital flows into urban infrastructure projects.

TNUDF was established by the government of Tamil Nadu in 1996 with the participation of Indian financial institutions such ICICI, Housing Development Finance Corporation Ltd. (HDFC), and IL&FS, and a line of credit from the World Bank. Created as a trust fund and managed by a private asset management company, Tamil Nadu Urban Infrastructure Financial Services Ltd., the fund is engaged in municipal financing in Tamil Nadu without using state government guarantees. Municipalities, statutory boards, and state-level public sector undertakings are eligible borrowers. The tenor of the loans offered is 12–15 years, depending on the type of project funded. Special recovery mechanisms such as escrow accounts of property tax collection, water charges, and hypothecation of movables are generally used. In certain cases, the debts are blended with the grants to reduce the interest cost for ULBs.

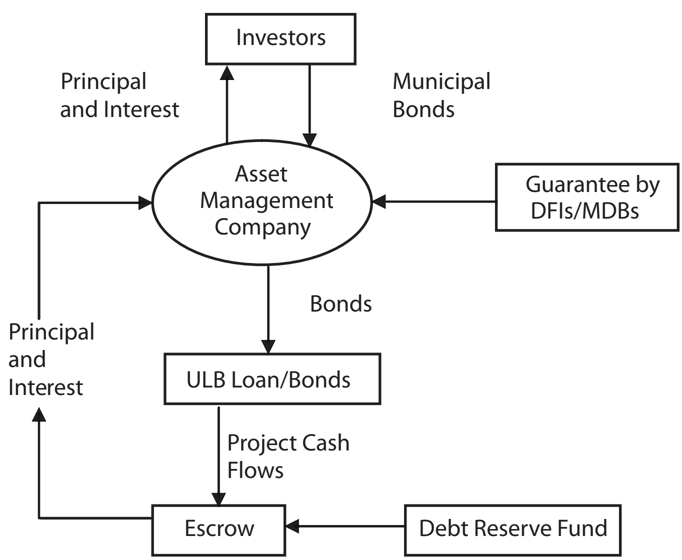
Over 500 projects covering water supply and sanitation, roads, bridges, streetlights, solid waste plants, bus stations, and shopping complexes in 90 out of 110 municipalities in Tamil Nadu have been financed by the fund. It provides grants to ULBs to (i) subsidize the capital cost of projects, (ii) provide training and technical equipment, (iii) support project preparation and implementation, and (iv) support privatization and other innovative schemes. Supported capacity-building activities include computerization of accounts and training development of municipal administration to improve ULBs' management performance. In 1999, the World Bank provided a $105 million loan based on the London interbank offered rate (LIBOR), with a 20-year maturity and 5-year grace period to the central Government to finance urban development projects in Tamil Nadu. The balance of the $205 million project came from ULBs ($50 million), TNUDF ($25 million), and financial institutions ($25 million). TNUDF mobilized about Rs1,100 million through bond issuance during 2001 and another Rs400 million under the pooled financing scheme during 2002.

Built on the success of TNUDF, a pooled financing arrangement has been completed in the state of Tamil Nadu. The first of its kind in India, the fund is promoted by USAID, in collaboration with TNUDF, to cater to the financing needs of smaller municipalities and provide guarantees to lengthen municipal bonds' tenor and improve the pricing factor. Under the arrangement, 14 ULBs pooled some water and sanitation projects under an SPV called the Water and Sanitation Pooled Fund, and raised about Rs300 million from the bond market at 9.2% interest. The concept is similar to that of state-level bond banks in the US, where a state-sponsored financial intermediary raises finance by issuing bonds and then onlending to ULBs by buying their bonds.

Financing pools are of two types: (i) a "blind pool," where a bond bank raises sufficient funds based on its own credit rating and then onlends to local governments; and (ii) a project-specific pool, where several projects are pooled and lumped together in a bond issuance, thereby significantly reducing transaction costs and improving pricing. Tamil Nadu uses the second type, with several small municipalities pooled in the bond offers to finance municipal environmental infrastructure projects for underground water and sewerage. The proposed structure envisages USAID as providing a partial credit guarantee to lengthen bond maturity from 7 to 15 years, with put and call options after 7 years or, alternatively, an annuity repayment mechanism. Tamil Nadu Urban Infrastructure Financial Services Ltd. will purchase municipal bonds and fund them by issuing its own bonds, with regular credit enhancement structures (Figure 5).

TNUDF's success should encourage other state governments to design and implement the municipal financing program through special-purpose funds. The national budget of 2002 proposed the creation of a pooled finance development scheme to help small ULBs access capital markets by issuing bonds with the credit enhancement facilities. Typically, TNUDF or the proposed pooled financing mechanisms

Figure 5. Municipal Bonds with Asset Management Company as an Intermediary



DFI = development finance institution, MDB = multilateral development bank, ULB = urban local body.

are not just debt funds that run on commercial principles, but also bundle grants as well as loans. The funds also provide technical assistance to build ULB capacity in project preparation and financial management. This experience reveals the great potential for financing numerous local governments.

Enabling Environment for Subnational Bond Market Development

The experience of urban infrastructure financing and municipal bond issuance provides good pointers for the spread of bond markets for local financing. The issue is how to create the institutional and supporting mechanism to develop an active local bond market, and enhance the attractiveness of the municipal securities by reducing their transaction costs and risks. An enabling environment would include a broadening of the issuers' and investors' base; institutional characteristics such as secondary market trading; promotion of distribution among underwriters, merchant bankers, and trustees; and innovations such as credit enhancement and guarantees.

Vibrant National Bond Market

India has established a relatively sophisticated capital market, with trading, clearing, and settlement operations in place. Significant institutional and regulatory changes are also under way, resulting in efficiency and price discovery:

- The market infrastructure for effective bond pricing has been established with the setting up of a real-time gross settlement system, lending transparency and efficiency to market operations, as against the traditional over-the-counter deals negotiated over the telephone.
- The negotiated dealing system, which became operational in February 2002, provides an on-line electronic bidding facility in auctions, screen-based electronic dealing and reporting, and dissemination of real-time trade information. This system also facilitates paperless settlement of transactions in government securities with connectivity to the Clearing Corporation of India Ltd., set up in June 2001, and the delivery vs. payment system at the Public Debt Office of RBI.
- The bond market is dematerialized with the National Securities Depository Ltd. and 2,100 securities were available in this form as of December 2001. All outstanding stocks of bonds and debentures were to be dematerialized by June 2002.
- Effective January 2003, government securities could be traded in the retail market

for the first time through the exchanges. This facility allows investors across the country to buy and sell government securities through their brokers on the National Stock Exchange of India Ltd. (NSE).

- A system of primary dealers, as specialized bond dealers from among financial institutions, is critical in promoting market liquidity, auctioning central and state government securities, and providing two-way trade quotes.
- The Discount and Finance House of India, set up in 1988, and the Securities Trading Corporation of India, set up in 1994, have been transformed into primary dealers to develop an efficient secondary market in government securities.
- Transaction taxes such as stamp duties on bond transfers, which deterred secondary market trading, have been eliminated in the dematerialized segment.
- The auction system for selling securities of 91- and 364-day treasury bills as well as dated government securities facilitates transparency in the government borrowing program and establishes market-determined yield. (Auctions of 14- and 182-day treasury bills were stopped from 14 May 2001.)
- Government securities have a benchmark yield curve, stretching up to 20-year maturity and providing a reasonable amount of liquidity of securities across the maturity range. Short-term money market instruments, such as repurchase agreements, provide short-term pricing benchmarks and establish strong linkages with other money market segments.
- The debt market has been opened up to foreign institutional investors.

Investors

Most central and state government securities are held by institutional investors, including commercial banks, development finance institutions, insurance companies, provident funds, and nonbank finance companies. Commercial banks account for about 60% of the securities issued by state governments, followed by LIC (10%) and provident funds (4%) (Table 23).

Under the statutory liquidity requirement, commercial banks must hold 25% of their net demand and time liabilities in eligible securities. Insurance companies such as LIC must place not less than 50% of their total investments in central and state government securities. Almost all resources raised through employees' provident funds and pension funds go into fixed-income securities markets, with over 40% invested in central and other government-guaranteed securities. The mutual fund industry, particularly the gilt funds, has grown significantly in recent years, making sizable investments in debt securities.

Bank investments in subnational securities are in Table 24, and the corresponding state figures states-wise are in Appendix Table A1.7. Government-guaranteed munic-

Table 23. Ownership of State Government Securities, end-March (Rs10 million)

Category of Holders	1995	1996	1997	1998	1999	2000	2001
RBI	0	0	0	0	0	0	0
Commercial Banks	22,797	25,661	28,892	32,923	38,413	45,713	—
LIC	3,681	4,617	5,868	7,395	9,947	11,932	14,381
Unit Trust of India	1	1	0	0	1	16	15
Provident Funds	617	834	1,283	1,738	2,419	3,236	4,028
Other PF Schemes	258	670	659	827	—	—	—
Others	3,854	6,149	6,880	7,946	—	—	—
Total	**31,208**	**37,932**	**43,582**	**50,828**	**61,531**	**73,885**	**86,765**

— = data not available, LIC = Life Insurance Corporation of India, RBI = Reserve Bank of India, PF = provident fund.
Source: Reserve Bank of India.

ipal bonds are also eligible to be counted toward the statutory liquidity requirement. Local-authority loans and securities carry additional risk weighting over loans and securities issued by the central and state governments. RBI guidelines require banks to assign a risk weighting of 20% to state government-guaranteed securities. In case of default, such investments are to be treated as nonperforming assets, and 100% risk weighting is to be attached with adequate provisioning. Another factor limiting the preference of institutional investors for subnational securities is the central bank's guideline making it mandatory for banks, financial institutions, and primary dealers to hold debt securities only in dematerialized form, whether publicly issued or privately placed.

The household sector remains the most significant source of savings, with over 80% held in fixed-income investments. Many household savings, however, are in the form of bank deposits (Table 25). The potential to widen the retail investor base in subnational securities is high and requires increasing awareness about them. The existence of secondary markets will encourage buying of such securities. Promoting local issuer-investor relationships is important. Local issuers are not familiar with municipal securities as an investment option. With an improved environment of disclosure and secondary market trading, local investors will consider the local securities as more advantageous.

Creating Secondary Markets

A secondary market in subnational securities is needed to increase demand for securities in the primary issuance. Secondary-market trading of bonds takes place mostly over the counter, although the wholesale debt market segment of NSE, set up in 1994, and of the Mumbai Stock Exchange, permitted since November 2000,

Table 24. Investments by Banks in Local Securities (Rs100,000)

Issuers of Securities/Shares/ Bonds/Debentures	State Bank of India and Associates	Nationalized Banks	Other Indian Scheduled Commercial Banks	Foreign Banks	All Scheduled Commercial Banks
Local Authorities[a]	5,993	91,124	10,546	10	107,673
	(0.7)	(5.3)	(5.3)	(—)	(3.8)
State Financial Corporations	92,386	208,923	29,131	23,041	353,481
	(11.4)	(12.2)	(14.6)	(28.5)	(12.6)
State Industrial Development Corporations	4,164	33,331	10,894	—	48,389
	(0.5)	(1.9)	(5.5)	—	(1.7)
State Electricity Boards	248,207	260,484	26,006	3,830	538,527
	(30.6)	(15.2)	(13.0)	(4.7)	(19.2)
Cooperatives	18,138	9,793	682	62	28,675
	(2.2)	(0.6)	(0.3)	(0.1)	(1.0)
Industrial Finance Corporation of India	82,463	142,983	13,601	1,351	240,398
	(10.2)	(8.3)	(6.8)	(1.7)	(8.6)
National Bank for Agriculture and Rural Development	6,386	21,705	5,160	20,205	53,456
	(0.8)	(1.3)	(2.6)	(25.0)	(1.9)
Industrial Development Bank of India	151,243	371,364	30,161	10,547	563,315
	(18.6)	(21.6)	(15.1)	(13.1)	(20.0)
Industrial Credit & Investment Corporation of India	50,016	133,446	4,899	1,562	189,923
	(6.2)	(7.8)	(2.5)	(1.9)	(6.8)
Rural Electrification Corporation	9,171	35,161	2,435	—	46,767
	(1.1)	(2.0)	(1.2)	—	(1.7)
Export-Import Bank of India	9,014	30,868	5,005	1,328	46,215
	(1.1)	(1.8)	(2.5)	(1.6)	(1.6)
National Cooperative Development Corp. of India	5,775	50,006	—	—	55,781
	(0.7)	(2.9)	—	—	(2.0)
Housing and Urban Development Corp. of India	11,424	40,274	7,412	1,646	60,756
	(1.4)	(2.3)	(3.7)	(2.0)	(2.2)
Unit Trust of India	17,658	19,877	4,831	158	42,524
	(2.2)	(1.2)	(2.4)	(0.2)	(1.5)
Industrial Reconstruction Bank of India	13,281	52,319	7,740	70	73,410
	(1.6)	(3.0)	(3.9)	(0.1)	(2.6)
Housing Boards	2,563	15,834	1,382	48	19,827
	(0.3)	(0.9)	(0.7)	(0.1)	(0.7)
Others	84,252	200,498	39,822	16,858	341,430
	(10.4)	(11.7)	(19.9)	(20.9)	(12.1)
Total	**812,134**	**1,717,990**	**199,707**	**80,716**	**2,810,547**
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

Note: Figures in parentheses are percentage of total.
[a] Includes municipalities and port trusts.
Source: Reserve Bank of India.

Table 25. Savings of Household Sector in Financial Assets (%)

Financial Asset	1990/91	1995/96	1996/97	1997/98	1998/99	1999/2000
Currency	10.6	13.4	8.6	7.4	10.0	8.9
Fixed-Income Investments	74.9	78.9	84.4	88.5	86.1	83.6
Deposits	33.3	42.1	48.2	47.5	41.9	37.1
Insurance/Provident Funds	28.4	29.4	29.2	29.8	31.9	35.2
Small Savings	13.2	7.4	7.0	11.2	12.3	11.3
Securities Markets	14.4	7.8	6.9	4.5	4.1	7.5
Mutual Funds	9.1	0.5	2.7	1.4	1.9	5.2
Government Securities	0.2	0.4	0.4	1.6	0.6	0.9
Other Securities	5.1	6.9	3.8	1.5	1.6	1.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Reserve Bank of India.

are emerging as trading platforms for debt securities. The wholesale debt market segment of NSE is a fully automated screen-based trading system, which enables members across the country to trade simultaneously with ease and efficiency.

Eligibility criteria for listing on NSE include a minimum paid-up capital of Rs100 million or market capitalization of Rs250 million (net worth of Rs250 million for unlisted companies). Public issues are directly eligible and a credit rating is required for listing of private placements. Municipal bonds and bonds issued by statutory bodies are eligible for trading in the permitted category of NSE. Only a few bonds of Ahmadabad and Nasik municipal corporations and the National Capital Region Board are listed on NSE, and their trading is very thin.

Secondary market trading comprises mostly central and state government securities (Table 26). Investors in municipal bonds effectively hold them to maturity. Municipal issuers will benefit from listing and trading in the secondary market, which will greatly enhance their visibility. NSE is preferred for listing of subnational issues. NSE has terminals in most cities, allowing nationwide access for investors. Listing and trading require continuing disclosure requirements for local bond issuers. The monitoring of the outstanding bonds by local rating agencies will also facilitate information disclosure and development of a secondary market.

Regulatory Design for Local Debt Markets

Securities markets come under the following major regulatory structures:

- Public Debt Act, 1944. It empowers RBI to regulate the primary issuance for debt securities by the central and state governments.

Table 26. Secondary Market Distribution in Turnover in the Wholesale Debt Market Segment (Rs10 million)

Securities	1999/2000	2000/01
Government Securities	282,880	390,952
Treasury Bills	11,007	23,143
Public Sector Enterprise Bonds	1,528	3,617
Institutional Bonds	3,345	4,270
Bank Bonds and CDs	805	2,027
Corporate Bonds and CDs	4,615	4,516
Others	36	57
Total	**304,216**	**428,582**

CD = certificate of deposit.
Source: National Stock Exchange of India Ltd.

- Securities and Exchange Board of India (SEBI). Established in 1992, it regulates primary issuances in capital and debt markets, other than government securities, and ensures sound trading practices in the secondary market through stock exchanges. SEBI has introduced a number of measures for investor protection, listing, and disclosure norms.
- Local Authorities Loan Act, 1914. It governs ULB securities. Issuance and disclosure in the offer document, listing, and trading norms of debt instruments are covered in SEBI guidelines.
- Companies Act, 1956. It sets out the code of conduct for the corporate sector in relation to issue, allotment, and transfer of securities, and disclosures to be made in public issues. The law also governs SPV issues.
- Securities Contracts (Regulation) Act, 1956. It regulates securities transactions through control of the stock exchanges.
- Depositories Act, 1996. It provides for electronic maintenance and transfer of ownership of dematerialized securities.
- Fixed-Income and Money Market Dealers' Association. It is a self-regulatory organization for fixed-income and money market instruments, and prescribes norms to promote operational flexibility and smooth functioning of these markets.

Even if debt instruments issued by ULBs are "government securities" under the Public Debt Act when they are offered to the general public, SEBI will have the authority in respect of their issuance. The responsibility for regulating the securities market is shared by the Department of Economic Affairs, Department of Company Affairs, RBI, and SEBI. A high-level committee on capital markets coordinates their activities. SEBI orders may be appealed before a securities appellate tribunal.

In March 2000, the central Government clearly delineated areas of responsibility between RBI and SEBI. Contracts for sale and purchase of government securities, gold-related securities, money market securities, and securities derived from these securities and ready-forward contracts in debt securities will be regulated by RBI. Such contracts, if executed on stock exchanges will, however, be regulated by SEBI in a manner consistent with RBI guidelines. Therefore, the manner of debt instrument issuance by local bodies is governed by multiple laws, which should be integrated into a single law. State finance commissions are expected to assign powers relating to taxes, transfers, and borrowing, but have done little with respect to borrowing.

Private Placement

Private placement of issues is the preferred method in the debt market, even by the AAA credit-rated borrowers, due to the disclosure norms followed for public issues. Disclosure requirements are relaxed for private placement. Most subnational issues are made through private placement. State-level undertakings are dominant in private placement, next to the all-India financial institutions and banks.

Regulators, including SEBI, have little experience in local debt issuance. All subnational bond issues should be made against a prospectus, whether or not they are being presented as a public or private placement. Listing and disclosure rules must be made suitable for municipal securities. SEBI should standardize and enforce such disclosure requirements, which should include the particulars of the issue, project cost, sources of financing, listing proposed, auditors, lead managers, trustee, credit rating, and other matters such as local government borrowing powers and clearances from the ministries.

A model issue document for subnational bond issuance is needed to differentiate various categories of issuers. The document should not be bureaucratic or complex, but rather aim to improve market discipline. The guidelines for the issuance of tax-free municipal bonds provided by the Ministry of Urban Development and Poverty Alleviation are considered appropriate (Box 2), and similar guidelines for the other subnational issues need to be designed.

Credit Rating

Credit rating is mandatory for debt instruments (if public issue) with a maturity exceeding 18 months. The three major credit-rating agencies are Crisil, ICRA, and CARE. They have partnerships with international credit majors: Crisil with Standard & Poor's, ICRA with Moody's, and CARE with Fitch Ratings, together accounting for the entire domestic bond issuance. These agencies rate bonds and debentures, fixed deposits, and short-term instruments such as commercial papers.

Box 2. Ministry of Urban Development and Poverty Alleviation Guidelines for the Issue of Tax-Free Municipal Bonds

- Eligible issuers of tax-free municipal bonds will be local self-governments, other local authorities, or public sector companies duly constituted under an act of Parliament or state legislature, or constituted under relevant state government statutes such as water supply and sewerage boards or authorities, or through a financial intermediary.
- Funds raised will be used only for capital investments in urban infrastructure; setting up of new projects and expansion; augmentation or improvement of the existing system; provision of potable water, sewerage or sanitation, drainage, solid waste management, roads, bridges, and flyovers; and urban transport.
- The project financing plan should be approved by the local authority or the board of the agency before the bond issue, with benchmarks for commencement and completion, milestone dates for all the proposed components, with land acquisition and other statutory clearances.
- The issuer will create an escrow account for debt servicing with earmarked revenue, and all state grants or transfers to the issuer should be deposited into the account. The bond issue must clearly set forth the order of priority according to which the revenue generated by the enterprise will be allocated for various purposes. An independent trustee will monitor earmarking of revenue through the escrow mechanism.
- Within 6 months of the close of every financial year, the escrow and project accounts will be audited by a firm of chartered accountants appointed by the concerned state urban development departments from a panel of chartered accountants approved by the Controller and Auditor-General and the fully compiled audit report submitted to the Ministry of Urban Development and Poverty Alleviation.
- Issuers will maintain a debt service coverage ratio of at least 1.25 throughout the tenor of bond after meeting all the obligations and liabilities. This ratio is defined as a ratio of net income of the entire utility/corporation to the long-term debt service obligations.
- Tax-free bonds should have a minimum maturity of 5 years, and can have an option to offer deep-discount bonds or other financial innovations such as buy-back, after a lock-in period of 3 years, to enhance the tenor of the bond.
- Issuers may raise the amount either as a public issue or by private placement or a combination of both. The public issue will be governed by Securities and Exchange Board of India guidelines.
- Interest income of up to 10.5% will be entitled to exemption from income tax under the Income Tax Act, 1961, without limit.

Box 2. Ministry of Urban Development and Poverty Alleviation Guidelines for the Issue of Tax-Free Municipal Bonds (*cont'd.*)

- The maximum amount of tax-free municipal bonds as a percentage of total project costs (excluding interest during construction) will be 33.3% or Rs2 billion, whichever is lower.
- The debt-equity ratio for the project will not exceed 3:1. In case of municipal authorities, issuers will contribute at least 20% of project costs from internal resources, other grants, or a mix.
- Issuers will obtain an investment grade rating from a Reserve Bank of India-approved credit-rating agency before issuance, and the agency will carry out due diligence process when the rating is awarded and monitor it as part its surveillance during the tenor of the bonds.
- The Ministry of Urban Development and Poverty Alleviation will process the proposal for bond issuance, seek approval by a committee of representatives of the Department of Economic Affairs of the Ministry of Finance and Central Board of Direct Taxes, and notify the bonds issuance in the *Official Gazette* with the approval of the finance minister.
- Tax-free bonds may be listed on the National Stock Exchange of India Ltd.

Most subnational issues are in the form of revenue bonds, often with an explicit government guarantee. The issues include credit enhancement features in their bond offerings, which determine to a large extent the issuer's credit rating. Short-term ratings are few. Agencies use structured obligations, which are rated by rating agencies using the following criteria: (i) economic base, diversity, and growth; (ii) state government finances; (iii) economic management; and (iv) operations of ULBs (Box 3).

ULBs differ considerably in their revenue-raising powers, coverage of service delivery, legal and administrative framework, and economic base. Criteria used by Indian rating agencies for subnational bond issuance are evolving, as city governments are bringing in more financial disclosure and accountability.

Private placement issues made by a number of state-level agencies generally do not obtain credit ratings. The enterprises are not legally required to provide financial and accounting information to regulators and higher levels of government. The Ministry of Urban Development and Poverty Alleviation Circular of February 2001 requires obtaining an investment grade rating for the issuance of tax-free municipal bonds.

Credit rating is not just a regulatory issue as much as a measure of market discipline. The state government guarantee is not a substitute for important disclosure through credit ratings. To standardize private placement issues, RBI proposes ratings

Box 3. Credit Rating Information Services of India Ltd.: Rating Indicators for State and Municipal Governments

State Government Ratings

Economic Structure

- Net state domestic product (NSDP) composition and growth rate
- Per capita NSDP and growth rate
- Demographic profile
- Per capita availability of power, roads, railways, etc.
- Per capita availability of education and health facilities
- Industry growth rate
- Per capita sanctions and disbursements by financial institutions
- Mineral reserves

State Government Finances

- Revenue receipts and expenditure
- State's own revenues/Total revenues
- Grants from center/Revenues
- Revenue deficit
- Fiscal deficit and its composition
- Gross fiscal deficit/NSDP
- Debt/NSDP
- Debt/Revenue receipts
- Capital expenditure/Fiscal deficit
- Revenue receipts/Interest

Economic Management

- State government guarantees
- Utilization of ways-and-means advances and overdraft facility
- Performance of state-level public sector undertakings
- Plan performance

Municipal Ratings

Economic Base of the Service Area

- Population and its growth rate
- Sanctions and disbursements made by financial institutions
- Nondomestic power consumption
- Industrial water connections in the service area
- Sales tax collections
- Stamp duty collections on property transfers
- Per capita income
- Number of vehicles registered with the regional transport office
- Demand for telephone connections with Department of Telecommunications
- Growth in bank deposits raised by major public sector banks

Current Financial Position

- Tax receipts/Total revenues
- Nontax receipts/Total revenues
- Grants from state government/Total revenues
- Revenue deficit
- Overall deficit
- Collection efficiency of property tax
- Collection efficiency of water tariff
- Debt service coverage ratio

Operations of the Municipal Body

- Expenditure on core services/Total expenditure
- Expenditure on wages and salaries/Total expenditure
- Water supplied per capita
- Per capita expenditure on primary education
- Per capita expenditure on health services

Source: Credit Rating Information Services of India Ltd.

for all issuers, private and public, and subnational entities as well. State government guarantees should not be treated as a substitute because they only increase a local body's dependence on safety nets.

Credit ratings reveal important information for the investor as well as issuer, thereby serving as a reliable guide to investors in determining the default risk associated with bond issuances. Mandatory rating, along with a statutory limitation on borrowing powers of subnational bodies, will considerably raise market discipline. Indian rating agencies should periodically publicize the ratings of state governments and provide independent assessment of credit risks to facilitate capital market functioning at the subnational level, as more and more such bodies are accessing markets. Local sociopolitical changes need to be captured by rating agencies and information disseminated. The rating agency is also expected to monitor the same as part of surveillance during the tenor of the bonds. State governments could make available the credit ratings of their local bodies by prescreening potential issuers, for example.

Borrowing Powers

State government powers to borrow are subject to Article 293 (3) of the Constitution; central Government approval is required. Article 293 (4) provides that the central Government may impose such conditions restricting borrowing. This is a standard requirement of a lender, although a transparent framework laying down the factors governing such consent is not yet in place. Government borrowing is considered as borrowing against the security of the consolidated funds of India or of the respective states.

State governments guarantee borrowings by state-level enterprises and statutory boards, which have the potential of becoming states' own liabilities in the event of default by these enterprises. While a few states have passed laws on guarantees, none has passed a law on borrowings. Provisions relating to borrowings and guarantees by states should be reviewed.

The policy environment and legal framework governing borrowing powers of local bodies such as municipalities are given in the Local Authorities Loans Act of 1914. Subject to the boundaries laid down under the act, state governments are free to lay down the framework within which their local authorities raise loans. The salient provisions of this act include the following:

- A local authority may, subject to the prescribed conditions, borrow on the security of its funds or any portion thereof for any of the purposes specifically mentioned therein. These purposes include public welfare activities such as giving relief and establishing and maintaining relief works, prevention of outbreak or spread of dangerous diseases, etc.

- The relevant state government may make rules consistent with the said act, in respect of, among others: (i) the nature of the funds on the security of which money may be borrowed; (ii) the works for which money may be borrowed; (iii) the manner of making applications for permission to borrow money; (iv) the manner and time of making or raising loans; (v) the sum to be charged against the funds which are to form the security for the loan, as costs in effecting the loan; (vi) the attachment of such funds, and the manner of disposing of or collecting them; and (vii) the accounts to be kept in respect of loans.

The acts governing local authorities' borrowing powers are out of date and need to be amended. Maharashtra amended the act of 1914 with the Bombay Provincial Municipal Corporation Act of 1949.

Municipal Bankruptcy

An important consideration by private investors in local infrastructure projects is the comfort of enforceable security during times of financial default. The existing framework of insolvency can be applied to SPVs set up by state governments as shareholders. As SPVs are registered under the Companies Act, the Provincial Insolvency Act of 1920 and Presidency Towns Insolvency Act of 1909 apply. Private lenders' interests are not protected in constitutional bodies such as municipal corporations or statutory boards insofar as enforcing secured assets of, or bringing insolvency proceedings against, such bodies.

The insolvency laws provide the legal and administrative structures for recovery. Efforts[4] have recently been made to identify and address problems pertaining to insolvency of corporate entities. The above initiatives seek to create separate substantive as well as procedural laws to govern corporate insolvency, and do not apply to local bodies. No local body has ever been declared "insolvent" under the insolvency laws.

India has no specific statutes that contemplate insolvency of local bodies, let alone govern insolvency procedures. If a local body defaults, the investor's only legal remedy is to seek relief by way of a writ in the relevant high court as provided under Article 226 of the Constitution. However, seeking remedy against local bodies is complicated as the courts are reluctant to enforce any security offered by a local body as it has sovereign immunity. This would be more difficult where more than one body is involved, for example, in a water supply or purification project passing through more than one local body.

To permit local bodies to function as independent entities in accessing capital markets and to ensure that investors can bring insolvency proceedings against local bodies, the following are recommended:

- Promulgate a separate law on the insolvency process (a fast-track recovery process) for local bodies.
- Constitute separate insolvency courts with jurisdiction over local bodies.
- Promulgate a separate statute setting out the revised manner of constitution of local bodies to facilitate greater transparency and responsibility in fiscal dealings.

Fiscal Incentives for Bond Issuance

Fiscal incentives in the form of tax exemption and deduction have been used for several years for infrastructure investment. Investments in urban infrastructure such as water supply and solid waste management are also eligible for tax deduction and exemptions. The market participants that benefit from these incentives are (i) financial institutions and commercial banks that raise bonds for infrastructure investment, (ii) companies or funds involved in infrastructure projects, and (iii) primary investors that supply the funds. The benefits are tax exemptions, deductions on profits and gains, and rebates. Various sections of the Income Tax Act that benefit investors are as follows:

- Section 10 (15) (vii). Interest income earned on municipal bonds is tax exempt. All bonds issued by local authorities such as municipal and statutory corporations are tax-exempt.
- Section 10 (23 G). Income from dividends, interest, or long-term capital gains of an infrastructure capital fund or an infrastructure capital company wholly engaged in developing, maintaining, and operating infrastructure facilities is exempted from tax. Interest includes any fee or commission received by a financial institution for giving any guarantee to, or enhancing credit in respect of, an enterprise approved by the central Government.
- Section 88. Individuals who invest in equity, debentures, bonds of a public company engaged in infrastructure, or units of a mutual fund, the proceeds of which are utilized for infrastructure, can seek a tax rebate under this section. Income up to 20% of the amount invested (enhanced up to Rs80,000 in 2001/02) in bonds for qualified infrastructure projects is exempt from an individual's tax liability.
- Section 80-IA. All of the profit is deductible for 10 consecutive years from the initial assessment year for enterprises that have entered into concession agreements with the central or state government or local authority to develop, maintain, and

operate a new infrastructure facility. Build-operate-transfer, build-own-operate-transfer, and build-operate-lease-transfer schemes for urban infrastructure development are entitled to claim exemption.
- Section 80L. A deduction is available for the amount invested in debentures of, and equity shares in, a public company engaged in building infrastructure.

Tax benefits for private funds investing in urban infrastructure projects and municipal bonds will encourage financial institutions to deploy their resources mobilized from households to finance urban infrastructure projects.

The capital market infrastructure in the national system provides the impetus to develop local bond markets. Market participants also need liquidity, legal protection of their investments, protection of return on investments, and a supportive subnational socioeconomic environment. Investors in subnational securities benefit as much from a fair and transparent market structure as investors in national securities. Securities regulations are not designed in segments but should be viewed as part of an overall system existing alongside and complemented by national systems of regulations. Regulations with defined and enforceable debt contracts, protecting the issuers' rights in the event of default, and an efficient judiciary overseeing the enforcement of such rights are necessary preconditions.

Capacity Building

Development of municipal bond markets requires viable infrastructure projects, with definite cash flows, a regulatory framework enabling private sector participation in local projects, and cash-flow-generating capability of projects through defined user charges and fiscal and financial capability of the city governments. However, ULBs are caught in a vicious circle. They have a poor revenue base, inefficient collection, and restricted functions due to inadequate local laws and provisions. They are also unable to demonstrate the financial and operational efficiency necessary to attract investments from the private sector. ULBs need significant capacity building to access municipal bond markets.

Improving Sources of Revenue. The revenue base must be augmented through user charges, additional sources of tax and nontax revenues, and improved collection efficiency. Property taxes are not buoyant due to improper record maintenance, the outdated Rent Control Act still prevailing in many states, and complicated valuation procedures. Adopting an area-based valuation system as done by Patna Municipal Corporation, or a mass appraisal technique taking into account the important characteristics of the properties, would reduce the complexities and increase collection efficiency. Maintaining records using a geographic information system as implemented in Mirzapur municipality would improve information on property holdings. However, property tax alone cannot fully capture the increase in the land use and value; alternative land-based taxes could be explored to widen the revenue base. Options such as tax on land value increment and a betterment levy should be considered.

User Charges. User charges should be levied on utilities such as water supply and services such as waste management. Water rates are low and the pricing structure complex. Private investments will not be forthcoming in urban infrastructure projects unless they are financed by user charges. The pricing structure is generally static with little change in the format and structure over the years. Political will is necessary to gradually do away with subsidies. In the power sector, this is gradually emerging as the regulatory commissions have applied principles of cost of supply, which can be extended to water supply, municipal waste, etc.

Financial Management. Lack of prudent financial management practices of ULBs makes it difficult for them to reach the capital market. The single-entry cash-based accounting system used by most ULBs does not convey any useful information on the financial health of local governments. They must shift to a double-entry accrual-based system. Tamil Nadu has implemented a double-entry accounting system in all municipalities, with assistance of the USAID-Financial Institutions Reform and Expansion (FIRE) Project. Lack of expertise, substantial investment in computerization, training of personnel, and pending annual accounts for several years are the reasons for nonimplementation of a double-entry system. Significant external support is needed in the form of finance, training of personnel, and deputation of qualified accountants during the transition.

Bond Issuance Process. Structuring and raising bonds for capital projects require several issues and procedures to be resolved, and the ULBs need external support at different stages, such as project feasibility study, capital planning process, preparing for disclosure, decision to issue bonds, obtaining a credit rating, formation of bond parties (underwriter, trustee), preparation of information memorandum, audit and standing committee approval, approval from the central Government and SEBI, issuance of bonds, listing on the stock exchange such as NSE, use of funds in the project, and follow-up for repayment.

Budgeting. Proper budgeting gives the management relevant information on the expenditure plans and revenue commitments. Cash-based accounting does not take into account the time of expenditure and often results in past expenditure preempting future revenues, thereby rendering the budgeting exercise futile. Improved budgeting techniques, such as a performance-based system, can be used only with accrual-based accounting. The historic costs used by municipalities are obsolete and do not offer the accurate marginal cost of offering the services. Activity-based costing would help fix the tariff for services provided commercially. The increments used in revenue and expenditure forecasting should be linked to factors such as inflation to make such increments realistic.

Financial Control and Audit. The 74th Constitutional Amendment provides for the state legislatures to enact provisions for external and internal audit of municipal accounts. Although an annual external audit is statutory, this rule is seldom followed, partly due to insufficient human resources and ineffective internal audits conducted by municipal staff. Relevant statutes need to be modified to engage external professional accounting firms as external audits. The scope of internal audits needs to be widened, to include compliance with various statutory audits and operational indicators apart from financial indicators. These changes will ensure transparency and help get a better rating for bond issues.

Project Management Skills. Urban managers need skills and expertise in project development such as technical sanctions, costing for various works, development of contractual documents, bidding procedures, and commercial assessment. In addition to using the services of the state department or parastatal agencies, urban managers need to hire specialized project management consultants to implement large or fast-track projects. This has been successfully used by City and Industrial Development Corporation to implement a large number of urban infrastructure projects in New Mumbai, as well as by Ahmadabad and Chennai municipal corporations.

Need for Debt Management Policies. Capital market access through bond issuance requires careful consideration of the revenues and level of indebtedness of the ULB. Debt management is necessary to consider how each debt issuance relates to previous and future issuances and also to long-range strategic development and budgetary goals of local governments. A debt management policy would provide necessary risk management tools for local government portfolios. Debt management ultimately aims to reduce the cost of borrowings through credit rating and capital planning.

Human Resources Management. Human resources are woefully inadequate to undertake new responsibilities. A human resources policy should be developed to assign development responsibilities. Recruitment and transfer for ULBs are fully controlled by state governments. Executives are generally deputed from the state government departments, and frequent changes in the executive cadre make local governance unstable. A separate municipal cadre needs to be prepared and transfer policy made consistent with that of state government employees to ensure stability.

Urban Indicators. No performance measurement tools are available to measure the comparative ULB performance, lack of information on which hinders raising capital through capital markets. Local governments can use city-level indicators to set performance targets, and make rational financial and planning decisions. This would be useful for higher-level government policy analysis, providing the ULBs with performance benchmarks. Tamil Nadu has a statewide performance indicator system based on service levels and coverage, service efficiency, and financial management. These indicators help the administration target local bodies for development financing and capacity building.

Awareness Campaign. A campaign should raise awareness of the potential for private capital market access and, in particular, bond market access, which will depend on how fast the local institutional capacity is built and urban sector reforms undertaken. The central Government and various external agencies should make a concerted effort and provide technical assistance. City governments have undertaken reforms when external agencies were committed to support infrastructure development by way of loans and technical assistance.

Local Bond Market Development: A Roadmap

Local governments need long-term capital for investment in urban infrastructure, and given ULB resource constraints, the time is ripe to develop municipal bond markets. The experience of the Ahmadabad Municipal Corporation and others (Table 24) shows that India has the potential to do so. The growth of institutional investors, such as pension funds, provident funds, and insurance companies, implies increasing demand for local debt securities. However, if bond markets are to cater to the needs of local government financing, particularly of urban infrastructure, the central, state, and local governments must solve their legal, administrative, and capacity-building problems. The few cases in this study show that municipal bond issuance requires significant capacity building and capital planning by the issuers, as well as building capital market relationships, making investors aware of the issuer profile, and becoming familiar with market intermediaries and the regulatory environment.

External aid agencies, in collaboration with rating agencies, merchant bankers, regulatory agencies, and stock exchanges, should facilitate and expedite the development of more pilot projects to issue municipal bonds. Local bond market development should be enabled by the following measures, the duration and sequencing of which would depend on how deeply local government is involved, as well as on the framework for the measures:

- wide acceptance of the 74th Constitutional Amendment;
- achievement of stability and transparency in intergovernmental fiscal relations;

- correction of states' fiscal imbalances;
- improvement of local fiscal and financial management;
- solution of urban management problems (user charges, taxes, and capacity building);
- solution of national and state regulatory design problems;
- privatization of essential urban infrastructure;
- development of local bond markets;
- regulatory design issues;
- wider dissemination of successful cases;
- capacity building of ULBs; and
- policy dialogue at the center, state, and local levels.

The roadmap for local bond market development in Table 27 covers policy objectives, key performance indicators, and areas of intervention.

Areas of Technical Assistance

The above analysis highlights issues in furthering ADB's role in implementing local lending programs in India, particularly promoting local government financing and bond market financing.

ADB has significantly increased lending in India since operations began in 1986. In the urban sector, seven loans with a total value of about $1 billion have been approved to support improvement of basic services, including water supply, wastewater management, drainage, transportation, solid waste management, slum rehabilitation, and capacity building.

ADB assistance should do the following:

- Support decentralization by improving the core service delivery efficiency of local governments such as states and ULBs.
- Support improving the efficiency of local fiscal systems (state and city) so that these entities can be economically efficient and sustainable.
- Strengthen the role of the private sector in providing basic urban services, by reforming the legal and regulatory frameworks and supporting an enabling environment.
- Deepen the nascent bond market and spread its coverage nationwide by providing access to the thousands of ULBs that need funds for long-term investments.
- Strengthen the links and building synergies among the Indian stakeholders such as state and central governments, private sector service providers, and financial institutions, for flotation of urban finance projects.

Table 27. Local Bond Market Development: A Roadmap

Policy Objective	Key Performance Indicator	Areas of Intervention
Central Level		
Objectives of the 74th Constitutional Amendment	Process of decentralization and financial devolution, and capital market access	Identifying through case studies reform-minded and nonreforming states, studying the evolution of their financial resources and fiscal management practices, and identifying constraints and lessons for future interventions
		Facilitating the implementation of the 12th schedule of the 74th Constitutional Amendment, which requires state governments to restore 18 approved functions to urban local bodies (ULBs)
		Promoting state finance commissions as empowering bodies to design local governance
Regulatory Issues	Determination of the borrowing powers of local bodies	Amending the Local Authority Loans Act of 1914 to allow states to incorporate in their own statutes provisions on borrowing powers, security provisions, etc.
	Capital market regulations affecting private placement of bonds	Examining the suitability of guidelines of the Securities and Exchange Board of India Act of 1992 for ULBs private issue placements, disclosure formats, model prospectus
	Secondary-market trading of municipal bonds	Working with the stock exchanges to list and trade municipal bonds and other private placements by local bodies, and drafting of regulatory mechanisms
	Municipal bankruptcy	Creating a separate statute for municipal bankruptcy
Performance Indicators for ULBs	Building a database	Development of urban indicators for all ULBs with the Ministry of Urban Development and Poverty Alleviation
Policy Dialogue	Dissemination and common understanding	Conducting national and state workshops to bring stakeholders together to develop a common understanding of options and action plans
		Promoting efficient and corruption-free local bodies and transparency in governance

Table 27. Local Bond Market Development: A Roadmap (*cont'd.*)

Policy Objective	Key Performance Indicator	Areas of Intervention
State Level		
Fiscal and Financial Management	Strengthening of state finances	Training staff and financing improvements in tax administration, medium-term expenditure management framework, management of public debt, and guarantees, including reforms of the civil service and bureaucracy
Privatization	Privatization of essential urban infrastructure services such as water and sewerage systems	Strengthening and reforming regulatory agencies and the contractual framework for private sector participation in service delivery, and creating a new regulatory infrastructure where it does not exist
Debt Management	Debt management policy for fiscal stability	Putting in place a debt management policy Restricting borrowings for capital expenditure Prescribing ULB debt service indicators and their structuring Putting in place a risk management system to mitigate various risks
	Contingent liabilities of the state governments	Drawing up a national policy on contingent liabilities and guarantees of the states
Urban Local Body Level		
Organization of Municipal Structure	Strong municipal commissioner system in ULBs, avoiding fragmentation of executive authority	Restructuring the recruitment policy for ULBs so that competent executives are employed Making staff transfer rules consistent with those for state government employees
Financial Accounting	Inappropriate staff structure	Providing technical assistance to prepare operating manuals for reforms in fiscal and financial management of municipal corporations, and operating manuals for an accrual-based accounting system for such corporations Implementing the double-entry accrual-based accounting system Following generally accepted accounting principles, to be implemented in phases
Financial Control and Audit	Mandatory audit	Providing adequate training for auditing staff Implementing a double-entry accrual-based accounting system and identifying performance indicators to enable performance-based audit or efficiency and cost audit Exploring private sector participation in activities

Table 27. Local Bond Market Development: A Roadmap (*cont'd.*)

Policy Objective	Key Performance Indicator	Areas of Intervention
Human Resources Management	Training and capacity-building activities	Providing training programs for city managers (key officials) in (i) fiscal and financial management, accounting, and audit; (ii) budget preparation; (iii) capital planning; (iv) capital raising from financial markets; (v) establishment of an enabling legal and regulatory environment for the capital market, including credit rating; (vi) determination of user chargers for core services and other taxes such as property taxes and innovative sources of revenues; (vii) municipal bond issuance, documentation, and negotiation; and (viii) application of information technology in municipal governance
Urban Management	User charges	Giving ULBs the power to raise tariffs under certain conditions, reducing user charges, metering all connections, making energy audit mandatory, and specifying performance parameters
	Property tax	Modifying the Rent Control Act, which is redundant, to suit present conditions Giving ULBs the power to periodically revise the annual ratable value of property, and indexing for inflation to make the revenue sources buoyant. Following the Mirzapur experiment, using the geographic information system to generate property records Using the private sector or community participation to collect taxes Using land as a source of revenue (such as in Navi Mumbai and Delhi) and introducing other land-based tax sources
	Other tax revenues	Giving ULBs power to raise tariffs under certain conditions
Local Government Finances	Municipal bond issuance	Building capacity of selected cities to prepare for municipal bond issuance
	Credit rating	Building capacity of selected cities (reform-minded ones and those not well-off) to prepare them for credit rating, in collaboration with Indian credit-rating agencies
	Intergovernmental transfers	Strengthening the role of state finance commissions in formulating transfer rationale and mechanisms of grants to be allotted to ULBs, on the merit of the commercial viability of the projects and other reforms
Skilled Technical Staff and Human Resources	Development of competency in preparing master plans, technical drawings, contractual documents, bidding procedures, and project design skills	Combining technical and financial consultancies and hiring external consultants

ULB = urban local body.

- Introduce international best practices that have been successful in many decentralized setups and facilitate innovative schemes for urban financing.

The proposed activities could be introduced into progressive and reform-minded states as well as those that have great potential for reform and decentralization. Although reforming states with a history of successful decentralization are expected to be the main beneficiaries of any new initiative, states with potential can be brought into dialogue with central and state governments, financial institutions, regulatory bodies, and funding agencies to fully realize the benefits of decentralization and capital market access.

Multilateral assistance has catalyzed reform and modernization of fiscal management in some states such as Uttar Pradesh and Andhra Pradesh, the medium-term expenditure framework in Tamil Nadu, public enterprise reform in Orissa, urban property tax reform and urban finance reform in Gujarat, *panchayati raj* institutional reform in Madhya Pradesh, urban management of the environment in Karnataka, municipal development funds in Tamil Nadu, private-public provision of core service delivery in Tamil Nadu and the National Capital Region, civil service and other reforms in municipalities, manuals for municipal accounting systems, and training programs for municipal managers in Gujarat.

Fiscal and financial management at the state and city government level requires financial and technical resources that many local governments do not have. Areas needing attention are numerous, such as fiscal reform, expenditure management, tax reforms, user charges, reform of state public enterprises, reform of urban sector and city governance, and design of regulatory frameworks such as for municipal borrowing power and bankruptcy. These require significant training and capacity building.

Endnotes

[1] Three new states—Jharkhand in Bihar, Uttaranchal in Uttar Pradesh, and Chattisgarh in Madhya Pradesh—were created in November 2000 by Parliament, essentially because the areas are so socioeconomically diverse.

[2] See RBI (2001a, 2001b, 2001c).

[3] ICICI Ltd. was a development financial institution merged with ICICI Bank to become a universal bank in 2002.

[4] Recent initiatives include (i) the setting up by the central Government of a committee chaired by a retired Supreme Court Justice to review laws pertaining to corporate insolvency, and (ii) the setting up by RBI of an advisory group on bankruptcy

laws. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance was promulgated by the President on 21 June 2002. The consensus seems to be to form a national company-law tribunal by consolidating the powers and jurisdiction currently exercised by different structures.

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Appendix 1

Table A1.1 Tax Revenues of Municipal Corporations (%)

State/Local Body	1990/91	1995/96	1999/2000
Gujarat-Ahmadabad			
Property	27.6	27.3	26.1
Octroi	71.4	69.1	69.2
Miscellaneous	0.9	3.6	4.7
Karnataka-Hubli-Dharwad			
Property	57.9	66.7	40.0
Service	33.1	20.7	18.6
Trades and Callings	4.1	2.4	1.3
Miscellaneous	4.9	10.2	40.0
Kerala-Kozhicode (Calicut)			
Property	46.1	28.3	32.2
Service	22.5	18.7	27.8
Trades and Callings	2.4	2.4	3.9
Toll	11.6	8.4	7.0
Miscellaneous	17.4	42.1	29.1
Madhya Pradesh-Indore			
Property		17.4	20.2
Service		10.2	8.5
Octroi		62.0	62.7
Terminal		2.8	2.6
Trades and Callings		6.9	5.5
Animals and Vehicles		0.0	0.0
Maharashtra-Nashik			
Property	9.2	7.7	6.8
Octroi	70.6	70.8	54.2
Miscellaneous	20.2	21.5	39.1
Meghalaya-Shillong			
Property	30.7	52.5	41.4
Service	5.5	4.7	6.6
Animal and Vehicles	0.0	0.2	0.1
Toll	54.9	36.9	43.1
Miscellaneous	8.8	5.7	8.8
Punjab-Ludhiana			
Property	14.3	17.4	16.4
Octroi	79.8	73.6	78.2
Miscellaneous	5.8	9.0	5.4
Pondicherry			
Property	21.3	17.9	15.8
Service	0.5	0.4	1.3
Octroi	16.4	28.0	15.5
Trades and Callings	0.7	0.3	1.3
Toll	0.1	0.1	0.1
Miscellaneous	60.9	53.3	66.1
Rajasthan-Jodhpur			
Tax Revenue	98.9	99.6	
Octroi	1.1	0.4	
Tamil Nadu-Chennai			
Property	43.4	38.9	40.8
Miscellaneous	56.6	61.1	59.2
General Administration	2.9	5.0	4.1
Miscellaneous	100.0	100.0	100.0

Source: Central Statistical Organization. 2001. *Statistical Abstract India*.

Table A1.2 Expenditures of Municipal Corporations (%)

State/Local Body	1990/91	1995/96	1999/2000
Gujarat-Ahmadabad			
General Administration	13.1	4.7	16.5
Public Health	2.8	2.2	2.5
Safety and Convenience	3.7	4.1	3.5
Education	23.5	22.2	21.7
Public Works	1.4	3.7	3.5
Miscellaneous	55.5	52.9	52.3
Karnataka-Hubli-Dharwad			
General Administration	6.2	15.6	24.5
Public Health, Safety, and Convenience	32.7	36.9	28.5
Education	0.0	0.0	0.0
Public Works	32.4	28.0	40.7
Miscellaneous	28.6	19.4	6.3
Kerala-Kozhicode (Calicut)			
General Administration	15.1	14.6	11.6
Public Health	4.9	12.7	10.0
Public Works	59.6	55.4	84.9
Miscellaneous	20.4	17.3	5.1
Madhya Pradesh-Indore			
General Administration		69.5	77.3
Public Health		13.2	8.4
Safety and Convenience		6.3	6.6
Education			0.1
Public Works		11.0	7.6
Maharashtra-Nashik			
General Administration	1.4	17.6	9.8
Public Health	9.8	23.9	28.9
Safety and Convenience	2.9	6.6	7.4
Education	6.2	0.1	1.2
Public Works	5.4	8.6	5.1
Miscellaneous	74.2	43.2	47.6
Meghalaya-Shillong			
General Administration	19.7	19.0	17.7
Public Health	57.9	55.6	39.2
Safety and Convenience	1.4	10.0	5.5
Public Works	13.4	9.6	33.4
Miscellaneous	7.7	5.8	4.2
Punjab-Ludhaina			
General Administration	9.4	5.3	5.9
Public Works	14.2	34.5	36.9
Miscellaneous	76.4	60.2	57.2
Pondicherry			
General Administration	10.6	9.7	10.5
Public Health	1.3	1.4	1.2
Public Works	16.6	7.8	7.4
Miscellaneous	71.5	81.1	91.3
Rajasthan-Jodhpur			
General Administration	19.1	4.9	
Public Health	30.2	14.3	
Safety and Convenience	0.3	0.2	
Public Works	25.2	48.5	
Miscellaneous	25.1	32.1	
Tamil Nadu-Chennai			
General Administration	2.9	5.0	4.1
Miscellaneous	100.0	100.0	100.0

Source: Central Statistical Organization. 2001. *Statistical Abstract India.*

Table A1.3 Loan Repayments and Wages and Salaries (% of revenue expenditure)

State/Local Body	1990/91	1995/96	1999/2000
Gujarat-Ahmadabad			
Repayment of Loans	13.6	12.0	14.7
Wages and Salaries	4.6	4.5	4.3
Karnataka-Hubli-Dharwad			
Repayment of Loans	9.2	1.0	5.3
Wages and Salaries	52.8	70.4	52.2
Kerala-Kozhicode (Calicut)			
Repayment of Loans	18.0	31.1	14.9
Wages and Salaries	207.1	209.4	234.2
Madhya Pradesh-Indore			
Repayment of Loans		1.0	0.6
Wages and Salaries		56.2	57.6
Maharashtra-Nashik			
Repayment of Loans	12.9	0.4	0.2
Wages and Salaries	27.9	53.9	43.9
Meghalaya-Shillong			
Repayment of Loans	5.1		
Wages and Salaries	54.1	59.2	52.8
Punjab-Ludhaina			
Repayment of Loans	6.6	1.2	1.3
Wages and Salaries	62.1	35.1	32.8
Pondicherry			
Repayment of Loans	2.6	1.1	1.1
Wages and Salaries	28.2	30.0	48.0
Rajasthan-Jodhpur			
Repayment of Loans	4.2	0.2	
Wages and Salaries	406.9	125.3	

Source: Central Statistical Organization. 2001. *Statistical Abstract India*.

Table A1.4 Composition of Municipal Revenues for 1997/98 (%)

State	Own Resources	Tax Receipts	Nontax Receipts	Shared Revenue	Grants	Others
Andhra Pradesh	51.17	36.37	14.80	33.56	13.03	2.25
Assam	59.08	23.24	35.84	0.00	23.37	17.55
Bihar	52.77	36.86	15.91	2.99	40.31	3.93
Gujarat	87.45	79.74	7.71	0.18	11.10	1.27
Haryana	80.51	42.80	37.71	13.44	3.95	2.09
Karnataka	43.18	18.12	25.06	5.67	43.62	7.53
Kerala	70.32	44.69	25.63	20.65	4.74	4.29
Madhya Pradesh	47.34	22.61	24.73	11.88	39.90	0.88
Maharashtra	95.40	65.44	29.96	0.53	3.84	0.23
Orissa	67.12	46.92	20.20	0.93	28.59	3.36
Punjab	89.02	69.60	19.42	6.14	3.81	1.03
Rajasthan	89.80	62.90	26.90	0.17	9.30	0.74
Tamil Nadu	44.34	21.21	23.13	21.93	29.49	4.24
Uttar Pradesh	19.44	13.50	5.95	0.36	79.14	1.06
West Bengal	59.33	36.51	22.82	5.05	30.53	5.10
Himachal Pradesh	25.86	15.27	10.59	0.00	72.04	2.09
Manipur	98.29	90.42	7.87	0.20	0.15	1.35
Meghalaya	46.27	37.66	8.62	0.00	40.09	13.63
Tripura	42.92	27.31	15.61	0.00	33.74	23.34
Total	**82.78**	**56.40**	**26.38**	**4.05**	**11.99**	**1.19**

Source: Mathur, O.P., Sengupta, P., and Bhaduri, A. 2000. *Options for Closing the Revenue Gap of Municipalities: 2000/01 to 2004/05*. New Delhi: National Institute of Public Finance and Policy.

Table A1.5 Per Capita Expenditure, Revenue Receipts, and Revenue Gap of All Municipalities (Rs)

State	Per Capita Expenditure		Per Capita Revenue Receipts		Revenue Gap	
	1992/93	1997/98	1992/93	1997/98	1992/93	1997/98
Andhra Pradesh	146.96	318.38	246.52	410.47	44.06	108.34
Assam	49.75	81.77	46.10	79.78	19.34	34.63
Bihar	80.73	104.29	42.70	113.11	53.19	44.61
Gujarat	328.12	438.21	381.99	707.45	-11.59	-180.49
Haryana	364.96	598.22	378.90	531.21	18.80	170.55
Karnataka	203.90	321.05	199.69	381.61	109.62	156.28
Kerala	152.50	228.38	154.40	275.46	31.56	34.67
Madhya Pradesh	169.62	322.74	179.89	300.88	85.44	180.31
Maharashtra	889.98	1750.50	960.51	1,917.20	-14.17	-78.53
Orissa	205.22	248.29	193.08	231.51	78.90	92.90
Punjab	269.09	542.81	258.63	499.03	50.74	98.58
Rajasthan	248.77	497.24	273.96	479.35	10.64	66.78
Tamil Nadu	172.84	331.46	215.86	424.37	42.72	143.28
Uttar Pradesh	169.22	223.23	169.33	225.02	132.42	179.47
West Bengal	440.88	522.83	396.83	568.40	258.45	185.61

Source: Mathur, O.P., Sengupta, P., and Bhaduri, A. 2000. *Options for Closing the Revenue Gap of Municipalities: 2000/01 to 2004/05*. New Delhi: National Institute of Public Finance and Policy.

Table A1.6 Selected Indicators of Fiscal Positions of States (%)

	GFD/GFD Expenditure		Revenue Deficit/ Gross Fiscal Deficit		Capital Outlay/ Gross Fiscal Deficit		Interest Payment/Rev. Expenditure		State Tax Revenue/Rev. Expenditure		State Nontax Revenue/Rev. Expenditure		Gross Transfers/Agg. Disbursements		Debt Servicing/ Gross Transfers	
States	**1990–95**	**2001/02**	**1990–95**	**2001/02**	**1990–95 Avg**	**2001/02 (BE)**	**1990–95 Avg**	**2001/02 (BE)**	**1990–95 Avg**	**2001/02 (BE)**	**1990–95 Avg**	**2001/02 (BE)**	**1990–95 Avg**	**2001/02 (BE)**	**1990–95 Avg**	**2001/02 (BE)**
Andhra Pradesh	17.6	28.4	11.5	43.7	58.5	42.9	11.8	19.3	47.0	44.7	15.5	10.7	40.4	36.3	19.9	24.7
Assam	12.0	27.6	442.1	66.4	-218.5	25.2	13.9	15.5	21.5	19.3	13.5	6.3	65.0	49.4	26.1	23.1
Bihar	20.7	22.7	51.3	39.9	31.2	43.4	18.1	21.2	23.5	19.7	12.3	3.5	58.5	62.8	20.6	23.0
Gujarat	20.2	32.8	11.3	83.6	70.3	35.4	14.5	14.2	57.9	36.9	18.0	14.3	26.1	29.3	42.1	26.2
Haryana	13.4	22.6	14.1	37.3	48.1	55.4	12.3	19.9	50.0	58.5	32.9	18.1	21.7	15.1	34.6	55.9
Himachal Pradesh	21.7	39.4	6.9	71.8	85.6	28.8	14.4	24.6	18.9	16.5	7.4	4.1	60.2	42.6	14.4	21.4
Jammu and Kashmir	14.0	10.7	468.4	-68.7	-363.7	169.0	20.7	16.5	11.7	14.0	6.8	5.2	75.9	72.8	18.7	14.6
Karnataka	16.7	22.8	11.2	51.2	85.9	42.5	11.1	14.3	58.6	54.4	12.7	6.5	30.9	31.2	24.3	24.9
Kerala	20.7	23.4	44.0	73.1	36.9	21.0	14.8	18.6	52.2	56.9	7.5	6.1	37.4	22.1	26.6	22.2
Madhya Pradesh	14.7	23.1	10.1	59.9	77.5	36.1	11.9	16.7	37.3	35.8	19.9	9.7	42.0	42.4	20.1	21.6
Maharashtra	16.0	16.2	8.8	37.4	75.7	57.1	11.3	17.5	59.4	67.0	18.6	13.0	26.3	14.8	34.3	82.4
Orissa	23.2	27.6	22.4	54.2	71.9	30.8	18.4	29.3	25.7	27.6	11.9	7.9	56.2	51.4	21.5	30.9
Punjab	30.0	28.0	45.9	60.4	27.3	33.0	16.0	20.2	47.1	42.1	20.5	25.3	37.7	17.1	38.9	71.9
Rajasthan	18.2	28.5	3.4	56.3	83.4	36.3	14.9	24.5	35.0	38.4	20.2	10.3	43.4	32.5	22.2	40.0
Tamil Nadu	16.5	23.3	72.3	56.9	29.1	37.1	9.0	13.5	52.5	58.7	8.6	5.6	33.8	22.3	20.2	34.3
Tripura	12.1	26.5	-56.2	23.0	155.6	75.6	9.8	10.9	5.7	6.7	3.7	4.6	83.1	67.5	8.1	5.6
Uttar Pradesh	24.1	23.6	34.2	39.5	30.3	47.5	16.4	27.2	32.0	38.2	11.0	5.2	50.8	45.5	17.7	31.6
West Bengal	21.7	39.3	52.0	59.9	27.8	25.7	15.8	28.7	45.0	34.5	4.4	4.3	48.6	32.9	27.8	43.0
All India	**19.0**	**25.1**	**24.6**	**49.8**	**55.3**	**42.2**	**13.6**	**19.5**	**42.2**	**43.0**	**15.8**	**9.9**	**40.1**	**34.2**	**24.0**	**31.1**

Agg. = aggregate, Avg. = average, BE = budget estimates, Exp. = expenditure, GFD = gross fiscal deficit, RE = revised estimates, Rev. = revenue.
Source: Reserve Bank of India.

Table A1.7 State Distribution of Investments of Banks in Securities of Local Authorities (31 March 2000, Rs10 million)

State/Union Territory	1	2	3	4	5	6	7	8	9	10	Total
1. Andhra Pradesh	4,983	24	43	345	0	352	13	19	49	178	6,006
2. Arunachal Pradesh	34	0	0	0	0	0	0	0	0	0	34
3. Assam	1,108	1	0	400	0	40	0	0	0	0	1,549
4. Bihar	3,515	62	0	430	0	130	7	0	5	0	4,149
5. Goa	175	0	0	0	0	0	0	0	0	4	179
6. Gujarat	1,583	29	37	393	166	276	8	109	77	182	2,859
7. Haryana	1,018	16	33	245	0	163	3	0	0	105	1,583
8. Himachal Pradesh	426	4	6	143	0	64	0	0	40	144	826
9. Jammu & Kashmir	451	4	1	88	0	58	0	0	0	30	632
10. Karnataka	2,125	33	65	85	17	432	3	25	0	257	3,043
11. Kerala	2,596	3	43	310	3	183	22	20	11	216	3,406
12. Madhya Pradesh	2,749	65	18	1,001	0	196	26	31	0	3	4,089
13. Maharashtra	2,171	22	42	891	247	213	5	143	160	1,429	5,323
14. Manipur	126	0	0	0	0	0	0	0	0	0	126
15. Meghalaya	168	0	0	72	0	0	0	0	0	0	240
16. Mizoram	67	0	0	0	0	0	0	0	0	0	67
17. Nagaland	230	0	0	0	0	0	0	0	0	0	230
18. Orissa	2,793	37	0	75	0	285	0	41	0	123	3,354
19. Punjab	1,416	9	20	515	4	163	0	64	12	93	2,297
20. Rajasthan	3,640	52	8	371	0	190	20	57	25	71	4,435
21. Sikkim	86	0	0	0	0	0	0	0	0	5	91
22. Tamil Nadu	2,738	5	14	589	15	180	39	154	0	150	3,885
23. Tripura	172	0	0	0	0	0	0	0	0	0	172
24. Uttar Pradesh	8,071	120	2	474	0	445	2	37	0	108	9,259
25. West Bengal	3,271	14	3	452	118	148	10	98	0	562	4,677
28. Delhi	0	0	0	0	0	9	47	0	0	73	129
Total	45,713	501	337	6,879	571	3,527	205	798	380	3,732	62,642

1 = state government securities, 2 = regional rural banks, 3 = cooperative institutions, 4 = state electricity boards, 5 = urban local bodies, 6 = state financial corporations, 7 = housing boards, 8 = state industrial development corporations, 9 = road transport corporations, 10 = other government and quasi-governmental bodies.

Notes: Figures are inclusive of nonguaranteed bonds and unsecured debentures. Urban local bodies include municipalities, municipal corporations, and port trusts.

Source: *Reserve Bank of India Bulletin*. April 2001.

Appendix 2. Ahmadabad Municipal Corporation Bond Issue, 1998

The following bond issue was made possible by significant financial market assistance and capacity building coordinated by the USAID-Financial Institutions Reform and Expansion (FIRE) Project.

Objective: To finance a portion of the water supply and sewerage project

Issue size: Rs1,000 million.
Face value: Rs1,000 at par.
Redemption: 3 tranches of Rp333, Rp333, and Rp334, at the end of years 5, 6, and 7.
Interest: 14% per annum payable semiannually on the outstanding principal.
Security: Charge/Mortgage on Ahmadabad's properties.
Structured obligations: Octroi collection from 10 designated points were to be earmarked and kept in an escrow account to service the bond.
Issue opened on: 16 January 1998
Issue closed on: 27 January 1998
Deemed Date of Allotment: 1 February 1998
Rating: Credit Rating and Information Services of India Ltd. provided the rating of AA (SO) based on the financial performance of Ahmadabad in 1996/97, indicating a high degree of certainty of timely payment of interest and principal (SO = structured obligation). Ahmadabad became the first urban local body in India to obtain a formal credit rating.

The private and public issue components follow:

- 75% (Rs750 million), in the form of private placement (firm allotment basis), organized by Infrastructure Leasing and Financial Services Ltd. with co-lead managers such as Kotak Mahindra, State Bank of India Capital Markets, ANZ Grindlays Bank; and
- 25% (Rs250 million) in the form of public issue, fully underwritten by the lead managers.

Applications for listing were made with the National Stock Exchange and Ahmadabad Stock Exchange in December 1997.
The draft prospectus was approved by Securities and Exchange Board of India for public placement, as per the guidelines.
The total cost of bond issuance was 3.5% of the total value.

The applications received from the investors included the following categories:

Investors	No. of Applications
Government-Sponsored Financial Institutions (Unit Trust of India, Life Insurance Corporation, etc.)	2
Nationalized banks	6
Government companies and corporations	4
Mutual funds promoted by institutions and banks	2
Private and cooperative banks, private mutual funds	9
Corporate bodies	10
Trusts and foundations	112
Cooperatives, societies, provident funds	38
Hindu Undivided Family	62
Individuals	4,861
Total Applications	**5,106**
Amount Received (Rs million)	**1,040.67**

Indonesia

Carunia Mulya Firdausy
Professor
Center for Economic Research
Indonesian Institute of Sciences
Jakarta

Acronyms

ADB	Asian Development Bank
BAPEPAM	Badan Pengawas Pasar Modal (Capital Market Supervisory Agency)
BAPPENAS	Badan Perencanaan Pembangunan Nasional (National Planning Board)
BBJ	Bursa Berjangka Jakarta (Jakarta Commodity Market Agency)
BPD	Bank Pembangunan Daerah (local government bank)
CBS	Central Bureau of Statistics
DIP	Daftar Isian Proyek (annual government project list)
DKI Jakarta	Jakarta Special Province
GRP	gross regional product
JICA	Japan International Cooperation Agency
PDAM	Perusahaan Daerah Air Minum (state-owned water enterprise)
RDI	Rekening Dana Investasi (Investment Fund Account)
RDA	Regional Development Account
Rp	rupiah
SLA	Subsidiary Loan Account
US	United States
USAID	United States Agency for International Development

Executive Summary

Of the Southeast Asian countries that suffered the economic and financial crisis of the late 1990s, Indonesia has been the slowest to recover. In 2001, it grew by only 3.3%, and by 4.8% in 2002. Low growth has been caused by (i) the slow rate of economic reform, especially in debt restructuring, banking, financial supervision, revenue generation, and privatization; (ii) poor global prospects affecting exports and investments; and (iii) social and political instability, including the bombing in Bali on 12 October 2002.

While these problems have not been solved, the central Government has been committed to implement local autonomy and fiscal decentralization since January 2001. However, achieving these goals has not been as easy as expected. Deuster (2002), for instance, found that decentralization is challenged by the lack of equity in revenue sharing, mushrooming local taxes, fees and restrictions on business and trade, investment uncertainty, lack of direction from the central Government on decentralization and monitoring, disproportionate increases in minimum wages, and lack of local electoral reform to improve accountability.

In recent years, it has been suggested—and the idea is still being debated—that local government bonds be issued to help local governments obtain funds (Rowter 2001, Adiningsih 2002). The International Monetary Fund (IMF), in particular, has argued strongly against this because of the contingent liability that the central Government might incur. Former coordinating Minister of Economics Rizal Ramli, however, supports the use of local government bonds, arguing that they are an effective alternative to bank lending and will provide basic infrastructure to develop not only the financial system and local economy but also the national economy, especially since banks and other financial institutions still have recapitalization problems and large debts.

As the establishment of bond markets is still being debated, and as pressure is significant to implement local autonomy and decentralization, which demand sufficient budgets for regional development, local government finance and the possibility of developing bond markets as an alternative regional financing source should be considered. This chapter examines these themes, and aims to:

- briefly describe fiscal trends and developments of local governments since 1995, and discuss local governments' major social and economic responsibilities;
- examine major economic and political changes, such as decentralization efforts and fiscal reforms and their impact on local government finance;
- analyze patterns of expenditure and revenue of local governments from various perspectives (category, maturity, source, etc.);

- discuss how to financially strengthen local governments;
- critically examine the possibility of establishing local bond markets and evaluate past long-term financing by local governments, focusing on bond issuance in domestic and international financial markets;
- examine the regulatory and institutional framework for the local government bond and debt securities market, including the regulatory body, legal and regulatory framework, and market participants (investors, underwriters, guarantors);
- discuss major impediments to bond financing by local governments;
- recommend policy to facilitate bond financing by local governments, covering fiscal management, capacity of local financial departments, laws and regulations, institutional constraints, debt management, capital market constraints, tax issues, guarantee problems, etc.; and
- identify where the Asian Development Bank (ADB) may help reform fiscal and financial systems to strengthen local government bond and debt securities financing.

The methodology relies heavily on both secondary and primary sources. Secondary sources are institutions and agencies, including the Capital Market Supervisory Agency (BAPEPAM), Bank Indonesia (the central bank), commercial banks, Jakarta and Surabaya stock exchanges, National Planning Board (BAPPENAS), and Central Bureau of Statistics (CBS) at the provincial and districts levels. Secondary data describe local government fiscal trends and developments since 1995, and past long-term financing by local governments, with a focus on bond and debt securities issuance in domestic and international financial markets. Other secondary data include patterns of local government expenditure and revenue from various perspectives, as well as major economic and political changes and their impact on local government finance.

Primary data were collected through interviews with resource persons in Jakarta, West Java, East Java, and West Sumatra, which have issued corporate bonds. In Jakarta, interviews were held with the heads of BAPEPAM and the Jakarta Commodity Market Agency (BBJ); representatives of Bank Indonesia, Jakarta and Surabaya stock exchanges, Department of Finance, and BAPPENAS; and with university professors. Outside Jakarta, interviews were held with resource persons in regional banks, the regional Coordinating Board of Investment, and other local government elites (heads of the financial division, economic division, and regional budget offices).

The interviews were intended to identify issues related to financial strengthening of local governments, major impediments to local bond financing, and policy recommendations to facilitate it, including issues in fiscal management, capacity of local financial departments, laws and regulations, institutional constraints, debt management, capital market constraints, tax issues, and guarantee problems.

Fiscal Decentralization and its Impact on Local Government Finance

Fiscal Trends and Budget Structures

Fiscal Trends since 1995

Fiscal policy concerns the size and structure of the government budget, along with economic policies on monetary and balance-of-payments concerns. As with the national budget, local budgets consist of revenue and expenditure structures (Table 1). At the local level, the structure of government consists of provincial and district/municipal (*Kabupaten/Kota*) governments. The provincial government coordinates with district/municipal governments, especially on regional development.

Trends of provincial expenditures and revenues in 1995–2000 show a budget surplus (Figure 1). However, the FY1999 budget decreased to Rp9.0 trillion for revenues and Rp7.6 trillion for expenditures due to the crisis; the economy had contracted by 13.2% in 1998. In FY2000, revenues and expenditures were much larger as the economy slowly recovered.

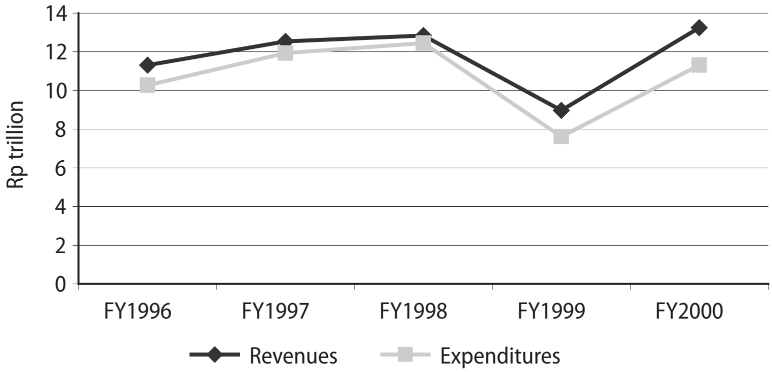
At the district/municipal level, data showed an increased budget for FY1996–1999. In FY1996, revenue was about Rp11.2 trillion, which increased by 86% to

Table 1. District/Municipal Revenues and Expenditures, Various Years (Rp billion)

	FY1996	FY1998	FY1999
Revenues	**11,171.91**	**15,522.63**	**20,819.61**
Surplus from Previous Year	363.36	461.18	500.59
Local Revenue	1,528.24	2,056.13	2,380.93
Tax and Nontax	1,704.28	2,358.51	2,736.79
Subsidy and Other Assistance	7,455.51	10,508.56	14,990.80
Other Development Revenue	120.52	138.25	210.50
Expenditures	**10,767.49**	**15,009.37**	**19,545.84**
Routine	5,805.99	8,406.17	13,285.61
Personnel	3,747.85	5,511.85	9,857.81
Materials	713.30	1,024.88	1,290.17
Maintenance	181.25	241.99	279.13
Official Trips	114.48	138.29	153.08
Others	657.11	868.67	955.76
Debt Payment	70.88	87.87	114.83
Subsidy	107.29	206.97	244.93
Pension	0.45	1.00	1.09
Other	184.86	274.59	292.85
Miscellaneous	28.52	50.06	95.96
Development	4,961.50	6,603.20	6,260.23

Source: Central Bureau of Statistics. Various years. *Financial Statistics of District/Municipal Government.*

Figure 1. Government Revenues and Expenditures at the Provincial Level, FY1996–2000



Source: Central Bureau of Statistics. Various years. *Government Financial Statistics.*

Rp20.8 trillion in FY1999. Total expenditure in FY1996 was about Rp10.8 trillion, which increased by 80% to Rp19.5 trillion in FY1999 (Figure 2). The increased local government budget might have been due to the 77% inflation rate in 1998 and local government pressure to sustain regional financial development.

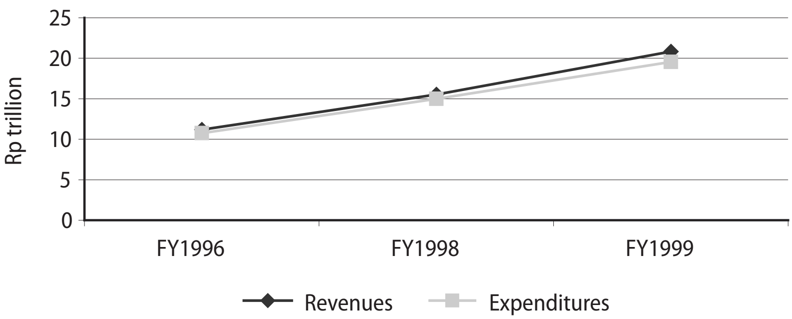
Table 1 shows that from FY1996 to FY1999, revenues from the central Government via subsidy and other assistance were the main source of local government revenue, followed by tax and nontax revenue, and local revenue. However, other development revenue, although it increased, contributed the least to local government revenue. These data suggest that (i) the financial sources of local governments before local autonomy heavily depended on central government financial sources; and (ii) local government revenue from local sources has been small, contributing less than 20% of total revenue. Not surprisingly, local governments desperately seek financial sources to sustain local revenue.

Table 1 also shows that from FY1996 to FY1999, most local budget expenditure was allocated for routine spending, with, in FY1999 for instance, routine spending accounting for about 68% of total district/municipal expenditure and local development about 32%.

Budget Structures Before and After Local Autonomy

Before the 1999 local autonomy and decentralization laws, the fiscal arrangement was highly centralized. On the expenditure side, two types of grants and subsidies were allocated by the central Government. The first was for routine expenditure such as local government civil service salaries, and the second was for bureaucratic expenditures in the districts and municipalities. The latter covered funds for invest-

Figure 2. Revenues and Expenditures at the District/Municipal Level, FY1996–1999



Source: Central Bureau of Statistics. Various years. *Financial Statistics of District/Municipal Government.*

ment or government expenditure. Funds for routine expenditure were transferred through subsidies from the central Government. This subsidy was the main source of direct income for the districts and municipalities.

Funds for investment and development were transferred in two types of subsidy. The first was in the form of grants for specific purposes defined by the central Government, such as to build district/municipal schools and public facilities. The second was in the form of much smaller block grants that could be used by districts and municipalities without central government intervention. The total investment fund usually made up only 20% of district/municipal revenues. The central Government also provided local government with shared tax and nontax revenue, which usually made up less than 10% of district/municipal total revenues. Local governments fully controlled fund use. The remaining 10% of district/municipal income was derived from local revenues and other sources.

The central Government used to transfer money to the regions not only through the local government administration but also through central government regional vertical offices. This funding was commonly known as the annual government project list (DIP).[1] It was much higher than total revenue received by local governments. Total funds allocated to DIP were 5.2% of gross domestic product (GDP), considerably higher than total grants and subsidies allocated for routine and development expenditures (3.5%) (Saad 2001).

After local autonomy and fiscal decentralization were implemented, the composition of local government financial sources changed significantly. Law 25/1999 allows local governments to raise funds from (i) local revenue or income (regional taxes, user charges, revenue from local state-owned companies, and revenue from local asset management); (ii) central-local balance fund (taxes on land and building construction, revenue from taxes on land and construction rights, revenue from natural resources, general allocation fund, and specific allocation fund); (iii) local borrowings; and (iv) other legal revenue in the region.

Of local revenue from taxes on land and building construction, 10% is allocated to the central Government and the rest to the local government. Of revenue from taxes on land and construction rights, about 20% is given to the central Government and the rest to the local government. Revenue given to the central Government is then distributed to all districts and municipalities. Of revenue from natural resources in the region (forests, mines, quarries, and fish), 20% goes to the central Government; of after-tax state revenue from oil, 85%; and from natural gas, 70%. The rest goes to the region.

The general allocation fund makes up about 25% of local revenue from the national budget, and is allocated to the provinces (10%) and districts and municipalities (90%). The portion for the province is based on the calculation of the general allocation fund, which is determined in the national budget. The district/municipal portions are calculated from the general allocation fund for the whole district multiplied by the respective portions of the districts. Criteria to determine the weight of the general allocation fund are based on local needs and resource potential.

The specific allocation fund is allocated from the national budget to the region for specific needs, which are those that cannot be estimated from the general allocation fund formula, or are national priorities. The specific allocation fund includes a reforestation fund, of which 40% is allocated to the region and the rest to the central Government.

If the regions intend to borrow money from abroad, they must course such borrowing through the central Government. Local governments may also borrow from domestic sources. Loans may be used only to fund regional infrastructure development, which is expected to result in capital benefit to repay the loan and to benefit the region. Local governments may also take out short-term loans but only to maintain current cash flows for local financing. All borrowings have to be agreed on by the regional people's representative council. Local governments may not borrow loans greater than that decided by the central Government. Local governments are also not allowed to make bail-out agreements that might create problems for regional financial sources.

Budget Allocation for Regional Development in FY2001 and FY2002

In FY2001, the central Government allocated 23.9% (Rp81.5 trillion) of total state expenditure or 5.5% of GDP to fund regional governments, distributed as follows: 74.4% for the general allocation fund, 24.9% for revenue sharing, and 0.7% for the specific allocation fund. In FY2002, the central Government increased funding for regional governments by 10.8% to Rp90.4 trillion (or 5.3% of GDP). The largest portion was allocated to the general allocation fund (73.5%) and the rest for revenue sharing and the specific allocation fund.

Central government funding for regional governments was increased in FY2001 and FY2002 to implement local autonomy. Not many regions have sufficient local revenue sources, either because of insufficient natural resources and low intensity of economic activity, or because of the inability to increase local taxes and user charges, which is associated with scarcity of base data and system information about tax and user charges, weakness of local tax and local user-charge management, and limited capability of government officers (Firdausy 2001, Kadjatmiko 2001). Therefore, the financial needs of local autonomy greatly affect the ability of local governments to sustain their development.

Developments in Local Government

Local developments before the 1997 crisis were much better than after. At the aggregate level, one of the greatest achievements was the significant reduction in the percentage of the population living below the poverty line. In 1976, about 40% of the population was poor, but in 1996 only 11.2% was. Disparities in education and health were also lowered as a result of strong, nationwide programs to achieve universal primary school enrollment, which are now being applied to the secondary level (World Bank 1999).

However, at the regional (or provincial) level as well as between regions (or provinces), economic and social achievements differ. Apart from spatial distribution of economic activity and uneven population and natural resources, social and economic achievements are affected by factors such as the degree of economic and social openness, nature of the trade regime, quality of human resources and entrepreneurial skills, physical infrastructure (electricity, ports, roads, communication, and transportation), and social and economic policies. Java, with 6% of Indonesia's land area, for instance, (but two thirds of the population) contributes about 64% of the country's non-oil GDP. By contrast, the poorer provinces of East and West Nusa Tenggara and Kalimantan contribute little. Jakarta and West Java account for almost one third of national non-oil GDP.

In other major island groupings, certain provinces stand out. North and South Sumatra are by far the largest non-oil economies on that island, contributing about 59% of the total. South Sulawesi contributes about 58% to the total economy of Sulawesi. East Kalimantan produces 62% (including oil) or 40% (excluding oil) of Kalimantan's gross regional product. Thus, natural resources (oil or non-oil) affect economic performance.

However, the relationship between the social and economic success of local development is not so simple. Some frontier resource-rich regions on Kalimantan record high incomes but poor education, health, and other social indicators. Other provinces such as Yogyakarta and North Sulawesi, which have below-average economic indicators, have superior social achievements. Therefore, although the factors mentioned may be important, they operate only in conjunction with other influences.

The conditions of local development after the crisis have changed significantly due to slow economic growth and other poor economic indicators (e.g., low exports and investment, huge debt, budget deficits, and banking problems). The social and economic miracles achieved before 1997 thus turned into a debacle. In 1998, the proportion of the poor increased to 24.2% (49.5 million) but decreased to 18.2% (37.5 million) in 1999. In 2000, the poor were estimated to make up 22.3% of the total population of 206 million, increasing to about 30% in 2002.

The high poverty regions are mainly in eastern Indonesia, especially West and East Nusa Tenggara, followed by Maluku and Irian Jaya. In Sumatra and some parts of Sulawesi, poverty incidence is lower because the depreciation of the rupiah against the dollar increased the household income of the poor working in the estate and fishery sectors. In Java, however, rural poverty increased significantly as many urban poor moved back to their rural homes as jobs disappeared (Hill 2000, CBS 2002).

Poverty has always been greater in rural than urban areas, especially in East and West Nusa Tenggara, Irian Jaya, Maluku, and West Kalimantan. In western Indonesia, poverty is highest in Bengkulu, Jambi, and Central Java (Hill 2000).

The factors determining levels of, and trends in, regional (or local) development are much more complex than commonly presumed. They not only depend on natural resources, quality of human resources, entrepreneurial skill, and physical infrastructure, but also on social and economic policies and national economic progress.

Major Social and Economic Responsibilities of Local Governments

According to the outline of the state guidelines, as decreed by the People's Assembly, the development objectives are to (i) preserve economic, political, and social stability; (ii) equalize the costs as well as the benefits of economic development; and (iii) pursue rapid economic growth.

Before the financial crisis, the national program was in the 5-year development plan, which was replaced after the crisis with the national development program. This is also an indicative plan establishing national development priorities to provide the basis for allocating public sector investment and to guide the private sector. Local governments also have a regional development plan. This aims to improve the welfare of the people by raising their standard of living materially and spiritually. Local governments plan to improve the economy, society, religion, science and technology, law, politics and the government apparatus, information and communication, and security. Each development field has its own policies.

However, not all development activities should be under the responsibility of local governments. Law 22/1999, chapter 4, section 7, states the following:

> (1) A region's authority embraces the entire government authority, except authority in foreign affairs, defense and security, jurisdiction, and monetary, fiscal and religious affairs, and authority in other fields. (2) The authority in other fields as referred to in sub-article (1) comprises the policies regarding national planning and macro national development, controlling fiscal balance, state administration systems and state economic institutes, human resource guidance and development, use of strategic natural resources and high technology, conservation, and nationwide standardization.

Section 8 states the following:

> (1) The government authority delegated to the regions shall be accompanied with appropriate expenditure commensurate with the delegated authority. (2) The government authority under the deconcentration framework delegated to the Governor shall be accompanied by appropriate expenditure commensurate with the delegated authority.

The central Government's willingness to implement local autonomy and decentralization is not new, as seen in Laws 32/1956 and 5/1974. However, because of the absence of strong political pressure on the central Government until 1998, and local governments' lack of capacity in general and the low quality of human resources in particular, these laws were not implemented (Firdausy 2001).

Local autonomy and decentralization are meant to (i) empower and increase regional economic activities; (ii) create a regional financial system that is fair, proportional, rational, transparent, and accountable; (iii) achieve a regional financial system that supports the execution of local autonomy through local government; (iv) allocate government revenue to the regions; (v) sharpen financial accountability in the regions; and (vi) guide regional financial allocation.

Achieving these objectives will not be easy because (i) local autonomy and decentralization laws still have administrative and legal ambiguities; (ii) local governments lack financial resources; and (iii) the central Government is unwilling to transfer its power to the local governments, while the first level of local government is reluctant to transfer part of its authority to the second level (Firdausy 2001).

Major Economic and Political Changes and Impact on Local Government Finance

Implementation of local autonomy and decentralization were successful in the first year because (i) the central Government avoided a major breakdown in public services, (ii) the central Government transferred over 2 million of its employees to the local governments, (iii) allocation funds were generally received on time, and (iv) many local governments proved energetic and creative (Deuster 2002). However, a number of problems emerged as a result of the implementation of decentralization and local autonomy (Islam 1999, Widjajanti 2002).

Resource persons interviewed in West Java, East Java, West Sumatra, and Jakarta said that many local elites have different perspectives and understanding of Laws 22/1999 and 25/1999, with no consideration of the national interest. An increasing number of local executives and lawmakers seem incompetent (Hidayat 2001).

The field study also found that decentralization has encouraged many districts and municipalities to impose taxes and user charges despite the resulting harm to the local economy, such as higher agricultural prices, low investment, product distribution problems, and market distortion. User charges include those for agricultural facilities, use of roads through districts and other transportation facilities, and parking fees. Increasingly, buyers of land in districts are compelled to pay illegal fees.

Resource persons in West Java, East Java, and West Sumatra (excluding Jakarta) said that some local governments levy an illegal extensive tax. Provincial governments encourage an intensive tax policy, which is legal. The extensive tax policy in some districts was a response to their financial limitations in developing the local economy.

These findings support Deuster's (2002) observations, among others, that decentralization is facing critical challenges. The most serious of these are (i) the lack of equity in revenue sharing, (ii) mushrooming local taxes, (iii) fees and restrictions on businesses and trade, (iv) investment uncertainty, (v) lack of clear direction from the center on decentralization and monitoring, (vi) disproportionate increases in minimum wages, and (vii) lack of electoral reform to improve accountability.

Local autonomy and decentralization were implemented poorly for the following reasons:

- Most local elites misinterpret local autonomy and decentralization to mean that they are free to manage the local economy as they like, as the law states that local governments have the full right to manage the local economy (Law 22/1999, chapter 1, point i); that districts and municipalities can be on their own; and that no hierarchy exists among regions (chapter 3, clause 4, point 2).
- Some laws are not consistent with Laws 22/1999 and 25/1999, which state that local governments can borrow from abroad if permitted by the central Government.

Law 104/2000, however, states that local governments cannot borrow from abroad, especially during a crisis.

- Many regional bureaucrats and politicians interpret local autonomy legislation as unlimited power, and thus assume that they have an absolute right to govern their region as they like. They sometimes ignore the provincial government in deciding local policies. An increasing number of local regulations are therefore made without any coordination with provincial or other local governments.
- Local bureaucrats and politicians increase local revenues at the expense of efficiency and good public service, as can be seen from the increasing number of new taxes and user charges.
- The central Government is half-hearted in implementing local autonomy and decentralization, as can be seen from the large number of local regulations (e.g., on overseas borrowings, international trade arrangements, and foreign investment) that remain to be decided by the central Government.
- Some interest groups would like to see the collapse of the nation state.
- As almost all local regulations made by local executives should be decided by the local legislature, conflict arises between it and the executives and the local people (Sudarsono 2001).

The increasing number of local regulations on local revenue collection has been due to many factors. Saad's (2001) study on two districts in North Sumatra (Simalungun and Karo) and three districts in North Sulawesi (Gorontalo, Bollaang Mongondow, and Minahasa) suggests at least five:

- The increase in authority requires a bigger budget.
- The general allocation fund block grants for districts and municipalities are only enough to finance routine expenditure, leaving less than 25% to finance development.
- The financial capacity of the region will mainly determine the success of regional autonomy, and so district/municipal governments should increase their local revenues as much as possible or else be merged with their neighbors.
- Local revenue is a symbol of independence.
- Every regional office has to compete to find sources of funds. Local revenue offices say that the allocation from the regional budget for local government offices will depend on how much each is able to contribute to the local treasury.

The consequences of poor implementation of decentralization on the local economy have been examined. Saad (2001), for instance, cites (i) increased distribution costs, (ii) prices forced down at the farmer or producer level, (iii) market distortion, (iv) weakening of local competitiveness and commodity exports, (v) deterioration of the quality of public services, and (vi) escalation of conflict of interest between the provincial and district/municipal governments due to overlapping taxes and user charges.

Hidayat (2001) writes that for decentralization to work, the historical background of central-local government relations, especially since the colonial occupation, should not be ignored. MacAndrews and Amal (1993) as quoted by Hidayat (2001) states that at least three main factors were significant in determining the dynamics of organizational and structural change of government: (i) the history of Indonesia since the colonial period, (ii) diversity of the territory, and (iii) diversity of ethnicity.

If local autonomy and decentralization are to be implemented well, many constraints need to be resolved. Laws should clarify the relations among political and economic authorities and between central and local governments. Laws should also consider factors such as the differences in regions' natural resources, population, quality of human resources, and financial sources in implementing local autonomy and decentralization.

Patterns of Local Government Revenue and Expenditure

Regional Budget Revenue and Expenditure

Before local autonomy and decentralization, Indonesia consisted of 27 provinces, including East Timor. Each province consists of several districts and municipalities, further divided into subdistricts. Each subdistrict consists of villages, which are further divided into neighborhoods. In 2002, about 300 districts and municipalities were spread over eight islands. Of the population of 206 million in 2000, about two thirds live in Java. The rest live in Sumatra, Kalimantan, Bali, Nusa Tenggara, Sulawesi, Maluku, and Irian Jaya.

Heads of provincial, district, and subdistrict government levels used to be appointed by the central Government. Now, although they are not necessarily civil servants, village heads receive salaries from the central Government. Revenues of the lower layers of government, from the provincial to subdistrict level, are largely dependent upon subsidies and grants from the central Government. However, most lower layers of government cannot afford to pay the salaries of their administrative staff, let alone carry out basic programs such as education and health.

The budget for all provinces, and districts/municipalities in FY1997–2000 is in Appendixes 1 and 2. For all provinces, total revenue in FY1997 (i.e., before the crisis) was about Rp12.5 trillion, while total expenditure was about Rp11.9 trillion. In FY1998, total revenue was about Rp12.8 trillion, decreasing to Rp8.9 trillion in FY1999. Expenditures decreased from Rp12.5 trillion in FY1998 to Rp7.6 trillion in FY1999. In FY2000, revenue increased to Rp13.3 trillion and expenditure to Rp11.3 trillion, indicating that the government budget was strongly affected by the crisis, and then by economic recovery.

For the second regional level, which consists of 236 districts and 62 municipalities, total budget revenue in FY2000 was Rp28.4 trillion, and Rp27.1 trillion for expenditure. The budget for the second regional level in FY2000 was also higher than for FY1999, at Rp20.8 trillion for revenue and Rp19.6 trillion for expenditure. The economic crisis clearly weakened the economy at all levels.

The significant increase in the local government budget in FY2000 was due to higher revenue transfer from the central to local governments as economic growth improved. However, the large increase of revenue transfer was from the central Government to the district level, while the significant increase in expenditure was due to local government spending on employee salaries.

By province, the budget for Jakarta is the largest, followed by East Java, West Java, and Central Java, which is not surprising as they are economically dominant. Bengkulu, West Nusa Tenggara, and East Nusa Tenggara have low revenues because of their poor natural resources and sluggish economies, among other reasons.

The ratio of regional budget revenue to gross regional product (GRP) before local autonomy and fiscal decentralization was low, except in Southeast Sulawesi (10.3%) (Table 2). In West Java and East Java, for instance, the ratio in FY2000 was only 1.8%. In other provinces such as Jambi, Bengkulu, Jakarta, Central Kalimantan, Central Sulawesi, West and East Nusa Tenggara, Maluku, and Irian Jaya, the ratio was 5–8%. These data indicate that before decentralization, almost all local governments depended on the central Government for regional development.

The largest revenue sources of provincial governments before decentralization were mainly income from higher-level government, followed by original regional revenue. In West Java, for instance, the percentage of revenue from higher government and/or authority was about 68% of total revenue; in East Java, about 83% (Table 3). These data confirm that most regions are largely dependent on central government financial sources. Current (routine) expenditure is not always allotted the largest amount. The proportion of routine expenditure allocated by local governments varies among provinces (or districts), depending on regional economic resources and conditions, size of the local economy, geographical location, and stage of regional development. Riau, which has rich natural resources and is relatively undeveloped, for instance, has larger development expenditure than East Kalimantan, which has rich natural resources but is much more developed. Similarly, West Java, which has

Table 2. Ratio of Regional Budget Revenue to Gross Regional Product

Province	Revenue FY2000 (Rp billion)	GRP FY1999 (Rp billion)	Revenue/ GRP (%)
Aceh	251	9,913	2.54
North Sumatra	516	22,898	2.25
West Sumatra	235	7,581	3.10
Riau	547	20,311	2.69
Jambi	167	3,181	5.27
South Sumatra	334	13,659	2.45
Bengkulu	131	1,658	7.91
Lampung	222	6,878	3.23
Jakarta	4,179	56,638	7.38
West Java	1,075	60,036	1.79
Central Java	886	39,362	2.25
Yogyakarta	181	4,845	3.74
East Java	972	54,270	1.79
West Kalimantan	254	7,066	3.60
Central Kalimantan	262	3,987	6.57
South Kalimantan	287	5,978	4.80
East Kalimantan	574	21,383	2.69
North Sulawesi	172	3,887	4.43
Central Sulawesi	180	2,287	7.87
South Sulawesi	336	9,631	3.49
Southeast Sulawesi	163	1,588	10.27
Bali	336	7,299	4.60
West Nusa Tenggara	187	3,319	5.65
East Nusa Tenggara	193	2,835	6.80
Maluku	152	2,122	7.18
Irian Jaya	461	8,148	5.65
All Provinces	**13,256**	**380,763**	**3.48**

GRP = gross regional product.
Source: Central Bureau of Statistics. 2001. *Government Financial Statistics*.

rich natural resources and is closer to Jakarta than East Java, has higher development expenditure than East Java.

In the districts, unlike in the provinces, the largest proportion of local expenditure is allocated for routine spending. All districts and municipalities in Table 4 have larger current than development expenditures, perhaps because of the size of their economies, available budget, stage of development, and economic needs. Local governments desperately need more revenues for development and routine spending.

Table 3. Provincial Budgets, FY2000 (Rp billion)

	East Kalimantan	Riau	East Java	North Sulawesi	West Java	West Nusa Tenggara
Revenue	574.37	971.91	172.37	1075.33	187.41	546.94
Previous Year Surplus	29.31	79.02	1.26	38.55	20.49	54.35
Original Regional Revenue	78.71	539.97	28.40	443.38	35.68	128.64
Regional Taxes	54.54	465.91	21.90	421.38	21.98	101.20
Regional User Charges	17.33	25.93	1.06	7.13	4.70	3.17
Public Service	0.74	16.03	0.44	5.00	3.30	0.24
Commercial Service	15.67	3.08	0.56	0.45	1.37	0.26
Specific Permit	0.92	6.82	0.06	1.69	0.03	2.67
Regional Own Enterprise Profit	1.98	2.73	0.53	5.27	1.03	12.14
Other revenues	4.86	45.41	0.41	9.43	7.97	12.13
Incomes from Higher-Level Government	466.35	336.56	142.71	593.41	127.60	363.96
Tax Share	34.87	78.07	5.04	92.57	5.12	54.95
Nontax Share	219.33	13.69	11.35	11.31	2.42	63.67
Subsidies to Local Government	45.80	92.88	37.00	308.02	28.06	45.56
Development Contribution	166.35	151.92	85.33	181.50	91.99	199.79
Other Revenue	0.00	0.00	3.99	0.00	0.00	0.00
Regional Loan	0.00	16.37	0.00	0.00	3.64	0.00
Current Expenditure	339.33	392.90	92.42	634.85	59.55	213.91
Development Expenditure	192.49	436.55	79.79	282.92	105.84	234.35
Total Expenditure	531.82	829.45	172.21	917.77	165.38	448.26

Source: Central Bureau of Statistics. 2001. *Financial Statistics of Provincial Government.*

Sources of Revenue

Local revenue from central government transfers is important for regional development. Of the total budget revenue for all provinces in FY2000, about 55.3% came from central government transfers, followed by local revenue from local taxes, local user charges, local state-owned enterprise profit (32.9%), and other local sources (11.8%) (Table 5). Only Bali and East Java had low central government transfers, with revenue coming largely from local income, at 68.4% and 55.6%, respectively. Conversely, the provinces with a large government transfer (or less local revenue) were Southeast Sulawesi, Central Kalimantan, and Irian Jaya, where local revenue made up less than 10% of the total provincial budget revenue. Low local revenue in these provinces is associated with the stage of economic development, economic resource potential, and population size, to name a few factors: more developed provinces with better economic potential have higher local revenues than less developed provinces.

Table 4. District/Municipal Budget, FY2000 (Rp billion)

	Samarinda City	Sidoarjo District	Kampar District	Bitung City	Bandung City	Middle Lombok District
Revenue	112.86	179.86	123.55	25.07	319.82	98.25
Previous Year Surplus	7.78	10.67	4.00	0.48	20.63	1.47
Original Regional Revenue	13.16	40.53	4.15	3.11	94.28	3.81
Regional Taxes	7.20	18.05	0.39	1.53	44.77	2.07
Regional user charges	5.10	19.90	2.48	1.28	20.82	1.11
Public Service	2.10	14.41	0.99	0.79	11.90	0.83
Commercial Service	0.72	2.78	0.90	0.33	5.07	0.16
Specific Permit	2.21	2.71	0.59	0.17	3.85	0.12
Regional Own Enterprise Profit	0.05	0.03	0.12	0.10	0.01	0.00
Other Revenues	0.81	2.55	1.16	0.20	28.68	0.63
Incomes from Higher-Level Government	91.69	128.66	113.54	20.81	204.90	92.98
Tax Share	13.93	25.29	22.86	2.74	48.14	4.24
Nontax Share	4.83	0.02	1.72	0.48	0.00	0.14
Subsidies to Local Government	39.19	85.06	52.34	10.63	118.69	61.88
Development Contribution	33.75	18.29	36.41	6.92	35.53	26.62
Other Revenue	0.00	0.00	0.21	0.03	2.54	0.09
Regional Loan	0.22	0.00	1.86	0.67	0.00	0.00
Current Expenditure	64.85	125.38	77.78	15.97	200.73	67.73
Development Expenditure	36.11	42.00	42.39	8.72	104.25	28.60
Total Expenditure	100.95	167.38	120.17	24.69	304.98	96.33
Population in 2000	521,333	1,549, 883	445,106	141,306	2,140, 031	745,147

Source: Central Bureau of Statistics. 2001. *Financial Statistics of District/Municipal Government.*

Central government financial assistance to local governments should be based on the proportion of local revenue collected by each local government. Local governments able to collect high local revenue from their economic resources should have less central government financial assistance than those less fortunate. Differences in the proportion of local revenue by province (Table 5) can be used by central government policy makers to determine the distribution of central government transfers to local governments.

Local tax collection has been the dominant source of local income, well above 50% (Table 6). In West Java, for instance, revenue from regional taxes is about 95.0%; East Java, 86.3%; East Kalimantan, 69.3%; and West Nusa Tenggara, 61.6%. The rest of local revenue comes from regional user charges, other revenues, and regional state-owned enterprise profit. Revenue from state-owned enterprises was small due to inefficient operation and management.

In the districts, local taxes contribute the most to local income, except in

Table 5. Shares of Local Revenue and Revenue from Central Government in Total Revenue in the Provincial Budget, FY2000 (%)

Province	Share of Local Revenue in Total Revenue	Share of Central Government Transfer in Total Revenue
Local Income of over 50%		
Bali	68.44	25.44
East Java	55.56	34.63
Local Income of 20–50%		
West Java	41.23	55.18
Jakarta	40.51	37.33
North Sumatra	36.36	47.94
Central Java	35.94	58.51
Yogyakarta	31.98	63.06
South Sulawesi	27.59	64.59
Lampung	26.04	69.34
West Sumatra	25.74	67.06
South Sumatra	23.63	67.79
Riau	23.52	66.54
West Kalimantan	21.25	66.87
Jambi	20.40	74.15
Local Income of 10–20%		
South Kalimantan	19.47	75.10
West Nusa Tenggara	19.04	68.09
Central Sulawesi	18.34	79.20
North Sulawesi	16.48	82.79
Bengkulu	14.09	78.93
East Kalimantan	13.70	81.19
Aceh	13.06	86.81
Maluku	11.40	80.73
East Nusa Tenggara	10.62	84.43
Local Income of less than 10%		
Southeast Sulawesi	9.58	83.43
Central Kalimantan	7.17	83.46
Irian Jaya	6.92	87.06
All Provinces	**32.92**	**55.27**

Source: Central Bureau of Statistics. 2001. *Financial Statistics of Provincial Government.*

Kampar, Riau. Local taxes there contributed only 29.3% to local income, and local user charges, about 49.8% (Table 7) as Kampar is much less developed than other districts in Riau. The Kampar population is highly dependent on agriculture. Kampar thus uses other sources to increase its local income, particularly user charges and other revenues.

No general pattern emerges for central government revenue sources between provinces (Table 8). In West Java, for instance, subsidies to local government have the

Table 6. Local Revenue Sources in Six Provinces, FY2000 (%)

Description	East Kalimantan	Riau	East Java	North Sulawesi	West Java	West Nusa Tenggara
Regional Taxes	69.3	78.7	86.3	77.1	95.0	61.6
Regional User Charges	22.0	2.5	4.8	3.7	1.6	13.2
Regional State-Owned Enterprise Profit	2.5	9.4	0.5	1.9	1.2	2.9
Other Revenues	6.2	9.4	8.4	1.5	2.1	22.4
Population in 2000	2,433,320	4,727292	34,507,946	2,808,063	43,546,975	3,821,134

Source: Central Bureau of Statistics. 2001. *Financial Statistics of Provincial Government.*

Table 7. Local Revenue Sources in Six Districts and Municipalities, FY2000 (%)

Description	Samarinda City	Sidoarjo District	Kampar District	Bitung City	Bandung City	Middle Lombok District
Regional Taxes	54.7	44.5	29.3	49.3	47.5	54.3
Regional User Charges	38.8	49.1	49.8	41.3	22.1	29.3
Regional State-Owned Enterprise Profit	0.4	0.1	2.9	3.1	0.01	0.0
Other Revenues	6.1	6.3	28.0	6.3	30.4	16.4
Population in 2000	521,333	1,549,883	445,106	141,306	2,140,031	745,147

Source: Central Bureau of Statistics. 2001. *Financial Statistics of District/Municipal Government.*

Table 8. Incomes from Higher-Level Government in Six Provinces, FY2000 (%)

Description	East Kalimantan	Riau	East Java	North Sulawesi	West Java	West Nusa Tenggara
Tax Share	7.5	15.1	23.2	3.5	15.6	4.0
Nontax Share	47.0	17.5	4.1	7.9	1.9	1.9
Subsidies to Local Government	9.8	12.5	27.6	25.9	51.9	22.0
Development Contribution	35.7	54.9	45.1	59.8	30.6	72.1
Other Revenues	0.0	0.0	0.0	2.8	0.0	0.0
Population in 2000	2,433,320	4,727,292	34,507,946	2,808,063	43,546,975	3,821,134

Source: Central Bureau of Statistics. 2001. *Financial Statistics of Provincial Government.*

largest percentage (52.0%), followed by development contribution (30.6%), and tax share (15.6%). In East Java, the major source is development contribution (45.1%), followed by subsidies to local government (27.6%), and tax share (23.2%). In East

Kalimantan, the source of income from central government has been dominated by nontax share (47.0%), followed by development contribution (35.7%). Differences in provincial revenue from the central Government may be due to differences in size of regions, their economic intensity and development needs, degree of urbanization, and level of industrialization or mix of industries.

In districts and municipalities, however, subsidies have generally been the largest source of revenue from higher-level government (Table 9). In Bandung City, West Java, for instance, subsidies made up 57.9% of total revenue from this source in FY2000; 66.6% in Central Lombok, West Nusa Tenggara; 51.1% in Bitung City, North Sulawesi; 46.1% in Kampar District, Riau; 66.1% in Sidoarjo District, East Java; and 42.7% in Samarinda City, East Kalimantan.

Subsidy size does not appear to be related to population size. Middle Lombok district, with a population one third that of Bandung, received a higher subsidy than Bandung. Bitung, with a population one fourth that of Samarinda and Kampar, received a higher subsidy than either. Subsidy size might depend on level of economic activity, regional economic needs, and local government income receipts from economic resources.

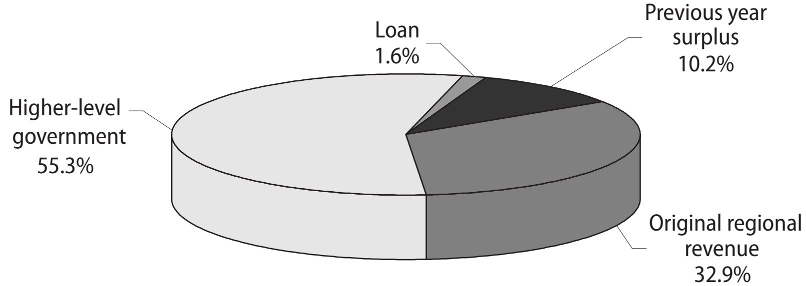
Table 9. Income from Higher-Level Government in Six Districts and Municipalities, FY2000 (%)

Description	Samarinda City	Sidoarjo District	Kampar District	Bitung City	Bandung City	Middle Lombok District
Tax Share	15.2	19.7	20.1	13.2	23.5	4.6
Nontax Share	5.3	0.01	1.5	2.3	0.0	0.2
Subsidies to Local Government	42.7	66.1	46.1	51.1	57.9	66.6
Development Contribution	36.8	14.2	32.1	33.3	17.3	28.6
Other Revenue	0.0	0.0	0.2	0.2	1.2	0.1
Population in 2000	521, 333	1,549,883	445, 106	141,306	2,140, 031	745, 147

Source: Central Bureau of Statistics. 2001. *Financial Statistics of District/Municipal Government.*

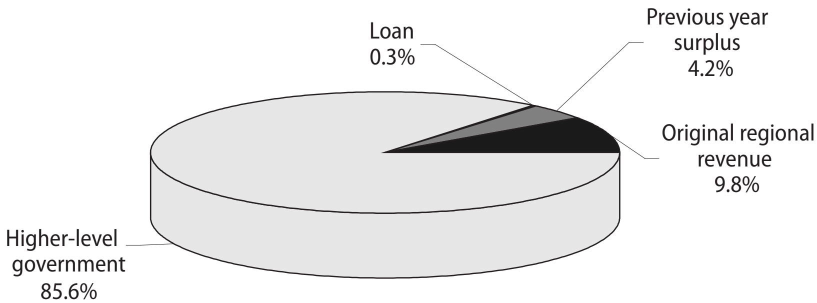
Regional loans are not a significant regional revenue source, particularly since 1988, because the central Government restricted local government borrowing unless the loans could be used directly for revenue-generating projects with an assured yield. Local governments may not issue their own bonds or incur open-ended overdrafts with banks. Revenue from regional loans for FY2000 for all provinces was thus only 1.6% of total budget revenue (Figure 3), while at the district/municipal level it was only 0.3% (Figure 4).

Figure 3. Revenue Shares of Local Budget for All Provinces, FY2000



Source: Calculated from Central Bureau of Statistics. 2001. *Financial Statistics of Provincial Government*.

Figure 4. Revenue Shares of Local Budget for All Districts and Municipalities, FY2000



Source: Calculated from Central Bureau of Statistics. 2001. *Financial Statistics of District/Municipal Government*.

Before 1988, local governments had five main sources of loans on different terms and conditions. The first was foreign aid for urban development, and was the largest for local government. The main lender has been the World Bank, followed by ADB, Japan, West Germany, and Netherlands. Loans were mostly to develop local water supply, and terms were generally 9% interest over 20 years, with a 6-year grace period, although with some variation; the rate has recently been increased to 11% (Alisjahbana 2002).

The second loan source was the Investment Fund Account (RDI), which lent to government enterprises at national and local levels at 9% interest over 20 years, with a 5-year grace period. RDI funds were used for local companies, cargo terminals, and abattoirs. The third source was the Government Capital Counterpart, primarily used by the central Government to provide equity capital for state enterprises. The central Government lends to local governments to capitalize local enterprises through a special budget category. This money was used mainly to provide counterpart contributions to aid agency-funded programs at soft terms—generally 0% interest over 20 years, with a 6-year grace period (4% over 15 years, with a 3-year grace period, in the case of capital for regional development banks).

The fourth source was the Presidential Instruction on Market Development Program, which provided funds to construct markets to serve low-income groups and small-scale traders at 0% interest over 15 years, with a 5-year grace period. The money comes from Bank Rakyat Indonesia, with the central Government paying the interest cost. The fifth source was the Advance Payment Assistance to Regional Income Contribution, which helped local governments develop their regions. The loan amount was relatively low, with an interest rate of 0% over 2 years, and was mainly used for development projects such as roads, bridges, irrigation, and offices for local authorities.

Expenditure Categories and Uses

Expenditures are either current (routine) or development. By province and district/municipality, current expenditure has not always been larger than development expenditure. In FY2000, for instance, DI Aceh, Riau, Jambi, South Sumatra, Bengkulu, Lampung, and East Java, to name a few provinces, had development expenditure larger than current expenditure (Appendix 1). Development expenditure in western Indonesia (68%) has been more than twice that of eastern Indonesia (32%); it is not surprising that western Indonesia is much more developed than eastern Indonesia. The differences in development expenditure are due to differences in the amount of revenue collected. Revenue from the central Government to western Indonesia was about 66%; for eastern Indonesia, 34%.

Local current expenditure can be divided into eight items: personnel, goods and services, maintenance, official trips, debt payments, subsidy, pensions, and miscellaneous. Development activities can be divided into projects, programs, and sectors. Resource persons in the field reported that government official spending is the largest category among current expenditures. Many writers have suggested ways to make government spending more efficient, including zero-growth official government recruitment, and employment productivity programs.

Strengthening Local Government Financial Sources

Local governments' ability to finance local development is limited, with the most revenue coming from a higher government level, followed by local taxes. Local governments are under great pressure to finance development, even more so as the economy has not yet recovered from the financial crisis. How can local governments strengthen their financial sources and what financing sources are feasible? Can local governments feasibly impose further taxes or even impose new taxes and other charges? If not, what other sources of revenue are available?

Taxes and User Charges

Local governments have selected taxes and user charges as priority local revenue sources. However, resource persons in West Java, East Java, and West Sumatra observed that local taxes and user charges dampen local consumption as well as investment. Tax collection is not easy due to lack of a good database on actual and potential taxpayers, inefficient tax administration, lack of high-quality staff, underdeveloped legal and accounting systems, and general reluctance of people to pay taxes. The head of the Tax Office in West Java said, "Taxes and user charges are the most important source of local revenue in West Java. However, it has been observed that the collection of new taxes and user charges leads to higher prices and discourages investment and creates a high-cost economy."

Similarly, in West Sumatra, the head of the Tax Office said, "Taxes and user charges have been well organized by the districts and city government. However, it is difficult to collect local taxes simply because the number of staff is inadequate, and tax administration is inefficient."

Heads of the local tax offices in West Java, West Sumatra, and East Java suggested that new taxes and user charges should be based on regulations and laws acceptable to the people, especially investors, and not raised simply because regional income needs to be increased. Any new taxation policy needs to consider efficient administration, not just increasing local revenue.

The tax office heads also said that taxes should be intensified rather than extended. Such taxes include those on vehicles, land and construction, entertainment, hotels and other accommodation, advertising, roads, and other items not directly related to consumption. These taxes can be easily collected. The tax office heads also argued that corporate income taxes, although seldom imposed, are flawed as their tax base is cyclical and unsuitable, therefore, to finance essential services.

Taxes and user charges, at least in the provinces surveyed, should be raised with caution. The heads of the financial and decentralization bureaus in West Java said that local own-revenue sources can be increased in four ways: (i) provincial and district governments working together to calculate the region's economic potential, (ii) taxing as much as possible any greatly profitable economic activity, (iii) intensifying tax collection, and (iv) supporting expansion of economic activities and encouraging new ones. Local governments seem to lack the initiative to do these.

Central-Local Balance Fund

The central-local balance fund has three sources: (i) taxes on land and construction, land and construction rights, and natural resources; (ii) the general allocation fund, which originates from central budget revenue and is allocated to regional development; and (iii) the specific allocation fund, which originates from the central budget revenue and is allocated to specific development.

The proportion of central budget revenue allocated to a region varies. The central Government receives 10% of the total regional revenue from taxes on land and construction, and 20% from taxes on their rights. Such revenue received by the central Government is then distributed to districts and municipalities.

The central Government receives 20% of the state revenue from natural resources (forests, mines, quarries, and fish), 85% of after-tax oil revenue, and 70% of after-tax natural gas revenue.

Regions receive a portion of the general allocation fund equivalent to about 25% of the total central budget revenue. Of this, the provincial government receives 10%, and districts and municipalities receive the rest. The fund given to a province is calculated as follows:

$$G = H \times \frac{Wp}{Wa}$$

where G = general allocation fund for a province
H = total amount of the general allocation fund for all provinces
Wp = weight for a province
Wa = total weight for all provinces

The formula is the same to calculate the general allocation fund for districts and municipalities. The weight for provinces or districts is determined on the basis of need and economic resource potential, both of which will be subjected to an empirical study accommodating relevant variables such as population size, geographical area, geographical conditions, income of the people (especially the poor), revenue potential of industries, natural resources, human resources, and GRP.

A region can receive a specific allocation fund only if a specific regional need cannot be covered by the general allocation fund. However, the amount of the specific allocation fund given to a region depends on the availability of the national budget fund and is determined every fiscal budget year. The specific allocation fund assigned to a region includes about 40% of the fund for reforestation, with the rest going to the central Government. Regions are also encouraged to provide the specific allocation fund from their regional budget.

The resource persons, however, criticized the allocation formula. They suggested that the central Government should not receive any of the revenue from land and construction taxes and rights, particularly in poor regions, and that only rich regions should share their revenue from these sources. The resource persons also argued that allocating revenue from natural resources, as they are now, can disadvantage poor regions. Regions need economic, policy, and existence rights, particularly for the oil sector as it is still dominated by the central Government, which also needs to be transparent in calculating regional resource potential from sectors it still dominates: forestry, energy and mining, fisheries, and oil and gas.

How the central Government drew up the allocation formula is open to criticism. The central Government should accommodate the regions, and allocation of funds should be transparent and fair. The formula for dispensing the general allocation fund to the regions should consider any environmental costs arising from the central Government's exploitation of economic resources.

Critics point to three necessary revisions: (i) in the formula itself, (ii) in the proportion of funds distributed from the national budget to the regions or districts and cities, and (iii) in components used to formulate the general allocation fund. The tax office heads in West Sumatra and West Java suggested that the denominator to determine the general allocation fund should consider different weights for rich and poor regions. Poor regions should be treated differently from richer ones; regions with less local revenue need more central government financial assistance than those with more local revenue.

Resource persons suggested that the proportion of the general allocation fund from the national budget should be greater than 25%. The proportion of the fund that needs to be allocated from the national budget is at least 40%, as regions have difficulty paying public servants as well as the operational cost of government building maintenance and the like with only 25%. The head of the Economic Bureau of West Sumatra, for instance, stated: "Regions should be relieved of the responsibility to pay public servants, as money from the general allocation fund is inadequate. The proportion of the fund from the national budget should be matched with regional economic development needs. Further studies should be undertaken."

The Agricultural Office head in West Sumatra said something similar: "The general allocation fund in principle seems fine. However, the amount of funds distributed should depend on the region's resource economic potential. Here we do not have many natural resources and we still feel the economic crisis." The proportion of the general allocation fund should thus be matched with the region's conditions and needs.

While the formula should consider a region's population, resource potential, area and geography, and income of people, especially the poor, as well as other economic aspects, other variables such as environmental and social costs are also critical. Cross subsidies from rich provinces are needed to help poor regions. These views were stated by the heads of the regional Coordinating Board for Investment, regional people's representative council, and Energy and Mineral Department in West Sumatra; and by the heads of the Economic Bureau, Tax Office, and Decentralization Bureaus in West Java.

The guidelines and allocation formula of the central-local balance funds thus need to be revised to reflect not only differences in regional economic potential—natural resources, population, and geography—but also ability to obtain local revenue, labor productivity, number of poor, number of government officials and quality of human resources, environmental costs, and infrastructure. Social and economic needs are better indicators than regional economic resource potential. Regions that perform well economically and have rich economic resources should receive less financial assistance from the central Government than poorer regions that are productive or have potential to become so soon. The central Government needs to know regions' income levels if local autonomy and fiscal decentralization programs are to be successful.

Strengthening Regional Loans

Regional loans (short and long term), including bonds, are important revenue sources for local development, especially infrastructure development, as revenue from local taxes and user charges is limited. These loans can be from domestic or foreign sources. Domestic sources include central and local governments, banks and other financial institutions, and loans from other regions. The decision to take out a regional loan, however, should be based on regional payment capability (as measured by the debt service ratio and debt coverage ratio) as well as the risk of the loan, especially the principal and interest payment risk. As Magrassi (2000) as cited in Alisjahbana (2002) pointed out: "Local government should only use subnational debt to finance capital projects that are anticipated to produce financial rate of returns that, vis-à-vis the project socioeconomic benefits, justify the debt service paid to lenders." The loan should be used for investments that earn direct revenue, as a supplementary fund to accelerate regional development.

However, as economic performance is still bad partly due to large debts and financial and banking problems, issuing bonds to public and foreign investors is an alternative for local governments to sustain their development. Bond markets are relatively new but, as the economy suffered deeply from the crisis, they became critical to governments and private companies to sustain their financial needs. However, governments need to improve many aspects of bond market financing.

Sequence of the Reform Package

Reforms of local government financial sources can start with revision of ambiguous laws, especially those that give local governments the full right to manage local needs, allow districts and/or municipalities to be on their own, and establish no hierarchical relations among regions (Law 22/1999, chapter 3, clause 4, point 2). Regulations in Law 104/2000 that are inconsistent with those in Laws 22/1999 and 25/1999 on when local governments can borrow money from abroad should also be revised to stop unlimited devolution of power at the regional level, and the confusion of local governments in policy making.

After the revisions, the central Government should provide an operational guide for all local governments on executing laws and regulations. It will not only help local governments determine what they should or should not do, but also discuss any problems in coordinating policy and programs to minimize social, economic, and political mistakes that might cause further imbalances among regions.

Each region should then discuss policies, programs, and regulations to avoid negative impacts on other regions. Local governments should identify potential and ongoing economic activities to be prioritized to generate local revenue. Local governments can then determine policy and programs based not only on noneconomic or economic reasons alone but also, more important, on the people's welfare.

Coordinating policy making among all local governments within a region or between regions is critical, as economic activities in one region may also exist in another, and taxation of these activities in one region will affect the profitability of the same activities in other regions. The impacts will be worst if the level of profit earned by the same economic activities in other districts/municipalities or regions is low. Any financial tools derived by local governments to increase revenue should take into account the level of profitability of the same economic activities in different places. A mechanism should manage policies, programs, and regulations to avoid problems in debt repayment as well as moral hazard of economic agents in a region.

Finally, the quality of human resources and management should be improved, and good and transparent governance at all levels of local government promoted, both to minimize market distortions and other economic inefficiencies that make economic agents unwilling to expand their activities in the region, and to push local government financing to market-based forms.

Bond Market Financing

Long-Term Financing by Local Governments

Long-term financial instruments for regional development have been dominated by regional loans. However, their proportion to total local revenue has been small. Regional loans contributed 1.6% to total budget revenue at the provincial level in FY2000, and 0.3% at the district/municipal level. These loans come either from aid agencies (via the central Government) or directly from the central Government. Local governments have not yet engaged in long-term financing through the bond market, although it was established in 1983. The following paragraphs describe the record of regional loans, then discuss the record of the corporate and government bond markets.

Record of Regional Loans

Regional loans can be obtained from several sources. Domestic sources are the central Government, banking institutions, and nonbanking institutions. External sources have been dominant, especially before 1988. The main external sources of funds were the World Bank, ADB, Japan, West Germany, and Netherlands. Between 1975 and 1986, the World Bank issued 420 loans; other agencies, 209 (Table 10).

Table 10. External Loans before 1988 (Rp billion)

Sources	Period	Loans
World Bank Loans for Water	1975–1986	141
World Bank Loans for Urban Development	1975–1986	279
Other Agency Loans for Water	1979–1986	158
Other Agency Loans for Urban Development	1979–1986	51

Source: Ministry of Finance, as quoted in Alisjahbana (2002).

However, in 1982 the central Government established the Regional Development Account (RDA) to rationalize and unify local government financing. RDA is a revolving fund in the form of an account with Bank Indonesia, administered and managed by the Ministry of Finance. RDA fund sources are debt service payments by local governments and local public enterprises, funds allocated from the central budget, and foreign loans and grants. However, RDA funds are disbursed through RDI, which organizes funds from the central Government and other domestic sources (including the private sector), and the Subsidiary Loan Account (SLA), which organizes foreign loans and grants.

RDA funds disbursed until 2000 amounted to Rp4.6 trillion (74% through SLA, 26% through RDI) (Table 11). Since 1998, total loan disbursement under

RDI and SLA decreased significantly due to the crisis. In 2000, total loan disbursement was only Rp3.4 billion under RDI and Rp6.3 billion under SLA. In 1982–2000, regional borrowing from the private sector was limited (Alisjahbana 2002).

Table 11. Total Loan Disbursement to Provinces and Municipalities in Indonesia by Investment Fund Account and Subsidiary Loan Account, 1982–2000 (Rp million)

Year	Investment Fund Account	Subsidiary Loan Account	Total
1982	10,931.25	70,278.91	81,210.16
1983	20,530.10	62,129.71	82,659.81
1984	2,748.00	40,437.17	43,185.17
1985	11,026.87	9,523.65	20,550.52
1986	3,420.00	161,068.97	164,488.97
1987	16,762.14	284,384.87	301,147.01
1988	53,821.33	333,168.13	386,989.46
1989	10,931.25	132,281.25	143,212.50
1990	72,332.17	418,989.69	491,321.86
1991	71,855.50	308,838.92	380,694.42
1992	92,707.77	74,165.53	166,873.30
1993	155,150.43	85,901.06	241,051.49
1994	217,805.82	680,025.09	897,830.91
1995	87,136.26	240,771.07	327,907.33
1996	175,330.22	308,858.01	484,188.23
1997	137,620.98	93,129.93	230,750.91
1998	29,026.60	52,959.30	81,985.90
1999	17,080.41	8,808.69	25,889.10
2000	3,477.60	6,354.25	9,831.85
Total	**1,189,694.70**	**3,372,074.20**	**4,561,768.90**
Percentage	26	74	100

Source: Ministry of Finance, various years.

Much of the borrowing, especially under RDI, is generally used by the more developed and financially better-off provinces and urban areas such as Jakarta, East Java, West Java, and North Sumatra, which accounted for 50% of total RDI loans during 1982–2000 (Table 12). East Java used 19% of RDI funds; DKI Jakarta, 13%; West Java, 10%; and North Sumatra, 8%. These loan funds were used mostly by enterprises, particularly state-owned water enterprises (PDAMs), owned by provincial- or district/municipal-level governments. About 33.4% of RDI-disbursed credits went to PDAMs in these provinces, and 16.6% to other urban infrastructure development such as irrigation and roads.

Despite favorable conditions for RDI and SLA lending, such as interest rate subsidies and loan repayment terms, repayment has been poor. At the end of 1999, over 40% of the total amount due (on principal, interest, penalties, etc.) was in arrears.

Table 12. Investment Fund Account Loan Disbursement to Four Provinces (Rp million)

Year	West Java	DKI Jakarta	North Sumatra	East Java	Indonesia
1982	—		—	—	10,931.25
1983	—		150.00	500.00	20,530.10
1984	—	—	—	300.00	2,748.00
1985	300.00	500.00	250.00	—	11,026.87
1986	—	—	—	3,420.00	3,420.00
1987	5,461.85	—	3,630.48	1,866.82	16,762.14
1988	14,609.70	—	13,034.26	2,809.63	53,821.33
1989	649.36	4,852.00	4,159.98	—	10,931.25
1990	24,595.58	25,756.87	18,041.92	—	72,332.17
1991	12,667.69	—	8,507.03	10,549.56	71,855.50
1992	22,566.66	19,125.78	3,916.29	7,446.46	92,707.77
1993	18,313.72	3,500.00	3,223.45	31,591.37	155,150.43
1994	1,284.02	64,415.45	10,357.32	30,730.45	217,805.82
1995	—	—	2,866.57	53,268.94	87,136.26
1996	14,998.65	—	9,620.40	57,741.18	175,330.22
1997	—	—	16,748.35	15,976.43	137,620.98
1998	4,779.13	17,706.44	2,056.64	—	29,026.60
1999	—	—	—	3,746.25	17,080.41
2000	—	—	—	3,477.60	3,477.60
Total	**123,558.36**	**154,786.64**	**96,562.69**	**224,590.69**	**1,189.694.70**
Percentage	10	13	8	19	100

— = data not available.

Source: Ministry of Finance, various years.

Overall arrears then increased significantly, reaching over 50% by the end of 2000. The most arrears were found among PDAMs, not because they were unable to repay but rather because they were unwilling to, and the central Government could not make them. Other problems were lack of monitoring during project implementation, communication during the debt service period, project justification, demand analysis, involvement of the Directorate on Lending in project preparation, and information sharing between agencies (Bank Indonesia and Directorate of Budget).

Repayment of regional loans by regional governments has been poor, and internal management practices in regional loan mechanisms must be strengthened. Improvements are needed in regional government credibility, rewards and punishments for regional governments, repayment mechanisms, selection of regional projects, and administration and coordination between regional and central governments. Regional loans should be based not only on equity considerations, but also on efficiency. Investment projects that are feasible, provide a high return, and have few negative externalities should be given priority over those with low investment returns. Otherwise, no investors or aid agencies will invest in the regions or lend to local governments.

Record of Corporate and Government Bond Markets

Unlike loans through RDI and SLA, loans issued through local government bonds have not yet been established. So far, only corporate and central government bonds have been issued, through public offering or private placement, as regional capital markets are not developed and no specific laws or regulations govern local government bond market financing.

Only six corporate bonds in the regions have been sold on the capital market. All were issued by the local government banks of West Java, East Java, Central Java, North Sulawesi, West Sumatra, and PT Bank DKI. Bonds issued had 12,843 sheets with an emission value of Rp1.2 trillion (Table 13).

Regional corporate bonds funded mainly PDAMs and urban infrastructure development. In West Java, for instance, corporate bonds allocated for urban water development in 2000 were worth about Rp150 billion, while in DKI Jakarta total corporate bonds were worth about Rp500 billion, mostly for urban water development and toll-road development.

At the national level, corporate bonds developed slowly. In 1983–1987, the Surabaya Stock Exchange recorded only nine issuers and an emission value of

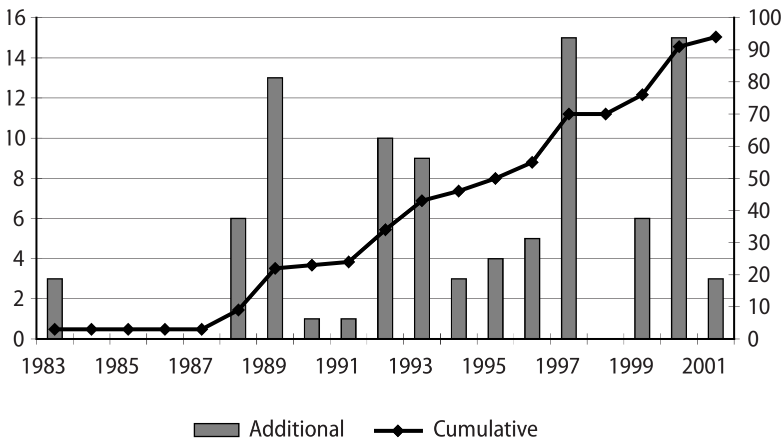
Table 13. Bond Emissions of Local Government Banks

Issuer	Bond Name	Listing Date	Maturity Date	Interest (%)	Emission	
					Amount	Value (Rp trillion)
BPD West Java	BPD JABAR I	15-07-91	8-07-96	23.00	1,000	25
	BPD JABAR II	15-07-93	2-07-98	Float	1,268	50
	BPD JABAR III	25-04-00	18-04-05	16.25/ Float	1,500	150
BPD Central Java	BPD JATENG II	24-10-91	24-10-96	Float	1,268	50
	BPD JATENG III	17-09-93	1-09-98	17.25	1,268	50
BPD East Java	BPD JATIM II Seri A	28-01-92	14-01-97	23 3/8	667	25
	BPD JATIM II Seri B	27-04-92	8-04-97	22.50	667	25
BPD North Sulawesi	BPD SULUT II	17-01-94	30-12-98	15.00	518	20
BPD West Sumatra (Bank Negara)	BPD SUMBAR III	31-10-92	22-10-97	Float	592	25
	BPD SUMBAR IV	25-07-97	16-07-02	15.25	1,040	200
PT Bank DKI	Bank DKI II	9-02-93	1-02-98	17.50	1,830	75
	Bank DKI III	23-06-97	18-06-04	15.00	1,225	500
				Total	**12,843**	**1,195**

BPD = local government bank.
Source: Capital Market Supervisory Agency, 2001.

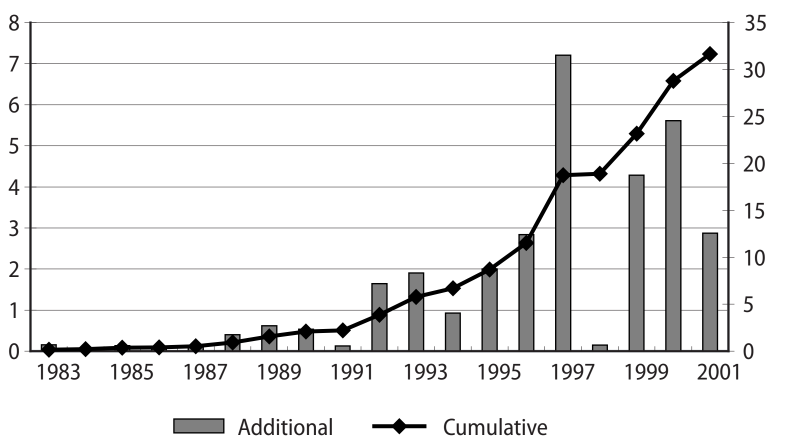
Rp535.7 billion. In 1988–1997, until before the crisis, corporate bonds increased significantly. By 1988, there were nine issuers; by 1997, 70. In 2001, corporate bond issuers increased to 94, with a cumulative emission value of Rp31.6 trillion (Figures 5 and 6).

Figure 5. Growth in Number of Corporate Bond Issuers, 1983–2001



Source: Surabaya Stock Exchange. 2001. *Journal of Surabaya Stock Market* (special edition).

Figure 6. Growth in Value of Corporate Bonds Issued, 1983–2001 (Rp trillion)



Source: Surabaya Stock Exchange. 2001. *Journal of Surabaya Stock Market* (special edition).

However, in 2000–2001 the number of corporate bond issuers increased by only three. In 1999–2000, corporate bond issuers had increased from 76 to 91. The slow increase was due partly to slow economic recovery in 2001, which, in turn, was partly due to domestic social and political instability and the unsound global economy. In 2001, economic growth was only 3.3% (year on year), whereas in 2000 it was 4.8%. Corporate bond development was slowed by high inflation of 12.6% (9.4% in 2000), depreciation of the rupiah by 18% to Rp10,256 to $1 (from Rp8,438 in 2000), and low exports and investments. At the micro level, the decrease in the number of corporate bond issuers was due to the increase of interest rates on Bank Indonesia certificates from 14.7% in January 2001, to 17.6% at the end of the year—in addition to default cases faced by some issuers (e.g., Sinar Mas Group), tax issues, and other problems.

Bonds can be issued through private placement and/or general public offering. A general public offering has four steps:

- Preparation. Companies call a general meeting with stockholders to ask their agreement to issue bonds. If stockholders agree, companies point out the possible stockholders, lead underwriters, or other supporting capital market professionals to prepare bond issuance documents; conduct a due-diligence meeting; and sign the initial contract with the stock exchanges.
- Registration with BAPEPAM.
- Offering of the bonds to the public in the capital market.
- Recording of the bonds in the capital markets and selling of bonds to the secondary markets.

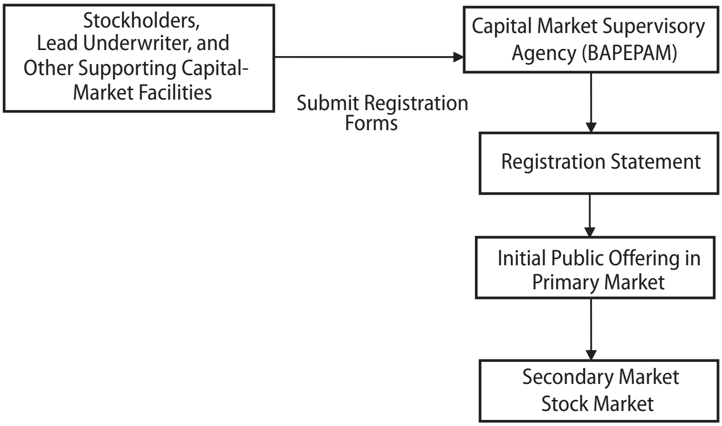
Figures 7, 8, 9, and 10 show how bonds are issued.

Corporate bonds were mainly issued by financial companies (17.4%), followed by the property sector (15.3%), wood-based and agricultural industries (14.3%), and the banking sector (12.2%). The textile, pharmaceutical, telecommunications, and computer service industries issued less than 5% of the total each. The financial and property sectors were hit harder than others by the financial crisis, so they needed to sustain their activities by issuing corporate bonds.

Only 18 issuers of corporate bonds, or 30% of the total, rated an A for performance, and 20 (33.3%), B and above. The rest were rated CCC and D or not at all (Figure 11), which may affect the development of bond market financing. Therefore, the central Government (especially BAPEPAM) should improve the bond issuance mechanism and the regulations and procedures for private sector issuance. Otherwise, capital market investment will fail to develop.

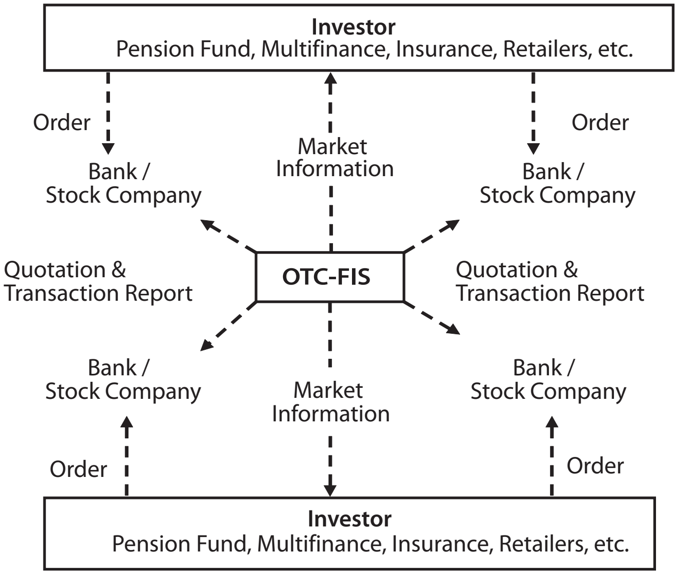
On 23 May 1999, the Government issued Rp103.8 trillion of bonds to implement

Figure 7. Process of Issuing Bonds



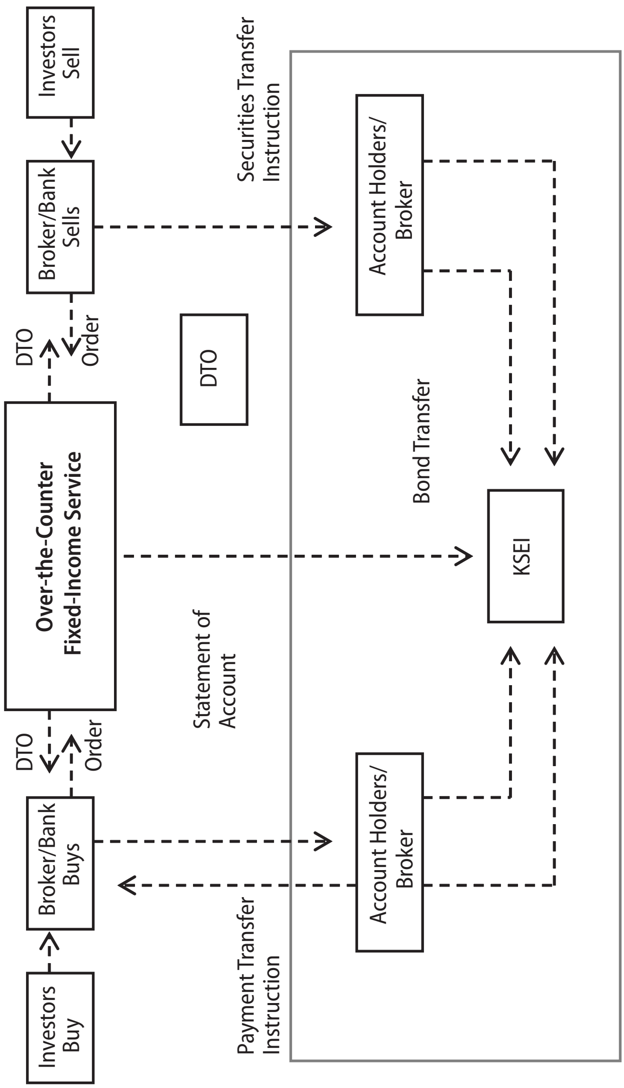
Source: Surabaya Stock Exchange. 2001. *Journal of Surabaya Stock Market* (special edition).

Figure 8. Bond Trading through Over-the-Counter Fixed-Income Service



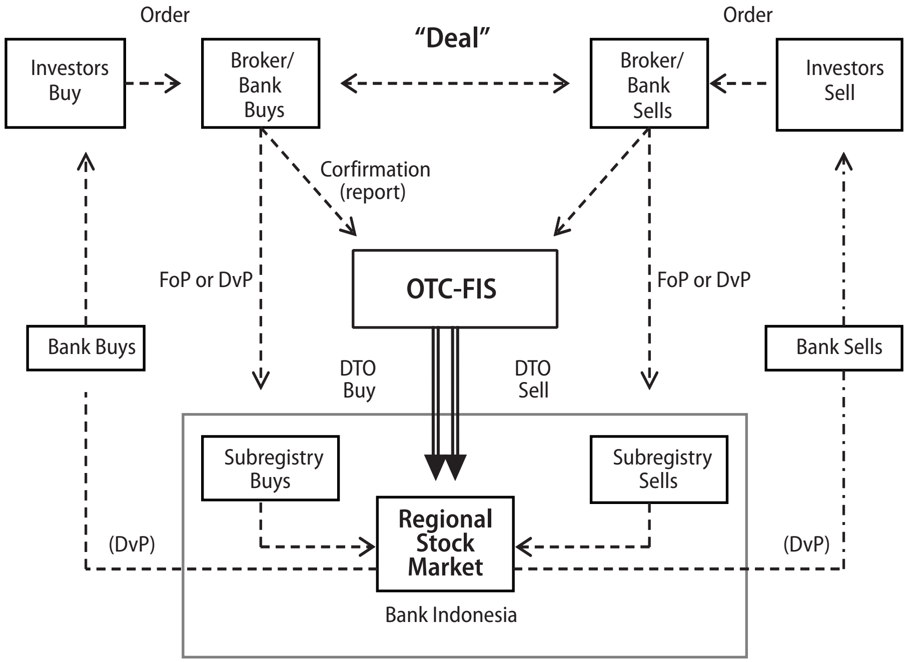
Source: Surabaya Stock Exchange. 2001. *Journal of Surabaya Stock Market* (special edition).

Figure 9. Secondary Market Mechanisms of Corporate Bonds



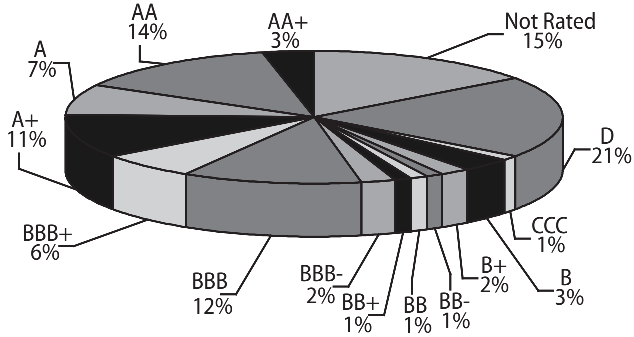
DTO = data transaction obligation, KSEI = Indonesian Central Stock Custodian.
Source: Surabaya Stock Exchange. 2001. *Journal of Surabaya Stock Market* (special edition).

Figure 10. An Example of Bond Trading through Stock Markets



DTO = data transaction obligation, DvP = delivery versus payment, FoP = free of payment, OTC-FIS = Over-the-Counter Fixed-Income Service.
Source: Surabaya Stock Exchange. 2001. *Journal of Surabaya Stock Market* (special edition).

Figure 11. Composition of Corporate Bonds Based on Rating



the banking restructuring program. This amount more than doubled to Rp281.8 trillion in January 2000. By the end of July 2001, it had reached Rp432.86 trillion. The initial offering of these bonds was not held through open bidding but through direct placement to the banks participating in the recapitalization program.

In February 2000, nonrecapitalized banks held Rp6 trillion of government bonds, and by June 2000, Rp8.56 trillion, while the subregistry held Rp30 billion.

The bulk of government bonds held by a number of recapitalized banks affected trading in the secondary market. Data from the Surabaya Stock Exchange Over-the-Counter Fixed-Income Service show that the liquidity rate of the secondary market for government bonds is still low, as it is for corporate bonds. In 1997, trading volume reached Rp6 trillion; capitalization value, Rp15 trillion; and in 2000 market capitalization, Rp18 trillion. However, in 2000–2001 government bond trading in the secondary markets (Surabaya Stock Exchange) was far greater than corporate bond trading. Table 14 shows that the transaction value of government bonds reached Rp64.7 trillion with a monthly average of Rp5.4 trillion and 1,193 transactions. For corporate bonds, the transaction value only reached Rp1.1 trillion with a monthly average transaction of Rp92.9 billion and 403 transactions.

Government bonds, however, have created many problems for banking restruc-

Table 14. Trading Transaction between Government and Corporate Bonds (via Over-the-Counter Fixed-Income Service), 2000–2001 (Rp billion)

Period	Total Bonds Traded		Transaction Value		Daily Average		Transaction Frequency (Number)	
	Corporate	Gov't.	Corporate	Gov't.	Corporate	Gov't.	Corporate	Gov't.
2000	18,885	31,635	8,511.78	11,201.3	35.32	50	2,400	159
2001								
January	18,885	33,635	28.00	10,445.5	1.27	475	15	65
February	18,885	39,977	79.24	4,745.6	3.96	237	11	120
March	19,097	45,674	64.80	3,089.8	3.24	154	14	108
April	20,091	48,034	130.87	9,083.3	6.54	454	34	112
May	19,954	48,034	140.73	2,945.7	6.70	140	34	45
June	20,187	54,508	69.39	8,180.4	3.47	409	21	55
July	20,554	60,803	158.10	4,154.6	7.19	189	22	60
August	19,524	61,310	89.42	3,289.9	4.06	150	22	87
September	19,444	64,066	135.19	3,348.2	6.76	167	20	127
October	19,444	65,636	143.50	3,389.7	6.52	154	22	104
November	18,891	74,527	9.00	6,668.4	0.41	303	22	178
December	18,831	64,654	66.88	5,342.7	4.46	356	15	132
Total 2001			1,115.12	64,683.8	4.53	263	252	1,193
Ave. Monthly Transaction Value			**92.93**	**5,390.3**				

Source: Surabaya Stock Exchange. 2001. *Journal of Surabaya Stock Market* (special edition).

turing programs. Apart from the difficulty of taking back the capital from recapitalized banks, management of banking restructuring programs must deal with the fact that many recapitalized banks selected by the central Government are not qualified to be recapitalized. Corruption, collusion, and nepotism are the main causes of the Government's failure to restructure banks. Bond market financing through corporate and government bonds is, therefore, still far from expected. The performance of issuers, market procedure, and government transparency and accountability must be improved.

Existing Regulatory and Institutional Framework for Local Government Bond Markets

Local government bond market financing is not yet developed as no laws and/or government regulations focus on local government bonds, although Laws 22/1999 and 25/1999 permit local governments to obtain loans from domestic and foreign sources to finance regional development. Domestic loans can be from the central Government, commercial institutions, and/or through the issuance of local government bonds after notification is given to the central Government. However, for foreign loans, local governments must first notify the central Government, which must approve them. Government Regulation 105/2000 covers management and responsibility of regional finance; Central Government Regulation 107/2000, regional loans; Law 8/1995, capital market and government regulation; and Law 139/2000, income tax resulting from bonds.

Many parties, such as local government banks that issue corporate bonds regionally, invoke Law 25/1999 on fiscal balance between central and local governments, Law 22/1999 on local government autonomy, and Law 8/1995 on regulation of the capital market. Therefore, regulations on local government bonds should be developed soon to avoid confusion and expand regional financial sources for regional development.

Some existing institutions (regulators, issuers, investors, and other supporting institutions or market participants) can help develop the local government bond market. Regulators can be institutions either involved in the whole process or in support of regulation. Institutions considered competent to be direct regulators are the departments of Home Affairs and Finance (particularly the Directorate General of Fiscal Balance and BAPEPAM). Supporting regulators can include Bank Indonesia, Center Management of Government Bonds, and BAPPENAS.

The Department of Home Affairs can be the principal regulator at it is responsible for implementing local autonomy. The Department of Finance is responsible for fiscal decentralization. These departments must coordinate in regulating the issuance, trading, and management of bonds. A good relationship between these two departments is critical to establish transparent governance.

The chairman of BAPEPAM said he welcomes the issuance of local government bonds but suggested that before permission is granted to issue the bonds, each region has to improve local government and governance. Some critical requirements to establish the bond are institutions that can manage local investment professionally, willingness of local governments to be audited by a designated auditor, and formulation of local government financial statements according to standard accounting practices. The director of the Jakarta Commodity Market Agency (BBJ), head of the Jakarta Stock Exchange, and senior staff at Surabaya Stock Exchange agreed with this view.

Local governments must select regional agencies competent to issue bonds, such as the education and health agencies, and other authorities that manage regional public facilities such as industrial areas, airports, harbors, toll roads, and enterprises. Local governments need the approval of the regional people's representative council to issue bonds.

Investors are both individuals and institutions—the latter including insurance firms, pension funds, and other financial institutions such as banks. To encourage investors to buy local government bonds, a strong legal base, investor guarantors to secure investment return, and satisfactory economic and financial performance of the issuers and their rating by a rating agency are needed.

Finally, the following supporting institutions are important: issuing and trading parties such as securities and rating companies; capital market institutions such as custodian banks/depositories, securities administration agencies, and trust agents; and self-regulating organizations such as stock exchanges, clearing and guarantee corporations, and settlement and depository agencies. Fortunately, these supporting institutions already exist, but they need regulations to govern them.

Major Impediments to Bond Financing by Local Governments

Resource persons hold various views on the major impediments to bond market financing by local government. The chairman of BAPEPAM pointed out that at least four factors impede local government bond development: poor financial administration, inadequate regional accounting systems, incompetent regional institutions that will process bond issuance, and poor financial reports.

The BBJ director pointed out that, although committed to decentralization, the central Government has not given local government bonds attention, as seen in the absence of regulations governing them. Regulations specifically focusing on local government bonds therefore should be introduced. Issuance of local government bonds should be tax-free to encourage investors. Regional infrastructure—high-quality human resources and well-managed financial administration—is needed to organize local government bond markets.

Tax office heads in West and East Java, and senior Surabaya Stock Exchange staff agree that the above factors impede bond development. These resource persons added that other impediments are the nonfixed interest rate; lack of credibility of issuers; policy inconsistency; lack of coordination within local governments (province and district/municipality); small investor base; lack of market makers; and public ignorance of local bonds, which can be remedied with promotional activities.

In summary, local government bond market financing is not yet developed. Laws and regulations are lacking, and local governments still rely on central government financial assistance to develop their regions. Large amounts of working capital and high-quality staff for local bond market development are, though, rarely available.

Summary and Conclusions

Local government finance has changed significantly since January 2001, when the central Government committed itself to implement local autonomy and fiscal decentralization. Before that, local government financial sources were highly centralized. Local government revenue came from five sources, in decreasing order of importance: subsidies and other assistance, tax and nontax revenue, local revenue, other development revenue, and surplus from the previous year.

As local autonomy and fiscal decentralization proceeded, the composition of local government financial revenue sources changed. Law 25/1999 provides that local governments can collect revenue from local revenue or income, central-local balance fund, local borrowings, and other legal revenues in the region. Local revenue is from four sources: regional taxes, user charges, revenues from local state-owned companies and local asset management companies, and other legal local revenues. The central-local balance fund consists of local revenues from taxes on land and building construction, taxes on land and building construction rights, revenue from natural resources, general allocation fund, and specific allocation fund.

If regions intend to borrow money from abroad, they must do so through the central Government. Local governments may also take out long-term loans from domestic sources, but these loans may be used only to fund local infrastructure development, as it is expected to result in capital benefit to repay back the loan and to benefit the public. Local governments may also take out short-term loans, which should be used to maintain local cash-flow financing. All borrowings must be approved by the regional people's representative council. The local government is not allowed to borrow more than the amount decided by the central Government, or to enter bail-out agreements that might create problems for regional financial sources.

The four local revenue sources, however, are limited to financing local government expenditures, leading local governments to impose excessive new taxes and user charges, which dampen local consumption and investment. Collection of tax and user charges has not been as easy as expected due to lack of a database on actual and potential taxpayers, inefficient administration, lack of high-quality tax staff, underdeveloped legal and accounting systems, and the public's general reluctance to pay taxes.

As pressure mounts to obtain local government revenues, local governments should consider bond markets as a means to finance regional development, apart from reforms and initiatives to strengthen other local government revenue sources outlined in Law 25/1999. Local governments should reform taxes, the central-local balance fund, and regional loan policy. For instance, local governments should impose taxes and user charges on the basis of regulations and laws acceptable to the public, especially investors. District/municipal governments should work with provincial governments to determine the economic activity to be taxed. Highly profitable economic activities should be taxed as much as possible. Local governments should maintain their present economic activities and initiate new ones to increase tax sources and other local revenues.

Revision of the central-local balance fund guidelines and allocation formula should consider not only differences in regional economic resource potential, such as natural resources, population size, and geographical location, but also the region's ability to obtain local revenue, as well as labor productivity, number of poor, number of government officials and quality of human resources, environmental costs, and availability of infrastructure. Actual regional social and economic needs are better indicators than regional economic resource potential. Regions that perform better economically and have rich economic resources should receive less central government financial assistance than those that perform poorly and have scarce economic resources, as long as these poor regions are productive or have the potential to become so in the near future. The central Government must, therefore, have data on regions income to achieve local autonomy and fiscal decentralization.

Policy Recommendations

Fiscal management and capacity of local finance departments should be improved, laws and regulations established, institutional constraints resolved, and debt managed.

Detailed recommendations are as follows.

Fiscal Management

Fiscal management to facilitate bond financing by local governments involves many complex issues: (i) the relationship among issuers (local governments), intermediaries (underwriters, brokers, dealers, market makers, and financial advisors), and investors (individual and institutional); (ii) the relationship between local and central governments, and between provincial and district/municipal governments; and (iii) involvement of the regional legislative body, which decides on strategic economic activities such as foreign borrowings, and other types of regional fiscal management (including tax and other fee management).

Local government bond issuance without coordination between central and local governments can have adverse macroeconomic effects, including balance-of-payment problems, inflation, and budgeting problems. The bonds can have important implications for macroeconomic stability and adjustment, especially if introduced for political and institutional reasons as well, rather than just for economic efficiency. However, bond issuance based only on noneconomic rational factors will lead to excessive debt accumulation and deficit financing, which will hinder not only regional and central macroeconomic management and performance in the short run, but also intergenerational equity in the long run.

Regulations should thus be drawn up or independent financial institutions developed. Hard budget constraints can be imposed on local governments, and they can be involved in the central Government's management and adjustment efforts. However, local governments need a clear mandate by law or regulation to issue local government bonds.

Capacity of Local Financial Departments

Local governments should build the capacity of their financial departments, which are ill managed, unprofessional, and, more important, have been plagued by collusion, corruption, and nepotism. The chairman of BAPEPAM pointed out that local financial departments lack not only high-quality human resources but also the ability to prepare financial reports and other documents.

Staff should be trained, services improved, and other technological and computerized infrastructure provided to professionalize bond financing to attract investors and encourage local governments to issue bonds.

Laws and Regulations

Resource persons cited the absence of laws and regulations for local government bonds as discouraging the development of bond markets. The central Government should issue them to create a regulatory framework, and to cover bond issuance and its structure, investors and intermediaries, and taxation. A securities law should include all regulations on issuance, initial and continuing disclosure, and settlements applicable to local government bonds. Regulations should require financial information to be presented to the market in case of public issue of local government bonds, taking into account the local government accounting framework for three reasons: (i) to prevent local entities from designing their own formats for initial and continuing disclosure, (ii) to help investors analyze the issuer's financial credibility, and (iii) to make the market more transparent. Regulations may also cover private issuance by local entities, providing for minimum size, ex ante notification of investors to the local government, and minimum requirements for disclosure to private investors.

The general regulatory framework for securities needs specific regulations for local government bond issuance:

- The local government (regulator) must require local issuers to obtain a legal opinion on general obligations and revenue bonds.
- Specific regulations should cover interregional undertakings and enterprises and regional associations, focusing on revenue assignment, designation and collateralizing of assets, and establishment of sinking and escrow funds. The central Government should establish a regulatory environment where institutional investors have the freedom to invest across a broad range of instruments, including local bonds.
- The central Government needs to establish specific tax systems for local government bonds and free investors (particularly public ones) from taxation to encourage them to invest in bonds for public services (hospitals, schools, etc).

Institutional Constraints

Institutional constraints occur when no coordination mechanism exists between central and local governments, among local governments, and among private parties. Institutional constraints can also occur from moral hazard, lack of market transparency, low local capacity for accounting, and poor budgeting and financial management. These problems should be reduced by, for instance, formulating financial policy to help local governments plan their investments, manage their finances, and increase their revenue, and by strengthening the legal aspects of institutional relationships.

Budget policies on fiscal decentralization, public debt channels, and financial sector channels are needed to reduce moral hazard. A broad array of policy reforms are needed to promote local debt market transparency, including (i) establishing a local government accounting framework separating current and capital expenditures, (ii) establishing a legislative framework for local government assets, (iii) developing local government account audit by the state audit office, and (iv) regulating procedures and formats for debt disclosure and registration by local government. Legal aspects should include local, capital market, and privatization laws. Regulations should organize and coordinate financial relationships among local governments.

Debt Management

To establish effective and efficient debt management, several issues need to be considered: (i) use of the loan (whether or not it can be used for cost recovery investment), (ii) amount of the loan, (iii) requirement of the loan and loan repayment procedure, (iv) responsibility to repay loan, and (v) debt service ratio. Government Regulation 107/2000 deals with cost recovery investment, although the amount of the loan is limited. Central and local governments should regulate non-cost recovery investment as it has the potential to push growth.

The amount of the loan is relevant only to a non-recovery investment. The local government thus has to set a maximum amount of loan for non-recovery investment, determined by the central and local governments to avoid using local revenue to repay the loan.

The loan requirement relates to the interest rate, period of loan, and agreement between issuers and investors. Repayment procedures relate to the repayment process, especially whether the loan will be repaid using development expenditures (current expenditures) or other alternatives. The central Government usually repays the loan via a transfer payment. Local governments are not much involved in local borrowings, resulting in local government reluctance to receive the loan, which creates problems when the local government has to repay it. A regulation on loan repayment responsibility should be formulated and agreed by local and central governments.

Areas of Technical Assistance

ADB support is crucial to local autonomy and decentralization. Areas of technical assistance that ADB can provide can be grouped into two: (i) improvement of local government financial efficiency (education and management training for local government finance staff); and (ii) direct provision of infrastructure for local development. ADB should also help local governments strengthen the role of the private sector and other funding agencies in providing basic services such as water supply and sanitation, sewerage, and other local infrastructure.

Direct ADB assistance to local governments, by providing urban development and other social and economic development projects, is important to speed up regional economic development. ADB can assist in the water sector, road construction, drainage, sewerage and sanitation, solid waste system, and village improvement. Social and economic services include hospitals and health, schools, and other social services. However, the regions must first be assessed financially before investing in local government bonds. Regions where bond markets might be introduced now include DKI Jakarta, West Java, East Java, North Sumatra, East Kalimantan, and Riau as they have better economic resources than other provinces.

ADB can also directly raise funds for regional development through local government bonds, which is important not only because of financial limitations of local private and institutional investors, but also because ADB would encourage local stakeholders to participate in its local development projects.

Endnote

[1] A project list financed by the central Government through the technical department every financial year. The department's central office allocates funds to its district and municipal offices.

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Appendix 1. Actual Revenues and Expenditures of Provincial Government, FY1997–2000 (Rp million)

Province	Fiscal Year	Revenues		Expenditures					
				Routine		Development		Total	
			%		%		%		%
Aceh	1997	255,366	2.0	166,540	2.2	84,145	1.9	250,685	2.1
	1998	269,490	2.1	181,779	2.2	85,601	2.0	267,380	2.1
	1999	172,030	1.9	103,452	2.2	68,250	2.4	171,702	2.3
	2000	251,402	1.9	96,598	1.4	148,545	3.3	245,143	2.2
North Sumatra	1997	673,820	5.4	491,516	6.5	169,338	3.9	660,854	5.5
	1998	772,629	6.0	575,982	7.1	195,048	4.5	771,030	6.2
	1999	347,839	3.9	200,767	4.2	141,793	5.0	342,560	4.5
	2000	515,926	3.9	202,232	3.0	246,820	5.4	449,052	4.0
West Sumatra	1997	167,120	1.3	80,811	1.1	71,475	1.7	152,286	1.3
	1998	176,697	1.4	92,702	1.1	76,834	1.8	169,536	1.4
	1999	165,647	1.8	85,340	1.8	63,377	2.2	148,717	2.0
	2000	234,859	1.8	107,387	1.6	91,932	2.0	199,319	1.8
Riau	1997	307,088	2.4	112,911	1.5	154,591	3.6	267,502	2.2
	1998	333,322	2.6	134,382	1.7	151,019	3.4	285,401	2.3
	1999	358,552	4.0	145,290	3.0	158,916	5.6	304,206	4.0
	2000	546,944	4.1	213,911	3.2	234,345	5.1	448,256	4.0
Jambi	1997	129,581	1.0	42,684	0.6	76,005	1.8	118,689	1.0
	1998	133,018	1.0	47,731	0.6	74,666	1.7	122,397	1.0
	1999	126,248	1.4	47,042	1.0	70,076	2.5	117,118	1.5
	2000	167,496	1.3	62,628	0.9	92,031	2.0	154,659	1.4
South Sumatra	1997	257,984	2.1	116,144	1.5	119,271	2.8	235,415	2.0
	1998	271,182	2.1	123,771	1.5	112,905	2.6	236,676	1.9
	1999	294,178	3.3	163,676	3.4	101,814	3.6	265,490	3.5
	2000	334,338	2.5	130,520	1.9	143,820	3.1	274,340	2.4
Bengkulu	1997	96,332	0.8	38,948	0.5	51,758	1.2	90,706	0.8
	1998	102,388	0.8	42,721	0.5	55,889	1.3	98,610	0.8
	1999	107,826	1.2	51,083	1.1	47,591	1.7	98,674	1.3
	2000	131,143	1.0	56,070	0.8	67,150	1.5	123,220	1.1
Lampung	1997	166,647	1.3	87,121	1.1	75,956	1.8	163,077	1.4
	1998	167,452	1.3	90,828	1.1	73,256	1.7	164,084	1.3
	1999	166,417	1.9	80,277	1.7	75,875	2.7	156,152	2.0
	2000	222,356	1.7	103,195	1.5	104,402	2.3	207,597	1.8
Jakarta	1997	2,972,350	23.7	1,606,729	21.1	1,229,105	28.4	2,835,834	23.8
	1998	2,868,409	22.3	1,729,641	21.4	1,116,651	25.5	2,846,292	22.8
	1999	2,480,155	27.6	1,417,014	29.6	240,302	8.5	1,657,316	21.8
	2000	4,178,545	31.5	2,459,305	36.5	836,209	18.3	3,295,514	29.1

Appendix 1. Actual Revenues and Expenditures of Provincial Government, FY1997–2000 (Rp million) (*cont'd.*)

Province	Fiscal Year	Revenues		Expenditures					
				Routine		Development		Total	
			%		%		%		%
West Java	1997	1,646,283	13.1	1,148,848	15.1	473,419	10.9	1,622,267	13.6
	1998	1,607,070	12.5	1,129,699	14.0	475,189	10.9	1,604,888	12.9
	1999	698,549	7.8	401,127	8.4	258,873	9.1	660,000	8.7
	2000	1,075,333	8.1	634,854	9.4	282,917	6.2	917,771	8.1
Central Java	1997	1,500,398	12.0	1,210,312	15.9	249,828	5.8	1,460,140	12.2
	1998	1,452,105	11.3	1,177,748	14.6	242,624	5.7	1,420,372	11.4
	1999	636,869	7.1	411,171	8.6	176,549	8.5	587,720	7.7
	2000	886,311	6.7	536,929	8.0	259,562	3.9	796,491	7.0
Yogyakarta	1997	213,380	1.7	157,356	2.1	47,173	1.1	204,529	1.7
	1998	213,914	1.7	158,029	2.0	50,301	1.1	208,330	1.7
	1999	133,307	1.5	81,109	1.7	43,231	1.5	124,340	1.6
	2000	180,971	1.4	103,998	1.5	53,015	1.2	157,013	1.4
East Java	1997	1,692,519	13.5	1,185,103	15.6	418,459	9.7	1,603,562	13.4
	1998	1,867,329	14.5	1,363,528	16.9	426,484	9.7	1,790,012	14.4
	1999	786,343	8.8	407,729	8.5	300,327	10.6	708,056	9.3
	2000	971,914	7.3	392,900	5.8	436,546	9.6	829,446	7.3
Bali	1997	185,873	1.5	73,641	1.0	85,595	2.0	159,236	1.3
	1998	195,765	1.5	88,591	1.1	95,237	2.2	183,828	1.5
	1999	166,724	1.9	72,991	1.5	75,712	2.7	148,703	2.0
	2000	335,698	2.5	146,467	2.2	88,971	1.9	235,438	2.1
West Nusa Tenggara	1997	109,170	0.9	40,813	0.5	57,430	1.3	98,243	0.8
	1998	133,853	1.0	46,790	0.6	71,466	1.6	118,256	0.9
	1999	136,478	1.5	47,669	1.0	68,318	2.4	115,987	1.5
	2000	187,411	1.4	59,547	0.9	105,836	2.3	165,383	1.5
East Nusa Tenggara	1997	129,102	1.0	48,295	0.6	75,019	1.7	123,314	1.0
	1998	138,155	1.1	53,521	0.7	77,123	1.8	130,644	1.0
	1999	132,438	1.5	50,411	1.1	72,439	2.6	122,850	1.6
	2000	192,860	1.5	62,086	0.9	120,312	2.6	182,398	1.6
East Timor	1997	83,072	0.7	31,353	0.4	47,469	1.1	78,822	0.7
	1998	93,523	0.7	36,989	0.5	52,445	1.2	89,434	0.7
West Kalimantan	1997	142,831	1.1	57,729	0.8	75,122	1.7	132,851	1.1
	1998	160,254	1.2	64,614	0.8	91,179	2.1	155,793	1.3
	1999	162,319	1.8	69,236	1.4	74,504	2.6	143,740	1.9
	2000	254,422	1.9	96,213	1.4	125,791	2.8	222,004	2.0

Appendix 1. Actual Revenues and Expenditures of Provincial Government, FY1997–2000 (Rp million) (*cont'd.*)

Province	Fiscal Year	Revenues		Expenditures					
				Routine		Development		Total	
			%		%		%		%
Central Kalimantan	1997	232,520	1.9	124,578	1.6	96,577	2.2	221,155	1.9
	1998	243,190	1.9	128,687	1.6	104,820	2.4	233,507	1.9
	1999	185,037	2.1	74,630	1.6	85,850	3.0	160,480	2.1
	2000	261,856	2.0	89,077	1.3	138,789	3.0	227,866	2.0
South Kalimantan	1997	208,754	1.7	124,375	1.6	62,300	1.4	186,675	1.6
	1998	188,363	1.5	93,639	1.2	83,543	1.9	177,182	1.4
	1999	208,690	2.3	94,653	2.0	98,432	3.5	193,085	2.5
	2000	287,103	2.2	144,158	2.1	128,846	2.8	273,004	2.4
East Kalimantan	1997	290,275	2.3	130,070	1.7	128,742	3.0	258,812	2.2
	1998	305,012	2.4	157,824	2.0	137,103	3.1	294,927	2.4
	1999	349,097	3.9	205,845	4.3	113,448	4.0	319,293	4.2
	2000	574,369	4.3	339,329	5.0	192,489	4.2	531,818	4.7
North Sulawesi	1997	120,467	1.0	56,093	0.7	63,525	1.5	119,618	1.0
	1998	127,846	1.0	63,282	0.8	64,121	1.5	127,403	1.0
	1999	134,640	1.5	71,926	1.5	61,452	2.2	133,378	1.8
	2000	172,370	1.3	92,420	1.4	79,790	1.7	172,210	1.5
Central Sulawesi	1997	210,103	1.7	136,263	1.8	68,714	1.6	204,977	1.7
	1998	208,678	1.6	127,571	1.6	77,803	1.8	205,374	1.6
	1999	130,013	1.4	53,155	1.1	72,425	2.6	125,580	1.6
	2000	180,067	1.4	64,682	1.0	104,435	2.3	169,117	1.5
South Sulawesi	1997	242,941	1.9	101,847	1.3	99,533	2.3	201,380	1.7
	1998	285,788	2.2	121,013	1.5	129,061	2.9	250,074	2.0
	1999	262,694	2.9	117,307	2.5	119,201	4.2	236,508	3.1
	2000	336,137	2.5	162,453	2.4	133,823	2.9	296,276	2.6
Southeast Sulawesi	1997	100,493	0.8	30,837	0.4	62,372	1.4	93,209	0.8
	1998	110,187	0.9	38,679	0.5	64,663	1.5	103,342	0.8
	1999	117,451	1.3	40,037	0.8	66,086	2.3	106,123	1.4
	2000	163,104	1.2	56,904	0.8	86,084	1.9	142,988	1.3
Maluku	1997	117,040	0.9	41,913	0.6	67,416	1.6	109,329	0.9
	1998	130,174	1.0	50,973	0.6	75,304	1.7	126,277	1.0
	1999	125,344	1.4	49,444	1.0	63,905	2.3	113,349	1.5
	2000	152,321	1.1	61,360	0.9	82,650	1.8	144,010	1.3
Irian Jaya	1997	291,885	2.3	162,926	2.1	117,117	2.7	280,043	2.3
	1998	289,970	2.3	159,984	2.0	117,531	2.7	277,515	2.2
	1999	385,297	4.3	237,058	5.0	120,528	4.2	357,586	4.7
	2000	460,589	3.5	263,962	3.9	183,289	4.0	447,251	4.0
Indonesia	1997	12,543,394	100.0	7,605,756	100.0	4,327,454	100.0	11,933,210	100.0
	1998	12,845,763	100.0	8,080,698	100.0	4,377,866	100.0	12,458,564	100.0
	1999	8,970,182	100.0	4,779,439	100.0	2,839,274	100.0	7,618,713	100.0
	2000	13,255,845	100.0	6,739,185	100.0	4,568,399	100.0	11,307,584	100.0

Source: Central Bureau of Statistics. 2001.

Appendix 2. Actual Revenues and Expenditures of District/Municipal-Level Government, FY1997–2000 (Rp million)

Province	Fiscal Year	Revenues		Expenditures					
				Routine		Development		Total	
			%		%		%		%
Aceh	1997	328,221	2.5	159,490	2.3	163,483	2.9	322,973	2.6
	1998	399,144	2.5	195,710	2.3	196,423	2.9	392,133	2.6
	1999	494,761	2.4	296,397	2.2	179,226	2.9	475,623	2.4
	2000	795,353	2.8	414,763	2.2	322,437	3.8	737,200	2.7
North Sumatra	1997	669,577	5.2	347,029	5.1	302,852	5.3	649,881	5.2
	1998	850,241	5.4	425,798	5.0	402,146	6.0	827,944	5.4
	1999	1,343,121	6.4	869,808	6.5	435,228	7.0	1,305,036	6.7
	2000	1,747,843	6.1	1,182,699	6.3	487,391	5.8	1,670,090	6.2
West Sumatra	1997	431,104	3.3	279,810	4.1	139,553	2.5	419,363	3.3
	1998	505,838	3.2	321,362	3.8	170,554	2.5	491,916	3.2
	1999	615,040	2.9	311,732	2.3	197,980	3.2	509,712	2.6
	2000	840,625	3.0	537,534	2.9	252,807	3.0	790,341	2.9
Riau	1997	413,906	3.2	213,695	3.1	187,216	3.3	400,911	3.2
	1998	530,163	3.4	253,700	3.0	228,260	3.4	481,960	3.2
	1999	687,499	3.3	364,732	2.7	280,407	4.5	645,139	3.3
	2000	729,842	2.6	460,975	2.5	214,360	2.5	675,335	2.5
Jambi	1997	278,150	2.1	157,496	2.3	113,602	2.0	271,098	2.2
	1998	328,746	2.1	184,602	2.2	131,961	2.0	316,563	2.1
	1999	369,656	1.8	215,970	1.6	137,529	2.2	353,499	1.8
	2000	460,542	1.6	300,438	1.6	133,244	1.6	433,682	1.6
South Sumatra	1997	638,202	4.9	382,218	5.6	238,289	4.2	620,507	5.0
	1998	706,505	4.5	424,713	5.0	257,240	3.8	681,953	4.5
	1999	818,008	3.9	497,699	3.7	253,497	4.0	751,196	3.8
	2000	1,059,426	3.7	681,991	3.7	290,105	3.4	972,096	3.6
Bengkulu	1997	155,660	1.2	90,957	1.3	61,133	1.1	152,090	1.2
	1998	195,373	1.2	109,614	1.3	82,914	1.2	192,528	1.3
	1999	224,712	1.1	131,420	1.0	84,723	1.4	216,143	1.1
	2000	285,045	1.0	176,324	0.9	99,522	1.2	275,846	1.0
Lampung	1997	427,765	3.3	275,269	4.0	147,852	2.6	423,121	3.4
	1998	523,276	3.3	330,809	3.9	185,999	2.8	516,808	3.4
	1999	645,201	3.1	408,547	3.1	218,636	3.5	627,183	3.2
	2000	863,234	3.0	579,564	3.1	266,809	3.2	846,373	3.1

Appendix 2. Actual Revenues and Expenditures of District/Municipal-Level Government, FY1997–2000 (Rp million) (*cont'd.*)

Province	Fiscal Year	Revenues		Expenditures					
				Routine		Development		Total	
			%		%		%		%
West Java	1997	1,824,945	14.0	788,750	11.5	944,708	16.7	1,733,458	13.8
	1998	2,337,208	14.8	1,207,110	14.2	1,066,700	15.9	2,273,810	14.9
	1999	3,159,240	15.1	2,048,035	15.4	960,835	15.3	3,008,870	15.4
	2000	4,168,031	14.7	2,835,231	15.2	1,162,151	13.8	3,997,382	14.8
Central Java	1997	1,214,049	9.3	578,891	8.4	586,561	10.4	1,165,452	9.3
	1998	1,493,609	9.5	786,391	9.2	652,844	8.7	1,439,235	9.4
	1999	2,595,344	12.4	1,954,186	14.7	534,391	10.4	2,488,577	12.7
	2000	3,500,504	12.3	2,626,637	14.1	747,796	6.3	3,374,433	12.5
Yogyakarta	1997	198,128	1.5	110,406	1.6	79,610	1.4	190,016	1.5
	1998	261,109	1.7	159,784	1.9	92,739	1.4	252,523	1.7
	1999	365,049	1.8	261,706	2.0	83,610	1.3	345,316	1.8
	2000	477,387	1.7	340,046	1.8	108,835	1.3	448,881	1.7
East Java	1997	1,382,200	10.6	601,468	8.8	711,792	12.6	1,313,260	10.5
	1998	1,572,179	10.0	692,925	8.1	806,009	12.0	1,498,934	9.8
	1999	2,762,933	13.2	1,806,453	13.6	826,374	13.2	2,632,827	13.5
	2000	4,121,730	14.5	2,937,005	15.8	1,010,041	12.0	3,947,046	14.6
Bali	1997	462,964	3.6	278,180	4.1	160,594	2.8	438,774	3.5
	1998	529,569	3.4	319,778	3.8	186,205	2.8	505,983	3.3
	1999	772,663	3.7	392,671	3.0	207,881	3.3	600,552	3.1
	2000	1,150,841	4.0	557,614	3.0	452,283	5.4	1,009,897	3.7
West Nusa Tenggara	1997	277,559	2.1	186,989	2.7	86,548	1.5	273,537	2.2
	1998	336,285	2.1	223,822	2.6	107,478	1.6	331,300	2.2
	1999	370,964	1.8	267,541	2.0	86,967	1.4	354,508	1.8
	2000	637,544	2.2	371,556	2.0	249,860	3.0	621,416	2.3
East Nusa Tenggara	1997	421,323	3.2	249,490	3.6	162,967	2.9	412,457	3.3
	1998	497,082	3.2	292,257	3.4	196,694	2.9	488,951	3.2
	1999	484,592	2.3	340,628	2.6	118,426	1.9	459,054	2.3
	2000	695,371	2.4	472,358	2.5	198,701	2.4	671,059	2.5
East Timor	1997	186,056	1.4	93,456		87,046		180,502	
	1998	224,979	1.4	119,341		101,460		220,801	
West Kalimantan	1997	391,176	3.0	226,271	3.3	148,439	2.6	374,710	3.0
	1998	451,943	2.9	263,730	3.1	178,182	2.7	441,912	2.9
	1999	498,602	2.4	314,548	2.4	160,024	2.6	474,572	2.4
	2000	676,594	2.4	431,475	2.3	229,630	2.7	661,105	2.4

Appendix 2. Actual Revenues and Expenditures of District/Municipal-Level Government, FY1997–2000 (Rp million) (*cont'd.*)

Province	Fiscal Year	Revenues		Expenditures					
				Routine		Development		Total	
			%		%		%		%
Central Kalimantan	1997	241,263	1.9	88,505	1.3	140,500	2.5	229,005	1.8
	1998	259,515	1.6	91,476	1.1	153,238	2.3	244,714	1.6
	1999	428,536	2.1	235,163	1.8	163,203	2.6	398,366	2.0
	2000	542,925	1.9	317,531	1.7	208,181	2.5	525,712	1.9
South Kalimantan	1997	348,466	2.7	183,475	2.7	149,456	2.6	332,931	2.7
	1998	454,888	2.9	247,939	2.9	190,583	2.8	438,522	2.9
	1999	525,139	2.5	316,343	2.4	173,114	2.8	489,457	2.5
	2000	698,530	2.5	416,246	2.2	245,109	2.9	661,355	2.4
East Kalimantan	1997	482,161	3.7	254,546	3.7	209,829	3.7	464,375	3.7
	1998	557,180	3.5	296,394	3.5	238,201	3.6	534,595	3.5
	1999	641,328	3.1	329,471	2.5	206,711	3.3	536,182	2.7
	2000	915,281	3.2	501,136	2.7	301,734	3.6	802,870	3.0
North Sulawesi	1997	316,327	2.4	214,115	3.1	92,773	1.6	306,888	2.5
	1998	383,778	2.4	250,600	2.9	124,247	1.9	374,847	2.5
	1999	431,165	2.1	274,366	2.1	150,287	2.4	424,653	2.2
	2000	514,615	1.8	311,794	1.7	193,191	2.3	504,985	1.9
Central Sulawesi	1997	157,898	1.2	44,014	0.6	108,425	1.9	152,439	1.2
	1998	227,231	1.4	81,066	1.0	141,284	2.1	222,350	1.5
	1999	285,039	1.4	201,362	1.5	72,394	1.2	273,756	1.4
	2000	445,774	1.6	274,060	1.5	158,126	1.9	432,186	1.6
South Sulawesi	1997	784,919	6.0	490,492	7.2	278,903	4.9	769,395	6.1
	1998	967,514	6.1	578,643	6.8	362,423	5.4	941,066	6.2
	1999	992,250	4.8	685,481	5.2	249,971	4.0	935,452	4.8
	2000	1,385,643	4.9	929,626	5.0	405,500	4.8	1,335,126	4.9
Southeast Sulawesi	1997	169,909	1.3	110,514	1.6	56,785	1.0	167,299	1.3
	1998	228,219	1.4	146,536	1.7	75,136	1.1	221,672	1.5
	1999	289,042	1.4	177,140	1.3	101,334	1.6	278,474	1.4
	2000	398,929	1.4	248,360	1.3	136,552	1.6	384,912	1.4
Maluku	1997	233,752	1.8	129,464	1.9	88,464	1.6	217,928	1.7
	1998	325,700	2.1	165,556	1.9	147,317	2.2	312,873	2.1
	1999	432,798	2.1	175,955	1.3	177,549	2.8	353,504	1.8
	2000	440,307	1.5	203,482	1.1	226,863	2.7	430,345	1.6
Irian Jaya	1997	555,655	4.3	322,459	4.7	218,627	3.9	541,086	4.3
	1998	600,338	3.8	355,851	4.2	228,437	3.4	584,288	3.8
	1999	621,190	3.0	408,257	3.1	199,932	3.2	608,189	3.1
	2000	878,104	3.1	533,392	2.9	327,024	3.9	860,416	3.2
Indonesia	1997	12,991,335	100.0	6,857,449	100.0	5,666,007	100.0	12,523,456	100.0
	1998	15,747,612	100.0	8,525,507	100.0	6,704,674	100.0	15,230,181	100.0
	1999	20,853,872	100.0	13,285,611	100.0	6,260,229	100.0	19,545,840	100.0
	2000	28,430,020	100.0	18,641,837	100.0	8,428,252	100.0	27,070,089	100.0

Source: Central Bureau of Statistics. 2001.

Republic of Korea

Junghun Kim
Research Fellow
Korea Institute of Public Finance
Seoul

Acronyms

ELST	education local shared tax
ELTF	education local transfer fund
DRECL	Daejeon Riverside Expressway Company Ltd.
FII	fiscal independence index
LIBOR	London interbank offered rate
MEHRD	Ministry of Education and Human Resources Development
MOCT	Ministry of Construction and Transportation
MOFE	Ministry of Finance and Economy
MOGAHA	Ministry of Government Administration and Home Affairs
MPB	Ministry of Planning and Budget
OECF	Overseas Economic Cooperation Fund
SMRTC	Seoul Metropolitan Rapid Transit Corporation
SMSC	Seoul Metropolitan Subway Corporation
SPV	special-purpose vehicle
US	United States
VAT	value-added tax
W	won

Executive Summary

The Republic of Korea (Korea) introduced local autonomy in 1995. Its progress, however, has by no means been satisfactory. Participation in the past three local elections has steadily declined, as has the proportion of local tax revenue in local government budgets.

Local autonomy has not led to satisfactory political and economic decision making because local government powers and responsibilities are mismatched. For the potential benefit of decentralization to materialize, institutional arrangements affecting local governments' behavior and local citizens' perceptions should change to enhance local governments' power and accountability. Needed institutional changes are the following:

Division of Responsibilities between the Central and Local Governments. Hardly any local governments have changed their tax rates since 1995, as the central Government helps local governments provide all types of public services. If these local public services are clearly assigned to local governments, and citizens know for which public services they need to pay local rather than national taxes, local governments' power and responsibility will be greatly enhanced. Because local and national services were never differentiated in law until 1995, defining local services has been extremely difficult. Clear division of public responsibilities between the central and local governments is the most important element to achieve local autonomy. This requires clear-cut criteria for distributing intergovernmental grants, market-oriented loan subsidies, and infrastructure investment.

Asymmetric Decentralization. Decentralization is hampered by the economic agglomeration around Seoul, which is arguably the most concentrated in the world: Seoul collects 70% of corporate income tax and 57% of income tax, and 45% of the country's population lives around the city.

The solution to decentralize power without transferring national resources to local governments that already have resources is asymmetric decentralization: giving local governments a menu of public services that can be provided at the local level if the governments opt for it. Normally, when transfer of resources is limited, no local government volunteers to assume new expenditure responsibilities. However, some local governments might prefer independent decision making even with little financial support.

Education, for example, is provided by the central Government, and Seoul might opt for the right to independent decision making for local education even with little financial support from the central Government, which can then use the saved resources to support local education in poor regions. By giving rich local gov-

ernments more fiscal responsibility and independence, the central Government can achieve balanced regional development and decentralization.

Restructuring of Central Government Loans and Compulsory Bonds. In theory, local governments incur debts to finance long-term projects, such as local infrastructure, on the assumption that the debts will be retired through local governments' future tax revenue. In practice, however, when local governments initiate public projects such as roads, housing, subways, environmental facilities, or local economic development, the central Government helps the local governments after evaluating the projects' merits, usually with specific grants. However, if the central Government's revenue set aside for intergovernmental grants is insufficient, the central Government typically allows local governments to assume debts to finance the project. As a result, the central and local governments regard local debts as a type of intergovernmental subsidy granted when the central Government needs to transform the financial burden of intergovernmental subsidies into its own debt.

Another notable characteristic of local debt is the dominance of the compulsory bond, the buying of which is like paying a tax. Many types of licensing, registration, and contracts are subject to local governments' compulsory bonds, such as those for regional development, urban railroads, and urban development.

Local bond market development is hindered by the fact that most debts are incurred through either central government loans or compulsory bonds. Since borrowing from the central Government often leads to inefficient decision making on infrastructure investment, private investors should be involved in building local infrastructure. Private sector participation will involve many issues, including the structure of intergovernmental grants, division of responsibility for local infrastructure investment, and legal and institutional changes to improve the environment for public-private partnership.

The best alternative to the compulsory bond is significant improvement of land taxation, including the adoption of tax increment financing. Whether the amount of revenue secured by compulsory bonds can be replaced by land tax revenue, however, is questionable. Since a compulsory bond is similar to a user charge, the burden of the compulsory bond should be made consistent with the benefit of public investment.

Intergovernmental Grants and Infrastructure Investment. Even though government-backed borrowings should be reduced to develop the local bond market, whether bond financing will replace such borrowings is unclear. Of public projects financed by local debt in 2001, road-related expenditures accounted for 20.0%, and water and sewage, 27.8%. When other environment-related expenditures are included, road and environment expenditure takes up more than 50% of local debt financing. However, since the local transfer fund is allocated to local governments mainly for roads and the environment, changes in the system of intergovernmental grants are closely related to local bond market development.

The distribution of the local transfer fund across local governments is similar to that of the local shared tax, which is the general-purpose grant that helps poor jurisdictions. Local infrastructure is not built to meet demand for such facilities but to guarantee equal distribution of local infrastructure, especially roads. Therefore, unless the focus of the balanced regional development strategy, which might be the most important item on the political agenda in local public finance, is shifted away from local infrastructure, the role of local bonds is likely to be played by intergovernmental grants, such as the local transfer fund.

Soft Budget Constraints. Developing the local bond market is related to making local governments face hard budget constraints. In Korea, local governments' soft budget constraints are different from those in countries with a long history of local autonomy, where local governments play "fiscal games" with the central Government and issue local bonds, expecting that the burden of local debt will ultimately fall on the central Government. However, local governments in Korea are tightly controlled by the central Government and so soft budget constraints have not resulted in serious local debt default. Developing the local bond market, therefore, gives local governments more independence and fiscal power and lets them finance local infrastructure using local bonds rather than intergovernmental grants under hard budget constraints.

Local Public Finance

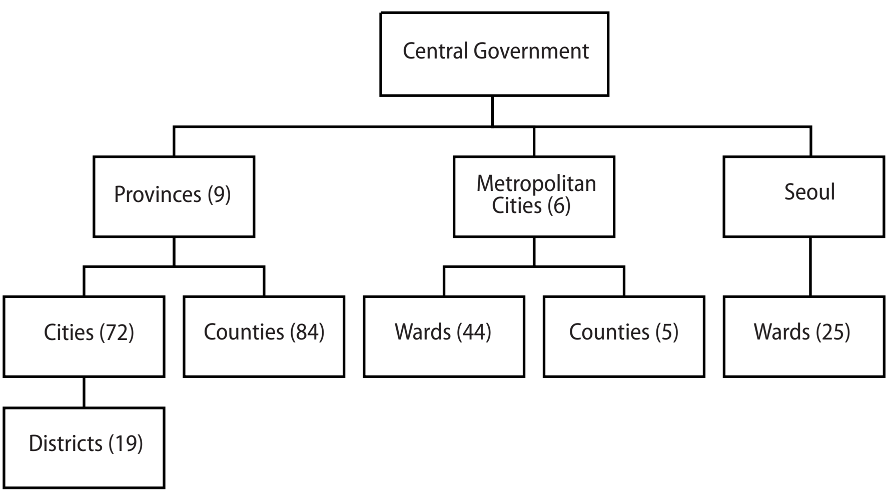
Structure of Government

Overview

Korea has an area of 99,408 square kilometers (km²) and a population of 47.7 million. The first Local Autonomy Act was enacted in 1948, when the country became independent. However, local autonomy ended in 1961, when President Park Jung Hee seized power and started central government-driven economic development. After 24 years of centralization, the country resumed local autonomy in 1995 by electing local heads by popular vote.

Local governments are prefectures and municipalities. Prefectures consist of a special metropolitan city (Seoul); six metropolitan cities (Busan, Daegu, Incheon, Gwangju, Daejeon, and Ulsan); and nine provinces (Gangwon, Kyonggi, Chungbuk, Chungnam, Jeonbuk, Jeonnam, Gyeongbuk, Gyeongnam, and Jeju) (Figure 1). Prefecture boundaries were determined historically, and populations and areas thus vary greatly from prefecture to prefecture. The new Local Autonomy Act divides prefecture functions into two categories: intermediation between the central and municipal governments, and area-wide administration. Prefectures are responsible for matters that affect broad areas within their jurisdiction or for which a single standard needs to be maintained throughout a prefecture.

Figure 1. Local Government System, 2001



Source: Ministry of Government Administration and Home Affairs.

The 16 prefectures are by no means homogeneous in their fiscal capacities and expenditure responsibilities. The difference between the city prefectures and the provinces is significant since provinces are mostly rural. Therefore, while local government is two-tiered, to categorize local governments simply as either upper or lower level would be misleading.

Upper- and lower-level local governments are diverse. Lower-level local governments consist of cities, counties, and wards. Cities have a population of 50,000 or more, and counties, 50,000 or less. Wards are municipalities under big cities. Seoul and metropolitan wards are autonomous and their heads elected. Other cities whose populations are over 500,000 can have nonautonomous wards as administrative arms.

Disparities among Local Governments

The biggest local government is Seoul, with a population of around 10 million (Table 1). The second largest is Busan, a southeastern port city, followed by Incheon, a port city 30 km west of Seoul. Kyonggi is by far the largest province, with a popu-

Table 1. Structure and Size of Local Government, 2001

Prefectures	Municipalities					Population
	Total	Cities	Counties	Wards		
				Autonomous	Non-autonomous	
Total	251	74	89	69	19	47,732,499
Seoul	25			25		10,311,268
Metropolitan Cities						
Busan	16		1	15		3,796,506
Incheon	10		2	8		2,545,769
Daegu	8		1	7		2,524,253
Daejeon	5			5		1,385,606
Gwangju	5			5		1,371,909
Ulsan	5		1	4		1,040,225
Provinces						
Kyonggi	44	25	6		13	9,219,350
Gyeongnam	20	10	10			3,094,385
Gyeongbuk	25	10	13		2	2,797,186
Jeonnam	22	5	17			2,130,614
Jeonbuk	16	6	8		2	1,999,255
Chungnam	15	6	9			1,921,604
Gangwon	18	7	11			1,554,688
Chungbuk	13	3	8		2	1,497,513
Jeju	4	2	2			542,368

Source: Ministry of Government Administration and Home Affairs.

lation of more than 9 million, and much bigger and more fiscally powerful than the second largest, Gyeongnam, with a population of about 3 million. The area including Seoul, Incheon, and Kyonggi is usually called the capital area, and has the largest population, greatest fiscal capacity, most attractive business environment, and one of the most important roles in shaping local public finance policy.

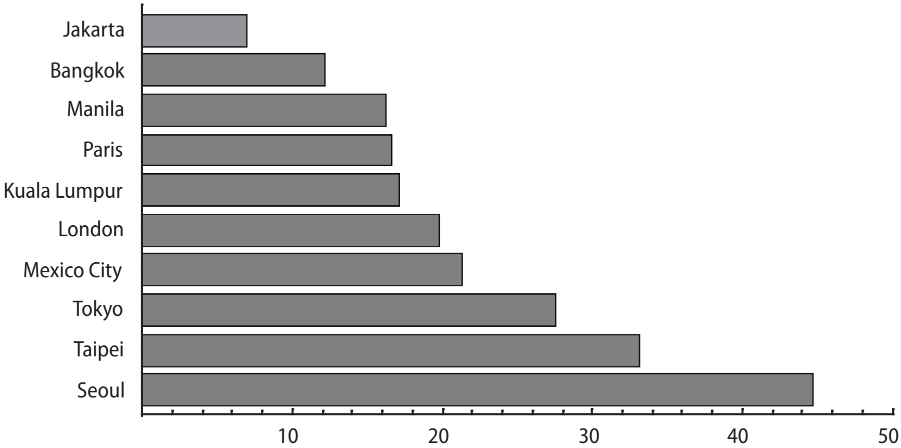
Seoul's share of the population is about 45% (Figure 2), which is by far the highest among economies with serious economic agglomeration problems, such as Taipei,China (Taipei, 33%), and Japan (Tokyo metropolitan area, 27%). London and Paris metropolitan areas have less than 20% of the population.

Fiscal variables highlight the dominance of Seoul. The share of individual income tax revenue is 71%, and of corporate income tax, as high as 85%. The share of local taxes is somewhat lower (50%) since they are chosen so that their revenue distribution across local governments is even.

Since local autonomy was introduced in 1995, discussions on devolving political and economic power to local governments have continued. However, many see simple devolution as centralizing Seoul even more.

Ades and Glaeser (1995) write that people converge in Seoul because information and power have long been concentrated there.[1] Decentralization will be difficult as Seoul is very large. Some think that since outright decentralization might weaken Seoul's and, hence, the country's, productivity,[2] widely supported, well-thought-out strategies are needed.[3]

Figure 2. Concentration of Population around Metropolitan Areas, 2002 (%)



Source: Principal Cities and Agglomeration (available: www.citypopulation.de).

Expenditure Assignment

Overview

The basic rights and responsibilities of local governments are stipulated in the Constitution. Article 117 states that local governments have the right to manage their property, affairs, and administration, and to enact their own regulations within the law. The Local Autonomy Act assigns expenditure responsibilities. Article 9 stipulates that local governments should take care of (i) purely local public services and (ii) national public services that local governments must provide by law.

Article 9 also states that, "unless otherwise stipulated in law," the following are local public services: (i) local administration; (ii) public services that enhance residents' welfare; (iii) local industrial development of agriculture and commerce; (vi) regional development and local environmental facilities; (v) public services that promote education, sports, culture, and the arts; (vi) environmental protection, including pollution prevention; and (vii) local civil defense and fire protection. These are the "inherent" functions of local governments. Under each are specific local public services: social welfare, personnel management, housing, elementary and junior high school education, and local roads (Table 2).[4]

In addition, Article 11 stipulates that the following public services, "unless otherwise stipulated in law," should be outside the domain of local governments'

Table 2. Expenditure Responsibilities of Local Government

Category	Subcategory
Local Administration	Ordinance, regulation, personnel management, budgeting
Residents' Welfare	Welfare facilities; support for seniors, low-income people, and the disabled; public hospitals; garbage collection
Agriculture and Commerce	Irrigation, distribution of agricultural products, forestry, dairy business, small and medium businesses
Regional Development	City planning, construction and civil engineering, local roads, residential environment, housing, local economy
Education, Culture, etc.	Elementary and junior high schools, libraries, museums, art galleries, stadiums, local culture, and art
Environmental Protection	Water supply, sewage treatment, historic preservation, city parks, supervision of regional rivers, disaster protection, traffic utility systems
Civil Defense and Fire Protection	Management of civil defense system, fire fighting

Source: Article 9, Local Autonomy Act.

responsibilities: those (i) crucial to national defense (foreign policy, military defense, administration of justice, and national tax); (ii) uniformly provided (monetary policy, financial policy, and trade policy); (iii) managed nationwide (supply control of agriculture, fishery, and livestock, as well as trade); (iv) provided nationwide (national development plans and management of national forests, national rivers, highways, harbors, expressways, and national parks); (v) subject to uniform standards (labor and survey standards); (vi) coordinated nationwide (postal systems and railways); and (vii) related to inspection, testing, research, navigation management, meteorological management, and nuclear engineering development, which require high technologies.

Blurred Division of Responsibilities

The wide range of local responsibilities defined in the Local Autonomy Act emphasizes local government independence in providing public services. However, public service delivery is still generally centralized for political, administrative, and economic reasons, such as unclear assignment of expenditure responsibilities between levels of government.[5] When the distinction between local and national public goods is unclear, local governments do not have an incentive to raise revenue from local taxes for public goods since they may be potentially funded by the central Government. Local tax rates have not been changed since 1995, and the share of local tax revenue in local governments' general revenue has steadily declined.

Since upper- and lower-level local governments differ significantly, especially metropolitan areas and other local governments, defining the power and responsibilities of each local government according to its own capacities is not easy. The division of local government responsibilities is blurred in almost every country but is worse in Korea due to its short history of local autonomy.

The Local Autonomy Act's division of local government responsibilities is vague. Articles 9 and 11 are not helpful in determining expenditure responsibilities of central and local governments. First, the law does not clearly define purely local and delegated or mandated public services: "Public services that enhance local residents' welfare" is too broad. More important, the provisional clause "unless otherwise stipulated in law" allows each law to define national or local responsibilities regardless of Articles 9 and 11. Almost 4,000 ordinances, regulations, and laws govern public services; each independently, and vaguely, defines local, delegated, mandated, and national services. Recent efforts to examine all the legislation and to define expenditure responsibilities more clearly have not resulted in consensus.

Expenditure assignment is not clear as local autonomy began only recently. The expenditure assignment of each public service is defined in specific laws, which are vague because the Local Autonomy Act is vague. The central Government thus interprets its responsibilities to its own advantage and, as a result, many policies are formulated and decisions made at the central level.

Change, however, is evident. Led by the city's council of government officials, a movement in Seoul recently opposed the national audit of local public services by Parliament, arguing lack of jurisdiction. As a result, beginning in 2003, Parliament implicitly exempted from national audit purely local services independently managed by Seoul.

Decentralization, therefore, is evolutionary. While the council of government officials argues that about 70% of public services managed by Seoul are purely local, consensus is lacking on the criteria to be used to define expenditure assignment. If the agreement between Seoul and Parliament is finalized, lively discussions will ensue on the nature of expenditure assignments, which might result in a clear-cut definition of central and local government responsibilities.

Over-Measurement of Local Expenditure

Even when expenditure assignment is clearly defined, revenue assignment is sometimes not consistent with it, resulting in over-measurement of the size of local government. By law, the central Government is responsible for local education and, therefore, about 90% of educational expenditures, including salaries of elementary, secondary, and high school teachers. However, the education budget is included in the local governments' budget as a special education account. To give local governments more financial responsibility for education, the education tax previously administered by the central Government is now split into the national and local education taxes.[6] Although the local tax appears bigger now as a result, its nature has not changed except that it enlarges the budget of local governments and significantly overrepresents their role as service providers.

While education is a notable case of mismatch between expenditure and responsibility, many other public services are provided by local governments under the control of the central Government. The degree of autonomy of local public finance is thus generally limited.

Revenue Assignment

Overview

Local government revenue consists of local taxes, nontaxes (own-source revenue), intergovernmental grants, and local debts. In evaluating the fiscal capacity of local governments, the Ministry of Government Administration and Home Affairs (MOGAHA) often uses the fiscal independence index (FII): the sum of local tax and own-source revenue divided by the sum of own-source revenue and intergovernmental grants.[7]

FII differs from one local government to another, reflecting their diverse financial profiles. For example, Seoul is financially almost independent, with its FII being 94.7 (Table 3). The average FII of metropolitan cities is much lower, at 66.0. City and county (upper-level) governments' financial capacity is much lower, with the average FII at 34.6. Exacerbating the problem of provinces' low average FII is its large variance: the wealthiest province, Kyonggi, has an FII of 70.1; the poorest, Jeonnam, 13.7.

Cities with over 50,000 people have an average FII of 47.5, with the highest at 94.8 and the lowest at 14.3. Wards have an average FII of 46.0; variance is also high. Rural local governments can hardly be regarded as autonomous as they have an average FII of only 19.1. Metropolitan city governments are the exception.

Table 3. Fiscal Independence Index of Local Governments, 2002 (%)

	Seoul	Metropolitan Cities	Provinces	Cities (>50,000)	Counties	Wards
Average	94.7	66.0	34.6	47.5	19.1	46.0
Highest		73.1 (Incheon)	70.1 (Kyonggi)	94.8	58.5	93.7
Lowest		56.7 (Gwangju)	13.7 (Jeonnam)	14.3	9.2	21.5

Source: Ministry of Government Administration and Home Affairs.

Table 4 shows FII distribution in more detail. Of 248 autonomous local governments, 43% have an FII of under 30%, and another 35% have an FII of 30–50%. To sum up, about 78% of local governments have an FII of under 50%. The financial dependence of local governments on the central Government is much more marked among rural local governments. FII is less than 30% for 77 counties, and under 50% for 43 small-city governments.

Table 4. Distribution of the Fiscal Independence Index of Local Governments, 2002

Index (%)	Total	Prefectures	Cities	Counties	Wards
Less than 10	5 (2%)	0	0	5	0
10–30	101 (41%)	4	21	72	4
30–50	88 (35%)	4	22	10	52
50–70	30 (12%)	2	16	4	8
70–90	19 (8%)	5	12	0	2
90 and over	5 (2%)	1	1	0	3
Total	248 (100%)	16	72	91	69

Source: Ministry of Government Administration and Home Affairs.

While it offers simple descriptive statistics to show the financial capacity of local governments, FII has a drawback when used to recommend more central government grants to poor local governments. MOGAHA and the press often interpret low fiscal independence of a local government as evidence that it needs more fiscal assistance from the central Government. However, when a local government receives more grants, its fiscal independence is lowered further, indicating the need for even more intergovernmental transfers.

Since FII is not directly used in the formula for intergovernmental grants, the peculiar nature of FII does not affect horizontal imbalance between local governments. However, FII is often used as a reference for revenue assignment between the central and local governments since FII is easily interpreted in public discussion as an indicator of local governments' fiscal difficulties. Thus, FII does have a significant impact on vertical assignment of revenue between the central and local governments.

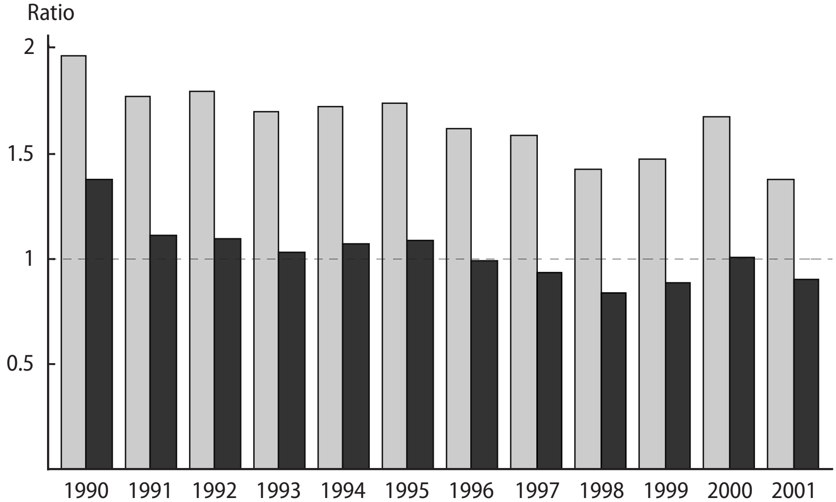
The other measurement used to determine revenue assignment is the size of net expenditure of local governments compared to that of the central Government. The Ministry of Finance and Economy (MOFE) and Ministry of Planning and Budget (MPB) generally prefer this index since it shows how much tax revenue collected by the central Government is eventually spent by local governments. The ratio of the central Government's net expenditure to that of local governments was about 2.0 in 1990, and even when education expenditures are counted as local expenditures, the ratio was close to 1.4 (Figure 3). However, in 2001 the ratio was less than 1.5, and when education expenditures are counted as local expenditures, the ratio was less than 1.

This trend is due to two factors:

- The size of intergovernmental grants has grown steadily throughout the 1990s: a new intergovernmental grant was introduced in 1991, and the size of specific grants has significantly increased, especially after 1995.
- The growth rate of national tax revenue has been higher than that of local tax revenue. Since demand for local public services has increased at least as much as that for national public services, the gap has been filled by intergovernmental grants, which, in turn, were funded by plentiful national tax resources (Figure 4).

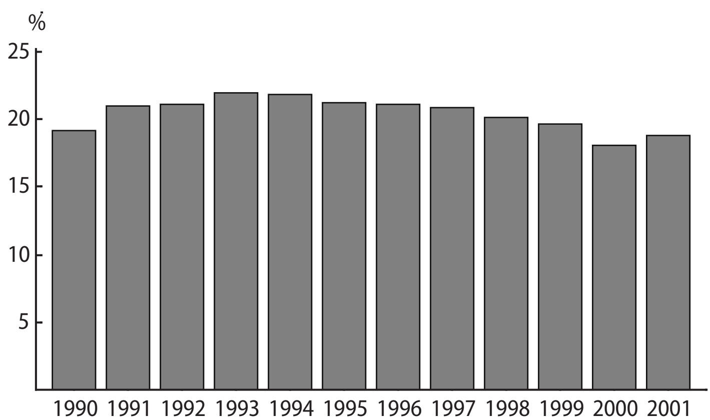
Thus, while FII and the size of the central Government's net expenditure indicate local governments' fiscal capacity, their simple interpretation as published by MOGAHA and MPB often leads to more confusion than understanding about local public finance. FII should not be used to justify grants from the central Government, and the size of local governments' expenditure should not be interpreted to represent the degree of autonomy or service responsibilities of local governments.

Figure 3. Ratio of Central Government to Local Government Expenditure



Notes:
1. Ratio = (national tax – grants)/(local tax + grants).
2. Light bars indicate when education expenditures are not counted as local expenditures. Dark bars indicate when education expenditures are counted as local expenditures.
Sources: Ministry of Government Administration and Home Affairs; National Tax Service.

Figure 4. Ratio of Local Tax to National Tax



Note: Local education tax was excluded from local tax in 2001.
Sources: Ministry of Government Administration and Home Affairs; National Tax Service.

Because of the conflicting positions of MOGAHA, which controls local government budgets, and MPB, which is in charge of the national budget, revenue assignment is influenced more by political and administrative considerations than by economic principles. The size and composition of local taxes and intergovernmental grants reflect these aspects and, therefore, revenue assignment should be understood not just through statistics but also the political and institutional environment.

Local Tax

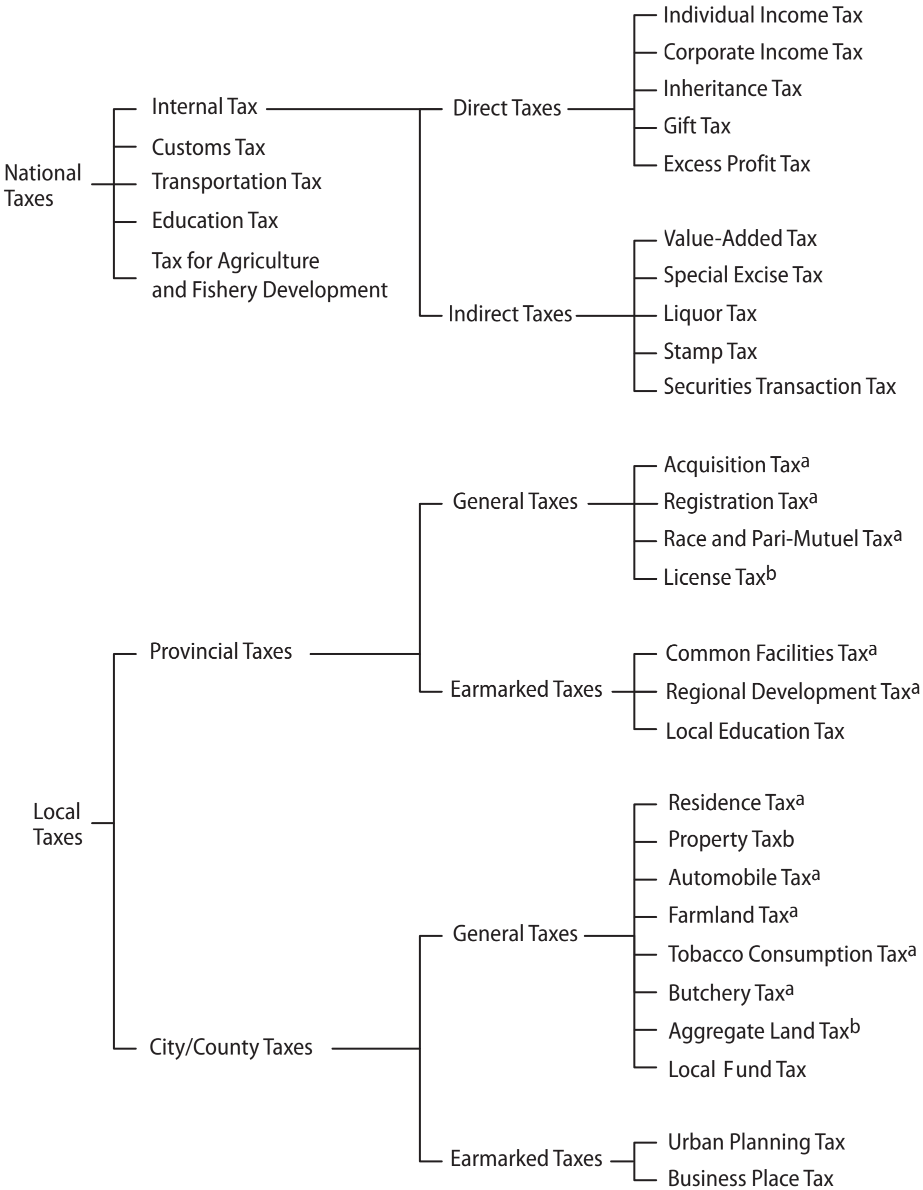
The Local Tax Act provides the framework for the local tax system, including taxable items and their rates. Local taxes are divided into provincial taxes and city or county taxes (Figure 5). Seoul and six other metropolitan cities collect provincial and city or county taxes, except four ward taxes (license, property, aggregate land, and business place taxes). Two local taxes were recently introduced: the local fuel tax, which is a surtax on the national transportation tax, was introduced in 2000; and the local education tax, which is attached to many other local taxes, was introduced in 2001.

It is often argued that local governments do not have independent taxing power as Article 59 of the Constitution stipulates that the rates and bases of all taxes should be determined by law. However, the Local Tax Act allows local governments to determine tax rates within certain limits (usually 50% below or above the standard rate).

Even if the Local Tax Act guarantees a degree of local autonomy in determining the burden of local taxes, no local government has voluntarily changed the local tax rates as tax assignment and revenue sharing are not clearly differentiated. The tobacco consumption tax, for example, became a local tax in 1988 to increase local governments' own-source revenue. Because of low income elasticity of tobacco consumption, the distribution of tobacco tax revenue is even among local governments. Since the tobacco tax does not reflect the price of local public goods, however, it cannot be considered to be a "good" local tax. Therefore, if the criterion for choosing an appropriate local tax among national taxes is that it should make local governments responsive and responsible to local residents' need for local public goods, the tobacco tax should not have been chosen. However, since revenue of the tobacco tax is sizable and evenly distributed among local governments, it was a preferred choice as a means of revenue transfer from the central Government to local governments.

Since local governments and residents see local taxes as an instrument to transfer central government tax resources, local governments have no interest in raising local tax rates. When a local government wants to increase its expenditures, it either argues for transfer of national taxes to local governments or for more intergovernmental

Figure 5. Tax System



[a] Special metropolitan city and metropolitan city taxes.
[b] Autonomous district taxes.
Source: Ministry of Finance and Economy. 2002. *Korean Taxation.*

grants.[8] An increase in local expenditure, therefore, is often accompanied by an increase in intergovernmental grants rather than in local tax rates.

While the ultimate nature of local taxes is revenue sharing between the central and local governments, national taxes are distinct from local taxes. The principle of "tax base separation" determines local and national taxes. Article 4 of the National and Local Tax Adjustment Act forbids tax sharing between the central and local governments except when the law explicitly allows it. However, the exceptions have become prevalent because two earmarked taxes (education tax and special tax for rural development) impose surtaxes on many national and local taxes.

Besides the earmarked taxes, two other national taxes are allowed for tax sharing between the central and local governments: income tax (corporate and individual) and transportation tax (on gasoline and diesel). The central Government levies income tax, and local governments impose a 10% surtax on income tax. The local transportation tax was introduced in 2001, and accounts for 12% of the national transportation tax revenue. Unlike other local taxes, it is collected by the central Government, and then distributed to local governments in proportion to the number of registered cars. This arrangement is not so much collection of a local tax as tax sharing between the central and local governments. Local residents do not recognize the local transportation tax as a local tax since it does not appear on their gasoline receipts.[9]

Intergovernmental Grants

Intergovernmental fiscal transfers are administered through three major transfer mechanisms: local shared tax, local transfer fund, and national treasury subsidies. Intergovernmental grants can also be categorized as general and education special accounts. Since the central Government is responsible for local education and provides resources for educational services, the local governments' education budget is separately dealt with as a special account. This implies that the education special account is directly controlled by the Ministry of Education and that the local governments' role in executing the budget is passive.

Local Shared Tax

The local shared tax is a general grant whose main purpose is to fill the gap between basic fiscal need and basic fiscal capacity of local governments to equalize local governments' expenditure levels. The size of the local shared tax is defined as 15% of the "domestic" tax revenue, which is the national tax revenue minus the revenue from the transportation tax, education tax, special tax for rural development, and customs duties.[10] MPB defines the liquor tax as a domestic tax. However, it is the revenue source of the local transfer fund, which is another intergovernmental grant, and is excluded when calculating the local shared tax.

The local shared tax is divided into ordinary and special local shared taxes. The former, which constitutes 10/11 of the total, is distributed on the basis of the predetermined equalization formula; the latter, which constitutes 1/11 of the total, is allocated on the basis of local governments' special needs. The special local shared tax is ad hoc and distributed to local governments as special funds for such purposes as disaster control and special regional development. Although the official function of the tax is to secure funds for special needs, many see it as a powerful financial tool wielded by MOGAHA to control local governments.

The calculation of the ordinary local shared tax involves several steps. The first is to calculate for each local government the basic fiscal needs (Ξ_1) and basic fiscal revenue (R_1), which is 80% of general local tax revenue. In the second step, supplementary fiscal needs (Ξ_2) and supplementary fiscal revenue (R_2) are calculated. Examples of R_2 are the amount of local governments' contribution to education special accounts and, for upper-level local governments, general grants given to lower-level local governments. Included in R_2 are 80% of the revenue from earmarked local taxes and the revenue from fees and user charges.[11] The central Government then calculates the needs incentive (Ξ_3) and the revenue incentive (R_3).

The needs incentive is used to induce local governments to reduce the number of local officials and other expenditure items. The revenue incentive is used to compensate for the increase in the basic fiscal revenue when a local government increases a local tax rate. This feature is important in understanding the controversies surrounding local tax efforts. Theoretically, the basic fiscal revenue should be calculated by multiplying the tax base by the average tax rate.[12] However, the basic fiscal revenue is obtained by using econometric forecasting models. Therefore, when a local government increases a local tax rate, the amount of local shared tax is reduced and then compensated for by the revenue incentive. The problem is that this process is done not by law but by administrative decision. Since the procedure is complicated and not legally binding, local governments believe that local tax efforts reduce the local shared tax.

The fourth stage in calculating the ordinary local shared tax is to calculate standard fiscal needs (Ξ) and standard fiscal revenue (R) by summing up the three components of fiscal needs and fiscal revenue. The difference between Ξ and R, fiscal shortage, is the basis of the ordinary local shared tax. However, since the total amount to be transferred through the ordinary local shared tax is predetermined (15% of domestic tax revenue), the sum of fiscal shortages is the same as the predetermined level only by chance since the fiscal shortages are calculated independently of the ordinary local shared tax. Usually the sum of fiscal shortages across local governments is less than the 15% of domestic tax revenue, and therefore an adjustment factor (α) less than 1 is applied to the fiscal shortage of each local government to reach the final amount of the local shared tax.

In sum, the procedure to determine the ordinary local shared tax (*s*) can be expressed as follows:

$$s = \alpha(\Xi - R), \quad \alpha < 1$$

Calculation of the ordinary local shared tax has often been criticized for its obscurity. The calculation procedure has become more transparent recently by opening the procedure to the public. However, the calculation of the ordinary local shared tax is so complicated that few local officials understand it. The most difficult part is calculating basic fiscal need.

Basic fiscal need consists of workloads (*Z*) such as the number of population and local officials, unit cost (*c*), and modification factor (θ). Basic fiscal need Ξ_1 is calculated by the following formula:

$$\Xi_1 = Z \times c \times \theta$$

The unit cost *c* is calculated by first calculating standard administrative needs (*S*) and then dividing them by the number of workloads. The calculation of *S* is based upon regression formula $f(X)$, where *X* is a vector of independent variables such as population and number of local officials. The definition of the adjustment factor is simple and can be written as follows:

$$\theta = \frac{S + \Lambda}{Z \times c}$$

where Λ is special needs for regional balance. Therefore, the basic fiscal need Ξ_1 can be rewritten as follows:

$$\Xi_1 = S + \Lambda$$

Although Ξ_1 looks simple, calculation of *S* is arbitrary and complicated because of the nature of the regression specifications.[13] The calculation of special needs for regional balance is by no means objective, either. The MOGAHA manual on the local shared tax shows how to calculate it for a sample city. Transportation administration cost, Ξ_1^T is calculated as follows:

Ξ_1^T = 58,120 (no. of cars) x W19,200 (unit cost) x 1.269 (adjustment factor)

Total basic fiscal needs amount to W149,562 million. Supplementary fiscal needs for the city consist of the amount of contribution to the education special account, and the extra amount given to the city because it was recently merged with a smaller town, as was encouraged by the central Government. The total amount of Ξ_2 is W5,273 million. For incentive needs, the city is entitled to W973 million because of its effort to reduce the number of local officials and other expenses. Altogether, standard fiscal needs of the city are W155,808 million:

$\Xi = \Xi_1 + \Xi_2 + \Xi_3$ = W149,562 + W5,273 + W973 = W155,808 million

As for the calculation of the standard fiscal revenue, the general local tax revenue of the city is forecast to be W38,644 million. Therefore, the basic fiscal revenue is W30,931 million (W38,644 x 0.8). The supplementary fiscal revenue of the city consists of:

- 80% of the earmarked local tax revenue, forecast to be W2,968 million;
- 80% of the revenue from fees and service charges, forecast to be W9,940 million;
- general grants from upper-level government, forecast to be W9,827 million;
- forecast local tax revenue used to calculate the standard fiscal revenue 2 years ago, which turns out to be greater than the actual local tax revenue by W14,764 million (this discrepancy was adjusted by subtracting 50% of actual tax revenue from the current year's basic fiscal revenue); and
- the amount of forecast upper-level local government general grant that was used to calculated the standard fiscal revenue 2 years ago, which turns out to be greater than the actual amount by W2,198 million. Half of this amount, W1,099 million, is subtracted from the basic fiscal revenue of this year. Altogether, the amount of the supplementary fiscal revenue for the city is W14,254 million.

The incentive revenue of the city is W353 million because it raised the tax base of the property tax and the user charges above that determined by the central Government. Altogether, the "standard fiscal revenue" of the city is W44,832 million:

$R = R_1 + R_2 + R_3$ = W30,931 + W14,254 – W353 = W44,832 million

Since the adjustment factor in the current year is 0.7754788, the ordinary local shared tax for the city is determined to be W86,060 million:

$$s = 0.7754788 \text{ x } (\text{W}155{,}808 - \text{W}44{,}832) = \text{W}86{,}060 \text{ million}$$

Local Transfer Fund

The local transfer fund, introduced in 1991, is a block grant used for five broad local functions: roads, sewage, regional development, rural area development, and juvenile care. However, the fund is also a tax sharing between the central and local governments since the revenue does not come from the central Government's general revenue but from 100% of the liquor tax and 14.2% of the national transportation tax.

The fund was meant to increase local governments' revenue to prepare for local autonomy. However, simply assigning more tax bases to local governments was ruled out since that would increase regional revenue disparities. Thus, tax base sharing and equalizing grants were combined to strengthen the local fiscal base and ensure balanced regional development. The Local Transfer Fund Act originally stipulated that 50% of the excess land tax, 15% of the liquor tax, and 100% of the telephone tax were the sources of the fund. The excess land tax has since been abolished and the percentage of the liquor tax revenue increased to 60% in 1992, 80% in 1994, and 100% in 1997. In 2001, the telephone tax was abolished and the national transportation tax replaced it as a tax base of the fund.

The law also specifies the fund's distribution method and share of target projects. The fund was to be used for local road construction and maintenance. Eventually, other projects were included as target projects. In 2001, the fund was W4.7 trillion, of which local road construction and maintenance projects made up 48.0%; sewage treatment projects, 25.6%; regional development projects, 17.6%; rural development projects, 8.1%; and youth-related projects, 0.7%. Recently, the importance of sewage projects has been emphasized and their share in the local transfer fund is expected to grow.[14]

National Treasury Subsidies

National treasury subsidies are category grants to local governments from the central Government's general and special accounts for specific projects. The subsidies are budgeted by MPB in consultation with other ministries. However, the ultimate size and number of projects are determined by Parliament, where representatives exercise significant influence. Until the early 1990s, the share of the local shared tax was the largest among the intergovernmental grants. However, the share of the subsidies has been rising rapidly since 1995, and it was much greater than that of the local shared tax in 1999, a year before its share in domestic tax revenue increased from 13.3% to 15.0%.

MOGAHA classifies the subsidies into three: (i) costs of national services (for administering a general election, military recruitment, etc.); (ii) cost sharing (for recovery from natural disasters, public facilities); and (iii) promotional subsidies (for local governments to undertake certain projects).

In textbook discussions, the main function of specific grants is to cover intergovernmental externalities, but these are almost impossible to measure in real public projects. The matching rates of the subsidies are mainly influenced by the fiscal capacities of local governments.

Most subsidies are either for local delivery or redistribution of national goods. Health care and support for low-income households are national programs but delivered by local governments. Rural development projects are redistributive and take a big portion of the subsidies. Subways in big cities are arguably local public goods with few externalities, but the matching rates of such huge projects were 50%.

Since major parts of subsidies are heath and income related, their share in intergovernmental grants has rapidly risen since the 1997 financial crisis. However, the greater political power of local governments after initiation of local autonomy contributed to enlarging the subsidies. The central Government is also interested in the subsidies since financial power is now an important tool in controlling local governments after administrative and political powers are ceded to them.

Educational Grants

The Ministry of Education and Human Resources Development (MEHRD) is responsible for providing local educational services. Its local administrative arm is the Office of Education, which is in Seoul, the six metropolitan cities, and the nine provinces. There are upper- and lower-level education offices, which are in lower-level local governments. Heads of upper-level education offices are elected by local councils, and heads of lower-level education offices are appointed by the heads of upper-level education offices.

Education grants consist of the education local shared tax (ELST), education local transfer fund (ELTF), and education national subsidy. Before the local education tax was introduced in 2001, all education taxes were ELTF's revenue source. Now its sole revenue source is the national education tax. However, since the revenue from the local education tax is transferred to local education special accounts, the effect is essentially the same. The distribution of ELTF to education offices is simple and proportional to the number of people in each jurisdiction. ELTF is then combined with revenue from the local education tax transferred to local education special accounts.

The determination of ELST is similar to that of the local shared tax but much simpler. The total size of ELST is determined as 13% of domestic tax. The amount of ELST distributed to local educational jurisdictions is determined as the difference between the standard fiscal need and standard fiscal revenue. The standard fiscal revenue for each educational jurisdiction is the revenue from ELTF and local education tax. The standard fiscal need is basically proportional to the number of students, schools, and teachers.

Seoul and other big cities in Kyonggi province do not receive any local shared tax because their standard fiscal revenue is greater than their standard fiscal need. In the case of ELST, the standard fiscal need is almost the same as actual educational spending. The standard fiscal revenue does not reflect local governments' fiscal capacity since the revenue from the local education tax is less than 15% of the total local educational expenditure. Therefore, unlike with the local shared tax, local governments' fiscal capacities are not taken into account when ELST is distributed.

The education national subsidy funds student lunch programs, school facilities, scholarships, and information technology, etc. The size of the subsidy is negligible compared to the other two education grants.

Recent Developments in Local Public Finance

Institutional Changes

Local Tax

Before local autonomy, the most notable change made in the local tax system was the transformation of the tobacco tax from a national to local tax in 1988, to increase the local tax base in preparation for local autonomy. Another major change was the introduction of the aggregate land tax in 1991, before which the property tax was levied on the combined value of land and structures. However, as land speculation in the early 1990s became serious, the tax bases of the property tax were separated and a heavily progressive land tax was introduced. The tax base of the aggregate land tax doubled in 3 years but, as land speculation subsided, the tax base has stayed at almost the same level it was in 1995.

When local tax policy issues were discussed when local autonomy started, local governments' inability to adjust local tax rates was often criticized. The criticism, however, was not justified since local governments could adjust the rates of many local taxes within 50% of the standard rate, and yet no local government did so. MOGAHA first extended the system of flexible tax rates to the aggregate land tax in 1995, and property transaction taxes (registration and property purchase taxes) and the property tax on structures in 1997.

Local governments may not change the aggregate land tax rate, but may change the tax base. Every year the Ministry of Construction and Transportation (MOCT) reports the assessed value of land, and MOGAHA announces a certain percentage (around 36%) of it as the standard assessed value for the aggregate land tax. Local governments can then set their own assessed value differently from that set by MOGAHA. While some governments have changed the aggregate land tax bases since 1995, the differences in effective tax rates among local governments are small.

For property transaction taxes, local governments can change the tax bases and rates. Unlike for the aggregate land tax, the assessed value of land for transaction tax purposes increased over 4 years around the end of the 1990s, and in 2001 the assessed value was the same as that announced by MOCT for all local governments.[15] At least for property transaction taxes, therefore, local governments have tried to increase their effective tax rates. This result is ironic since the burden of property transaction taxes, which is heavier than that of property holding taxes, has been strongly criticized, yet local governments still prefer the property transaction taxes as their burden is not transparent.

Since 1995, two new local taxes have been introduced: local fuel tax in 2000 and local education tax in 2001. Since car ownership tax rates were set when automobiles were still luxury goods, the rates were high and progressive. As car ownership sharply increased and traffic conditions seriously deteriorated during the 1990s, car owners called for a shift of the tax burden from the car ownership tax to the fuel tax. Car ownership tax revenue was indeed very high, making up about 12% of local tax revenue in 1998, almost twice the aggregate land tax revenue. The United States (US) also criticized progressive tax rates because the large cars it exports to Korea are subject to a high car ownership tax. In 1998, the car ownership tax was made less progressive and, to compensate for the loss of tax revenue, the local fuel tax was introduced.[16] In 2001, tax rates for cars over 5 years old were significantly reduced in response to the argument that the car tax should be regarded as a property tax. As a result of these changes, the share of car ownership tax revenue in local tax revenue shrank to 7.1% in 2001.

The introduction of the local education tax in 2001 could be considered significant if it had significantly increased local tax revenue and strengthened the role of local governments in education. However, the tax has had no such effect yet. Local governments collect the tax but transfer the revenue to education special accounts, which are under MEHRD, and to local education offices. Since almost all education costs are covered by intergovernmental educational grants, and local education tax revenue is small, the tax does not reflect local governments' fiscal capacity. The share of local tax revenue in total tax revenue is often used in policy debates as an indicator of local governments' tax resources. Therefore, MPB can argue that more tax resources are in the hands of local governments. This is a superficial argument, but since the share of local tax revenue in total tax revenue is officially reported by MOGAHA and MPB, the political effect of the local education tax cannot be ignored. When local governments become responsible for local education in the future, the local education tax will make more sense than the national education tax.

Intergovernmental Grants
The most notable change made in intergovernmental grants since 1995 has been the increase in the amount of the local shared tax. Before 2000 it was 13.3% of domestic tax revenue, but in 2000 it increased to 15.0%. The share of ELST in domestic tax revenue was increased from 11.8% to 13.0% in 2001.

Since the calculation of the local shared tax is complex, its transparency and fairness are often the subject of debate. The calculation of standard fiscal needs requires the concept of a national minimum, which is not clearly defined. Choosing the standard expenditure categories and determining the unit cost of each is not straightforward.[17] Recently, MOGAHA reduced the number of standard expenditure categories from 24 to 12 and minimized the use of adjustment coefficients, which are determined arbitrarily.[18] The calculation of the standard fiscal revenue included user fees and charges from 2001. Including nontax revenue in standard fiscal revenue is controversial since nontax revenue can be viewed as the cost of public services. While more studies are needed to determine whether this change is in the right direction, the effect is expected to be small since the revenue from user fees and charges is about 10% of local tax revenue.

The revenue sources and target projects of the local transfer fund have been subject to continual change. When the fund was introduced, its revenue sources were 50% of the excess land tax, 15% of liquor tax revenue, and 100% of the telephone tax. The excess land tax was repealed later and the share of the liquor tax increased gradually until it reached 100% in 1997. In 2001, the telephone tax was repealed as it was absorbed into VAT. As a result, 14.2% of the transportation tax and 100.0% of the liquor tax are the resources of the fund. The target project of the fund was only road construction and repair at the beginning. Since then, projects have included sewage treatment, regional development, rural development, and juvenile care. Since expenditures on these projects are determined by such unrelated economic activities as liquor consumption and telephone usage, the efficiency of the fund is often questioned. Also, since local roads have been constructed for the past 10 years, road construction efficiency, especially, is being questioned. In response to this criticism, the share of road construction and maintenance in the fund has been decreased from 50.1% in 1999 to 48.0% in 2001.

Fiscal Trends

As of 2001, national tax revenue was W95.8 trillion, and local tax revenue was W26.7 trillion (Table 5). However, the local education tax is not a local tax as its revenue goes into an education special account that is out of the local governments' control. Excluding this tax, local tax revenue in 2001 was about W23.2 trillion. It increased by 51.4% in 1995–2000, while national tax revenue increased by 68.7%. The local shared tax increased by 95.3%; national subsidy, by 155.6%; and local transfer fund, by 166.2%. As a result of the unbalanced growth between own-source revenue and intergovernmental grants, the share of local tax in general revenue (local tax plus intergovernmental grants) decreased from 58.1% in 1995 to 47.7% in 2001.

Since this share has been decreasing for the past 7 years, the fiscal standing of rich local governments, which receive few intergovernmental grants, can be expected to deteriorate. However, Seoul's local tax revenue increased by 43.0% in 1995–2000, and Kyonggi's by 37.4%, while the average growth rate was 32.9% (Table 6). Although Seoul and Kyonggi receive few intergovernmental grants, the share of these two local governments' expenditures in total local expenditure went up in 1995–2000 (Table 7).

Table 5. Local Government Revenue Trends (W billion)

	National Tax	Domestic Tax	Local Tax (A)	Local Shared Tax (B)	National Subsidy (C)	Local Transfer Fund (D)	A/(A+B+C+D) (%)
1990	26,847	19,130	6,367	2,765	2,068	0	56.8
1991	30,320	24,089	8,035	3,452	1,788	557	58.1
1992	35,218	30,080	9,462	3,928	1,336	1,251	59.2
1993	39,261	34,175	11,026	4,413	1,743	1,471	59.1
1994	47,262	38,449	13,231	4,862	2,337	1,774	59.6
1995	56,775	44,382	15,316	5,275	3,888	1,870	58.1
1996	64,960	49,202	17,395	6,635	4,936	2,551	55.2
1997	69,927	52,153	18,406	7,040	5,546	3,189	53.8
1998	67,797	51,238	17,150	7,251	7,766	2,863	49.0
1999	75,658	56,393	18,586	6,900	9,808	2,773	48.8
2000	92,935	71,106	20,600	8,365	9,893	3,671	48.4
2001	95,793	74,027	26,665	10,304	10,349	4,780	51.2[a]

[a] 47.7%, if the local education tax of W3,478 billion is excluded.

Sources: Ministry of Government Administration and Home Affairs; Ministry of Finance and Economy.

Table 6. Local Government Tax Revenue (W billion)

Prefecture	1995 (A)	1996	1997	1998	1999	2000 (B)	(B-A)/A (%)
Seoul	4,339	4,891	5,333	4,944	5,566	6,204	43.0
Busan	1,215	1,424	1,407	1,311	1,384	1,432	17.9
Daegu	815	926	896	826	869	931	14.3
Incheon	767	853	953	867	889	1,015	32.3
Gwangju	368	414	476	446	435	484	31.5
Daejeon	444	470	488	444	507	556	25.2
Ulsan[a]			437	398	436	465	
Kyonggi	3,152	3,561	3,802	3,520	3,918	4,331	37.4
Gangwon	402	456	500	469	471	498	24.0
Chungbuk	393	453	451	415	453	474	20.8
Chungnam	467	553	587	551	577	634	35.8
Jeonbuk	456	480	518	509	509	531	16.5
Jeonnam	411	503	507	479	513	562	36.7
Gyeongbuk	724	846	864	804	859	949	31.1
Gyeongnam	1,196	1,387	1,083	962	972	1,060	27.6[a]
Jeju	170	179	196	201	211	235	38.5
Total	**15,317**	**17,395**	**18,498**	**17,149**	**18,569**	**20,361**	**32.9**

[a] The tax revenue of Ulsan is included in that of Gyeongnam for 1995 and 1996.
Source: Ministry of Government Administration and Home Affairs.

Table 7. Local Government Expenditure (W billion)

Prefecture	1995 (A)	1996	1997	1998	1999	2000 (B)	(B-A)/A (%)
Seoul	6,979	8,949	9,772	8,796	9,654	10,997	57.6
Busan	2,675	2,931	3,112	2,936	3,454	3,517	31.5
Daegu	1,980	2,164	2,701	2,658	2,708	2,444	23.4
Incheon	1,720	1,900	2,058	2,069	2,378	2,541	47.7
Gwangju	1,084	1,350	1,581	1,552	1,607	1,608	48.3
Daejeon	1,058	1,114	1,195	1,190	1,294	1,376	30.1
Ulsan			976	872	1,099	1,191	
Kyonggi	7,902	9,959	11,025	11,283	12,349	13,096	65.7
Gangwon	2,482	3,430	3,893	3,907	4,315	4,309	73.6
Chungbuk	2,007	2,387	2,684	2,969	2,797	2,862	42.6
Chungnam	2,907	3,258	3,565	3,782	3,948	4,239	45.8
Jeonbuk	2,793	3,249	3,620	3,689	3,645	4,022	44.0
Jeonnam	3,231	3,968	4,754	5,000	5,152	5,826	80.3
Gyeongbuk	3,699	4,381	4,907	5,745	5,743	5,945	60.7
Gyeongnam	4,362	5,050	5,018	5,133	5,520	6,039	65.7
Jeju	732	876	1,158	1,120	1,261	1,421	94.1
Total	**45,611**	**54,965**	**62,018**	**62,702**	**66,924**	**71,431**	**56.6**

Source: Ministry of Government Administration and Home Affairs.

Long-Term Financing of Local Governments

Institutional Framework of Local Debt

Definitions and Conditions for Issuing Local Debt

Local debt is a local government loan or local bond whose maturity is more than 1 year. The basic criteria for incurring local debt are found in the Local Autonomy Act and in more detail in the Local Finance Act. Article 115 of the Local Autonomy Act stipulates that local governments can incur local debts after securing the central Government's permission, either to permanently increase residents' welfare or to deal with natural disasters. Article 7 of the Local Finance Act declares "the principle of no local debt" and stipulates that local governments' expenditure should be within the revenue excluding debt, except for cases that meet criteria in article 115 of the Local Autonomy Act. Since local debt can be incurred only after the central Government approves it, and the criteria for granting approval are stringent, local government debt is under tight central government control.

MOGAHA sets up internal regulations and controls the issuance of local debt by checking layers of criteria, including appropriate projects, appropriate local governments, additional appropriateness, and projects not allowable. MOGAHA also has guidelines for "special occasions" for local debt. While appropriate projects are broadly defined in the Local Finance Act, other restrictions on local debt issuance are imposed by internal regulations of MOGAHA.[19]

Article 7 of the Local Finance Act provides that projects permanently beneficial to local residents, or disaster relief projects are (i) public facilities, (ii) projects generating profits enough to retire the debt, (iii) disaster recovery and prevention projects, (iv) retirement of previous debts, and (v) other projects to improve residents' welfare.

The definition of appropriate projects is strict in principle but can be arbitrary in practice because of the first and fifth categories above. The central Government in effect determines appropriate projects for local debt. A good recent example can be seen in the soccer stadiums for the World Cup games. Although it is not clear which criterion for local debt was met for the stadiums, all the cities holding World Cup games built stadiums with local debt.[20] Because of the ambiguities involved in granting permission to incur debt, MOGAHA sends local debt guidelines each year to local governments.

Local governments eligible for local debt issuance should meet the following criteria for fiscal soundness: (i) retirement of debt has not been delayed; (ii) the debt repayment ratio[21] is less than 20%, where it is defined as follows:

$$\frac{\text{Average debt retirement for past 4 years}}{\text{Average general revenue for past 4 years}} \times 100$$

where debt retirement includes interest payment, and general revenue is local tax revenue plus nontax revenue plus general grants (local allocation tax) and, in the case of wards, general grants from the metropolitan cities;[22] (iii) the ratio of the budget deficit to general revenue is not more than 10%; (iv) forecast local tax revenue is not less than 90% of the previous local tax revenue; and (v) issuance of debts has been consistent with the original application sent to MOGAHA.

MOGAHA explicitly forbids issuance of local debt for the following purposes: (i) current maintenance cost, (ii) nondurable facilities, (iii) facilities whose service life is very short, and (iv) small projects (less than W3 billion for prefectures, less than W1.5 billion for cities with more than 300,000 people, less than W1 billion for cities with fewer than 300,000 people, and less than W700 million for counties and wards).

While it establishes layers of restrictions on local debt issuance, MOGAHA also has criteria for exceptional cases: (i) refunding of debt without additional costs, (ii) projects that generate enough profit to retire the debt, (iii) central government policy- or disaster-related projects, and (iv) local debt to be retired by central government grants or earmarked revenue.

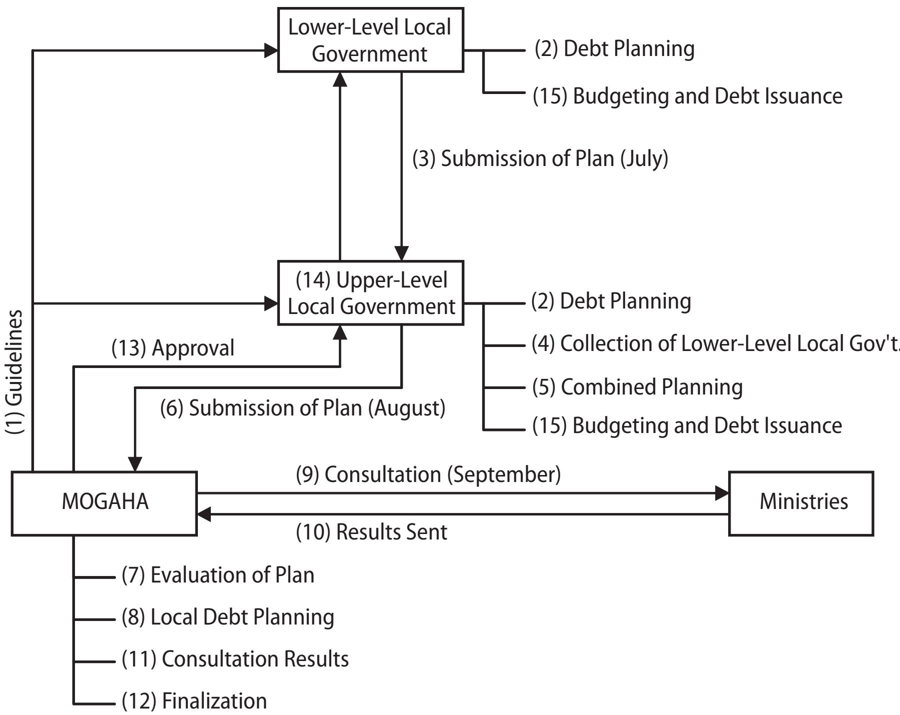
Procedures of Issuance

Local government applications for local debt should show that target projects are appropriate and consistent with projects in MOGAHA's Midterm Local Finance Plan. As discussed in more detail in the next section, most local debts are not local bonds but borrowings from the central Government. The central Government manages many types of special funds, such as the national housing fund, rural development special account, and environment improvement special account. Local governments must obtain the approval of ministries that manage them before applying to MOGAHA for local debt.

If a local government's application meets all the criteria for local debt and fiscal soundness, MOGAHA approves the application. The local government then submits the plan for local debt to the local council, which determines the final amount of local debt. Local councils may approve a final amount lower than that approved by MOGAHA but seldom do, since local debt is viewed not so much as a future tax burden as a form of central government assistance.

The procedure for issuing local debt is depicted in Figure 6. The debt issuance plans of lower-level governments are submitted to upper-level governments, and upper-level governments combine their own debt issuance plans and those of

Figure 6. Local Debt Issuance



lower-level governments. Final debt issuance plans of upper-level local governments are sent to MOGAHA by the end of August. MOGAHA then determines whether the plans meet the debt issuance guidelines. Since local governments' debt issuance plans include the results of applications for loans that are managed by central government ministries, MOGAHA consults them about whether the debt issuance plans of local governments are consistent with the loans granted by the ministries. MOHAGA then finalizes its approval of local debt issuance and send the results to upper-level local governments by the end of October.

Once MOGAHA approves the amount of debt, local councils determine the final amount of local debt. Local governments need additional approval from MOGAHA if (i) the debt amount is increased, (ii) the interest rate is increased, and (iii) the maturity of debt is extended. A decrease in debt amount or interest rate, and refunding of debt without additional costs, can be determined independently by local councils.

The Local Autonomy Act and Local Finance Act do not outline the penalties for violations of MOGAHA regulations. However, the Local Autonomy Act clearly states that local debts should be approved by MOGAHA, which suspends approval of local debt issuance by local governments that violate regulations and censures local government officials involved.

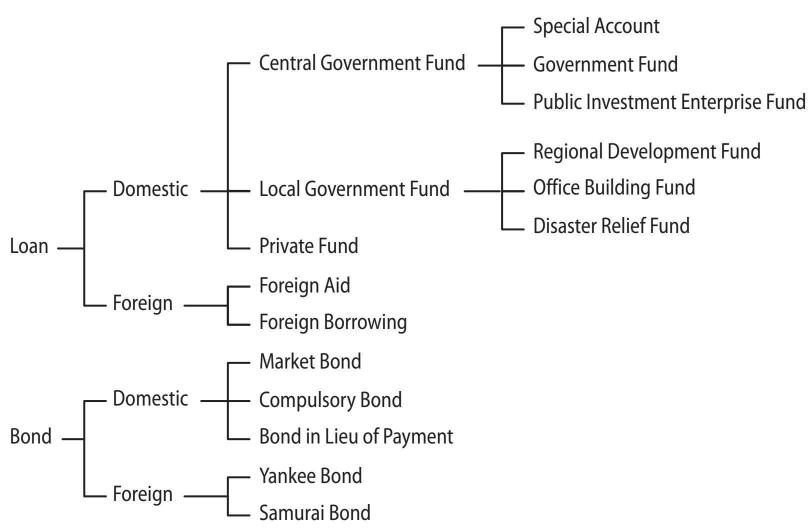
Types of Local Debt

Local government debts are categorized by the characteristics of target projects: (i) general account debt (road construction, bridge construction, public facilities repair, and public projects for disaster relief), (ii) special account debt (housing, sewage, water, and rural enterprise), and (iii) public enterprise debt (subway, water, sewage, public development, and regional development).[23]

Local debts are also categorized by the way they are incurred. They consist of loans and bonds (Figure 7). Loans are domestic or foreign. Domestic loans are borrowed from (i) central government special accounts and central government-managed funds, (ii) local government-managed funds, and (iii) private banks and financial institutions. Foreign loans consist of aid and borrowings, but Korea is no longer eligible for foreign aid from the Asian Development Bank, World Bank, and Overseas Economic Cooperation Fund (OECF).

Local bonds are domestic or foreign, such as the Yankee and Samurai bonds. Korea also has the compulsory bond, which must be bought for certain types of

Figure 7. Types of Local Debt



transactions: purchase of cars, registration of cars and construction machinery, licensing of contracts, and urban land development, etc. Compulsory local bonds are for the metro railroad, regional development, and urban development.[24] The regional development bond is issued by all upper-level local governments except Seoul. The metro railroad bond is issued by metropolitan cities that have a subway system (Seoul, Daegu, Incheon, Gwangju, and Daejeon). Busan also has subway system, but the Busan Transport Authority is a central government public enterprise and, therefore, the city's metro railroad bond is called the Busan transport bond and categorized as a national debt rather than a debt of Busan.[25] The urban development bond was introduced in 2001, as cities need to replace and rehabilitate old infrastructure.

Local borrowing through compulsory bonds makes up a large part of local debt, next to borrowing from central government-managed funds. Since compulsory bonds are not so much ordinary bonds as taxes, whether such bonds should be maintained is a subject of policy debate. Another local bond is the bond in lieu of payment, which is basically postponement of payments to contractors for public works. It is not popular and is expected to play a minimum role or be abolished.

Since central government loans to local governments make up most of their debt, the structure of central government-managed funds should be examined in considering the role of the local bond market. The central and local governments manage many types of special accounts and public funds that are available to local governments (Tables 8 and 9).

The central Government's special accounts relevant to local borrowing cover fiscal loans, land management and regional development, transportation infrastructure, rural and fishing village reconstruction, energy and natural resources, and environmental improvement. Public funds available for local borrowing cover price stabilization of agricultural and marine products, national housing, tourism promotion, and public fund management. Local government public funds available for local borrowing cover regional development and office building.

Among the central government-managed funds, the fiscal loan special account is the most important. Its revenue source is closely related to that of the public fund management fund, which manages surpluses of government pensions, postal savings, and other funds managed by ministries. Much of the fund is deposited in a fiscal loan special account while some is used to retire government and public bonds. Local borrowing from the fiscal loan special account is managed by various ministries, depending on the nature of projects (Table 8) because, when local governments apply for a loan for a certain type of project, the ministry related to that project evaluates the proposed project's merit, although the fiscal loan special account belongs to MOFE.

Table 8. Central Government Funds Available for Local Borrowings, 2002

Type of Fund	Project	Interest Rate (%)	Years of Maturity (Deferment)	Ministry
Special Account				
Fiscal Loan	Residential Environment for the Urban Poor	6.25	20(1)	MOCT
	Freight Terminal Construction	6.18	10(5)	MOCT
	Local Small and Medium Business	6.25	5(3)	SMBA
	Urban Water Sanitation Projects	5.68	10(5)	MOCT
	Rural Water Sanitation Projects	5.68	10(5)	ME
Transportation Infrastructure	Relocation of Urban Railroads	5.68	10(3)	MOCT
Rural and Fishing Village Reconstruction	Rural Residence Development	5.5	15(5)	MAF
	Collective Settlement	5.0	15(5)	MAF
	House Repair	4.0	7(3)	MAF
	Tourism and Resorts	6.5	5(5)	MAF
Energy and Natural Resources	District Heating Projects	5.75	10(5)	MOCIE
Environmental Improvement	Medium-Sized City Water Supply	3.0	10(5)	ME
	Sewage Pipes and Drainage Pipes	5.75	10(3)	ME
	Environmental Projects	5.75	10(3)	ME
Fund				
Price Stabilization of Agricultural and Marine Products	Wholesale Market Construction	3.0	10(5)	MAF
National Housing	Public Rental Housing	4.0	20(10)	MOCT
	Low-Cost Housing	7.5–9.0	19(1)	MOCT
	Employee Rental Housing	3.0	20(5)	MOCT
	Low-Cost Employee Housing	7.5–9.0	20(5)	MOCT
Tourism Promotion	Tourist Location Development	6.0	5(3)	MCT
Public Fund Management	Local Social Overhead Capital Projects	6.84	10(5)	MOFE

MAF = Ministry of Agriculture and Fishery; MCT = Ministry of Culture and Tourism; ME = Ministry of Environment; MOCIE = Ministry of Commerce, Industry, and Energy; MOCT = Ministry of Construction and Transportation; MOFE = Ministry of Finance and Economy; SMBA = Small and Medium Business Administration.

Source: Ministry of Government Administration and Home Affairs. 2003. *Guidelines for Local Debt Issuance*.

Table 9. Local Government-Managed Funds for Local Borrowing, 2002

Type of Fund	Project	Interest Rate (%)	Years of Maturity (Deferment)	Ministry
Regional Development				
Bonds Sold		4.0	5(0)	Prefectures
Loans to Projects	Water and Sewage	4.5–5.0	10(2)	Prefectures
	Other Projects	5.0–6.0	5(3)	Prefectures
Office Building Fund	Office Building Construction	3.0	10(2)	KLFA

KLFA = Korea Local Finance Association.
Source: Ministry of Government Administration and Home Affairs. 2003. *Guidelines for Local Debt Issuance.*

Besides being loaned to local governments, most of the revenue of the fiscal loan special account is redeposited in many special accounts and funds are managed by ministries. The rural and fishing village reconstruction special account was one of the biggest, receiving funds from the fiscal loan special account, much of which is, in turn, loaned to local governments.[26]

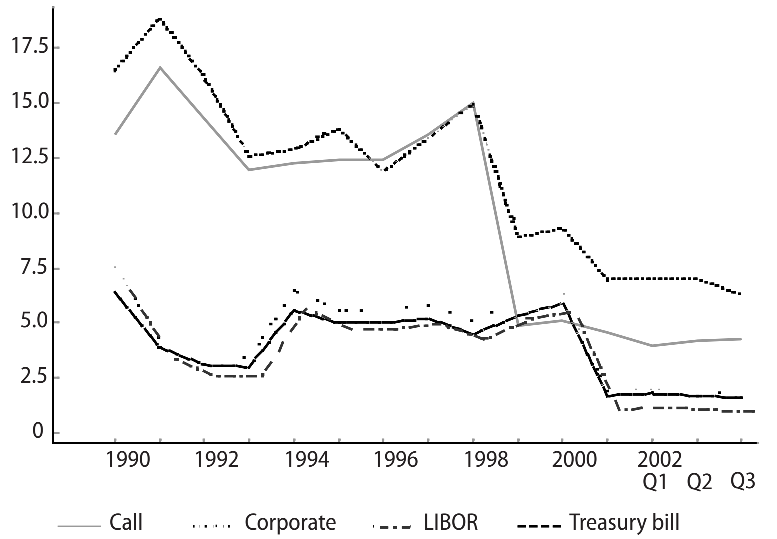
Another important central government-managed fund for local borrowing is the national housing fund, managed by MOCT. Of the fund's many revenue sources, the compulsory national housing bond is the most important. A part of the fund is then loaned to local governments to build public rental and low-cost housing.

Local government-managed funds have become increasingly important in local government debt financing since central government loans have been significantly reduced to curb budget spending of central and local governments (Table 9).

Metro railroad bond revenue is all put into subway accounts. The office building fund is small and funded by local public employees. The regional development fund, which started as a water project fund in 1969, became the water and sewage fund in 1985. The projects covered by this fund were extended to local public enterprise projects in 1989. About 45% of the regional development fund is put into public works other than water and sewage. MOGAHA is planning to expand the fund's role. With the introduction of the urban development bond in 2001, local government-managed funds are expected to expand their roles and partly take on the previous roles of central government-managed funds.

Expansion of local government-managed funds is hampered by some obstacles, the most fundamental of which is that the funds' revenue source—selling compulsory bonds—is not market-based, which is often criticized by citizens and the press. The future of local government-managed funds is uncertain as long as they are funded by compulsory bonds.

Figure 8. Interest Rate Trends, 1990–2002



Note: Based on 3-month London interbank offered rate (LIBOR) and treasury bills.
Source: Korea National Statistical Office (available: www.nso.go.kr).

Another problem of local government-managed funds is more immediate and practical. Interest rates have rapidly decreased over the last couple of years (Figure 8). Demand for the regional development fund has thus also decreased sharply. On the supply side, the interest rate paid for the regional development bond has not been adjusted to reflect market interest rates, probably because management of the fund is not as efficient as that of private banks. Since interest rates seem likely to stay low for a long time, these funds' prospects of revenue loss is even greater. Although local governments hope to expand the roles of local government-managed funds and compulsory bonds, their dubious legal status, poor management, and economic effect on taxes need to be addressed first.

Size and Structure of Local Debt

Size of Local Debt

As of 2001, local governments' debt was W17.8 trillion, or 3.3% of gross domestic product (GDP). Compared to the central Government's debt of W113.1 trillion, or 20.7% of GDP, local government debt is not large. Local debt has been tightly controlled, even during the financial crisis. In 1996, a year before the crisis, the central Government's debt was around 8.8% of GDP, increasing to 16.1% in 1998,

Table 10. Size of Central and Local Government Debt, 1995–2001 (W billion)

Year	1995	1996	1997	1998	1999	2000	2001
GDP (A)	377,350	418,479	453,276	444,367	482,744	521,959	545,013
Central Government Debt (B)	35,626	36,828	50,454	71,437	89,715	100,942	113,116
Local Government Debt (C)	11,526	12,947	15,114	16,223	18,019	18,796	17,770
Local Tax (D)	1,532	1,740	1,841	1,715	1,859	2,060	2,219
Local Nontax (E)	10,782	16,058	18,859	17,546	17,821	17,692	17,500
B/A	9.4	8.8	11.1	16.1	18.6	19.3	20.8
C/A	3.1	3.1	3.3	3.7	3.7	3.6	3.3
C/(D+E)	**93.6**	**72.7**	**73.0**	**84.2**	**91.6**	**95.2**	**90.1**

GDP = gross domestic product.

Sources: Ministry of Government Administration and Home Affairs; Ministry of Finance and Economy.

and then to 20.7% in 2001. The size of local debt relative to GDP has remained fairly stable (Table 10).

Structure of Local Debt

Of the total debt of W17.8 trillion in 2001, the share of the general account is 42.2%; of the special account, 30.4%; and of the public enterprise debt, 27.4% (Table 11). The shares in each local government, however, vary greatly. The share of the special debt account is the highest in Seoul and Busan but negligible in Kyonggi.

Importance of Subway Debt

The amount of local debt published by MOGAHA and local governments hides an important type of local debt—that of subway companies in major metropolitan cities. Since subway companies are local public enterprises, their budgets are legally outside the responsibility of metropolitan city governments. Therefore, neither MOGAHA nor metropolitan city governments officially publish debts of subway companies in budget reports. As of 2001, total subway debt—with subway companies' debt of W8.35 trillion and local governments' debt related to subway construction of W4.0 trillion—was about W12 trillion, equivalent to 67% of total local government debt. Seoul's debt is more than three times the city government's debt. Busan's debt, which is 250% greater than the city's tax and nontax revenue, would be worse if the Busan Transport Authority debt were counted (Table 11). Other metropolitan cities such as Daegu, Gwangju, and Daejeon, which have recently started to build subways, have high debt-to-revenue ratios as well. Including this subway debt, the local governments' debt is not insignificant, and is a cause of concern, especially for the large metropolitan cities.

Table 11. Local Debt and Revenue, December 2001 (W billion)

Prefecture	General Account	Special Account	Public Enterprise Account	Sub-total	Subway Debt	Debt Total (A)	Local Tax and Nontax (B)	A/B (%)
Seoul	200	1,580	117	1,897	4,320	6,218	9,203	67.6
Busan	774	1,168	532	2,474	—	2,474	2,099	117.8
Daegu	595	942	376	1,914	367	2,281	1,420	160.6
Incheon	273	20	421	714	592	1,306	1,544	84.6
Gwangju	482	266	199	948	—	948	702	135.0
Daejeon	286	285	243	814	—	814	799	101.9
Ulsan	259	96	159	514	—	514	616	83.4
Kyonggi	1,156	193	910	2,259	—	2,259	7,056	32.0
Gangwon	425	63	223	712	—	712	918	77.5
Chungbuk	233	39	118	390	—	390	785	49.7
Chungnam	417	99	325	840	—	840	976	86.1
Jeonbuk	483	101	269	853	—	853	905	94.2
Jeonnam	279	202	144	625	—	625	892	70.1
Gyeongbuk	813	118	282	1,213	—	1,213	1,438	84.4
Gyeongnam	436	99	452	987	—	987	1,840	53.7
Jeju	3,93	127	95	616	—	616	466	132.1
Total	**7,506**	**5,399**	**4,865**	**17,770**	**—**	**23,050**	**31,748**	**70.4**

— = data not available.

Sources: Ministry of Government Administration and Home Affairs; Korea Transport Institute.

The Dominance of Borrowings from Government-Managed Funds

Most local debts are borrowings from the central government-managed fund, local government-managed fund, and government-invested financial institutions; 86.1% of local debt is incurred from borrowing, and 13.9% from issuance of local bonds (Table 12). The government-managed funds are a central government-specific grant since they are granted after evaluation of the public projects to be financed. The second-largest source of local borrowing is the local government-managed fund. Local borrowing from abroad and financial sectors is negligible (Table 12). Except for these types of bonds, regular bonds purchased in the market make up only about 4.6% of local debt. Local bonds sold abroad have recently increased and now account for 2.1% of local debt.

Interest Rates and Target Project

The structure of interest rates for local debt is in Table 13. Out of W17.8 trillion of outstanding local debt, W5.7 trillion, or 32.3% of total local debt, pays interest of less than 5.0%. Another W2.3 trillion, or 13.1% of total local debt, pays interest of 5.0–6.0%. Most local debt (47.3%) pays interest of 6.0–8.0%. As for the target

Table 12. Source of Local Debt, December 2001 (W100 million)

Total	Borrowing				
	Subtotal	Government	Public Fund	Foreign Borrowing	Financial Institutions
177,696 (100%)	152,918 (86.1%)	104,089 (58.6%)	40,218 (22.6%)	3,916 (2.2%)	4,696 (2.6%)
	Bonds				
	Subtotal	Regular Bonds	Compulsory Bonds	Bonds in lieu of Payment	Foreign
	24,778 (13.9%)	8,251 (4.6%)	12,578 (7.1%)	221 (0.1%)	3,728 (2.1%)

Source: Ministry of Government Administration and Home Affairs.

Table 13. Interest Rates of Local Debts

Interest Rate	Number of Issues	Amount (W trillion)	Share (%)
Below 5%	1,516	5.74	32.3
5–6%	1,378	2.32	13.1
6–8%	2,214	8.40	47.3
8–10%	1,431	1.43	7.3

Source: Ministry of Government Administration and Home Affairs. 2002. *Local Government Debt*.

Table 14. Target Projects of Local Debts

Project Item	Number of Issues	Amount (W trillion)	Share (%)
Water and Sewage	2,770	4.9	26.8
Roads	594	3.5	19.1
Subways	42	2.0	10.9
Public Housing	1,299	0.9	4.9
Home Lots	147	1.2	6.6
Disaster Relief	86	0.4	2.2
World Cup Stadiums	44	0.7	3.8
Others	2,557	4.7	25.7

Source: Ministry of Government Administration and Home Affairs. 2001. *Local Government Debt*.

projects, water and sewage projects take the largest portion of local debt (27.8%) (Table 14). Local roads are the next biggest project item financed by local debt (19.9%). Other important project items financed by local debt are subways, public housing, and World Cup stadiums.

Source of Debt Retirement and Share of Local Debts among Local Governments

Most local debt is retired by local government general revenue (Table 15). Of total local government debt, W7.6 trillion or 43.1% is scheduled to be retired by upper-level local government general revenue. Another 19.4% of total debt or W3.4 trillion is issued by lower-level local governments. Since the public enterprise account takes an important share of local debt (Table 15), 23.8% of total local debt is retired by the profits of local public enterprises.

Table 15. Source of Debt Retirement

Source	Amount (W trillion)	Share (%)
General Revenue of Upper-Level Local Government	7.65	43.1
General Revenue of Lower-Level Local Government	3.45	19.4
Profits of Local Public Enterprises	4.23	23.8
Others	2.37	13.7

Source: Ministry of Government Administration and Home Affairs. 2002. *Local Government Debt*.

Upper-level local governments issued W10.7 trillion or about 61% of total local debt (Table 16). Among lower-level local governments, city governments issued about W5.1 trillion or about 29% of total local debt. County government debt is small, making up 9.4% of total local debt. However, county governments issued 2,342 loans (W712 million); upper-level local governments, 1,084 (W9,940 million); and city governments, 3,779 (W1,359 million).

Table 16. Share of Local Debt among Local Governments

Type of Government	Number of Issues	Amount (W trillion)	Share (%)
Upper-Level Local Government	1,084	10.8	60.6
City Government	3,779	5.1	28.9
County Government	2,342	1.7	9.4
Wards	334	0.2	1.1

Source: Ministry of Government Administration and Home Affairs. 2002. *Local Government Debt*.

Local Debt Issues

Subway Debt

As of 2001, about W12.4 trillion of local debt had been issued to finance subway construction, including that issued by local governments and subway companies. Subway companies' debt is W8.35 trillion, and local governments' debt related to subway construction, W4.0 trillion. Therefore, of the total local debt of W17.8 trillion, W13.8 trillion is for public projects other than subway construction, implying that the share of subway-related local debt in total local debt of W26 trillion is as large as 47.3%.

Before the 1990s, subway construction was supported by the central Government without any specific law governing subway subsidies. In 1991, the Urban Rail Act was passed, and the matching rate for subway construction was determined to be 25% for Seoul, and 30% for other metropolitan cities. As the financial burden of subway construction became more serious, the matching rate was increased to 40% for Seoul, and 50% for other metropolitan cities. Of the remaining metropolitan cities' burden, 20% was allowed to be covered by local debt. In 2000, the policy toward subway subsidies changed and the 50% matching rate for metropolitan cities except Seoul was retroactively applied to construction costs in 1991–1997. The central Government is contemplating more measures to mitigate the problem of subway debt, including additional subsidies, extension of construction period, and cancellation of new subway construction.

The frequent changes in policy on subway debt reflect how it contrasts sharply with other types of local debt, which the central Government has no legal and administrative difficulties in controlling. The stable size of local debt, even during the financial crisis and the recent decline of local debt, shows that the central Government can control it. However, it has tremendous difficulties in controlling the size and administration of subway debt. Among several reasons for this, the largest is the unclear division of responsibility among the central Government, local governments, and public enterprises. Before the 1990s, local governments' subway construction was assisted by discretionary grants. After 1991, legislation made the matching rate more transparent and objective. However, the Busan Transport Authority, established in 1989 as a central government public enterprise, sent a signal to other metropolitan cities that the burden of subway construction could be transferred to the central Government, or at least mitigated by central government subsidies. That is, the soft budget constraint was important in increasing the size of subway debt. This problem does not exist for other types of local debt because of tight ex ante regulations.

The problem of the soft budget constraint for subway debt was exacerbated by another type of unclear division of responsibility between governments and public enterprise. From a purely legal point of view, the budget of subway enterprises is outside local governments' responsibility. Debt management suffers from unclear definition of local government debt, and became a national issue a couple of years ago when an opposition member of Parliament argued that the national debt was much larger than previously thought if it included debts of national public enterprises such as the Korea Highway Corporation and Korea Electric Power Corporation, among others. The lesson from the ensuing heated debate about the nature of government debt was that the central Government should transparently and systematically report debts of public enterprises that provide public goods.

A recent Board of Audit and Inspection report on local governments shows that metropolitan governments first lobbied for subway subsidies with their own back-up resources and then transferred the responsibilities and debts to subway companies after the central government subsidies were approved. Such debts will ultimately be the burden of metropolitan city governments. Seoul, which cannot expect much support from the central Government, drew up a special plan to manage subway debt in 1999, which provided for more central government assistance and introduced a debt reduction fund, which would receive at least 50% of the budget surplus of the general account. Since it controls the use of local governments' budget surpluses, MOGAHA included a new clause in the guidelines for local debt issuance allowing the budget surplus to be put in the debt reduction fund from 2001.

While Seoul's effort is a notable change in dealing with subway debt, whether the debt will be significantly reduced remains to be seen. Since the budget surplus is not a stable source of revenue, Seoul might be able to raise W3.1 trillion by 2007 as planned. Other metropolitan cities are much more passive in dealing with subway debt since it is officially out of their budget reports.

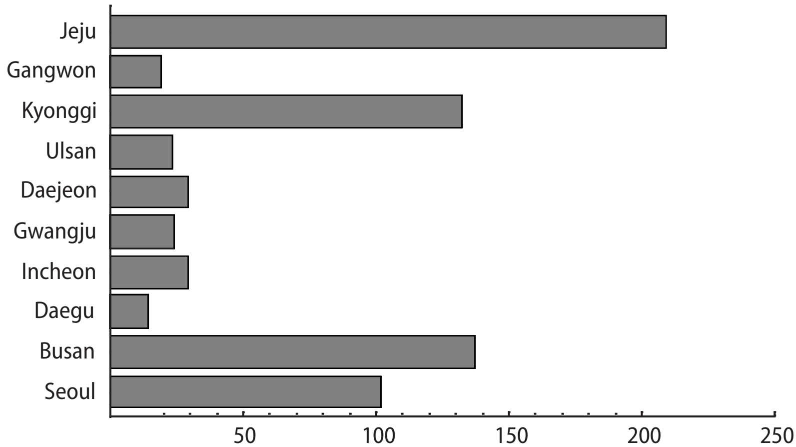
One final obstacle to tackling subway debt is the price control policy still popular among policy makers and the public.[27] Water and electricity charges are well below market prices, and the subway fare is also far below the minimum price to redeem subway system operations. Operating revenue loss and construction costs are big concerns for metropolitan cities with subway systems. In 2001, the subway system in Seoul lost W509 billion; Busan, W67 billion; Daegu, W88 billion; and Incheon, W90 billion. Under the special plan to manage subway debt in Seoul, the subway fare was scheduled to increase by W100 every 2 years; it should have increased in September 2002 to W700 but remains at W600.[28]

Foreign Loans and Bonds

Foreign borrowings total W765 billion (or about 4.2% of total local debt), of which W392 billion is foreign loans, and W373 billion, foreign bonds. Foreign debt issues total 53. The foreign debt is concentrated in Seoul, Busan, Kyonggi, and Jeju (Figure 9).

Jeju, an island famous for tourism, has the largest amount of foreign debt, having issued Samurai bonds worth ¥20.9 billion in 1997 to build and repair roads. Busan has the next largest amount of foreign debt, which was incurred to build the city expressway, and consists mainly of ¥11 billion of Samurai bonds. Kyonggi also issued ¥12 billion of Samurai bonds in 1997 to build and repair local roads.

Figure 9. Local Government Foreign Debt (W billion)



Source: Ministry of Government Administration and Home Affairs.

Foreign debt only covers local government debt. However, subway debt is more important than the local government debt of the general account. In Seoul, foreign borrowings of the two subway companies are six times as large as the foreign debt of the city government. Daegu's foreign debt is only W14 billion, but the city borrowed from the foreign bond market aggressively in the 1990s. However, these foreign debts are retired now. Daejeon recently ventured into public-private partnerships in which Samurai bonds were converted into foreign bank loans. This type of foreign debt is the most interesting from the viewpoint of local bond market analysis and does not appear in the budget report of local governments. These issues for Seoul, Daegu, and Daejeon, will now be looked at in more detail.

Seoul

Debts of subway companies in Seoul consist of many types of government funds and debts (Table 17). For Seoul Metropolitan Rapid Transit Corporation (SMRTC), the biggest portion of debt is the metro railroad bond (30.6%), followed by an OECF loan (22.7%) and the Yankee bond (9.5%). For Seoul Metropolitan Subway Corporation (SMSC), the largest debt comes from the metro railroad bond (74.5%); foreign borrowing is negligible.

The OECF loan was borrowed in 1984 and 1997, at 4.00–4.75% interest, and is expected to be fully retired by 2015. However, Seoul converted the loan into Samurai bonds in 2002, and is expecting a gain from debt refunding of about W70 billion (City of Seoul 2002). Under the debt-refunding plan, in 2002 SMRTC

Table 17. Debt Composition of Subway Companies in Seoul, December 2002

	SMRTC			SMSC		
	Debt (W100 million)	Interest Rate (%)	Share (%)	Debt (W100 million)	Interest Rate (%)	Share (%)
Domestic						
Fiscal Loan[a]	980	5.5–6.0	4.9	1,588	5.5	6.0
Transportation Fund[a]	1,440	5.0	7.2	7,00	5.9–6.0	2.6
City Fiscal Loan	1,776	5.0	8.9	1,317	5.0	5.0
Metro Railroad Bond	6,096	4.0–6.0	30.6	19,721	4.0–6.0	74.5
Corporate Bond	1,800	6.9–9.7	9.0	3,128	6.0–8.3	11.8
City Bond	1,400	8.4	7.0	—	—	—
Subtotal	13,492	—	67.8	26,454	—	99.9
Foreign						
Yankee Bond	1,886	7.8	9.5	34	2.4–2.9	0.1
OECF	4,517	4.0	22.7			
Subtotal	6,403	—	32.2	34	—	0.1
Total	**19,895**	**—**	**100.0**	**26,488**	**—**	**100.0**

— = data not available, OECF = Overseas Economic Cooperation Fund, SMRTC = Seoul Metropolitan Rapid Transit Corporation, SMSC = Seoul Metropolitan Subway Corporation.
[a] Central Government's special account.
Source: Korea Transport Institute.

issued ¥12.5 billion of Samurai bonds (with maturity of 1 year), ¥11 billion (2 years), ¥10 billion (3 years), ¥10 billion (4 years), and ¥5 billion (5 years). In 2003, SMRTC will issue ¥4 billion (3 years) and ¥4 billion (4 years); in 2004, ¥6 billion (4 years); in 2005, ¥5 billion (5 years); and in 2007, ¥5 billion (5 years) and ¥5 billion (6 years). The retirement period of Samurai bonds is thus shorter than that of OECF loans by 2 years, and about ¥7 billion of interest payment will be saved (Table 18).

Seoul's effort to improve the debt situation of subway companies sends positive signals to the market. Moody's upgraded the credit rating of foreign bonds issued by Seoul from Baa2 to A3 in October 2002. Since local governments' credit ratings are usually the same as the national credit rating or slightly lower, these results were expected.

Daegu

While Seoul takes advantage of low interest rates in the Japanese financial market, not every local government pays attention to the potential benefit of tapping foreign financial markets. Daegu is taking a reverse course. In the 1990s, Daegu was the most active in taking advantage of the foreign capital market. In 1993, Daegu became the first local government to issue Samurai bonds (¥5 billion) in the Japanese capital

Table 18. Comparison of Debt Retirement (¥ billion)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
OECF	6.1	11.9	17.7	23.2	28.6	33.8	38.4	42.3	46.1	49.8	53.3	56.7	60.1
Samurai	4.9	10.4	15.8	20.3	24.7	31.3	36.7	42.1	42.3	47.6	52.8		

OECF = Overseas Economic Cooperation Fund.
Source: City of Seoul. 2002. Press Report.

market, after obtaining a credit rating of AA+ from Japan Rating and Investment Information Inc. (then the Japan Bond Research Institute), a Japanese credit-rating company. The maturity of the Samurai bonds was 5 years, and the interest rate, 3.55%. The lead manager was Daiwa Security Company.

In 1996, Daegu issued another ¥6 billion of Samurai bonds, with an interest rate of 2.8%, with the same maturity and lead manager as in 1993. Since the interest rate in the Korean financial market was 11–12% in 1997, Daegu regarded the deal as successful. Daegu then issued Yankee bonds in 1997, first getting credit ratings from Standard &Poor's (A) and Moody's (A1). With JP Morgan as lead manager, in October Daegu issued $300 million with an interest rate of 7.375% and maturity of 10 years with 5 years put. The lenders could ask for early retirement of the debt in case Daegu's credit rating deteriorated. Daegu became fifth city in the world, except for cities in the US and Canada, to venture into the Yankee bond market, after Naples, Barcelona, Tokyo, and Seoul.

The timing of active borrowing in the foreign capital market, however, could not have been worse. Just a couple of months after Daegu issued the Yankee bonds, the financial crisis hit Korea, and its national credit rating and, therefore, Daegu's credit rating, collapsed in late 1997. Daegu had to retire the Yankee bonds by 9 March 1998. Daegu had a deposit of $220 million in the Foreign Exchange Bank, but $82 million had already been spent for social overhead capital and road construction. Daegu sought another source of foreign borrowing to avoid an exchange rate loss, and took out a syndicated loan of $90 million from Citibank, with an interest rate of London interbank offered rate (LIBOR) plus 8.1%.

Daegu's experience provides several important lessons. One is that, when local governments go into a foreign capital market, they benefit not only from foreign borrowing but also from exposure to a variety of advanced legal and financial services. The learning process is costly and difficult since local government officials do not have expertise in these areas, but it can positively impact local governments' administration in the globalization era. Daegu now advises other local governments when they consider borrowing in foreign bond markets. It is ironic, therefore, that Daegu no longer issues foreign bonds, mainly because it was unsuccessful due to the 1997 financial crisis, which it could not have foreseen. Daegu's large foreign debt during the financial crisis, however, was usually depicted in the media as the result of unscrupulous debt management.

The second reason that Daegu is reluctant to go into the foreign capital market is the general public's attitude to foreign borrowing. Even though Korea greatly benefited from an International Monetary Fund (IMF) loan during the financial crisis, Koreans think of the loan as a stigma rather than realizing how important it is to be able to borrow from abroad when necessary. Since the public and even local council members and many other local officials think of foreign borrowing as an economically unhealthy act rather than portfolio management that takes advantage of low interest rates in foreign capital markets, it is not surprising that local governments do not often borrow abroad.

The fundamental reason why local governments—including Daegu—are reluctant to issue foreign bonds, however, is the exchange rate risk. Although Daegu avoided the exchange rate loss by refunding the Yankee bond with a syndicated loan, the uncertain exchange rate greatly deters local officials from foreign borrowing as their biggest concern is subsequent responsibilities of loan projects they initiate.

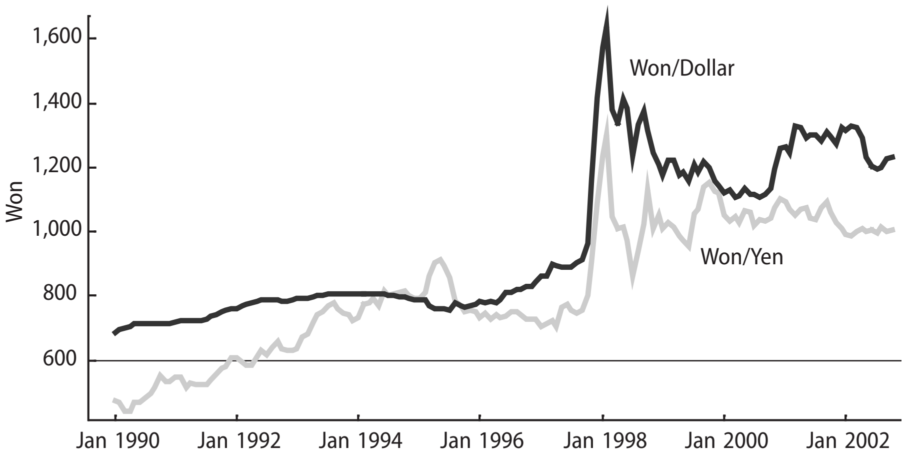
Although the interest rate in Japan is near zero and the gain from issuing Samurai bonds seems to be attractive, won-yen exchange rate fluctuations should be taken into account when considering foreign borrowing. While these fluctuations are less volatile than on the won-dollar rate, the price of ¥1 increased from W726.5 in December 1996 to W1,003.5 in October 2002—an almost 40% won depreciation (Figure 10). Since local officials generally do not have much knowledge about advanced financial techniques to hedge foreign exchange exposure when borrowing in foreign capital markets, and do not have much incentive to learn this skill given the unfavorable official and public attitude to foreign borrowing, local governments will not issue foreign bonds in the absence of more favorable incentives.

Daejeon

The financing of Daejeon's express highway under public-private partnership may be the most innovative example of foreign borrowing by a local government. Macquarie Bank (2002) reports that the project's Samurai bond issue was groundbreaking: it was the first 10-year private sector Korean Samurai issue, the first structured one, and the first Korean private participation in infrastructure with foreign equity.

Debt financing consisted of ¥13 billion, 10-year Samurai bonds issued by Daejeon Riverside Expressway Funding plc, an Irish special-purpose vehicle (SPV), and guaranteed by Daejeon, the grantor of the concession. Another W24.4 billion loan was provided by Hana Bank and guaranteed by the Korea Infrastructure Credit Guarantee Fund. Egis Projects of France, Doosan Construction and Engineering Company of Korea, and Singapore Piling & Civil Engineering formed a consortium—Daejeon

Figure 10. Won-Dollar and Won-Yen Exchange Rates (Won/$1, Won/¥100)



Source: Korea National Statistical Office (available: www.nso.go.kr).

Riverside Expressway Company Ltd. (DRECL)—with equal shares. Doosan is the civil works contractor, Egis Projects supplies the fixed operating equipment. A joint venture between Doosan and Transroute International, an operating subsidiary of Egis, will operate the tollway. The Group Egis newsletter reported that the parties had to go through numerous negotiations because the deal involved two guarantors, two fund providers, and three jurisdictions. Therefore, extensive discussions were necessary to agree on the priority of each party in the event of any default or claims.

To comply with the commerce law clause that requires the amount of corporate bonds to be less than 400% of net assets, and to take advantage of the low tax rates in Ireland and the double-tax treatment between Korea and Ireland, the SPV was created in Ireland. Thus, the limited-recourse Samurai bond was issued by the SPV, and the proceeds from selling the bond were loaned to DRECL via Macquarie Bank.

Daejeon's venture into the Samurai bond market, project financing, and creation of the SPV has important implications for local government bond financing and infrastructure investment. First, the first public-private partnership to build urban infrastructure with foreign equity was successful.[29] Second, while many other local governments are reluctant to tap the Japanese capital market, Daejeon took advantage of the low interest rates in that market.[30] Third, if local governments are innovative enough, MOGAHA's tight control over the local bond market can be avoided by joint ventures with private companies and financial institutions. A

Samurai bond issued by a foreign SPV is not directly subject to MOGAHA's debt control policy, although the project financing and foreign borrowing are regulated in other respects.

Despite the success of Daejeon's project financing with foreign equity, however, such deals are not expected to be popular among local governments, at least in the near future. Daejeon hired a finance expert to launch this project, but central and local government human resources are not prepared for project financing, especially with foreign equity, which requires sophisticated knowledge about finance, accounting, and law. Language is a problem since those involved in this type of project usually communicate in English. Another problem is that the public sees foreign borrowing as dependency on foreign countries rather than an opportunity. Since the interest rate in Korea is low, foreign borrowing is seen as replacing domestic borrowing. Finally, transaction costs, such as legal and financial consulting fees related to project financing with foreign equity, influence local governments' decisions to go into foreign capital markets.

Policy Issues to Improve Local Public Finance

Improving Accountability in Local Government

Korea introduced local autonomy only in 1995. Its performance in the past 7 years, however, has by no means been satisfactory. Three local elections took place after 1995, but participation declined from 68.4% in 1995, to 52.7% in 1998, and to 48.8% in 2002. The number of corruption charges against local public officials increased from 23 in the first term of local autonomy to 49 in the second term. FII decreased from 63.5% in 1995 to 57.6% in 2002.

Local autonomy has many positive effects. The benefit of politically decentralized decision making may not be easily felt, but its potential contribution to the welfare of citizens will be significant in the long run. The positive psychological effect of decentralization on citizens is also hard to calculate but must be substantial. Few people support centralizing the political system despite the poor record of decentralization, and believe that the remedy is a better system of decentralization.

Local autonomy does not lead to satisfactory political and economic decision making because local governments have more powers than responsibilities. Therefore, to realize the potential benefit of decentralization, institutional arrangements should improve local governments' behavior, and citizens and local public officials should keep local government accountable to the people.

Local governments should have more legal and financial power, and citizens should pay close attention to their local government's decision making. If local public services are clearly assigned to local governments and citizens know for which public services they need to pay local rather than national taxes, local governments' power and responsibility will be greatly enhanced. Clear-cut criteria are needed for distributing intergovernmental grants, market-oriented loan subsidies, and infrastructure investment, including that required to develop the local bond market.

Successful decentralization requires a clear division of local and central public services. Local governments have no incentive to adjust their tax rates since residents think that services can be supported by the central Government, either through intergovernmental grants or tax transfers. Only after expenditures are clearly assigned can local governments be induced to adjust the local tax burden before resorting to intergovernmental grants. Then local residents will feel the burden of local taxes, and local services will be provided at an optimal level. Expenditure assignment is important not only for a more efficient and responsible expenditure system but also for a more efficient tax system, since property-related local taxes need to be mobilized more than national taxes.

Asymmetric Decentralization

Simply strengthening the decentralization process faces a fundamental constraint: the transfer of power from the central Government to local governments only enriches a few large cities because of their heavy concentration of population. Of 47 million people, more than 21 million (45%) live in Seoul. Another 12.6 million (26.6%) live in the six metropolitan cities. Economic concentration around Seoul is even greater than its share of income tax.

While the concentration of the population in the metropolitan area can be regarded as a natural economic phenomenon, the enormous political and financial influence of Seoul is the result of the long period of political centralization. Since one objective of local autonomy is to balance regional development, the granting of more financial and economic power to local governments to make them more independent and diversified might, ironically, result in a more centralized pattern of regional development. Thus, making local governments stronger and more independent while promoting balanced regional development is the most difficult challenge faced by Korea.

Decentralization can be enhanced without transferring national resources to local governments that already have resources through asymmetric decentralization: local governments are given a menu of public services that can be provided at the local level if the local governments opt for it. Normally, transferring resources needed to provide such public services is subject to heated debate. Under the asymmetric decentralization scheme, however, local governments may opt not to participate in the local provision of public services if the amount of transferred resources is unsatisfactory.

However, some local governments might prefer independent decision making even with little financial support. When Spain initiated decentralization in the late 1970s, local governments had the option of providing education and health care at the local level, without being guaranteed sufficient financial transfers from the central Government. Rich cities such as Madrid and Barcelona opted for the independent provision of those services since it meant greater political independence for them. Other local governments gradually followed suit (Castells 2001).

In Indonesia, decentralization as stipulated in Law 22 follows the principle of subsidiarity, with a restricted range of functions assigned to the central and provincial governments, and the residual set of functions assigned to local governments. However, this leaves uncertainty and arbitrariness in the interpretation of local governments' functions. Thus, the Ministry of Home Affairs recently prepared a "positive list" of local functions so that each local government can submit its own list of functions that it sees as its responsibility. Each list will be different, leading to asymmetric decentralization (Sidik and Kadjatmiko 2002).

Indonesia tried asymmetric decentralization because of the large difference of fiscal capacities between rural and urban areas.[31] Regional fiscal disparity in Korea is even worse than in Indonesia, slowing down decentralization or even making it impossible. Providing already rich local governments in Korea with more fiscal responsibility and independence, therefore, can achieve the policy objectives of balanced regional development and decentralization.

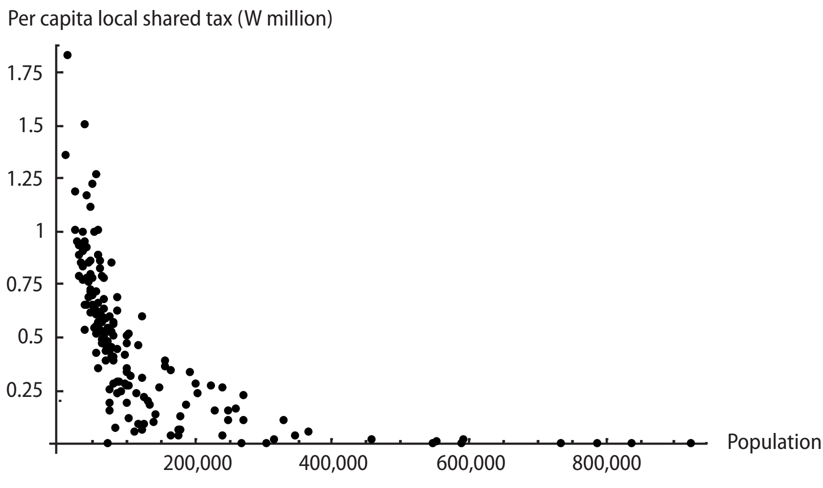
Expenditure Reassignment

Asymmetric decentralization has an important implication for balanced regional development. Typical public services that can come under asymmetric decentralization are welfare-related expenditures, such as education or health care, since they directly affect the welfare of local residents. Such services have the characteristics of publicly provided private goods and, therefore, the burden of providing them increases in an almost linear fashion with the size of the local population. Redistributive local expenditures may thus be unsustainable because such a policy induces local governments to compete with each other in terms of tax rates or expenditure levels to avoid immigration of poor individuals.[32]

If, however, the central Government had the power to regulate local governments' expenditures or tax rates, that is, to intervene in local governments' expenditure policies to prevent a "race to the bottom," decentralizing the provision of publicly provided private goods such as education or health care would make local expenditure roughly proportional to population. Then expenditure reassignment, along with asymmetric decentralization, would mitigate the fiscal surplus that comes from the economies of scale in the consumption of public goods, which a large local government such as Seoul enjoys.[33] This will in turn mitigate the concentration of population around the metropolitan cities.[34]

Expenditure reassignment also has an important implication for equalization grants. When the distribution formula is designed for the grants, strong economies of scale are assumed to exist in the consumption of local public services. A per capita equalization grant is markedly disproportional to population because of assumed large fixed costs in the provision of local public goods (Figure 11). Therefore, if per capita cost of public goods provision is made fairly constant by expenditure reassignment, fiscal resources to subsidize the fixed costs in small jurisdictions can be saved.[35]

Figure 11. Relationship between per Capita Local Shared Tax and Population of Local Government



Policy Issues in Local Bond Market Development

Central Government Loans and Compulsory Bonds

In theory, local government debts are incurred to finance long-term projects, such as local infrastructure, on the premise that the debts will be retired through local governments' future tax revenue. In practice, however, when local governments initiate public projects such as roads, housing, subway, environmental facilities, or local economic developments, the central Government helps them after evaluating the merits of such projects. The central Government usually supports this type of project with specific grants. However, if the central Government's revenue set aside for intergovernmental grants is insufficient for the projects, the central Government typically allows local governments to assume debts to finance the project.

As a result, local debts are often regarded by the central and local governments as a type of intergovernmental subsidy granted when the central Government needs to shift the burden of intergovernmental subsidy into the future. Since local debts are in effect another type of intergovernmental transfer, the central Government tightly controls local debt issuance. At the same time, the central Government often subsidizes a part of local debt retirement.

Another notable characteristic of local debt is the dominance of the compulsory bond. Buying such a bond is like paying a tax rather than a loan. Compulsory bonds also exist in other countries. The insurance bond is typical and often required of businesses that involve risks. The compulsory insurance bond bought by airline carriers is a good example. The compulsory bond, however, is unique in its magnitude and widespread usage. Many types of licensing, registration, and contracts are subject to local governments' compulsory bonds for regional development, urban railroads, and urban development.

Given that most debts come from either the central Government's subsidy (loan) or semi-tax (compulsory bonds), local bond market development is greatly limited. The central government subsidy and compulsory bonds are not without merit, however. Since the subsidy is usually provided to local infrastructure projects, it can be better than direct specific grants, which often suffer from the lack of a long-term arrangement. Compulsory bonds can be better than general taxes if they are well-functioning user charges. The question is, however, whether alternatives exist that can achieve the same objectives at less social cost.

To answer this question, two issues need to be addressed. The first concerns decentralized decision making in local infrastructure investment, and the other the relative advantage of a compulsory bond over a tax. The Daejeon experience shows that resource allocation can be improved if loan decision making is decentralized, which, in turn, will involve the structure of intergovernmental grants, division of local infrastructure investment responsibilities, as well as legal and institutional changes to improve the environment for public-private partnerships.

Many critics argue that compulsory bonds should be abolished and the system of land taxation improved, including through the adoption of tax increment financing. Whether the amount of revenue currently secured by compulsory bonds can be raised through the land tax is questionable. Since the compulsory bond has the characteristics of a user charge, the burden of the compulsory bond should be made consistent with the benefit of public investment.

Intergovernmental Grants and Infrastructure Investment

Even though government-backed borrowings should be reduced to develop the local bond market, whether bond financing will replace borrowings is unclear. Of public projects financed by local debt in 2001, road-related expenditures accounted for 20.0% and water and sewage for 27.8%. If other environment-related expenditures are included, road and environment expenditures accounted for more than 50%. However, since the local transfer fund is allocated to local governments mainly for roads and the environment, changes in the system of intergovernmental grants are closely related to local bond market development.

The distribution of the local transfer fund across local governments is similar to that of the local shared tax, which is a general-purpose grant to help poor jurisdictions. Local infrastructure is not built to meet demand for it but to guarantee its equal distribution, especially roads, as per article 1 of the Local Transfer Fund Act, which stipulates that balanced regional growth must be promoted.[36] Therefore, unless the focus of the balanced regional development strategy, which is the most important item on the political agenda of local public finance, is shifted away from local infrastructure, the role of local bonds is likely to be played by intergovernmental grants such as the local transfer fund.

Soft Budget Constraints

Developing the local bond market is also critically related to making local governments face hard budget constraints. Soft budget constraints in Korea are different from those in countries with a long history of local autonomy and where local governments are independent. Local governments in such countries play “fiscal games” with the central Government and issue local bonds, expecting that the burden of local debts will ultimately fall on the central Government. However, local governments in Korea are tightly controlled by the central Government and, therefore, soft budget constraints have not resulted in serious local debt default. Developing the local bond market, therefore, gives local governments more independence and fiscal power and lets them finance local infrastructure using local bonds rather than intergovernmental grants under hard budget constraints.

Endnotes

[1] Other factors are high tariffs, and the high cost and low level of international trade.

[2] Krugman (1991, 1993, 1996) writes that since economic agglomeration around major cities is a natural result of economic development, government intervention to mitigate economic agglomeration is not necessarily advisable. The popular balanced regional development policy is especially doubtful since its aim is more ambitious than simply correcting negative externalities created by economic agglomeration. However, balanced regional development is an unavoidable policy theme: all three major candidates for the December 2002 presidential election proposed policy packages for such development early in the election campaign.

[3] While decentralization is politically popular, whether a country can benefit from it depends on how it proceeds, especially developing countries (Bardhan and Mookherjee 2000, Besley and Coate 1999).

[4] These public services are all directly or indirectly managed by the central Government.

[5] Ahmad et al. (1995) and Schiavo-Campo and Sundaram (2000) express similar views about decentralization in the People's Republic of China.

[6] The education tax before 2001 was a surtax on many kinds of national and local taxes. It became the local education tax in 2001.

[7] The denominator of FII used to include local debt.

[8] In Seoul, for example, the new mayor promised to restore Chonggye stream, by removing the paved road and elevated highway above it, and then redeveloping the surroundings. To finance the project, he proposed introducing a local value-added tax (VAT) (10% of national VAT). If the proposal is accepted, the burden of such a big project will not be taken into account.

[9] The local consumption tax of 1997 in Japan is collected by the central Government as a part of VAT, and then one fourth of the revenue is distributed to local governments based upon consumption statistics. In this sense, that tax and the local transportation tax in the Republic of Korea are similar. However, in Japan the local consumption tax is shown on receipts separately from VAT.

[10] Calling a general-purpose grant a tax rather than a grant can be confusing to outside observers. It is MOGAHA's way of stressing that the revenue of national taxes is split between central and local governments.

[11] Revenue from fees and charges was included in the supplementary fiscal revenue from 2001 to accurately reflect local governments' fiscal revenue. This measure could be controversial since fees and user charges are necessary to provide local services not covered by basic fiscal needs. However, no special account is associated with local earmarked taxes, and revenue from the earmarked taxes is all included in the general

account. Therefore, it is reasonable to include the revenue from the earmarked taxes in supplementary fiscal revenue.

[12] This is the representative tax system. See ACIR (1993), Ladd (1994), and Ladd and Yinger (1994).

[13] Twelve categories, including general and transportation administration costs, are used to calculate Ξ_1.

[14] Under the 2002 budget, the share of road expenditure was 39.5%, and of sewage treatment, 32.9%—8 percentage points higher than in the previous year.

[15] Property transaction taxes are collected by upper-level local governments.

[16] The transportation tax rate was reduced by the same amount.

[17] For example, those who think that the local shared tax treats cities more unfavorably than small counties recently suggested that environment-related spending categories be included in calculating standard fiscal needs.

[18] Reducing the number of expenditure categories was superficial since it just combined many small categories.

[19] These internal regulations are legally binding since article 115 of the Local Autonomy Act stipulates that local debt should be incurred only with permission from MOGAHA.

[20] The World Cup stadiums were built with a 30% national subsidy. Since the stadiums are assets of local governments, they should assume part of construction cost with local debt. However, since holding World Cup games can be viewed as a national rather than local event, local governments are likely to ask for central government assistance to reduce the burden of local debt incurred to build the stadiums. Local governments of big cities have even been asking the central Government to help build subways.

[21] Average debt retirement for the past 4 years / average general revenue for the past 4 years, where general revenue is (local tax + nontax + central government general grants).

[22] Wards do not directly receive general grants from the central Government, but from metropolitan cities.

[23] A local public enterprise is owned by local governments, and its employees are government officials. A local public investment enterprise is a private firm to which local governments' contribution quota is 100%.

[24] The central Government compulsorily sells the national housing bond when licensing and registration of property take place or when public works are contracted.

[25] The central Government's assumption of Busan's subway debt has caused political difficulties in controlling the large amount of subway debt in metropolitan cities. All other metropolitan cities including Seoul argue that they deserve the same treatment as Busan. The Busan Transport Authority is scheduled to be transferred to Busan by the end of 2007, but it is uncertain that the Authority's huge debt will be transferred to Busan as well.

[26] Since the financial crisis, however, the savings insurance and nonperforming loan management funds have been receiving most of the funds. Under the 2002 budget, about W7 trillion, out of W8.5 trillion transferred to various accounts and funds, was deposited in these two accounts.

[27] MOFE's Price Policy Division tightly controls the price of many consumption goods and public utilities. Although charges for water and sewage, and subways can be determined by the local government charter, local governments are not completely free from the influence of the Price Policy Division in determining the prices of public utilities.

[28] W600 is about $0.5, which is less than one fifth the New York subway charge and less than half the Paris subway charge. Since a passenger can go anywhere in Seoul with one subway ticket, it is very low compared to other prices, such as for housing and gasoline.

[29] Project Finance International awarded Daejeon the Bond Deal of the Year in 2001.

[30] Daejeon initiated project financing in 1998, when foreign borrowing was almost impossible for local governments or companies, to continue construction of the express highway, which started in 1989. So the project financing was the result of Daejeon's desperate effort to continue construction rather than to take advantage of the low interest rate in the Japanese capital market.

[31] Asymmetric decentralization is discussed in detail in Litvack et al. (1998). It is in line with rule 4 in Bahl (1999) for fiscal decentralization of newly decentralizing countries: "One intergovernmental system does not fit the urban and the rural sector." See also Shah (2000), who elaborates on asymmetric decentralization in Indonesia.

[32] A huge body of literature deals with migration, local redistribution policy, and the central government's role. See, among others, Wellisch and Wildasin (1996), Wildasin (1994, 1995), and Brueckner (2000).

[33] This argument is valid assuming that big cities such as Seoul voluntarily take more responsibility in providing publicly provided private goods under asymmetric decentralization.

[34] This argument is derived from the observation that the fiscal burden of providing public goods to a given population depends on the characteristics of the public good. The theoretical implication of this fact for the intergovernmental grant system is discussed in Boadway and Flatters (1982) and Boadway and Hobson (1993).

[35] More detailed discussions on this point can be found in Kim (2002).

[36] It is not surprising, therefore, that the most severe critics of the local transfer fund are Seoul and Kyonggi.

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Malaysia

Azmi Setapa
Senior Research Fellow and Head
and
Elayne Yee Siew Lin
Research Fellow

Policy Studies Division
Malaysian Institute of
Economic Research
Kuala Lumpur

Acronyms

ABS	asset-backed securities
BIDS	bond information and dissemination system
BNM	Bank Negara Malaysia
FAST	fully automated system for tendering
GDP	gross domestic product
MGS	Malaysian government securities
MHLG	Ministry of Housing and Local Government
MPAJ	Majlis Perbandaran Ampang Jaya (Ampang Jaya Municipal Council)
MPK	Majlis Perbandaran Klang (Klang Municipal Council)
MPPJ	Majlis Perbandaran Petaling Jaya (Petaling Jaya Municipal Council)
MPSA	Majlis Perbandaran Shah Alam (Shah Alam City Council)
PDS	private debt securities
RAM	Rating Agency Malaysia
RENTAS	real-time electronic transfer of funds and securities
RM	ringgit
ROC	Registrar of Companies
SPEEDS	Sistem Pemindahan Elektronik Untuk Dana dan Sekuriti (electronic fund and securities transfer system)
SPV	special-purpose vehicle
US	United States

Executive Summary

Local governments' efforts to achieve sustainable development in Malaysia are hindered by the country's growing population, which may cause scarcity of water, pollution, traffic jams, and flooding. Local governments need to change how they operate, from simply issuing directives to conducting community-based analysis to develop action plans that will mobilize public support and community resources.

Local governments face growing challenges as the standard of living rises, but they are hampered by limited financial resources. Although they have either a small financial deficit or a surplus, they constantly face financial limitations that impede meeting the increasing need for better services. The four local governments studied in this chapter, though, have a financial surplus, achieved through careful planning.

Local governments should increase their revenue to meet the challenges of globalization and technological advances, and look beyond traditional sources of finance as the costs of providing services have increased due to increasing jurisdiction, inflation, urbanization, and population growth. Income has not correspondingly increased or revenue collection significantly improved.

Although local governments are constrained by the Constitution from manipulating and changing the taxation system, they can generate more income by restructuring their activities and strategies within the existing framework.

Transparency and good governance are necessary for sustainable development. Policy formulation and implementation must result from consensus building among various sectors to encourage them to contribute their energy and money to local councils. Transparency will restore local governments' reputation and make people more willing to pay taxes.

Bond financing can help solve the financing problems of local governments. State and local governments are expected to iron out the constitutional and legislative problems impeding such financing. The federal Government, particularly the Treasury, will be responsible for supervision and monitoring of bond financing.

Before local government bond financing starts, however, accounting and transparency problems should be solved. Local governments have up-to-date data since they are required to submit their audited financial statements to the state governments every year. However, bond financing will require much more detailed information. While some local government accounting weaknesses are technical and can be easily rectified, local governments may have difficulty in disclosing full information as required by rating agencies due to the social and political implications of doing so. Rating agencies must be allowed to explore, examine, and analyze all local government information and data.

Local governments should each set up a special-purpose vehicle to transfer some of their assets for securitization and bond issuance. This proposal is feasible because most local governments have a great deal of fixed and current assets that generate stable income.

Introduction

High economic growth, particularly before the Asian financial crisis of 1997, improved living standards in Malaysia. Its per capita gross domestic product (GDP) rose from RM10,053 in 1995 to RM13,412 in 2000. Higher income, coupled with a rising level of education, transformed people's lifestyles. Not only did service quality improve but local governments were now faced with new roles and responsibilities. Such development, however, strained local government finance, a situation worsened by the growing population in urban and municipal areas.

High economic growth and higher standards of living also increased the number of qualified personnel and experts in fields such as management and information technology, who can be used to enhance the financial efficiency of local governments and broaden their revenue base. If properly managed, the large population, although it puts pressure on the environment, could generate more economic activity and raise more revenue for local governments.

The financial burden of local governments can be reduced with sufficient capital or market financing for certain profitable activities. Such financing can be obtained through bond issuance in local and international markets. Although the ultimate benefit of bond financing is obvious, it should be analyzed carefully since it will face constitutional restrictions and have macroeconomic impacts.

This study analyzes the sources of revenue and expenditure of Shah Alam City Council (MPSA), Petaling Jaya Municipal Council (MPPJ), Klang Municipal Council (MPK), and Ampang Jaya Municipal Council (MPAJ). These local governments were selected for their strategic location in the Klang Valley, being close to Kuala Lumpur, Putra Jaya, Kuala Lumpur International Airport, Port Kelang, and Multimedia Super Corridor. All these local governments have great growth potential because of their well-developed financial system and fast-growing information technology sector. Already host to much manufacturing activity, they will continue to attract foreign investors. All these factors will lead to growing opportunities as well as responsibilities for local governments, which, in turn, require a clear and efficient financial plan.

Overview of Local Government

The government hierarchy has three levels: federal, state, and local. The federal Constitution stipulates that local governments outside the federal territories of Kuala Lumpur and Labuan are under the state list, and therefore, they come under the exclusive jurisdiction of their respective state governments, which thus have wide legislative powers to control local governments and to ensure their proper functioning. Local governments are the city, town, and local councils, depending on the territory's population. For example, an urban area may be a city or town when its population exceeds 100,000.

The National Council for Local Government (NCLG) formulates national policy to promote, develop, and control peninsular local governments, and must be consulted on any proposed legislation dealing with peninsular local government. NCLG is made up of a federal minister, one representative from each of the 11 peninsular states, and up to 10 federal government representatives, who meet to discuss local government policy matters at least once a year. The federal Government and its agencies can thus exert their influence and maintain functional links with local governments through NCLG. NCLG policy decisions bind federal and state governments (Phang 1997, pp.1–8).

Local governments have limited jurisdiction as the Constitution stipulates that a local government can only perform those functions enumerated in its statutes and only within its jurisdiction. The allocation of powers among the three levels of government is constitutionally determined. The highest power is given to the federal Government (national sovereign), followed by state governments (quasi-sovereign), and local governments (infra-sovereign).

Before 1985, Malaysia had 373 local governments. However, restructuring reduced them to 90 in 1985: 15 municipal councils, 74 district councils, and Kuala Lumpur city hall. As local governments developed and the economy changed rapidly, local governments were further refined and/or regrouped. Now there are 145 local governments, of which 97 are in the peninsula (West Malaysia), and 23 in Sabah (including Labuan) and 25 in Sarawak (together, East Malaysia). In total, there are 7 city halls and councils, 34 municipal councils, and 104 district councils (Table 1).

Local governments consist of a president and 8–24 councillors (Figure 1), appointed by the state government (Act 171, section 10). The councillors normally sit on various committees established to help the local government in management and decision making. The number of committees depends on local governments' planning as well as the development plan.

Local, rather than state, governments are studied in this chapter, primarily due to the rapid rise in urban population, which has raised demand for housing, roads, transportation, and health care, and thus directly contributes to deteriorating local government functions.

Table 2 shows the development of the urban population since 1980 and forecasts it until 2020. The ratio of urban to total population increased from only 34% in 1980 to 60% in 2000, and is forecast to increase further to 80% in 2020.

Local government financial sources have remained conspicuously static, with

Table 1. Local Government by State, April 2002

State	Cities[a]	Municipal Councils	District Councils	Total
Johor	1	4	9	14
Kedah		4	7	11
Kelantan		1	11	12
Melaka		1	2	3
Negeri Sembilan		3	5	8
Pahang		2	9	11
Perak	1	2	12	15
Perlis		1		1
Pulau Pinang		2		2
Selangor	1	6	5	12
Terengganu		2	5	7
WP Kuala Lumpur	1			1
Subtotal (West Malaysia)	4	28	65	97
Sarawak	2	3	20	25
Sabah	1	2	19	22
WP Labuan		1		1
Subtotal (East Malaysia)	3	6	39	48
Total	**7**	**34**	**104**	**145**

[a] Some states have been accorded "city" status on meeting specific criteria: city halls of Kuala Lumpur, Kuching Utara, and Kota Kinabalu, and city councils of Ipoh, Kuching Selatan, Johor Bahru, and Shah Alam.

Source: Ministry of Housing and Local Government.

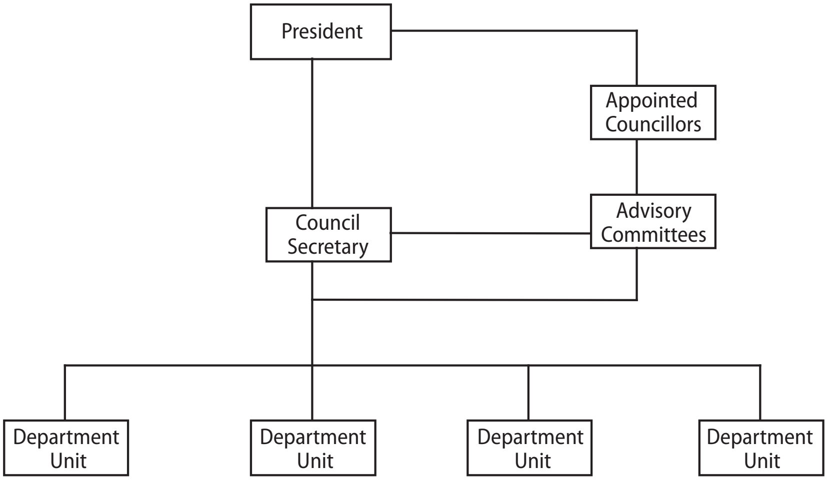
Table 2. Ratio of Urban to Total Population

Year	Total Population (million)	Urban Population (million)	Ratio (%)
1980	13.1	4.45	34
1991	17.6	8.80	50
2000	21.3	12.38	60
2010	23.3	16.17	70
2020	24.7	19.76	80

Source: Ministry of Housing and Local Government.

property rating (assessment tax) still the most significant and valuable source of income. Local governments are constrained from maximizing their income by the intrusion of local government politics and the inevitable consequences of rising costs of service delivery. Local governments are also expected to provide more services, be innovative, and keep up with the increasingly sophisticated demands of an articulate populace that knows its rights.

Figure 1. Organizational Chart for City, Municipal, and District Councils



Sources of Revenue

Peninsular local revenue is covered by the Local Government Act 1976 (part 5, section 39). Sabah is governed by Local Government Ordinance 1961 (section 55). Sarawak is governed by Local Government Ordinance 1948 (chapter 117, volume 5); Local Authority (Rating) Regulations; Kuching Municipal Ordinances 1988 (modification of cap. 116/1948); and City of Kuching North Ordinance 1988. Local government revenue can be obtained from local sources and consist of taxes, rates, rents, fines, user charges, *cess*,[1] dividends from investments, and income from local government properties (Phang 1997, pp.19–23).

Other local revenues are grants and contributions from the federal and state governments and other public governments. Loans may also be raised but they are subject to approval by the state government.

The Ministry of Housing and Local Government (MHLG) has its own classification of sources of income for all local governments: (i) assessment tax; (ii) licenses; (iii) rentals; (iv) government grants (inclusive of road grants); (v) car parking charges, planning fees, compounds, fines, and interest; and (vi) loans (from higher government and/or financial institutions).

Assessment Tax

The property tax is collected on the basis of the annual assessment of rental value or the value-added (selling price) of the property. The Local Government Act sets a ceiling on the tax of 35% of annual value or 5% of value-added of a holding; the ceiling's imposition is not subject to the Rent Control Act (1960). Taxation rates, however, can be varied according to the use and location of the property. Thus, the amount of revenue that can be collected from the assessment tax depends on the property's level of physical development, and on whether or not a particular locality has many residential houses, commercial and industrial buildings, and vacant land. Some local governments, however, impose punitive rates on vacant land to discourage holding of unproductive and undeveloped land.

Assessment tax revenue, therefore, varies with the taxation rate, annual value (or value-added), and number and type of holdings. Rate increases are subject to approval by councils and state governments, whereas changes in the annual value (or value-added) of holdings require an elaborate revaluation exercise, which is expensive for the council.

The rating percentages levied by the Sarawak local governments, for example, range from 12.5% to 31.0%. MPSA, however, levies from 6% for residential properties to 9% for commercial and industrial properties. Under the Local Government Act 1976 (section 130 [a]), peninsular local governments (apart from those in Johor) may levy not more than 35% of the annual value of the ratable properties, while Johor local governments may levy not more than 5% of the improved value of the properties. Peninsular local governments (except in Johor), however, have levied only an average of 9.8%. Increases in the number of holdings are the result of large-scale physical development. Assessment tax revenue, however, is rigid yet growing. Its contribution is considerable: more than 60% of total revenue of almost all local governments, and 76.4% of MPSA, 72.5% of MPAJ, 65.2% of MPPJ, and 68.9% of MPK in 2000 (Table 3).

If local governments imposed the maximum rate, assessment tax revenue would contribute significantly more to total revenue. For social and political reasons, however, local governments have not done so. People must pay their dues promptly and realize that the assessment tax must be settled whether or not the services of the local government are commensurate with the amount taxed, but arrears are huge despite continuous efforts of councils to recover them (Table 4).

Licenses and Permits

Licenses are issued mainly to control the establishment, ownership, and activities of businesses. Revenue from issuing or renewing licenses is an important source of local revenue. Licenses are issued for photography shops, restaurants, launderettes, grocery stores, pawnshops, goldsmiths, and hawkers. The amount collected is directly

Table 3. Major Sources of Local Revenue, 2000 (%)

Source	Petaling Jaya Municipal Council	Klang Municipal Council	Shah Alam City Council	Ampang Jaya Municipal Council
Assessment Tax	65.2	68.9	76.4	72.5
Licenses and Permits	3.8	4.0	1.9	2.9
Rentals	4.2	5.0	4.8	2.2
Car Parking	—	3.7	—	—
Grants	3.5	5.2	4.6	12.3
Interest and Investment	2.4	3.3	3.6	1.0
Services	10.1	4.2	2.5	2.0
Fines	5.6	3.1	3.1	0.4
Sales	0.1	0.7	0.6	0.3
Others	5.1	1.9	2.5	6.4

— = data not available.
Source: Malaysian Institute of Economic Research.

related to the level of urbanization and is supposed to cover expenses necessary to provide services to businesses. Principally, a license is applied to all trades but as many are "obnoxious"[2] in nature, the local governments are unable to issue them licenses. As a result, local governments cannot rely on issuance of licenses to increase revenue. In 2000, license revenue contributed 3.8% to MPPJ, 4.0% to MPK, 1.9% to MPSA, and 2.9% to MPAJ (Table 3). Increasing license fees, however, is politically unpopular because hawkers and small traders make up the political base of the community.

Rentals

This is a steady source of income as it is elastic. Local governments are able to raise rentals during economic booms when demand for property is high. In 2000, rentals contributed 4.2% to the revenue of MPPJ, 5.0% to MPK, 4.8% to MPSA, and 2.2% to MPAJ (Table 3).

Car Parking

This is an important source of revenue for big and busy local governments. Although data on parking revenue for MPPJ, MPSA, and MPAJ are not available, the revenue should be important for them as they are in big towns. Parking revenue is important for MPK, contributing 3.7% of total revenue in 2000 (Table 3).

Table 4. Outstanding Assessment Taxes (RM million)

	1996	2000
Petaling Jaya Municipal Council	3.8	25.6
Ampang Jaya Municipal Council	9.6	21.3
Shah Alam City Council	2.3	29.9
Klang Municipal Council	10.1	18.6

Source: Malaysian Institute of Economic Research.

Grants

The extent of financial autonomy of a local government is exclusively determined by the Local Government Act. Ideally local governments should be financially autonomous, but they need state and federal government grants given the persistent deficit in local government accounts. While federal grants to states are constitutionally determined, grants to local governments are not guaranteed and are at federal and state discretion. Since a local government is under the responsibility of the state government, whose own financial capability is dependent on the federal Government, a local government receives small grants, averaging less than 10% of total revenue.

A local government receives five types of grants: two from the state government (equalization and development grants) and three from the federal Government (launching, maintenance, and road grants). Depending on its financial position and the local government's deficit, the state government pays an equalization grant. The development grant finances specific small projects such as drainage, shop lots, food stalls, mini markets, and streetlights. The amount of such grants is uncertain and, therefore, affects the locality's development planning.

Since 1978, MHLG has paid a launching grant from a total amount set at RM136.1 million to restructure all local governments, which must use the grant only for capital goods and expansion of amenities in new housing, commercial, or industrial estates. The grant has a ceiling for each local government. Since 1978, the federal Government has also paid an annual maintenance grant, based on the size of the community and its revenue, to help local governments pay increases in salaries and wages. Some state governments also pay a similar grant to their local governments.

State governments may divert the state road grant from the federal Government to local governments that have state roads eligible for the grant. Many town roads under the jurisdiction of a local government, especially in housing estates, are not eligible for the grant. In 1993, the federal Government introduced the back-lane grant to help maintain local roads that are not eligible for the road grant.

Annual Equalization Grant

The federal Government gives this grant to peninsular local governments through their state governments in accordance with the State Grants (Maintenance of Local Governments) Act 1981 (Act 245). The Cabinet approved the annual grant on 15 August 1990, based on a new equalization formula, for all peninsular local governments. Local governments in Sabah and Sarawak do not receive this grant since they are governed by their own local government acts and ordinances.

The annual equalization grant is calculated on the basis of a formula set by MHLG. The formula replaces the previous method of allocating the annual grant to local governments based on only two criteria—total population and total revenue. The maximum payable was RM107,500 per year. By virtue of the small amount and low ceiling, the annual grant was deemed as having no incentive effects on local government performance (Phang et al. 1988).

In 1990, MHLG, with technical advice and research by the German Agency for Technical Cooperation (GTZ) and the Faculty of Economics and Administration of the University of Malaya, established a new formula to calculate the annual equalization grant. Implemented the same year, it increased sixfold the total annual grant paid to local governments, with a minimum amount of RM215,000. The formula was still in use in 1997, and involves a series of steps and procedures to calculate the fiscal residuum or fiscal gap of a local government, which is equal to fiscal need minus fiscal capacity (Phang 1997).

The formula to calculate the annual grant takes into account total population of the local government, population density, population size, size of local government area, socioeconomic development rate of the local government, and poverty rate.

The indicators, other than the total population, are converted into fictive population by giving each a fixed weight. This fictive population is then translated into monetary indicators by multiplying each need factor by a base value, which is the average expenditure incurred by an inhabitant.

The fiscal residuum determines the amount of grant to bridge the fiscal gap. MHLG states that the federal Government only considers 15% of the fiscal residuum because it is often much too large to finance.

Fiscal capacity is calculated based on two indicators: (i) adjusted total property tax revenue (annual value) and (ii) administrative revenue or non-land-based source of revenue. The adjusted property tax revenue can be computed by multiplying the annual value of each local government by the average national assessment rate, which MHLG gives as 8.9% using 1987 as the base year.

MHLG's formula to calculate the fiscal capacity (FC) of a local government is the following:

$$FC = \frac{(8.9\% \times \text{Annual value}) + (\text{Administrative revenue})}{2}$$

(It should be noted that the formula for calculating fiscal capacity has a denominator of 2 and the writer has been unable to clarify the basis for including this denominator.)

Sample Calculation: Fiscal Need and Fiscal Capacity, and Annual Equalization Grant

Fiscal residuum = Fiscal need – Fiscal capacity

where

Fiscal need = (Total local government population + Fictive population) x Base value

The following is a sample calculation of fiscal need:

	Local Government	Cardinal Factor	Weight
Total Population	= 61,372	—	1
Size of Area	= 81.60 km^2	—	—
Population Size	= <100,000	0.5	0.5
Population Density	= 752.11	0.4	0.6
Socioeconomic Dev't. Role	= Capital city	0.4	0.3
Poverty Rate	= 33.7	0.67	0.6

Therefore:

Fiscal need = [(61,372) (1) + (61,372{(0.5) (0.5) + (0.4) (0.6) + (0.4) (0.3) + (0.67) (0.6)})] x 63.13

= [(61,372) + (61,372{0.25 + 0.24 + 0.12 + 0.402})] x 63.13

= [(61,372) + (61,372{1.012})] x 63.13

= 123,480.46 x 63.13

= RM7,795,321.4

$$\text{Fiscal capacity} = \frac{(8.9\% \text{ x Annual value}) + (\text{Administrative revenue})}{2}$$

Given the annual value of the local government "X" = RM19,813,247 and administrative revenue = RM3,231,000

Therefore:

$$\text{Fiscal capacity} = \frac{[(0.089)\ (19{,}813{,}247)] + 3{,}231{,}000}{2}$$

$$= \frac{1{,}763{,}379 + 3{,}231{,}000}{2}$$

$$= \frac{\text{RM}4{,}994{,}379}{2}$$

$$= \text{RM}2{,}497{,}189.5$$

Hence, fiscal residuum is calculated as follows:

Fiscal residuum = Fiscal need – Fiscal capacity

= RM7,795,321.4 – RM2,497,189.5

= RM5,298,131.9

The annual equalization grant based on 15% of the federal territory will be:

Annual equalization grant = RM5,298,131.19 x 15%

= RM794,719.78

Source: Ministry of Housing and Local Government.

Based on the new formula, the federal Government has given out under the annual equalization grant a total of RM83.5 million to all peninsular local governments. The largest grant is RM4 million and the smallest RM215,000, paid to a local government with a negative fiscal residuum. Some observers have suggested that state governments may want to use this formula to subsidize any shortfall in local government revenue. Most state governments prefer to provide grants based on small-scale development projects and maintenance activities.

In Sabah and Sarawak, state governments finance their local governments through special allocations.

Development Project Fund

All local governments are eligible for this grant. It is mainly utilized to implement socioeconomic projects approved by MHLG, especially to upgrade local government services: infrastructure development, social facilities, cleanliness and beautification, purchase of equipment and machinery, recreation parks, and sanitary projects (landfills and incinerators).

Grants for development projects are seldom paid outright but given in stages through development warrants through the state governments, depending on project progress. Under the Seventh Malaysia Plan (1996–2000) local governments could obtain development grants for socioeconomic projects such as bus stations, markets, food courts, and shops, especially to help bumiputra[3] businesses and the industrial community. New and traditional villages under the local government were also given grants to help them develop and bring them into the mainstream of socioeconomic activities and functions.

Launching Grant

This grant was introduced to help local governments restructure themselves, upgrade their facilities, and buy equipment. The grant is given outright to a local government once it is restructured, and only once. However, MHLG spreads out payment over several years to enable local governments to distribute their expenditure on capital items.

Drain Maintenance Allocation

All local governments receive an allocation to maintain and upgrade their drains and encourage flood mitigation activities to control frequent flash floods. As the allocation is ad hoc, MHLG is not compelled to provide it annually. In 1994, MHLG paid RM50 million directly to all local governments, and in 1996, RM100 million.

A drainage and sewerage tax can be attached to the assessment tax, with a ceiling rate of 5% of the annual value, or 1% of the value added, to cover local government drainage and sewerage expenses.

Road Grants

All local governments are eligible for road maintenance grants. Nonfederal roads are considered state roads and are maintained by local governments, which can claim from state governments for the roads' upkeep. Road grants are calculated based on the average cost of 1.6 kilometer of road, based on the minimum quality as specified by the federal Government. To obtain a grant, the local government has to apply to the state government and have the Public Works Department certify that the claims meet the standards required for a maintenance grant. The list of approved roads is then submitted to the federal Treasury for payment of the annual road maintenance grant (Phang 1997).

Loans

Local governments rely on loans to finance capital projects and some operating expenditure. The Local Government Act 1976 allows a local government to obtain loans to cover special expenditures from any financial institution. However, such loans are subject to a number of conditions, including the local government's ability to repay the loans. Every loan needs the approval of the state government, and total loans should not be more than five times the value of the current valuation list of the local government, and the repayment period should be not more than 6 years.

Other Types of Revenue

These include interest and investment earnings, rentals, fees and charges, and fines and compound notices.

Revenue and Expenditure Trends

Tables 5–7 present revenue and expenditure of local governments. Total revenue rose by 33.8% from RM2.9 billion in 1995 to RM3.8 billion in 2001, primarily due to the rise in own revenue (by 38.2% from RM2.3 billion to RM3.2 billion). State and federal grants, another component of local government revenue, rose by only 11.6% from RM545 million to RM608 million.

Own revenue constitutes a major part of local government revenue, increasing its share from 79.9% in 1995 to 82.5% in 2001, while state and federal grants declined from 19.0% in 1995 to only 15.8% in 2001 (Tables 6 and 7).

However, operating expenditures rose faster than the increase in total revenue: by 34.0% from RM2.1 billion in 1995 to RM2.8 billion in 2001. Development expenditure rose even faster than operating expenditure and total revenue: by 73.7% from RM760 million to RM1.3 billion. Total expenditure rose by 44.5%.

Table 5. Local Government Consolidated Finances, 1995–2001 (RM million)

	1995	1996	1997	1998	1999	2000	2001
Revenue	2,872	3,108	3,242	3,343	3,535	3,410	3,844
Annual Change (%)	9.2	8.2	4.3	3.1	5.7	-3.5	12.7
Own Revenue	2,294	2,364	2,509	2,586	2,769	2,815	3,170
State and Federal Grants	545	721	688	712	721	529	608
Federal Reimbursements	33	23	45	45	45	66	66
Current Expenditure	2,105	2,140	2,030	2,256	2,573	2,415	2,821
Annual Change (%)	20.6	1.7	-5.1	11.2	14.0	-6.1	16.8
Current Surplus/(Deficit)	767	968	1,212	1,087	962	995	1,023
Net Dev't. Expenditure	760	782	824	1,428	1,262	1,225	1,320
Annual Change (%)	-5.7	2.9	5.4	73.2	-11.6	-2.9	7.75
Overall Balance	7	186	388	-341	-300	-230	-297
Sources of Financing:							
Net Federal Loans	-9	-38	-11	-15	-11	-13	-9
Net State Loans	10	-1	-1	-6	-3	-71	-1
Change in Assets	**-8**	**-147**	**-376**	**362**	**314**	**314**	**307**

Source: Ministry of Finance.

Table 6. Various Statistics for Local Government, 1995–2001 (RM million)

	1995	1996	1997	1998	1999	2000	2001
Revenue							
Own Revenue	2,294	2,364	2,509	2,586	2,769	2,815	3,170
State and Federal Grants	545	721	688	712	721	529	608
Federal Reimbursements	33	23	45	45	45	66	66
Total Revenue	2,872	3,108	3,242	3,343	3,535	3,410	3,844
Expenditure							
Operating Expenditure	2,105	2,140	2,030	2,256	2,573	2,415	2,821
Development Expenditure	760	782	824	1428	1262	1225	1320
Total Expenditure	2,865	2,922	2,854	3,684	3,835	3,640	4,141
Own Revenue Operating Expenditure	1,534	1,582	1,685	1,158	1,507	1,590	1,850
Own Revenue less Total Expenditure	-571	-558	-345	-1,098	-1,066	-825	-971
Total Revenue less Total Expenditure	7	186	388	-341	-300	-230	-297
Own Revenue/Total Revenue (%)	79	76	77	77	78	82	82
State and Federal Grant/Total Expenditure (%)	19	25	24	19	19	15	15
Total Deficit/Total Expenditure (%)	**00**	**06**	**13**	**-09**	**-07**	**-06**	**-07**

Table 7. Local Government Annual Revenue and Expenditure Changes, 1996–2001 (%)

	1996	1997	1998	1999	2000	2001
Own Revenue	3	6	3	7	1	12
Grants	32	-4	3	1	-26	14
Total Revenue	8	4	3	5	-3	12
Operating Expenditure	1	-5	11	14	-6	16
Development Expenditure	2	5	73	-11	-2	7
Total Expenditure	1	-2	29	4	-5	13

Source: Malaysian Institute of Economic Research.

Own revenue still covers operating but not total expenditure. The gap between own revenue and total expenditure was particularly large during 1998–2000, declining slightly to RM971 million in 2001. Before the financial crisis, local government finance was in surplus. However, after 1998, local government had a deficit of about RM300 million every year.

Federal and state grants were erratic. They made up RM545 million or 18.9% of total revenue in 1995. Although their value rose to RM608 million in 2001, their contribution to total revenue declined to 15.8%. The grants were high in 1996–1999, which may be attributable to the crisis. The ratio of grants to total expenditure declined from 19% in 1995 to 15% in 2001 (Table 6).

Table 8 shows MPPJ's revenue and expenditure in 1996–2000. Except in 1997, when the economy was facing a financial meltdown, total revenue has climbed continu-

Table 8. Petaling Jaya Town Council Revenue and Expenditure (RM million)

	1996	1997	1998	1999	2000
Revenue					
Own Revenue					
Tax Revenue	60.1	55.4	64.8	83.7	90.8
Nontax Revenue	48.5	50.2	48.9	38.2	43.2
Grants/Contributions	5.2	4.7	10.0	5.1	4.9
Total Revenue	113.8	110.3	123.7	127.0	138.9
Expenditure					
Operating Expenditure	113.6	112.3	100.8	102.4	118.9
Development Expenditure	4.8	6.2	5.0	9.1	7.4
Total Expenditure	118.4	118.5	105.8	111.5	126.3
Balances					
Own Revenue					
Operating Expenditure	-5.0	-6.7	12.9	19.5	15.1
Total Expenditure	-9.8	-12.9	7.9	10.4	7.7
Total Revenue less Total Expenditure	-4.6	-8.2	17.9	15.5	12.6

Table 9. Ampang Jaya Municipal Council Revenue and Expenditure (RM million)

	1996	1997	1998	1999	2000
Revenue					
Own Revenue					
Tax Revenue	31.7	40.0	52.9	52.8	56.2
Nontax Revenue	6.0	8.1	6.0	7.2	7.1
Grants/Contributions	5.1	7.2	7.4	9.7	8.9
Total Revenue	42.8	55.3	66.3	69.7	72.2
Expenditure					
Operating Expenditure					
Development Expenditure					
Total Expenditure	45.4	57.9	63.2	60.7	64.1
Balances					
Own Revenue					
Operating Expenditure					
Total Expenditure					
Total Revenue less Total Expenditure	-2.6	-2.6	3.1	9.0	8.1

ously. Most of MPPJ's total revenue was derived from tax revenue, followed by nontax revenue, while grants from state and federal governments are almost negligible.

MPPJ's expenditure also climbed every year except 1997. While the council's ledger has been in the black, total expenditure has always moved closely to total revenue, reflecting the declining balance between revenue and expenditure in 1998–

Table 10. Klang Town Council Revenue and Expenditure (RM million)

	1996	1997	1998	1999	2000
Revenue					
Own Revenue					
Tax Revenue	42.1	43.9	53.1	61.3	68.8
Nontax Revenue	26.9	32.8	33.9	24.9	24.3
Grants/Contributions	7.2	7.7	4.9	4.9	5.1
Total Revenue	76.2	84.4	91.9	91.1	97.7
Expenditure					
Operating Expenditure	73.6	87.7	68.6	75.3	86.6
Development Expenditure	20.6	10.6	8.2	4.9	12.7
Total Expenditure	94.2	98.3	76.8	80.2	99.3
Balances					
Own Revenue					
Operating Expenditure	-4.6	-11.0	18.4	10.9	6.5
Total Expenditure	-25.2	-21.6	10.2	6.0	-6.2
Total Revenue less Total Expenditure	-18.0	-13.9	15.1	10.9	-1.6

Table 11. Shah Alam City Council Revenue and Expenditure (RM million)

	1996	1997	1998	1999	2000
Revenue					
Own Revenue					
Tax Revenue	41.0	75.9	100.2	104.2	113.4
Nontax Revenue	23.4	27.4	27.3	24.7	28.0
Grants/Contributions	5.4	3.8	6.4	7.6	6.9
Total Revenue	73.8	107.1	133.9	136.5	148.3
Expenditure					
Operating expenditure	50.7	57.6	73.2	81.1	107.3
Development Expenditure	16.4	16.8	16.1	15.5	34.9
Total Expenditure	67.1	74.4	89.3	96.6	142.2
Balances					
Own Revenue					
Operating Expenditure	17.7	45.7	54.3	47.8	34.1
Total Expenditure	1.3	28.9	38.2	32.3	-0.8
Total Revenue less Total Expenditure	6.7	32.7	44.6	39.9	6.1

2000. In 1998, the balance was RM17.9 million, falling to RM15.5 million a year later before registering RM12.6 million in 2000.

MPAJ presents a similar picture (Table 9). Although total revenue climbed every year in 1996–2000, so did total expenditure. While the balance between total revenue and total expenditure displays a deficit for 1996 and 1997, it shrank from RM9.0 million in 1999 to RM8.1 million in 2000. MPK shows the same trend (Table 10) and is the worst off, facing a deficit three times in 1996–2000.

MPSA balance between total revenue and total expenditure was also substantially reduced (Table 11). The 2000 balance of RM6.1 million represents a steep plunge of RM33.8 million from just a year before.

Increasing Local Government Revenue

Challenges to Local Governments

High economic growth and higher education improved lifestyles across the Asia and Pacific region, putting strong pressure on local governments, which no longer see the population only as a body they should cater to but also as an integral part of the governmental system and the national development process.

However, while local governments continue to face increasing challenges, limited financial resources hamper efforts to meet clients' expectations. Lack of money has generated other problems such as lack of skilled personnel, low level of computerization, low standards of reporting, weak management, and poor monitoring. Malaysia's "Vision 2020" leaves little doubt that local governments have to expand their range of services and encourage growth and development.

Sustainable development is hindered by the country's large population, which may cause scarcity of water, pollution, traffic jams, and flooding. Local governments need to employ planning, consultation, discussion, and a professional approach, which means changing their ways of operation from giving directives to using community-envisioned or -based analysis to develop an action plan to mobilize community support and resources.

Transparency and good governance are necessary for sustainable development. Policy formulation and implementation have to result from consensus building among various sectors, which will encourage people to contribute their energy and money to the local councils. Transparency and good governance will restore local governments' reputation and make people more willing to pay taxes.

Sources of Revenue

Revenue is mainly from traditional sources assigned to local governments when they were established. These revenue sources have remained the same although the cost of providing services and carrying out local government tasks has increased. For a variety of reasons such as increasing jurisdiction, inflation, urbanization, and population growth, costs have not abated. While operating expenditures have increased substantially, income has not increased correspondingly and revenue collection has not significantly improved. The consequence of this common malaise is the inability of local governments to finance their own services and development projects. Further dependence on higher-level governments for grants and loans is unrealistic and the federal Government has urged local governments to seek alternative, innovative solutions to their financial woes locally and globally.

Best practices in many local governments in the world can be employed in Malaysia. However, the success of such best practices will depend much on local factors and whether all levels of government and the community accept these best practices. A local government may want to concentrate on its traditional sources and determine how much more revenue they can generate by using trend analysis and elasticity measurement to determine their viability and potential.

Recommendations for Local Government Revenue Sources

Financial Constraints on Local Government

Most revenue of the local governments studied in this chapter comprised tax and nontax revenue, with minimal assistance from the federal and state governments through the provision of grants or transfers (Tables 8–11). Except for MPAJ, which did not have a breakdown of total expenditure, the other councils' total expenditure is made up mainly of operating expenditure with little development expenditure, indicating the local governments' inflexibility and inability to expand and to plan so as to meet the expectations of their constituencies.

Averaging RM5 million–RM7 million per city council per financial year, the grants and transfers are far too small to enable local governments to deal with a changing urban environment and to serve a wider area and larger population. Enormous changes will stem from new policies and regulations, including environmental issues, privatization of functions and services, new building and planning procedures, new arrangements for solid waste management, and youth and community care.

Representatives of the four councils listed expectedly similar challenges. One is maintenance. Millions of ringgit have been spent and still need to be spent on the upgrade and maintenance of roads and drains. The task is most daunting for MPAJ as, according to its president, Ahmad Kabit, development in Ampang Jaya was not planned. When MPAJ was established, the areas under its jurisdiction consisted of existing housing estates and villages, unlike the gradual and systematically planned development of MPPJ and MPSA. Another problem is growth of population, which spills over into mushrooming squatter colonies. All the council representatives interviewed are confident of completely eliminating squatters by 2005 as more housing projects, including low-cost housing, are in progress. The most common public complaint concerns bad roads and drainage. Hawkers have to be relocated to stalls. Interviewees cited the lack of land to build facilities such as a mini stadium, bus terminals, and sports complexes. Burial grounds for people of various faiths are lacking. The list goes on. The next section identifies possible sources of income for local governments, including some available to local governments in other countries that may be considered in Malaysia.

Possible Avenues of Local Government Financing

Although local governments cannot constitutionally manipulate and change the tax system, they can restructure their activities and strategies within the existing framework.

Rezoning
Changing the status of land usage from a lower to a higher rate category requires redefining agriculture, residential, and commercial land. In certain residential areas, for example, businesses may be conducted in houses and on the premises, which are assessed as residential. In some areas, pockets of agricultural land still provide minimal revenue returns from their assessments. Land-use categories of such property should be converted in line with the activities of a city or municipal zone, and a higher assessment rate then charged. Local governments need to apply this technique cautiously due to possible negative public reaction and opposition from politicians.

Land Pooling
Land pooling can encourage people to surrender to the local government their land that is too small to generate any economies of scale, to be consolidated for profitable projects. While this strategy is practical where land is scarce, land pooling or readjustment is widely used in various countries, such as Japan and the Republic of Korea. Known by different names in different countries—land consolidation in Taipei,China and in Indonesia; land pooling in Australia and Nepal; and land plotting in Canada—it is essentially the same technique.

Requesting Housing Developers to Allocate Land for Community Use
Malaysian housing developers are normally required to allocate land for local governments to turn into playing fields or, alternatively, provide community halls or sports centers in exchange for planning permission and council services. These buildings become the council's assets, for the use of which fees and charges can be collected. Housing developers, however, may transfer this cost to the house buyers.

Selling of Municipal Bonds
Local governments may issue bonds since the councils have many highly profitable projects with stable rates of return. However, the legalities of bond issuance may have to be sorted out by the federal and state governments.

Collecting of Fees
Only appropriate charges must be levied on permits, licenses, and so on, as excessive fees will burden and discourage people from paying them or participating in the activities, thus reducing local government revenue. Efficient administration, regular monitoring, and strong enforcement will generate more revenue than charging excessive fees.

Privatization

Beginning in the mid-1980s, local governments privatized car parks, sport centers, community centers, and various other properties. Property development and construction of roads and bridges are also being privatized. Most local governments arrange for deferred payment to contractors. Sometimes, local governments engage in build-operate-transfer arrangements with private companies, which bear the whole cost of construction, operate the project, and collect revenue from it for an agreed duration, after which they transfer the project to the local government. This method became popular after the 1997 financial crisis.

Joint-Venture Share Equity

The local government engages in a joint venture with a private company that is awarded a project for privatization by holding a certain percentage of equity in that company.

Taxation and Constitutional Bias

Constitutionally, the federal Government has sources of revenue that are responsive to economic growth and cover increasing expenditures. State governments have no similarly buoyant sources of revenue.

State governments will mobilize their resources more effectively by strengthening local governments. In industrial economies, local governments are becoming more important in providing local public outputs and prompting policy makers to continuously reassess the roles of the public and of intergovernmental relations (Bahl and Linn 1992).

The case for decentralization is strong. For example, Oates (1972) argues that when public outputs can be produced at equal cost, responsibility should devolve to the local level. This concept has recently received much attention in Europe under the subsidiarity principle: functions should be assigned to the lowest level of government capable of meeting the responsibility effectively and efficiently.

If they are responsible for providing services, local governments will be more responsive and accountable to the community. They should be given more autonomy, decision-making power, and financial autonomy to fund services to promote experimentation and innovation.

Decentralization, however, is not good simply for its own sake. Among other factors, responsibility assignments must consider economies of scale and scope, potential benefit and cost/tax spillovers, and the decision-making costs of coordination and intergovernmental relations, since services will rarely coincide exactly with jurisdictional boundaries.

A major constraint to enhancing the role of local government is finding and keeping skilled labor. However, this problem can be overcome with federal-state-local labor-sharing schemes. The potential for local revenue to finance a greater part of local public expenditures is high. Local government revenue has been growing at a faster pace and is more responsive to economic growth than state revenue. Revenue from taxes—excise, corporate profit, value-added, road, etc.—can be redistributed or partly reallocated to local governments to balance disparities.

In practice, these are the elastic and buoyant sources of revenue that belong to the federal and state governments, leaving the less lucrative and inelastic sources, which do not normally correspond to rising expenditures, to local governments. Amendment or redistribution of revenue from the following taxes will enhance the financial position of local governments:

- Taxes on motor vehicles through road licenses and transfers, especially in large municipalities and cities. The annual transfer or partial reallocation of these taxes will produce substantial income for local governments.
- Taxes on local products, especially agricultural produce, which is controlled by a marketing monopoly. These taxes should be handled carefully to avoid discouraging production.
- Entertainment taxes on hotels, restaurants, cinemas, etc. These taxes are easy to administer and equitable.
- *Octroi*, a tax on goods entering a municipal or local area for use, sale, or consumption. The tax is collected by municipal customs posts and is a substantial and buoyant revenue source. The tax is levied in various areas of India, Nepal, and Pakistan to support a range of devolved functions, including expenditure on education and health.
- Local sales taxes. These are buoyant and can be elastic depending on the economic activities in the area.
- Stamp duty grant, a surcharge on stamp duty to the extent of 0.5%. The additional income is passed on to local governments in villages.
- Forest revenue grants, also given to village governments. The amount is equal to 2% of the amount of gross revenue realized from forests and has to be utilized for forestry development activities.
- Betterment taxes or valorization charges on the increase in land values resulting from the provision of infrastructure, payable by the land owner and widely used in Latin America to finance urban infrastructure.
- Poll taxes, which are flat-rate taxes on every adult (or every working adult). While relatively easy to administer, the taxes are clearly regressive and most unpopular. An experiment with poll tax (community charge) in the United Kingdom was

abandoned because of the tax's perceived unfairness, which led to high evasion rates and high collection costs.

- Surcharge on vehicle fuel, which can be collected through the oil companies. The surcharge will only marginally reduce fuel usage but will benefit the local government.
- Taxes on utility bills, notably on electricity, telephone, and water. A surcharge is added to the bills and passed on to the local governments. It is relatively equitable and easy to administer, and taxes the rich and not the poor. The problem is that the surcharge distorts prices and may discourage people from consuming too much of the utility.
- Other high-yielding and equitable local taxes. These should be considered if collection costs are low. For example, in Labuan, the local government imposes a small tax on every ferry ticket sold. This mode of transportation is popular and a good source of income.

Taxes, however, may have conflicting objectives. A local government may want to eliminate some local revenue sources that are inequitable and low yielding and have high collection costs, and select those that are high yielding. A local government may also want to choose taxes or surcharges that will least damage the economy and people (Phang 1997, pp.72–82).

Improving the System of Revenue Administration

Management must be improved to strengthen local governments' revenue performance. Poor administration has resulted in poor monitoring, delayed revenue collection, and substantial revenue collection outstanding. Local governments should aim for more efficient and effective collection and utilization of revenue resources and to have a set of performance standards against which to measure actual performance. Financial management and reporting still lag far behind international standards. Local governments should know the cost and return of their activities. Unless they have high social costs, unprofitable projects and activities should be abandoned. The financial system needs to meet international standards to allow local governments to monitor and compare the progress of revenue and expenditure throughout the year. Administrative costs, unless controlled, can absorb an excessive proportion of local resources and revenue.

The registration list of taxpayers should be improved and updated. All properties should be revalued every 5 years. People should be encouraged to pay their dues on time through an incentive method supplemented by personal contact and persuasion. An enforcement system should be in place to address difficult cases.

For other sources of revenue, notably charges and fees, tariffs should be revised, either annually or on some other regular basis, in accordance with the elasticity of revenue with the growth of GDP to ensure that revenues increase in parallel to inflation. Local governments must ensure that the correct amount is paid and on time, money collected is accounted for, records are checked and cross-checked, and random spot-checks are carried out by senior management.

All revenue and administration costs should be minimized through efficient collection and prudent monitoring of recurrent spending. The local government budget can be used for policy making, management, and control to ensure that expenditures do not exceed revenues. The budget shows local government priorities, including allocation of funds for different departments, expenditure patterns, and income sources. More important, the budget shows the direction of development and the services to be provided.

Community involvement needs to be pursued vigorously. For any development program to be successful, public participation has to be fostered and encouraged. Through voluntary organizations and residents' associations, the communities can be mobilized to help their local governments. Community participation and involvement help reduce expenditures. Encouraging local participation creates awareness of the role of the local government and, eventually, pride in it. Public participation and cooperation are lacking and need to be nurtured to benefit communities and local governments.

Urban management will be directly related to urban finance. With the country's fast-paced development, local government will be further implicated in all things urban, particularly infrastructure. Local government in Malaysia has maintained, rather than developed, services, mainly because of lack of funds. Expanding revenue and increasing income are not easy: tapping sources yet unexplored and from other countries may appear appropriate but needs to be investigated further, and the skills and experience to do it need to be developed.

The Importance of Bond Financing

In the last decade, the bond market has been transformed from one dominated by government bonds to one with a more balanced mix of public sector, quasi-government, and private sector bonds. Such rapid growth reflects the expanding private sector's financing needs, especially for corporate debt restructuring arising from the financial crisis.

Initially, the federal Government issued bonds to meet the investment needs of the Employees' Provident Fund as well as to partly fund the government budget deficit. More and more bonds were issued as public expenditure increased in the 1970s and early 1980s, which saw outstanding government bonds growing at an average rate of 17% during 1970–1985.

In December 1986, Bank Negara Malaysia (BNM) took the first step in developing the private debt securities (PDS) market by setting up Cagamas Berhad, the national mortgage corporation, to provide liquidity assistance to banks to allow them to make affordable housing loans. Within a year of the Cagamas bond issue, the outstanding amount of PDS increased to RM976 million from RM395 million (Cagamas *Annual Report* 1987).

The PDS market came to life in the mid-1980s when conventional bank borrowing was found to be inadequate to fund private sector long-term infrastructure and development projects. The federal Government realized that it needed to develop the PDS market to enable the private sector to tap alternative sources of financing.

The Asian financial crisis has highlighted the problems of excessive reliance on bank financing by corporations and the critical need for a balanced mix of equity and bonds as financing and investment choices in the capital market. Since then, governments affected by the crisis have acknowledged that the region should develop deeper, longer-maturity, more stable, and more transparent debt markets.

A survey by Hong Kong, China, in August 1998 revealed that the potential to develop bond markets in Asia is enormous in view of the generally high savings rates and low ratios of bonds to GDP. Outstanding bonds in the Asia-Pacific Economic Cooperation forum member economies, excluding the United States (US) and Japan, represented on average only 34% of their GDP, compared to 105% for all the member economies in mid-1998, indicating that bond markets in the region are generally underdeveloped and have much room for improvement.

To raise funds from external sources, corporations can either increase their equity capital by issuing new shares or raise debt. Debt can be raised directly from banks or by the issue of corporate bonds. While issuing bonds is more complicated than direct borrowing, they are normally the cheapest way to raise debt financing as the ultimate financiers of a bond issue are the investors, and bonds are negotiable instruments. Unlike shares, bond financing does not dilute the equity base, and bondholders do not interfere in company management as they are deemed creditors, not shareholders, of the corporation. While shares have to be traded on an exchange, the market place for bonds is global. Bond trading can be conducted via intermediaries, spread out over the vast network of the telecommunications system. Fund raising and investment are not, therefore, limited to the domestic market.

Bonds may also be more attractive to investors than shares in that the regular coupon payments provide investors with a steady income stream while preserving the principal sum. As a low-risk asset, bonds are a safer investment than shares because, as long as the issuer does not default, the investor gets paid the coupons whether or not the company makes a profit. If the borrower becomes insolvent, bondholders, as providers of loan capital, have a prior claim on the company's assets. Bond yields are also often higher than the interest received from bank savings and deposits. The high liquidity of bonds makes them highly marketable as investors are able to sell their bonds, converting the investment into cash when needed.

However, investing in bonds is not without risk. For instance, issuers might delay or miss coupon payments. Then, credit-rating agencies warn investors of possible default or of the likelihood of the issuer making timely repayments of principal and interest over the life of the bond.

The creation of Rating Agency Malaysia (RAM) in 1990 and Malaysian Rating Corporation Berhad in 1996 have helped create a sound corporate governance system that assures shareholders and creditors of a return on their investment.

Recent Developments in the Bond Market

The ringgit bond market expanded in 2001 and has increased in importance as a source of financing due to low interest rates and ample liquidity, increased recourse to the bond market for long-term financing, and intensified debt restructuring. The expansionary fiscal stance of the federal Government resulted in significantly higher issuance of Malaysian government securities (MGS) to finance the fiscal deficit, which continued to provide a benchmark yield curve for the ringgit bond market. Total net funds raised in the bond market remained high at RM31.5 billion, accounting for 83.7% of total funds raised in the capital market (Table 12). As of end-2001, outstanding ringgit bonds had risen by 13.3% to RM275.8 billion from RM243.6 billion as of end-2000 (BNM 2001, p.167). In the primary market, the public sector raised net funds of RM15.2 billion in 2001, and the federal Government issued and reopened four MGS issues.

To finance its fiscal stimulus programs, the federal Government raised new issues, which were also the rollover of maturing issues, to enhance secondary-market liquidity. MGS were issued quarterly, at RM5 billion each in the first three quarters, and RM6.5 billion in the fourth quarter. Three MGS were reopening of existing MGS (BNM 2001, p.167).

Government investment issues and Khazanah bonds (see below) were issued to roll over existing issues. In November 2001 the Malaysia Savings Bonds Series 02, issued in November 1999, matured. The federal Government announced in the 2002 budget that BNM would issue the third series of the savings bond, Malaysia Savings Bonds Series 03, for subscription by senior citizens and charitable organi-

Table 12. Funds Raised in the Bond Market (RM million)

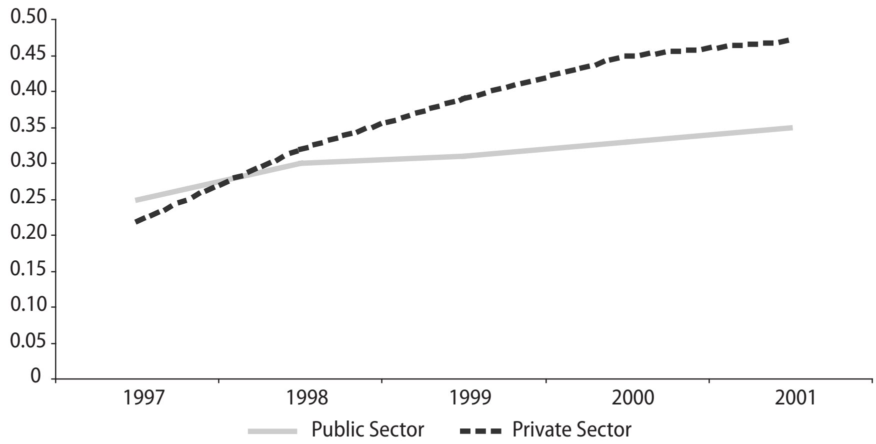
	2000	2001
By the Public Sector		
Government Securities, gross	16,413	23,087
Less Redemptions	5,286	7,100
Equals Net Federal Receipts	11,128	15,987
Khazanah Bonds (net)	551	-220
Government Investment Issues (net)	2,000	-195
Malaysia Savings Bond (net)	-19	-359
Net Funds Raised by the Public Sector	13,659	15,213
By the Private Sector		
Private Debt Securities, gross	30,953	37,220
Straight Bonds	12,940	13,813
Bonds with Warrants	0	913
Convertible Bonds	1,944	1,328
Islamic Bonds	7,666	13,501
Asset Backed Securities	0	1,235
Cagamas Bonds	8,403	6,430
Less Redemptions	10,459	20,890
Private Debt Securities	6,205	15,575
Cagamas Bonds	4,254	5,315
Net Funds Raised by the Private Sector	20,494	16,330
Net Funds Raised in the Bond Market	34,153	31,544
Net Issues of Short-term Securities	-1,482	-2,093
Total	**32,671**	**29,451**

Source: Bank Negara Malaysia. *Annual Report 2001.*

zations to mitigate the impact of low interest rates on their incomes, which were primarily dependent on income from deposits in banking institutions. The series was offered in January 2002.

The private sector also turned to the bond market to raise funds for medium- and long-term financing. Many companies issued PDS to lock in financing at low interest rates. With ample liquidity and uncertainties in the equity markets, investors preferred more stable investment options. In 2001, the value of new PDS issues increased to RM37.2 billion. After netting off redemptions of RM20.9 billion, however, total net funds raised were lower at RM16.3 billion, after RM20.5 billion in 2000 (Table 12). The high redemptions were due partly to early redemptions by a major corporation under a debt-restructuring scheme. In aggregate, total PDS outstanding increased by 13.1% to RM158.4 billion or 47.6% of GDP (41.1% at the end of 2000). The equity market raised only RM6.1 billion, and the PDS market thus remained the main source of financing in the capital market for the private sector (Figure 2).

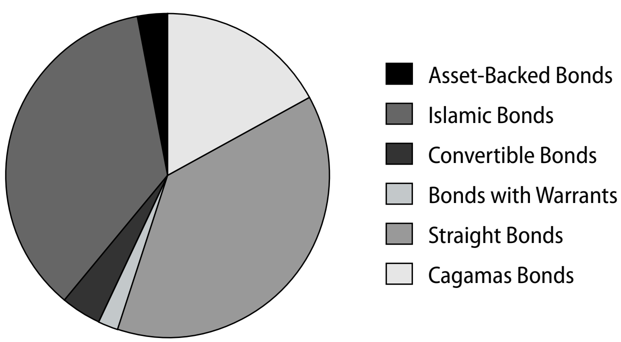
Figure 2. Ratio of Bonds Outstanding to Gross Domestic Product



Straight bonds and Islamic PDS were the most popular forms of funding in 2001. Of total proposed PDS issues rated by RAM, 35% were medium-term bonds (5–7 years) while 60% were long-term bonds (more than 7 years). Meanwhile, higher demand for Islamic instruments was seen (Figure 3). Privatized water and power projects have been successfully funded by Islamic PDS. The issuance of bonds with warrants and of convertible bonds, however, remained small.

A notable development in the PDS market during the year was the introduction of the Guidelines on the Issuance of Asset-Backed Debt Securities (ABS) by the Securities Commission. Total issuance of ABS amounted to RM1.2 billion in 2001. The interest in issuance of ABS reflected the benefits accruing to originators and investors. From the originators' perspective, securitization provides a vehicle to transform illiquid financial assets into liquid assets and enables the originator to

Figure 3. Private Debt Securities Issued in 2001 by Type of Instrument (%)



achieve more efficient and cheaper financing as ABS generally carry a higher rating than the long-term credit rating of the originator. This is because payments to investors for such debt securities are principally derived, directly or indirectly, from the cash flows on them. Thus, the credit rating of such debt securities is derived from the quality of the underlying assets and not the credit standing of the originator of the assets, as is the case in debt securities issued by the corporation itself. From the investors' perspective, ABS widens the selection of fixed-income products in the bond market.

Cagamas has maintained its position as an active issuer in the PDS market, accounting for 17.3% of total issues. Cagamas reopened seven of its existing fixed-rate bonds to enlarge the size of existing issues, thereby enhancing the liquidity of Cagamas bonds in the secondary market. For the first time, Cagamas issued 10-year fixed-rate bonds in December 2001 to fund its purchases of housing loans for a 10-year tenor, enabling Cagamas to develop a long-term yield curve for its debt securities and, therefore, to price purchases of loans, particularly for the longer tenors, at market rates.

Utility and infrastructure companies were among the largest issuers of PDS, accounting for 30.0% and 16.1% of the total new issues, respectively. Major issuers within this sector were independent power producers and toll road concessionaires, which required long-term financing of more than 10 years for their projects. Manufacturing companies also increasingly tapped the PDS market, accounting for about 7.5% of the total PDS issues in 2001 (Table 13). Debt restructuring of a few large and strategic corporations was reflected in higher new issues of PDS in the federal Government and other sectors. Issues were made by special-purpose vehicles (SPVs), which were set up during the year, as part of the federal Government's commitment to accelerate the corporate restructuring process to strengthen investor confidence.

Table 13. New Issues of Private Debt Securities by Sector (RM million)

	2000		2001	
		% share		% share
Agriculture, Hunting, Forestry, and Fishing	42.5	0.2	26.6	0.1
Mining and Quarrying	0.0	0.0	0.0	0.0
Manufacturing	1,354.6	6.0	2,512.0	7.5
Electricity, Gas, and Water Supply	4,564.1	20.2	10,006.9	30.0
Wholesale and Retail Trade, Restaurants, and Hotels	1853.9	8.2	420.0	1.3
Construction	2,006.3	8.9	3,299.9	9.9
Transport, Storage, and Communications	7,320.3	32.5	5,374.5	16.1
Financing, Insurance, Real Estate, and Business Services	5,108.3	22.7	5,103.2	15.3
Government and Others	300.0	1.3	6,598.2	19.8

The maturity of bonds issued by these SPVs has been appropriately sequenced. The issuance of bonds was accompanied by other debt and operational restructuring to improve the financial and operational capacities of the corporation to generate the cash flow to redeem the bonds. Of the total PDS issued, 41.6% were for new activities, 37.7% for refinancing, and 20.7% for restructuring, which was a positive development as a significant share would be used to generate new economic activities. In 2000, the bulk of PDS issued were for restructuring purposes (Figure 4).

Trading in the secondary market for ringgit bonds was sharply higher in 2001, which augured well for the deepening of the bond market. Trading volume increased by 49% and was valued at RM378.2 billion in 2001 (RM253.8 billion in 2000). Similarly, liquidity in the bond market, as measured by the ratio of trading volume to total outstanding, also rose to 137.1% (104.2% in 2000). Higher trading activity was mainly due to the higher supply of MGS, which were the most actively traded paper, rising by 148.2% and accounting for 58.2% of total trading activities (34.9% in 2000) (Figure 5). The volume traded was highest in the third quarter. Expectations of a possible reduction in interest rates prompted investors to take longer positions in the bond market, especially in risk-free paper. Bond investors were also switching to government and quasi-government paper due to their more stable returns.

In contrast, secondary trading for Cagamas bonds declined sharply by 11.4%, accounting for 6.9% of total trade (11.5% in 2000). With the low interest rates, trading interest was skewed to long-maturity paper such as MGS. Most Cagamas bonds were issued for 2–3 years. Cagamas bonds were also relatively small (RM200 million–400 million), affecting the liquidity of Cagamas paper. Despite investors' interest being centered on MGS, demand for PDS with high ratings and good quality remained strong. Nevertheless, the share of PDS turnover declined to 29.4% of total trade (from 45.9% in 2000).

Figure 4. Utilization of Proceeds from Private Debt Securities (%)

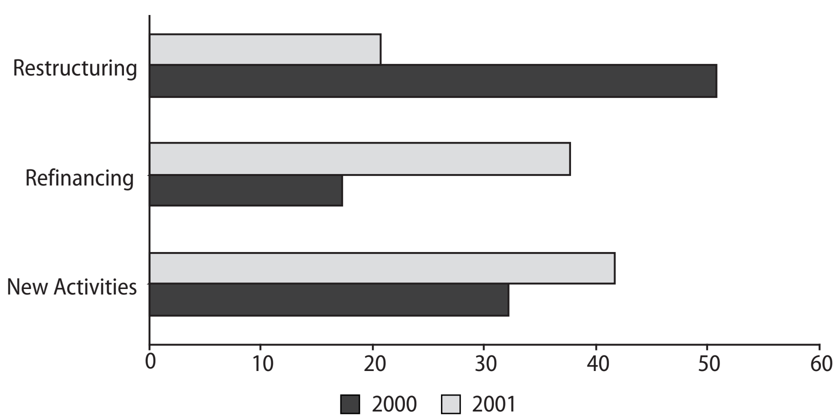
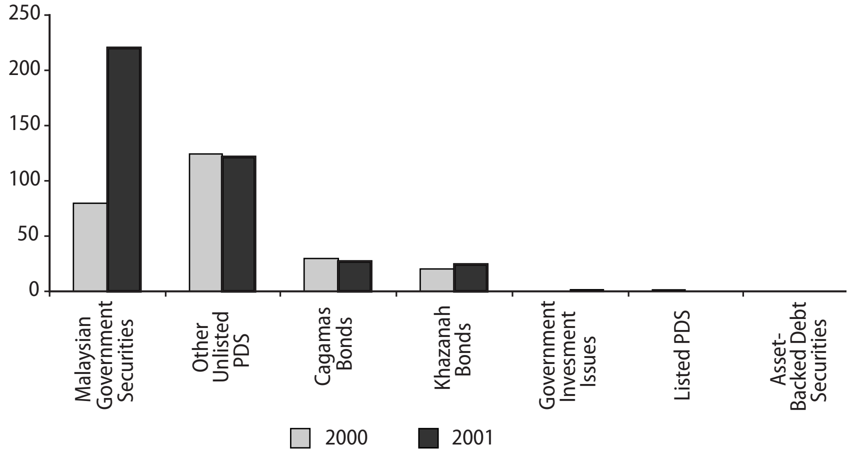


Figure 5. Trading of Ringgit Bonds (RM billion)



PDS = private debt securities.

Several measures have been introduced to develop the bond market: production of guidelines on issuing ABS, relaxation of restrictions on the use of proceeds from issuance of PDS, and guidelines on the securities borrowing and lending program under the real-time electronic transfer of funds and securities system (SPEEDS).

Viability of Bond Financing for Local Government

Impact on Monetary and Fiscal Policy

One major setback of bond financing for local government is the difficulty of streamlining local and federal government budgetary policies. The decision on the form of the federal Government's policy—whether it should be contractionary, expansionary, or a balanced budget—is based on the actual and future direction of the national and international economic environment. Keeping inflation stable and unemployment low is always crucial at the federal level. The federal Government needs to ensure that the volume of money and credit is suitable for the required level of interest and exchange rates to move general economic activities in line with the targeted price level.

Although it should not be seen as an obstacle to bond financing, monetary and fiscal policy sheds light on the importance of clear regulations and guidelines to bring local government financing in line with national economic objectives. For example, the federal Government should determine and allocate the amount of borrowing for each state in line with national budget objectives. The allocation process needs a clear formula.

Local governments submit their budget and project proposals to the state governments, which, in turn, forward them to the Budget Division of the Ministry of Finance. Bond and market financing will require the involvement of the central bank and the Securities Commission. Thus, a mechanism involving the local government, state government, Ministry of Finance, central bank, and Securities Commission needs to be formulated.

Constitutional Restrictions on Borrowing

Local governments may raise loans from the market with the approval of the state government (Local Government Act 1976 for peninsular Malaysia, Local Government Ordinance 1961 for Sabah, and Local Government Ordinance 1948 for Sarawak).

These acts do not hinder local governments from raising market loans or issuing bonds because planning, development programs, and local government activities are carried out under state advice and supervision where local government presidents are directly answerable to the state assembly. The state government always supports local government efforts to raise capital as it helps the state government implement its own development plan.

However, the state government's room for maneuver is limited by the Constitution, which provides that state governments cannot give any guarantees except with the approval of the federal Government and subject to such conditions as may be specified by it (article 111[22]). Borrowing includes raising money by granting annuities or by entering into any arrangement that requires payment before the due date of any taxes, rates, royalties, fees, or any other payment; or by entering into any agreement by which the government has to repay or refund any benefits it has enjoyed under the agreement (article 160). The federal Government can borrow from domestic and foreign sources.

The state government can borrow only from the federal Government or from a bank or other financial sources approved for that purpose by the federal Government, for not more than 5 years. Before the 1976 Constitutional Amendment, the state government could only borrow from the federal Government or from any approved bank for not more than 12 months. Thus, the federal Government not only has the absolute power to borrow for its financial requirements, but also to determine the aggregate guarantees given by the state government. The federal Government also prescribes the terms and conditions that apply to all loans raised by the state government, and state-guaranteed loans. State governments borrow almost entirely from the federal Government (Tables 5 and 6). In turn, local governments borrow almost entirely from the state and federal governments.

Inadequacy of Financial Reporting and Transparency

Before local government bond financing starts, accounting should be made transparent. Local governments are required to submit their audited financial statements to the state government every year. Bond financing, however, will require much more detailed information. While some weaknesses in the accounting standards of local governments are technical and can be easily rectified, full information disclosure as required by rating agencies may be difficult to fulfill due to social and political implications. Rating agencies should be able to explore, examine, and analyze all information and data related to local government activities. Thus, accounting, auditing, and disclosure standards must be made transparent before local governments undertake bond financing (Fabozzi 1997).

Transparent information is critical for the overall growth of the bond market, and an active secondary market is also highly dependent on the availability of information to all market participants. The federal Government launched the Bond Information and Dissemination System (BIDS) in October 1997 to facilitate pricing, trading, and revaluation of securities information on MGS and PDS. BIDS provides a comprehensive database on the government and PDS market, and stock and facility information on all ringgit-denominated nonequity-linked debt securities, as well as their last traded prices and volumes (Bee and Choy 2001, p.397). In 1999, BNM integrated certain functions of the fully automated system for tendering (FAST) with BIDS to improve its operating efficiency.

Bond Market Infrastructure

The capital market, particularly the PDS market, is still young. However, it is developing fast and equipping itself with the necessary institutional and regulatory infrastructure and will be able to accommodate local bond issuance.

Tendering, Trading, and Settlement System

The foundation for an efficient tendering, trading, and settlement system was formed when the interbank fund transfer system was introduced in 1989. In December 1990, the scripless securities trading system was introduced to accommodate the electronic settlement of deals between parties and the registration of securities in banks' and customers' accounts. At that time, the scripless system only covered government securities. With the increasing number of PDS, an efficient, fully automated clearing system was set up for them—SPEEDS. In January 1996, the system was upgraded to serve as the central depository and paying agent for all unlisted bonds. Market participants now use the real-time electronic transfer of funds system (RENTAS), which replaced SPEEDS in July 1999. RENTAS enables real-time delivery against payment for electronic book-entry settlements and is set up as a real-time gross settlement system to continuously process and undertake final settlement of funds. RENTAS enables transfer instructions on securities and funds to be effected on a trade-by-trade basis, with the final transfer of the securities from the seller to the buyer occurring at the same time as the final transfer of funds from the buyer to the seller. RENTAS can also handle partial redemption, multiple interest payments, and reopening of existing stocks, which SPEEDS could not (Norashikin 2000, p.108). With the introduction of RENTAS, Malaysia became the 29th country in the world and the seventh in Asia to use a real-time gross settlement system for interbank payments and securities transactions.

In September 1996, BNM launched FAST to replace the tender form submission by principal dealers in bidding for government securities. Later, FAST's scope was extended to cover commercial paper, medium-term notes, Khazanah bonds, and corporate bonds. The issuer of securities or facility agent invites tenders by posting the information (type of securities, tender date, issuance date, maturity date, issue size, and other details) in FAST, 3 business days before the tender date. FAST members who are principal dealers can submit their bids electronically from their workstations through a secure network to a central host computer at BNM. Nonprincipal dealers must, however, route their bids through the principal dealers' directory. All bids must be submitted before the cut-off time, after which the system automatically ranks, sorts, and allots the successful bidders on the basis of the lowest yield and highest price until all the stocks are fully allotted (Norashikin 2000, p.107; Bee and Choy 2001, p.398).

Benchmark Yield Curve

MGS and Khazanah bonds are used to construct the yield curve. Government securities are free from default risk. The MGS yield curve is not limited to government or quasi-government bonds, but is also useful and widely used to determine bond prices and yield in other debt markets such as the corporate bond market.

Bond yields in all tenors declined steadily throughout 2001. MGS declined from around 6% in December 2000 to 4.5% in December 2001. MGS has not proven to be a good benchmark because of its irregular issuance. Insurance companies and pension funds are legally required to invest in these securities. As the funds grow, the more they must purchase government securities, and unless the rate of new issuance keeps pace, more securities will be locked up and not traded. Such artificial demand disturbs yields and discourages independent assessment of other investment opportunities (Bee and Choy 2001, p.395).

To overcome the inadequacy and weakness of MGS as a benchmark yield curve, the federal Government set up Khazanah Nasional Berhad in September 1997 to issue bonds, later known as Khazanah bonds, which are Islamic zero-coupon bonds, guaranteed by the federal Government and issued quarterly by way of competitive tender through principal dealers. The bonds' covering maturities are 3, 5, 7, and 10 years, with the issue size ranging from RM1 billion to RM2 billion.

The 3-year MGS fell from 4.02% at the end of 1999 to 3.07% at the end of 2000. The same trend was observed for the 10-year MGS, which had fallen by 188 basis points. Yields for other paper such as the 3-year Khazanah and Cagamas bonds also trended lower, with narrowing yield differentials vis-à-vis MGS. Yield differentials between 3-year Cagamas bonds and 3-year MGS in the secondary market were 6–18 points. The narrow spreads enabled Cagamas to continue to provide low-cost funds to financial institutions. The declining yield trend was due to market expectations of further reduction in interest rates, continued ample liquidity in the market, and the shift of investments from equities to bonds in a volatile global stock market. Yields fell further in September following further interest rate cuts in the US and the reduction in the 3-month BNM intervention rate. In December, however, yields rose slightly due to the expectations of interest rates bottoming out, in line with the shifting of yield curves in the regional markets, following indications of a US economic recovery.

Rating Agency

All issues, offers, or invitations that come within the scope of the Guidelines for Rating Agencies must be rated by a rating agency recognized by the Securities Commission, unless it otherwise allows. An indicative rating must have been obtained by the issuer when declarations and information were submitted to the Securities Commission.

Malaysia has two credit-rating agencies, RAM and Malaysian Rating Corporation Berhad, whose professionalism has gained them the confidence of the market. In February 1998, RAM, in collaboration with Quant Shop Pty Ltd., an Australian company, constructed a bond index called RAM-Quantshop MGS, which provides up-to-date information on the risk, return, and interrelationships of different MGS maturity terms and is a useful guide for portfolio managers to select securities and allocate assets across broad markets. Since April 1996, RAM has published a monthly bond index that measures the overall performance of the corporate bond market.

Requests for ratings are numerous as corporations, especially those with strong credit ratings, shift to bonds as a cheaper funding option. In 2001, RAM completed

88 new ratings with the proposed gross issue valued at RM27.1 billion. Long-term issues represented 76% and 87% of the total number and gross issue values, respectively. Meanwhile, Malaysia Rating Corporation Berhad completed 29 new corporate debt ratings with a total rated value of RM9.5 billion. The rated issues are generally concentrated on the AA and A categories, as companies with good credit quality take advantage of the relatively easy access to the bond market.

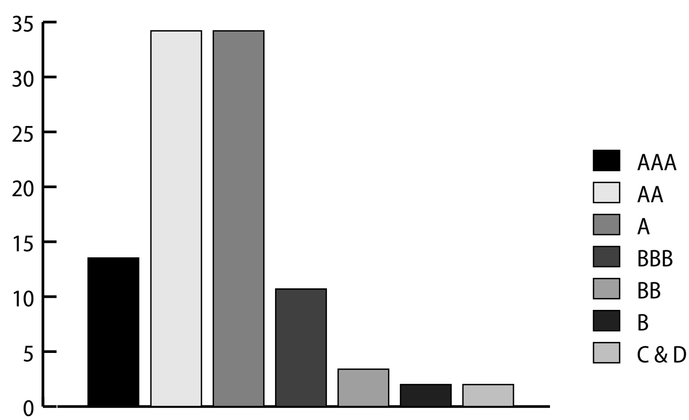
Of 192 rating views of existing long-term debt securities conducted by RAM and Malaysian Rating Corporation Berhad, 153 were affirmations and/or reaffirmations, 14 were upgrades, while 25 were downgrades. As of the end of 2001, the bulk of the long-term bonds were in the AA and A categories (Figure 6).

Regulatory Structure

Two bodies are responsible for private debt issuance in Malaysia—BNM and the Securities Commission. BNM regulates debt issue by private limited companies while the Securities Commission regulates debt issue by public and listed companies. The Registrar of Companies (ROC) and Kuala Lumpur Stock Exchange will be involved in public issue and listing.

The Securities Commission was established on 1 March 1993 and aims to consolidate and streamline regulations, and regulate and promote the development of the capital market. Beginning on 1 July 2000, the Securities Commission became the sole regulator of activities for raising funds. ROC falls under the Ministry of Domestic Trade and Consumer Affairs and has extensive powers under the Company Act 1965, which lays down the statutory requirements and policies on disclosure of information and compels a corporation to issue a prospectus before it raises money from the public. The act further stipulates that the prospectus must be registered

Figure 6. Rating Distribution of Outstanding Private Debt Securities (December 2001)



with ROC and undertake that the corporation will issue to that person a document acknowledging the indebtedness after acceptance of any money, deposit, or loan.

The local government needs the approval of the state government and Ministry of Finance before issuing bonds as required by the Local Government Act 1976, which states that any such monies may be invested in securities in which trustees are empowered to invest, or in such other manner as authorized by the minister of finance (section 40). On upper-level government involvement, the Trustee Act 1949 states that the trustee may invest any trust funds in any government securities, securities whose interest payment is guaranteed by Parliament or the federal Government, and fixed-interest securities issued with the approval of the Treasury by any public government established under federal or state law (section 4).

Guidelines for Private Debt Securities Issuance

PDS issued by public companies and able to be converted into equity (convertible loan stocks, irredeemable convertible loan stocks, and convertible bonds) are covered by PDS guidelines as well as the Securities Commission's Policies and Guidelines on Issue/Offer of Securities, which cover the following:

Types of PDS. PDS are bonds, notes, loan stocks, and commercial paper, convertible into equity or not, and redeemable or otherwise.

Documents and Information Required. The issuer and advisor must submit to the Securities Commission the declarations and information pertaining to the issue, offer, or invitation. The Securities Commission may require additional information, including due-diligence reports and rating reports, if applicable, for post-vetting.

Time Frame for Approvals from the Securities Commission. In the following cases, the Securities Commission will give its approval within 14 working days from the date of receipt of all declarations and information as required: (i) any issue, offer, or invitation in respect of private debt securities that are not capable of being converted into equity; (ii) any issue, offer, or invitation in respect of private debt securities, together with warrants, that are not capable of being converted into equity; and (iii) any issue, offer, or invitation of PDS by a private company.

Underwriting. The underwriting of any issue, offer, or invitation will be decided by the issuer and its advisor. Should they decide that no underwriting is required, the issuer must state the minimum level of subscription necessary to achieve the funding objectives.

Minimum Denomination. Except for Islamic PDS, any issue, offer, or invitation in respect of PDS must be denominated in an amount not less than RM1,000, and in multiples of RM1,000 at the time of issuance.

Mode of Issue. All issues of PDS must be reported and/or tendered on FAST unless a listing is sought on any Malaysian stock exchange. Issuers and advisors must ensure that such issues comply with all rules and requirements of FAST.

Except for commercial paper and medium-term note programs, all issues of PDS must be made under RENTAS unless a listing is sought on any Malaysian stock exchange. Issuers and advisors must ensure that such issues comply with all rules and requirements of RENTAS.

Utilization of Proceeds. Any funds raised from any issue, offer, or invitation in Malaysia must not be channeled to finance such activities as may be announced by the National Bond Market Committee.

Additional Requirements for Islamic Private Debt Securities. The issuer must appoint either of the following:

- independent Shari'ah[4] advisors approved by the Securities Commission who meet the following criteria: (i) are not bankrupt; (ii) have not been convicted of any offense arising out of a criminal proceeding; (iii) are of good repute; (iv) possess the relevant qualifications and expertise, particularly in *fiqh muamalah*[5] and Islamic jurisprudence, and have at least 3 years experience in or exposure to Islamic finance; or
- the Shari'ah committee of an Islamic bank or a licensed institution approved by BNM to carry out Islamic banking, to advise on all aspects of the Islamic PDS, including documentation, structuring, investment, as well as other administrative and operational matters.

Options for Local Government Bond Financing

Local government bond financing should be consistent with the constitutional and regulatory framework as it cannot be expected to be amended. The bond-financing proposal should not be linked to power allocation between state and federal governments, which is complicated and unresolvable. However, this restriction can be positively utilized as a monitoring tool for state and local government expenditure by the federal Government. The practice of local government submitting project proposals to the state for funding should, therefore, be continued.

The local government can issue bonds in three ways:

- **Create business corporations that issue bonds**. This approach, which requires local government involvement in business, may have difficulty obtaining approval from the federal Government since other government subsidiaries perform below par.

- **Issue bonds directly**. The federal Government should not waive the rating requirements for the local government, so as to encourage it to compete for a good rating and thus improve its performance in the long run. However, local governments might be reluctant to disclose information deemed socially sensitive.
- **Issue ABS**. This approach is workable since local governments have a significant number of assets, some of which, such as parking lots and shop lots, generate stable cash flow through assessment taxes. Such assets can be securitized for bond issuance. ABS are private debt securities issued pursuant to a securitization transaction and exclude all debt securities convertible into equity, redeemable or otherwise. Excluded debt securities include exchangeable bonds and private debt securities with attached warrants.

The rating agency will rate only the asset, not the local government, as the latter can choose to securitize only those assets that do not contain socially sensitive information. Therefore, to rate the local government instead of their assets can, in effect, render the rating bias less representative.

Securitization will bring many benefits to issuers and investors. For issuers, it offers cheaper and more efficient funding for operations combined with greater balance-sheet flexibility. For investors, it provides a broad selection of fixed-income alternatives.

Under Securities Commission guidelines, assets to be securitized must fulfill all of the following criteria:

- the assets generate cash flow;
- the originator (the local government or its agency) has a valid and enforceable interest in the assets and in the cash flows of the assets before any securitization transaction;
- no impediments (contractual or otherwise) prevent the effective transfer of the assets or the rights in relation to such assets from an originator to an SPV;
- the assets are transferred at fair value;
- no trust or third-party interest competes with the originator over the assets; and
- where the interest of the originator in the assets is as a chargee, the charge must have been created more than 6 months before the transfer.

Where the issue, offer, or invitation of ABS is Islamic, the assets to be securitized must be acceptable to the tenets of Shari'ah. In the event of doubt, clarification should be sought from the Shari'ah Advisory Council of the Securities Commission.

The assets to be securitized have to be transferred to an SPV, which must be resident in Malaysia for tax purposes and also have independent and professional directors or trustees. Securities Commission guidelines require the following of an SPV:

- An SPV must not enter into activities not incidental to its function in a securitization transaction.
- An SPV must subcontract to third parties all services that may be required by it to maintain the SPV and its assets.
- An SPV must not have employees or incur any fiduciary responsibilities to third parties other than those involved in the securitization transaction.
- All liabilities, present or future, of an SPV (including tax) must be quantifiable and capable of being met out of resources available to it.
- An SPV must maintain accounts and records of its assets, liabilities, income, and expenditure, and comply with all other regulatory reporting requirements in respect of ABS issue, offer, or invitation. An SPV must ensure that its assets are managed with due care and in the best interests of ABS holders.

If no prospectus is required, an information memorandum must be made available to the investors and contain at least the following:

- risk factors of investing in the ABS;
- detailed description of the structure of the securitization transaction and all significant agreements relevant to the structure;
- corporate profile of all parties;
- detailed description of the securitized assets, including the cash-flow profile, aging of cash flows, and, if available, historic levels of arrears or rates of default for the portfolio of assets and stress levels of cash flows;
- an explanation on the flow of funds stating the following:
    - how the cash flow from the assets is expected to meet an SPV's obligations to ABS holders, and parameters for investing temporary liquidity surpluses;
    - how payments are collected;
    - order of priority of payments to the holders of different classes of private debt securities;
    - details of any other arrangements on which payments of interest and principal to investors are dependent;
    - information regarding the accumulation of surpluses in an SPV; and
    - details of any subordinated debt securities;
- measurement of the fair value of securitized assets, including the methodology used to determine such fair value and the key assumptions involved;
- terms and conditions of the ABS;

- information on credit enhancement and liquidity facilities, if any, provided to the securitization transaction, including an indication of where material potential shortfalls are expected to occur;
- a summary of the rating report which, among other matters, will highlight the key risk factors in the securitization transaction;
- any fee payable by an SPV, including management fees and expenses charged by the servicer; and
- an explanation of any matter of significance to investors relating to the ABS issue, offer, or invitation to enable investors to make an informed decision.

Conclusions

Although the financial account deficit of local governments is small and many of them are in surplus, the development fund is still insufficient to fulfill the increasing need for high-quality services. The four local governments under study have surpluses achieved through careful planning of expenditure on the basis of certain revenues. When expected income increases, a surplus is generated because expenditure, which is already planned, does not change. However, local governments are not flexible and dynamic, and they become passive after business plans have been drafted.

In terms of infrastructure, some local governments choose to defer payments in carrying out important projects, but few contractors are willing to spend their money and to wait long for returns. If the parties agree, they can incorporate the waiting period into the project cost.

Bond financing could solve the financial problems of local governments. State and local governments are expected to iron out the constitutional and legislative problems impeding bond financing. The federal Government, particularly the Treasury, will be responsible for supervision and monitoring of bond financing.

This approach, if implemented, would increase the number and volume of quality bonds and would be in line with the federal Government's effort to develop the capital market. Opening doors to rating agencies, which require greater transparency in information disclosure, would also make local government services more efficient.

The lack of benchmarks in bond pricing should be addressed when the supply of new government paper in Malaysia's bond market dwindles, as the shortage of MGS and their captive market can lead to an inefficient pricing of bond issues, which could cause companies to source funds from offshore markets. However, the introduction of the Khazanah bonds has greatly reduced the benchmark problem.

Liquidity in the secondary market should be increased as investors are demanding a higher liquidity risk premium, which increases the funding cost of issuers. Investors are also discouraged from using bank guarantees as they could mask the overall risk profile of the corporate bond market because banks assume the credit risks of the companies they guarantee. ABS should be issued to allow companies to increase their liquidity and financing flexibility.

Local governments should set up an SPV through which they can transfer some of their assets for securitization and bond issuance. This proposal is feasible because most local governments have a large value of fixed and current assets that generate stable income. Fixed assets were RM194 million for MPSA, RM68 million for MPAJ, RM146 million for MPPJ, and RM117 million for MPK in 2000.

International financial institutions, such as the Asian Development Bank (ADB), can help formulate plans and supervise program implementation. Many local governments are expected to have low ratings. ADB can embark on a long-term program to help local governments improve them. Local government officials should be encouraged to acquire the skills to upgrade service provision. ADB can buy the bonds, help the local government find a buyer, or stand as guarantor for the local government.

Finally, bond financing can help local governments pursue Vision 2020, i.e., for the country to become industrialized by 2020.

Endnotes

[1] A source of revenue that is land-based and exclusive to Sabah. Sabah's Local Government Ordinance 1961 allows the local authority to levy and collect *cess*. The Sabah local authority collects land *cess* and cocoa *cess*.

[2] Examples of obnoxious trades are selling pirated video compact discs, running certain entertainment outlets, operating gaming machines, etc.

[3] Indigenous people in Sabah and Sarawak in East Malaysia, and citizens of Malay origin in peninsular Malaysia (West Malaysia).

[4] Islamic law. Shari'ah advisors are members of an Islamic committee and must ensure that Islamic investment instruments do not contradict Islam.

[5] Islamic investment instruments.

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Pakistan

Shahid H. Kardar
Director
A. Ferguson & Co.
Lahore

Acronyms

CDGK	City District Government of Karachi
CDGL	City District Government of Lahore
GDP	gross domestic product
LGO	Local Government Ordinance
NFC	National Finance Commission
NWFP	North-West Frontier Province
O&M	operation and maintenance
PFC	provincial finance commission
PRe/PRs	Pakistan rupee/s
TFC	term finance certificate
US	United States

Executive Summary

This chapter examines bond markets and other debt instruments that are intended to enhance the capacity of subnational governments (provincial and local) to finance infrastructure deficits, stimulate economic growth, and facilitate efficient delivery of economic and social services in Pakistan.

Provinces are exclusively responsible for highways, urban transport, irrigation, and mineral resources. Provincial governments have assigned to local governments responsibility for elementary education, health care services, and local and farm-to-market roads. Historically, provincial and local government tax bases have been narrow because of the highly centralized tax structure, resulting in the federal Government having an almost exclusive preserve over all the major and buoyant taxes and duties. In fact, over 80% of provincial revenue consists of federal tax transfers.

The local tax bases have low elasticity with respect to economic growth. Higher levels of government have also encroached on the revenue bases of lower tiers, resulting in a host of only low-yield taxes left for exploitation by local governments that have buoyancy coefficients in their revenue-generating potential. Consequently, the fiscal health of subnational governments has steadily deteriorated.

Large overall deficits of the provinces have caused an accumulation of debt, the servicing of which takes 18–20% of recurrent expenditures. Substantial contingent liabilities exist in respect of guarantees for loans to public sector enterprises and autonomous corporations.

As the country has no central repository or warehouse for data on local governments, the chapter focuses on the financial situation in general and debt-carrying capacity in particular of the two major, commercially viable, and potentially creditworthy local governments—the city district governments of Karachi and Lahore—to assess their ability to float bonds and service them on the basis of their revenue streams. However, their accounts do not fully capture the extent of the overall deficit because of the structural deficits in coverage and quality of services that do not enter into the calculations of financial deficits.

Subnational governments' ability to carry additional debt is limited unless fiscal space can be created through a combination of revenue mobilization measures, reprofiling and restructuring of the existing stock of debt, and reprioritization of expenditures. The selection of projects to be funded from borrowings and potential direct and indirect revenues from investments will also be critical to determine debt that subnational governments can accumulate and service.

Whereas article 167 of the Constitution allows provincial governments to borrow against the provincial consolidated fund, if they are indebted to the federal Government they can do so only after obtaining its consent. The Constitution empowers the federal Government to impose any conditions it deems proper. Section 120 of the Provincial Local Government Ordinances, 2001 prohibits local governments from incurring debt. Sindh Province and North-West Frontier Province (NWFP) have obtained low-interest structural adjustment loans from multilateral lending agencies to finance priority expenditures. These loans have been guaranteed by the federal Government, which has also agreed to shoulder the associated exchange rate risk.

Since agriculture, irrigation, and other essential physical infrastructure such as roads fall within the functional domain of the provincial governments, the acceleration of growth and its future sustainability requires well-maintained infrastructure, which, in turn, requires much larger allocations than being made now.

Financing of infrastructure has been confined to budgetary support and funds from funding agencies, with fiscal capacity to expand physical and social infrastructure, depending on the nature of the local economy and the size of the tax base. Financing from budgetary sources, however, is becoming increasingly difficult since all levels of government face severe resource constraints. Private sources of funding are, therefore, needed to meet growing demand for local services.

Resources can be supplemented with credit, especially since taxpayers should not have to bear the entire cost of infrastructure provision. Obtaining credit would require removal or modification of legislative, and even constitutional, provisions constraining it unless the role of subnational governments in infrastructure provision can be taken on by the private sector.

Many countries, developed and emerging, have successfully funded their urban infrastructure by accessing capital markets. Infrastructure investments have been financed through debt instruments, commonly domestic bonds floated by subnational governments. In Pakistan, a money market has developed following the launching of financial reforms in the early 1990s. The securities market, including the market for corporate bonds, has shown encouraging growth. An auction system to raise government debt based on two key debt instruments, treasury bills and Pakistan Investment Bonds, has been established, while a new debt instrument—the term finance certificate (TFC)—has been used by the corporate and commercial banking sectors. Thirty-six TFCs worth around PRs20 billion have been issued.

However, in Pakistan, the viability of bond market financing at the provincial government level will require the removal of a number of constraints. A major one is the low rate of domestic savings, at around 12% of gross domestic product (GDP), compared with more than 35% in most Southeast Asian countries. A related weakness is the poor intermediation systems and mechanisms—be they credit or capital markets—to transform savings into investments. The East Asian average for broad money to GDP is over 80%, but is less than 40% for Pakistan, suggesting that low levels of financial development may be a barrier to savings. Constitutional or legislative restrictions placed on subnational governments will also have to be amended. Even if subnational governments could borrow, their ability to borrow against the security of receivables should be clarified.

Regulatory or taxation-related restrictions are placed on the investments (which include instruments issued only by the federal Government) that provident, pension, and life insurance funds can make. These restrictions will have to be lifted or revised to increase the pool of savings available for investment. Provincial stamp duties on financial instruments issued by the private sector (and even those issued by local governments) are high at 5–6%, although securities issued by the federal and provincial governments are exempt from stamp duty.

Other factors inhibiting private financing include the dearth of reliable and timely information on the financial and operational performance of subnational governments (especially local governments), and their limited autonomy and weak accounting and auditing practices and standards.

Investors and financial institutions are not fully conversant with municipal or local government bonds. Hardly any financial institution has a deep understanding of the financial and taxation capabilities of provincial and local governments. Local governments, in particular, have little in-depth familiarity with their own legal, institutional, and regulatory frameworks. A repository of knowledge, data, and indicators on local government operations and finance is lacking, which is perhaps the single most important factor underlying the widely held perception that subnational governments are commercially nonviable. Creating a market for their bonds, especially those issued by local governments, will take time.

If subnational governments are permitted to borrow, they will be able to use their assets to lever additional resources. The need to ensure financial discipline and macroeconomic stability can be met through rule-based controls or through fixing an overall ceiling and subceilings for market borrowings.

If a subnational government is to raise private finance through bonds to fund infrastructure, either projects should have direct revenue streams to service the debt, or resource mobilization from other revenue instruments should be adequate to do this. Projects with good potential to tap capital markets on a stand-alone basis should be identified either on the basis of the expected revenue streams or by securitizing infrastructure assets. Such instruments will require clearly identified project cash flows to become marketable. The legal implications of creating such a security, the possibility and manner of earmarking specific revenue streams for debt servicing, and the reliability of the revenue estimates and cash-flow projections should also be clear. However, the creation of a market for pure revenue-type bonds on a project-specific basis may be difficult.

The market for another type of bond, say the general obligation bond, will depend on the creditworthiness and general fiscal health of the issuing subnational government, whose debt will be serviced from its tax and nontax revenues. Such bonds can be employed to finance projects with low direct financial returns, e.g., investments in education, roads, and public buildings. Given the financial state of local governments, most of the smaller ones will be unable to issue such bonds soon.

Typical local government bonds may have to be structured with risk-mitigating mechanisms, such as provincial government guarantees for early issues of debt instruments, which could be discontinued for subsequent issues. These guarantees would have to be supported by adequate fiscal concessions to investors. International experience suggests that the tax-exempt status of municipal bonds has enabled local governments to raise debt at reasonable interest rates.

To establish a market for debt instruments/bonds issued by subnational governments, rates of return must be at least 2–3 percentage points higher than market rates on bonds issued by the federal Government. Unfortunately, in view of their weak financial position and the revenue-generating instruments they are empowered to wield, few local governments will be able to issue long-tenor bonds. Long-dated fixed securities can, at best, be issued by the large municipalities with sufficient and stable sources. Only Karachi, Lahore, and perhaps Faisalabad will able to access bond markets directly. Therefore, a strategy for financial intermediation should be developed for most local governments until they can tap the market on the basis of their internal strength. For example, specialized financial intermediaries can help these local governments access credit from institutional investors by pooling the credit demand and underwriting the bonds issued.

Credit rating and making local government bonds part of the liquidity reserve requirement of financial institutions will help develop the market for such bonds, while an efficient and vibrant secondary debt market will help develop a capital market for them. The resulting liquidity of the paper will also help reduce the cost of borrowing. After the listing of the bonds on the stock exchanges and as bond-trading expertise grows, a long-term active secondary market can be created. Such instruments will also require that services be priced appropriately to recover the cost of capital as well as operation and maintenance (O&M) charges.

Institutional Framework

Constitutional Provisions

The allocation of responsibilities between the federal Government and the four provincial governments of Balochistan, NWFP, Punjab, and Sindh is specified in the Constitution, article 4. The Federal Legislative List sets out the functions of the federal Government, while the Concurrent List mentions the functions that can be performed either by the federal or provincial governments. In the event of any conflict between their legislation, however, the federal Government prevails. Residual functions, not enumerated in either list, are the responsibility of the provinces (Appendix 1).

Federal Government Functions

The Federal Legislative List states that the federal Government is responsible for regulatory as well as service functions, which include defense; external affairs; currency, coinage, and legal tender; foreign exchange; foreign loans and foreign aid; nuclear energy; stock exchanges; national planning and economic coordination; national highways and strategic roads; geological and meteorological surveys; census; railways; exploitation of minerals and natural gas; and development of industries.

The federal Government also performs several functions specified in the Concurrent List, such as population planning and social welfare; labor exchange; training establishments; electricity; conservation of ancient and historical monuments and sites; curriculum, syllabus planning, running centers of excellence, and standards of education; and tourism. In addition, the weak financial position of provincial governments and their overwhelming dependence on federal grants compel them to relinquish some of their responsibilities to the federal Government.

Provincial Government Functions

The provinces undertake functions related to social welfare, labor exchanges, training establishments, and management of ancient and historical monuments and sites. The provinces have sole responsibility for law and order, justice, highways, urban transport, secondary and university education, agriculture extension and provision of inputs, irrigation, land reclamation, industries, and mineral resources.

Provincial governments historically assigned some of their responsibilities to local governments through provincial Local Government Ordinances (LGOs),[1] and, where necessary, executive powers through rules and administrative instructions.

However, the provinces, until recent devolution moves, performed some functions that should have been delegated to local institutions due to their financial and institutional inability to provide elementary education, health care services, farm-to-market roads, and rural development. Some of these functions have become the exclusive preserve of local governments.

Local Governments and the Constitution

In 2000, the federal Government launched a fundamental and ambitious program to restructure administrative, functional, financial, and fiscal relations between different levels of government. This radical effort aims to transfer power by devolving authority and granting autonomy to lower levels. The new structures are expected to enable citizens to design investment programs and take on expenditure commitments, with local priorities determined through participatory mechanisms. Provincial governments will be transformed from direct providers of some basic social and economic services (largely municipal services) to financiers, regulators, and supervisors of local governments as primary delivery agents.

The political imperatives for devolution were created by the urge for more effective and widespread democracy and for enhancing government accountability, as well as to enable local communities to better articulate their choices. The overarching objective is to improve delivery of services within the framework of effective, efficient, transparent, accountable, and participatory governance by linking taxes and user charges to services and expenditures. The shifting of resources and authority to lower levels of government is expected to force officials to respond to local needs and priorities and thus maximize the return on taxpayers' contributions.

However, even after these far-reaching reforms, local governments continue to derive their functional and fiscal powers from provincial legislation. The Constitution still does not recognize local governments as a separate tier of government with their own powers and functional domains, although a constitutional amendment was proposed in August 2002, including the following: (i) provinces will be required to legislate the establishment of a local government system and devolve political administrative and financial responsibility and authority to elected representatives of local governments, and (ii) the LGOs of 2001 cannot be repealed without the prior sanction of the President. Local governments, however, will not have constitutional protection, and provinces will continue to be empowered to dismantle them, although under the LGOs of 2001 their powers to do so have been curtailed.

The provinces will continue to be responsible for critical province-wide services, including the management of consolidated finances and fiscal transfers to local governments; execution of development programs; delivery of services such as irrigation and road networks, and tertiary services; monitoring and evaluation of policy implementation and quality of service delivery; and establishment and operation of the regulatory framework that will govern private sector activity.

Local governments formed under the new system, their membership, and functional responsibilities are described in Appendix 2.

LGOs have also changed local government taxation. Powers to levy taxes on immovable property (including property transfers) and cattle have been conferred on the towns, subject to the approval of rates by the provincial governments and/or to their rules and instructions. The fee to license professions and vocations has been devolved to the union councils, and the district councils have been given two new sources of revenue—taxes for health and education.

Management of assets and service facilities of provincial governments has also been handed over to local governments, enabling them to collect user charges. However, the liabilities associated with these assets have not been transferred. Provincial governments will continue to service all the loans raised to finance the acquisition of these assets as local governments are prohibited from incurring debts.

Revenue-Sharing Arrangements

Provinces receive a share of federally levied and collected taxes as transfers, which constitute over 80% of provincial revenues. At least every 5 years, the National Finance Commission (NFC) decides the list of taxes comprising the divisible pool—the ratio of the provincial to the federal share of the pool and the formula for distribution of resources between provinces.

NFC comprises the federal finance minister, the four provincial finance ministers, and other members selected by the President. Under the 1996 award, the provinces share 37.5% of the receipts in the divisible pool, which is made up of income tax, sales tax, revenues from customs, and federal excises. Provinces also receive other tax transfers and grants from the federal Government, including straight transfers (federally ceded taxes, e.g., sales tax on services that the provinces are empowered to levy under the Constitution and returned to them on a collection basis after a 2% federal collection charge has been netted out).

Another NFC award is set to become operational in 2002/03, with the provinces entitled to a 40% share of the divisible pool, to be distributed among them on the basis of population. PRs20 billion per annum will also be set aside for subvention grants to be shared by three provinces—Balochistan, NWFP, and Sindh—based on a composite index of geographical area, relative backwardness, and national revenues collected from the province.

Federal-provincial fiscal arrangements suffer from serious vertical imbalances, and the manner in which these agreements have been implemented has made resource flows to the provinces volatile, with the average shortfall between estimated and actual budget at around 9% over the previous 5 years. This factor, combined with poor governance in the provinces, has caused their fiscal position to deteriorate and affected the quality of public service delivery.

Provincial finance commissions (PFCs), established under the LGOs of 2001, allocate funds among the provinces and their local governments. PFCs decide the vertical and horizontal transfers and the extent to which these will be formula driven, based on a variety of criteria, including population, area (to reflect population densities), relative backwardness, and revenue effort, complemented with tied or incentive matching grants to promote national and provincial goals and programs. These formula-based transfers are expected to be granted statutory protection eventually.

Provincial and local tax bases have been narrow because of the highly centralized tax structure that has resulted in the federal Government having an almost exclusive preserve over all major and buoyant taxes, import duties, sales tax, income tax, and excise duty. Local tax bases have low elasticity with respect to economic growth. Higher levels of government have also encroached on the revenue bases of the lower tiers, resulting in a host of taxation instruments with only low tax buoyancy coefficients in their revenue-generating potential being left for exploitation by local governments. For instance, provincial governments levy the motor vehicle tax but do not share it with local governments, although these are also required to maintain roads. Provincial governments also raise and retain some property-related taxes such as stamp duties and registration charges, and revenue from property taxes should principally accrue to the local government where the property is located. In other words, taxes that ought to be shared by provincial governments with local governments should fall within the fiscal domain of both levels of government.

Despite these weaknesses, the fiscal effort of local governments, at least up to the first half of the 1990s, collectively contributed more than 6% of national tax revenues, exceeding the four provincial governments' share of around 5%.

Under the LGOs of 2001, and the June 2002 decision[2] of the federal Government to transfer to local governments 2.5 percentage points of the general sales tax (which had been levied initially to compensate for the loss of the *octroi* and *zila* taxes[3]—by far the most potent source of revenue for local governments), the main sources of revenue for the district governments will be the referred transfer of general sales tax, and for town councils, the property tax.[4]

Limitations of Current Fiscal and Borrowing Powers and Tax Systems

The LGOs of 2001 substantially extended local government expenditure obligations.

However, the taxes or shares to match these additional responsibilities and related obligations are only partly in place.

The provinces are empowered to collect stamp duties on financial and property-related transactions, motor vehicle taxes, agriculture income tax and land revenue, registration fees, and other user charges. The property tax was earlier collected by the provincial government and passed on to the municipalities, which will now assess, levy, and collect the tax. The bulk of provincial nontax revenues comprise irrigation charges and various administration fees and user charges for social and economic services. However, due to the highly centralized tax structure, most provincial and local revenue sources lack buoyancy. The tax base is narrow and tax instruments, especially of local governments, have either become irrelevant or are unable to fulfill their potential, partly because of political considerations, being visible taxes (like the property tax). Local government problems in raising revenue from local taxes, other than the constricted and inelastic tax base, include lack of administrative capacity. Although they are authorized to do so, some local governments are thus reluctant to impose and collect taxes.

Complex systems of taxation that enhance officials' discretionary powers make administration difficult, especially when subnational governments do not have adequate human and complementary resources. Compliance costs of businesses have thus increased without augmenting revenue instruments' productivity and buoyancy. Therefore, the taxation system needs to be simplified and the enforcement machinery strengthened and reengineered by computerized information systems.

The taxation structure as envisaged by the LGOs of 2001, however, does not address the overlap of provincial and local fiscal powers, which could fragment the tax base as well as contribute to interjurisdictional conflicts. For example, whereas article 163 of the Constitution empowers provincial governments to levy taxes on professions, trades, and employment, the LGOs of 2001 allow union councils to impose licensing fees on professions and vocations. Some confusion exists over which level of government will eventually have the exclusive right to impose a tax and fees on cinemas, theaters, and other entertainment. This continued multiplicity of taxes will not only add to the cost of taxpayers' compliance but also of doing business.

A major indicator of lack of financial autonomy is the inability of subnational governments to access capital markets. While the federal Government is reluctant to grant provincial governments permission to borrow, local governments are not empowered to raise loans.

Local governments also have limited autonomy over investing surplus funds that they may hold from time to time and are required to invest them in accordance with provincial policy.

Financial Position of Subnational Governments

Provincial Finances

Over the last decade, provincial fiscal health has deteriorated steadily. While funding agencies and the federal Government have made great efforts to restore federal government fiscal balance, poor financial management in the provinces and its impact on overall macroeconomic stability and allocative efficiency of micro-level operations have become a serious subject of debate only in recent years.

Transfers from the federal divisible pool have often been volatile, rendering provincial revenue and expenditure estimates unrealistic. The high degree of dependence on federal transfers has left provincial governments little leeway to absorb the cost of shortfalls in such transfers since the potential to mobilize revenues from own taxes and user charges has been limited, at least in the short term. The outcome has been unplanned cuts in spending, resulting in the deferral of expenditures, especially those required to maintain critical physical infrastructure. Liabilities have thus increased due to underfunding by provincial governments to meet such obligations, even after having diverted monies held in a fiduciary capacity to finance other commitments. All these developments contributed to fiscal stress.

The source of fiscal imbalances and lack of fiscal space has been the slightly faster growth in expenditures than revenues. Although the revenue account has had surpluses, overall fiscal deficits have fluctuated at around PRs9 billion in recent years, growing rapidly from about PRs4 billion. However, the revenue surpluses are largely illusory, masking the poor allocations for essential nonsalary inputs required for service delivery or for maintenance of installed infrastructure.

The lack of fiscal space is due to inflexible expenditures and revenues to undertake investments and supplement maintenance expenditures in priority areas. Revenues have been unable to keep pace with the growing obligations on account of salaries, pensions, and debt servicing, which sharply reduced real expenditures on the creation and maintenance of key physical and social infrastructure, impairing prospects for growth and poverty-reducing investments.

In the short run, inability to accommodate revenue shortfalls has forced governments to cut back on already low levels of allocation for O&M or development programs. As a result, the share of provincial spending on development and O&M fell from 27.5% of total expenditures in 1991/92 to 11.0% in 2000/01, with allocations for repair and maintenance of roads barely 55% of what would have been required on the basis of accepted norms and yardsticks revised at the end of 2000/01.[5] A huge infrastructure deficit has resulted owing to the backlog of rehabilitation-related spending and regular repair and maintenance expenditures.

Annual allocations for roads are around PRs2 billion compared with a requirement of PRs7.5 billion–8.0 billion, while the gap between irrigation network O&M requirements and actual expenditures is 30–40%.

Transfers from the central divisible pool under the NFC award have grown more slowly than the increase in provincial tax revenues. Federal transfers grew at a compound rate of 10.2% per annum between 1993/94 and 1999/2000, in contrast with provincial revenues, which increased at 14.3% between 1990/91 and 2000/01. However, the gap widened after 1994/95. Between 1995/96 and 1999/2000, federal transfers grew at 4.4% per annum (although tax transfers from the divisible pool grew at close to 13.0%), while revenues from provincial taxes increased at a compound annual rate of 11.7%. (Appendixes 3 to 6 give data for the provincial governments, in aggregate and by province.)

Provincial tax revenues and recurrent expenditures have grown at the same rate—14.3% per year, between 1990/91 and 2000/01. However, a large gap exists of close to 8 percentage points between the growth in provincial recurrent expenditures and provincial nontax revenues. Whereas provincial nontax revenues grew at 5.3% per year between 1991/92 and 2000/01, recurrent expenditures grew at 13.4%. Although the difference in growth rates of recurrent expenditures and nontax revenues has narrowed, the gap is still 4–5 percentage points. The increase in revenues from such instruments was moderate, at 7.0–8.5% per annum during the period 1995/96 to 2000/01. In comparison, revenue expenditures grew at a compound annual rate of 10.0–12.0%, with allocations for subsidies increasing by 17.5% per year between 1990/91 and 2000/01, rising much more sharply, at almost 36% per year, in the second half of that period.

The gap between the growth rates of nontax revenues and recurrent expenditures is largely because of the inability, if not reluctance, of provincial governments to employ user charges to cover costs of provision of nonmerit goods and services. Large explicit and implicit subsidies exist. For instance, barely a quarter of the cost of providing water through irrigation systems is recovered through user charges.

Problems in providing services efficiently have been exacerbated by the complicated procedures to ensure timely release of allocations, low productivity of capital expenditures, and rapid growth of development schemes. All these contributed to the accumulation of a huge portfolio of development projects where resources were spread thinly, resulting in an escalation of spillover commitments, lengthening of scheme-completion periods, large cost overruns, and loss of efficiency in use of scarce resources. Since performance is measured in terms of expenditure incurred rather than output or outcome, allocative and technical efficiency in the design and execution of capital programs has suffered.

Provincial fiscal deficits are financed mainly by overdrafts from the state bank, some market borrowings, and loans from multilateral and bilateral funding agencies. Funding agencies essentially finance projects, although they are also beginning to provide program and structural adjustment loans. All provincial borrowing is approved by the Ministry of Finance. Therefore, although the annual consolidated provincial deficits have exceeded PRs9 billion, provincial governments have little room to reduce their fiscal deficits since borrowings are determined by the federal Government. For instance, to contain the overall consolidated federal and provincial fiscal deficits, the federal Government discontinued lending to provinces to finance development schemes from 2000/01 but without addressing the issue of deteriorating quality of the deficits in terms of underlying reasons—growing recurrent expenditures as opposed to higher development spending.

The large overall deficits have caused debt accumulation, servicing of which is now taking 18–20% of recurrent expenditures. In Punjab, for instance, the ratio of the outstanding stock of debt to total revenues rose to 125% in 2001/02, the interest costs of which now absorb 15% of revenues. Although the debt burden may not look excessive, it does not include the debt and associated interest charges pertaining to deductions from employees' salaries for the General Provident Fund that the federal Government uses to finance other expenditures. Servicing debt obligations has resulted in diversion of scarce resources from key priority sectors and services. Not only did the volume of borrowing increase, but average rates of interest also sharply escalated (over 17% for loans from the federal Government in 1998/99) as a result of financial sector reforms launched in 1991, causing debt-servicing obligations to swell.

Other than the rapid build-up of these debt obligations, outstanding liabilities include General Provident Fund contributions and uncovered liabilities relating to pensions and salary payments due against leave unused by staff. Substantial contingent liabilities also exist with respect to guarantees given for loans to public sector enterprises and autonomous corporations: Punjab alone had PRs35 billion in liabilities (excluding interest) as of 30 June 2000. Most of these loans are nonperforming.

City District Government of Karachi

Since local governments should not tax mobile bases, taxes that can be exported to other areas, those that are subject to large visible cyclical variations, and those where large economies of scale exist in administering the related tax (which, for reasons of efficiency or equity, should be controlled at the federal level)—for these reasons, the range and variety of local taxes that fall within local governments' fiscal domain are restrictive. Potential revenue from local taxes that can be efficiently levied and collected is thus smaller than local government expenditure.

Therefore, it is not surprising that the financial position of the City District Government of Karachi (CDGK), a major commercial center, is much the same as, if not worse than, that of the government of Sindh, the province where Karachi is located.

The consolidated receipts and expenditure accounts of the CDGK and the defunct Karachi Metropolitan Corporation, the 18 town councils and the defunct district municipal corporations, and the development authorities from 1997/98 to 2002/03 indicate a weakening financial position (Appendix 7). From 2001/02, CDGK started receiving huge funds transferred from the divisible pool as devolved resources, but these were to be utilized to finance the expenditure obligations that accompanied the devolution of service delivery.

The consolidated revenue receipts of CDGK, 18 town councils, and associated public sector entities grew by around 3% per annum (from PRs7,178 million in 1997/98 to PRs7,909 million in 2000/01). These receipts mainly comprise the matching grant in lieu of *octroi*, income accruing from water supply and conservancy charges, revenue generated from the sale of land, and receipts from plot development charges. Other sources of revenue such as the town councils' share of property and betterment tax, interest from investments, grants, receipts from trade licensing fees, revenue from fire tax, and rents contributed less than 13% of total revenues for 1997/98–2000/01.

The amount transferred in lieu of *octroi* totaled PRs3,089.6 million in 1997/98 and accounted for 43% of total revenues in that year. Receipts from this matching transfer increased to PRs3,904.2 million in 1999/2000 and constituted half the total receipts, but declined by nearly 25% the following year to constitute 37% of total consolidated revenues.

Revenue from the sale of land and development charges jointly contributed PRs963 million (13%) to total revenues in 1997/98. Revenue generation from these sources has been limited in recent years because of a ban imposed by the federal Government on the sale of developed plots and apartments. Receipts from these items declined in 1998/99 and in 1999/2000, and revenue from the sale of land and development accounted for only 7% of total revenues in 1999/2000, contributing 13% of total receipts in 2000/01.

Salaries, expenditures for services, and other commodities and, to some extent, development works, contributed the bulk of consolidated expenditures of CDGK, 18 town councils, and associated public sector entities from 1997/98 to 2000/01, with expenditure on repairs and maintenance of installed facilities and infrastructure, debt servicing, and additional payments to the pension fund accounting for less than 16% of total expenditure.

Recurrent expenditures cover establishment charges (allocations for salaries and allowances of officers and support staff); contingencies (consumption of utilities, expenditure on stationery, and other consumables, etc.); and allocations for repair and maintenance of assets transferred for management to CDGK, such as roads, buildings, and equipment.

From 1997/98 to 2000/01, staff salaries absorbed 32–36% of total expenditure of Karachi's municipal bodies. Expenditure related to devolved units accounted for 33.0% of total spending from 2001/02, when the share grew by nearly 7.2% per annum from 1997/98 to 2000/01. Expenditure on commodities and services, which absorbed 17% of total spending in 1997/98, increased to 37% of aggregate expenditure in 2000/01. Debt-servicing obligations increased by roughly 30% per annum from 1997/98 to 2000/01, when they accounted for 4% of total spending. The share of development spending and expenditure on the purchase of durables was 33% of total expenditure for 1997/98 and 1998/99, which declined in the next 2 years, falling to just 18% of total spending in 2000/01, to accommodate the higher expenditure on establishment, commodities and services, and rising outflows for interest payments.

Annual per capita revenues from matching grants in lieu of *octroi* and property tax were PRs381 and PRs60 for 2001/02, or around PRs2,286 and PRs360, respectively, on a per household basis. In contrast, per capita expenditure on salaries and pensions was PRs387 (PRs826, including devolved departments), while the per capita outflow for debt servicing in nominal terms was PRs39 in 2000/01 (the latest year for which this breakdown is available).

City District Government of Lahore

Most receipts of the City District Government of Lahore (CDGL) have recently come as provincial government fiscal transfers to perform the functions devolved to it. These transfers accounted for 63% of total revenues in 2001/02 and are budgeted to contribute nearly 66% of revenues in 2002/03. CDGL's own sources of revenue include grants received in lieu of *octroi*, rental income, revenue from the approval of building plans, returns on investments, property tax, property transfer fee, and user charges for social services. The single most important source was the grant received in lieu of *octroi*, accounting for nearly 65% of locally generated revenue in 2001/02, and is expected to contribute 76% of the district's own revenue in 2002/03 (Appendix 8).

Revenue from property transfer fees accounted for nearly 25% of total non-*octroi* local revenues in 2001/02, while its contribution in 2002/03 is expected to be minimal (about 1%). Rental income and property tax also contribute significant amounts to non-*octroi* local revenues. Rental income constituted roughly 22% of local income (excluding *octroi* grants) in 2001/02, and its share is expected to increase to 40% by 2002/03. Similarly, while property tax made up 17% of local non-*octroi* revenues in 2001/02, it is expected to reach 29% by 2002/03. Under the LGOs of 2001, collections from property tax have to be transferred to town councils.

Recurrent expenditures of CDGL accounted for 75% of total expenditures in 2001/02 and nearly 80% of total district spending in 2002/03. The share of development spending in total expenditures was 19% in 2001/02 but is expected to decline to only 13% in 2002/03. The balance was reserved for town councils and cantonment boards. More than 60% of recurrent expenditures are earmarked for education and health. Historically, expenditure on primary health care and secondary education was handled in the main by provincial departments, and now by district governments. However, CDGL was also running some primary schools and basic health facilities even before this function was transferred to district governments. Salaries account for the bulk of expenditure on health and education. Nearly 95% of recurrent expenditure on education and more than 60% of that on health are absorbed by salaries, allowances, and pensions.

CDGL had an overall deficit of PRs180.6 million (4% of total revenues) in 2001/02, while a deficit of PRs362.4 million (8% of total revenues) is anticipated for 2002/03, which CDGL will finance from cash reserve balances.

Limitations of City District Government Accounts

The CDGK and CDGL accounts do not fully capture the extent of the overall deficit because structural deficits in terms of coverage and quality of services are not included in the calculation for financial deficits. Terms such as "budget surplus" and "deficit" carry little meaning in the context of local governments because they cannot borrow, and expenditure can exceed income only by running down cash balances and utilizing General Provident Fund contributions and monies received as advances from customers to carry out minor civil works for them. Since local governments have to ensure that their expenditures are strictly within their earnings, such a requirement is likely to lead to postponement of certain essential expenditures, and may even make local governments more dependent on provincial governments.

Generally, because expenditures cannot exceed budgeted income, the amount set aside for capital and maintenance expenditures is merely the balancing figure after allocations for establishment and supplies and services. The allocation for a department is not necessarily determined by priorities and long-term plans but is more the outcome of past appropriations based on a particular function, number of department staff (which is a proxy for the department's bargaining strength), and traditional role of the department.

Capital expenditures are commonly emphasized since "development" connotes improved and expanded infrastructure. However, a substantial proportion of what passes for development expenditures is the cumulative effect of delayed repairs—a deferred maintenance charge—and often includes works that may be classified as repairs and maintenance. Sensible budgeting requires a balance between recurrent and capital expenditures. A major failing is that infrastructure investments are made without a full appraisal of O&M implications of the project's financial, technical, and management capabilities.

Finally, since the utility of provincial and local government budgets is restricted to limiting expenditures within budgeted receipts, budgets are only marginal instruments of financial control to monitor the affairs of agencies to make service provision more efficient. Cash-based systems are inherently incapable of offering pricing and costing services in a manner that considers all relevant costs, especially those capital in nature.

Debt-Carrying Ability of Subnational Governments

If subnational governments are to promote economic growth they must undertake fiscal and service delivery reforms since agriculture, irrigation, human development (particularly basic education and health and provision of drinking water), and other essential physical infrastructure such as roads are within the functional domain of provincial governments. Acceleration of growth and its sustainability requires well-maintained infrastructure, which, in turn, requires good fiscal health and much larger allocations. In the face of competing demands, increased provisions for social services and physical infrastructure will have to come largely from increased tax revenues, enhanced cost-recovery efforts, and the winding up of loss-incurring public sector enterprises.

Subnational governments' ability to carry additional debt will be limited unless revenue is mobilized, the stock of debt is reprofiled and restructured, and expenditures are reprioritized. Project selection and potential direct and indirect revenues from investments will also determine the levels of debt that subnational governments will be able to accumulate and service.

Sindh and NWFP have obtained low-interest structural adjustment loans from multilateral lending agencies to finance priority expenditures. These loans have been guaranteed by the federal Government, which has also agreed to bear the associated exchange rate risk. The provinces will undertake fiscal and management reforms to increase tax revenues, improve tax administration, and restructure and reprioritize government expenditures.

Borrowing Powers of Subnational Governments

Provincial Governments

Article 167 of the Constitution provides that provincial governments can borrow against the security of the provincial consolidated fund within limits fixed by the provincial legislature. However, a provincial government indebted to the federal Government can only borrow after obtaining its consent. The Constitution empowers the federal Government to impose any conditions it may deem fit and proper.

As the Punjab minister of finance, the author of this report experienced the consequences of this constitutional provision. He had sought federal government approval to borrow funds from the market using a combination of bonds and bank loans to pay off federal government debt to the provincial government at 15% and more interest per annum. He was able to leverage provincial revenue streams and good financial management to raise funds from the market at much lower rates of interest. Reprofiling of the debt would have created fiscal space for priority expenditures. The federal Government denied permission to raise funds from the market on the basis that savings from debt servicing would be used for spending that would push the overall fiscal deficit beyond the targets agreed with the International Monetary Fund.

In theory, therefore, the provinces cannot spend more than their estimated revenues plus borrowing limits approved by the federal Government. In practice, however, provinces have recourse to additional borrowing resources, including ways-and-means advances from the State Bank of Pakistan and public accounts (particularly General Provident Fund contributions).

Local Governments

Section 120 of the LGOs of 2001 prohibits local governments from incurring debt. In India, the Constitution was amended to create an environment similar to that in the United States (US), enabling local governments to structure appropriate financial instruments to mobilize funds to finance urban infrastructure investments in water supply, sewerage, sanitation, roads, and bridges.

Investment in Infrastructure

Importance of Infrastructure

Good local infrastructure, whose provision is largely the mandate of provincial and local governments, is essential to all economic activity. Infrastructure makes key economic services more efficient, enhances the country's capacity to compete internationally, improves productivity, and supports strong economic growth.

Infrastructure services are often monopolistic. Investments in this sector are typically bulky, with high up-front costs and long payback periods. Compared to other projects, however, infrastructure generates large positive and negative externalities, which are not easily translated into traditional levies that users pay to access services. For instance, it could be argued that urban transport, water works, or collection and disposal of solid waste are more suited to traditional government ownership as positive externalities and nonexclusion make pricing difficult. Infrastructure services have thus been traditionally produced and provided by the public sector in most countries.

The financing of infrastructure by subnational governments in industrial and developing economies relies on an array of sources, channels, and instruments. In developing economies, however, infrastructure financing has been confined to budgetary support and funds from funding agencies, with fiscal capacity to contribute to expansion of physical and social infrastructure, depending on the nature of the local economy and the size of the tax base. Financing from budgetary sources, however, is becoming increasingly difficult. The widening gap between demand for and supply of infrastructure services hits the poor badly, while the unabated growth of population, especially in major urban centers, worsens infrastructure shortages and urban decay. Private sources of funding are, therefore, increasingly needed to compensate for declining budgetary sources and growing demand for local services.

Since traditional public sector and funding agency sources to finance urban infrastructure investment are inadequate,[6] they can be supplemented with credit, especially since taxpayers should not have to bear the entire cost of infrastructure provision. However, constitutional and legislative constraints and prohibitions on borrowing by subnational governments must be modified, unless the private sector takes over their role as providers of infrastructure.

Private Sector Provision of Infrastructure and International Experience

As privatization and deregulation sweep the globe, ownership and operation of infrastructure are increasingly recognized as separable, and models for individual projects are more sophisticated.

Creation of market and complementary mechanisms for infrastructure in Pakistan will allow investment to become profitable. However, although the private sector is actively engaged in the transport sector, an enabling framework for private sector investment in urban infrastructure is missing. Constraints include vague contractual rights and obligations, unclear property rights, inefficient approval and implementing mechanisms and systems, and inadequate procedures and institutional arrangements to enforce regulations. Efforts are also insufficient to realize sustainable investment in infrastructure, since a policy to ensure that infrastructure projects yield adequate revenue streams is also missing.

Many countries have encouraged private participation in infrastructure to stimulate economic growth. Industrial countries have been particularly successful. In the US, private companies and property owners' associations own outright toll roads and residential streets. Even in Pakistan, under a range of franchise, contracting, and regulatory arrangements, private enterprises collect solid waste and operate urban transport.

Rapid innovations are being made both in contractual agreements of projects to enable private participation and in mechanisms and instruments to channel private savings into long-term investments. However, most attempts to attract private capital to invest in infrastructure in developing countries have involved projects identified and designed by governments. For example, when a government invites bids for a road project, the private sector typically demands a traffic guarantee or, even worse, a revenue guarantee, resulting in the private sector bearing little demand-side risk.

Sometimes repayment of funds does not depend on project success. Lenders carry no project risk as their investments are backed by government guarantees, as in private power projects. For such projects, whatever legal form their contracts may take, the net result is no different from the government borrowing to finance the project in the public sector. The only difference is that the government's liability in the so-called private infrastructure project is off the balance sheet. The liability does not show up as a government debt but as a contingent liability to make good the revenue shortfall under the project. This kind of guarantee regime is unsustainable. Admittedly, however, in developing countries this move may be possible only when domestic private entrepreneurs use modern risk-management techniques. The private sector in Pakistan appears willing to review potential investment opportunities.

Sources of Funding for Infrastructure Investment

Funds for infrastructure investment can come from promoter capital, banks (syndicated loans), debt issues on domestic capital markets, sale of equity rights, and borrowings in international capital markets. Since the role of the banking system is likely to be limited, given that most of its funds are for short maturities, the capital market can bring infrastructure developers and private savers together. Many countries, industrial and developing, have successfully funded their urban infrastructure by accessing capital markets. Infrastructure investments have been financed through debt instruments, commonly domestic bonds floated by subnational governments. In the US, for instance, the municipal bond market is almost twice as large as the corporate debt market. Similarly, the bond market in Thailand has grown rapidly, from B547 billion in 1996 to B1,507 billion in 2001, and daily trading from B822 billion in 1996 to B6,472 billion in 2001.

In India, the municipal corporations of Ahmadabad, Bangalore, Delhi, Hyderabad, and Pune issued different types of infrastructure bonds to suit the liquidity, yield, and risk preferences of all investors. The bonds are also transferable by endorsement and delivery, and may be paid prematurely after being held for a minimum period. The principal and interest on such bonds (including those issued by the public sector) have been guaranteed by the central or state government. In 1998, Ahmadabad Municipal Corporation issued bonds worth Rs1 billion to complete its water and sewerage project; 75% of the value of the issue was privately placed with institutional investors and the balance sold to the public.

A major boost to capital markets in developing economies can also come from divestment of government holdings in utilities. Malaysia launched such a program in the early 1980s. As a result, the share of infrastructure stock as a proportion of total stock market capitalization is almost 30%.

Experience with Government and Corporate Debt Instruments

Money Market and Government Debt Instruments

The debt market can be broadly classified into the money and securities markets, with the latter including the bond market for long-term government securities and corporate bonds.

A money market has developed in Pakistan, following financial reforms launched in the early 1990s. The money market comprises the primary market for government securities such as treasury bills of 3-, 6-, and 12-month maturities; the secondary market for repo transactions among banks to satisfy liquidity requirements; and the call market for clean lending and borrowing to meet cash requirements.

An auction system has been established to raise government debt based on two key debt instruments—treasury bills and Pakistan Investment Bonds. The composition of domestic public debt has thus markedly shifted from nonmarketable to marketable securities and from short-term floating and unfunded debt to long-term and permanent debt. The introduction of treasury bill auctions followed by the closure of the discount window has enabled the development of the interbank money market,[7] where these liquid debt instruments are used.

Corporate Debt Instruments

Securities include corporate bonds. In the early 1980s, public utility agencies floated bonds to raise funds for infrastructure investments. Initially, the bonds were backed by government guarantees then replaced by a new debt instrument now used by the corporate and commercial banking sectors (public and private)—TFCs.[8] These were first issued to the public by private companies in 1995; 36 TFCs of around PRs20 billion have been issued, most by leasing companies and investment banks. The paper can only be floated after prior consent from the Securities and Exchange Commission of Pakistan, which grants it only if the following criteria have been met: (i) the issue has been rated by a credit-rating company, (ii) the instrument is listed on any of the stock exchanges, and (iii) the issue has been underwritten. The commission's consent is not required if the issue is placed privately.

Perpetual TFCs have also been floated, which will foster the growth of instruments of long-term maturities required for project finance, available for a maximum of 5–7 years.[9] One bank has used the "shelf registration" process to reduce the cost to the issuer. Under shelf registration, the issuer can split the TFC into many tranches and thus price them differently. The "green shoe" option allows the issuer to retain the oversubscribed portion of the initial public offer, although the issuer must specify in advance the amount to be retained. Most buyers view TFCs as loans rather than tradable securities and retain them due to their high yields. Hence, a robust secondary market for these securities has not developed. However, the lack of market makers for corporate debt and bonds has not unduly constrained the activity of the secondary market. Stock on offer can be offloaded without great difficulty. With the withering away of development finance institutions with access to long-term specific or direct credit lines, TFCs, with their rapidly growing market, have created the environment to develop a debt market for long-tenor bonds, and its future looks bright.

Factors Hindering Subnational Government Bond Issuance

The viability of bond market financing at the provincial level will require the removal of a number of constraints.

Low Rate of Domestic Savings and Weak Intermediary Systems

Domestic savings are equivalent to around 12% of GDP compared with more than 35% in most Southeast Asian countries (World Bank 2002). Intermediation systems and mechanisms to transform savings into investments in credit or capital markets are poor. The average East Asian ratio for broad money to GDP is over 80%, that for Pakistan, less than 40%, suggesting that low financial development hampers savings in Pakistan. Capital markets are more dynamic when legal systems and financial markets acquire depth. Capital markets in Pakistan are much shallower than those in East Asia.[10]

Legislative Constraints

Constitutional or legislative restrictions placed on subnational government borrowing need to be modified. Administrative controls to maintain financial discipline and attain macroeconomic stability should be replaced by rule-based controls along the lines of the draft fiscal responsibility act, or an overall ceiling and subceilings for market borrowing should be fixed.

Even if subnational governments could borrow, their ability to do so against the security of receivables, receipts from which will be credited to the provincial or district consolidated funds, will require clarity. The legality of securitizing flows into the consolidated fund, especially in the case of local governments, by establishing escrow accounts needs to be determined and may even require a constitutional or legislative amendment.

Regulatory and Tax Constraints

Countries that have been successful in financing infrastructure projects through domestic capital markets have taken a number of measures to support their development. First is the accumulation of savings pools that institutional investors can channel into securities. Internationally, the most important sources for investment in infrastructure have been pension and life insurance funds. Pakistan has regulatory or taxation-related restrictions on investments (which only include instruments issued by the federal Government) that such funds may make. These restrictions have to be revised to increase the pool of savings.

Provincial stamp duties on financial instruments issued by the private sector and local governments are too high at 5–6%, although securities issued by the federal and provincial governments are exempt from stamp duty.

Lack of Financial Information on Subnational Governments

Factors that inhibit private sources of financing include the dearth of reliable and timely information on the financial and operational performance of subnational governments (especially local governments), their limited autonomy, weak institutional capacity, and weak auditing standards. Investors and financial institutions in Pakistan are not fully conversant with municipal or local government bonds. Hardly any financial institution in Pakistan has a deep understanding of the financial and taxation capabilities of provincial and local governments, or in-depth familiarity with local governments' legal, institutional, and regulatory frameworks. Data on, and indicators of, local government operations and finance are also lacking, which is perhaps the single most important reason that subnational and local governments are seen as commercially nonviable. Capital markets have neither the depth nor the breadth to induce investors to regard local government bonds as sound investments. Creating a market for such bonds will, therefore, take time.

Well-charted norms and policy guidelines covering such investments are lacking. All potential investors and borrowers must, therefore, initially work closely together to create durable, transparent, and predictable regulatory rules to develop an acceptable structure for placing bonds.

Weak Financial Management and Accountability Systems

Other factors constraining the development of a market for bonds issued by subnational governments include their poor financial management policies and practices that have weakened internal controls and accountability systems, compromising the reliability of provincial accounts. The end product is public accounts of deficient quality, and information that will not provide the level of comfort essential to attract private savings. Auditing has been poor because accounts have not been presented on time, and the public accounts committees have either not been in place or have failed to review the audit reports promptly. Public accounts committees have failed to highlight or correct poor compliance with financial policies, systems, or procedures.

Key initiatives, however, have been launched to address these weaknesses. Provincial governments have adopted the national financial management reforms being championed by the federal Government proposed under the Pakistan Improvement of Financial Reporting and Accounting project. These reforms aim to improve financial discipline and the effectiveness of public expenditures by strengthening the quality of provincial accounts, debt and quasi-fiscal management (covering off-budget public accounts and guarantees on loans extended to public sector corporations and autonomous bodies), transparency, and public accountability systems.

To ensure the integrity and transparency of public accounts, provincial fiscal monitoring committees have been set up to supervise the timely reconciliation of departmental accounts with the figures reported in the civil accounts by the office of the accountant general. These committees have started producing comprehensive, credible, and accurate quarterly accounts.

Reliable financial information is expected to be produced through adoption of the budgetary classification of the new chart of accounts under the new accounting model being installed by the federal Government under the supervision of the World Bank, International Monetary Fund, and Asian Development Bank. Financial rules are being revised to be consistent with the new model. Efforts are also under way with external assistance to enhance the capacity of district governments to prepare their own budgets. The position of the district account officer, who has the critical responsibility of managing the accounting of receipts and expenditures, is being upgraded in terms of cadres and skills. Local government capability will have to be enhanced through automation and provision of communications facilities. However, weaknesses remain in the accounting of local government transactions, and the reliability, accuracy, and regular availability of such information.

Provincial governments are considering a bill along the lines of the ordinance on fiscal responsibility and debt limitation put out by the federal Government for public comment, which sets out medium-term targets for some key fiscal indicators.

Recommendations

Strategy for Issuing Subnational Government Bonds

Scope of Bonds

If subnational governments are granted permission to borrow, they can use their assets to lever additional resources. Financial discipline and macroeconomic stability can be achieved through rule-based controls (as envisaged by the draft fiscal responsibility act) that will replace the system of administrative controls over debt accumulation. The level of comfort of potential subscribers to the bonds should be supplemented with other parameters indicating the fiscal health of the subnational governments: enough cash to cover 2 months' commitments, for example, including cots of establishment, pension payments, and other committed liabilities such as repayment of debt, and interest payments, which should not be more than 20% of revenue receipts.

If subnational governments are to fund infrastructure through bonds, projects should either have direct revenue streams, or resource mobilization from other revenue instruments that are adequate to service the debt. Projects with good potential to tap capital markets on a stand-alone basis should be identified on the basis of the expected revenue stream along with a mechanism for securitizing assets.

Revenue Bonds or General Obligation Bonds
Subnational governments can issue revenue or general obligation bonds, which can be at fixed nominal rates of interest or at floating rates, or indexed to inflation. Revenue bonds can be floated to finance projects to be serviced by the revenues generated by the assets financed from these bonds. By tying the funding from such bonds to the financing of discrete projects, revenues from which can be pledged to service these bonds (say through the establishment of escrow accounts), the issuer being limited to this source of revenue to pay for the bonds, the borrowing can be classified as nonguaranteed debt that can be excluded from the statutory limits on borrowings of local governments. Such an instrument would require clearly identified project cash flows to become marketable. The legal implications of creating such a security, possibility and manner of earmarking specific revenue streams for debt servicing, and reliability of the revenue estimates and cash-flow projections should also be made clear.

However, the review of the fiscal position of subnational governments (particularly local governments) and their recent fiscal efforts shows inelasticity of project-based revenues. Due to cost-recovery difficulties, the creation of a market for pure revenue bonds on a project basis may be difficult.

The market for a general obligation bond is dependent on the creditworthiness and general fiscal health of the issuing subnational government, whose debt will be serviced from its tax and nontax revenues. Such bonds can be used to finance projects with low direct financial returns, e.g., investments in education, roads, and public buildings. Since all projects will not be commercially viable on a stand-alone basis, revenues must be collected and captured efficiently. Risk assessment should be based on each government's debt-carrying capacity, present and potential future revenues, economic and tax base, collection efficiency, and quality of financial management. Given their finances, local governments, particularly the smaller ones, will not be able to issue such bonds soon.

The selection criteria governing investments will, therefore, have to be improved substantially along with the pricing policies and models needed for sustainability of service provision and debt-servicing capability and for bond investors' remedies in the event of default.

Incentives, Risk-Mitigating Mechanisms, and Regulatory Reforms
Whereas arrangements for credit rating of instruments floated by subnational governments will dilute the negative impact of such concerns, investors will still have to be provided with a greater level of comfort than typically necessary for more conventional transactions. Local government bonds may then have to be structured with risk-mitigating mechanisms such as government guarantees (with all the implications for

the sustainability of such concessions). Provincial governments will have to guarantee the private debt raised by local governments to increase private sector participation in funding infrastructure development, especially in the early years, since legislation prohibits borrowing by local governments. Thus, market creation of early issues of debt instruments will require securities and guarantees that can be discontinued for subsequent issues (after the legislation has been amended).

Such risk-mitigating mechanisms must be supported by adequate fiscal concessions to investors. International experience suggests that the tax-exempt status of municipal bonds enables local governments to raise debt at reasonable interest rates, as in the US, where the federal Government cannot tax interest earned on bonds issued by state and local governments, which also means that these bonds can carry a lower coupon rate than equivalent taxable bonds. (This tax exemption is regarded as the single most important factor in the orderly development of the municipal market for bonds in the US.) Therefore, tax breaks will enable provincial and local governments to access commercial services at lower cost. Among the potential benefits of taking this route include the expansion of the pool of potential lenders and investors. The demonstration effect will help disseminate outcomes and experiences.

Establishing a market for debt instruments/bonds issued by subnational governments will initially require rates of return on such instruments to be at least 2–3 percentage points higher than prevalent market rates on bonds issued by the federal Government. Credit rating and making subnational government bonds part of the liquidity reserve requirement of financial institutions will help develop the market for such bonds. Liberalizing the prudential norms of provident, pension, and life insurance funds will also create a good market for such long-term paper.

Municipal Bonds: Potential and Possible Institutional Arrangements

While local governments have recently been given a great deal of autonomy in deciding on infrastructure investment, resource mobilization, and development of public private partnerships, options available to local governments to finance infrastructure investment and improve their access to domestic capital markets are limited. Unfortunately, in view of their weak financial position and revenue-generating instruments, few subnational governments, especially local governments, will be able to issue long-tenor bonds. Long-dated fixed securities can, at best, be issued by the large municipalities with sufficient and stable sources. Only Karachi, Lahore, and perhaps Faisalabad will be able to access bond markets directly.

A financial intermediation strategy will have to be developed for most local governments until they can tap the market on their own strength. Specialized financial intermediaries can help small and medium-sized local governments access credit if they cannot directly access long-term private credit markets, even in countries where these markets are developed. Such intermediaries can pool risks and approach the capital market on behalf of local governments and bridge credit demand and supply (from institutional investors such as insurance companies and provident and pension funds) by pooling the credit demand of local governments and underwriting bonds issued by municipalities when institutional investors cannot assess individual government risk and need to diversify their exposure. For instance, only the strongest local governments as a group could theoretically have a reasonable collective rating. They could then be helped collectively, through underwriting, to issue bonds to raise resources, provided that a secondary market exists for such paper.

Other institutional arrangements that can facilitate this process include the creation of either a provincial development fund or a guarantee fund comprising property assets such as land with development potential, and buildings whose income is placed in a managed property fund that a variety of borrowers can access. Therefore, helping smaller cities in particular may well require a new type of credit instrument—in the form of a structured debt obligation—designed to enable a group of local bodies to tap the capital market. Such arrangements will enable bonds to be issued on the condition that the borrowing agency pledges or escrows certain buoyant sources of revenue for debt servicing.

The creation of an equity fund can help coalesce the critical mass of risk capital required to attract debt on the scale required by infrastructure. Infrastructure financing is all about mitigating risk and obtaining steady returns. Infrastructure projects are typically funded preponderantly by debt, with equity playing a smaller role of launching the project and executing it. In Pakistan, however, the risk is so great that even the small amounts required to launch projects will not be readily forthcoming, especially after the bitter battle over the rights of international power producers under contracts signed with a sovereign government. Therefore, a fund that operates like a mutual fund will ease private entrepreneurs' task of mobilizing the equity needed for a project.

Secondary Market for Bonds

Capital-market funding of urban infrastructure requires an efficient and vibrant secondary debt market that will introduce much-needed liquidity in the paper. This liquidity will also satisfy the motive for arbitrage opportunities, treasury operations, portfolio balancing, and asset-liability management, and reduce the cost of borrowing. After bonds are listed on the stock exchanges and expertise in bond trading grows, a long-term active secondary market can be created, thereby ensuring market sustainability of such instruments.

An active secondary market, while adding value to the paper, will also help diversify risks. Computerizing the trading system for securities will strengthen the market for them.

Strengthening the domestic capital market will require direct measures such as the establishment of a legal framework for trading and supervision, supplemented by self-regulatory structures to implement standards and conventions for bond trading, an environment for fair and secure trading, and dissemination of information on the secondary bond market.

Improved Cost-Recovery Structures

The success of the above strategies will require that services be priced to recover the cost of capital and O&M charges. Users of infrastructure will have to pay for the service they consume at a rate that not only covers the cost of supplying the service but also provides a reasonable rate of return to the investor. If the projects are not commercially viable, grants and subsidies will be required to make the basket of development programs sustainable, although, ideally, equity should be achieved through targeted rather than general subsidies.

Enforcement of Private Investor Rights

The property rights of the service provider should be enforceable expeditiously and without uncertainty. Any disputes among agencies must be resolved quickly. Therefore, mechanisms for arbitration and legal resolution have to be firmly in place and must generate confidence if functional market structures for infrastructure are to be created and made sustainable.

Recommendations for Resource Mobilization

The provinces need to develop and adopt a medium-term framework to restore fiscal balance, along with a plan to restructure the civil services by rightsizing and prioritizing and rationalizing spending, and creating an enabling environment for private sector investment.

The revenue base should be diversified and broadened, and the taxation structure and its incidence made more progressive by increasing the taxes paid by middle- to upper-income urban taxpayers; by exploiting the full potential of the agricultural income tax and local business tax; and by a replacing the rigid, flat-rate road tax paid by motor vehicle owners, which is not even indexed to inflation, with a fuel-based consumption tax.

The property tax should be made a district-level tax to be shared with town councils. The structure of the property tax should also be revised to enable local governments to levy it on the capital value of properties. The property tax would serve as a proxy for user charges to ensure full cost recovery for services provided by the town councils such as repairs and maintenance of roads, street lights, and parks, and garbage disposal. Determining the extent of benefit to the service recipient is difficult[11] and the tax is administratively cumbersome to impose and collect.

When revenues from taxes cannot keep pace with expenditure growth, nontax revenues can be raised through user charges to recover costs of municipal services.

When beneficiaries can be readily identified and the accruing benefits are measurable, user charges are the best instrument to finance public services.[12] Intergovernmental transfers should not be used to finance services if their cost of provision can be recovered from user charges or a collective tax. The cost of services that have significant implications for neighboring areas—health, education, solid-waste management—can be supported through intergovernmental transfers. To the extent feasible and practical the poor and needy should be subsidized or helped directly. Price reductions would distort the market for services. Appendix 9 presents estimates on the potential to mobilize additional resources in Karachi.

Achieving fiscal balance and consolidation will be long and arduous, partly because of opposition from vested interest groups. Political will, determination, administrative capability, and creation of a constituency for reform in civil society will be critical to achieve reforms.

Enhancement of Institutional Capability

Local governments will take time to take root. However, if they are to flourish they will need support through capacity building, larger flow of untied resources, and greater authority to spend these allocations and transfers to improve local services.

Local governments lack some key financial engineering, management, and project appraisal capabilities. Computerized systems to improve financial management—budgeting, accounting, and strategic financial planning systems—are also needed to make local governments not only more efficient but also more accountable. Improved information systems and reliable financial data will be critical to raise funds from private capital markets.

Transparency to Facilitate Investment Decisions

Budget documents should contain information on the following to provide a composite picture of government liabilities:

- basis of projections and assumptions underlying budget estimates;
- overdrafts and ways-and-means advances;

- guarantees given (principal plus interest);
- other contingent liabilities of the government in respect of pensions;
- disputed liabilities;
- financial statements of key public sector enterprises getting financial assistance from the provincial government;
- information on the losses of corporations and statutory corporations whose finances are outside the budget;
- tax expenditures—cost of concessions, exemptions, and deferrals, as provided by the federal Government through its various official publications, such as the Budget and the Annual Economic Survey;
- percentage of roads in good condition;
- budget provisions for O&M and shortfalls against accepted norms and yardsticks; and
- public accounts committee recommendations and how the provincial government is addressing them.

Quarterly fiscal accounts should also be made public, along with information on collections from the main revenue instruments or user charges, and expenditures on priority areas, by function and economic classification. All subnational governments should develop a system to record transaction liabilities. Provincial governments should post on their websites their fiscal performance indicators and reconciliation of public accounts.

Implementing these recommendations will raise investors' level of comfort in information, which is critical not only to develop a sustainable market for subnational government debt instruments but also to rapidly bring down these instruments' interest rates.

Conclusions

Creating market infrastructure is essentially political in nature, but the technical components consume policy makers' time and attention enough to draw their focus away from the paucity of political determination and courage, holding back market development. The task is difficult because, as is typical of most large infrastructure projects, costs and benefits are distributed asymmetrically. Benefits are often distributed among a large number of entities whose individual gain is not large enough to make them vocal supporters of the project. Costs are just as often concentrated and borne by groups harmed enough by the project to turn them into active opponents. The conflicts that arise from the asymmetry must be handled with skill.

Endnotes

[1] The LGOs of 2001 replaced the LGOs of 1979. LGOs define the constitution, functions, management, fiscal powers, and resource arrangements for elected local governments at the district and lower levels and require the establishment of new institutions at the provincial level (e.g., local government commission, provincial finance commission). Plans to restructure the federal and provincial frameworks and relations between the two levels of government are being formulated.

[2] Earlier transfers to local government as compensation for loss of the *octroi* and *zila* taxes were frozen at the nominal values of their collections from this source at the time these taxes were abolished. Their loss eroded the revenue and financial base of local governments, which were then unable to provide basic services, worsening the public's apathy to local governments.

[3] *Octroi* (a tax on imports into towns and cities) and *zila* (a tax on exports from rural areas) were assessed at check posts.

[4] The property tax was assessed and collected by the provincial government and shared between the municipalities and local water and sanitation agencies after a deduction of 15–17%.

[5] For instance, the yardsticks for maintenance of irrigation channels were last updated in 1991/92.

[6] Funding agencies are not a sustainable source of investment financing because not only did funding decline in the 1990s, but it is also highly sensitive to international politics.

[7] To discourage the use of the State Bank of Pakistan's rediscounting facility, only a 3-day repurchase offer is available, provided that the cash requirement of the bank is greater than its treasury-bill holding. Cash is only provided overnight.

[8] The factors that determine the demand for a financial instrument are the return (yield), risk of holding, ease with which it can be liquidated, and efficiency of the payment system.

[9] A 5–7-year loan has a high debt-servicing burden of 20% of just the principal amount.

[10] Market capitalization of listed companies in Pakistan is around 15.5% of GDP, and the ratio of the value of stocks traded to GDP just under 10%, compared with 50% in most East Asian economies.

[11] Some users may not be able to pay for the service, but those who can, should do so—for example, to ensure the collection and disposal of solid waste—to reduce heath expenditures.

[12] Where beneficiaries cannot be identified and costs and benefits measured only with difficulty, a collective tax such as a property tax should be levied for public services such as maintenance of roads, streetlights, and traffic lights.

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Appendix 1. Federal and Provincial Powers

Federal Government	Federal and Provincial Governments	Provincial Governments
Defense	Population planning	Historical sites and monuments
External affairs	Curriculum development	Law and order
Posts and telegraphs	Syllabus planning	Justice
Telephones	Centers of excellence	Tertiary health care and hospitals
Radio and TV	Tourism	Highways
Currency	Social welfare	Secondary and higher education[a]
Foreign exchange	Vocational and technical training	Urban transport
Foreign aid	Employment exchanges	Agricultural extension
Institutes for research		Fertilizer and seed distribution
Nuclear energy		Irrigation[b]
Ports and aerodromes		Land reclamation[b]
Shipping		
Air service		
Stock exchanges		
National highways		
Geological surveys		
Meteorological surveys		
Censuses		
Railways		
Mineral oil and natural gas		
Industries		

[a] The federal Government, through the University Grants Commission, funds university education, but administrative control lies with provincial governments.

[b] Development of irrigation is a federal matter.

Appendix 2. Organizational Structure and Functional Responsibilities of Local Government

The previous provincial administration comprising divisions, districts, and *tehsils* has been replaced by a structure consisting of countrywide local bodies: districts (called city districts in the four provincial capitals), *tehsils* (called towns in the four city districts), and union councils.

The local governments established under the new system are as follows.

Table A2.1 Districts and City Districts

Province	Districts	City Districts	Total
Punjab	33	1	34
Sindh	15	1	16
Balochistan	21	1	22
North-West Frontier Province	23	1	24
Total	**92**	**4**	**96**

Table A2.2 Tehsils and Towns

Province	Tehsils	City Towns/Town Councils	Total
Punjab	116	6	122
Sindh	86	18	104
Balochistan	71	2	73
North-West Frontier Province	34	4	38
Total	**307**	**30**	**337**

The union council, the lowest tier in local government, comprises 21 elected members. The *nazim* (mayor) and *naib nazim* (deputy mayor) are elected on a joint ticket and automatically granted membership of the district and *tehsil* councils, respectively. The remaining 19 seats of the union council are allocated to ensure adequate representation of women, minorities, and peasants (4 out of the 12 Muslim seats, and 2 of the 6 peasant seats are reserved for women, while minority communities are also guaranteed 1 seat wherever applicable).

District and *tehsil* councillors and the district *nazim* and *naib nazim* are elected by the union councillors. Women represent 33% of all unions at the district as well as at the *tehsil* level. Minorities and peasants are guaranteed 5% of all seats at the district and *tehsils* level. District governments are responsible for social or human capital services such as health and education while the *tehsil* and union councils primarily provide municipal services.

Although district, *tehsil*, and union councils have joint electorates, they are neither related hierarchically nor managerially linked. Funds flow to the *tehsils* via the district provincial account. The committee of district *nazim* and *tehsil nazimeen* coordinate activity between districts and *tehsils*.

Union councils receive grants from districts, mainly for capital expenditures (development budgets). Districts distribute these grants among the union councils.[1]

Union council schemes must be approved by the district development committee (composed of district officials chaired by the district *nazim*). Specifying union council schemes is the responsibility of *tehsil* officers, who do not possess decision-making power even though some are involved in *tehsil* activities.

The district coordinating officer (DCO, the most senior officer in the district, in charge of different sectors) replaces the district commissioner and is the district accounting officer, reporting to the *nazim*. The DCO is supported by 12 executive district officers (for education, health, and literacy), who report to the DCO and no longer to the line departments.

Tehsil staff are employed by the *tehsil*, while district officers who were paid through provincial budgets in 2000/01 are expected to continue until 2003. Since decisions regarding their careers continue to be taken by the federal or provincial governments, district staff's loyalty to the districts is likely to remain doubtful.[2]

Since they have been formed from former *tehsil* municipal corporations, many *tehsils* will not only be given the personnel and organizational structures of these bodies but also have access to their financial resources. *Tehsils* will provide municipal services (sanitation, street lighting, water supply, and roads) and incorporate staff posted to the *tehsils* from provincial line departments.

Scope of Local Government Reform

Local government legislation is based on the subsidiary principle, under which each service is assigned to a government, which internalizes the costs and benefits of service provision. Increased local political participation improves allocation of public expenditures to reflect local needs, leading to willingness of local residents to pay for services. The geographical deconcentration of services is expected to strengthen accountability by bringing service providers closer to their clients.

Local governments now provide a wide range of public services, including primary education, health and sanitation, drinking water, law and order, agricultural extension, and district roads. Local governments are also expected to perform regulatory functions. Both categories—service provision and regulation—have functions that are obligatory or optional.

Along with the devolved functions, funds expended by provincial governments to provide services were also transferred to the district governments. The shifting of resources and authority to lower levels is expected to force officials to respond to local needs and priorities to maximize the return on taxpayers' contributions.

Table A2.3 Responsibilities of Levels of Local Government, 2002

Responsibility	District	Tehsil	Union Council
Education	Primary and secondary education, literacy	X	X
Health	Dispensaries and local hospitals	X	X
Roads	District roads	Local roads and streets	Local streets
Water	Water and sanitation agencies (only city district governments)	Water supply systems	Wells and ponds
Sewers and Sanitation	See above	Yes	X
Fire Services	X	Yes	X
Parks, Playgrounds	X	Yes	Yes
Animals	X	Slaughterhouses, fairs	Cattle ponds and grazing areas
Cultural and Sports Services	X	Fairs, cultural events	Libraries
Street Services	X	Street lighting, signals	Street lighting
Other	X		Registry of births and deaths

X = no responsibilities.
Source: Local Government Ordinances, 2001.

Community members can participate in monitoring development activities and have a say in local affairs through local (village, town, and city) organizations to be called citizens' community boards. As quasi-public organizations, they will not be subject to the same rules and regulations as public bodies. District governments will have to spend 25% of the development budgets through the boards to finance up to 80% of the budgeted amount of an approved development schedule. Citizens' community boards, which will mobilize funds for development, will also monitor the delivery of services and redress public grievances.

[1] During 2001/02, the transfer and grant system was not formula driven and did not cover transfers from provinces to the lower tiers of government such as the *tehsils*, towns, and union councils. However, unlike the government of Punjab, whose provincial finance commission has proposed mechanisms for direct transfers to *tehsil*, town, and union councils, in Sindh even in 2002/03 the formulas for horizontal transfers do not extend to these tiers, resource flows to which are decided by the provincial government.

[2] Converting provincial government employees (even district and *tehsil* cadres) into district government staff is politically daunting. A host of issues will emerge, particularly career paths and promotion prospects based on seniority, for example, among teachers and doctors. Provincial civil servants might thus hinder reform and not discharge their duties.

Appendix 3. Provincial Government Operations, 1993/94–1999/2000 (PRs million)

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000
Total Revenues	98,821	127,226	147,819	157,170	148,920	157,725	199,151
Provincial Share in Federal Revenues	79,875	104,273	120,446	131,555	114,078	115,573	143,231
Provincial Taxes	7,939	9,351	11,614	13,964	13,908	15,494	18,774
Property Taxes	1,771	2,079	2,392	3,608	4,194	4,161	3,876
Of which: Agricultural Tax	—	—	—	—	—	1,274	1,408
Excise Duties	543	525	815	938	911	1,264	1,334
Stamp Duties	2,875	3,410	4,213	4,463	4,814	5,267	6,398
Motor Vehicle Tax	1,246	1,623	1,667	1,931	2,113	2,362	2,803
Others	1,504	1,714	2,527	3,024	1,876	2,440	4,363
Provincial Nontax	6,391	6,356	5,923	7,149	10,053	14,574	16,144
Interest	367	343	423	141	1,534	243	813
Profits from Hydroelectricity	5,032	7,347	6,860	6,461	5,442	6,000	—
Irrigation	(5,363)	(7,798)	(8,734)	(7,133)	(6,702)	(6,266)	—
Receipts	1,347	1,296	1,806	1,986	2,323	2,528	—
Expenditures	6,710	9,094	10,540	9,119	9,025	8,794	—
Forest	644	838	823	734	616	823	—
Other	5,711	5,626	6,551	6,946	9,163	13,774	—
Federal Grants	4,616	7,246	9,836	4,502	10,881	12,084	21,002
Total Expenditures	104,607	131,550	156,004	153,700	157,817	161,087	215,858
Current Expenditures	84,948	100,302	125,950	134,401	133,607	137,512	179,605
Interest to Federal Government	20,877	21,353	22,264	23,409	26,010	25,469	28,270
Others (after errors and omissions)	64,071	78,949	103,686	110,992	107,597	112,043	151,335
Development Expenditures	19,659	31,248	30,054	19,299	24,210	23,575	36,253
Balance	(5,786)	(4,324)	(8,185)	3,470	(8,897)	(3,362)	(16,707)
							% of GDP
Provincial Share in Federal Revenues	5.1	5.6	5.7	5.4	4.3	4.0	4.5
Provincial Taxes	0.5	0.5	0.5	0.6	0.5	0.5	0.6
Provincial Nontax	0.4	0.3	0.3	0.3	0.4	0.5	0.5
Total Expenditures	6.7	7.1	7.4	6.3	5.9	5.5	6.8
Current Expenditures	5.4	5.4	5.9	5.5	5.0	4.7	5.6
Development Expenditures	1.3	1.7	1.4	0.8	0.9	0.8	1.1

— = data not available.

Appendix 4. Revenue Receipts of Provinces

Table A4.1 Punjab (PRs million)

Major/Minor Function	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
Tax Revenues					
Direct Taxes					
Agriculture Income Tax	619	1,000	1,217	672	1,250
Property and Wealth Tax					
Property Tax	171	201	190	476	375
Transfer of Property	165	156	247	228	260
Land Revenue	546	1,373	2,129	2,010	1,994
Total Property and Wealth Tax	882	1,730	2,566	2,714	2,629
Other Direct Taxes	121	143	0	185	220
Total Direct Taxes	1,622	2,873	3,783	3,571	4,099
Indirect Taxes					
Provincial Excise	418	517	467	480	415
Stamp Duties	3,080	3,426	4,416	3,218	4,000
Motor Vehicles	1,141	1,328	1,602	1,593	1,560
General Sales Tax on Services	0	0	0	934	1,140
Other Indirect Taxes	1,235	1,266	1,732	689	1,696
Total Indirect Taxes	5,874	6,537	8,217	6,914	8,811
Total Tax Receipts	7,496	9,410	12,000	10,485	12,910
Nontax Receipts					
Income from Property and Enterprise	1,318	129	350	1,334	1,268
Receipts from Civil Administration					
Law and Order Receipts	554	640	696	800	843
Community Service Receipts	517	580	486	409	435
Social Service Receipts	993	1,078	697	999	1,089
Economic Service Receipts	2,601	2,685	2,965	3,058	3,639
Other Receipts	111	112	121	134	236
Total Receipts from Civil Admin.	4,776	5,095	4,965	5,400	6,242
Miscellaneous Receipts	2,560	6,398	2,530	1,880	1,055
Total Nontax Receipts	8,654	11,622	7,845	8,614	8,565
Total Revenue Receipts	**16,150**	**21,032**	**19,845**	**19,099**	**21,475**
Yearly % Growth		30.2	(5.6)	(3.8)	12.4

F = forecast, BE = budget estimate.

Table A4.2 Sindh (PRs million)

Major/Minor Function	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
Tax Revenues					
Direct Taxes					
Agriculture Income Tax	110	225	117	547	700
Property and Wealth Tax					
Property Tax	305	521	201	421	165
Transfer of Property	196	194	197	257	355
Land Revenue	166	124	145	158	0
Total Property and Wealth Tax	667	839	543	836	520
Other Direct Taxes	142	141	142	143	220
Total Direct Taxes	919	1,205	802	1,526	1,440
Indirect Taxes					
Provincial Excise	431	655	755	691	991
Stamp Duties	1,580	1,684	1,772	1,814	2,317
Motor Vehicles	570	582	637	929	995
General Sales Tax on Services	0	0	0	376	458
Other Indirect Taxes	916	1,094	1,369	2,188	2,238
Total Indirect Taxes	3,497	4,015	4,533	5,998	6,999
Total Tax Receipts	4,416	5,220	5,335	7,524	8,439
Nontax Receipts					
Income from Property and Enterprise	86	5	384	76	82
Receipts from Civil Administration					
Law and Order Receipts	310	333	350	132	569
Community Service Receipts	145	141	99	68	84
Social Service Receipts	282	281	350	314	477
Economic Service Receipts	801	778	741	842	1,138
Other Receipts	45	51	53	60	95
Total Receipts from Civil Admin.	1,583	1,584	1,593	1,416	2,363
Miscellaneous Receipts	1,043	1,614	1,775	1,674	2,075
Total Nontax Receipts	2,712	3,203	3,752	3,166	4,520
Total Revenue Receipts	**7,128**	**8,423**	**9,087**	**10,690**	**12,959**
Yearly % Growth		18.2	7.9	17.6	21.2

F = forecast, BE = budget estimate.

Table A4.3 North-West Frontier Province (PRs million)

Major/Minor Function	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
Tax Revenues					
Direct Taxes					
Agriculture Income Tax	42	45	71	23	180
Property and Wealth Tax					
Property Tax	54	62	67	136	41
Transfer of Property	8	8	11	9	10
Land Revenue	177	176	172	177	200
Total Property and Wealth Tax	239	246	250	322	251
Other Direct Taxes	11	13	21	25	60
Total Direct Taxes	292	304	342	370	491
Indirect Taxes					
Provincial Excise	12	17	16	15	20
Stamp duties	116	113	142	139	200
Motor Vehicles	312	357	417	444	540
General Sales Tax on Services	0	0	0	219	267
Other Indirect Taxes	131	177	369	282	344
Total Indirect Taxes	571	664	944	1,099	1,371
Total Tax Receipts	863	968	1,286	1,469	1,862
Nontax Receipts					
Income for Property and Enterprise	122	110	92	150	110
Receipts from Civil Administration					
Law and Order Receipts	101	102	150	147	218
Community Services Receipts	197	219	229	151	215
Social Services Receipts	304	246	345	244	386
Economic Services Receipts	540	642	578	550	819
Other Receipts	52	46	32	33	97
Total Receipts from Civil Admin.	1,194	1,255	1,334	1,125	1,735
Miscellaneous Receipts	504	687	432	571	253
Total Nontax Receipts	1,820	2,052	1,858	1,846	2,098
Total Revenue Receipts	**2,683**	**3,020**	**3,144**	**3,315**	**3,960**
Yearly % Growth		12.6	4.1	5.4	19.5

F = forecast, BE = budget estimate.

Table A4.4 Balochistan (PRs million)

Major/Minor Function	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
Tax Revenues					
Direct Taxes					
Agriculture Income Tax	0	3	116	1	2
Property and Wealth Tax					
Property Tax	21	22	48	53	49
Transfer of Property	10	10	11	6	15
Land Revenue	19	30	23	23	33
Total Property and Wealth Tax	50	62	82	82	97
Other Direct Taxes	0	0	2	1	1
Total Direct Taxes	50	65	200	84	100
Indirect Taxes					
Provincial Excise	50	75	97	138	119
Stamp duties	38	44	45	59	64
Motor Vehicles	90	95	125	155	168
General Sales Tax on Services	0	0	0	86	104
Other Indirect Taxes	21	11	49	28	37
Total Indirect Taxes	199	225	316	466	492
Total Tax Receipts	249	290	516	550	592
Nontax Receipts					
Income for Property and Enterprise	9	0	1	6	12
Receipts from Civil Administration					
Law and Order Receipts	51	42	52	103	65
Community Services Receipts	13	22	22	26	48
Social Services Receipts	30	26	31	26	41
Economic Services Receipts	154	195	213	312	308
Other Receipts	4	6	3	21	23
Total Receipts from Civil Admin.	252	291	321	488	485
Miscellaneous Receipts	93	59	577	1,052	281
Total Nontax Receipts	354	350	899	1,546	778
Total Revenue Receipts	**603**	**640**	**1,415**	**2,096**	**1,370**
Yearly % Growth		6.1	121.1	48.1	-34.6

F = forecast, BE = budget estimate.

Appendix 5. Current Revenue Expenditure

Table A5.1 Punjab (PRs million)

Major/Minor Function	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
General Administration	3,700	4,625	4,709	8,122	14,626	11,854	9,530	12,732	13,993	13,928	13,559
Law and Order											
Justice and Law Courts	253	299	315	404	431	439	509	563	591	656	809
Police & Civil Armed Forces	3,090	3,517	3,889	4,562	4,956	5,331	5,820	6,113	7,307	8,084	8,048
Jails and Detention Places	273	312	332	404	440	435	549	679	681	722	811
Others	93	98	110	122	137	123	148	177	184	209	238
Total	3,709	4,226	4,646	5,492	5,964	6,328	7,026	7,532	8,763	9,671	9,906
Community Services	1,413	2,167	2,109	2,584	2,805	2,840	3,326	3,319	3,101	3,219	3,705
Social Services											
Education	10,511	11,611	13,683	16,750	18,661	19,062	21,513	21,709	23,049	24,661	30,758
Health	2,506	2,931	3,078	3,892	4,123	4,168	4,837	5,142	5,921	6,361	8,128
Social and Other Welfare	377	336	201	222	252	272	272	313	341	356	402
Others	280	482	343	357	336	707	591	587	746	503	364
Total	13,674	15,360	17,305	21,221	23,372	24,209	27,213	27,751	30,057	31,881	39,652
Economic Services											
Agriculture and Food	1,848	2,103	2,270	2,718	2,927	2,989	3,286	3,764	3,590	3,842	4,406
Irrigation	2,067	2,323	2,127	2,603	3,796	4,254	2,977	2,709	285	2,993	5,072
Rural Development	329	296	256	263	324	335	489	304	360	421	442
Industries, Mineral Resources	181	192	195	237	224	237	208	230	1,003	1,033	1,168
Others	38	37	42	50	52	47	52	51	61	65	107
Total	4,463	4,951	4,890	5,871	7,323	7,862	7,012	7,058	5,299	8,354	11,195
Subsidies											
Food	810	590	0	500	1,100	1,500	1,131	2,942	3,500	4,000	5,000
Others	58	-58	0	0	0	0	0	0	0	0	0
Total	868	532	0	500	1,100	1,500	1,131	2,942	3,500	4,000	5,000
Debt Servicing Investment Fund and Grants											
Debt Servicing (interest)	9,130	10,520	11,945	12,467	12,951	13,669	13,966	14,311	14,743	15,666	16,058
Grants and Subventions	134	248	137	160	145	88	390	330	9,061	6,504	9,065
Total	9,264	10,768	12,082	12,627	13,096	13,757	14,356	14,641	23,804	22,170	25,123
Miscellaneous	4	30	29	0	0	317	0	0	4	0	0
Grand Total	37,095	42,659	45,770	56,417	68,286	68,667	69,594	75,975	88,521	93,223	108,140
Yearly % Growth		15.0	7.3	23.3	21.0	0.6	1.3	9.2	16.5	5.3	16.0

F = forecast, BE = budget estimate.

Table A5.2 Sindh (PRs million)

Major/Minor Function	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
General Administration	2,024	2,335	2,330	5,844	10,145	9,970	4,875	6,545	5,268	10,398	13,857
Law and Order											
Justice and Law Courts	124	146	187	241	230	242	264	285	364	447	366
Police & Civil Armed Forces	2,365	2,237	3,139	3,916	4,192	4,005	4,350	4,492	4,986	5,791	6,216
Jails and Detention Places	134	147	156	181	169	145	190	163	309	231	505
Others	27	27	28	39	42	40	47	48	58	116	218
Total	2,650	2,557	3,510	4,377	4,633	4,432	4,851	4,988	5,717	6,585	7,305
Community Services	786	756	872	956	1,012	929	1,392	1,181	1,469	1,484	1,825
Social Services											
Education	5,016	5,402	6,181	8,106	8,689	8,829	10,253	10,323	11,424	12,181	14,328
Health	1,458	1,337	1,487	1,745	2,067	2,189	2,547	2,597	2,995	3,154	4,207
Social and Other Welfare	95	103	108	135	161	160	201	192	177	184	214
Others	161	561	105	189	143	122	131	120	222	450	246
Total	6,730	7,403	7,881	10,175	11,060	11,300	13,132	13,232	14,818	15,969	18,995
Economic Services											
Agriculture and Food	843	643	801	899	1,066	893	956	920	1,229	1,381	2,165
Irrigation	922	935	938	1,448	1,255	1,240	1,408	1,294	1,402	1,320	1,818
Rural Development	24	26	34	43	43	42	43	50	56	2,416	83
Industries, Mineral Resources	101	98	102	141	125	127	149	126	151	126	121
Others	497	511	740	670	420	376	498	770	889	1,435	1,811
Total	2,387	2,213	2,615	3,201	2,909	2,678	3,054	3,160	3,727	6,678	5,998
Subsidies											
Food	0	235	359	200	133	1,216	100	0	388	2,949	3,577
Others	112	91	104	104	115	161	32	24	11	229	0
Total	112	326	463	304	248	1,377	132	24	399	3,178	3,577
Debt Servicing Investment Fund and Grants											
Debt Servicing (interest)	4,512	5,364	7,172	6,366	7,009	8,208	10,682	10,124	11,595	10,441	11,409
Grants and Subventions	159	300	54	257	47	22	160	58	8,074	6,500	6,645
Total	4,671	5,664	7,226	6,623	7,056	8,230	10,842	10,182	19,669	16,941	18,054
Miscellaneous	24	42	19	114	424	4	34	102	72	551	2,090
Grand Total	19,384	21,296	24,916	31,594	37,487	38,920	38,312	39,414	51,139	61,784	71,701
Yearly % Growth		9.9	17.0	26.8	18.7	3.8	(1.6)	2.9	29.7	20.8	16.1

F = forecast, BE = budget estimate.

Table A5.3 North-West Frontier Province (PRs million)

Major/Minor Function	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
General Administration	1,109	1,306	1,328	1,867	2,610	2,249	2,405	2,688	2,910	3,295	4,402
Law and Order											
Justice and Law Courts	58	71	76	91	106	103	125	141	161	170	200
Police &Civil Armed Forces	1,042	1,085	1,130	1,432	1,477	1,428	1,586	1,765	1,983	2,096	2,158
Jails and Detention Places	65	75	86	90	93	93	112	129	145	148	167
Others	13	16	17	20	23	20	24	25	26	29	31
Total	1,178	1,247	1,309	1,633	1,699	1,644	1,847	2,060	2,315	2,443	2,556
Community Services	715	736	866	1,003	996	730	1,010	1,213	1,279	1,241	1,360
Social Services											
Education	3,157	3,569	3,932	4,750	5,499	5,505	6,230	6,648	7,729	8,222	8,478
Health	881	1,008	1,163	1,372	1,590	1,535	1,725	1,956	2,192	2,118	2,493
Social and Other Welfare	19	21	26	30	39	42	50	45	51	51	62
Others	75	80	88	80	68	26	58	52	70	51	57
Total	4,132	4,678	5,209	6,232	7,196	7,108	8,063	8,701	10,042	10,442	11,090
Economic Services											
Agriculture and Food	569	621	683	771	838	750	813	804	894	887	1,140
Irrigation	552	597	586	658	709	366	713	810	727	657	762
Rural Development	62	60	48	58	62	65	65	62	708	1,129	1,002
Industries, Mineral Resources	62	83	70	76	89	64	85	80	78	64	79
Others	14	12	14	643	1,250	2,407	230	292	597	734	516
Total	1,259	1,373	1,401	2,206	2,948	3,652	1,906	2,048	3,004	3,471	3,499
Subsidies											
Food	250	400	550	940	850	1,200	1,550	2,750	3,250	1,950	3,000
Others	0	0	0	0	0	0	0	0	0	0	0
Total	250	400	550	940	850	1,200	1,550	2,750	3,250	1,950	3,000
Debt Servicing Investment Fund and Grants											
Debt Servicing (interest)	3,597	4,057	4,559	4,800	4,942	5,740	6,155	6,282	7,621	6,878	8,632
Grants and Subventions	86	82	44	84	39	11	25	48	129	286	0
Total	3,683	4,139	4,603	4,884	4,981	5,751	6,180	6,330	7,750	7,164	8,632
Miscellaneous	0	0	0	0	0	0	0	0	0	0	9,500
Grand Total	12,326	13,879	15,266	18,765	21,280	22,334	22,961	25,790	30,550	30,006	44,039
Yearly % Growth		12.6	10.0	22.9	13.4	5.0	2.8	12.3	18.5	(1.8)	46.8

F = forecast, BE = budget estimate.

Table A5.4 Balochistan (PRs million)

Major/Minor Function	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01(F)	2001/02(BE)
General Administration	714	1,039	1,021	1,117	1,581	1,192	1,315	1,458	2,271	2,619	2,404
Law and Order											
Justice and Law Courts	32	33	37	45	56	60	67	93	110	134	145
Police &Civil Armed Forces	684	895	855	1,044	1,074	1,067	1,286	1,438	1,536	1,731	1,801
Jails and Detention Places	29	30	34	47	40	44	56	70	61	86	74
Others	4	4	5	6	6	7	8	9	9	8	10
Total	749	962	931	1,142	1,176	1,178	1,417	1,610	1,716	1,959	2,030
Community Services	792	1,226	940	1,130	1,238	1,161	1,385	1,467	1,442	1,996	1,886
Social Services											
Education	1,254	1,499	1,623	1,869	2,253	2,418	2,806	3,175	3,541	3,572	4,846
Health	490	561	687	747	821	885	965	947	967	1,281	1,727
Social and Other Welfare	41	28	40	48	48	48	55	56	64	59	79
Others	61	75	89	103	97	91	112	121	354	372	154
Total	1,846	2,163	2,439	2,767	3,219	3,442	3,938	4,299	4,926	5,284	6,806
Economic Services											
Agriculture and Food	475	594	635	771	810	919	959	1,018	1,118	1,294	696
Irrigation	163	178	183	205	217	231	234	291	261	705	362
Rural Development	52	61	71	80	87	88	91	103	104	698	120
Industries, Mineral Resources	67	73	78	95	95	86	81	82	89	102	73
Others	0	0	0	0	0	0	0	0	0	27	639
Total	757	906	967	1,151	1,209	1,324	1,365	1,494	1,572	2,826	1,890
Subsidies											
Food	224	100	70	250	550	0	0	0	1,390	0	300
Others	0	0	0	0	0	0	0	0	0	0	0
Total	224	100	70	250	550	0	0	0	1,390	0	300
Debt Servicing Investment Fund and Grants											
Debt Servicing (interest)	1,442	1,716	1,920	2,040	2,146	2,388	3,106	2,907	2,875	2,813	3,051
Grants and Subventions											
Total	1,442	1,716	1,920	2,040	2,146	2,388	3,106	2,907	2,875	2,813	3,051
Miscellaneous	0	0	0	0	0	0	0	0	0	0	18
Grand Total	6,524	8,112	8,288	9,597	11,119	10,685	12,526	13,235	16,192	17,497	18,385
Yearly % Growth		24.3	2.2	15.8	15.9	(3.9)	17.2	5.7	22.3	8.1	5.1

F = forecast, BE = budget estimate.

Appendix 6. Development Expenditure

Table A6.1 Punjab (PRs million)

Major/Minor Function	1991/ 92	1992/ 93	1993/ 94	1994/ 95	1995/ 96	1996/ 97	1997/ 98	1998/ 99	1999/ 2000	2000/ 01(P)	2001/ 02(BE)
Community Services	4,304	4,822	4,281	6,735	6,871	5,534	6,901	5,761	5,380	6,448	8,035
Social Services	1,078	811	879	1,317	1,540	1,205	2,729	2,324	1,952	829	870
Economic Services	5,574	3,568	1,121	3,251	3,256	1,686	2,358	3,596	3,992	6,976	8,052
DSIFG	912	993	284	652	523	1,489	2,979	2,763	4,306	2,315	927
Others	75	51	63	25	94	25	30	34	184	14	2,246
Total	11,943	10,245	6,628	11,980	12,284	9,939	14,997	14,478	15,814	16,582	20,130

Table A6.2 Sindh (PRs million)

Major/Minor Function	1991/ 92	1992/ 93	1993/ 94	1994/ 95	1995/ 96	1996/ 97	1997/ 98	1998/ 99	1999/ 2000	2000/ 01(P)	2001/ 02(BE)
Community Services	3,526	3,192	3,081	4,359	4,254	2,073	2,750	2,322	1,667	2,819	3,609
Social Services	259	219	330	422	488	283	422	431	578	301	724
Economic Services	1,020	1,031	1,125	1,807	1,980	983	1,277	792	609	510	1,065
DSIFG	1,025	1,012	1,101	2,146	1,107	383	171	108	786	306	253
Others	37	16	10	23	20	13	12	39	83	40	99
Total	5,867	5,470	5,647	8,757	7,849	3,735	4,632	3,692	3,723	3,976	5,750

Table A6.3 North-West Frontier Province (PRs million)

Major/Minor Function	1991/ 92	1992/ 93	1993/ 94	1994/ 95	1995/ 96	1996/ 97	1997/ 98	1998/ 99	1999/ 2000	2000/ 01(P)	2001/ 02(BE)
Community Services	1,958	2,334	1,887	2,858	2,784	1,253	1,172	1,617	1,423	1,288	825
Social Services	850	1,027	750	791	706	1,081	834	687	909	962	1,182
Economic Services	1,871	1,262	1,326	1,182	1,478	637	609	1,092	595	2,373	2,021
DSIFG	647	139	21	134	218	8	12	12	155	18	0
Others	29	93	101	93	116	102	70	169	120	150	3,783
Total	5,355	4,855	4,085	5,058	5,302	3,081	2,697	3,577	3,202	4,791	7,811

Table A6.4 Balochistan (PRs million)

Major/Minor Function	1991/ 92	1992/ 93	1993/ 94	1994/ 95	1995/ 96	1996/ 97	1997/ 98	1998/ 99	1999/ 2000	2000/ 01(P)	2001/ 02(BE)
Community Services	1,135	1,011	1,429	1,436	1,516	558	513	787	775	1,761	2,211
Social Services	946	519	1,752	1,806	1,624	954	619	719	383	3,919	3,519
Economic Services	1,580	1,499	1,279	1,536	1,441	1,005	729	495	273	2,118	2,048
DSIFG	0	0	0	0	0	0	0	0	0	0	0
Others	71	48	33	79	38	28	23	8	14	57	174
Total	3,732	3,077	4,493	4,857	4,619	2,545	1,884	2,009	1,445	7,855	7,952

For all tables: P = projection, BE = budget estimate, DSIFG = debt servicing investment fund and grants.

Table A7.1 Consolidated Revenues and Expenditures of Karachi City District Government, Town Councils, and Development Authorities (PRs million)

	1997/ 98	1998/ 99	1999/ 2000	2000/ 01	2001/ 02(RE)	2002/ 03(B)
Revenue						
Matching Receipt in Lieu of *Octroi*	3,089.6	3,654.5	3,904.2	2,911.2	3,811.7	5,158.5
Property Tax	107.5	150.0	85.8	340.2	600.0	1,140.0
Divisible Pool Transfers Relating to Devolved Units					4,926.9	6,081.6
Fire Tax	18.7	14.5	0.7	0.6	50.0	100.0
Income from Water Supply	1,737.6	2,143.2	2,213.3	2,317.5	2,111.0	2,500.0
Conservancy Charges	510.1	644.7	592.9	619.8	336.0	520.0
Trade License Fee (Health Department) and Medical Institutions	39.8	33.5	41.3	70.0	120.4	193.1
Rent	54.4	61.2	62.1	96.4	119.7	123.7
Interest from Investment	147.0	227.7	8.4	3.3	656.2	660.5
Loans and Grants	0.9	11.0	39.9	11.3	35.9	53.3
Revenue from Sale of Land and Development Charges	963.1	711.4	534.3	1051.3	887.7	2,584.5
Receipts from Liyari Development Authority					444.0	1,186.2
Receipts from Malir Development Authority					166.8	1,583.0
Others	509.4	447.5	370.1	487.6	1,422.3	3,269.2
Total Revenue	7,178.0	8,099.1	7,853.1	7,909.2	15,688.6	25,569.7
Expenditure						
Establishment Expenditures	2,475.7	2,652.7	2,772.0	3,042.1	3,715.9	5,099.1
Establishment Relating to Devolved Units					4,393.7	4,892.2
Additional Payments to Pension Fund	85.0	90.0	100.0	0.0	150.0	150.0
Commodities and Services	1,214.7	1,495.2	2,286.3	3,417.9	2,674.4	2,828.1
Commodities and Services Relating to Devolved Units					452.7	632.9
Repair Maintenance	154.3	184.3	146.5	163.7	305.5	408.7
Repair Maintenance Relating to Devolved Units					71.9	62.4
Purchase of Durable Goods and Dev't. Expend.	2,269.5	2,702.2	1,580.7	1,695.6	3,223.2	4,732.7
Durables Relating to Devolved Units					8.7	
Annual/Public Sector Development Programme						494.0
Liabilities of Karachi Development Authorities Assumed by City Government						1,101.2
Expenditure Relating to Liyari Dev't. Authority					443.0	1,176.4
Expenditure Relating to Malir Dev't. Authority					165.9	1,573.0
Interest Expense	173.7	350.0	386.0	386.0	300.0	300.0
Provision for doubtful debts	260.6	272.0	291.0	291.0	300.0	300.0
Debt retirement					135.0	265.0
Others	337.4	404.1	377.9	251.0	510.6	1,624.9
Total Expenditure	6,971.0	8,150.6	7,940.4	9,247.2	16,850.5	25,640.6
Surplus/(Deficit)	207.1	(51.5)	(87.3)	(1,338.0)	(1,161.9)	(70.9)

RE = revised estimate, B = budget.

Table A7.2 Karachi Municipal Corporation/Karachi City District Government (PRs million)

	1997/98	1998/99	1999/2000	2000/01	2001/02(B)
Revenue					
Matching Receipt in Lieu of *Octroi*	3,089.6	3,654.5	3,904.2	2,911.2	3,904.3
Fire Tax	18.7	14.5	0.7	0.6	50.0
Conservancy Charges	47.3	64.7	3.9	4.4	140.0
Trade License Fee (Health Department) and Medical Institution	15.9	20.1	29.7	54.6	94.9
Others					
Rent	51.8	59.0	60.8	95.0	98.4
Charged Parking					
Interest from Investment	142.1	198.8			900.0
Others	29.6	49.4	42.0	65.6	113.8
Total Others	223.4	307.2	102.7	160.6	1,112.2
Nonrecurrent Receipts					
Revenue from Sale of Land and Dev't. Charges	99.3	61.5	35.4	81.7	351.7
Total Revenue	3,494.2	4,122.6	4,076.7	3,213.0	5,653.1
Expenditure					
Recurrent Expenditures					
Establishment	447.4	539.7	584.4	578.0	679.7
Additional Payments to Pension Fund	85.0	90.0	100.0		150.0
Commodities and Services	259.3	274.0	261.2	433.6	411.2
Repair Maintenance / Contingencies	58.9	53.1	43.4	46.1	128.2
Total Recurrent Expenditures	850.6	956.7	988.9	1,057.7	1,369.1
Purchase of Durable Goods	59.2	89.5	55.1		183.1
Development Expenditure	384.0	711.6	407.9		1,791.0
Total for Durables and Development	443.3	801.1	463.0	442.9	1,974.1
Debt Servicing					70.0
Share of District Municipal Corporations	2,191.2	2,315.7	2,281.7	2,036.9	2,280.0
Subsidy to Karachi Water and Sewerage Board	249.2	202.6	12.0	20.8	10.0
Total Expenditure	3,734.2	4,276.1	3,745.6	3,558.2	5,703.2
Surplus/(Deficit)	(240.01)	(153.57)	331.09	(345.17)	(50.2)

B = budget.

Appendix 8. Lahore City District Government Revenues and Expenditures (PRs million)

	2001/02(RE)	2002/03(B)
Revenues		
Fiscal Transfers from Provincial Government	2,619.28	3,003.03
Grant in Lieu of *Octroi*	844.62	1,013.63
Approval of Building Plans and Commission Fees	23.32	50.00
Profit on Investment	25.99	3.00
User Charges for Social Services	15.34	16.64
Rental Income	101.13	120.24
Property Tax	78.63	90.00
Property Transfer Fee	111.08	3.00
Tax on Animals	69.62	
Sanitation Fees	6.05	15.00
Miscellaneous	20.51	15.80
Subtotal (own revenues)	1,296.29	1,327.31
Deposit Works	1.64	6.00
Sale of Property	247.93	
Own Revenues	1,545.86	1,333.31
Grant in Aid		211.34
Total Revenues	4,165.14	4,547.68
Recurrent Expenditures		
Education	1,897.50	2,176.42
Salary Expenditure	1,796.78	2,069.03
Nonsalary Expenditure	100.72	107.39
Health	250.84	276.93
Salary Expenditure	164.06	184.02
Nonsalary Expenditure	86.78	92.91
Expenditure in Other Departments	1,093.11	1,493.68
Salary expenditure		879.87
Nonsalary expenditure		613.81
Miscellaneous (repairs)	35.49	
Total Recurrent Expenditures	3,276.94	3,947.02
Transfer to Union Councils in Lieu of *Zila* Tax	231.8	340.73
Subtotal	3,508.74	4,287.75
Development Expenditures	836.979	622.36
Total Expenditures	4,345.72	4,910.11
Surplus/(Deficit)	(180.58)	(362.43)

RE = revised estimate, B = budget.

Appendix 9. Income Distribution and Household Affordability Analysis

If we take a 20% ratio of tax to gross domestic product (GDP) for countries economically similar to Pakistan, and set the ratio as the standard for Pakistan, then compared with the present tax-to-GDP ratio of federal and provincial revenues of 14%, the difference, i.e., 6%, represents a potential tax base that remains to be exploited by different levels of government. Assuming that over the medium term the ratio for federally and provincially administered taxes can be raised to 17.5% through base broadening and improved tax administration, then 2.5% of GDP represents a tax base that can be tapped by the local government, compared with the estimated present share of gross regional product of approximately 0.6%, assuming that Karachi accounted for 20% (PRs695 billion) of the national GDP of PRs3,472 billion in 2000/01.

A study by the Applied Economics Research Centre (1993) estimated Karachi's per capita income to be 2.6 times Pakistan's average. Using this as the multiple, per capita income of Karachi in 2000/01 translates to around $2,700, which is a large enough base for the Karachi City District Government and town councils to mobilize additional revenues. The study calculated the poverty line for Karachi to be PRs2,900 per household. The 2000/01 poverty line (ignoring changes in consumption patterns), allowing for inflation, is estimated at around PRs6,800 per month for households that would suffer from higher taxes and user charges. This is consistent with the findings of the Household Income and Expenditure Survey 1998/99, which shows that urban households in Sindh begin to save only after their monthly incomes exceed PRs7,000.

Higher-income groups are able to contribute enough of their savings to increase earnings of Karachi City District Government, town councils, and associated public sector enterprises by 1.9% of Karachi's gross regional product, or PRs13 billion of tax revenues, compared to the PRs4.4 billion mobilized in 1999/2000 by the district municipal corporations and Karachi City District Government combined. If only the top 20% of households, which enjoy over 50% of Karachi's household income, were made to bear the entire burden of these additional revenues, this stratum's gross savings would be reduced by less than 3.5%.

Philippines

Lydia N. Orial
Senior Vice President
Operations Group
LGU Guarantee Corporation
Manila

Acronyms

ADB	Asian Development Bank
BOT	build-operate-transfer
BSP	Bangko Sentral ng Pilipinas (Central Bank of the Philippines)
COA	Commission on Audit
DBM	Department of Budget and Management
DOF	Department of Finance
DPWH	Department of Public Works and Highways
GDP	gross domestic product
GFI	government financial institution
IRA	internal revenue allotment
LGC	Local Government Code
LGU	local government unit
LGUGC	LGU Guarantee Corporation
MDFO	Municipal Development Fund Office
NGA	national government agency
P	peso
PFI	private financial institution
PNB	Philippine National Bank

Executive Summary

Local government financing has become a key policy issue not only in developing but also in most industrial economies. It is a more pronounced issue under decentralized regimes, where governance is being redefined at all levels. In the Philippines, rapidly increasing local expenditure is creating intolerable fiscal pressure on the local tax base. The increase in demand for public services is mostly driven by population growth, caused by natural growth and migration. Local government units (LGUs) face a higher and more complicated level of competition in the third millennium. Their ability to maintain high economic growth to compete in the fast-emerging global economy while halting and mitigating environmental degradation will depend largely on how they manage development and administer their revenue as well as access capital to finance infrastructure and expand services.

Expanding local government expenditure, ever-rising spending on, and demand for, social services, and the increasing cost of providing these services all strain local resources. Consequently, LGUs must (i) learn new fiscal management methods; (ii) establish an accountable, efficient, and dynamic organizational and management structure; (iii) enhance the capability of local leadership; and (iv) embark on comprehensive and extensive development planning and efficient revenue and resource mobilization with strong community participation to respond to the twin challenges of local autonomy and globalization.

Innovative revenue generation and resource mobilization schemes must be explored as traditional central government budget allocations and international development agency financing are fast becoming insufficient. LGUs must broaden their financial horizons and redefine their financing strategies to respond to new challenges. Most LGUs in the Philippines follow established development processes, from traditional revenue generation schemes to nontraditional resource mobilization strategies. LGUs should, in addition, undertake more specific measures:

- Examine macroeconomic trends. They should analyze records of recent revenue collection efforts to assess whether they are consistent with regional gross domestic product (GDP) trends, government expenditure, interest rates, and other economic and financial indicators. Revenue yields below the level of these macroeconomic trends undermine the principles of adequacy and elasticity.
- Consider inflation in tax collection. Market interest rates may be higher than interest and penalties on delayed tax payments, inducing taxpayers to delay or default on tax payments to finance business activity.
- Upgrade revenue collection targets, improve statistical information underlying revenue estimation, and develop mechanisms to enhance revenue projections and assessment of revenue impact of tax policy changes.

- Review the tax burden of the different economic sectors to improve equity. The tax rates on manufacturers and wholesalers vis-à-vis those on retailers under the Local Government Code (LGC) is a classic example of a regressive tax structure.
- Balance tax administration by lowering tax rates and broadening the tax base.
- Remove perverse incentives such as periodic tax amnesties.
- Implement a clear, concise, and regularly updated tax ordinance.
- Upgrade physical infrastructure and simplify procedures and forms.
- Establish a one-stop transaction center for customers to improve compliance and tax collection efficiency.
- Establish interagency information sharing to define the tax base and enforce effective tax collection.
- Penalize tax delinquency to encourage tax compliance.
- Be politically committed to revenue administration.
- Promote good governance through value formation of personnel.
- Improve public expenditure management to promote operational efficiency, reduce waste, and eradicate corrupt and excessive government spending.
- Get feedback from stakeholders and taxpayers to improve revenue generation.
- Promote participatory governance through consultations.
- Explore other areas of collaboration and partnership with the private sector and nongovernment organizations in service delivery.

Best practices in revenue generation and resource mobilization confirm that financially efficient LGUs are more inclined than less efficient ones to pursue complex, nontraditional, and innovative strategies, such as build-operate-transfer (BOT) arrangements or bond flotation. An efficient traditional revenue generation mechanism is a prerequisite to pursue nontraditional approaches.

Decentralization requires fiscal sustainability. Different levels of LGUs gain and lose under the internal revenue allotment (IRA), and the national Government continues to fund some devolved responsibilities, suggesting that expenditure assignments between national and local governments should be reviewed to resolve overlaps and duplications. Minimum standards of service delivery to be financed by the IRA must be established. LGUs should be rewarded for efficient tax collection and service delivery. The absence of straightforward performance indicators in central government grant allocation could undermine LGUs' tax efforts as well as their operational efficiency and accountability. An unconditional grant does not encourage LGUs to engage in long-term capital investments and other development projects beyond basic services. As LGUs confront devolution, however, and as they become increasingly aware of the extent of their responsibilities, the IRA formula should be reviewed as it has resulted in inequitable increments for LGUs. More and more of them, especially the urbanizing ones, are beginning to realize the importance of mobilizing local revenues and even adopting credit financing to underwrite the substantial financial requirements of devolution and development.

To date, though, bond flotation to finance local infrastructure projects has not taken root among local chief executives. Much more needs to be done to establish the capital market for LGU bonds. Primary LGU bond issues are scarce due to lack of LGU awareness of bond flotation. Since 1991, only 13 LGUs have issued bonds, totaling P1.56 billion. The national Government has issued no policy direction on the LGU bond market. The private financial sector is not prepared to accept LGU risks without any form of credit enhancement, considering LGUs as high-risk, highly politicized entities. The lack of accessible, timely, and uniform LGU financial and other information from a single source does not help improve LGU creditworthiness.

Investors will not choose LGU bonds, which have no national guarantee or tax benefits, over treasury bills and treasury notes, which have zero risk as they are guaranteed by the national Government. LGUs are discouraged from banking with private banks as LGU deposits and trust accounts are allowed only with government financial institutions. This compounds the gap between the private financial sector and LGUs and does nothing to stimulate private investor appetite for LGU bonds as they offer no compensating business.

The institutional and procedural framework for the LGU bond market is still evolving. Investors and LGUs will be encouraged to look at bond floats if transparent bond processes and institutional arrangements are in place. To help develop the LGU primary and secondary debt markets, the following reforms are recommended:

- The executive branch of the Government should issue an executive order to support LGU bond market development.
- The lead national government agencies, in collaboration with the Department of Interior and Local Government, should conduct a nationwide information dissemination campaign on LGU bond flotation.
- The lead national government agencies should establish an institutional and procedural framework for LGU bond issuance.
- Bangko Sentral ng Pilipinas (BSP, Central Bank of the Philippines) and the Commission on Audit (COA) should remove restrictions on LGU deposits and trust accounts.
- The national Government should exempt bond team contracting from LGU guidelines on procurement of supplies and services.
- The national Government should provide tax incentives for LGU bonds and make LGU rating a requirement for LGUs issuing bonds.
- The national Government should establish a central depository of LGU data.

Introduction

The global economic slowdown has lessened many national governments' capacity to deliver basic services and implement critical infrastructure projects, leading to the conclusion that subnational units must be involved in them, especially in those developing countries where governments are highly centralized.

In the early 1990s, developing countries began to decentralize politically. Among the first Southeast Asian countries to pass a law on decentralization was the Philippines. It enacted the LGC in 1991, expanding LGU responsibilities to deliver basic services and giving LGUs more fiscal autonomy to finance their new activities (Appendix 1 shows LGU classification by income bracket).[1] The LGC effected a major paradigm shift in governance, mandating the devolution to LGUs of many functions previously carried out by national government agencies (NGAs) and providing for a higher LGU share in internal revenue taxes and taxes on national wealth. The LGC also allows LGUs greater autonomy not only in mobilizing resources but also in allocating them. The LGC grants LGUs the authority to issue bonds for revenue-generating, self-liquidating projects.

The devolution of basic services and activities to LGUs is expected to make them more effective in meeting people's basic needs and advancing the national Government's social reform agenda. The LGC empowers LGUs to create their own revenue sources; levy taxes, fees, and charges; and access nontraditional LGU financing sources such as government and private bank loans, BOT or joint-venture arrangements, and bond flotation. LGUs are thus expected to depend less on transfers from the national Government, such as the IRA.

LGUs, however, continue to use traditional sources of funding such as the IRA and tax revenues to finance expenditures, which are mostly for salaries and operation and maintenance. Capital outlays have been minimal at 7.5% of budget. Less than 30% of LGUs have accessed loans from government financial institutions (GFIs) and only 13 have issued bonds to finance development projects since the LGC was enacted.

While the LGC has brought about gains, the following are concerns:

- continued involvement of NGAs in devolved activities;
- increased financial burden on some LGUs despite the IRA increase;
- increased risks in service delivery; and
- lack of clear policies, programs, and mechanisms for LGU access to financing sources, especially private financing sources such as the capital market.

This chapter examines local government fiscal management since 1995 and

LGU bond market development. Recommendations will be given to facilitate this development and to improve the LGUs' financial situation. Areas where the Asian Development Bank (ADB) may be of assistance will be identified.

Local Government Structure and Powers

Structure

The Constitution identifies provinces, cities, municipalities, and *barangays* as territorial and political subdivisions. The *barangay* is the smallest unit of government; groups of *barangays* constitute a city or municipality. The province is the highest form of local government. The LGC empowers provinces to exercise general supervision over their component cities and municipalities. Highly urbanized and independent component cities are not under the supervision of the province.

Powers

LGUs exercise government and corporate powers and functions. Government powers include those necessary for governance, such as the promotion of health and safety, improvement of property, improvement of morals, maintenance of peace and order, and the preservation of the comfort and convenience of the inhabitants. LGUs also have the power to create their own sources of revenue and to levy taxes.

Economic and Political Trends since 1995

Major Economic and Political Changes

The LGC of 1991 introduced far-reaching political changes by transferring substantial powers, functions, and responsibilities from the national Government to LGUs, thereby allowing change and development to originate from the communities. The LGC's primary objectives are to enable LGUs to fully develop as self-reliant communities and transform themselves into active partners in pursuing national goals through a responsive and accountable decentralized local government structure. The LGC has transformed LGUs from mere administrators of local affairs to managers of communities through the following:

- devolving the service delivery functions of NGAs to LGUs;

- transferring the regulatory powers of certain NGAs to LGUs;
- enhancing the government and corporate powers of LGUs to enable them to discharge their devolved powers and functions;
- institutionalizing relations among LGUs, nongovernment organizations, and the private sector to ensure broad support for local autonomy; and
- requiring NGAs to deconcentrate the requisite authority and power to their respective regional and field offices.

Devolution of Functions from National to Local Government

The LGC was extremely relevant during and after the Asian financial crisis of 1997, when most economies in the region, including that of the Philippines, collapsed. The national budget deficit continued to soar, making transfers and aid from the national Government to LGUs less feasible even as they needed to deliver more basic services. The national Government abandoned important infrastructure projects, resulting in a substantial infrastructure gap. The LGC devolves the following responsibilities to LGUs:

Agricultural Extension and On-Site Research. Most agricultural support services, including establishment of agricultural facilities, have been devolved from the Department of Agriculture to cities and municipalities. Provinces provide agricultural services and facilities that require more resources and cut across municipalities.

Conservation and Protection of the Environment. LGUs share with the national Government the responsibility to manage and maintain the ecological balance. The LGC requires NGAs or government corporations engaged in projects that impact the environment to consult LGUs, nongovernment organizations, and other sectors before implementing such projects.

Field Health Services and Hospital Services. The Department of Health (DOH), particularly the provincial, district, city, and municipal health offices, used to be responsible for delivery of health services and facilities. The LGC has transferred these functions to LGUs.

Locally Funded Public Works and Infrastructure Projects. Most infrastructure projects were undertaken by the Department of Public Works and Highways (DPWH) through its district engineering offices. Most infrastructure projects have been devolved to municipalities. Provinces are assigned only intermunicipal projects and large undertakings such as reclamation projects. However, most municipalities lack the funds and technical capability to undertake all infrastructure projects devolved to them. The LGC thus allows the next higher LGU and the national Government to fund such projects. While the LGC devolves to LGUs responsibility over locally funded infrastructure facilities, DPWH retains responsibility over such projects when they are nationally funded. As long as the national Government continues to fund infrastructure projects devolved to LGUs, DPWH regional offices and district engineering offices will not be substantially affected by the devolution of service delivery. LGUs and DPWH may, therefore, find themselves providing the same infrastructure facilities in an area. DPWH's project implementation functions therefore should be clearly defined.

School Building. The LGC gives to cities and municipalities the responsibility to build, rehabilitate, repair, and maintain public school buildings. The national Government may, however, continue to do the same for elementary and secondary schools. The Department of Education may continue to implement its own school-building program for as long as the national Government funds it.

Social Welfare and Development. Services and facilities once provided by the Department of Social Welfare and Development offices from the regional to the municipal level have been devolved to LGUs.

Tourism Promotion and Development. The Department of Tourism and its corporation, Philippine Tourism Authority (PTA), managed, operated, and maintained tourist facilities and attractions before the LGC. LGUs now undertake tourism development projects without need for PTA approval and perform these Department of Tourism and PTA functions. However, facilities established by the PTA are not covered by devolution. The LGC allows LGUs to regulate tourism establishments.

Telecommunications. The Department of Transportation and Communication provides telecommunications services and facilities with the private sector. The LGC also requires provinces and cities to provide telecommunications services and to install, operate, and maintain public telephones in every municipality.

Low-Cost Housing. Provinces and cities may undertake programs and projects for low-cost housing and other mass dwellings, except those funded by the Social Security System, Government Service Insurance System, and Home Development Mutual Fund. Only housing production by the National Housing Authority, the only government agency involved in direct shelter production, is covered by devolution. However, National Housing Authority programs and projects cannot be devolved unless provided by law. Little devolution, therefore, has occurred in housing provision.

Other Services and Facilities. Cities and municipalities maintain public libraries, and provide information services, including for investment, jobs, and marketing. Provinces and cities provide services for industrial research, development services, transfer of appropriate technology, and investment support, including access to credit financing. The departments of science and technology and of trade and industry provide these services on a limited scale.

Impact of Devolution on Local Government Finance

Devolution has several repercussions, among them the downsizing of NGAs, and the emergence of the need for a significant capability-building program for LGUs and for huge funding.

LGUs have the power to create their own sources of revenue, and to levy taxes, fees, and charges that will accrue exclusively to LGUs. They are allowed to borrow and secure credit from government or private lending institutions to finance local projects as well as to issue bonds, securities, debentures, collateral, notes, and other obligations to finance self-liquidating and income-producing development and livelihood projects.

The LGU share in national taxes has been increased and fixed, the release of which should be automatic unless the national Government incurs an unmanageable public sector deficit. From 20% (and even less) before the LGC, the LGU share in the IRA increased to 30% in 1992, 35% in 1993, and 40% in 1994. Even with their expanded fiscal powers and increased IRA share, however, LGUs, especially the small ones, have not managed to perform their new functions efficiently.

Staff from NGAs were transferred to LGUs, considerably increasing their personnel numbers. About 15,000 agricultural and fishery extension services staff and about 2,000 administrative services employees were transferred from the Department of Agriculture alone. Some employees were made redundant.

Many local officials were wary that IRA increments would only be utilized for salaries of transferred personnel. Such apprehension, however, was unfounded. In the first year of the LGC, LGUs were entitled to receive an amount equivalent to the cost of devolved personnel services in addition to the 30% of IRA. IRAs in succeeding years were estimated to be sufficient to cover the cost of devolved personnel services.

Depending on their classification, LGUs may appropriate only 45–55% of their regular income for personnel services. LGUs should standardize salary structures to harmonize pay rates of local personnel with those of transferred national personnel. The restriction hampered LGU capacity to finance the salaries of national personnel despite the increased IRA. Provinces and municipalities, which acquired more responsibility, lost from devolution, while cities and *barangays*, which acquired less, gained. Provinces, for example, assumed the operation of provincial hospitals formerly managed and financed by DOH. Cities have a broader revenue base and taxing powers than provinces and municipalities, and are thus better able to absorb the additional functions.

Government-wide salary standardization is imperative to eradicate or minimize wide discrepancies in the salary structures between national and local personnel. The

LGC allows local councils to prescribe the salary structure of local personnel provided that it does not exceed budgetary ceilings. Personnel transfers also gave rise to excess staff for certain positions when LGUs already had the full staff complement.

Several studies on decentralization have been undertaken. Loehr and Manasan (1999) focused on the effects of fiscal decentralization and economic efficiency in service delivery, revealing the following:

- Production efficiency has been improved, probably as a result of fiscal decentralization, as LGUs spent about 3.9% of GDP in 2000, compared to about 1.9% before the LGC. Lack of local capability has not been a major constraint, although the experience among LGUs has been uneven. Innovation has made revenue more productive. More services, such as education and law enforcement, should be devolved to LGUs in the medium term.
- Allocative efficiency has improved slightly. The mix of expenditures has changed since 1992, and LGUs' preferences are better reflected in expenditure patterns. Changes in the expenditure mix have been very small and favor public welfare and internal safety (education, health, housing, nutrition, and peace and order) in lieu of general government.
- Fiscal efficiency needs to be improved. Most LGUs spend more in administering taxes (such as real property tax) than they collect in revenues.
- Macroeconomic stability is not threatened by fiscal decentralization.

The study concluded that LGUs face the following problems:

- Few LGUs have fully exploited their own sources of revenue, yet all face hard budget constraints. Ultimately, allocative efficiency will be improved for those jurisdictions that improve revenue generation through local taxes, such as property and business taxes.
- Many LGUs, especially provinces, are unable to fulfill their devolved expenditure responsibilities, and have even created new expenditures when their share in the national taxes (i.e., the IRA) increased after the LGC.
- Inflation cuts into shared revenue before it is delivered to LGUs, it rarely comes from natural resource exploitation, and sometimes LGU revenue is lowered to meet national objectives. LGUs should receive the revenue mandated for them by the LGC.
- Employees should receive equitable and adequate pay, as well as skills training.
- NGAs have not fully yielded responsibility to LGUs for devolved services and should shift from supervisory to supportive roles.

Local Government Fiscal Management

Local Government Fiscal Patterns

Data on the budgetary operations of the three levels of local government for FY1991–2000 are in the appendix tables. Appendix Table 2.1 summarizes the revenue and expenditure of all provinces combined; Appendix Table 2.2, for all cities; and Appendix Table 2.3, for all municipalities.

Total revenue of all provinces, cities, and municipalities combined increased from P24.1 billion in 1991 to P66.5 billion in 1995 to P138.3 billion in 2000. The average annual growth rate of total LGU revenues in 1995–2000 was 15.8%. Due to legislated increases in IRA shares of LGUs, LGU revenue grew from 20% in 1991, to 30% in 1992, 35% in 1993, and 40% in 1994.

Total expenditure of all provinces, cities, and municipalities combined also increased, from P22.8 billion in 1991, to P64.4 billion in 1995, and to P127.9 billion in 2000. The average annual growth rate of total LGU expenditure for 1995–2000 was 16.2%, while that for 1991–1994 was 33.2% due to the increase in LGU functions. LGU revenue as a share of GDP averaged 3.0% in 1992–1995 and 3.9% in 1996–2000. LGU expenditures as a share of GDP averaged 2.8% in 1992–1995 and 3.7% in 1996–2000. The increasing proportion of LGU revenue and expenditure in GDP shows how significant local government finance has become. LGUs contributed a net surplus to consolidated public sector finances in 1991–2000 (Appendix Tables 2.1–2.3).

The main sources of local government income are tax and nontax revenue and income from external sources. Provinces are the most dependent on revenue from external sources, followed by municipalities, then cities (Appendix Table 2.4).

The IRA is the major external source of income of LGUs. Since 1992, the IRA has never been lower than 95% of total external sources of income for all LGU levels. Cities had the greatest dependence on IRA, with an average of 99% in 1992–2000. Municipalities followed with 98%, then provinces with 97%. The average share of IRA to total revenue was 75% for provinces, 45% for cities, and 66% for municipalities (Appendix Tables 2.5 and 2.6).

Revenue from local taxation (real property and business taxes) was the second-largest revenue source for all levels of local government in 1992–2000. The average shares of local taxation to total local sources were 45% for provinces, 67% for cities, and 59% for municipalities (Appendix Table 2.7). Real property tax is the predominant revenue source for provinces, while real property and business taxes contribute almost equally to the coffers of cities and municipalities, making their tax base larger than that of provinces (Appendix Tables 2.1–2.3).

Nontax revenue sources are receipts from economic enterprises, fees and charges, loans, and miscellaneous receipts. LGUs have not fully tapped these sources. Loans and borrowings, classified as nontax income, are a growing source for cities but not for provinces and municipalities. Receipts from economic enterprises are higher for cities and municipalities than provinces, although none of them gives this potential income source much importance.

In 1993–2000, general government expenditure[2] accounted for an average of 31% of total local government expenditure, decreasing significantly from pre-LGC levels. Public welfare and internal safety (health, education, nutrition, peace and order, etc.) accounted for 24%, and economic development for 13%. LGUs appropriated an average capital outlay of close to 10% (Appendix Table 2.8). The category "others" represents intergovernmental aid to hospitals and to *barangays* and other LGUs. Municipalities' general government expenditures represent on average 53% of total LGU expenditure on general government; cities, 30%; and provinces, 17% (Appendix Table 2.9).

Cuaresma and Ilago (1996) examined the equity and efficiency of the central government grant system and the IRA formula. LGU taxing powers and tax bases underscored the importance of LGU development plans and how they affect LGU revenue generation and resource mobilization. Their study essays the different revenue-raising powers provided for in the LGC: local taxation, various forms of financing (bond financing or borrowing from government institutions, particularly GFIs), tapping private capital markets via BOT and its variants, and the IRA (Appendix 3).

Their study concludes the following:

- The national Government has not adequately supported local development, and its expenditure is concentrated in Metropolitan Manila and other urban centers. It continues to give priority to debt servicing instead of poverty reduction, housing, and other social welfare programs. The national Government should give LGUs fiscal autonomy, and LGUs should improve their fiscal administration.
- While LGU revenue-raising powers and regulatory and administrative functions have expanded, the national Government continues to hold on to productive taxes with huge tax bases (such as income tax and tax on motor vehicles). The nationally mandated distribution of the internal revenue allotment has only minimally reduced the urban-rural fiscal gap.
- Because their revenue generation efforts have been limited, LGUs have not embarked on additional programs and projects. Much less local revenue has been generated than external revenue. LGU dependence on the IRA continues to deepen as larger amounts are allotted and automatically released. LGUs heavily depend on real property tax and business taxes and licenses.
- A great number of LGUs have not utilized their power to use nontraditional sources of financing. Few LGUs have issued bonds to finance development projects.

- Local development plans must include programs, projects, realistic funding estimates, and financing mechanisms.
- LGUs continued funding traditional development projects using the 20% development fund and the "pork barrel" of their Congress representatives or senators. The 20% development fund is usually used to finance infrastructure projects that do not meet pressing or long-term development needs.

Strategies to Strengthen Local Government Finance

Ever-increasing expenditure on social services and pressure on public services and infrastructure facilities, and the rising cost of providing public services such as health and education, seriously threaten the local revenue base. More funds must flow into the LGUs, and service delivery must be made more innovative and cost-efficient. Simply put, LGUs need to close the fiscal gap. To do this, they need to confront the major fiscal problems, i.e., high dependency on the IRA, outdated local tax codes, underutilization of real property tax bases, underassessment of local business taxes, poor operation and management of economic enterprises, insufficient utilization of financial resources, and poor planning and budgeting.

LGUs need to undertake some critical revenue-generating measure, as listed in the following paragraphs.

Traditional Sources of Revenue

Such sources include real property tax and local business tax. Urbanization and development of LGUs have opened opportunities for increased tax earnings from high-value real property. Regular updating of property values and classifications and a comprehensive inventory of all real property through tax mapping will maximize the potential of property taxes. Innovative approaches to property taxation can be explored through the use of development or betterment levies, through which the social increment in land values, especially in urban and urbanizing LGUs, is made available for public use.

Idle-Land Tax

Imposing an idle-land tax will discourage large-scale land speculation, rationalize and optimize land use and management, maximize the property tax yield, and rationalize land prices.

Computerization

The real property administration system should be computerized through proper mapping appraisal and assessment, recording and billing, and tax collection.

Automatic Indexation

The general revisions of property assessments against the schedule of fair market value of the property should be automatically indexed. Automatic indexation will help avoid radical adjustments in the schedule and narrow the gap between the official schedule and true market value, thus making property taxation more dynamic and transparent. Automatic indexation will also insulate real property valuation from political interference. The assessor's value and zonal value should be harmonized to ensure predictability, uniformity, and transparency.

Real property tax collectibles should be monitored separately from delinquent accounts. Aggressive collection and enforcement through periodic posting of notices of delinquencies will significantly improve tax collection. Warrants of levy should be issued immediately to trigger auctions of delinquent properties. These aggressive moves, however, require strong political will and support from local leaders.

In addition to these measures, LGUs should be given incentives to collect taxes efficiently. The incentives can be part of the IRA formula to counteract any tendency of local officials to rely solely on IRA and forgo efforts to improve local revenue generation. Perverse incentives, such as tax amnesties, should also be stopped.

The biggest anomaly in local business tax collection is underdeclaration of gross receipts of business establishments, which results in big losses for local governments. The staff of the local treasurer's office, who are at the forefront of tax collection, must be trained to verify the authenticity of financial statements. LGUs must coordinate closely and share information with the Bureau of Internal Revenue to establish a formidable tax collection mechanism. The use of the presumptive income level, particularly for small and medium-sized establishments, should be explored to determine realistic gross receipts. This approach estimates daily output by examining unit price, electric bills, number of employees, and amount of inventory. LGUs need to use creative and innovative methods to cultivate this potent tax revenue source.

Use of Market-Oriented Fees and User Charges

The inherent costs of services delivered can be computed and reflected in the fee structures, especially in the operation of economic enterprises where LGUs exercise a proprietary function. Services and infrastructure can be made sustainable by charging beneficiaries the full cost. LGUs must avoid subsidizing costs when the beneficiaries are clearly and specifically identified. This is one way of injecting the entrepreneurial spirit into local government operations and avoiding depletion of meager resources.

Regular Updating of Local Government Revenue Codes

LGUs should marshal the political will to regularly adjust and update the rates in their revenue codes to ensure the buoyancy and elasticity of tax and nontax revenues.

Encouragement of Cooperation among LGUs

Because development concerns often transcend political boundaries, contiguous LGUs will greatly benefit from collective planning and pooling of resources, as in the Gingoog Bay Area, Partido District (Camarines Sur), and the eastern towns of Misamis Oriental. LGUs can capitalize on economies of scale and comparative advantage in trade, commerce, environmental management, etc.

Efficient Use of Existing Financial Resources in Service Delivery

Performance indicators and benchmarks can make the use of existing financial resources in service delivery more efficient. LGUs can establish performance indicators and benchmarks in service delivery by looking at the trend of the per capita cost of service delivery. Parallel surveys on the level of satisfaction of the constituents can be documented to validate the level of service. Initially, LGUs are not to be compared with each other; rather, their performance is to be measured over time. However, in the medium and long term, LGUs can start benchmarking with other comparable LGUs.

Access of LGUs to the Capital Market

Rural capital infrastructure is sorely lacking. LGUs can resort to borrowing for productive infrastructure such as economic enterprises, power generation, waterworks and sewerage, and irrigation. Other forms of financing such as bonds and BOT have significant potential. The modest countryside savings and capital market resources can be directly accessed. Municipal bonds can be made attractive to investors through viable projects and interest rates that are higher than at banks.

Caution must be exercised, however, as the capital market is still in its infancy. The early evolution of an appropriate policy environment, legal mandates, and support structures such as liberalization of LGU depository banks, a disclosure system, a secondary market, and a credit-rating system for LGUs will enhance LGU entry into the capital market. For example, Mandaluyong City built its public market through BOT, while a number of LGUs, including the municipality of Victorias, the cities of Legaspi and Urdaneta, and the province of Aklan floated bonds to finance development and resource-generating projects.

Although the increased IRA has to some extent been a windfall for many LGUs, their greater capacity and willingness to raise local revenue is the linchpin of LGU creditworthiness. The IRA is insufficient to meet the requirements of local development infrastructure and of a growing populace. While IRA flows can be leveraged into investment funds through credit, loans will still have to be repaid. LGU capability to repay these loans should, therefore, be developed at an early stage. There is no substitute for sustained local revenue mobilization, including the collection of user charges for revenue and project maintenance.

LGUs should pursue public-private partnerships (BOT arrangements or any of its derivatives, joint ventures, etc.) to gain access to sophisticated technology, cost-effective design, and flexible financing, including the use of private capital.

Strengthening of Planning and Budgeting

LGUs' revenue generation and resource mobilization must reflect the community's vision and aspirations. Financing mechanisms and budgetary thrusts should work in concert with participatory planning. Projects should thus be prioritized to ensure fiscal and allocative efficiency.

Financing Alternatives and Local Government Financing Trends

Financing Alternatives

Traditional Funding Sources

LGUs have a wide array of financing alternatives, from short-term cash-flow shortfalls to long-term capital-intensive infrastructure development projects (Table 1).

Traditional funding sources of LGUs include internally generated revenue from real property and business taxes, fees and charges, and economic enterprises; IRA from the national Government, representing the LGU share in internal revenue

Table 1. Financing Alternatives for Local Government Units

Internal Sources	External Sources	Borrowings	Private Sector Tie-Ups
Tax Revenues Real Property Tax Business Tax Nontax Revenues Receipts from Economic Enterprises Fees and Charges	IRA Share in National Wealth Local/Foreign Grants, and Aid	Direct Loans MDFO GFIs PFIs Bond Issuance	Build-Operate-Transfer Schemes Joint Ventures

GFI = government financial institution, IRA = internal revenue allotment, MDFO = Municipal Development Fund Office, PFI = private financial institution.

collections as of 3 years earlier; share in national wealth utilization for resources in LGUs; share in value-added taxes; financial aid from local or foreign sources; and donations in kind from local or foreign sources.

Direct Loans

Even before LGC implementation in 1992, aggressive local executives were already borrowing from special government loan programs and GFIs. Such loan transactions, however, are still one-to-one deals where the LGU deposits cover the loan amount or, at the very least, the annual debt service, and the lender automatically debits payment from the account of the LGU that is late in paying.

The most active GFI in LGU lending is the Land Bank of the Philippines, with around P18 billion in its LGU loan portfolio as of the end of 2001. The now-privatized Philippine National Bank (PNB) released P6.83 billion to LGUs in 1996–2001, while the Development Bank of the Philippines had an outstanding LGU portfolio of P4.66 billion as of the end of February 2002. The Philippine Veterans Bank, a new player in the LGU market, lent P677 million to LGUs in 1999–2001.

The Department of Finance (DOF), under its Municipal Development Fund Office (MDFO), implements a special LGU credit facility, the Local Government Finance and Development Project, which is funded by the World Bank and targets mainly low-income LGUs. In 1995–2001, MDFO released P1.96 billion in loans to LGUs.

Unexpected credit support for LGUs comes from the Government Service Insurance System, the pension fund for public employees, which offers loans of up to P20 million to LGUs for their small funding needs. In 1993–1996, it loaned a total of P134.96 million to 11 municipalities. LGU loan terms were 1–10 years, with 3–5-year loan tenors. Most loans ranged from a few thousand pesos to around P20,000.

Box 1 discusses the direct loan experience of Anda, Pangasinan, and Box 2 details the Municipal Development Fund (MDF) loan for a public market project evaluated under a best-practice report format by the World Bank. Appendix 4 enumerates the different LGU lending programs of GFIs and MDFO.

Private Sector Tie-Ups

When loans from GFIs or MDFO are difficult to access, LGUs can turn to the private sector for innovative financing packages, foremost among which are BOT and joint venture schemes, and bond flotation. Under BOT, a private contractor builds and finances an infrastructure facility, and supports its operation and maintenance in exchange for generated income within an agreed-on period. Then the facility is turned over to the LGU. In a joint venture, the LGU participates in the project.

Box 1. Case Study of Municipal Government of Anda, Pangasinan: Philippine National Bank Loan for a Public Market and Bus Terminal

Anda, the only island town of Pangasinan, is primarily rural, with 18 *barangays*, a population of 32,833 as of 2000, an annual population growth rate of 1.36%, and an income of P21.03 million for 2000. The town has no big industrial companies. Most of its income is from fishing, salt making, and rice production.

The administration decided to build a public market and bus terminal in 2002. The local council authorized the mayor to negotiate and contract a P20 million loan with Philippine National Bank (PNB) or with any financial institution, and to contract with an engineering or construction firm to prepare a feasibility study and project design, and manage construction of the projects. The council authorized the treasurer to transfer the internal revenue allotment (IRA) deposits from Development Bank of the Philippines to PNB.

PNB approved the loan request 4 months later, on 7 February 2002. The loan is payable over 7 years, with a 1-year grace period on principal (allotted for the construction period), with principal and interest payable monthly. Interest is based on prevailing market rates and repriced quarterly. Lower interest rates may be given depending on the average daily deposit balance of the municipality. The loan is secured by the continuing assignment of the IRA, project revenues, and other sources of income.

Problems Encountered

Project planning, authorization, and execution were delayed due to (i) piecemeal dialogues regarding *barangay* concerns and direct benefits the *barangay* would derive from the project; (ii) overly long council deliberations; and (iii) very stringent government and/or Commission on Audit regulations on public bidding (accreditation of qualified contractors, prequalification requirements, etc.) imposed on the project contractor.

Loan implementation was stalled for 2 more months because a Department of Budget and Management (DBM) directive provided that transfers of the IRA depository account would be effected by DBM only once a year, or in January each year. PNB's loan approval condition, however, was that releases would only commence upon the transfer of the IRA deposit account to PNB.

PNB requested DBM to reconsider and allow the transfer of the IRA since it was a contractual commitment of the local government unit in the loan agreement. After 2 months, DBM yielded to the request upon examining the loan documents and council resolutions.

Project construction began on 10 April 2002, for completion in 300 days.

Three LGUs have finalized two BOT arrangements and one joint venture aggregating $41.8 million. Only one project has been concluded. Two other LGUs are negotiating for BOT packages of P1.43 billion, including a marketplace, water

Box 2. Case Study of Pulilan, Bulacan: Municipal Development Fund Loan for a Public Market

Pulilan showcases the development efforts of a low-income, resource-poor local government unit (LGU). It is one of the most successful beneficiaries of the World Bank-assisted municipal development projects in the Philippines.

The municipality built a public market, supported by strong political leadership, which led to increased trade and, therefore, increase in the income of the local entrepreneurs, provision of jobs and other sources of livelihood, and more income for the LGU. The availability and supply of diverse and quality basic goods and commodities in the public market satisfied of the needs of consumers and local entrepreneurs. The public market has significantly enhanced local economic growth and improved people's lives.

The municipality received two financing packages for municipal development projects.

	Local Component (P million)			Grant (P million)	Total Package (P million)
	Subloan	Equity	Total		
MDP II (1993)	6.750	1.242	7.992	11.054	19.046
MDP III (1996)	4.667	0.519	5.186	2.362	7.548
Total	**11.417**	**1.761**	**13.178**	**13.416**	**26.594**

MDP = municipal development project.

The local component financed the construction of two public market buildings. The grant component financed intrasite drainage facilities and various farm-to-market roads covering about 5.5 kilometers.

Problems Encountered

Problems were minimal during project preparation and implementation because the projects were directly implemented by the LGU, and strong technical assistance was provided. The LGU complied with all project documentary requirements on time, which resulted in smooth project execution. The projects were completed on schedule, and even fund disbursement was not delayed.

The experience of Pulilan supported previous study findings that a "bottom-up" demand-driven project approach is more efficient and effective for successful project implementation results than a "top-down" preselected project-specific approach.

supply systems, an integrated bus terminal, and information and communications technology.

In a bond flotation, the LGC authorizes provinces, cities, and municipalities to issue bonds to finance self-liquidating, income-producing development or livelihood projects in accordance with local development plans or public investment programs. An LGU bond is an interest-bearing or discounted local government security that obligates the issuing LGU to pay the bondholder a specified amount at identified periods, and to fully pay the principal amount of the obligation at bond maturity.

Since 1991, only 13 LGUs have issued bonds, aggregating P1.56 billion (Appendix 5). Seven bonds were for housing projects while the rest funded an abattoir, jetty port and port terminal, general hospital, dry-goods and public markets, a commercial center and toll parking, and a convention center. Bond amounts for a single LGU issuer ranged from P8 million to P620 million. Except for one issue, all bonds were guaranteed: four by the government-owned Home Guaranty Corporation (formerly Home Insurance Guaranty Corporation) and eight by the LGU Guarantee Corporation (LGUGC), a private guarantee corporation majority owned by the Bankers Association of the Philippines, with Development Bank of the Philippines as its minority partner. The longest tenor for the guaranteed bonds is 7 years. Boxes 3 and 4 summarize the bond flotation experiences of Urdaneta and Tagaytay cities.

Local Government Financing Trends

Loans and borrowings of all LGU types increased significantly in 1995–2000, proof that LGUs had to fend for themselves after the 1997 economic crisis. The new breed of local chief executive is more aggressive in using nontraditional sources of funding for basic service delivery and enterprise projects. Facing an unrestrained national budget deficit, local chief executives may well make full use of their fiscal powers to create debt to ensure the growth of their localities and delivery of basic services.

Current Local Government Bond Market Situation

Low Level of Local Bond Issuance

Since 1995, LGUs have obtained more than P20 billion in direct loans but have floated only P1.56 billion of LGU bonds since 1991. Clearly, local chief executives have not embraced bond issuance as an alternative source of project financing. There are several major reasons for this.

Box 3. Case Study of Urdaneta City: Municipal Bonds for Abattoir Upgrading

Urdaneta has an area of 10,026 hectares, only 132 of which are urban, and a population of 100,623 in 1995. Among the major contributors to economic enterprise incomes are schools, a slaughterhouse, and wholesale and public markets.

To complement the market and take advantage of its position as the second leading wholesale livestock market in the country, the city improved its abattoir. The project included value-added activities such as cold storage and meat-processing plants.

After failing to obtain a direct loan for the project from various government and private financial institutions, the city decided to float bonds. The P25 million Urdaneta municipal bonds had a term of 5 years with interest payable every 6 months and a balloon principal payment upon maturity. Pricing was based on the 182-day treasury bill rate plus 3 percentage points. Assignments on the internal revenue allotment, project revenues, and project assets were offered as security. Repayment of principal was assured via a sinking fund mechanism where semiannual deposits were made to cover the full principal at bond redemption.

Problems Encountered

The local government unit (LGU) took 3 years to obtain financing because no bank was interested in the project. This led the LGU to opt for other financing sources. Urdaneta was the first LGU in the country to issue non-housing bonds since the Local Government Code's passage and became a test case for the potential of an LGU debt capital market. No financial institution was willing to underwrite the bonds without a guarantee. Although all the requisite approvals for the bond flotation were completed by the city (then still a municipality) in 1997, it was only in 1999 that the bonds were issued, after obtaining a guarantee from the LGU Guarantee Corporation.

Construction began in 1998 and was completed in 1999. However, the operation of the facility was delayed, which caused the city huge opportunity losses and unnecessary pressure on its cash flow. The new mayor did not operate the new abattoir until May 2002, reportedly for political reasons.

The city, however, has serviced its debt obligations on time and its sinking fund level is more than required. The 2-month operation of the abattoir has yielded revenues of around P200,000 per month, lower than projected.

Political risk is something that cannot be avoided when dealing with LGUs. As in Urdaneta, well-meaning projects of an old administration may be sidelined or even mothballed by incoming officials for whatever reason.

Constituents should thus be vigilant to ensure that their taxes do not go to waste. Active participation of nongovernment organizations and people's organizations in LGU affairs is recommended.

Box 4. Case Study of Tagaytay City: Local Government Bonds for a Convention Center and Lodging Facilities

Tagaytay is becoming highly urbanized. Its population in 1999 was 34,126. Economic activities are mainly in tourism and agriculture. Of the city's 889,235 hectares, 144,038 are devoted to tourism activities, such as lodging and other commercial tourism facilities. The city prioritized the construction of an infrastructure complex with a convention center, function rooms with lodging facilities, assembly halls, and auditoriums to meet demand for convention venues and good lodging.

Tagaytay has benefited from the experience of the first four local government units (LGUs) to float LGU Guarantee Corporation-guaranteed bonds, as the bond issuance process was shortened and requirements more established. While Urdaneta had to wait 3 years before launching its bonds (Box 3), it took Tagaytay less than 1 year.

The P220 million Tagaytay city bonds had a term of 7 years, inclusive of a 1-year grace period on principal. Interest is floating, based on the weighted average of the 182-day treasury bill rate plus a spread of 2.5 percentage points. There is also a sinking fund requirement equivalent to the principal due annually deposited to the fund 2 years in advance. The bonds issued were in denominations of P1 million, P100,000, P10,000, and P1,000. Around P2 million-worth of bonds were sold to Tagaytay constituents.

Problems Encountered

Although project construction is ahead of schedule, deviations from project construction plans stipulated by the mayor without clearance from, or advice to, the trustee or guarantor have been reported. This is a gray area that must be addressed in future bond flotations by including clear provisions on the issue in the guarantee agreement and trust indenture documents. The idea is to professionalize the entire bond flotation process, including implementation of projects funded by the bond proceeds. Local chief executives must be made aware that they have contractual agreements that must be followed.

Generally, Tagaytay's bond flotation was smooth and problem-free due to strong leadership of the local chief executive and his ability to get the cooperation of the city council for the project, a well-prepared financial package and project feasibility study, a clear master development plan for the city, and good revenue potential of the project.

Lack of Knowledge. There is little technical knowledge on bonds or how to float them at the local level. Some local chief executives may not even be aware that LGUs are authorized to float bonds to fund projects.

Absence of Support. While it has actively participated in workshops on LGU bond development, DOF has not championed LGU bonds. Local officials from different NGAs involved with LGU finance thus receive mixed signals regarding

LGU bonds. The absence of clear-cut executive direction on LGU bond development compounds the problem.

No Private Financial Sector Confidence. The private financial sector has no confidence in LGUs, which are perceived to be very high risk and politically driven rather than management oriented. Few private financial institutions (PFIs) are willing to underwrite LGU bonds.

Evolving Framework. The regulatory, institutional, and procedural framework for LGU bonds is still evolving (see next section). While some basic structures and processes have been identified through various workshops and dialogues among major LGU bond proponents and the few actual LGU bond issuers, the infrastructure is still shaky and may change. Most local officials thus prefer the more established direct loan route to less familiar bond flotation.

Regulatory and Institutional Framework for Local Government Bonds

Regulatory Framework

Bonds issued by LGUs are exempt from registration with the Securities and Exchange Commission. However, before issuing a bond, LGUs must secure approval to issue from BSP in the form of a favorable opinion on the probable effects of the proposed bond flotation on the country's monetary aggregates, price levels, and balance of payments.

For projects involving real estate or the environment, clearances from the departments of agrarian reform and environment and natural resources are required before the project starts. LGUs must also have approval in the form of a council ordinance, and component cities and municipalities need a provincial council resolution.

Institutional Framework

To monitor LGU bond issuances, LGUGC has committed itself to provide DOF with timely information on LGU bonds guaranteed, as well as a copy of the official statement of the issue. DOF has yet to enter into a similar arrangement with the Home Guaranty Corporation. To help DOF capture information on all LGU debts, including bond flotation, in May 2002 BSP encouraged all banks and nonbank financial institutions to require a DOF certification of debt service ceiling from LGUs applying for any type of financial assistance. To ensure that the total annual debt service obligation of LGUs, inclusive of debt service arising from the contemplated bond float, will remain within the 20% debt service cap imposed by the LGC, DOF's Bureau of Local Government Finance will issue upon request a certificate of maximum debt service capacity for the concerned LGU. No LGU debt should be entertained by any financial institution without such certification.

Figure 1 shows the bond issuance process and the institutional framework of the LGU bond market. A credit-rating agency is required to give investors confidence in the LGU issuer, but no such independent body exists. LGUGC has an LGU credit-screening and -rating system.

Market Players

The following are the major participants in the bond issuance process:

Financial Advisor. An independent entity, it offers LGUs project identification, feasibility study, and financial packaging assistance; advice on the project's financing mode; and, if bond flotation is the financing mode, help in selecting the bond trustee, underwriter, and guarantor, negotiating their fees, and preparing the prospectus.

Underwriter. An investment house or universal bank, it buys the bonds from LGUs then sells them to other institutions or individuals.

Trustee. The custodian of the trust fund, which is composed of bond proceeds, project revenues, and project assets, the trustee represents the bondholders and acts as the bond registrar and paying agent.

Guarantor. It pays all amortization due to bondholders in case LGUs fail to honor their obligation.

Impediments to Local Government Bond Market Development

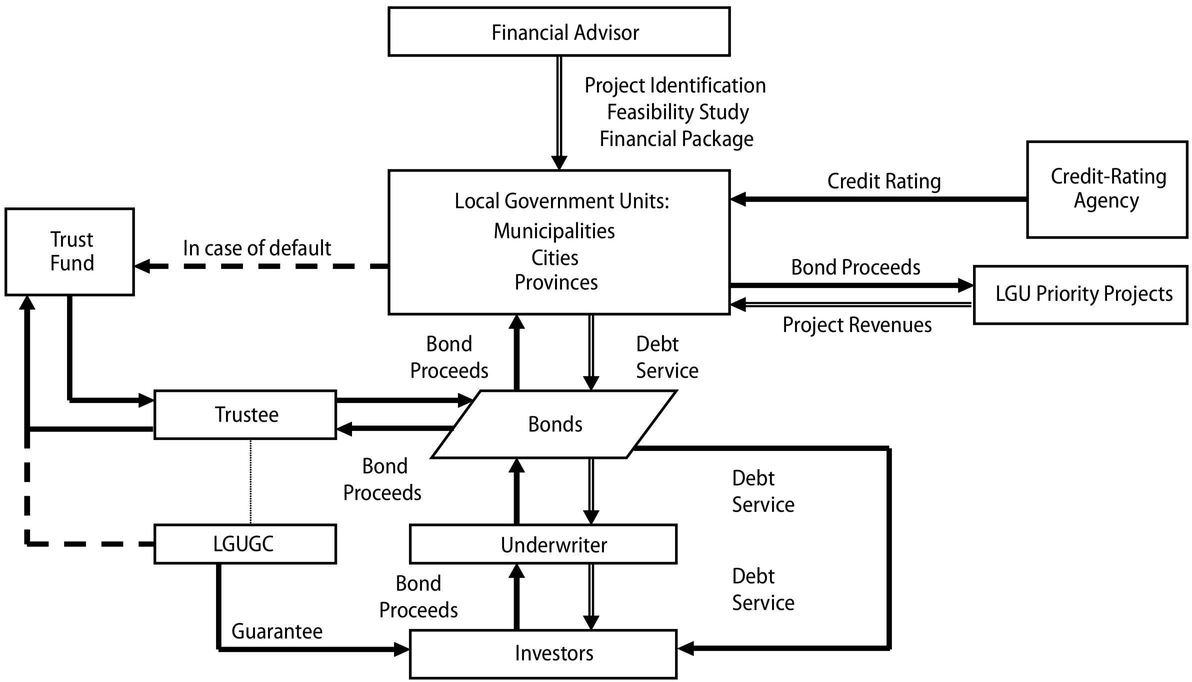
The major constraints to primary and secondary LGU bond market development are regulatory, legislative, administrative, and structural.

Regulatory Constraints

Restrictions on Depository Accounts. While the LGC allows LGUs to choose their depository bank, BSP and COA restrict LGU deposits to GFIs. The same is true for LGU trust accounts. This restriction prohibits PFIs from offering their banking services to LGUs and so getting to know the LGU market better, and enables GFIs to dominate the LGU debt market and to keep local officials away from the capital market.

Bidding of Specialized Professional Services. LGU guidelines require bidding for procurement of supplies and services, including those of financial advisors, underwriters, and guarantors. Due to these guidelines, many LGUs have difficulty getting the special expertise that bond packaging requires.

Figure 1. Bond Issuance Process and Institutional Framework



LGU = local government unit, LGUGC = LGU Guarantee Corporation.

Legislative Constraints

Tax Treatment. LGU bonds do not provide any tax benefits to bondholders. Bond interest income is subject to final tax. Documentary stamp taxes are imposed on the primary sale of the bonds and shouldered by the issuer. LGU bonds are less attractive than treasury bills and treasury notes, which have the full faith and guarantee of the national Government. LGU bonds should have a tax incentive to allow them to compete in the capital market.

Debt Service Cap. The LGC limits the annual debt servicing of LGUs to 20% of their regular income to discourage them from undertaking capital-intensive but revenue-generating projects, as the maximum acceptable bond tenor is only 7 years.

Administrative Constraints

Accounting Treatment. Up to the end of 2001, COA had no guidelines to book bond proceeds, disbursements for projects funded by LGU bonds, and income arising from temporary placements of proceeds, among others. Local treasurers and accountants did not have records of bond transactions. This system bred corruption as information was limited to a few officials, and transactions were not fully disclosed. Newly elected chief executives are suspicious of inherited bond-funded projects. In Puerto Princesa City, for example, which issued P320 million in housing bonds in 2000, not a single bond document is available. The bond team (financial advisor, trustee, underwriter, and guarantor) had to brief a new mayor on the purpose of the bond, its terms and conditions, and the status of the project, and to provide a complete set of bond documents.

Local Government Financial Records. Private financial sector confidence in LGUs is critical to bond market development. This confidence can be built by making LGU financial records available to possible investors on time and in an easily understood format. COA started revising the Government's cash accounting system to the more familiar accrual-based one. DOF has also revised the LGU budget operations statement and requires a quarterly rather than annual submission by LGUs. However, government agencies still need to rationalize their applied LGU account titles and treatment so as not to confuse the private sector. Discussions are ongoing among DOF, COA, and the Department of Budget and Management (DBM) to unify their LGU financial reporting systems.

National Policy. The national Government has no formal policy declaration on LGU bond market development. NGAs, therefore, are not engaged in a concerted, focused effort to promote and support LGU bond flotation to fund local infrastructure projects.

Structural Constraints

Lack of Credit-Rating Agency. The Philippines has no independent credit-rating agency with the database and experience to rate LGUs. Given that they are viewed as high risk, LGUs must have high credit ratings to attract private investors to buy LGU bonds.

Weak Institutional Framework. LGUs have to deal with DOF, COA, DBM, and BSP for financial matters. The Department of Interior and Local Government sometimes also has a say in LGU fiscal policies, which is not conducive to LGU bond market development. Different agencies have occasionally issued guidelines detrimental to it.

Bond Tenors. Bonds are the best instruments to finance capital-intensive projects. Such projects normally have long payback periods and, therefore, require long maturities. Unfortunately, the capital market has shown resistance to LGU bonds with tenors of over 7 years.

Conclusions and Recommendations

Overall Status of the Local Government Bond Market

The LGU bond market in the Philippines is in its infancy. LGU officials are unaware of the merits of bond flotation and do not have the technical knowledge to float a bond. The executive branch has issued no directives to support LGU bond development. A national blueprint for LGU bond market development is lacking, and no NGA champions it. The different NGAs give mixed signals on LGU bonds and some even issue guidelines that hinder their development.

The private financial sector and private investors are not prepared to consider LGU bonds as investment instruments comparable to nonrisk treasury bills and treasury notes. Credit enhancement is critical and LGU bondholders should be given tax benefits and other incentives. LGU rating is equally important to encourage investor acceptance of LGU bonds.

Proposed Reforms

Immediate Reforms

Executive Order. The executive branch should support LGU bonds. Executive officials often profess their support of decentralization, and the President recently praised a local official for issuing bonds to fund a local public market. Executive support, however, must be in the form of an executive order that identifies an NGA, logically DOF, as the lead agency; that directs all other NGAs to support LGU bond market development; and that provides the lead agency with the authority to achieve the mandated objective.

Focused Information Campaign. The lead NGA and Department of Interior and Local Government should design and implement a sustained nationwide bond flotation awareness campaign, with private sector participation.

Framework for LGU Bond Issuance. The lead NGA should study bond flotation practices and improve them if necessary. LGU bond market development should not be hampered by an eagerness to regulate or monitor the market. Market players and LGUs will welcome a predictable and transparent bond issuance process, including approval requisites, but not red tape. The approach should be motivational rather than regulatory.

Short-Term Reforms (1 Year)

The executive branch should remove the following hindrances to LGU bond market development, to encourage a conducive policy, regulatory, and legislative environment:

Restrictions on LGU Depository Accounts. BSP and COA should revise their circulars limiting LGU deposit and trustee accounts to GFIs.

Bidding of Specialized Professional Services. Contracting of financial advisors, underwriters, and guarantors for a bond flotation package should be exempted from guidelines on procurement of supplies and services. Financial advisory work is a highly specialized skill and involves much trust and confidence between LGU and advisor. Payment of financial advisory services when the bond float is successful and from bond proceeds will counter any potential for unfair contracting practices. As LGU bonds are not yet attractive, only a handful of PFIs are willing to underwrite or buy LGU bonds. Asking PFIs to even bid for this privilege is unimaginable. Finally, only two guarantee institutions will accept LGU risks: Home Guaranty Corporation for housing projects, and LGUGC for all types of revenue-generating projects. Guarantors end up paying for the bond amortization when the issuer defaults and, therefore, have no motive to bid. LGUs will benefit by getting a guarantor to improve the marketability of the bond issue.

Tax Incentives. Tax benefits to make LGU bonds more attractive are:

- Exemption from tax, the interest income up to a certain percentage (up to the equivalent yield on treasury bills or treasury notes of the same tenor, for example). To limit forgone national government revenue and focus tax preferences, the tax exemption may be applied only to revenue-generating projects and bond tenors beyond 7 years.

- Exemption from capital gains from the resale of LGU bonds from income taxes to encourage the growth of secondary market for LGU bonds.
- Abolition of the documentary stamp tax on primary issues of LGU bonds for the first 10 years of LGU bond market development.

LGU Financial Statements. The President should mandate NGAs to unify the financial reporting systems imposed on LGUs, especially the chart of accounts and accounting method.

Medium-Term Reforms (5 Years)

LGU Rating. Since LGU bonds are exempt from Securities and Exchange Commission registration, LGUs have no incentive to seek a rating before they issue a bond. Investors, however, prefer to know if the bond issuer is creditworthy through an independent rating published regularly. The national Government should examine the internal LGU credit screening and LGUCG rating system, which United States and Australian experts have declared as meeting international standards, and determine how to help LGUGC create a separate, independent rating agency. LGUGC has repeatedly announced its intention to distance itself from the rating business once the rating activity can be self-liquidating.

Central Repository of Local Government Information. A major barrier to maintaining an efficient and cost-effective rating system for LGUs is the cost associated with collecting and analyzing financial, economic, political, and social data on LGUs. The Philippines has no central repository for LGU data, which are dispersed in various NGAs. LGUGC reports 11 data sources for its internal LGU rating system. For an LGU credit-rating agency to be sustainable, a national repository of LGU data is necessary.

Groundwork for Bond Banking. Small LGUs will always have difficulty penetrating the capital market. A bond bank that can pool their bond issues will give small LGUs the chance to take advantage of the benefits of the capital market, prepare to participate in the formal financial sector, and thus practice good governance.

Some Considerations for Successful Local Government Credit Financing

LGU credit financing will be highly successful when LGUs set up structures conducive to bond market development and if a stable macroeconomic environment for savings and investment is established. LGUs should do the following:

- Project an image of strong political leadership. Local government officials must become marketing managers, projecting sense and savvy.

- Support the right projects. Investors will support only those bond issues that will be used for productive projects. Project viability is a major criterion used by banks in evaluating loan applications.
- Project a positive image in the market. Clean, peaceful, and working communities attract the market's attention and confidence.
- Have properties to serve as collateral or security.
- Display disciplined and progressive management of financial resources.
- Continuously improve nondebt-related finances. Capacity to pay will be determined by taxes and fees that the LGU can collect.

Potential Areas for Asian Development Bank Assistance

ADB could help develop the LGU bond market and improve LGU fiscal management through the following:

- Aggressively advocate the issuance of an executive order supporting LGU bond market development and laying down the policy for it, identifying a lead agency, and urging all NGAs to help build market infrastructure and motivate private sector participation.
- Help the executive branch draft the executive order.
- Lobby for legislative reforms.
- Support NGAs and nongovernment organizations that help build LGU capacity and organize good governance projects or workshops.
- Support information campaigns to increase LGU awareness of nontraditional funding sources in general, and bond flotation in particular.
- Help establish the national central repository of LGU data.
- Help LGUGC spin off its internal LGU credit-screening and -rating system into an independent LGU credit-rating institution.
- Fund a study on bond banking to pool bond issues of small LGUs.

Endnotes

[1] LGUs are provinces, cities, and municipalities. The Philippines has 79 provinces, 114 cities, 1,496 municipalities, and some 42,000 *barangays* spread over 16 regions, including the Autonomous Region of Muslim Mindanao.

[2] Office of the governor/mayor, local council, and following posts at provincial, city, or municipal level: administrator, budget officer, treasurer, assessor, and auditor.

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Appendix 1. Local Government Unit Classification by Income Bracket

As provided for under Sections 1 and 2 of Executive Order No. 249 issued on July 25, 1987 by the President, "provinces, cities and municipalities, except Manila and Quezon City which shall remain as Special Class cities, shall be divided into six (6) main classes according to the average annual income that they actually realized during the last four (4) calendar years immediately preceding the year of reclassification. Accordingly, on the basis of the financial statements of LGUs for calendar years 1996–1999 as certified by the Commission on Audit, the classification of the three levels is based on the following income brackets":

Average Annual Income (P million)

Class	Provinces	Cities	Municipalities
First	255 or more	205 or more	35 or more
Second	170 or more, less than 255	155 or more, less than 205	27 or more, less than 35
Third	120 or more, less than 170	100 or more, less than 155	21 or more, less than 27
Fourth	70 or more, less than 120	70 or more, less than 100	13 or more, less than 21
Fifth	35 or more, less than 70	35 or more, less than 70	7 or more, less than 13
Sixth	Below 35	Below 35	Below 7

Appendix Table 2.1 Consolidated Budget Operations Statement, All Provinces Combined, 1991–2000 (P million)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Local Sources	2,554.8	1,793.9	2,309.4	3,045.9	3,368.7	4,935.0	5,607.2	5,188.3	5,431.5	7,141.6	31,672.2
Revenue from Tax	515.3	773.5	1195.0	1,462.5	1,576.5	2,003.9	2,167.0	2,352.0	2,711.0	3,003.0	13,813.4
Real Property Tax	372.5	574.8	804.8	1,043.6	1,122.4	1,286.9	1,581.2	1,864.2	2,029.0	2,245.4	10,129.1
Business Tax	142.8	198.6	390.1	419.3	454.1	717.0	585.8	487.8	682.0	757.6	3,684.3
Nontax Revenues	2,039.5	1,020.4	1,114.4	1,583.3	1,792.2	2,931.1	3,440.2	2,836.3	2,720.5	4,138.7	17,858.9
Receipts from Econ. Ents	191.3	174.1	300.0	389.3	460.9	484.3	587.6	547.3	539.7	625.1	3,245.0
Fees/Charges	31.6	32.4	204.8	177.4	209.6	276.3	305.9	384.5	379.8	427.0	1,983.0
Loans and Borrowings	333.7	55.6	106.9	330.7	292.0	822.0	966.8	477.3	599.2	1,516.1	4,673.4
Other Receipts	1,482.9	758.3	502.7	685.9	829.6	1,348.5	1,580.0	1,427.1	1,201.8	1,570.4	7,957.5
Aid and Allotments	3,246.1	4,620.9	7,756.6	10,721.5	12,711.6	13,449.0	17,173.4	19,545.0	21,909.1	26,570.5	111,358.5
BIR Allotments	2,769.2	4,499.8	7,615.6	10,478.7	12,106.5	13,317.0	16,836.3	18,737.0	21,247.6	25,968.1	108,212.4
National Aid	476.8	121.2	141.0	147.6	161.5	82.2	285.1	738.2	627.0	543.7	2,437.6
National Wealth	-	-	-	95.1	443.5	49.9	52.0	69.8	34.5	58.7	708.5
Total Income	5,800.9	6,414.8	10,066.0	13,767.4	16,080.2	18,384.0	22,780.6	24,733.2	27,340.6	33,712.1	143,030.7
Current Expenditures	5,047.7	5185.0	8,348.5	11,083.8	14,339.5	15,721.9	19,618.7	21,492.0	22,667.3	28,135.9	121,975.4
General Government	1,656.2	1,889.8	2,241.3	2,557.0	3,358.0	3,728.5	4,743.5	5,303.2	5,489.1	6,557.9	29,180.1
Public Welf. & Int. Safety	525.3	779.4	2,657.5	3,785.4	4,895.8	5,637.2	6,936.3	7,472.4	7,660.0	9,361.7	41,963.4
Economic Development	1,150.3	1,448.7	1,862.7	2,175.7	2,997.6	3,136.8	3,704.2	4,424.5	4,167.6	5,302.8	23,733.4
Operation of Econ. Ents	98.0	312.2	275.9	513.7	465.5	626.5	757.7	425.3	466.6	605.5	3347.1
Other Charges	1,618.0	754.9	1,311.2	2,051.9	2,622.5	2,593.0	3,477.1	3,866.6	4,884.0	6,308.1	23,751.4
Capital Outlay	374.4	595.3	514.8	1,301.6	1,205.3	1,473.6	1,718.4	2,214.0	1,981.5	2,013.5	10,606.4
Total Expenditures	5,422.1	5,780.3	8,863.3	12,385.4	15,544.8	17,195.6	21,337.1	23,706.0	24,648.8	30,149.4	13,2581.8
Excess (Deficit) of Income over Expenditures	378.8	634.5	1,202.7	1,382.0	535.4	1,188.4	1,443.5	1,027.2	2,691.8	3,562.7	10,449.0

BIR = Bureau of Internal Revenue.

Source: Bureau of Local Government Finance, Department of Finance.

Appendix Table 2.2 Consolidated Budget Operations Statement, All Cities Combined, 1991–2000 (P million)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Local Sources	5,472.8	5,054.4	7,583.8	9,857.5	13,065.6	17,026.4	20,823.3	24,781.1	26,278.1	28,697.5	130,672.0
Revenue from Taxation	3,185.7	3,433.8	4,741.6	5,778.2	9,498.9	11,728.8	14,800.7	17,080.6	17,698.1	18,854.2	89,661.3
Real Property Tax	1,758.6	1,754.4	2,229.3	2,536.2	4,983.5	5,078.4	6,875.9	8,095.1	8,038.8	9,430.9	42,502.6
Business Tax	1,427.1	1,679.4	2,512.3	3,242.0	4,515.4	6,650.3	7,924.8	8,985.5	9,659.3	9,423.3	47,158.7
Nontax Revenues	2,287.1	1,620.6	2,842.2	4,079.4	3,566.7	5,297.6	6,022.6	7,700.5	8,580.0	9,843.3	41,010.7
Receipts from Econ. Ents.	635.3	612.9	686.6	968.8	1,042.5	1,075.5	1,399.1	1,566.1	1,096.7	1,462.5	7,642.4
Fees/Charges	274.5	317.0	532.1	689.9	990.8	1,160.8	1,397.3	1,434.4	1,622.2	1,823.1	8,428.7
Loans and Borrowings	32.6	294.7	1,153.9	1,549.2	731.0	1,760.8	1,823.8	2,242.0	4,417.6	4,819.9	15,795.1
Other Receipts	1,344.6	396.0	469.7	871.4	802.3	1,300.5	1,402.4	2,458.0	1,443.5	1,737.8	9,144.6
Aid and Allotments	2,789.6	4,564.5	8,567.7	10,287.4	11,277.3	12,585.6	15,207.8	17,585.1	19,055.4	24,001.3	99,712.5
BIR Allotments	2,728.0	4,541.6	8,486.0	10,233.8	11,193.3	12,521.3	15,138.7	17,438.4	18,887.6	23,828.7	99,007.9
National Aid	61.5	22.9	81.7	53.6	83.6	64.3	69.1	142.1	149.6	168.2	676.9
National Wealth	-	-	-	-	0.4	0.0	0.0	4.6	18.2	4.5	27.7
Total Income	8,262.4	9,618.9	16,151.5	20,144.9	24,342.9	29,612.0	36,031.1	42,366.2	45,333.5	52,698.8	230,384.5
Current Expenditures	6,920.8	7,478.0	11,093.4	15,384.8	20,043.7	24,483.3	32,841.6	37,820.2	39,923.1	46,536.6	201,648.5
General Government	2,013.2	2,384.4	3,179.8	4,016.2	5,996.6	7,467.2	9,931.0	11,240.9	11,083.6	13,135.0	58,854.3
Public Welf. & Int. Safety	1,528.7	1,945.8	3,100.7	4,145.2	5,664.1	6,712.9	8,786.8	11,146.2	10,780.4	12,157.0	55,247.4
Economic Development	1,093.0	1,252.4	1,604.5	2,139.6	2,462.7	3,356.8	4,451.7	4,778.1	4,587.9	5,558.4	25,195.5
Operation of Econ. Ents.	349.5	354.3	477.2	747.3	786.3	1,202.0	1,560.8	1,473.7	1,050.7	1,316.1	7,389.6
Other Charges	1,936.3	1,539.1	2,731.2	4,336.5	5,134.0	5,744.5	8,111.3	9,181.3	12,420.5	14,370.1	54,961.7
Capital Outlay	1,072.2	1,207.6	2,315.4	3,287.1	3,929.6	3,052.4	3,177.2	3,622.8	3,895.7	4,158.9	21,836.6
Total Expenditures	7,993.0	8,685.6	13,408.8	18,671.9	23,973.2	27,535.7	36,018.8	41,443.1	43,818.8	50,695.5	223,485.1
Excess (Deficit) of Income over Expenditures	269.4	933.3	2,742.7	1,473.0	369.7	2,076.3	12.3	923.2	1,514.7	2,003.3	6,899.4

BIR = Bureau of Internal Revenue.

Source: Bureau of Local Government Finance, Department of Finance.

Appendix Table 2.3 Consolidated Budget Operations Statement, All Municipalities Combined, 1991–2000 (P million)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Local Sources	5,428.7	4,998.4	6,491.0	8,743.2	7,956.9	9,897.8	11,581.9	10,059.7	11,404.1	14,298.5	65,198.9
Revenue From Taxation	2,758.7	3,209.5	4,340.8	5,666.8	4,575.4	5,597.0	6,452.9	5,585.3	6,290.3	7,781.9	36,282.8
Real Property Tax	1,542.9	1,593.7	1,906.5	2,577.4	2,203.0	2,481.5	3,028.1	2,471.7	2,896.9	3,815.9	16,897.1
Business Tax	1,215.8	1,615.8	2,434.3	3,089.4	2,372.4	3,115.5	3,424.9	3,113.5	3,393.4	3,965.9	19,385.7
Nontax Revenues	2,670.0	1,788.9	2,150.2	3,076.5	3,381.5	4,300.8	5,128.9	4,474.4	5,113.8	6,516.6	28,916.1
Receipts from Econ. Ents.	728.9	698.8	825.7	1,087.8	1,043.3	1,300.3	1,563.1	1,609.5	1,728.1	1,708.9	8,953.1
Fees/Charges	423.9	505.9	669.8	818.6	790.8	978.1	1,155.8	1,022.4	1,158.0	1,417.8	6,522.9
Loans and Borrowings	24.5	42.7	54.7	230.4	538.3	872.3	883.7	398.8	550.4	1,703.0	4,946.4
Other Receipts	1,492.7	541.5	600.0	939.7	1,009.1	1,150.1	1,526.4	1,443.8	1,677.3	1,687.0	8,493.7
Aid and Allotments	4,634.1	6,671.5	11,638.2	14,929.6	18,109.1	19,469.8	24,280.6	25,637.8	30,845.1	37,615.4	155,957.9
BIR Allotments	4,385.6	6,431.8	11,354.7	14,506.8	17,574.0	19,092.6	23,955.2	25,257.6	30,280.8	36,933.4	153,093.6
National Aid	248.5	239.7	283.6	287.2	397.2	289.6	226.4	294.9	480.7	609.2	2,297.9
National Wealth	-	-	-	135.6	138.0	87.7	99.0	85.3	83.6	72.8	566.4
Total Income	10,062.8	11,669.9	18,129.2	23,672.8	26,066.0	29,367.6	35,862.5	35,697.5	42,249.2	51,913.9	221,156.8
Current Expenditures	8,634.2	9,898.9	14,612.2	19,620.9	22,999.9	25,870.3	31,839.7	32,992.8	37,093.7	44,853.1	195,649.5
General Government	4,796.9	5,883.4	6,848.9	8,650.6	10,463.2	11,654.2	14,405.3	15,395.6	17,002.8	20,039.3	88,960.3
Public Welf. & Int. Safety	784.8	1,176.7	3,045.6	4,316.5	4,584.1	5,385.3	6,646.5	6,554.8	7,112.7	8,722.9	39,006.3
Economic Development	814.1	941.3	1,831.7	2,543.3	3,040.9	3,379.9	4,162.6	4,164.4	4,715.7	5,592.9	25,056.4
Operation of Econ. Ents.	503.8	502.3	694.9	971.0	1,291.7	1,533.1	1,982.4	1,873.5	1,901.9	1,887.6	10,470.1
Other Charges	1,734.7	1,395.3	2,191.0	3,139.5	3,620.0	3,917.8	4,642.9	5,004.5	6,360.6	8,610.4	32,156.3
Capital Outlay	796.4	940.4	1,579.3	1,919.4	1,870.0	1,794.3	2,331.4	1,455.1	1,986.2	2,226.7	11,663.8
Total Expenditures	9,430.6	10,839.3	16,191.5	21,540.3	24,869.9	27,664.7	34,171.1	34,447.9	39,079.9	47,079.9	207,313.3
Excess (Deficit) of Income over Expenditures	632.2	830.6	1,937.7	2,132.5	1,196.1	1,703.0	1,691.4	1,249.7	3,169.3	4,834.0	13,843.5

BIR = Bureau of Internal Revenue.

Source: Bureau of Local Government Finance, Department of Finance.

Appendix Table 2.4 Percentage Share of Externally Sourced Revenues in Total LGU Revenues

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average 1992–2000
Provinces	56	72	77	78	79	73	75	79	80	79	78
Cities	34	47	53	51	46	43	42	42	46	46	43
Municipalities	46	57	64	63	69	66	68	72	72	72	70

Source: Calculated from Appendix Tables 2.1–2.3.

Appendix Table 2.5 Percentage Share of Each LGU's IRA to Its Total Revenues from External Sources

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average 1992–2000
Provinces	85	97	98	98	95	99	98	96	97	98	97
Cities	98	99	99	99	99	99	100	99	99	99	99
Municipalities	95	96	98	97	97	98	99	99	98	98	98

Source: Calculated from Appendix Tables 2.1–2.3.

Appendix Table 2.6 Percentage Share of Each LGU's IRA to Total Revenues

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average 1992–2000
Provinces	48	70	76	76	75	72	74	76	78	77	75
Cities	33	47	53	51	46	42	42	41	42	45	45
Municipalities	44	55	63	61	67	65	67	71	72	71	66

Source: Calculated from Appendix Tables 2.1–2.3.

For above tables: IRA = internal revenue allotment, LGU = local government unit.

Appendix Table 2.7 Percentage Share of Each LGU's Local Taxes to Total Revenues from Local Sources

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average 1992–2000
Provinces	20	43	52	48	47	41	39	45	50	42	45
Cities	58	68	63	59	73	69	71	69	67	66	67
Municipalities	51	64	67	65	58	57	56	56	55	54	59

Source: Calculated from Appendix Tables 2.1–2.3.

Appendix Table 2.8 Percentage Share of the Different Expenditure Items to Total LGU Expenditures

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average 1992–2000
General Government	37	40	32	29	31	32	32	32	31	31	32
Public Welfare/ Internal Safety	12	15	23	23	24	24	24	25	24	24	23
Economic Development	13	14	14	13	13	14	13	13	13	13	13
Capital Outlay	10	11	11	12	11	9	8	7	7	7	9
Others	27	19	20	22	22	22	22	22	25	26	22

Source: Calculated from Appendix Tables 2.1–2.3.

Appendix Table 2.9 Percentage Share of Each LGU General Government Expenditure to Aggregate LGU General Government Expenditures

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average 1992–2000
Provinces	20	19	18	17	17	16	16	17	16	17	17
Cities	24	23	26	26	30	33	34	35	33	33	30
Municipalities	57	58	56	57	53	51	50	48	51	50	53

Source: Calculated from Appendix Tables 2.1–2.3

For above tables: LGU = local government unit.

Appendix 3. Sample Internal Revenue Allotment Computation: Dagupan City

Step 1: Deduct the total cost of devolved functions from the total IRA allocation

P 106.778 billion[a] - P6.539 billion[b] = P 100.239 billion

Step 2: Multiply the balance by the statutory share for each LGU level; in the case of the cities, it is 23%

P 100.239 billion x 23% = P 23.0543 billion

Step 3: The resulting figure shall be subdivided into the three weighted factors

Population	-	50%	x	P23.0543	=	P11.5271 billion
Land Area	-	25%	x	P23.0543	=	P5.7636 billion
Equal Sharing	-	25%	x	P23.0543	=	P5.7636 billion
Total					=	P23.0543 billion

Step 4: Compute the proportionate share of the city to the aggregate of all cities for the three factors

a) $\dfrac{\text{Population of the City}}{\text{Total Population of All Cities}} = \dfrac{130{,}328}{23{,}387{,}323} = 0.00557$

b) $\dfrac{\text{Land Area of the City}}{\text{Total Land Area of All Cities}} = \dfrac{37.23}{27{,}665.12} = 0.00135$

c) $\dfrac{1}{\text{Total Number of Cities}} = \dfrac{1}{113} = 0.00885$

Step 5: Combine steps 3 and 4 to determine the city share

Population	P11.5271 billion	x	0.00557	=	P64.2059 million
Land Area	P5.7636 billion	x	0.00135	=	P7.7809 million
Equal Sharing	P5.7636 billion	x	0.00885	=	P51.0079 million
IRA Share of Dagupan (Total)				=	P122.9947 million

COA = Commission on Audit, IRA = internal revenue allotment, LGU = local government unit.

[a] Using calendar year 2001 IRA data and cost of devolved functions. The 2001 IRA figure of P106.77 billion was derived by getting the third preceding year's (1998) gross national collections less deductions such as direct shares of LGUs, COA share, occupancy tax, etc.

[b] Refers primarily to health sector, mostly provincial hospitals, which will be distributed to concerned LGUs.

Appendix 4. Lending Programs of Government Financial Institutions and Municipal Development Fund Office

Government Financial Institution	Eligible Projects	Rate of Interest	Loan Term	Loan Amount	Collateral Requirement
Development Bank of the Philippines					
Urban Water Supply and Sanitation Environment Infrastructure Support Credit Program Phase II, funded by Japan Bank for International Cooperation (JBIC)	Water supply and sanitation; Urban drainage; Pollution control; Projects that promote efficient use and management of natural resources; Projects that improve occupational health and safety; Environmental infrastructure projects under build-operate-transfer arrangements	9% plus spread, not to exceed 3%	Minimum of 3 years to a maximum of 15 years, inclusive of a maximum grace period of 5 years for principal repayment	Depends on project requirements	Assignment of portion of local government units (LGUs) regular income and internal revenue allotment (IRA)
Land Bank of the Philippines					
1. Local Government Support Credit Program funded by JBIC 2. Private Infrastructure Project Development Facility funded by the Asian Development Bank 3. Water District Development Project funded by the World Bank	Health sector projects; Water system; Flood control and sanitation; Forestry; Waste disposal; Other environmental projects	12–14%	Minimum of 3 years to a maximum of 15 years, with 2 years grace period for principal repayment	Depends on the requirements of the project but not to exceed P50 million	Real estate mortgage, chattel mortgage
Philippine National Bank					
Credit facilities for income- and revenue-generating projects	Batching plant; Public market; Slaughterhouse; Commercial building; Shopping center; Water system; Electrification projects; Heavy equipment; Renovation of local government unit halls; Buildings, farm tools	Negotiable and shall depend on the cost of fund or source used	Maximum loan term of 7 years	Depends on the project requirements but shall in no case exceed five times the sum of 20% of the regular income and 20% of IRA	

Lending Programs of Government Financial Institutions and Municipal Development Fund Office (*cont'd.*)

Government Financial Institution	Eligible Projects	Rate of Interest	Loan Term	Loan Amount	Collateral Requirement
Philippine National Bank					
	Livelihood projects; Low-cost housing				- Assignment of 20% of IRA - Assignment of 20% of LGUs' regular income - Assignment of profits or income of the project or economic enterprise to be financed - Assignment of other special sources of revenues, e.g., excise taxes, real estate mortgage, mortgage of properties not being utilized for the public or government
Veterans Bank					
Credit facilities for revenue-generating projects	Public market; Slaughterhouse; Transport terminals; Municipal water system; Storage and infrastructure facilities; Hospital and help facilities; Heavy equipment; Roads and bridge construction; Computer hardware and software	Negotiable and shall depend on the cost of fund or source used	General terms of 5 years	Depends on the project requirement	Assignment of IRA hold-out against deposit or time placements, real estate mortgage, and other assignable funds of LGUs

Lending Programs of Government Financial Institutions and Municipal Development Fund Office (*cont'd.*)

Government Financial Institution	Eligible Projects	Rate of Interest	Loan Term	Loan Amount	Collateral Requirement
Government Service Insurance System					
Tulong sa Lokal na Pamahalaan (Help for local government)		Not lower than 14% per annum compounded monthly, to be reckoned from the date of the first release of the loan	Maximum term 6 years, including a grace period on the repayment of the principal of not more than 1 year	Maximum amount of P20 million per project by an LGU	1. First mortgage on real property where the project will be constructed, including the building and improvements to be constructed thereon and machinery and equipment to be installed therein; or 2. First mortgage on other real properties owned by the LGU borrower
Municipal Development Fund Office					
Local Government Finance and Development Project	Market; Slaughterhouse; Municipal water supply system (expansion and rehabilitation); Municipal piers and wharves; Bus and jeepney trans port terminals; Post-harvest facilities; Cold storage and ice plants	14% per annum, fixed	Maximum of 15 years, with 3 years grace on principal	Based on borrowing capacity	IRA intercept

Appendix 5. LGU Bonds Issued after the Passage of the Local Government Code

Bond Name	Project Amount (P million)	Tenor (years)	Guarantor	Status/Experience
Victorias Mabuhay Bonds (Negros Occidental)	8	2	HGC	Settled
Legazpi Suerte Bonds (Albay)	26	3	HGC	Settled
Claveria Housing Bonds (Misamis Oriental)	20	3	HGC	Settled
Puerto Princesa Housing Bonds (Palawan)	20	3	HGC	Payment restructuring
Sto. Domingo Housing Bonds (Nueva Ecija)	10	—	None	—
Urdaneta City Municipal Bonds Abattoir Upgrade (Pangasinan)	25	5	LGUGC	Project completed
Boracay-Aklan Provincial Bonds Jettyport and Port Terminal	40	7	LGUGC	Project completed
Puerto Princesa Green Bonds Socialized Housing (Palawan)	320	7	LGUGC	Project stopped Payment restructuring
Caloocan Katipunan Bonds General Hospital, Public Market and Commercial Center/Parking	620	7	LGUGC	Project implementation
Tagaytay City Tourism Bonds Convention Center	220	7	LGUGC	Project implementation
Iloilo City Bonds Employees Housing Program	130	3	LGUGC	Bonds prepaid via direct loan from PVB
Daraga Municipal Bonds Public Market (Albay)	75	7	LGUGC	Project 75% completed
Bayambang Aliguas Bonds Dry Goods Market (Pangasinan)	42	7	LGUGC	Project implementation

— = data not available, HGC = Home Guaranty Corporation, LGU = local government unit, LGUGC = LGU Guarantee Corporation, PVB = Philippine Veterans Bank.

Sri Lanka

Amarakoon Bandara
Former Head
International Finance Division
Economic Research Department
Central Bank of Sri Lanka
Colombo

Acronyms

ADB	Asian Development Bank
BOT	build-operate-transfer
DFCC	Development Finance Corporation of Ceylon
GDP	gross domestic product
GST	goods and services tax
LLDF	Local Loans and Development Fund
RTGS	real-time gross settlement
SEC	Securities and Exchange Commission
SLRe/SLRs	Sri Lanka rupee
US	United States
VAT	value-added tax

Executive Summary

Sri Lanka has a well-organized system of local government influenced mainly by practices in the United Kingdom. With the 13th amendment to the Constitution in 1988, provincial councils were established as a subnational level of administration with legislative powers.[1] Local government was put under the provincial councils, administration was devolved, and division-level administrative agencies took over local government and development functions.

With the administrative mechanism transformed, and political decentralization and powers increased, local governments acquired greater responsibility but also faced difficulties in delivery of services to local communities due to fiscal constraints of the central Government and limited own resources. This chapter explores the possibilities of raising funds for local governments by issuing bonds.

Before they can issue financial instruments in the domestic market, local governments must set the conditions to protect the interests of prospective investors and ensure the stability of the financial system. Local governments are saddled with a host of problems that hinder delivery of community services: lack of efficient cash-flow management systems, substandard accounting practices, lack of transparency, and large revenue arrears. Lack of accountability rules, antifraud legislation, and an enabling regulatory environment compound these problems. Thus, the local issuance of bonds should be considered only in the medium term, after the required infrastructure for such bond issues is established, which includes, on the part of local governments:

- Improving accounting standards.
- Improving their financial condition. This would entail: (i) strengthening cash management of local governments to minimize such costs and allocate resources more efficiently; (ii) adjusting rates to reflect prevailing market-determined costs; (iii) introducing new rates for local government public services and strictly enforcing the law; (iv) improving garbage collection and charging for it (local authorities should also explore the possibility of using garbage to manufacture fertilizer commercially); (v) establishing parking meters to generate revenue and control traffic; (vi) building car-parking facilities in joint ventures with the private sector; (vii) establishing day care centers to meet the needs of working people, particularly middle- and upper middle-income parents; (viii) auctioning property rights; and (ix) auctioning pollution rights.
- Promoting private-public partnerships. Major infrastructure projects can be undertaken as joint ventures with the private sector, or the private sector can be allowed to undertake projects on a build-own-operate, build-operate-transfer, or build-own-lease-transfer basis.

- Promoting urban tourism and ecotourism.
- Building toll roads, raising the capital through bond issues or borrowing from international agencies such as the Asian Development Bank (ADB) or the World Bank.
- Formulating block grants so that they do not fill the gap between a predetermined proportion of the recurrent expenditure of the province and its collected devolved revenue.
- Improving local governance by introducing generally accepted accounting principles, transparency rules, provisions to ensure accountability, and antifraud legislation.
- Providing an enabling regulatory environment by either establishing a municipal securities board or using the Securities and Exchange Commission (SEC), with some modified rules and regulations to suit the local government bond market.
- Introducing antifraud legislation.
- Introducing legislation to facilitate bond issuance.
- Obtaining a credit rating.
- Introducing an insurance scheme for municipal bonds.
- Granting tax concessions.
- Establishing a special-purpose vehicle or asset management company.

ADB can help develop local government bonds by:

- Directly financing projects, which will support local government financing until the creation of a conducive environment for issuing local government bonds or securities.
- Guaranteeing local government bonds or borrowings.
- Providing technical assistance.
- Improving accounting standards by helping introduce accepted accounting principles, training local government staff, and funding equipment purchases.
- Improving project implementation by helping improve the technical skills of staff to evaluate, implement, and monitor projects.
- Strengthening cash management through technical assistance.
- Drawing up a long-term development plan, particularly for township development, to reduce commuter traffic, urban congestion, and environmental pollution.
- Providing technical assistance to help local governments acquire the legal expertise to draft antifraud legislation.

Local Government Finance and Bond Financing

Sri Lanka has a well-organized system of local government, influenced mainly by practices in the United Kingdom. Local government powers and social responsibilities have gone through radical changes since independence in 1948.

A major political change took place in July 1981 with the establishment of district development councils (DDCs), which took over the functions of town councils and village councils. DDCs organize all district-level development activities. The *gramodaya mandalayas* (village councils) and *pradeshiya sabhas* (regional councils) were also established to secure people's participation in local administration and help DDCs carry out development programs. The establishment of *pradeshiya sabhas* is considered a landmark in the development of local government in Sri Lanka, paving the way for a new type of local authority to cover an area administered by an assistant government agent.

In 1988, the 13th Constitutional Amendment paved the way for the creation of provincial councils, which are subnational administrative bodies with legislative powers. Local government was put under the provincial councils. Under this devolved system, local government and development functions were assumed by the division-level administrative agencies.

With the administrative mechanism transformed, and with a higher level of political decentralization and increased powers, local governments acquired greater scope and responsibilities. Increased political decentralization and general economic improvement led to a higher demand for regional development and efficient delivery of modern economic and social services. However, local governments were hobbled by central government fiscal constraints and limited self-generated resources.

High fiscal deficits over the past several years forced the central Government to restrict fiscal transfers to local government. Fiscal transfers to provincial councils dropped from 2.3% of gross domestic product (GDP) in 1995 to 2.0% in 1999, while local government revenue remained at 0.6% of GDP. The deterioration of social services was a clear reflection of local governments' weak financial situation. Development works financed by own resources accounted for a minor fraction of total investments, indicating heavy reliance on fiscal transfers from the central Government. In 2000, the total revenue of provincial councils was sufficient only to cover 20% of their resource needs. Investments financed by own resources were limited to acquisition of fixed assets. The resource gap became even wider with political decentralization and the accompanying responsibilities and obligations to deliver services and achieve regional development.

To strengthen their own resources, local governments increasingly turned their attention to long-term borrowings or the issuing of long-term bonds, as most infrastructure development projects are long term and cannot be financed through the usual annual revenue collections. Long-term financing arrangements not only avoids the mismatch between expected revenue flows and debt service payments, but also helps provide better and sustainable services.

This chapter explores the possibility of raising funds for local governments—provincial and municipal—through long-term loans or bonds to facilitate development work. The study will focus on Colombo Municipal Council and Western Provincial Council, given their dominance among the local governments.

Socioeconomic Responsibilities, Economic and Political Changes, and Fiscal Trends

Local Government Structure

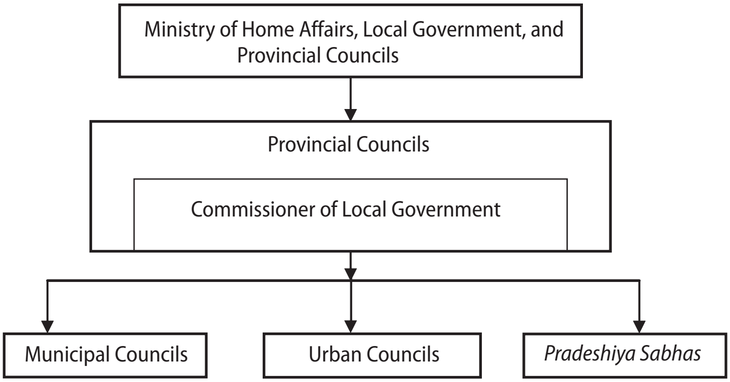
The structure of local government has changed significantly since the early 1980s. Local government consists of municipal councils, urban councils, and *pradeshiya sabhas* (Figure 1). The provincial councils are subnational administrative bodies with legislative powers outside the local government structure.[2] Provincial councils are established in eight of Sri Lanka's nine provinces. Local authorities function under their respective provincial councils. In urban areas, local government consists of 18 municipal councils and 37 urban councils. In rural areas, local government consists of 256 *pradeshiya sabhas*. Local government bodies are supervised by the commissioner of local government of the Department of Local Government.

Municipal Council Ordinance 29 of 1947, Urban Council Ordinance 61 of 1939, and Pradeshiya Sabhas Act 15 of 1987 govern the powers and functions of these institutions. Their functions fall within the categories of public health and environmental sanitation, public thoroughfares, and public utilities. Local authorities may raise revenues but, except for Colombo Municipal Council and Western Provincial Council, depend heavily on fiscal transfers from the central Government. Usually, the local government salary bill is paid by the central Government through the provincial councils.[3] The central Government provides capital grants to provincial councils, which have the discretion to allocate these grants to local government bodies under them.

Socioeconomic Responsibilities

With the development of local government as a subnational devolved system of administration, the scope of local government activity has widened significantly

Figure 1. Structure of Local Government



over the years. Socioeconomic responsibilities range from attending to traditional functions, such as maintenance of infrastructure, provision of public utilities and community services, and promoting and securing public health, to development planning and protection of the environment.

Development and Maintenance of Infrastructure

Ordinances require local governments to provide comfort to residents by, for example, maintaining roads. However, the level of road development and maintenance is far below public expectations due to a wide range of factors, some of which could be easily resolved if proper procedures were followed and accepted standards adopted. The major obstacles to the development and maintenance of infrastructure are:

- Lack of a clear-cut single authority responsible for coordination of road development and maintenance. A conflict arises, for example, when the powers of the Road Development Authority and Provincial Road Development Authority overlap.
- Incorrect concept of road maintenance. Repairs are usually started when roads are virtually beyond repair.
- Use of obsolete technology. Many nonmajor road development and maintenance projects used technology several decades old as a consequence of corruption and contractors' lack of technical knowledge.
- Malpractices in awarding contracts. The award of contracts is influenced by political factors rather than technical know-how, and is made outside standard tender procedures, often resulting in substandard work.

- Lack of traffic regulation. Lack of an effective law to regulate traffic is a major problem. Heavy vehicles are damaging roads of light-weight capacity.
- Lack of financial resources. Local governments lack funds to deliver services, most obviously in road development and maintenance, an area easily deprived of allocation in case of financial constraints.

However, provision of financial resources alone will not improve road conditions. Institutional drawbacks and political influence are also stumbling blocks in the effective provision of infrastructure facilities by local governments. These issues should be addressed hand in hand with the financial problems if local authorities are to be made efficient in developing and maintaining good road networks.

Public Health

Provincial councils are responsible for providing effective public health services through the local authorities. Public health services are preventive and curative. While major municipalities give equal importance to both, other local authorities focus on preventive health care. Local authorities operate maternity and child welfare clinics and dispensaries. The level of service is subject to the availability of financial resources and technical support. Local authorities are closely involved in preventive health care through the medical officers of health (MOHs) in major municipalities, and government MOHs in other local authorities, which include immunization among their health services.

Local governments also provide other ancillary services that help maintain public health, including toilet facilities for all houses; maintenance of public buildings, lands, and places; garbage disposal; construction and maintenance of drainage; sanitary inspection of buildings; and stopping public nuisances.

Environment

Environmental protection has received special attention in recent years as the population grows and suffers the adverse effects of urbanization and development. Environmental protection became a function of local authorities with the devolution of the powers of the Central Environmental Authority (CEA). Under the National Environmental Act, CEA confers on local authorities the power to deal with minor pollution agents and to issue environment protection licenses.[4] Local authorities, together with the central Government, also attempt to improve the environment by adopting proper town planning and landscaping.

However, local authorities have not been successful in the discharge of their environmental responsibilities due to numerous factors: political influence, corruption, lack of interest, and lack of resources and technical skills. The health of urban residents is threatened by unauthorized construction of houses and buildings, construction of factories that lack facilities to minimize pollution, too much use of polythene, lack of a solid and liquid waste disposal system, and poor maintenance of drainage and sewerage systems. Water, air, and noise pollution have increased, as has the incidence of hepatitis, cancer, respiratory disorders, hearing defects, and diarrhea. A significant proportion of children in Western Province, where most industries are, suffer from asthma. Hospitalized asthma patients have increased significantly from 397 per 100,000 people in 1980 to 895 in 2000 (Department of Health Services 2000). Motorists use diesel fuel, which has a very high sulfur content. Evidence is increasing of adverse health effects, including premature deaths, due to such sulfur emission. Aside from serious health hazards to present and future generations, particularly the young and the poor, the lack of attention to environmental concerns also has financial implications for local governments as more resources are needed to control pollution. Local governments should finance environmental protection from taxes, user charges, and prohibitive penalties.

Public Utility Services

Local governments provide several public utility services, some of which have been taken over by specialized institutions.

Water Supply. Municipal councils used to be in charge of it. Colombo Municipal Council, for example, was vested by the Colombo Municipal Council Waterworks Ordinance with powers to supply water to the public. This ordinance also applied to the Kandy and Galle municipal councils. The minister in charge of local government was vested with powers to apply the provisions to other municipal councils. In 1974, such responsibility was transferred to the newly established National Water Supply and Drainage Board as most local authorities had failed to deliver this service due to poor maintenance and weak management, which led to large-scale waste and losses.

Supply of Electricity. Local governments traditionally supplied electricity for consumers and for lighting of streets and public buildings. The Ceylon Electricity Board took over these functions. Local governments are now responsible only for lighting streets and public buildings, the cost of which is borne by local authorities.

Drainage, Conservancy, and Scavenging. These are basic functions of local government and directly affect daily life. No other public agencies can perform them at present. However:

- Drainage systems in many major municipalities, particularly in Colombo, are poorly maintained, resulting in flooding during heavy rain. The lack of a system to drain rainwater causes major flood-management problems.

- Conservancy is carried out only in a limited number of local authorities. Sewerage systems are in use only in Colombo and Dehiwala municipalities and in certain parts of the Kolonnawa Urban Council area. Most local authorities have not been able to provide adequate conservancy services due to lack of equipment and resources.
- Local authorities lack the equipment, labor, and dumping sites to dispose of solid and liquid waste, giving rise to serious health hazards. Advanced systems for refuse collection are not available, except in Colombo Municipal Council, and refuse is collected only periodically. The private sector has become involved in the collection of refuse only recently, noticeably improving service. Introduction of user charges, especially for scavenging, will enable local governments to provide better service and maintain a healthy environment. Public awareness programs on the use of polythene, disposal of solid and liquid waste, and strict enforcement of the law against activities that cause pollution and flooding are needed.

Housing Development. Local authorities are required to provide houses for the needy but have been unable to do this due to lack of resources and interest. Thus, local authorities have focused mainly on granting approval for construction of buildings but lack the power to enforce housing construction by private property developers. In the medium to long term, this causes environmental problems that entail heavy costs for local authorities.

Cemeteries. Maintenance of cemeteries and burial grounds has become an important function of local authorities, particularly in urban areas with their rapidly growing population.

Fire Fighting. This has not been a main function of local authorities, except in major municipalities such as Colombo, due to financial and technical constraints. Colombo Municipal Council is the best equipped in the country for fire fighting, but this function has recently been taken over by the Air Force. The country needs to establish a fire-fighting service network or else face immense economic losses. Local authorities can best provide the service because they have responsibility to ensure the safety of lives and property and are familiar with their respective areas.

Community Services. Local governments provide several community services, including libraries, preschool and nonformal education, and day care centers, particularly in urban areas.

Economic and Political Changes

Liberalization of the Economy

Sri Lanka embarked on far-reaching economic policy reform in 1977, shifting to a market-oriented policy for development and undergoing major structural transformation (Box 1). The economy has become more open, diversified, and market friendly, with the economic base shifting from agriculture to manufacturing and services.

The change in economic policy is also reflected in human development and income indicators. The per capita income of $839 in 2001 was well above that of other developing countries, and the 1998 human development index of 0.73 put Sri Lanka among the middle-income countries (United Nations Development Programme 2000).

Box 1. Policy Changes since 1977[5]

The major economic policy changes include the following:

- introduction of a managed floating exchange rate regime in 1978 and an independent floating exchange rate system in 2001;
- determination of interest rates by market supply and demand conditions;
- privatization of public enterprises to make them more efficient, and scaling down of state monopolies to improve competition with the private sector;
- creation of an environment conducive to private sector-led growth;
- gradual reduction of tariff protection afforded to local industries;
- liberalization of foreign direct investments and granting incentives to foreign investments in export processing zones;
- promotion and development of the Colombo Stock Exchange in particular, and the capital market in general, through a host of tax exemptions;
- permission to foreign banks to open branches and strengthening of the regulatory and supervisory mechanism of financial institutions;
- use of indirect controls in monetary management and greater coordination among monetary, fiscal, and exchange rate policies;
- acceptance of article VIII of the Articles of Agreement of the International Monetary Fund by removing all payment restrictions on current international transactions;
- consolidation of fiscal operations;
- relaxation of capital controls, particularly on foreign investments; and
- provision of legislation to support institutional and policy changes in the new economic environment.

Fiscal Reforms

Since 1977, various initiatives have been taken to consolidate fiscal policy and arrest the widening fiscal deficit during most of the postliberalization period. For example, the fiscal deficit during 1978–1989 averaged 14% of GDP, a high figure by any standard, mainly due to high capital expenditures on development projects and, to some extent, the increasing security-related expenditures since the outbreak of conflict in the northeast in 1983.[6,7] A wide range of fiscal policy reforms were undertaken in the 1990s to bring down high fiscal deficits to a level that could be sustained in the medium and long term.

The broad fiscal reform measures undertaken by the central Government include the following:

- Simplification of income tax structure. During the past several years, the income tax rate has been significantly reduced (from 55% to 35% in 1984–2002), and the income tax structure simplified (11 tax bands reduced to three).
- Introduction of goods and services tax (GST) and value-added tax (VAT). GST, considered to be superior to the business turnover tax, was introduced in 1998 to broaden the tax base and increase revenue. However, GST's unexpectedly poor performance caused a gradual decline in tax revenue. It was replaced by VAT in August 2002.
- Rationalization of government expenditure and subsidies. Rationalization of nonpriority expenditure through control and better targeting has been widely used to curtail expenditure. For example, current transfers to public enterprises, institutions, and households have been cut from 5.1% of GDP in 1997 to 4.2% in 2000.
- Improved cash management and centralization of major consumer subsidies. A new cash management system (in collaboration with the two state banks, spending agencies, and the Treasury) has been introduced and overdraft balances securitized. All subsidies are being brought under one umbrella.

In spite of efforts to consolidate fiscal operations, the fiscal situation of the central Government deteriorated considerably over the past several years. Sri Lanka ran budget deficits of over 7.5% of GDP during 1995–2001, registering a deficit of as high as 10.9% in 2001.

Poor fiscal performance stemmed from a range of factors. First, despite simplification of the income tax structure and tax rates, tax evasion continued. The contribution of income tax to government revenue declined from 2.4% of GDP in 1997 to 2.2% in 2000, reflecting weak and inefficient tax administration. Second, GST was introduced prematurely, well before the public was made aware of the new tax system and before a proper administrative and monitoring mechanism was put in place, causing a failure in the system. Third, efforts to rationalize government expenditure in certain sectors were nullified by fiscal slippages in other sectors. For example, the continued conflict severely drained the budget. Corruption and poor policy design and implementation were also slippage factors. Expenditure controls were mainly in the form of cuts in capital expenditure, which had an adverse impact on economic growth. Fourth, Treasury cash management, although making some progress, is well below optimal level as ad hoc management decisions continue. Continued high budget deficits are reflected in a high level of public debt and debt service payments. Public debt stock rose to 103.6% of GDP at the end of 2001, while interest payments accounted for 41% of total government revenue.

Impact on Local Government

Resource constraints of the central Government drastically reduced fiscal transfers to local governments, affecting development projects and other activities.

Large and persistent budget deficits also had indirect costs for local governments in terms of high interest rates and slow expansion of economic activities that generate income for the local government.

Political Changes

The local government structure consists of the municipal councils, urban councils, and *pradeshiya sabhas*. They are subject to the authority of a central government ministry overseeing the development of local government, while the Department of Local Government provides technical guidance. Local governments are governed by ordinances, which treat them as corporate bodies with a legal personality. The ordinances cover finance, particularly procedures governing the purpose, limits, and methods of borrowing.

The 13th Constitutional Amendment brought local governments under the supervision and administration of provincial councils, which have the authority to confer additional powers on local governments but not to take away existing powers. Matters relating to the form, structure, and national policy on other local government institutions were retained by central government.

Fiscal Trends[8]

Local governments receive financial resources for their activities mainly from two sources: own revenue, which is limited; and central government money transfers, which continue to provide the bulk of financial resources needed for development projects and social services.

Revenue Trends

The sources of local government revenue have traditionally been taxes on production and expenditure—turnover taxes, assessment rates, license fees, and other taxes; stamp duty; sales and other charges; interest on profits; dividends; and other revenue (Table 1). Total revenue collection of provincial councils increased from SLRs4,440 million in 1995 to SLRs8,674 million in 2001, or an annual average growth of 11.9%. However, total revenue declined marginally from 0.66% of GDP in 1995 to 0.62% in 2001, indicating that local government revenue has not kept pace with the changing economy (Figure 2).

Three major sources of revenue—turnover tax, license fees, and stamp duty—account for the bulk of total local government revenue: 91% of total revenue collected by the provincial councils in 1995 and 86% in 2001. Turnover tax accounts for about half of total revenue, contributing 52% in 1995 and 48% in 2001.

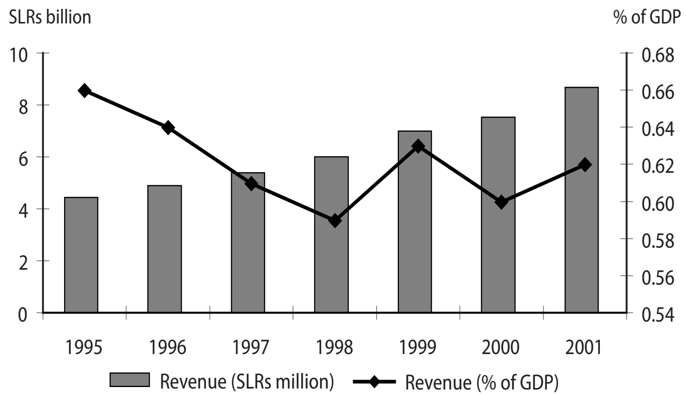
Total revenue collection by municipal councils increased from SLRs2,527 million in 1997 to SLRs3,123 million in 2000, or an annual growth of 8%. However, total revenue declined from 0.28% of GDP in 1997 to 0.25% in 2000. The main revenue source of the municipal councils is the rate collected from residences and

Table 1. Revenue Sources of Provincial Councils

Taxes	Duties	License Fees	Miscellaneous Fees
Turnover	Stamp duties on transfer of properties (land)	Motor vehicles	Court fines
Betting		Liquor	Fauna and flora fees
Lotteries		Arrack and toddy rents	Land development fees
Prize competition		Rents and tapping	Weights and measures
Mineral rights		Possession, transport, purchase, and sale of liquor	Medical ordinance fees
Toll collection			Departmental fees
Land and building			Court fees on documents
Drugs and chemicals			

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Figure 2. Provincial Council Revenue



business premises, which contributes about 51% to total municipal revenue. Western Provincial Council and Colombo Municipal Council, where businesses are concentrated, continued to account for most of total local government revenue. Western Provincial Council had an average 67% share in total revenue of provincial councils in 1999–2001, while Colombo Municipal Council had about a 58% share in total revenue of municipal councils in 2000. Since 1991, collection by Western Provincial Council has been 65–68% of total revenue of provincial councils. Central Provincial Council has the next largest collection, averaging 8–10% of total revenue. North Western and Southern provincial councils account for 7–8% and 6–7%, respectively. These four provincial councils account for about 86–93% of total revenue.

A similar uneven distribution of revenue is seen in municipal councils. The municipal councils of Colombo (57.6%), Kandy (11.1%), and Sri Jayawardenapura Kotte (5.2%) accounted for about 74% of total municipal revenue in 2000.

Expenditure Trends

Total expenditure incurred by the provincial councils in providing community services increased from SLRs20,852 million in 1995 to SLRs40,094 million in 2001, or an average growth of 11.8%, reflecting provincial councils' assumption of greater responsibility in implementing the regional development program. However, total expenditure of provincial councils for local services declined from 3.1% of GDP in 1995 to 2.6% in 1999, and increased to 2.9% in 2001.

Total expenditure of the municipal councils for local services increased from SLRs2,705 million in 1997 to SLRs3,421 million in 2000, an average increase of 9%. Total expenditure declined from 0.3% of GDP in 1997 to 0.27% in 2000.

Current expenditure has accounted for a major share of total expenditure over the last few years. Current expenditure was about 95% of total expenditure of provincial councils until 1999. With the transfer of the responsibilities of implementing the regional development program to local governments, the share of current expenditure to total expenditure declined to about 83% in 2001.

In contrast to uneven distribution of revenue, the distribution of expenditure among provincial councils is relatively equitable. Of total expenditure during 1997–2001, Western Provincial Council accounted for 26.9%, while Central, Southern, and North Western provincial councils accounted for 15–16% each, reflecting more equitable fiscal central government transfers.

Expenditure distribution among municipal councils is uneven. Colombo accounted for over 57% of total expenditure of municipal councils in 2000; Kandy, for 10.4%; Sri Jayawardenapura, for 4.5%; Negombo, for 3.7%; and Galle, for 3.4%, perhaps due to inadequate central government transfers.

Economic classification of current expenditure of provincial councils reveals that 80% of consists of personal emoluments. Functionally, over 85% of current expenditure went to social services such as education and health.

Capital expenditure of provincial councils accounted for about 5–8% of total expenditure before 2000. Acquisition of capital goods—mainly vehicles, furniture, and equipment—was the largest component of capital expenditure. With the introduction of province-specific development projects in 2000, the share of capital expenditure in total expenditure increased to about 17% in 2001. Development projects, mainly to develop highways and improve the quality of health and education in the provinces, accounted for over 60% of capital expenditure of provincial councils. Capital expenditure of provincial councils, which is earmarked mainly for development projects, has often fallen below original budget estimates. For example, the realized capital expenditure in 2001 at SLRs6,669 million was only 59% of the budget estimate of SLRs11,268 million. This shortfall is attributed mainly to the central Government's lack of resources. Delays in project implementation (due to tender procedures, lack of technical skills, political and economic uncertainties, and other administrative complexities) have also contributed to a slowdown in development activities.

Current expenditure accounted for 77% of total expenditure of municipal councils in 2000. Of total current expenditure, about 50% went on personal emoluments.

The volume and quality of development activities depend heavily on central government transfers. In 2001, for example, total revenue of provincial councils was sufficient to cover only 20% of total expenditure. The transfers consist of block grants to meet the resource gap in the current expenditure program, province-specific development grants to implement the regional development program, and criteria-based and matching grants to cover other capital expenditure.[9] Block grants accounted for the biggest share (92% in 1995 and 81% in 2001) of total central government transfers, while province-specific development grants were 13% of transfers in 2001.

Only limited authority has been devolved to local governments for own resources (Legislative Provisions to Borrow, section 4.2), hindering development activities, especially when the central Government faces financial difficulties, and additional development activities that would serve communities well in a rapidly changing economic environment. Local governments should have the power to generate their own resources by borrowing or imposing new taxes.

Strengthening the Financial Situation of Local Governments

Local governments depend heavily on the central Government to fill the financing gap arising from low revenue collection and high expenditure. Provincial council revenue and recurrent expenditure are seriously imbalanced: revenue collection covers only around 30% of recurrent expenditure (Table 2), with the balance financed by central government transfers. To reduce this dependency, the financial situation of local governments should be improved.

Table 2. Resource Gap of Provincial Councils, 2001 (SLRs million)

Provincial Council	Revenue	Recurrent Expenditure	Capital Expenditure	Revenue as % of Recurrent Expenditure
Western	5,954	7,923	391	75.1
Central	626	4,652	199	13.4
Southern	626	4,333	309	14.4
North Western	623	4,344	248	14.3
North Central	244	2,562	108	9.5
Uva	213	2,359	99	11.3
Sabaragamuwa	345	3,048	105	11.3
Total	**8,628**	**29,221**	**1,459**	**29.5**

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Fiscal Reforms

Assessment Rates

Local authorities are empowered to levy rates on the annual value of properties. The revenue collected constitutes a major source of income.[10] However, the method of computing the rates payable is highly inefficient and is not transparent. The present rates based on the annual value are complicated, cumbersome, and not understood by ratepayers.[11] At times different rates are applied to different ratepayers, causing confusion. The assessment notice sent to ratepayers does not show how the rate is calculated, making it difficult for ratepayers to verify the accuracy of the dues payable. The turnover tax collected by provincial councils is often based on self-assessment and the acceptance of taxpayers' declared returns, without a proper examination of the returns and accounts.

Lack of technically qualified staff has hampered the detection of tax evasion. Local government staff must be trained in relevant fields, undertake regular inspections, and carry out detailed audits and queries regularly to improve efficiency in tax collection.

The complexity of computation and lack of transparency could lead to corruption among local authorities and increase the chances of tax avoidance. A simple and transparent system of calculating rates is imperative. Evidence suggests that the capital value-rating system is superior to the present annual value-rating system and can be tested for provincial and municipal councils.

Local governments usually review the rates applied once in 5 years. However, the rates applied do not reflect the market rates due to undervaluation of properties.

Tax Reforms

Local authorities are empowered to collect taxes, rates, fees, and charges for the services they provide to industries, trades, businesses, and households. Often these levies do not reflect the true cost of services provided. Some services are provided free. In municipalities, for example, charges are levied only on commercial enterprises for collection of trade refuse. Lack of financial resources and equipment has been a major cause of inefficiency in keeping cities clean. Local governments can become financially strong and viable by revising the fees and charges to reflect the cost of services, and by introducing charges for new services provided.[12] Legislative provisions should provide for these measures.

Improvement in Revenue Collection

Less than 75% of the target income is collected. Local governments must, therefore, improve their revenue administrative mechanism. Strict law enforcement and new incentive schemes to motivate the local staff to collect the targeted revenue may be considered, as well as the following:

- limiting exemptions granted to certain commodities and institutions;
- introducing statutory provisions and regulations where revenue collection is inhibited by lack of them;
- defining activities, such as wholesale and retail sales, more clearly to avoid exclusions;
- streamlining the methodology for transferring stamp duties to local bodies; and
- rigorous inspections, auditing, and review.

Collection of Revenue Arrears

As the revenue collected is generally under target, local government maintains large revenue arrears. Colombo Municipal Council alone is said to have revenue arrears of SLRs2 billion. The private sector accounts for about 50% of arrears, while public institutions account for the rest, which is mainly arrears on property taxes payable by public institutions and stamp duties payable to local government.

Accumulation of revenue arrears from the private sector may be due to complexities and lack of transparency of the collection system and to willful evasion. Such arrears could induce corruption among generally underpaid local government staff. Collection should be done through an incentive scheme or through an independent unit.

Expenditure Management
This is a key aspect of budgetary control. As local governments have large resource gaps, revenue must be increased and expenditure managed through efficient use of resources (Table 2). Procurement procedures should be improved to minimize wastage and malpractices. Overexpenditures are sometimes made known only after accounts are finalized. Cash-flow planning is usually not properly done, resulting in high operational costs. Particular attention is needed in the following areas:

- strict limits on procurement of vehicles while improving the procurement procedure, to minimize waste and deter corruption;
- a proper cash-flow planning mechanism; and
- strict adherence to budgetary allocation.

Outsourcing Services to the Private Sector
Some services provided by local authorities could be handed over to the private sector to make such services efficient and cost effective. For example, Colombo Municipal Council recently hired private service providers to clean the streets, with good results. Such an arrangement reduces the number of laborers on the government payroll. Customarily, the number of those on payroll is larger than those who actually work. Similar arrangements could be made in other areas, such as hiring rather than outright purchase of vehicles. Transparency mechanisms should be in place to avoid corruption.

New Revenue Generation

New revenue-generating projects could solve the financial problems of local governments, allowing them to cater to the rapidly changing lifestyles of the population, particularly urban residents. Local authorities can undertake the following:

Auctioning Local Government Property Rights. This will minimize malpractices, improve marketability of properties, ensure that rates are adjusted regularly to reflect market demand and supply, and ensure that resources are utilized efficiently. The local government will thus make use of its otherwise underutilized or unutilized property to maximize revenue and provide better community services.

Auctioning Pollution Rights. Many firms and households pollute the air, water, and soil, but pay no taxes or penalties. Pollution affects even those who do not directly contribute to it in terms of increased medical expenses, etc. Pollution rights should be auctioned to polluters and the proceeds used to clean the environment and provide health facilities to those affected.

Promoting Private-Public Partnerships. Private sector participation in local government activities will improve the efficiency of services and help reduce the burden on the local government budget. Major infrastructure projects can be undertaken with the private sector as joint ventures or on build-own-operate (BOO), build-operate-transfer (BOT), or build-own-lease-transfer (BOLT) bases. These arrangements will reduce the fiscal burden on the local government as the private contractor builds, finances, and operates a project, and collects the revenues for a given period.[13]

Promoting Urban and Ecological Tourism. Local governments exert minimal effort, if any, to promote tourism. Ecotourism has received the attention of authorities recently, but the potential of Sri Lanka's cultural heritage and scenic beauty has remained untapped. Municipalities have few public parks, and facilities for entertainment and travel are inadequate. Promoting urban tourism will not only generate additional income and employment but also satisfy the growing demand for domestic tourism.

Building Toll Roads. Lack of a proper road network, particularly in large cities, is a major impediment to urban development. Heavy traffic during peak hours leads to lost time and more expenditure on, and waste of, fuel. Large cities require modern road networks with metro-railways, highfliers, and easy connections to highways and expressways. Such structures require long-term planning and coordination, capital, and technology. Capital can be raised through bond issues or borrowing from international agencies such as ADB or the World Bank.[14] Tolls may be imposed on the use of road networks to recover costs and control traffic.

Collecting Garbage. Local authorities collect garbage for free. They should adopt an island-wide mechanism to collect garbage and charge a fee from households and commercial enterprises. Strict law enforcement is necessary to compel citizens to pay to keep the environment clean and thus reduce public health service costs.

Installing Parking Meters. Introduction of parking meters will enable local authorities, particularly municipal councils, to generate revenue and control traffic.

Building Car-Parking Facilities. Lack of them is a serious problem in major cities, resulting in heavy traffic. Major municipal councils may build multistory car-parking facilities in joint venture with the private sector.

Establishing Day Care Centers. Local authorities provide day care facilities, but they cannot meet rising demand resulting from the growing number of working parents, especially middle- and upper middle-income parents, and increasing urbanization. Day care standards do not meet public expectations.

Financial and Debt Management

Proper financial and debt management allows efficient allocation and utilization of resources, minimizes waste, and prevents corruption.

Financial Management

Accounting System. Local government adopted the present accounting system in 1974. However, it does not operate properly due to delays in returns. Despite attempts to computerize the system, its methodology remains inadequate, unlike the vastly improved private sector standard accounting practices. The accounting system must be reviewed in view of its implications on budgetary controls. It may be replaced by a standard accounting system, which requires infrastructure, including human resources.

Cash-Flow Planning. This allows efficient allocation of resources and liquidity management, thus helping reduce borrowing costs, which is particularly relevant to local governments faced with financial constraints.

Investment Opportunities. Section 187 of the Municipal Council Ordinance allows local governments to invest funds only in a limited number of financial instruments such as stock or other securities issued or guaranteed by the central Government, and debentures issued by the State Mortgage and Investment Bank.

This restriction has prevented local governments from maximizing the returns on investments, as some returns are administratively determined and kept below market rates (e.g., government Sri Lanka rupee securities). The restriction has also excluded some lucrative investment opportunities. Local authorities should have more freedom in investment decision making, but prudential limitations should be in place to minimize risks.[15]

Debt Management

Proper debt management is vital to the financial stability of an institution, particularly when resources are very limited. One major drawback in the present debt management strategy of local governments is reliance on short-term bank borrowing in the form of overdrafts at high interest rates. At times, Colombo Municipal Council alone runs a bank overdraft of SLRs100 million–300 million. Local governments should consider replacing such short-term loans with long-term loans at low rates, or with debentures or bonds to reduce interest costs.

Raising Funds in the Market

Fiscal constraints of the central Government and its diminishing opportunities to borrow from multilateral lending agencies at concessional terms and conditions will compel local governments to explore alternative arrangements to finance long-term projects, including raising long-term funds in the local and international markets. The merits of this option will depend on operational transparency, financial viability, and integrity of local institutions.

While section 193 of the Municipal Council Ordinance empowers municipal councils to borrow from banks or to issue debentures or housing bonds, the Provincial Council Act does not enable municipal or provincial councils to borrow or raise funds from local or international markets. These laws should be amended to allow bond issuance.

Issuing bonds in international markets may be costly now since the required infrastructure is not in place. Local authorities still have to establish a mechanism for operational transparency. As a starting point, they can borrow from international lending institutions such as ADB and the World Bank to finance long-term development projects.[16]

Local authorities should conform to a set of preconditions before tapping the local and international markets, to keep local governments from falling into a debt trap.[17] Some of the most important preconditions are the following:

- adoption of a standard accounting system and compulsory publication by local authorities of annual (quarterly, if necessary) financial accounts with a reasonable time lag;
- adoption of transparent tender procedures with minimum occurrence of tenders being awarded to the same person or group of persons, with assignment of separate independent individuals or bodies to project identification, estimation, approval, execution, payment, and supervision;
- amendment of ordinances and acts to make the mayor or chairperson and all other councillors and staff fully accountable for misappropriation or misuse of funds, procedures, or privileges; and
- maintenance of appropriate sinking funds (asset management companies or special-purpose vehicles) to ensure repayment of borrowed money on time.

Law Enforcement

Law enforcement will help improve the financial condition of local governments by enhancing collection and reducing expenditure, particularly to help recover large amounts of revenue arrears and induce ratepayers to pay their dues on time.

National Environment Act 47 of 1980 provides for issuance of licenses and charging of fees on certain activities that affect the environment. However, the law is not enforced, and many important licenses are not issued because the licensing body lacks technical skill, capacity, and commitment.

Introduction of laws and their strict enforcement are needed in garbage collection. Worsening pollution in urban areas causes numerous health hazards such as regular outbreaks of dengue and malaria and increasing cases of respiratory disorders, mainly among children. Control of pollution through licensing and user charges will reduce expenditures in preventive and curative health services while generating revenue for the local government.

Introducing a Retirement Scheme

Local authorities employ many unskilled casual and permanent laborers. Employees in other categories have lower qualifications and skills than those in the public service or private sector. Local authorities have been accused of employing "ghost" laborers—those on regular payroll but who do not report for work or perform any duty. Even after outsourcing some services such as street cleaning to the private sector, municipal councils continue to employ the same number of employees regardless of financial implications. Laying off casual workers has also become difficult for political and social reasons.

Introducing a voluntary or mandatory retirement scheme to coincide with outsourcing of services to the private sector will reduce cost of redundant labor and overtime claims and at the same time make the outsourced services more efficient. A voluntary or mandatory retirement scheme may be introduced with financial assistance from international agencies such as the World Bank or ADB but should be subject to strict limitations on hiring of new labor.

Improved Project Implementation

Inordinate delay in implementing development projects is a major concern in the utilization of foreign aid because of substantial financial costs to governments. With the regional development program now a responsibility of local governments, its financial condition will depend on its efficiency in project implementation and ability to maximize available resources and undertake more development activities.

The major issue faced by local authorities is the lack of capacity and skills to execute development projects. Technically qualified staff may need to be recruited to solve this problem.

Improved Infrastructure Maintenance

Maintenance of infrastructure, particularly the road network, is a main responsibility of local governments. Most local authorities have neglected to maintain roads due both to lack of finances and technology and to corrupt practices. Roads are neglected until they are damaged beyond repair, requiring additional expenditure for reconstruction and repair.

Conducting Awareness Campaigns

Local governments spend a considerable amount of money on public health and on cleaning streets and public places. Urban health hazards are caused mainly by environmental pollution, drug addiction, and alcoholism, which can be reduced if the urban population, particularly the poor, are convinced through public awareness campaigns of the merits of maintaining cleanliness and refraining from use of illicit drugs and of alcohol.

Tapping Domestic and International Markets

Increasing social responsibilities, coupled with budgetary constraints of the central Government, make own resources increasingly necessary for local governments. Long-term borrowing from financial markets will enable local governments to embark on long-term development projects while providing low-risk investment opportunities to investors. Such borrowing will also reduce the burden on the central government budget. Since bank financing involves a serious term mismatch between short-term deposit liabilities and long-term loans, bank financing for long-term development projects could lead to financial market instability. It is a fundamental thesis that long-term productive investment should be financed by long-term capital, whether in the form of equity or of fixed-rate debt instruments (Kim and Suleik 2001).

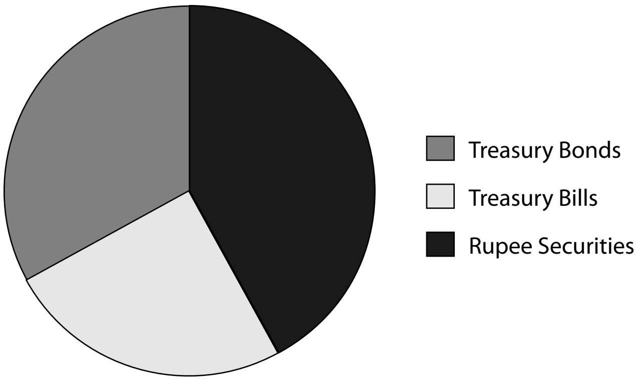
Bond financing for development activities of local governments has played an important role in the economic expansion of both industrial and developing countries. In the United States (US), for example, the ability of municipalities to issue bonds has played a critical role in economic expansion. Bonds generate financing for infrastructure development and for the operations of the issuer (Maco 1999). Several modern infrastructure projects in New York have been developed through the use of quasi-governmental authority financing.

Sri Lanka's Bond Market

Sri Lanka's bond market consists of government securities and corporate bonds. Government securities dominate the market. The instruments traded are limited to treasury bonds and bills, because rupee securities, which constitute nearly half of total government debt, are hardly traded in the secondary market (Figure 3).

Treasury bills are short-term instruments with a maximum maturity period of 1 year. Treasury bonds, introduced in 1997, have a maturity of up to 6 years. However, most treasury bonds have a medium-term maturity of 2–3 years.

Figure 3. Composition of Tradable Government Debt, 2001



Five government-owned institutions dominate the government securities market: Employees' Provident Fund (30%), Bank of Ceylon and Peoples' Bank (17%), National Savings Bank (12%), and Central Bank of Sri Lanka (11%). Altogether they account for 70% of the market, reflecting a narrow investor base. Sale of government paper is made through a bidding process involving primary dealers.

Two separate institutions regulate the securities and bond markets. The central bank, as fiscal agent of the central Government, regulates the government securities market. The SEC regulates the corporate bond market.

Corporate bonds are usually listed on the Colombo Stock Exchange after issuance of a prospectus. Usually, banks or other financial institutions act as underwriters of the issue. Some issuers obtain a rating before such issue, while others prefer to enhance credit quality by obtaining a guarantee from banks or international agencies.

Legislative Provisions to Borrow

Ordinances cover local government finance, particularly procedures governing the purpose, limits, and methods of borrowing. The following sections of the Municipal Council Ordinance provide for specific activities relevant to financing:

> Section 191
> To borrow any sum, without the sanction of the Minister, subject to the condition that the total loan outstanding does not exceed the total income received by the Council during the past three years, for the purpose of providing any public service.

Section 192
To borrow any sum, with the sanction of the Minister, subject to the condition that the total loan outstanding does not exceed the total income received by the council during the past five years, for the purpose of providing any public service.

Section 193
To raise money either by mortgage; or by issuing debentures under the Ordinance, with the consent of the Minister; or by issuing housing bonds under the Ordinance in any case when the money is to be raised for the purpose of a housing scheme with the consent of the Minister.

Section 195
To determine the repayment period of such loans borrowed with the sanction of the Minister.

Under the above provisions, municipal councils can borrow in the market, issue debentures, and issue housing bonds for housing development. Section 193 restricts the issuance of housing bonds to raise money for housing development and should be amended to extend the mode of borrowing to bonds to raise money for any development activity.

The Provincial Council Act also enables provincial councils to borrow in the market. The relevant sections follow:

- Section 21.1 vests powers in the minister of finance to give guarantees on loans raised by a provincial council.
- Section 21.5 restricts the raising of loans by a provincial council without the consent of the minister of finance, if any amount is outstanding with respect to loans from the Consolidated Fund of Sri Lanka or with respect to which a guarantee has been given under section 21.1.
- Section 22 allocates foreign aid to a provincial project or scheme that has been negotiated by the central Government.

Provincial councils are under more borrowing restrictions than municipal councils, which, unlike provincial councils, may borrow subject to certain limits without the sanction of the minister of finance. The Provincial Council Act is also silent on the issue of bonds, debentures, or securities by provincial councils. The Municipal Council Ordinance, however, empowers municipal councils to issue such instruments to raise funds for development activities.

Past Practice

Local authorities have traditionally financed their resource gap through budgetary transfers and resorted to borrowings from time to time from the Local Loans and Development Fund (LLDF). Local authorities also occasionally resort to short-term borrowing from commercial banks (overdraft facilities) to meet cash-flow requirements. Provincial councils have not borrowed either from LLDF or commercial banks, since a guarantee by the minister of finance is required.

Borrowing by municipal councils from LLDF and commercial banks is in Table 3.

Table 3. Borrowing by Municipal Councils (SLRs million)

Source	1997	1998	1999	2000
LLDF	26.4	16.0	2.0	23.8
Commercial Banks			140.7	236.7

LLDF = Local Loans and Development Fund.
Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Although ordinances allow local governments to tap the markets to raise funds, no local government has issued debentures or bonds. Although a bank has done a feasibility study and a proposal for Colombo Municipal Council on the issue of municipal bonds, the instrument was not issued, largely for legal reasons (Boyagoda et al. 2002). The Municipal Council Ordinance restricts the issue of bonds by municipal councils for purposes other than housing development.

Alternative Financing

Limited access to bank financing, in particular long-term development financing at low interest rates, and resource constraints of the central Government make it worth while to explore alternative arrangements to raise funds for local governments. Provided that existing legal impediments are eliminated and necessary precautionary measures adopted, four alternative financing arrangements may be considered: (i) issuing of bonds/debentures in the domestic market; (ii) issuing of international bonds; (iii) borrowing from multilateral lending agencies; and (iv) collaborating with international lending agencies such as ADB, World Bank, and International Finance Corporation for specific project financing.

Issuing Local Bonds

The success of bond issues in the domestic market depends on a number of factors, including the level of domestic bond market development, adequate legal and operational infrastructure, and integrity and repayment capacity of the local authority. Given their relatively small size, most local authorities are not in a position to issue bonds that will attract potential investors, unlike Western Provincial Council, which collects about SLRs6 billion or 70% of the total revenue of all provincial councils, and Colombo Municipal Council, which collects about SLRs3 billion or 77% of total revenue of all municipal councils. Colombo is authorized to issue about SLRs13 billion worth of debentures. If the Provincial Council Act is amended to enable provincial councils to borrow, Western Provincial Council could issue about SLRs30 billion worth of bonds. Such a large issue would enable local authorities to embark on large-scale revenue-generating development projects. The implied guarantee of such bonds by the central Government would also enable local authorities to raise funds at lower cost.

Issuing Bonds in the International Market

Tapping international markets requires several preconditions, including an enabling legislative and regulatory framework to protect foreign investors and ensure the expected return on investments, liquidity of the bonds issued, credit rating and financial integrity of the issuer, and political and macroeconomic stability.

Sri Lankan institutions have seldom issued international bonds. The central Government issued its first 3-year floating rate notes (FRNs) for $50 million in 1997. Since then, several attempts to issue sovereign bonds have been postponed due to unfavorable market conditions such as the financial crisis in July 1997, global economic slowdown in 2001, and uncertain domestic political and economic environment. Only three institutions have tapped the international market: Bank of Ceylon issued negotiable floating rate certificates (NFRCs) in August 1996 for $30 million, John Keels Holdings Ltd. issued global depository receipts (GDRs) for $33 million in 1997, and DFCC Bank issued FRNs for $65 million in 1998 (Box 2).[18]

An uncertain political and economic environment, lack of credit rating, and illiquid nature of the bonds entail a higher risk premium, which could be prohibitive. Local governments might not wish to consider issuing bonds in international markets until the infrastructure is established to make the bonds viable. However, major councils such as Western Provincial Council and Colombo Municipal Council could use their semisovereign status to tap the international market even before the infrastructure is established if a supranational lending agency such as ADB could guarantee their bond issues.[19]

Borrowing from Multilateral Lending Agencies

Long-term concessional borrowing from multilateral lending agencies appears to

Box 2. Floating Rate Note Issued by DFCC Bank

Background Information

The Development Finance Corporation of Ceylon (DFCC) was established in 1955 by an Act of Parliament (DFCC Act No. 35 of 1955) to cater to development finance needs, especially of small and medium enterprises. DFCC became DFCC Bank in 1997 as a licensed specialized bank.

DFCC finances its project lending through long-term borrowing, directly or indirectly from domestic and foreign sources. Indirect borrowing comprises mainly lending by the Government of Sri Lanka, which borrows from multilateral and bilateral donors to finance small and medium enterprises.

DFCC Bank issued floating rate notes in 1998 for $65 million. The Asian Development Bank guaranteed the principal amount while the Government of Sri Lanka guaranteed the interest payments. The issue was managed by ABN-AMRO Bank and was listed on the Luxembourg Stock Exchange. The floating rate note carried a coupon rate of 6-month LIBOR plus 200 basis points and was repayable in 10 years as a bullet payment. The proceeds of the issue were used by DFCC Bank to purchase rupee-denominated bonds of companies in the country.

The issue was a success as it was oversubscribed by 80%. DFCC Bank was able to secure an attractive rate of 200 basis points above LIBOR due both to the guarantees provided by ADB and the Government of Sri Lanka and its own financial stability. DFCC Bank recorded a posttax profit of SLRs857 million in 2001. It is rated one of the best-managed development finance institutions in the country.

be the most cost-effective and desirable mode of local government financing in the immediate future due to the considerable time it would take to develop the infrastructure for the successful issuance of bonds by local governments. Lending by multilateral agencies could be linked to the development of infrastructure that would support own resources, including a legislative framework, standard accounting systems, good governance, and transparency rules.

Collaboration with Multilateral Lending Agencies

Apart from directly borrowing from multilateral lending agencies, local authorities may collaborate with these institutions to finance long-term development projects, which could be undertaken as joint ventures, with shared responsibilities and returns. This arrangement could help establish good governance, reduce political interference, and increase the overall productivity of local government bodies.

Impediments to Bond Financing

A well-developed capital market, of which the bond market is an important part, brings immense benefits: high economic growth, capital accumulation, and greater productivity. Yet Sri Lanka's bond market is thin, underdeveloped, and confined mainly to government paper. Corporate debt is overly dependent on short-term borrowings. The underdeveloped bond market makes it difficult for potential issuers to raise a desired level of funds on a long-term basis at competitive cost. Lack of a robust bond market deprives policy makers and market participants of opportunities to better manage their risk, improve liquidity, and reduce intermediation costs. The following paragraphs outline the major drawbacks of the Sri Lankan bond market.

Inadequate Legislative Provisions

Local government ordinances and acts are inadequate for raising long-term funds for development projects. The Provincial Council Act restricts borrowing by provincial councils without the consent of the minister of finance if the councils have outstanding loans. The act is also silent on the issue of bonds or debentures. The Municipal Council Ordinance limits the issue of bonds by municipal councils to housing development.

Lack of an Efficient Regulatory Environment

Bond markets develop through innovation. Overregulation of the market inhibits it. The best regulator would be invisible, its presence better felt than seen. Fair regulation rules make better market conditions. The fairer the rules, the more attractive the market becomes to prospective participants (Ul Haque 2000). The regulatory system should be designed to regulate rather than control or manage the market and market participants.

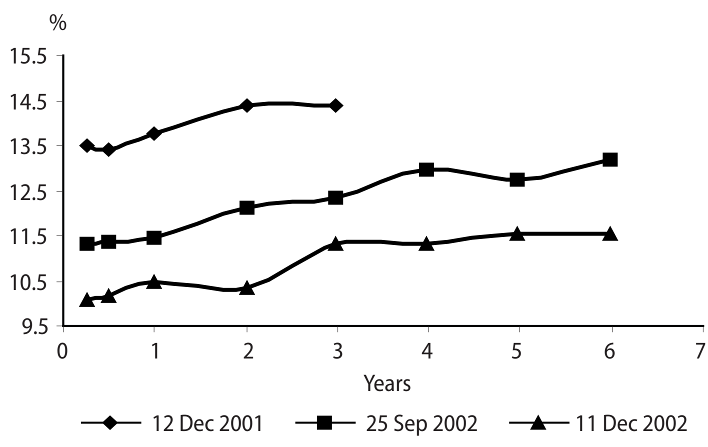
Regulators responsible for overseeing the capital market—the central bank and SEC—have often been accused of conflict of interest. The central bank, while being the regulator and the monetary authority, manages the country's largest pension fund, Employees' Provident Fund, and the government debt. Also, no strict rules force SEC officials to relinquish their associations with other institutions. Regulators have also been criticized for direct control of the market, allowing little room for innovation. The lack of an independent regulatory body to level the playing field and foster market innovation has delayed progress in the bond market.

Lack of a Long-Term Benchmark Yield Curve

Lack of a benchmark yield curve for long-term bond pricing has been a major impediment to the development of the bond market. Long-term government Sri Lanka rupee securities are administratively priced and not traded in the secondary market. Sri Lanka first issued treasury bonds with a maturity of more than 1 year only in March 1997. Although treasury bonds with 6-year maturity have been issued subsequently, the Government refrained from issuing longer-term treasury bonds from May 2000 to June 2002 due to high interest rates. With the issue of treasury bonds with 6-year maturity in June 2002, the yield curve now extends up to 6 years.[20] The yield curve enables investors to forecast interest rates in the medium term, but the lack of a long-term yield curve of at least 10–15 years has not only made it difficult for investors to expect long-term interest rates but also deprived them of tapping the market for long-term ventures. Large time variations in the expected future rate of interest at the long end of the yield curve within a short period (Figure 4) make long-term investment planning more difficult.[21]

One argument for the lack of a long-term yield curve is the practical difficulties involved in the issue of treasury bonds with a maturity of more than 6 years. The prevailing arrangements for treasury bond issues do not make room for issuing scripless bonds, which enable the issue of bonds with a much longer maturity. The central Government has been reluctant to issue long-term bonds in times of high interest rates apparently to avoid being locked into them. Such short-term fiscal considerations inhibit the development of the secondary market, which may prove counterproductive in the long run as a deep and liquid secondary market for government securities could reduce cost of funds (McCray 2001). The Government should

Figure 4. Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka.

ensure a steady supply of securities with varying maturities regardless of the fiscal position and short-term fiscal costs to reduce cost of borrowing on sustainable basis. Such a strategy will provide an impetus to develop the domestic bond market.

Lack of a Derivatives Market

The presence of a liquid and efficient derivatives market, including bond futures options, forwards, swaps, and other forms of derivatives of the underlying bond product can enhance activities in the secondary market for physical bonds, as it gives investors the opportunities to hedge against price fluctuations and to manage risk.[22] The derivatives market is very thin, with activities confined to a limited number of products such as foreign exchange forwards and swap arrangements. Even these products are not actively traded due to market uncertainties and the restrictive regulatory environment.

Derivatives instruments are important tools in risk management. They help increase the marketability of debt securities in the physical market. Thus, the derivatives market and hedging instruments have become necessary to stimulate bond markets. The central Government should provide an enabling legislative and regulatory environment to build investor confidence.

Lack of an Efficient Settlement System

Efficient payment and settlement technology allows the speedy completion of bond transactions. Payment and settlement delays add to transaction cost. In the absence of an efficient clearing and settlement system, bond traders run a variety of risks such as counterpart risk, fraud, and multiple trades of the same security. Mechanisms such as delivery versus payment and central depositories, which are important in settlement, are also essential (World Bank 1995).

Listed corporate bonds/debentures are traded on the Colombo Stock Exchange, but a proper settlement system for nonlisted corporate bonds is lacking. Government bonds are traded in the secondary market, with payment and settlement done over the counter.

The lack of a depository and clearing system for bonds greatly impedes bond market development. On average, it takes about 4–5 days to issue scrips for a government paper after settlement of primary auctions, delaying liquidity adjustments. This problem can be solved by developing a screen-based trading and settlement platform for electronic trading in government securities and thus improve liquidity, minimize price distortions, reduce settlement time, and improve monitoring of transactions. The central bank recently introduced real-time gross settlement (RTGS) and scripless securities settlement (SSS) systems to encourage more active secondary-market trading of government securities and to establish a central depository for recording ownership of scripless securities. RTGS and SSS are expected to go live during the second quarter of 2003 (Central Bank of Sri Lanka 2001).

Lack of Separation of Institutional Responsibilities

A clear separation of institutional responsibility for debt management and monetary policy functions is vital to make debt management more transparent and efficient, and minimize the impression that debt management is carried out with monetary policy implications (McCray 2001, Rhee 2001). Although Sri Lanka has taken steps to separate decision making, some members of the Monetary Policy Committee (MPC) are active members of the Domestic Debt Management Committee (DDMC) and have often been criticized for conflict of interest between monetary policy and debt management.

Lack of a Transparent Price Quotation System

A transparent market provides all market participants equal and immediate access to all quotations and reports of price and volume of all trades in the market. Without access to bid and offer quotations and last-sale reports, market participants are disadvantaged in assessing the value in the secondary securities market. Access to prices paid by other market participants enables investors to determine whether they have paid a fair price. Price transparency also creates a framework for continuing disclosure and curbing conflicts of interest and corruption.

Narrow Investor Base

The investor base for government securities is very narrow. More than 40% of government paper is held by two captive sources: the Employees' Provident Fund (30%) and the National Savings Bank (12%) (Table 4). The five government-owned institutions, including the central bank, account for 70% of government securities. The narrow investor base is also reflected in the higher interest rates on treasury bills and bonds than on bank deposits. The narrow investor base can be attributed mainly to the restricted and overregulated contractual savings (pension funds) system, lack of vibrant and developed mutual funds, and the inactive role of insurance companies in the capital market, including the government bond market. Subjecting the bond market to nonmarket forces such as allocation of bonds to captive sources outside the normal bidding process has until very recently also contributed to low demand. The contractual savings system, dominated by the Employees' Provident Fund, by far the largest mutual fund in Sri Lanka, is highly regulated and has a limited role in activating the bond market. Meanwhile, insurance companies, despite their huge asset base in comparison to that of other financial institutions, account for less than 2% of total government securities.

Table 4. Outstanding Central Government Debt by Institution

	1990		1995		2001	
	SLRs million	% share	SLRs million	% share	SLRs million	% share
Banks	48,255	36.0	111,025	38.4	256,808	31.0
Central Bank	37,080	27.7	26,878	9.3	92,871	11.4
State Banks	8,903	6.6	59,576	20.6	140,263	17.2
Other	2,272	1.7	24,571	8.5	23,674	2.9
Nonbank Sector	83,982	62.7	178,286	61.6	559,057	68.5
National Savings Bank	24,089	18.0	48,406	16.7	95,976	11.8
Savings Institutions and Individuals	13,018	9.7	19,349	6.7	150,839	18.5
Employees' Provident Fund	36,851	27.5	95,000	32.8	245,028	30.0
Insurance Companies	3,426	2.6	303	0.1	21,449	2.6
Finance Companies	1,446	1.1	8,420	2.9	3,124	0.4
Other	5,153	3.8	6,808	2.4	42,641	5.2
Sinking Fund	1,662	1.2	100	nil	100	nil
Total	**133,898**	**100**	**289,410**	**100**	**815,965**	**100**

Source: Central Bank of Sri Lanka.

Limited Supply of Bonds

The limited variety of instruments available has hampered the growth of a liquid bond market. The instruments available in the government bond market are limited to short-term treasury bills, treasury bonds, and rupee securities. Government paper traded in the market accounts for less than 50% of total government domestic debt and 58% of tradable securities because government rupee securities, which account for 42% of total tradable securities, are hardly traded in the market since they are mostly held by captive sources until maturity. The lack of bonds with a broader range of maturities has hindered the construction of long-term benchmark instruments and a yield curve. The longest maturity of tradable bonds is 6 years. However, most treasury bonds (63%) have a 2–3-year maturity.

Few companies have entered the corporate bond market to finance their investments, reflecting a heavily bank-centered financial system. Of the 243 companies listed on the Colombo Stock Exchange, only 15 have issued bonds or debentures. Total market capitalization of such debt stood at SLRs7 billion, or 0.4% of GDP, at the end of 2001. However, the secondary market trading of corporate debentures remains low at around SLRs3 million per day, as investors tend to hold debentures until maturity (Boyagoda 2001).

Credit Rating

Credit-rating agencies play an important role in corporate bond market development by providing an objective and impartial opinion of the credit quality of debt issues. A crucial aspect of the corporate bond market is the responsibility of evaluating the default risks of bond issuers devolved to investors. Credit-rating agencies facilitate this risk evaluation process by providing information to the market on the creditworthiness of the instrument and borrower.

The first (and still only) credit-rating agency in Sri Lanka, Duff and Phelps Credit Rating Lanka Ltd., was established in October 1999. It became Fitch Rating Lanka after the merger of its principal shareholder, Duff and Phelps (DCR) US, with Fitch IBCA and the formation of Fitch Inc., the international rating agency. Fitch Rating Lanka is a joint venture of Fitch Inc. of the US, International Finance Corporation, Central Bank of Sri Lanka, and a number of other leading financial institutions in Sri Lanka.

Only 10 companies, however, have obtained either an entity or issue rating. The lack of demand for credit rating by Sri Lankan companies pushed Fitch Rating Lanka to the brink of pulling out of Sri Lanka as its operations became commercially unviable. This lack of demand could be attributed to several factors. Obtaining a rating is not compulsory for any debt issuer. Listing on the stock exchange is also not compulsory. Borrowers lack the self-confidence that they will get a good rating, which affects the cost of borrowing through a potential debt issue or share prices. Borrowers also fear getting a low rating due to bad corporate governance issues, which are not known to the public.

Corporate Governance Issues

Capital markets are pressured to promote efficient governance and control of firms by exerting external pressure and discipline on their operations. Threats of takeovers, prudential regulations, and negative investor views of bad governance are powerful mechanisms that can impose discipline on publicly quoted companies. Economic benefits of allocative efficiency can best be achieved through a disclosure-based system that relies on market discipline. Good corporate governance helps protect the interests of capital providers, including bond holders. The corporate sector has often been accused of bad governance, including the following:

Substandard Accounting Practices. Despite high accounting standards adopted by many corporate establishments, some companies resort to substandard accounting practices in connivance with their external auditors to manipulate financial accounts and avoid prudential norms established by authorities such as SEC and the central bank. Several finance directors of failed finance companies were accused of such practices in the late 1980s.

Misappropriation of Public Funds. Several finance companies collapsed in the late 1980s as a result of gross misappropriation of depositors' funds. Recent events include cases of publicly quoted companies.

Unethical Management Practices. Many private management companies reap rewards by imposing exorbitantly high management fees, resulting in continuous operational losses and depriving the shareholders' capital of dividends for years. For many of these companies, productivity improvement and profitability have become secondary as their management fees are linked to turnover. Many management companies are probably used to channeling resources from their public counterparts (Kulatunga 2002).

Transfer Pricing. Many companies allegedly resort to transfer pricing and transfer of profits from one company to another mainly to avoid tax and dividend payments. Companies with links to financial institutions also manipulate interest rates to transfer resources from one entity to another. These malpractices have eroded the confidence of small investors in the capital markets.

Insider Trading. Sudden price movements of stocks before official release of information on quarterly or annual accounts, declaration of bonus or dividends, or any other important matter are indications of insider trading. Information asymmetry and lack of disclosure have put small investors at a disadvantage, resulting in a contraction of shareholder interest in stock market investments and affecting market liquidity.

Political Instability

Bond markets develop most rapidly in stable political and economic environments. Political instability has been a major impediment to overall economic development since 1983, with the outbreak of civil strife. Since 1994, successive governments have only had a slim majority in Parliament. Structural reforms and long-term development activities to revitalize the economy have thus been virtually halted. These twin problems have resulted in persistently high budget deficits. Despite publicly announced intentions of fiscal consolidation, fiscal policy has been largely ad hoc to achieve short-term gains as decision making has become politically sensitive. Bond market development has thus become secondary to fiscal considerations in both monetary and debt management.

Policy Recommendations

Local government authorities can catalyze local community development and thereby contribute to overall economic development. Local government development work is constrained by many factors, including the financial constraints of the central Government, limitations on generation of own resources, inadequate technical competence, lack of commitment, and widespread corruption. Solving these problems and providing the necessary infrastructure should be priorities in any attempt to facilitate local government bond financing. The following policies are recommended.

Recommendations for Bond Market Development

Introduction of a Benchmark Yield Curve. Development of a long-term yield curve depends much on the availability of securities with varying maturities and on market-determined interest rates for all securities. To make room for these improvements, the following measures are recommended:

- Conversion of government rupee securities into tradable bonds or securities to improve liquidity.
- Issue of treasury bonds with varying maturities, even in times of difficult fiscal situation, such as high interest rates.
- Ending the issuance of rupee securities at administratively determined interest rates.

Improvement of the Derivatives Market. Risk taking and innovations are key ingredients in financial market development. A derivatives market allows hedging against price fluctuations and minimizing risk. The central Government can facilitate the development of a derivatives market by providing an enabling legislative and regulatory environment.

Introduction of an Efficient Clearing and Settlement System. A screen-based trading and settlement platform for electronic trading of government bonds should be established. RTGS at the central bank, operated on an experimental basis, should be extended to government bonds and securities trading and settlement, and connected to the Colombo Stock Exchange.

Widening the Investor Base. This requires the following:

- Relaxing restrictions on the operation of the contractual savings system, particularly pension funds, by allowing the private sector to provide such services.
- Refraining from allocating bonds to captive sources outside the bidding process.
- Creating an environment conducive for mutual funds and for active engagement of insurance companies in the bond market.
- Relaxing restrictions on foreign investments in long-term bonds and securities.

Increasing the Supply of Bonds. To make the bond market more liquid, the supply of bonds and securities should be increased through the following:

- Converting government rupee securities into tradable bonds.
- Allowing the issue of bonds and debentures by local government authorities.
- Issuing treasury bonds with a broader range of maturities.

Separation of Institutional Responsibilities. This will make debt management transparent and monetary policy independent. The public debt management function of the central bank may be transferred to an independent debt office. However, the most important objective of this separation should be efficient debt management, independent of monetary policy. It should not be influenced merely by debt management or fiscal considerations.

Improving Corporate Governance. This is intended to protect the interest of stakeholders in the market and stabilize the financial system. The recent scandals in the US corporate market underscore the importance of good corporate governance, for which the following measures are recommended:

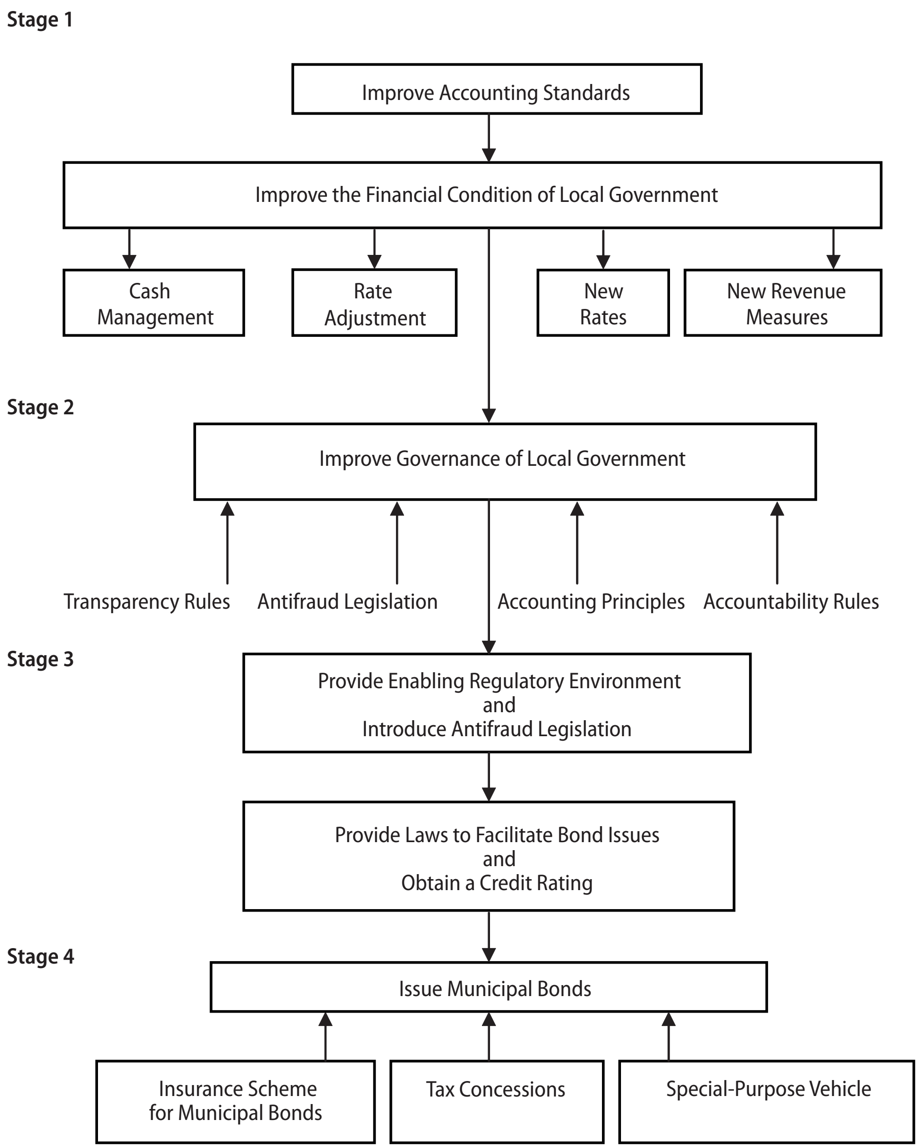
- Requiring the corporate sector to adopt standard accounting systems and making the directors and external auditors accountable for any malpractices, including manipulation of financial accounts.
- Strengthening anticorruption rules to prevent misappropriation of public funds.
- Strictly enforcing the law to minimize insider trading and unfair transfer pricing.

Recommendations for Local Bond Market Development

The issuance by local authorities of financial instruments in the domestic financial market should meet a set of preconditions to protect the interests of prospective investors and ensure the stability of the financial system. The host of administrative issues that keep local authorities from efficiently providing community services should be addressed, especially lack of efficient cash-flow management systems, substandard accounting procedures, lack of transparency, and large stocks of revenue arrears. Local governments also lack accountability rules, antifraud legislation, and an enabling regulatory environment to support the development of a local bond market. Thus, issuing of bonds by local governments in the domestic market should be considered only in a medium-term framework after establishing the required infrastructure.

Figure 5 shows the recommended roadmap of reforms necessary before the issue of bonds in sequence, as well as other policy recommendations. Most of these reforms are discussed in further detail in the following paragraphs.

Figure 5. Roadmap of Recommended Reforms



The following measures need to be undertaken prior to the issue of bonds:

- Improving accounting standards in local governments. Many local government bodies do not prepare regular financial statements. Audited annual financial statements should be made compulsory, as for corporate institutions. Accepted accounting principles should also be introduced in all local government bodies.
- Improving the financial condition of local governments, including:
    - Strengthening cash-flow management to enable local authorities to minimize costs and allocate resources more efficiently.
    - Raising rates to bring them closer to true market costs and thus enable local governments to improve their fiscal situation and provide better services.
    - Introducing new rates for public services that are not subject to local government rates. Local governments have not imposed any charges so far. To avoid default on payments, local government bodies can either have their own collection systems or link up with other utility providers to collect bills. Strict law enforcement procedures should be put in place to ensure implementation.
    - Adopting an island-wide mechanism to collect garbage and charging a fee from households and commercial enterprises for the service. The mechanism should be supported by ordinances and acts. Local governments should also explore the possibility of using garbage to manufacture fertilizer commercially.
    - Establishing parking meters for local governments, particularly municipal councils, to generate revenue and control traffic.
    - Building multistory car parking facilities in joint ventures with the private sector to solve major cities' traffic problems.
    - Establishing day care centers to meet demand created by the growing number of working parents and rising urbanization.
    - Auctioning property rights to minimize malpractices, improve marketability of properties, and ensure that rates are adjusted regularly to reflect market demand and that supply and resources are utilized more efficiently.
    - Auctioning pollution rights to those who desire to engage in activities that affect the environment, which will generate revenue to protect the environment and provide health facilities for those affected.
- Promoting private-public partnerships to improve the efficiency of services and help reduce the burden on local government budgets and the heavy dependence on central government transfers for development activities.
- Promoting urban and ecological tourism. This will not only generate income and employment but also satisfy the growing demand for domestic tourism.

- Building toll roads. Major cities require modern road networks with metro-railways, highfliers, and easy connections to highways or expressways. The use of such road networks can be made subject to tolls to recover part of the cost and to control city traffic.
- Formulating block grants so that they do not fill the gap between a predetermined proportion of the recurrent expenditure of the province and its collected devolved revenue. The present system discourages improvement of revenue collection of provincial councils as block grants shrink when revenue increases, and increase when recurrent expenditure increases. A rule-based provision of block grants with a linkage to revenue efforts would help improve the revenue collection by provincial councils.
- Improving governance. Lack of generally accepted accounting principles, transparency, and accountability results in conflicts of interest and in corruption. Such principles, transparency rules, and antifraud legislation should be introduced, and accountability assured.
- Providing an enabling regulatory environment. This is a key factor in fostering the bond market. The regulator should be a facilitator, with prudential rules and regulations in place to ensure fair play. The regulatory environment should improve the functioning of the bond market by introducing the following measures:
    - Legally preventing officials of regulatory bodies (SEC and others) from holding positions elsewhere, thus avoiding conflict of interest.
    - Separating institutional responsibilities of the central bank to minimize conflict of interest.
    - Minimizing the intervention of regulators in the market, except for prudential reasons.
    - Relaxing the rules on foreign investor participation in the capital market, including the government securities market, subject to prudential limits.
- Introducing antifraud legislation. Investor protection and market improvement measures, including a framework for secondary market disclosure, transparency, and enforcement of law, are needed to develop the bond market. Among other things, such antifraud legislation should provide for:
    - registration requirements for bonds and securities;
    - a system of broker-dealer regulation;
    - periodic reporting and disclosure of information and operating data to the public, including audited annual financial accounts;
    - rule-making and enforcement authority by the regulatory body; and
    - measures to curb conflicts of interest and corruption, in particular to prevent elected officials from awarding contracts.

- Providing laws to facilitate bond issues. The Provincial Council Act and Municipal Council Ordinance should be amended to enable bond issuance for development financing.
- Obtaining a credit rating before raising funds on the market. Requiring a credit rating will compel local government authorities to improve their financial position and enable prospective investors to make wise decisions on their investments.
- Introducing an insurance scheme for municipal bonds to guarantee that the interest and capital will be paid on the insured bond if the issuer fails to make payment. Insurance of municipal bonds could be made compulsory and sold as part of the issue process.
- Granting tax concessions. Public-purpose bonds, issued directly by the local authority, are used to finance projects for general public benefit and are clearly the responsibility of local government. Thus, interest income on such public-purpose bonds should be exempted from tax to enhance their marketability. However, tax concessions are not recommended if bonds are issued to finance private activity, i.e., if they are issued by the local government to supply funds for private projects.
- Establishing an independent special-purpose vehicle or asset management company to ensure the viability of projects financed by bond issues. It must be empowered to collect revenues from the projects to repay the bonds at maturity to make the process transparent, accountable, and free of political interference.

Assistance from the Asian Development Bank

ADB can help develop local government bond financing by:

- Directly financing projects, which will support local government financing until the creation of a conducive environment for issuing local government bonds or securities, including (i) concessionary lending for long-term project financing, giving priority to projects with revenue generation potential (such as toll roads); and (ii) capital contribution through partnerships with local government and the private sector for long-term joint ventures with shared responsibilities and returns.
- Guaranteeing local government bonds or borrowings. As a supranational agency with a triple-A rating, ADB can support local government bond issues in local and international markets by issuing guarantees, at least at the beginning.
- Providing technical assistance.

- Improving accounting standards by helping introduce accepted accounting principles, training local government staff in accounting and computer applications, and funding the procurement of equipment such as computers.
- Improving project implementation by helping improve the technical skills of staff to evaluate projects, including their environmental aspects, and to implement and monitor projects.
- Strengthening cash management through technical assistance and enabling local governments to improve allocation of resources and overall budgetary management.
- Drawing up a long-term development plan, particularly for township development, to reduce commuter traffic, urban congestion, and environmental pollution.
- Providing technical assistance to help local governments acquire the legal expertise to draft antifraud legislation, which is essential to develop the local government bond and securities market.

Endnotes

[1] Only Parliament can make laws. Provincial councils enjoy some legislative powers.

[2] The geographical boundary of a provincial council overlaps with that of a province. Sri Lanka is divided into nine provinces. The geographical boundaries of the North and East provinces have been amalgamated to establish the North East Provincial Council as an interim arrangement due to the war in the provinces.

[3] Only 50% of the Colombo Municipal Council salary bill is met by the central Government due to the council's dominance in revenue collection.

[4] Minor pollution agents include small-scale sawmills, rice mills, stone crushers, livestock farms, garages, printing presses, and grinding mills. See Report of the Commission of Inquiry on Local Government Reforms (1999) and Abeywardena (1992) for a detailed account of the services provided by local government.

[5] See, for example, Central Bank of Sri Lanka (1998).

[6] Investments in the Accelerated Mahaweli Development Programme alone accounted for an annual average of over 4.4% of GDP during 1979–1987, while expenditure on defense reached some 5% of GDP in certain years.

[7] The Sri Lankan Government has been engaged in a civil conflict since 1983 with the Liberation Tigers of Tamil Elam, which is fighting for a separate state. Although the conflict is largely confined to the North and East provinces, sporadic suicide bombings, particularly in the capital city of Colombo and in other major cities, have severely affected day-to-day life. The conflict has left over 60,000 dead and thousands more disabled, and severely damaged property. The war has disrupted the economy, which depends heavily on tourism and foreign direct investment, and reduced economic growth by about

2 percentage points per year. The direct cost of the war at times exceeded 3% of GDP. Several attempts to negotiate a settlement failed, but the new Government elected on 5 December 2001 secured a ceasefire on 24 December 2001, followed by a "permanent ceasefire agreement" on 22 February 2002. The central Government commenced peace talks, facilitated by the Government of Norway, on 16 September 2002, in Thailand.

[8] The discussion on fiscal trends excludes Dehiwala-Mount Lavinia, Matara, Kalmunai, and Anuradhapura municipal councils.

[9] Block grants are needs oriented and provided to fill resource gaps. There are no rule-based criteria to calculate block grants, which are the amounts needed to fill the gap between a predetermined proportion of the recurrent expenditure of the province and its collected devolved revenue. Province-specific grants are made to finance projects identified by provincial councils and included in the Public Investment Program. Criteria-based grants are earmarked for specific capital projects, while matching grants are provided to encourage revenue generation by provincial councils. See Appendix 1 for the methodology for allocating criteria-based grants and matching grants.

[10] For example, section 230 of the Municipal Council Ordinance makes provision for the local authority to levy rates for the amenities it provides in the area.

[11] See Report of the Commission of Inquiry on Local Government Reforms (1999) for a detailed account of this issue.

[12] Turnover tax is fixed at 1% for all commodities except furniture, timber, logs, gems, and jewelry, which are taxed at a maximum rate of 5%. The Provincial Councils Tax (Limitations and Exemptions) Act 25 of 1995 allows provincial councils to impose a maximum tax rate of 5%.

[13] In India many state governments have been successful in urban infrastructure development through project finance, i.e., by creating special-purpose vehicles, which not only finance but also execute the projects. Support from state governments—e.g., equity participation, concessions in land or water supply, dedicated revenue streams, and a transparent regulatory framework—have proved to be encouraging (Pradhan, this volume).

[14] Major infrastructure in New York and other major cities in the United States (US) were financed by municipal bond issuance. The Erie Canal, early railroads, Triborough Bridge in New York City, and the Rock and Roll Hall of Fame in Cleveland were all financed by municipal bonds. Historically, the ability of municipalities to issue municipal bonds played a critical role in the expansion and growth of the US in financing infrastructure development and in providing operational funds for the issuers. See Maco (1999).

[15] Funds might be misused by local authorities if they are given the freedom to make investment decisions without prudential regulations. The case of Orange County in California, US, is a good example.

[16] This should conform to government foreign borrowing regulations and be routed though the External Resource Department, as is usually the case.

[17] The amount of money spent by politicians to get elected to either Parliament or a local government body is a strong evidence of the lucrative nature of such positions.

[18] NFRCs by the Bank of Ceylon were for a period of 3 years at 6-month London interbank offered rates (LIBOR) plus 150 basis points. The GDR issued by John Keels Holdings Ltd. was a stock issue quoted on the Luxembourg Stock Exchange.

[19] Guaranteeing nonconcessional borrowing by the central Government is subject to a ceiling under the standby arrangement with the International Monetary Fund.

[20] The central Government resumed issuing 6-year treasury bonds in June 2002 after a lapse of 2 years, when the prevailing interest rates became favorable. See Batten and Kim (2001), Boyagoda (2001), and Jayawardena (2002) for a discussion on the yield curve.

[21] The large time variation in expected future interest rates, as reflected in Figure 4, is due to a market correction of high interest rates in 2000 and 2001. Expected interest rates at the long end of the yield curve could vary significantly in response to major structural changes in the economy. However, in Sri Lanka, a large drop in the expected rate of interest at the long end of the yield curve within a short period, and a flat yield curve, which usually indicates a stable inflationary environment (not necessarily a zero inflation rate), may reflect the underdeveloped nature of the bond market, lack of information, and market uncertainties.

[22] For a guide to applications of derivatives, see Taylor (1996).

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Appendix 1. Grants

Matching Grants

The methodology used to calculate the matching grants categorizes provinces by revenue base, revenue potential, tax incidence, and tax administration capacity. The system also differentiates rates of matching grants to reduce the possibility that provinces with larger revenue bases will receive disproportionately larger matching grants. Revenue efforts of other provinces are measured by taking the revenue collection of Western Province in 1987 as the basis.

Categories of provinces and rates applicable to each category follow.

Category	Province	Slabs (% above the benchmark)	Rates per Rupee Increase (SLRs)
A	Southern	0–25	1
	North Eastern	25–50	2
	North Western	50–75	3
	North Central	75–100	4
	Uva	Over 100	5
	Sabaragamuwa		
B	Central	0–50	1
		50–100	1.50
		100–125	2
		125–150	3
		150–175	4
		Over 175	5
C	Western	0–50	0.50
		50–100	0. 75
		Over 100	1
D	Reserve Category	0–50	0.25
	No province at the moment	Over 50	0.50

Criteria-Based Grants

The total provision of criteria-based grants is apportioned among the provincial councils on the basis of (i) population of each province and (ii) selected indicators of interprovincial social and economic differences. These indicators will relate to the following criteria:

	Share of Total (%)
Per capita Income	10
Per capita Income Difference	10
Poverty	10
Health and Nutrition	15
Education	15
Unemployment	15
Social and Economic Infrastructure	25

The procedure for apportioning the total amount of criteria-based grant (C) among the provinces is as follows:

The total amount is first divided as (ii) above, into components C_j (j=1,2,….,7) corresponding to different indicators. The component C_j is then apportioned among the provinces on the basis of the formula:

$$C_{ij} = C_j \left(P_i r_{ij} \middle/ \sum_i P_i r_{ij} \right)$$

where C_{ij} is the part of C_j apportioned to the i^{th} province and P_i and r_{ij} represent the population weight and the indicator value for that province.

The formula

$$C_i = \sum_j C_{ij} = \sum_j C_j \left\{ \frac{P_i r_{ij}}{\sum_i P_i r_{ij}} \right\}$$

gives the total of criteria-based grants for that province.

Appendix 2. Statistical Tables

Table A2.1 Kandy Municipal Council (SLRs million)

	1997	1998	1999	2000	2001
Recurrent Revenue					
Assessment Rates	79.2	100.6	125.9	134.9	133.0
Lease Rent	17.8	18.8	23.5	25.5	39.3
Licenses	10.3	7.5	7.5	7.9	8.5
Service Charges	16.0	12.6	11.1	15.5	17.1
Warrant Costs	5.4	8.0	10.0	7.0	8.1
Other Revenue	29.5	47.7	55.2	65.7	49.8
Revenue Grants	74.3	78.4	78.2	85.5	110.9
Internal Transfers	2.5	2.5	4.5	2.6	3.4
Total Recurrent Revenue	235.1	276.3	316.0	346.8	370.1
Recurrent Expenditure					
Personnel Emoluments	94.4	111.3	121.1	128.6	146.6
Traveling Expenses	1.4	1.5	1.8	2.3	1.3
Supplies and Requisites	29.1	36.0	47.8	47.9	49.3
Repairs and Maintenance of Capital Assets	2.3	3.5	4.5	3.8	3.6
Transportation, Communication, Utility, and Other Services	51.3	62.7	65.4	81.0	91.9
Interest Payments	4.1	3.4	6.8	7.0	6.8
Grants, etc.	4.5	4.8	6.1	6.2	6.3
Pensions	22.2	20.8	17.7	18.8	21.5
Internal Transfers	0.2	2.5	4.5	4.6	3.4
Total Recurrent Expenditure	212.4	246.6	275.6	300.4	330.8
Capital Grants	16.7	7.6	4.8	9.6	22.1
Loans—Local Loans and Development Fund	0	0	0	0	0
Loans—Banks	0	0	0	0	0
Capital Expenditure	53.6	30.5	50.1	55.9	55.2
Surplus/(Deficit)	**(14.2)**	**6.9**	**(4.9)**	**0**	**6.2**

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.2 Sri Jayawardenapura Kotte Municipal Council (SLRs million)

	1997	1998	1999	2000	2001
Recurrent Revenue					
Assessment Rates	12.7	33.2	32.2	34.2	34.5
Lease Rent	7.2	14.2	17.7	18.3	18.4
Licenses	2.7	6.6	6.2	7.0	7.4
Service Charges	7.5	7.3	17.3	37.0	38.1
Warrant Costs	0.4	0.4	0.5	0.6	1.7
Other Revenue	28.7	35.5	13.4	26.0	67.3
Revenue Grants	33.2	38.2	38.1	39.4	45.1
Internal Transfers	0	0	0	0	0
Total Recurrent Revenue	92.4	135.3	125.5	162.4	212.6
Recurrent Expenditure					
Personnel Emoluments	40.9	50.8	54.6	63.0	79.5
Traveling Expenses	0.7	0.9	1.9	1.2	2.1
Supplies and Requisites	7.3	10.4	12.5	15.7	25.3
Repair and Maintenance of Capital Assets	12.0	17.3	15.6	28.1	29.6
Transportation, Communication, Utility, and Other Services	5.7	8.7	11.7	16.2	14.6
Interest Payments	1.1	1.8	2.5	1.7	1.5
Grants, etc.	0.5	28.4	3.5	3.1	3.1
Pensions	3.7	4.6	5.1	5.1	5.9
Internal Transfers	—	—	0	0	0
Total Recurrent Expenditure	72.1	97.3	107.3	134.1	161.7
Capital Grants	19.8	27.6	8.9	9.0	3.9
Loans—Local Loans and Development Fund	0	0	0	0	0
Loans—Banks	0	0	0	0	0
Capital Expenditure	39.3	48.3	19.4	21.5	35.5
Surplus/(Deficit)	**0.8**	**17.3**	**7.7**	**15.8**	**19.3**

— = data not available.

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.3 Colombo Municipal Council (SLRs million)

	1997	1998	1999	2000
Recurrent Revenue				
Assessment Rates	1,029.4	1,040.1	1,114.0	1,206.1
Lease Rent	94.2	92.4	81.9	93.9
Licenses	63.9	156.0	123.9	110.7
Service Charges				
Warrant Costs				
Other Revenue	95.6	112.9	81.9	72.6
Revenue Grants	265.0	275.0	200.0	315.6
Internal Transfers				
Total Recurrent Revenue	1,548.1	1,676.4	1,601.7	1,799.0
Recurrent Expenditure				
Personnel Emoluments	654.1	825.3	841.4	888.6
Traveling Expenses				
Supplies and Requisites	177.9	252.6	224.3	160.4
Repair and Maintenance of Capital Assets	214.4	234.3	224.5	166.3
Transportation, Communication, Utility, and Other Services	32.2	55.2	373.9	235.8
Interest Payments	7.8	0.2	1.8	7.2
Grants, etc.	69.6	67.3	74.3	79.4
Pensions				
Internal Transfers				
Total Recurrent Expenditure	1,156.0	1,434.8	1,740.3	1,537.6
Capital Grants	324.7	92.4	267.9	281.6
Loans—Local Loans and Development Fund				
Loans—Banks				
Capital Expenditure	571.3	569.7	670.7	435.2
Surplus/(Deficit)	**145.6**	**(235.7)**	**(541.3)**	**107.7**

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.4 Budget Outturn for Western Provincial Council (SLRs million)

	1997	1998	1999	2000	2001(P)
Total Revenue	3,575	3,980	4,719	5,063	5,954
Tax on Production and Expenditure	2,603	2,844	3,185	3,503	3,843
Turnover Taxes	1,983	2,151	2,453	2,728	3,026
License Fees	620	693	732	775	817
Other Taxes	0	0	0	0	0
Interest, Profits, and Dividends	83	57	186	121	204
Sales and Charges	156	204	388	422	373
Stamp Duty	732	876	959	1,016	1,514
Other	1	0	2	0	20
Total Expenditure	5,662	6,114	6,607	7,026	8,314
Current Expenditure	5,307	5,678	5,870	6,543	7,923
Functional Classification	5,307	5,678	5,870	6,543	7,923
Provincial Administration	721	675	688	633	1,111
Economic Services	127	148	163	176	193
Social Services	4,459	4,855	5,019	5,704	6,619
Economic Classification	5,307	5,678	5,870	6,543	7,923
Personal Emoluments	3,611	3,967	4,120	4,520	5,434
Other	1,696	1,711	1,750	2,023	2,489
Capital Expenditure	355	436	737	483	391
Acquisition of Capital Goods	351	408	248	477	364
Capital Transfers	2	21	14	0	0
Province-Specific Development Projects	0	0	0	0	0
Special Projects	0	0	0	0	0
Other	2	7	475	6	27
Financing	2,221	2,879	2,933	2,679	3,724
Block Grants	1,850	2,571	2,673	2,319	2,805
Criteria-Based Grants	254	254	195	193	92
Matching Grants	118	54	65	167	91
Province-Specific Development Grants	0	0	0	0	736
Grants for Special Projects	0	0	0	0	0

P = provisional.

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.5 Budget Outturn for Central Provincial Council (SLRs million)

	1997	1998	1999	2000	2001(P)
Total Revenue	443	488	546	573	624
Tax on Production and Expenditure	334	356	405	415	471
Turnover Taxes	226	239	268	279	315
License Fees	100	111	129	130	149
Other Taxes	8	6	8	8	7
Interest, Profits, and Dividends	0	0	0	0	0
Sales and Charges	29	32	32	38	29
Stamp Duty	80	100	109	121	124
Other	0	0	0	0	0
Total Expenditure	3,330	3,728	3,964	4,366	4,851
Current Expenditure	3,122	3,534	3,710	4,020	4,652
Functional Classification	3,122	3,534	3,710	4,020	4,652
Provincial Administration	202	286	270	306	272
Economic Services	159	180	182	168	183
Social Services	2,761	3,068	3,258	3,546	4,197
Economic Classification	3,122	3,534	3,710	4,020	4,652
Personal Emoluments	2,451	2,735	2,902	3,149	3,728
Other	671	799	808	871	924
Capital Expenditure	208	194	254	346	199
Acquisition of Capital Goods	146	144	201	77	11
Capital Transfers	0	0	0	0	0
Province-Specific Development Projects	0	0	0	0	0
Special Projects	0	0	0	0	0
Other	62	50	53	269	188
Financing	2,810	3,252	3,387	3,846	4,544
Block Grants	2,611	3,044	3,136	3,555	3,912
Criteria-Based Grants	166	166	182	203	66
Matching Grants	34	42	69	88	28
Province-Specific Development Grants	0	0	0	0	537
Grants for Special Projects	0	0	0	0	0

P = provisional.

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.6 Budget Outturn for Southern Provincial Council (SLRs million)

	1997	1998	1999	2000	2001(P)
Total Revenue	404	424	477	559	626
Tax on Production and Expenditure	245	283	313	339	391
Turnover Taxes	166	193	211	229	277
License Fees	78	89	101	109	113
Other Taxes	1	1	1	1	1
Interest, Profits, and Dividends	9	4	6	39	29
Sales and Charges	68	41	60	74	91
Stamp Duty	69	86	90	94	104
Other	13	10	8	14	10
Total Expenditure	3,017	3,515	3,643	4,147	4,642
Current Expenditure	2,841	3,269	3,396	3,783	4,333
Functional Classification	2,841	3,269	3,396	3,783	4,333
Provincial Administration	220	321	329	317	360
Economic Services	110	135	137	191	216
Social Services	2,511	2,813	2,930	3,275	3,751
Economic Classification	2,841	3,269	3,396	3,783	4,333
Personal Emoluments	2,406	2,630	2,775	3,037	3,525
Other	435	639	621	746	808
Capital Expenditure	176	246	247	364	309
Acquisition of Capital Goods	14	18	39	83	39
Capital Transfers	7	14	34	31	15
Province-Specific Development Projects	0	0	0	0	0
Special Projects	0	0	0	0	0
Other	155	214	174	251	256
Financing	2,746	3,077	3,382	3,777	4,127
Block Grants	2,540	2,825	3,118	3,422	3,512
Criteria-Based Grants	177	177	195	214	77
Matching Grants	30	75	69	142	36
Province-Specific Development Grants	0	0	0	0	502
Grants for Special Projects	0	0	0	0	0

P = provisional.

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.7 Budget Outturn for North Western Provincial Council (SLRs million)

	1997	1998	1999	2000	2001(P)
Total Revenue	424	477	540	576	623
Tax on Production and Expenditure	238	260	280	306	334
Turnover Taxes	143	152	163	177	200
License Fees	95	108	117	128	133
Other Taxes	0	0	0	0	1
Interest, Profits, and Dividends	25	25	30	31	32
Sales and Charges	45	51	86	78	79
Stamp Duty	116	142	143	159	175
Other	0	0	0	1	3
Total Expenditure	2,833	3,301	3,647	3,971	4,592
Current Expenditure	2,652	3,131	3,416	3,704	4,344
Functional Classification	2,652	3,131	3,416	3,704	4,344
Provincial Administration	205	250	331	376	286
Economic Services	121	140	162	181	201
Social Services	2,326	2,741	2,923	3,147	3,857
Economic Classification	2,652	3,131	3,416	3,704	4,344
Personal Emoluments	2,189	2,616	2,714	2,873	3,547
Other	463	515	702	831	797
Capital Expenditure	181	170	231	267	248
Acquisition of Capital Goods	10	11	35	38	36
Capital Transfers	29	23	36	33	13
Province-Specific Development Projects	0	0	0	0	0
Special Projects	0	0	0	0	0
Other	142	136	160	215	199
Financing	2,489	2,768	3,256	3,323	4,400
Block Grants	2,303	2,578	3,014	3,030	3,704
Criteria-Based Grants	138	142	156	180	109
Matching Grants	48	48	86	113	43
Province-Specific Development Grants	0	0	0	0	544
Grants for Special Projects	0	0	0	0	0

P = provisional

Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.8 Total Revenue Collection, 2001 (SLRs million)

Province	Turnover Tax	Stamp Duty	Court Fines	Interest on Loans	Excise Duty	Motor Traffic Revenue	Others	Total
Western	3,026.4	1,183.3	164.5	184.8	68.7	876.9	177.0	5,681.7
(%)	73.1	70.6	44.8	55.8	39.3	63.4	44.2	67.0
Central	314.5	124.3	0.9	39.1	45.5	118.2	42.0	684.6
(%)	7.6	7.4	0.3	11.8	26.0	8.5	10.5	8.1
Southern	277.0	103.3	58.2	21.8	15.2	114.1	47.1	636.7
(%)	6.7	6.2	15.8	6.6	8.7	8.2	11.8	7.5
North East	0	0	0	17.1	0	0	28.2	45.3
(%)				5.2			7.1	0.5
North Western	200.2	174.7	51.2	26.9	12.8	130.4	27.1	623.3
(%)	4.8	10.4	13.9	8.1	7.3	9.4	6.8	7.4
North Central	106.3	8.8	35.0	17.6	3.6	37.8	25.2	234.4
(%)	2.6	0.7	9.5	5.3	6.5	2.7	6.3	2.9
Uva	95.6	18.2	20.9	10.4	9.7	32.2	27.6	214.5
(%)	2.3	1.1	5.7	3.1	5.5	2.3	6.9	2.5
Sabaragamuwa	121.4	60.0	36.7	13.4	11.6	74.4	26.0	343.6
(%)	2.9	3.6	10.0	4.1	6.6	5.4	6.5	4.1
Total	**4,141.4**	**1,672.9**	**367.4**	**331.1**	**167.2**	**1,384.0**	**400.3**	**8,464.1**

Note: Data slightly differ from those published by the Central Bank due to reporting delays.
Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Table A2.9 Provincial Revenue as Percentage of Provincial Gross Domestic Product at Current Market Prices, 1991–2001

Province	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Western	0.87	1.13	1.13	1.10	1.05	0.97	0.96	0.93	0.97	0.94	0.94
Central	0.45	0.51	0.52	0.51	0.52	0.45	0.48	0.45	0.47	0.44	0.44
Southern	0.38	0.50	0.45	0.42	0.46	0.46	0.41	0.44	0.43	0.45	0.46
North Eastern	0.04	0.03	0.04	0.03	0.08	0.06	0.06	0.05	0.06	0.05	0.04
North Western	0.37	0.53	0.52	0.47	0.54	0.45	0.46	0.45	0.47	0.44	0.43
North Central	0.17	0.29	0.34	0.27	0.30	0.30	0.26	0.25	0.27	0.28	0.26
Uva	0.28	0.30	0.36	0.37	0.40	0.37	0.32	0.32	0.33	0.29	0.29
Sabaragamuwa	0.37	0.42	0.40	0.39	0.39	0.37	0.32	0.34	0.34	0.32	0.32
Total	**0.54**	**0.71**	**0.71**	**0.68**	**0.69**	**0.63**	**0.61**	**0.60**	**0.62**	**0.61**	**0.60**

Source: Department of National Planning.

Table A2.10 Revenue Collection of Provincial Councils 1991 to 2001 (SLRs million)

Province	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Western	1,320.7	2,022.8	2,374.9	2,718.9	3,029.4	3,253.5	3,690.9	4,090.4	4,607.0	5,082.9	5,681.7
	(65.4)	(67.4)	(66.9)	(68.2)	(66.1)	(66.4)	(67.0)	(66.5)	(66.5)	(66.9)	(67.0)
Central	198.4	245.3	299.6	337.6	383,.1	385.9	480.6	513.2	583.6	612.5	684.6
	(9.8)	(8.1)	(8.4)	(8.4)	(8.3)	(7.8)	(8.7)	(8.3)	(8.4)	(8.0)	(8.1)
Southern	144.7	211.5	229.1	241.8	301.2	354.5	365.1	439.4	468.9	556.2	636.7
	(7.1)	(7.0)	(6.4)	(6.0)	(6.5)	(7.2)	(6.6)	(7.1)	(6.7)	(6.3)	(7.5)
North Eastern	11.1	10.3	14,.2	14.4	33.9	31.0	34.9	36.8	44.5	44.5	45.3
	(0.5)	(0.3)	(0.4)	(0.3)	(0.7)	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)	(0.5)
North Western	146.2	241.5	269.9	288.5	369.7	358.2	423.6	477.0	539.5	575.7	623.3
	(7.2)	(8.0)	(7.6)	(7.2)	(8.0)	(7.3)	(7.6)	(7.7)	(7.8)	(7.5)	(7.4)
North Central	40.1	77.0	109.9	103,.2	127.3	147.5	148.0	162.1	196.5	225.9	244.4
	(2.0)	(2.5)	(3.0)	(2.6)	(2.7)	(3.0)	(2.7)	(2.6)	(2.6)	(2.9)	(2.9)
Uva	55.5	66.5	98,.5	111.9	138.6	149.2	148.7	169.7	194.4	193.3	214.5
	(2.7)	(2.2)	(2.7)	(2.8)	(3.0)	(3.0)	(2.7)	(2.7)	(2.8)	(2.5)	(2.5)
Sabaragamuwa	101.6	127.4	151.0	171.3	200.8	218.4	217.7	263.1	286.1	306.1	343.6
	(5.0)	(4.2)	(4.2)	(4.3)	(4.3)	(4.4)	(3.9)	(4.2)	(4.1)	(4.0)	(4.1)
Total	**2,018.2**	**3,002.5**	**3,547.1**	**3,987.7**	**4,583.9**	**4,898.2**	**5,509.6**	**6,151.9**	**6,920.7**	**7,597.4**	**8,474.1**
% Increase		48.7	18.1	14.9	14.9	6.8	12.4	11.6	23.6	9.7	11.4

Note: Figures in parentheses denote percentage share of each province.
Sources: Ministry of Provincial Councils and Local Government; Central Bank of Sri Lanka.

Taipei,China

Steve Waicho Tsui
Professor
Department of Public Finance
National Chengchi University
Taipei City

Acronyms

BOT	build-operate-transfer
GDP	gross domestic product
GNP	gross national product
LGU	local government unit
LVIT	land value increment tax
MRT	mass rapid transit
NT$	New Taiwan dollar
VAT	value-added tax

Executive Summary

Local government finance is assuming greater importance for many developing member countries of the Asian Development Bank because of changing political and socioeconomic global conditions. Taipei,China is no exception. During the last decade, a more liberal political environment and the slowing down of economic growth have had important implications for government finance at the central and local levels. The "sound and conservative" principle of budgeting in the last 30 years of government finance has changed. Beginning in 1990, public borrowing has become a major source of funding for Taipei,China as a direct consequence of the rapid growth in public spending, accentuated by the decline in the Government's ability to generate revenue. Demand for expansion of public services, especially social welfare, has grown. The public is seeking a more comprehensive social assistance program and the establishment of various forms of social insurance, including a national health insurance scheme and a pension plan for those not yet covered by the insurance systems for government employees, for labor, and for servicemen.

However, the central Government has been reluctant to raise taxes and instead has reduced them: the highest marginal personal income tax rate has gone from 50% to 40%. The imputation system adopted in 1998 removed the contribution of business income tax to the general tax fund. The value-added tax (VAT) rate for the financial sector dropped from 5% to 2%. For 2002 and 2003, the three-tiered progressive land value increment tax (a capital gains tax on land transactions) is being collected with 50% tax relief across the board. Inevitably, budget gaps were mainly filled by borrowings raised through issuance of government bonds and credit financing by commercial banks. A high proportion of domestic commercial banks are government owned or controlled.

The ratio of debt financing has steadily increased since the 1990s. The ratio of outstanding government debt, including public bonds and bank borrowings, to gross domestic product (GDP) jumped to nearly 29% in 2001, more than double the 12% in 1989. The largest borrower is the central Government. In 2000, its outstanding debt accounted for 26.0% of the average gross national product (GNP) for 1997–1999, while the local government as a whole accounted for 2.9%. The low outstanding debt ratio of local governments does not mean that their fiscal standing is better than that of the central Government. The present system of responsibility, spending, and tax assignment among levels of government weakens the ability of local governments, except perhaps the capital city of Taipei, to generate own-source revenue for expenditures. Central government transfers are important revenue sources for local governments and are in the form of a central allotment, which is funded by a fixed percentage of revenues from several national taxes, and general grants and project grants, which are both directly appropriated from the central government budget.

Statistics on borrowings and transfers reveal that a high percentage of the central government deficit stems from filling local government finance gaps. The strategy of borrowing with one hand and giving out with the other would be tolerable if the central Government's fiscal condition were sound, that is, if the amount of annual borrowing were as low as it was before 1989. However, worsening central government finances have limited the amount of funds available for transfers to local governments, despite rising demand from local governments for such transfers to meet increased spending on local services and infrastructure.

The central Government has not satisfactorily met this demand. Given the widening gap in its annual budget, funds available for the relief of local financial burdens decreased rapidly. The principle of granting fiscal assistance solely on the basis of need was also challenged among ministries in the Cabinet. A more incentive-oriented central-to-local grant system was promoted so that the county or city with the greatest need should not automatically take the biggest share of the total transfer.

Several reform proposals to the grant-in-aid schemes have been implemented in recent years. These not only redesigned the mechanism of distributing grants among local government units (LGUs) but also changed the basic structure of intergovernmental relationships, including the assignment both of expenditure responsibility and of taxes among levels of governments.

Aside from the central Government, the local government may also obtain funds from commercial banks and other financial institutions. Developed cities such as Taipei and Kao-hsiung may also raise funds by issuing local development bonds.[1] Proceeds from debt financing can only be used for capital expenditures such as infrastructure, new transportation systems, and improvement of the environment as required by the Budget Law.

Bond financing was once granted only to the two cities. Thus, the local public bond market is largely undeveloped. However, given the difficulties in obtaining sufficient financial assistance from the central Government, local governments are probably more ready to accept the issuance of local bonds as a legitimate and desirable means to finance urgent and crucial local services.

This chapter discusses issues of local government finance and opportunities provided by a developed local government bond market. Specific topics covered are the following:

- the political system and major changes in government structure in Taipei,China;
- fiscal trends since 1995, and the development of intergovernmental relationships and local government finance in the last decade;
- major economic, political, and constitutional changes and their impact on local government finance;
- the pattern and structure of expenditures and revenues among local governments;
- a review of experiences in long-term financing for local government, with special reference to the role of debt financing for provincial governments (before the 1998 Constitutional Amendment that downsized provincial governments) and to the city governments of Taipei and Kao-hsiung;
- legal, regulatory, and institutional conditions governing local public bond finance;
- major impediments to public bonds as an effective and reliable means of local government financing; and
- the possibility and feasibility of establishing a local public bond market, and policy recommendations for such a market, including local government fiscal management, macroeconomic conditions for bond market, tax problems, and guarantee mechanism.

Basic Economic and Government Structure

Economic Trends

Taipei,China has a land area of some 36,000 square kilometers and had a population of 22.36 million as of end-July 2002. The annual population growth rate has declined to at most 1% since 1990. Over the 1990s, economic growth slowed. The average annual growth rate of real GNP fell to 6.3% from 8.1% in the 1980s (Council for Economic Planning and Development 2002) and from 9.4% in the 1970s. The slowdown is more evident when per capita GNP in US dollars is used since the new Taiwan dollar (NT$) has depreciated against the US dollar since 1992, and especially since the Asian financial crisis.

Aggregate savings as a percentage of GNP slid steadily in the 1990s, mainly due to huge budget deficits since 1992. Excess savings in the private sector are evident if the savings ratio is compared to the investment figure. The growth rate of fixed capital formation as a whole dropped to a record low of 1.7% in 1997, rebounded over the next 2 years, and fell again to 1.8% in 1999. The slowdown in investment was less serious in the private than in the public sector (which included public infrastructure investment by local and central governments, as well as the expansion of plant and equipment of public enterprises). The public sector investment slowdown reflected the heavily indebted central Government's shortage of funds, and resistance by local residents to any public construction projects.

Fiscal management became steadily worse over the 1990s. The ratio of total tax revenue to GDP fell from 18.8% to 13.2% at the end of the decade, the lowest among major industrial and newly industrialized economies. Low tax revenue has unavoidably led to an increase in government debt. As a percentage of GDP, government debt in the form of public bonds and borrowings from commercial banks (financing by direct borrowing from the central bank has never been acceptable to the central Government) increased from 5.8% to over 25% at the end of the decade. The current account deficit reached 6.1% of GDP.

The fiscal position of the central Government worsened in the new decade. In 2001, the economy experienced an unprecedented contraction of 2.2%, domestic investment and the value of international trade dropped by more than 10%, and actual tax collection fell short of the estimated figure by NT$70 billion, or by more than 7%, widening the budget deficit gap. The central Government was therefore in a dilemma: resorting to expansionary fiscal policy to stimulate the economy would increase the level of public debt. Even if the central Government risks trading off economic growth with expanding the deficit, the ceiling on the level of borrowing under the Public Debt Law—15% of annual total spending of all levels of government—leaves little space for further deficit financing. However, if the economic slowdown is caused mainly by external factors—such as a slowing United States (US) economy, the major buyer of Taipei,China's information and communications technology and consumer electronic products—stimulative domestic policy is of little help. Further weakening of the fiscal position due to higher spending and/or lower tax collection may simply result in more serious problems in intergenerational transfer and rigidity in future public spending.

Over the last 12 years, price inflation has never been a major issue. After 1997, the price level changed only minimally, and no evidence of deflation was seen. Price stability was also reflected in the decreasing rediscount rate set by the central bank.

Government Functions

The structure of government functions and powers is guided by the Constitution. Before the 1998 Constitutional Amendment, government was organized into three levels: central, provincial, and county/city. Taipei,China has two provinces, Taiwan and Fukien. Taiwan Province has 16 counties and 5 cities, while Fukien Province has 2 small counties. Cities, urban towns, and rural towns are all called township offices, not government offices, since their autonomous power is not clearly stated. They are classified according to the number of residents. All township offices fall under the jurisdiction of the 18 counties. However, the township offices' legal status is not explicitly stated in the Constitution. Taiwan Province has 309 cities, urban towns, and rural towns, while Fukien Province has 10 subordinate cities and townships. Relatively populous cities not on the scale of Taipei and Kao-hsiung are called "cities directly under the province." These are subdivided into districts. Taiwan Province has five such provincial cities.

Parallel to the province, as stipulated in the Constitution, are two special cities directly under the control of the Executive Yuan—Taipei and Kao-hsiung, the largest and most populous in Taipei,China. Their financial situation is better than that of the provinces due to special financial privileges granted by the central Government and to better economic conditions brought about by clustered industrial and business activities.

The Local Government System Law defines three types of city according to population. Special city status can be granted to a local unit that has over 1.25 million residents and has special significance in terms of political, economic, cultural, and metropolitan development. Provincial city status can be given to local units with a population of 500,000 to 1 million and with political, economic, and cultural importance. Cities subordinate to the county have a population of 150,000–500,000, with a well-developed infrastructure, healthy industry and business, and sufficient own-source revenue.

Chief executives of counties (magistrates) and cities (mayors) are elected. Taiwan Province and the two special cities had their first local elections for governor and mayor in 1994. Before this, the mayors of Taipei and Kao-hsiung cities and the chairman of the Taiwan Provincial Committee were all nominated by the Cabinet and appointed by the President. Fiscal decentralization was also accelerated at this time.

Each level of government has a representative organization that supervises the administrative body. The national level has the Legislative Yuan, and the subnational level (e.g., Taipei and Kao-hsiung cities), the city council. Other jurisdictions in Taiwan Province have county and city councils. For city offices within a county, and for urban and rural township offices, representative bodies supervise administration.

The 1998 Constitutional Amendment was meant to simplify the overall government system and thus make the public sector more efficient and cut down public spending. The amendment trimmed the powers of the autonomous Taiwan provincial government, making it a ministerial agency directly responsible to the Cabinet. The amendment abolished the Taiwan Provincial Assembly and replaced it by a centrally appointed Taiwan Provincial Advisory Committee. The present government structure is two-tiered: central and local. The local government includes the special cities, counties, and provincial cities. Township offices under county supervision are semiautonomous. The two special cities have a combined population of 4 million, or about 18% of the total population. The most populous local unit is Taipei county. The two counties in Fukien have less than 3% of the total population.

Responsibility and Expenditure Assignments

Theoretically, the three fiscal functions of the public sector—allocative efficiency, distributional equity, and economic stability—suggest that a certain public good or service should be provided by the level of government that most closely serves the jurisdiction that benefits from such a good or service. Based on this benefit principle, pure public goods (foreign affairs, national defense, the currency, and public goods and services) can only be provided most efficiently by the central Government. For other public goods that benefit people in a given province, city, or township, a decentralized decision on relevant expenditure is desirable for allocation and administrative efficiency. Otherwise, macroeconomic stability and redistributive equity requires centralized administration and policy.[2]

Governments do not always follow the above principles in supplying goods to the public. Public goods of limited benefit are sometimes provided by the central Government due to externalities or spillover effects. Local governments in many countries carry out redistribution or welfare programs for the aged, poor, and disabled, with or without central coordination. Various patterns of expenditure responsibility can be identified in divisions of functions among levels of government. For instance, economic theory may suggest that primary education, if provided and supervised by the local government, has certain advantages, such as higher quality and greater relevance to the local community. For tertiary education, however, economies of scale and positive externalities imply that centralized control may be more efficient. Yet, in reality, cross-country differences are significant in the provision of preschool, primary, secondary, tertiary, and higher levels of education, and in the cost shares of different levels of government in providing these education services (Ahmad, Hewitt, and Ruggiero 1997).

The Constitution stipulates the division of responsibilities among central and local governments, either by a system of classification or one based on general principle. Articles 107–110 divide government responsibilities into (i) central legislation and implementation, (ii) central legislation and central or local implementation, (iii) provincial legislation and provincial or county/city implementation, and (iv) county/city legislation and implementation.

Article 111 states that responsibilities not included in the four categories should be assigned to the central, provincial, or county/city government, depending on whether the matter should be uniform across the whole nation, province, or county/city.

Although the Constitution gives local governments (special city and county/city councils) the right to draft and pass laws and regulations, decentralized legislation has not yet been realized partly due to the failure of the Executive Yuan to draft the enabling laws. The central Government has the sole power to draft and pass laws. All local governments only act as administrative organs, with limited flexibility. Functions classified as under local implementation are responsibilities of the relevant local government. Items in this category should not be confused with autonomous tasks of the local government. Local implementation is still regulated by laws passed by the central Government. In most cases, the central Government also has the power over different geographical areas. Overlapping responsibilities in tiers of government are expected, as with social welfare and social assistance. Nevertheless, water and public transportation, tourism, and construction management, etc., are pure local government responsibilities under the present government structure.

Since the 1990s, LGUs have adopted a more generous policy of social assistance for the aged and needy. Even some counties and cities heavily dependent on grants from the central Government are involved in "welfare competition." Monthly allowances are given to people above 65 without any means test. Several LGUs provide uniform subsidies to children under 3 for the registration fee charged by medical institutions under contract with the national health insurance system.

Spending on education and police services is another issue of dispute between the central and local governments. The local government is responsible for financing primary and secondary education, but the central Government has the sole power to design the school system, define the qualification of teachers, and select textbooks. LGUs argue that education is a standard good, but they do not have any power to decide on the provision of the public school system, which accounts for a very high percentage of local government spending. Similarly, local police services across the country are coordinated by the central Government. LGUs have only minor powers, even over the appointment of local police chiefs. Therefore, LGUs argue, since education and police services are central matters implemented by the local government, the central Government should directly bear the full financial costs. This suggestion is not accepted by the central Government, and the dispute over the division of power and the financial burden between central and local governments still has to be resolved.

The acceleration of democratization of the political system, which began in the mid-1980s, has resulted in the decentralization of powers or functions. In 1995, local elections for the governor of Taiwan Province and for the mayors of Taipei and Kao-hsiung cities were held for the first time, and local residents have expected significant improvements in living conditions, transportation, education, public order and security, and jobs, etc. To meet these expectations, officials have needed more sources of finance. County governments also have asked for greater fiscal capacity, either in terms of own-source means of finance or larger unconditional grants from upper-level governments.

The 1998 amendment gave no clear guidelines on how the responsibility and power of the downsized Taiwan provincial government would be taken over by the central Government or passed down to the counties and cities. In the event, the central Government took over most of its functions, since the LGUs did not want to bear a greater financial burden because their revenue share was not going to increase correspondingly.

Tax Assignment

The division of taxes is a matter of central government legislation and implementation.[3] Before the 1998 downsizing, taxes were classified as national taxes, provincial/special city taxes, and county/city taxes. A decentralized public expenditure system needs good local tax support. The literature on fiscal federalism and local government finance usually recommends the following principles of tax assignment, based on efficiency and income redistribution considerations (as provided in Oates [1996]).

- Lower levels of government should mainly rely on benefit taxation of mobile economic units, including households and factors of production.
- If nonbenefit taxes on mobile economic units are needed to achieve redistributive equity, they should be implemented at the central government level.
- If local governments employ nonbenefit taxes, they should collect them from immobile tax bases across local jurisdictions.

In reality, classification of taxes as benefit or nonbenefit is rare. They are usually grouped as income, sales, property, payroll, and even natural resource taxes. Income taxes on individuals and businesses are usually assigned to the central Government. Historically, property taxes, including land taxes, have been widely used as subnational taxes. As for sales taxes, distinctions must be made in assigning them properly. Excise and retail taxes levied on the final sale to the consumer can be assigned to the local government as a revenue source, with or without the autonomous power to set the rates and bases of taxes. Excise taxes on goods should be assigned to the central Government to minimize tax exporting, and excise taxes on selected services consumed locally may be given to the local government as a reliable revenue source. Sales taxes on manufacturing should be assigned to the central and subnational governments if the areas covered are large.

VAT should be assigned to the central Government as it has extensive administrative capabilities to operate the tax and will be neutral with respect to spatial allocation of production and consumption.[4]

The major tax items have been assigned according to the principles discussed above. As shown in Table 1, the major generators of internal revenue for the central Government are taxes on personal income, business income, business,[5] commodities, estates and gifts, securities transactions, and futures transactions; and excise taxes on selected goods. In 2002, a new national tax on tobacco and alcohol replaced the monopoly revenue system. Personal income tax, formally called the consolidated income tax, is imposed on individual taxpayers. It treats family income as a tax base.[6] The tax rates range from 6% to 40%. The tax code exempts the salary income of military personnel and of primary and junior high school teachers and staff. Business income tax is collected on all forms of business units, including corporations. The basic tax rate is 25%, but 15% is applied to very small businesses. A system to integrate business and personal income taxes was enacted in 1998, thus removing double taxation on distributed dividends.

Commodity tax is collected on rubber tires, cement, oil and gas, beverages, flat glass, electric appliances, and vehicles. A specific tax is collected on cement, and oil and gas, while other items are taxed on an ad valorem basis from 8% to 25%. Estate tax is a major measure to redistribute income, with rates of 2–50%. It is supplemented by the gift tax, with rates of 4–50%.

Taxes on securities and futures transactions are collected at the following rates: 0.3% on corporate stocks, 0.1% on corporate bonds, 0.025% on stock index futures contracts, and not lower than 0.125% on options and stock options contracts (which, though, do not legally exist yet). Government bond sales are exempt from the securities transaction tax in the spot market (while a futures market for public bonds has not yet been established).

Local taxes are those imposed at the provincial and special city levels and at the county or city level. No separate tax is assigned to cities and townships as the Constitution does not consider this level of local government as autonomous.

Before the 1998 downsizing, provincial taxes were VAT (business tax) and stamp tax, which are in the forms of a surcharge on VAT, and the vehicle license tax, which is a benefit tax on automobile consumption. For second-level local government, taxes are in the form of property tax (which includes the house tax and land value tax).

A unique county and city tax in Taipei,China is the land value increment tax (LVIT), the only tax item explicitly mentioned in the Constitution. This tax is imposed on realized capital gains from land transactions or on accrual gains from transfer of ownership through gift, donation, or inheritance, etc. Taxation theory treats this tax as a form of capital gains tax, which should be administrated separately in a schedular system or combined with regular income tax. Either way, the capital gains tax is usually assigned to the central Government. However, LVIT is a local government tax, which may have some merit since it is imposed on an immovable object (land), and the tax base is the difference in assessed land value, which will benefit from local development, among other factors. Thus, to a certain extent, LVIT can be considered a type of benefit tax. Finally, local taxes of the two levels of government are all assigned to the two special cities.

No separate tax was designated as "own" tax for the city, urban town, and rural town level. However, the Law Governing the Allocation of Government Revenues and Expenditures provides independent tax revenue for these jurisdictions. All revenue from the now suspended agricultural land tax, although assigned as a county/city tax, went to township offices if the tax was collected in the jurisdiction of a county. The same was true for amusement tax.

In the counties, 30% of the land value tax, 40% of the house tax, and 80% of the deeds tax go to the township offices of cities and towns where these taxes are paid. The county government also sets aside another 20% of total revenue from these taxes for distribution to subordinate cities and towns according to their needs. For LVIT, 40% of the revenue collected in counties and cities is submitted to the provincial government. Half of the amount submitted is pooled with 50% of the total business and stamp taxes collected in the province. The provincial government gives this pooled amount as a grant to counties and cities to reduce horizontal inequity among them. The special cities do not redistribute revenue directly, but the central Government gives 50% of the total business and stamp tax collection as a grant to provinces and the special cities for horizontal equity.

The current tax assignment came after the Legislative Yuan passed the revised law on revenue and expenditure allocation. New national and local taxes were imposed, such as (i) national taxes on income, estates and gifts, business, commodities, tobacco and alcohol, securities transactions, futures transactions, mining lots, and customs duties; and (ii) local taxes (for the special cities, counties, and cities) on land value, agricultural land, land value increment, houses, vehicle licenses, deeds, stamps, amusement, and special local levies.[7]

Revenue from these taxes is proportionally distributed among different levels of government to reduce vertical and horizontal inequality in fiscal capacity. These taxes can be viewed as "shared." Of the national taxes, the business tax (formerly the local VAT) is the most important as regards its contribution to the revenue pool. The distribution of tax revenue is shown in Table 1.

Among local taxes, LVIT is one of the most important in revenue generation. About a decade ago, LVIT collection was healthy.[8] However, after the housing and land market bubble burst, revenue from LVIT dropped significantly.[9] Logically, local government demands for more fiscal transfers increased. By the Constitution and law, the upper levels of government bear the responsibility to ease the financial burden of local governments, but fiscal transfers have been inadequate, since the central Government itself is in serious financial difficulty, facing increasing budget deficits. In 2003, LVIT was reduced by 50% for 2 years to stimulate the sluggish housing market, among other things. The results so far, though, are not encouraging.

Revenue and Expenditure Structure

An analysis of revenue and expenditure by different tiers of government allows the following observations to be made:

- As measured by the ratio of net general government expenditure to GNP, the public sector grew significantly from FY1989 to FY1993 (Table 2). Even when

Table 1. Classification of Taxes, 2002

Taxes	Distribution of Tax Revenue						
	Central	Central Allotment[a]	Special City	Prefecture	Provincial City	County Allotment[a]	Township
National Taxes							
Income Tax	90	10					
Estate and Gift Tax							
Special Cities	50		50				
Counties	20						80
Provincial Cities	20				80		
Customs Duties	100						
Business Tax	60	40					
Commodity Tax	90	10					
Tobacco and Alcohol Tax	80	20					
Securities Transaction Tax	100						
Futures Transaction Tax	100						
City and County Taxes							
In Special Cities							
Land Value Tax			100				
Agricultural Land Tax			100				
Land Value Increment Tax			100				
House Tax			100				
Vehicle License Tax			100				
Deeds Tax			100				
Stamp Tax			100				
Amusement Tax			100				
Special Local Levies			100				
In Counties							
Land Value Tax				50		20	30
Agricultural Land Tax							100
Land Value Increment Tax		20		80			
House Tax				40		20	40
Vehicle License Tax				100			
Deeds Tax						20	80
Stamp Tax				100			
Amusement Tax							100
Special Local Levies				100			
In Provincial Cities							
Land Value Tax					100		
Agricultural Land Tax					100		
Land Value Increment Tax					100		
House Tax					100		
Vehicle License Tax					100		
Deeds Tax					100		
Stamp Tax					100		
Amusement Tax					100		
Special Local Levies					100		

[a] Central allotment and county allotment are fixed percentages from collection of specific taxes as shown in the table. The total appropriation is distributed to the lower-level government. Therefore, special cities, counties, and provincial cities receive central allotment, while townships subordinate to counties receive county allotment.
Source: Law Governing the Allocation of Government Revenues and Expenditures, 2000.

Table 2. Size of Public Sector, FY1980–1999 (%)

Fiscal Year	Expenditure[a]/ GNP	Central Government	Taipei	Kao-hsiung	Taiwan Province	Counties and Cities	Towns
1980	25.9	59.4	8.4	2.4	13.7	12.5	3.6
1981	26.5	55.1	8.4	2.5	17.4	13.2	3.4
1982	26.9	56.2	8.7	2.9	16.0	12.9	3.3
1983	25.1	58.3	8.9	2.8	13.9	12.7	3.4
1984	23.1	56.3	8.6	2.6	16.0	13.0	3.5
1985	23.0	58.0	9.1	2.8	13.2	13.4	3.5
1986	23.6	59.1	8.9	2.8	13.8	12.3	3.1
1987	21.2	58.6	9.0	2.7	13.9	12.5	3.2
1988	22.0	58.2	8.6	3.0	13.9	13.2	3.1
1989	33.0	42.5	11.6	5.1	15.2	12.3	13.3
1990	28.1	52.7	6.4	3.3	17.4	14.0	6.2
1991	31.2	54.2	11.1	2.5	15.3	12.2	4.7
1992	32.7	57.8	8.1	2.2	14.2	13.9	3.8
1993	32.6	57.1	8.3	2.4	13.0	14.3	4.9
1994	30.8	50.8	10.3	2.4	16.2	15.5	4.8
1995	31.0	51.1	7.3	2.5	21.9	13.7	3.5
1996	27.7	50.5	8.8	2.8	19.8	14.3	3.8
1997	26.4	51.3	8.2	2.8	19.5	14.2	4.0
1998	25.9	50.8	9.2	2.8	19.4	13.9	3.9
1999	24.1	57.8	8.0	3.1	13.9	13.3	3.9

[a] Net general government expenditure.

Note: The figures for FY1999 are those of annual budget appropriation. Figures of annexed budget are not included.

Source: Ministry of Finance. 1991, 1998. *Yearbook of Financial Statistics of the Republic of China,* Department of Statistics.

public expenditure increased in absolute and relative terms, the overall tax burden (the ratio of total taxes and custom duties collected to GNP) remained constant. This resulted in a widening gap between spending and revenue generation. Thus, public debt rose substantially over the years.

- Beginning in FY1994, overall spending of the central Government for local government decreased. No evidence shows that it is a result of "decentralization." Nonetheless, the decrease was offset by the increase in the provincial government's share to net general government spending. The other local governments had maintained a constant share from year to year. Table 3 shows the relative shares in net spending of central and local governments (excluding the Taiwan provincial government and the townships) for FY1999–2000 to FY2002 (projected). Clearly, the central Government's share increased since it has assumed most of the functions and the spending of the downsized Taiwan provincial government.
- Table 4 gives the revenue structure, in 6-year averages, before the public sector

Table 3. Net Expenditures by Government (%)

Fiscal Year	Central Government	Provincial Government and Special Cities	Counties and Cities
1977	60.3	20.8	18.9
1978	60.1	21.9	18.0
1979	58.7	21.5	19.8
1980	59.3	24.5	16.2
1981	55.1	28.3	16.6
1982	56.2	27.6	16.2
1983	58.3	25.5	16.2
1984	56.3	27.3	16.4
1985	58.0	25.1	16.9
1986	59.1	25.5	15.4
1987	58.6	25.6	15.8
1988	58.2	25.4	16.4
1989	42.6	31.9	25.5
1990	52.7	27.1	20.2
1991	54.2	28.9	16.9
1992	57.8	24.5	17.7
1993	57.1	23.6	19.3
1994	50.8	28.9	20.3
1995	51.1	31.7	17.2
1996	50.5	31.3	18.2
1997	51.3	30.5	18.2
1998	50.8	31.4	17.8
1999	58.0	24.7	17.3
2000	67.5	10.5	22.0
2001	66.2	10.0	23.8
2002	64.2	10.1	25.7

Note: After the downsizing, spending of the Taiwan provincial government was included in the central government budget. The second-level government consists of only two special cities.
Source: http://www.dgbasey.gov.tw/dgbas01/91ctab/91c706.xls.

downsizing. Surprisingly, Taiwan Province has a low tax finance ratio: only 23.1% of the province's revenue is generated by taxes, over 30% of its expenditure is financed by discretionary grants from the central Government, and over 20% by borrowings and issuance of bonds. In contrast, Taipei and Kao-hsiung cities have a higher ratio of own-source revenue. A very high percentage of counties and cities depend on grants from Taiwan Province, which, in turn, relies substantially on central assistance. Taiwan Province and its subordinate counties and cities cry the loudest for policy reforms to save themselves from financial difficulties.

- Income and commodity taxes combined have generated more than one third of total tax collection. Tariffs have played a very important role in raising central government revenue, even during the last decade when trade liberalization

Table 4. Revenue Structure of Different Tiers of Government (%)

	Central Government	Taipei	Kao-hsiung	Taiwan Province	Counties and Cities	Towns	General Government
Real Revenue							
Taxes	60.03[a] (57.92)[b]	73.35 (78.78)	52.48 (72.98)	23.11 (37.49)	47.06	24.73	50.50[c]
Other Nontax Revenue	24.76 (26.10)	20.24 (14.38)	26.81 (15.27)	24.93 (23.10)	11.21	18.19	21.89
Non-Real Revenue							
Grants-in-Aid	0 (0)	0.16 (0.14)	14.96 (5.03)	30.78 (17.73)	37.45	53.20	14.49
Debt Finance	13.36 (14.04)	4.45 (4.71)	5.53 (6.45)	21.18 (21.68)	2.20	1.48	11.49
From Fiscal Reserves	1.85 (1.94)	1.80 (1.99)	0.22 (0.27)	0 (0)	2.08	2.40	1.63
Total (%)	100.00	100.00	100.00	100.00	100.00	100.00	100.00

[a] Averages of FY1991–1996. [b] Figures in parenthesis are calculated with all business taxes and stamp taxes collected treated as provincial and city government revenue. [c] Average of gross receipts to different levels of government.

Source: Department of National Treasury, Ministry of Finance. 1997. Discussion Notes.

significantly reduced tariff rates. Taxes on security transactions accounted for 12.6% of total taxes and tariffs collected in FY1990, the year of the overheated stock market. Business tax is the single most important tax. Over 75% of provincial tax collection is based upon VAT. Property taxes contributed 6–7% to total government income, with revenue from the land value and house taxes going to local governments. Counties and cities depend most heavily on income from LVIT, which in some years accounted for more than two thirds of total taxes collected. Finally, monopoly taxes on tobacco and alcohol (which, in theory, are equivalent to excise taxes) have steadily become relatively less important.

- Time series data for expenditure from FY1990 to FY2001 show that revenue, education, cultural and scientific services, and public security (police administration) take the largest share (over 35% in most years) of total spending for Taipei and Kao-hsiung cities and Taiwan provincial government. Counties and cities spend over half of their budget on these services. For townships, transportation is the most important item, but spending is mostly on street lighting and road paving, not on road construction. Revenue data from FY1987 show that Taiwan provincial government relies heavily on grants from the central Government, most of which are financed by the 50% business and stamp taxes remitted by the two special cities, and by debt financing through loans and government bonds.

In FY1991, a mere 20.36% of total revenue was derived from provincial taxes, much lower than the tax revenue of the two special cities and subordinate counties and cities. Even for the two special cities, which are considered to be in a better financial situation, FY1991 was a difficult year, marked by a high degree of debt financing. Finally, township offices do not have their own tax to collect but receive disbursements from county and city taxes. Counties and provincial governments are still the largest sources of their finances. Over the last few years, on the expenditure side, local government as a whole has seen increasing shares for social security, reflecting the growing importance of social insurance programs, including the National Health Insurance System.

Problems in Local Government Finance

In theory, government financial performance can be evaluated on the basis of allocative efficiency, distributional equity, and economic stability, or simply on how social welfare has been maximized. In reality, the applicability of these criteria is highly limited or nil. The financial difficulties of local governments, and even the central Government, arise from failure to generate sufficient funds. When opportunities to increase revenue are lacking, governments have to hold back important projects and to choose plans that require a smaller budget, which slows down welfare improvement. The division of responsibilities among different levels of government allows little flexibility in the provision of goods and services. Primary and secondary education are assigned to local government, but the school system is governed by the central Government. Local government is obliged to provide uniform goods and services, including admission of students, training of teachers, development of curriculum, and selection of textbooks.[10] The burden of cost is on the local government. The local police service is another example. Local government has to accept the centralized and identical system requirement and the appointment of local police chiefs by a central agent, yet shoulders the full cost of police operations.[11]

To perform the assigned duties, local governments need large funds. Education and police expenditure amount to one third of total city and provincial spending, and more than 50% of county and city government outlays, leaving little room for discretionary spending on, for example, environmental improvement or local investment projects. Local taxes are collected in different jurisdictions based on identical tax bases at identical tax rates. Variations in tax capacity of localities determine tax revenues. There is no room to enhance tax efforts. Inflexibility in expenditure and revenue of local governments is the root of their financial hardship.

Specifically, the following observations are made on the problems of local public finance:

- From FY1990, public expenditure increased at a rate that could not be supported by revenue growth. While the central Government has relied heavily on debt financing, local governments, especially Taiwan Province and its subordinate counties and cities, have increased their borrowings and have depended heavily on grants from the central and other upper levels of government. Borrowing adds to local governments' financial burdens, and dependence on grants may induce a larger budget for local governments due to the "fiscal illusion" of the residents and the so-called "fly-paper effect" of specific grants.
- A very high share of county and city expenditures is spent on educational, cultural, and scientific services,[12] crowding out local infrastructure, environmental protection, and social welfare. The bulk of educational expenditure is for personnel expenses, i.e., salaries to teachers and staff, which will automatically grow as the central Government announces a pay raise for government employees.[13]
- Unbalanced regional development causes highly skewed distribution of taxable resources and significant horizontal inequity among local governments. Taipei,China's tax system places higher importance on income, consumption, and manufacturing activities than on property ownership. Thus, only the more industrialized and commercial regions can collect more taxes to support more development, resulting again in higher capacity to tax.
- Local governments lack autonomy even in local tax collection and are thus unable to collect more taxes even if they are willing to do so, especially if the grants-in-aid system adopted by the central or upper-level government is linked to the tax effort of the recipient government. The Local Taxes Code pending in the Legislative Yuan provides a mechanism to impose new local taxes and more flexibility in determining the tax rates. However, even if the code is passed, it is doubtful that local governments will increase their tax efforts. First, it is not politically advisable, on account of elections, to impose a higher financial burden on local residents and businesses. Second, as will be explained below, the "soft-budget" design of the grants-in-aid system discourages efforts to raise revenue through a tax scheme that is higher than the neighboring local government's system.
- Current grants or assistance programs overemphasize local needs and revenue availability, dampening the initiative of grantee governments to raise higher own-source funds since the better the government's financial situation, the smaller the grant it will receive.

Intergovernmental Transfer System

Before the downsizing, there were three different kinds of resource transfers: from central to the special cities and provinces, from province to counties and cities, and from county to townships. The biggest share consists of central government grants and ministerial subsidies (project grants). Part of the central government grant to the provincial government is indirectly channeled to the city or county government for local infrastructure or for services such as education and police. The central Government also provides grants or other forms of subsidy directly to counties and cities, bypassing the provincial level. This was not the usual practice before 1998, and even then the grant amount was minimal. Grants and ministry transfers came from general central government revenue, while the balancing budget fund was independently sourced from 50% of the locally collected business and stamp taxes submitted to the central Government by Taipei and Kao-hsiung cities and by Taiwan Province's cities and counties.

Over the last 15 years, grants-in-aid in all forms took a significant share of the central government annual budget: 10–25%. Articles 107 and 163 of the Constitution provide the legal basis for financial transfers across all levels of government. Both articles emphasize the local governments' lack of financial resources to undertake projects as the reason for central government assistance. The central Government is obliged to provide the necessary help, especially in the delivery of education and cultural services, which the Constitution requires to be developed fairly and in balance throughout Taipei,China.

The following discussion focuses on central government transfers to Taiwan Province, Taipei City, and Kao-hsiung City.[14] Central government fiscal transfers are in the form of grants through the balancing budget fund, grants to provinces and cities, and resource transfers through the ministries (or the ministerial-level agency) of the Executive Yuan. In 1992 and 1993, almost one fourth of the total central government budget was spent on grants-in-aid and on local services. Up to FY1999, the budget share of transfers to the local level was still high at 19.53%.[15] In the 1990s, ministry transfer for local services or projects became more important.

Taiwan Province received an overwhelming share of the fiscal transfers, while Taipei City received as much as 15% in FY1992 and FY1993 for subsidies to build the rapid transit system. During the last 4 years, Taipei City, considered to have the best financial position among LGUs, became the least subsidized. However, given the rapid increase in the total pool of grants, the amount given to the Taiwan provincial government still climbed to NT$222.2 billion in FY1992 and NT$241.3 billion in FY1993, 90% more than the FY1991 level.

Taipei City has a sound fiscal position, with low dependence on grants and debt financing. From FY1986 to FY1996, less than 1% of total city government expenditure was financed by central government grants. Kao-hsiung City had a peak of 20.8% dependence rate on grants in FY1993, which declined steadily, implying that the city's fiscal position improved. However, Taiwan Province relied heavily on central government grants. In FY1991, its rate of grant reliance was 35.9%.

In FY1999, in line with the adjustment of central and local government structures, a new tax assignment scheme was implemented. The central and local grants-in-aid system was also adjusted. Several tax items were classified as shared taxes, such that tax revenues from these shared taxes are allocated to relevant levels of government according to a fixed percentage. Since Taiwan Province has been depleted of all fiscal powers, the allocation of shared taxes involves first central and special city governments; then central and county/city governments; then the central Government and townships, bypassing the relevant counties; and, finally, counties and townships. For FY1999, special accounts at the central government and county levels were set up for the operation (input and output) of funds. Among them, the central allotment account is the largest and has the greatest effect on sensitive inter-governmental relationships.

Among the financial sources of the central allotment account are the revenue from several national taxes, including 10% of income tax proceeds, 10% of commodity tax revenue, 40% of business tax revenue,[16] 20% of all LVIT collection in Taiwan Province, and interest income of the account, if any.

Two separate accounts were established under the central allotment: (i) the special tax-sharing account, comprising 6% of all shared (national) tax revenue and income from other sources; and (ii) the general tax-sharing account, comprising all revenue from the central allotment net of the amount of the special tax-sharing account. The special tax-sharing account is reserved for local major or emergency needs, while the general tax-sharing account is allocated to different levels of local government based on the following percentages: for FY1999, when the central government allotment was first implemented, 94% of the shared (national) tax revenue put into the general account was distributed to the special cities (47%), counties and cities (35%), and townships (12%). These percentages were later revised to reduce the share of the special cities. The arrangement for FY2002 was 43% for the special cities, 39% for counties and cities, and 12% for townships.

The 20% LVIT revenue collected in Taiwan Province and put into the general account is allocated back to the counties and cities in the province. Finally, any interest income generated by these accounts in FY1999 was distributed as follows: 50% to the special cities, 37% to counties and cities, and 13% to townships.[17] Revision of the formula reduced the share of the special cities to 46% and raised the share of cities and counties to 41%.

The distribution of the general tax-sharing fund was determined as follows: the two special cities' shares in FY1999 were based on the weights of total business sales (60%), population (15%), and area (15%); the remaining 10% considers the cities' average fiscal capacity;[18] current percentage weights are 50%, 20%, 20%, and 10%, respectively.

For counties and cities, 85% of the allotment fund was allocated according to the relative gap between basic local spending need and basic local revenue. The remaining 15% was allocated according to local business sales.

Items included in basic local spending needs for counties and cities are (i) salaries and wages of permanent public employees; (ii) local government subsidies to social insurance and social assistance programs established by the central Government; and (iii) basic development needs, distributed according to share of population (35%), area (35%), farming, fishing, and agricultural population (15%), and industrial workers (15%). Funds for development needs consist of 35% of the 40% share in national taxes, and 17.5% of the 20% share in the collected LVIT.

In principle, basic local revenue is revenue from local taxes.

Finally, 6% of the general tax-sharing fund is allocated to townships based on the relative averages of personnel expenses, and of basic development needs, which are determined by share of population (55%) and land area (45%). In FY1999, 70% of the allocated amount went to personnel expenses. At present, the formula is 50% for personnel expenses and 50% for basic development needs. The 50% distribution for basic development needs to townships is 30% of the total available funds for townships, then 10% based on the size of population, and the rest (10%) based on the size of the jurisdiction.

The central Government also provides direct grants to the special cities and to counties and cities. Various central government ministries and agencies transfer resources to local governments for specific services. In FY2000 (over 18 months, due to the adjustment in the financial year periodicity), the total fund for grants and fiscal transfers, plus funds from the tax-sharing program, amounted to NT$573.5 billion—consisting of NT$140.5 billion for the tax-sharing program, NT$112.4 billion for the two special cities, NT$40.4 billion for grants-in-aid to local government as a whole, and NT$276.2 billion for ministerial transfers.

The new tax-sharing program will be difficult to implement now. Total tax revenue fell short of the projection by more than 10%. Expenditure needs for reconstruction have added to the serious financial burdens of central and local governments (except, perhaps, Taipei City). Cutting back on spending in non-emergency areas contributed only minimally to efforts to fill the growing financial gap.

The last two columns of Table 5 reveal that, during the first 2 years of the new system, LGUs received smaller fiscal transfers from the immediate upper-level gov-

Table 5. Comparison of Fiscal Transfer to Local Governments: Before and After the Downsizing of Taiwan Provincial Government (NT$ million)

Fiscal Year	Balancing Budget Fund and Central Transfer	Central Government Allotment, Central Transfer, and Project Grants		Rate of Change (%)	
	Average (1997–1999)	2000	2001	2000/ (1997–1999)	2001/2000
Counties					
Taipei	18,946	21,220	24,838	12.00	17.05
Ilan	8,683	7,257	7,897	-16.42	8.82
Taoyuan	12,463	7,320	8,306	-41.27	13.47
Hsinchu	8,493	5,023	5,414	-40.86	7.78
Miaoli	11,680	8,189	8,287	-29.89	1.20
Taichung	13,715	12,734	14,791	-7.15	16.15
Changhwa	17,180	14,407	14,544	-16.14	0.95
Nantou	12,012	8,658	9,985	-27.92	15.33
Yunlin	14,307	9,938	10,385	-30.54	4.50
Chiai	13,529	9,710	11,088	-28.23	14.19
Tainan	16,657	12,031	13,070	-27.77	8.64
Kao-hsiung	15,119	13,772	14,440	-8.91	4.85
Pingtung	15,952	13,558	15,553	-15.01	14.71
Taitung	8,794	6,337	7,434	-27.94	17.31
Hualien	9,140	3,782	8,473	-58.62	124.03
Penghu	5,317	4,101	4,486	-22.87	9.39
Cities					
Keelung	3,879	4,308	8,267	11.06	91.90
Hsinghu	3,376	3,374	3,600	-0.06	6.70
Taichung	7,683	3,806	5,426	-50.46	42.56
Chiai	3,314	2,926	4,197	-11.71	43.44
Tainan	6,039	3,883	5,631	-35.70	45.02
Reserves		0	7,367		
Total	**226,279**	**179,334**	**213,479**	**-20.75**	**19.04**

Notes:
1. FY2000 covers 18 months. For comparison purposes, figures in the table have been adjusted to an annual base.
2. NT$14.3 billion was subtracted from FY2000 central transfers.

Source: Directorate General of Budget, Accounting and Statistics; *Taiwan Provincial Government Financial Statistics Yearbook 1999.*

ernment. By removing the provincial government, therefore, LGUs may enjoy more fiscal autonomy. Total central fiscal transfers shrank due to the central Government's weakened financial capacity and fiscal position, which was largely caused by the economic slowdown, lower income elasticity of tax collection due to several major tax reduction policies over the previous 10 years, and increasing public demand for social services and welfare programs.

Public Debt and Bond Issuance

Public borrowing has become a significant financial source for Taiwan Province since FY1989, and for the central Government since FY1991. Before the 1990s, the central Government was suspicious and conservative with regard to borrowing, either through issuance of public bonds or through credit from commercial banks. Beginning in the early 1990s, public capital expenditure rose rapidly under the Six-Year National Development Plan.[19] This went hand in hand with a reduction in government savings—the surplus on the current account of the budget—due to increased spending to expand social welfare programs and the generous increases in government employees' salaries. Collection of various taxes, however, failed to match increasing expenditure needs because of inefficient tax administration and resistance to tax increases by the central Government and the public.

Table 6 shows the level of outstanding debts of central and local governments from FY1986 to the present. Government debts are of two types: public bonds, issued by the central Government or by the first-level local government (province and special city), and borrowings from commercial banks. The central Government does not frequently borrow from commercial banks, except in cases of short-term (less than 1 year) liquidity problems. The considerable share of total central government debt is in the form of outstanding public bonds. In contrast, Taiwan Province and the two special cities often fill their fiscal gaps by borrowing from commercial banks, especially those they own or control.

It can be seen from Table 6 that FY1992 was a turning point for the central Government. Outstanding debt that year jumped by NT$180 billion. Capping central government budget deficits and excessive accumulation of public debts became the most important government policy goal. Taiwan Province's debt problem was even more serious. Different measures had been taken to deal with the problem, including tightening current government expenditure by controlling its increase to below the rate of economic growth, and speeding up the privatization of government-owned enterprises or shareholdings. The central government budget deficit was eliminated and the amount of outstanding central government debt was reduced by FY1998.

All LGUs kept their indebtedness under control, with the exception of Taiwan Province, whose outstanding debt continued to rise. With the downsizing of Taiwan Province, the central Government decided to assume all its financial obligations, which inflated its debt by more than 60% in FY2000. Total outstanding debt of all levels of government increased from 2.3% of annual GNP to 33.1%. Debt per citizen jumped from NT$4,634 to over NT$140,000.

Taipei,China's fiscal system has an automatic "firewall" against skyrocketing government debt and puts a ceiling on the annual amount of debt financing at all

Table 6. Outstanding Debts, All Levels of Government, 1986–2002 (NT$100 million; %)

FY\ Gov't. Level	Central	Taiwan Province	Taipei City	Kao-hsiung City	County and City	Town-ship	Total Outstanding Debts	GDP	Outstanding Debts by Central Gov't./GDP (%)	Total Out-standing Debts/GDP (%)	GNP: Average of Previous 3 Years	Out-standing Debts/GNP (average of previous 3 years) (%)	Popula-tion ('000)	Out-standing Debt per Capita
1986	601	133	69	24	75	-	902	26,252	2.29	3.43	22,271	4.05	19,455	4,633.82
1987	896	153	90	20	80	-	1,239	30,613	2.93	4.05	24,583	5.04	19,673	6,298.12
1988	1,395	203	129	27	84	-	1,838	33,646	4.15	5.46	27,550	6.67	19,904	9,234.32
1989	1,908	1,414	652	368	368	76	4,786	37,276	5.12	12.84	30,860	15.51	20,107	23,802.66
1990	1,540	1,680	598	383	158	75	4,434	41,178	3.74	10.77	34,598	12.82	20,353	21,785.49
1991	2,162	2,382	682	382	210	110	5,928	45,296	4.77	13.09	38,239	15.50	20,557	28,836.89
1992	3,920	2,662	747	380	254	136	8,099	50,811	7.71	15.94	42,217	19.18	20,752	39,027.56
1993	5,942	3,191	1,069	379	248	147	10,976	56,179	10.58	19.54	46,877	23.41	20,944	52,406.42
1994	7,671	3,884	1,117	349	205	173	13,399	61,891	12.39	21.65	51,934	25.80	21,126	63,424.22
1995	8,795	4,588	1,033	333	236	140	15,125	67,307	13.07	22.47	57,454	26.33	21,304	70,996.06
1996	9,603	4,964	1,295	365	315	142	16,684	73,330	13.10	22.75	62,921	26.52	21,471	77,704.81
1997	11,366	4,892	1,299	405	352	137	18,451	79,794	14.24	23.12	68,611	26.89	21,683	85,094.31
1998	12,307	6,374	1,083	498	420	122	20,804	86,798	14.18	23.97	74,566	27.90	21,871	95,121.39
1999	12,176	7,689	1,100	574	617	118	22,274	91,385	13.32	24.37	80,944	27.52	22,034	101,089.23
2000	24,071	-	1,135	712	639	98	26,655	96,633	24.91	27.58	89,333	29.84	22,216	119,981.09
2001	27,359	-	1,242	764	788	98	30,251	95,066	28.78	31.82	93,952	32.20	22,339	135,417.88
2002	28,317	-	1,193	894	990	88	31,480	97,343	29.09	32.34	96,396	32.66	22,395	140,567.09

GDP = gross domestic product, GNP = gross national product, Gov't. = Government.

Source: Internal data compiled by the Department of National Treasury, Ministry of Finance.

Table 7. Outstanding Debts in FY2002, All Levels of Government (NT$100 million)

Government	Borrowings in FY2002	Outstanding Debt	Total Spending in FY2002	Outstanding Debt/Total Spending (%)	Share of GNP Average of Previous 3 Years (%)
All Levels	2,549.55	31,480.36	25,394.94	123.96	32.70
Central (1)	2,450.00	28,316.80	16,345.60	173.24	29.42
Central (2)	2,247.00	28,316.80	16,345.60	173.24	29.42
Local Government	302.55	3,163.56	9,049.34	34.96	3.29
Taipei City	0.00	1,192.59	1,801.36	66.20	1.24
Kao-hsiung City	101.40	893.82	748.39	119.43	0.93
Counties and Cities	197.48	989.68	5,176.65	19.12	1.03
Taiwan Provincial Counties and Cities	197.48	989.68	5,085.88	19.46	1.03
Fukien Provincial Counties	0.00	0.00	90.77	0.00	0.00
Townships	3.67	87.47	1,322.94	6.61	0.09
Townships in Taiwan Province	3.67	87.47	1,316.15	6.65	0.09
Townships in Fukien Province	0.00	0.00	6.79	0.00	0.00

GNP = gross national product.
Source: Department of National Treasury, Ministry of Finance.

levels of government and on the level of outstanding public debt. The Public Debt Law stipulates that the combined outstanding debts of all levels of government should not exceed 48% of the average GNP of the preceding 3 years. The levels are 28.8% (plus the 12.6% of Taiwan Province's share after downsizing) for the central Government, 3.6% for Taipei City, 1.2% for Kao-hsiung City, 1.2% for all counties and cities, and 0.6% for townships. The amount of outstanding debt should not exceed 45% of the combined general and special budget in counties and cities, and 25% in townships. An additional flow-control scheme is also applied: the aggregate amount of borrowings in each fiscal year should not exceed 15% of the combined general and special budget of each government, central and local.

The Budget Law[20] limits public borrowings to investment purposes. Borrowings over 1 year by all levels of government can only be used to supplement insufficient savings for capital expenditure. Therefore, borrowings are essentially for capital spending, of which a relatively high proportion goes to public projects.

County and city governments cannot choose between issuance of bonds and borrowings from commercial banks and other financial institutions. Before the downsizing, the Provincial (Special City) Government Construction Bond Issuance Statute allowed only the special cities and Taiwan Province to issue bonds to raise funds for local infrastructure and capital projects. When the Local Government System Law was passed in 1999, bond financing was permitted to county and city governments on condition that their local councils pass bylaws, and that permission be granted by the Ministry of Finance. So far, no county or non-special city has drafted a bylaw or issued a bond.[21]

From FY1999 to FY2001, the central Government was the most heavily dependent on debt financing, followed by the two special cities. (This is evident also in 2002, as shown in Table 7.) Counties and cities as a whole, although financially less autonomous, had little resource to debt financing. However, this should not been seen as a result of better financial management or a more favorable division of tax and other own-source revenue. Large portions of county and city governments' proceeds were provincial grants before FY1999, and central government allotments during the previous 3 years. When aid from upper-level government could be relied on to fill a large part of the fiscal gap, borrowing became less important. The spending needs of county and city governments are also lower than those of the special cities, as some high-cost public services (e.g., senior high school education) assigned to Taipei City and Kao-hsiung City are provided by the central Government (formerly by the provincial government).

Data reveal that central government borrowings are primarily in the form of bonds issued, amounting to NT$282.8 billion in 1999 and NT$437 billion in 2001 (Table 8).[22] Local bonds are on a much smaller scale than central bonds. In 2001, outstanding local government bonds amounted to less than 5% of total outstanding public bonds. In 1994, 1995, and 1999, no local bonds were issued, while issued central government bonds amounted to NT$148 billion, NT$125 billion, and NT$282.8 billion, respectively. Local governments tend to rely more on direct bank borrowings to bridge their budget gaps. From FY1989 until downsizing took place, Taiwan Province issued provincial government bonds of only NT$80.2 billion, while its outstanding debts increased by more than NT$178.1 billion. From 1993 to the downsizing, Taiwan Province issued no new bonds. Outstanding bonds stand at NT$14 billion (Table 9).

Of the two special cities, Taipei has been more aggressive in bond financing. Table 6 shows that among the local borrowers Taipei leads Kao-hsiung and the counties and cities as a whole. Department of Finance data show that over 70% of Taipei city government borrowings are in the form of bonds. In contrast, Kao-hsiung city government relies on direct borrowings from commercial banks. Tables 10 and 11 show the annual amount of issuance by the two special cities from FY1991. Bond financing is obviously more important for Taipei City than for Kao-hsiung. In 2001, Taipei city government had a total of NT$124.2 billion in outstanding debts, of which over NT$70 billion was in the form of local bonds. The Kao-hsiung city government outstanding debt was NT$76.4 billion, of which NT$17.0 billion was in local bonds.

Table 8. Issues, Redemptions, and Amounts Outstanding of Government Bonds (NT$ million)

Year	Total			Issued by Central Government			Issued by Local Government		
	Issues	Redemptions	Outstanding	Issues	Redemptions	Outstanding	Issues	Redemptions	Outstanding
1986	36,334	10,632	92,131	32,000	8,362	73,508	4,334	2,270	18,623
1987	55,292	16,682	130,741	46,000	14,436	105,072	9,292	2,246	25,669
1988	74,470	21,199	184,012	64,500	18,150	151,422	9,970	3,049	32,590
1989	54,073	29,390	208,695	44,000	25,575	169,847	10,073	3,815	38,848
1990	13,693	47,734	188,774	0	42,410	127,437	13,693	5,324	61,337
1991	208,981	50,108	347,647	174,500	41,774	260,163	34,481	8,334	87,484
1992	250,359	46,602	551,404	225,000	34,105	451,058	25,359	12,497	100,346
1993	237,334	66,469	722,269	210,000	47,518	613,540	27,334	18,951	108,729
1994	148,000	72,511	797,758	148,000	51,385	710,155	0	21,126	87,603
1995	125,000	55,617	867,140	125,000	30,045	805,110	0	25,572	62,030
1996	245,000	115,863	996,277	225,000	93,964	936,146	20,000	21,899	60,131
1997	174,000	135,446	1,034,831	160,000	120,752	975,394	14,000	14,694	59,437
1998	38,000	136,932	1,043,899	12,000	125,972	969,422	26,000	10,960	74,477
1999	282,820	81,487	1,245,232	282,820	70,312	1,181,930	0	11,175	63,302
2000	362,500	127,397	1,480,335	346,500	119,394	1,409,036	16,000	8,003	71,299
2001	457,000	79,031	1,858,304	437,000	73,423	1,772,613	20,000	5,608	85,691
2002	436,200	79,968	2,214,536	426,200	74,684	2,124,129	10,000	5,284	90,407

Source: Economic Research Department, Central Bank of China. Various issues. *Financial Statistics Monthly Taiwan District*.

Table 9. Issues, Redemptions, and Amounts Outstanding of Local Government Bonds (NT$ million)

Year	Taiwan Province			Special City		
	Issues	Redemptions	Outstanding	Issues	Redemptions	Outstanding
1986	3,000	1,500	9,880	1,334	770	8,743
1987	5,000	1,220	13,660	4,292	1,026	12,009
1988	7,000	1,460	19,200	2,970	1,589	13,390
1989	—	1,800	17,400	10,073	2,015	21,448
1990	13,365	2,800	42,085	328	2,524	19,252
1991	26,879	5,640	63,324	7,602	2,694	24,160
1992	20,000	8,149	75,175	5,359	4,348	25,171
1993	20,000	15,107	80,068	7,334	3,844	28,661
1994	—	14,999	65,069	—	6,127	22,534
1995	—	18,220	46,848	—	7,352	15,182
1996	—	13,690	33,158	20,000	8,209	26,973
1997	—	9,811	32,347	9,000	4,883	31,090
1998	—	9,347	14,000	26,000	1,613	60,477
1999	—	—	14,000	—	11,175	49,302
2000	—	—	14,000	16,000	8,003	57,299
2001	—	—	14,000	20,000	5,608	71,691
2002	—	—	14,000	10,000	5,284	76,470

Source: Central Bank of China. Various issues. *Financial Statistics Monthly Taiwan District*.

Table 10. Taipei City Government Bond Issuance (NT$ million)

FY	Type	Volume	Interest Rate (%)	Maturity (years)	Outstanding
1991	Taipei City construction bond	7,000	9.75	7	0
1992	Taipei City construction bond	5,000	8	5	0
1993	Taipei City construction bond	7,000	8.325	5	0
1996	Taipei City construction bond	10,000	6.5	7	2,000
1997	Taipei City construction bond (1)	10,000	5.997	10	10,000
	Taipei City construction bond (2)	9,000	6.3	10	9,000
1998	Taipei City construction bond	5,000	6.7	7	5,000
1999	Taipei City construction bond	9,000	5.55	7	9,000
2000	Taipei City construction bond (1)	8,000	5.2	7	8,000
	Taipei City construction bond (2)	8,000	5.375	7	8,000
2001	Taipei City construction bond (1)	10,000	4.619	10	10,000
	Taipei City construction bond (2)	10,000	3.698	10	10,000
	Total	**98,000**			**71,000**

Source: Department of Finance, Taipei City Government.

Local government borrowings shown in these tables include only commercial bank loans over 1 year and bond issuances. For the central Government, borrowings for the 15 off-budget operation funds (i.e., not included in the annual central

Table 11. Kao-hsiung City Government Bond Issuance (NT$ million)

FY	Type	Volume	Interest Rate (%)	Maturity (years)
1991	Kao-hsiung public construction land bond	342	10	5
1992	Kao-hsiung public construction land bond	500	9.75	5
1993	Kao-hsiung public construction land bond	500	9.75	5
1998	Kao-hsiung City construction bond	5,000	6.525	7
1999	Kao-hsiung City construction bond (1)	5,000	6.120	7
	Kao-hsiung City construction bond (2)	7,000	5.500	7
	Total	**18,342**		

Source: Bureau of Finance, Kao-hsiung City Government.

government budget) managed by the Executive Yuan and various ministries had accumulated by end-2002 to NT$467.04 billion, excluding bank loans, which are not recorded in statistics on central government debt. Another invisible item in central borrowing is short-term (under 364 days) treasury bills, which amounted to NT$180 billion at end-2002. Short-term borrowings from commercial banks and local farmers and fishers' credit cooperatives by local government, including counties, cities, and townships in Taiwan Province, are not shown in the tables, either. At end-2002, the 21 counties and cities and 309 townships of Taiwan Province recorded a total outstanding short-term debt of NT$122.03 billion, of which NT$70.91 billion (about 58%) was bank loans, and of which NT$51.12 billion was provided through temporary overdraft arrangements. Total outstanding short-term debt amounted to 19% of these LGUs' expenditure needs. Kao-hsiung City does not borrow from off-budget funds yet relied on overdrafts amounting to NT$9.88 billion at end-2002, representing 13.2% of the city's annual budget spending. Taipei City, the biggest borrower among the LGUs, neither borrows from its off-budget funds nor uses short-term financial instruments.

The construction of Taipei City's rapid transit system was a major factor in the city's high debt. A 50% matching grant for this expensive project required local government spending of NT$222.0 billion, with NT$156.2 billion by the city alone. Taipei City borrowed from the public throughout the years of construction.

Underdevelopment of the Local Government Bond Market

As discussed in an Asian Development Bank research project,[23] the government bond market in Taipei,China is a recent phenomenon, and the most important issuer is the central Government. The local government bond market is still undeveloped.

Even in Taipei City, the most active local bond issuer, all public bonds have recently been term bonds of fixed or negotiated interest rates, and of fixed maturity from 5 to 10 years. Commercial banks act as financial service firms to find the best offer for investors in the bonds or to underwrite the issue. Except for local land bonds issued by Taiwan Province decades ago, all local bond issues are in the form of general obligation debt, where payment of debt service and repayment of principal are financed only by general local revenue.

The first factor in the underdevelopment of the local government bond market is the relatively low cost of funds available through commercial banks, particularly for Taiwan Province, the heaviest borrower among first-level local governments before the 1998 downsizing. Since the Taiwan provincial government was the largest shareholder or owner of the most important commercial banks (including Bank of Taiwan, which issued the New Taiwan dollar), it was convenient and economical for it to obtain long- or short-term bank loans. Taipei city government held large blocks of shares of the Bank of Taipei before its privatization, while Kao-hsiung city government was an important shareholder of the Bank of Kao-hsiung. The cost of borrowing from banks by the two special cities could be reasonable if they bargained for it.

Loans from commercial banks and local credit institutions (such as the savings and loan department of local farmers' and fishers' cooperatives), are readily available even for LGUs suffering serious financial difficulties, since loans to the government are considered risk-free.

A study by the Taipei Finance Department has compared the relative advantages of bond finance versus loan finance. Bond finance is more cost effective only if the interest rate is expected to rise, since local government bonds pay a fixed interest rate. Bond financing has additional administration costs, including issuance charges (usually 0.045–0.025%) and charges on interest payment and principal repayment (1% of bond issuance). Borrowing from commercial banks, however, is more flexible in duration, interest cost, and swapping of loans.

A second factor in the weak local bond market is the lack of economies of scale in the issuance of local government bonds. After the downsizing, the financial gap for local governments as a whole was reduced by more than 60%. The annual budget deficit for all local governments was less than NT$65 billion, or equivalent to $2 billion at the current exchange rate. On average, it is expensive to issue local bonds for an individual locality on a small scale.

A third factor is the structure of demand for local goods and services in Taipei,China. Basic local infrastructure and services (roads, water, power, schools, public health, etc.) are well provided. Huge investment projects (such as improvement of an anti-flooding system and large-scale environmental protection and conservation programs, which usually involve several localities) are financed by central grants or direct central provision. Thus, local governments spend more on social welfare programs such as old-age pensions, subsidies for low-income household, and cultural and recreational facilities. However, under the Budget Law, debt cannot finance social welfare and service spending, but project grants from central government ministries or departments can be used to build cultural centers or museums if the local government fails to raise additional revenue. Alternatively, mechanisms for private sector provision or participation are available.

For example, the build-operate-transfer (BOT) mechanism was introduced in Taipei,China about 15 years ago. The high-speed rail project under construction is the most expensive BOT project in Taipei,China and was initiated by the central Government. Local governments, especially Taipei City, also used this new financial and development mechanism to implement some public facility projects or to generate additional revenue.

A good example of a local government BOT project is Taipei 101—a 101-story building of shops and offices. To compete with Hong Kong, China; Shanghai; and Singapore as a regional financial center, Taipei City decided to build a financial center with advanced facilities to meet the office space needs of international investment banks, foreign banks, and local financial institutions. The city government announced a BOT investment project to interested bidders. The project carried a lease contract of 70 years on land-use rights. A lump-sum initial charge and annual land rent will be collected by the government. The highest bid for the development rights was double the city government's sought amount at NT$20.7 billion. The total project cost is estimated to be NT$56.8 billion, not counting the initial charge and annual land rent. Once completed, the building will be the tallest in the world and host the Taiwan Security Exchange.

Taipei 101 is an example of real estate development rather than local infrastructure project that needs public funds. As an alternative, the city government simply has to sell the site to a private developer and regulate the mode of development by revising the zoning bylaw. BOT was adopted because the city government was reluctant to sell land and because the financial cost of the project, including the cost of land acquisition, would be too high to attract investors. Other BOT projects undertaken by the city government include a wholesale flower market and related facilities, and the multimode transportation depot for the mass rapid transit (MRT) system, local buses, and long-distance buses.

Other LGUs also undertake BOT projects, such as underground parking lots in Taipei City and recreation resorts in Ilan county. In Kao-hsiung City, the financial arrangement for the first phase of the MRT, now under construction, is divided into two parts: (i) self-liquidation, to recoup the cost from revenue generated by future operation; and (ii) nonliquidation. Total investment in this second local MRT is estimated to reach NT$181.4 billion, of which the city government shares 83.2%, or NT$150.9 billion, and the private developer 16.8%. Of the city government share, the central Government bears 79% and Kao-hsiung city government 21%. The project is expected to be finished by end-2006 and will be operated by a franchised corporation for 36 years.

BOT has recently become popular with central and local governments to directly provide public facilities with reasonable economic returns. Private investors in most BOT cases assume sole financial responsibility. In projects involving a sizable investment, a preferential financial arrangement can be applied for through the Long- and Medium-Term Loan for Development Projects Fund administered by the Council for Economic Planning and Development. Borrowing through issuance of corporate bonds is also a legitimate financial tool.

Feasibility of a Local Bond Market

Given the financial difficulties of the central Government, LGUs are fully aware that they can no longer rely on central fiscal funding as a stable source of revenue. The falling local tax collection due to a stale property market also hurts LGUs' ability to meet expenditure. Inevitably, they have to depend more on debt financing for local investment. However, higher reliance on debt may not mean higher demand for bonds since credit can be obtained from commercial banks at lower cost. Thus, the governments of Taiwan Province and Kao-hsiung City prefer loans to bonds.

In capital projects where long-term financing is needed, however, local bond financing is more appropriate for the local government than bank loans, which have short- and medium-term structures. The following paragraphs discuss various aspects of local bond financing.

Legal, Regulatory, and Institutional Conditions

Taipei,China has a legal framework to obtain long-term funds for development through local government bond financing. Under the Local Government System Law and Law Governing the Allocation of Revenues and Expenditures, the special cities and the county/city governments are empowered to issue local government bonds, provided that local councils pass the regulations on issuance and management. Limits on annual borrowing and total outstanding debt, including bonds, are stipulated in the Public Debt Law. Approval from the central Government is required if foreign bonds are to be issued by local governments. It is unclear whether prior approval of domestic issuance should be granted by the central Government. If so, it is an open question whether the Ministry of Interior Affairs, which is in charge of local autonomy development, or the Ministry of Finance, or both, should supervise the process. Commercial banks, as in the case of local bond issuance by Taipei and Kao-hsiung cities, are ready to underwrite local issues. Commercial banks and other financial institutions (investment banks, trust investment corporations, securities and money market bill financing corporations), domestic and foreign in most cases, have acquired sufficient experience and expertise in handling the issuance, sale, and management of bonds by taking part in the national government bond market since the 1990s. A qualified intermediary system exists to develop an active local bond market.

Although central government bonds have dominated Taipei,China's domestic bond market in terms of volume of issuance and daily transactions, it has no system for complete and timely disclosure of information about the operation of the central Government to the investors—by the underlying borrower, by the central Government itself, or by financial services firms. Since central government bonds are considered risk-free, the issued bond is not subject to credit analysis or creditworthiness examination. Government bonds issued by Taipei City and Kao-hsiung City are not subject to a credit rating either. In contrast, corporate bonds issued by private firms have a popular credit rating, although it is not legally required. Professional firms are available to provide these services. Disclosure of relevant information, credit analysis, and credit rating will surely be important in strengthening market operations once a larger number of LGUs decide to open the door to bond financing and the scale of the local bond market expands as transfers from the central Government fall. A legal framework and market structure for more local government bond issues exist, in addition to that for the two special cities. Whether a more developed local bond market can be created depends on demand for long-term investment funds for local capital spending, and on whether bond issuance has an edge over other forms of financing, such as direct credit from banks.

Major Impediments to the Development of a General Local Bond Market

Economies of scale are an important factor. It is not economically attractive for separate LGUs to issue public bonds in small amounts, especially when bank loans, usually at lower financial cost, are readily available.

Endnotes

[1] After the downsizing, the Local Government System Law empowered counties and cities to issue local government bonds, provided that local councils pass a statute permitting this.

[2] For a classical treatment of topics on fiscal federalism, see Musgrave (1969). Oates' correspondence theorem, which discusses efficiency in provision of public goods of different benefits is introduced in Oates (1972). Detailed discussions on fiscal relations among national and subnational governments in industrial and developing countries are in Ter-Minassian (1997).

[3] Central implementation means enforcement of the Law Governing the Allocation of Government Revenues and Expenditure by the central Government, not central collection of all taxes, national and local.

[4] Brazil and Taipei,China (before 1999) were the only exceptions to this. VAT is a state or provincial or city tax in these two countries. For a description of VAT and other local public finance problems in Brazil, see Ter-Minassian (1997).

[5] The official title of the business tax was changed to value-added and non-value-added tax in July 2001.

[6] Basically, a family or a tax unit consists of the husband, wife, and their dependents for married taxpayers, and the individual and his or her dependents for unmarried taxpayers.

[7] A brief introduction to all taxes in Taipei,China and some related issues are in Taxation and Tariff Commission (2002).

[8] For more details, see Steve W. Tsui (1999), *Land Value Increment Tax for Redistribution and Efficiency in Taiwan, ROC*. Proceedings of the International Seminar on Land Policy and Economics Development. Taoyuan: International Center for Land Policy Studies and Training.

[9] Taipei City perhaps is the only exception, but even there LVIT collection in 2001 finally decreased to less than 40% of the FY1999 level, which was about the same as in FY1981.

[10] Schools are now allowed to select textbooks.

[11] Lately, with the governor of Taiwan Province and the mayors of the two special cities elected by popular vote, a form of informal consultation has been established with the central Government in the appointment of local police chiefs.

[12] Of the three, education takes the largest share.

[13] Pay raises are uniformly implemented in the central Government and all local governments.

[14] Even after the downsizing, the Taiwan provincial government still provides grants-in-aid, although in reduced amounts, to cities and counties within its jurisdiction, even if the provincial government does not now have any autonomous own-source revenue. The provincial government can only spend the money received from the central Government. Before the downsizing, the 16 counties and five cities, and even the townships, relied on provincial grants, a very high percentage of which was distributed to lower-level units based on index of financial needs, population size, number of school children, and size of locality. A rough formula to impute the grants was used to distribute the limited resources, but the results were often adjusted for political and factional reasons, according to recipient entities that suffered unfair sharing of the grants. The effectiveness of the formula in reducing horizontal inequity between rich and poor cities and counties was also often challenged.

[15] In FY1999, the balancing budget fund was eliminated from the central government budget by a redefinition of the proceeds in this fund as the revenue to the recipient local government, no longer to the central Government. In other words, the local government received the transfers, but the revised law states that they are considered own-source revenue. Hence, the degree of fiscal autonomy will be higher in this new setting.

[16] After deducting 3% expenses relating to the "lucky stakes" program.

[17] In the second half of FY2000, the 6% special tax-sharing reserve was predistributed to the counties and cities during the budget allocation period right after the Legislative Yuan passed the central government budget. The reserve was distributed at the request of cities and counties, which had accused the central Government of keeping the reserve to use for political or partisan purposes. Some of the poor counties failed to balance their current account, which violated the Budget Law. Hence, the central Government did not keep any extra resources for emergency local needs such as the devastating earthquake of 21 September 1999. Therefore, the distribution shares were 47% for the special cities, 41% for counties and cities, and 12% for the 309 townships.

[18] Average fiscal capacity of the special cities is calculated as follows: the ratio of own-source revenue per capita of the special cities to own-source revenue per capita of a particular special city (denoted by Si) is taken. Si is multiplied by population size (TSi). Finally, the ratio of TSi to the sum of all TSi is taken.

[19] This plan was later scaled down to the Twelve Major Development Projects Program because of financial obstacles, especially at the local level.

[20] As pointed out by Ter-Minassian and Craig (1997), rules that limit local governments' debt financing to investment purposes are common in industrial countries such as Germany, Switzerland, and most states in the United States.

[21] The largest and most populous Taipei county recently asked the Department of National Treasury, Ministry of Finance, to regulate the issuance of its bonds.

[22] Data in Table 8 are for calendar, not fiscal, years.

[23] Hsueh 2001.

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Thailand

Sakon Varanyuwatana
Associate Professor
Faculty of Economics
Thammasat University
Bangkok

Acronyms

ADB	Asian Development Bank
ASCO	Association of Securities Companies
B	baht
BMA	Bangkok Metropolitan Administration
LGU	local government unit
PAO	provincial administrative organization
RUDF	Regional Urban Development Fund
SAO	subdistrict administrative organization
SEC	Securities and Exchange Commission
SET	Stock Exchange of Thailand
Thai BDC	Thai Bond Dealing Center
TRIS	Thai Rating and Information Services
VAT	value-added tax

Executive Summary

Thailand is a unitary state with a highly centralized fiscal system. The past decades have seen many attempts to promote autonomy and decentralize responsibility to local government, which has a substantial public service delivery role. This role needs to be strengthened, partly because early attempts to delegate autonomy to local bodies had no clear direction and intention.

Local administrations are categorized into municipalities, provincial administrative organizations (PAOs), subdistrict administrative organizations (SAOs), Pattaya City, and Bangkok Metropolitan Administration (BMA).

An important element of decentralization is increased fiscal capability of local governments to finance their own public services. Before the 1997 Constitution, many measures devolved fiscal autonomy and responsibility but did not increase local fiscal power. The most significant effort toward fiscal autonomy came after the promulgation of the 1997 Constitution. The Plan and Procedure for Decentralization Act of 1998 was designed to reassign functional responsibilities between the central Government and local governments, and among local governments. The law increased the share of local government expenditure, assigned more revenue sources to local governments, revised the grant transfer system to be more transparent and predictable, and promoted local accountability.

The most important feature of the new fiscal decentralization under the 1997 Constitution is the sharing system. The share of local government revenue to total central government revenue under the 1997 Constitution was mandated to be no less than 20% in FY2000 and no less than 35% in FY2006. The decentralization law also reassigned expenditure responsibility among local government bodies. For the first time, local government bodies have been recategorized into two tiers: (i) municipalities, Pattaya City, and SAOs; and (ii) PAOs as an upper tier of local government within a province. Revenue sources are reclassified according to reassignment of functional responsibilities. Although the decentralization plan allows for improvement of revenue opportunities, weaknesses of tax revenue sources remain, as the decentralization plan did not change the structure of these sources. The central Government is preoccupied with stimulating the country's economy in the short term, requiring an increase in public expenditure. As a result, the change in local revenue has been relatively insignificant.

The local government revenue base has been broadened by decentralization, and the share of local government revenue to total central government revenue has increased. However, the revenue distribution formula has focused mainly on the aggregate level of local revenue, causing inequality among local governments.

Each type of local government has its own functional responsibility and tax and nontax revenue sources. The tax revenue is composed of locally levied taxes, surcharges, and shared taxes collected by the central Government and distributed to local governments. Local taxes accounted for only around 10% of total local government revenue during 1996–2000, implying heavy financial dependence on the central Government. The surcharge and shared taxes are the most important local revenue sources, accounting for 40% of total local government revenue. The major surcharge taxes are value-added tax (VAT) and the excise tax. Nontax sources of local government revenue include intergovernmental transfers or grants, and borrowing. Intergovernmental transfers are a major source of revenue but are unpredictable, and over 70% are for specific purposes. Borrowing is still a minor element because of local governments' limited access to private financial sources.

Local government expenditure falls under the categories of central, regular, investment, or special. Data are unavailable on local government expenditure by function since a large share of local revenue comes from specific central grants. Regular expenditure is the largest expenditure item, followed by construction, which together absorb over half the total budget.

Inadequate revenue is the major obstacle to delegation of autonomy to local government. Borrowing can help overcome this problem. Issuing local bonds, a form of borrowing, is attractive because it can provide greater diversification and liquidity to investors than direct loans from financial institutions. Local governments, however, should meet the requirements of financial disclosure, creditworthiness, credit analysis, and credit ratings. Local governments must also design a system to control local borrowing and prevent local financial bankruptcy. To help local governments, particularly municipalities, acquire skills and expertise in project financing through unconventional sources, the Government Savings Bank, in cooperation with the World Bank, established the Regional Urban Development Fund (RUDF) to extend loans to municipalities and provide training in financial management for municipal staff.

Decentralization has initiated channels for local government borrowing, though two major problems constrain local borrowing: moral hazard and lack of local financial management capacity. The regulatory and institutional frameworks for the local government bond market also prevent local governments from accessing private institutions for funds. SAOs and Pattaya City are not allowed to float bonds, while municipalities, PAOs, and BMA are allowed to, but must secure approval from the Ministry of Interior. Under the decentralization law, bond issuance and local borrowing are even tighter than before as all local borrowings must obtain cabinet approval to prevent local authorities from borrowing excessively or doing anything that could affect the national economy. In this regard, the central Government has issued regulations on borrowing by public agencies to prevent a public debt crisis. These regulations also apply to local bond financing.

Local bond financing suffers regulatory, legislative, administrative, and structural constraints. Major concerns in developing this area are (i) improving the creditworthiness of local governments, which have poor revenue-generating capacity; (ii) improving the local budgetary system, accounting methods, and internal and external auditing systems; and (iii) promoting transparency and standard financial management practices. Local governments should improve their fiscal position by increasing their share of own-revenue collections and thus promote fiscal decentralization and build up local government creditworthiness. The central Government should reassign public expenditure between itself and local governments based on a clear definition of central and local government investment projects. The central Government should also establish a positive environment and clear strategic policy to develop local bond financing before local governments borrow. The intergovernmental transfer system should be made predictable and consistent and help local governments anticipate what type of project will receive central government financing.

During the transition period, the central Government may expand the role of RUDF as a credit pool to disperse or minimize the risks of private financial institutions that may be interested in lending to local governments. For their part, local governments should develop their human resources and undertake budgetary system reforms, local development planning, accounting, and financial control and auditing. The assistance of the Asian Development Bank will be significant in developing local bond financing.

Introduction

Thailand is a unitary state with a highly centralized fiscal system. The past decades have seen many attempts to promote autonomy and to decentralize responsibility to local government as part of the process of transforming the country from an absolute monarchy to a democratic system. As part of this process, the role of local government in providing public services and promoting democracy must be enhanced, primarily by strengthening the local fiscal system. Attempts to build local government capacity have largely failed, due to lack of clear direction and resources. However, the 1997 Constitution decentralized public administration and devolved central government functions to local governments to meet people's basic needs and promote local political reform and social responsibility.

Decentralization requires local governments to be able to finance their public services. However, although the law allows local governments to tap tax, nontax, and other conventional revenue sources, such sources are few and narrow. Local governments thus remain highly dependent on central government financial assistance.

Local governments should have other revenue sources such as borrowing, which presents a sound alternative since (i) long-term investment funds to develop infrastructure are too large to be raised from local revenue sources and even from central government transfers, (ii) local infrastructure requires maintenance, and (iii) direct beneficiaries of local public services should help finance investment to promote equity and efficiency.

Thailand's financial sector is sophisticated, and many of its aspects meet international standards. While the country has many financial institutions that serve the fast-growing domestic financial market, however, local bond financing does not exist. Local government authorities lack technical knowledge and awareness of the benefits of bond financing, which is why no agency helps local governments gain direct access to the capital market. Local governments must fulfill certain requirements to qualify as borrowers, and, without a full understanding of the consequences of bond financing, may do more harm than good to the economy if allowed uncontrolled access to capital markets. Local governments' budget mismanagement could cause economic instability. Local budgets are thus subject to tight central control and monitoring, which can enhance local governments' creditworthiness but also discourage local bond market development.

This chapter provides the background to ongoing fiscal decentralization moves and discusses the possibility of introducing local borrowing as an alternative revenue source to finance local investments in public services.

Development of Local Government

The public administration structure has three levels. The first is the central Government, which administers all national affairs. It has an executive body composed of agencies from ministries and various departments. Every ministry divides and delegates its powers and decision making to its provincial representatives.

The second level is the province or region, run by the field staff of various ministries. The provincial governor, appointed by the Ministry of Interior, acts as chief of the provincial field staff, supervising them and ensuring that they perform their functions. The provincial governor and central staff represent the ministries and must strictly follow their policy guidelines.

The third level is local government. The central Government gives it autonomy in governing local affairs. Before the 1997 Constitution, all local governments were under the supervision of the Department of Local Administration, Ministry of Interior. There are six local administrative entities: sanitary districts, municipalities, PAOs, SAOs, Pattaya City, and BMA.

Sanitary Districts. The sanitary district was the first local administrative unit. The Bangkok Sanitary District was established in 1898 as an experiment. It was the first attempt of the central Government to delegate local administrative functions such as sanitation, maintenance and control of buildings, and collection of household and commercial taxes and fees. After the 1932 revolution, all 35 sanitary districts were upgraded to municipalities. However, establishment of more municipalities was sluggish as most revenue was used to pay salaries of officials. The central Government then returned to promoting sanitary districts in 1952 to train officials outside municipalities, PAOs, and SAOs. The sanitary committee does not separate legislative and executive functions and consists of appointed provincial staff members and locally elected people.

Under the decentralization law, all sanitary districts are phased into municipalities in accordance with the Constitution, which requires all local affairs to be governed by local representatives only. To enhance the role of sanitary districts, the central Government upgraded them to municipalities but did not consider the districts' fiscal condition, thus creating a great fiscal disparity between old and new municipalities. Old ones had broader revenue bases than new ones and, therefore, were in better economic condition. The central Government allocated funds to fill the revenue gap but in an ad hoc manner, widening the revenue gap and worsening the horizontal and vertical imbalance among local governments.

Municipalities. These are the most important local governments and have the greatest degree of autonomy. Initially they were established in every district in the country. However, during 1946–1971, only three new ones were established.

Municipalities are cities, towns, or villages, classified by population, revenue capacity, and ability to provide public services. Before decentralization, the country had 150 municipalities.

Under the Municipal Act of 1953, municipalities can collect revenues from the following: (i) taxes; (ii) fees and fines; (iii) income from assets; (iv) public services fees; (v) revenue from bond issuance and borrowing (which need approval from the municipal council and Ministry of Interior); (vi) borrowing from central ministries, departments, organizations, and other public entities; (vii) subsidies from the central Government and PAOs; (viii) donations; and (ix) other revenue as indicated by law. Municipalities may collect local levies, surcharges, and share taxes. Local levies are taxes on houses and rent, land development, signboards, and animal slaughter. Municipalities may also add a surcharge of up to 10% on central government taxes on business, gambling, liquor and nonalcoholic beverages, rice exports, and VAT.

The 1997 Constitution redefined municipalities' functions and revenue assignments (see below).

Provincial Administrative Organizations. These are provincial units of local government created in 1955 to serve all inhabitants not within a municipality, sanitary district, or SAO. A PAO consisted of an elected assembly and the provincial governor as chief executive. In 1997, however, the governor's position was abolished and the chief executive was chosen from among the elected members of the assembly. PAOs coordinate and support local government units (LGUs) within their districts. PAOs are the first level of local government and so their duties are different from those of other local governments, and include:

- preparing the PAO plan and collaborating on the provincial plan;
- supporting subdistrict councils and other local administrations;
- coordinating and jointly performing the duties of subdistrict councils and other local affairs;
- providing grants to other LGUs;
- protecting, maintaining, and preserving forests, land, natural resources, and the environment;
- providing educational services;
- supporting democracy, equity, and people's rights;
- supporting people's participation in local development;
- supporting suitable technological development;
- providing and maintaining public water sewage;
- providing public garbage disposal and waste treatment;
- protecting the environment against pollution;
- operating and maintaining land and water transport terminals;

- supporting tourism;
- supporting commerce and investments by joint ventures or syndication;
- constructing and maintaining land and water transport hubs with other local governments;
- providing and maintaining central markets;
- supporting sports, athletics, traditions, and local culture;
- providing provincial hospitals, medical treatment, protection, and control against contagious diseases;
- providing museums;
- providing mass transit and traffic engineering;
- protecting against disaster and providing disaster relief;
- maintaining public order;
- supporting other government agencies and local governments in local development;
- providing social welfare services for women, children, the elderly, and disabled; and
- providing other services as mandated by other laws or decrees;

PAO revenue sources are taxes on petroleum and petroleum products, tobacco, specific business, vehicles, education, duty on birds' nest collection, minerals, and hotel receipts; VAT; fees, fines, and license permits; and PAO public utilities' income.

Subdistrict Administrative Organizations. These are the newest and smallest LGUs in Thailand. SAOs were delegated by the central Government to be self-governing units at the village level. SAO expenditures are financed through appropriations from the Department of Local Administration under the budget of the provincial council and from the Department of Community Development through its rural program budget. Before 1995, SAOs were not legal entities, which meant they had no legal power to perform public functions, and were financially and legally constrained from performing their functions. Financially, SAOs had to rely on central allocations. Now, however, SAO members are elected and SAOs can make their own regulations and develop plans.

A subdistrict council can be promoted to the status of an SAO if it has a regular revenue of more than B150,000 a year, or has that average revenue for 3 consecutive years. The only difference between an SAO and subdistrict council is administrative structure. An SAO consists of the council and committee, which act as the executive body.

SAO revenue comes from (i) taxes, (ii) fees and fines, (iii) income from assets, (iv) public utility revenue, (v) SAO businesses, (vi) central government subsidy, (vii) borrowings from public agencies or corporations, and (viii) other revenue as indicated by law. SAOs are allowed to levy taxes on buildings and land, land development, signboards, animal slaughter, education, and birds' nests. SAOs receive a share of the motor and vehicle tax and surcharges on taxes on specific business, liquor, gambling, tobacco, and mining royalties, as well as VAT. SAOs also receive fees from the use of underground water and airports; concession fees from fisheries, mining, timber, and petroleum exploration; and national park fees from the central Government.

Pattaya City. A chartered city created from Pattaya sanitary district in 1978, its functions resemble those of city management in the United States. The rapid growth of its tourism industry made the city incapable of handling urban development problems. Pattaya was thus given greater independence and flexibility. The city council oversees city development and passes ordinances that are not in conflict with national laws. The city gets its revenue from taxes; fees, fines, and permits; property income; social services; business income; bond issuance; borrowings, including those from abroad; subsidies; external assistance funds; and the same sources of revenue as municipalities and SAOs.

Bangkok Metropolitan Administration. BMA, a special form of government, was established in 1972 through the merger of all LGUs in Bangkok and Thonburi into one government entity, with unique organization and functions. The BMA assembly acts like a legislative body, reviewing and supervising all administrative works of the governor and his or her staff, and proposing and passing city ordinances. Assembly members and the governor are directly elected by BMA citizens for a term of 4 years. Four appointed deputy governors help the governor. BMA revenue sources are the following: taxes; fees and fines; income from assets; public utilities income; BMA businesses; BMA bond issuance; borrowings from public and corporate agencies; subsidies and grants; international assistance; international borrowings; and revenue from state enterprises operating in Bangkok. BMA can collect taxes on land and buildings, land development, signboards, petroleum and petroleum products, tobacco, specific businesses, education, vehicles, gambling, animal slaughter, hotels, and real estate registration; excise taxes on liquor and tobacco; mining royalties; VAT; and airport fees.

Local Fiscal Development before the New Constitution

Before the new Constitution, local government reforms were fragmented and focused only on certain local governments, and mostly on their administrative and bureaucratic structure, rarely on improving their financial condition (Box 1). Local government finance remained under the tight control of central agencies.

Box 1. Local Government Reform in 1994

Local government reform in 1994 gave legal status to all subdistrict councils and created the subdistrict administrative organizations (SAOs). Legal bodies can (i) enter into contracts, (ii) levy taxes and collect fees and fines, (iii) borrow from commercial sources, and (iv) receive subsidies from the central Government.

The purpose of the reform was to loosen the control of the Ministry of Interior and give SAOs more administrative freedom and generate more local participation. Before the changes, SAOs were directly under the Ministry of Interior, with all decisions made centrally and people having little say in local affairs. Thus, many public services provided by the village headman and the subdistrict chief did not necessarily meet or reflect local demands.

Overcentralization was burdening the central Government and producing questionable local government performances. The new Constitution also ignited public demand for more decentralization and clipped the powers of the village headman and subdistrict chief, thus enhancing people's participation in local affairs.

Some measures increased the role of elected officials in local political and economic affairs:

- The provincial administrative organization (PAO), formerly headed by the provincial governor (a Ministry of Interior appointee), is now headed by a directly elected official.
- The subdistrict chief and village headman, who were once appointed to local development committees, must now be directly elected.
- The role of central government agents (e.g., village headman, subdistrict chief) and that of local representatives should be clearly defined. If these agents want to participate in local government administration, they must resign from their positions and run for office. This process clarifies the role of SAO executives and removes central control exercised through these agents.

Early Attempts to Improve Local Financing

Of the central fiscal reforms to increase the revenue resources of local governments, the most significant were those introduced by the 1997 Constitution, although some major initiatives have allocated more revenue sources to local governments since 1992. The local revenue improvement initiatives involved (i) increasing (or improving) the revenue instruments available to local governments, (ii) increasing the proportions of surcharges and shared taxes allocated to local governments, and (iii) changing the allocation formulas for central government grant programs. However, only two revenue reforms (among many proposed) were implemented: (i) reducing the tax collection fee by central Government on VAT from 5% to 3%, and (ii) transferring the tax levy on birds' nests to local entities where it is collected. Consequently, local revenue received from these adjustments remained insignificant, with virtually no major impact on the revenue condition of local governments.

During the economic crisis, the central Government implemented some economic stimulus packages. One was the reduction of its fee on the transfer of property and land from 2.0% of total property value to 0.01%, but this significantly hampered local revenue capacity. During the political reforms of 1995–1996, the attempt to draft a new constitution and decentralization received attention as a scheme to encourage people's participation in a democratic system. The new Constitution provided fresh opportunities to overhaul the local fiscal system. However, the other local fiscal reforms that have been introduced have not progressed.

Local Government Reform under the New Constitution

The 1990s witnessed a number of reforms to strengthen local governments. While some of these reforms remain to be translated into concrete policy, they offer potential for significant change. The most important reforms are (i) institutional changes at the subdistrict level, (ii) increased role for elected officials in provincial and sanitary districts, (iii) a new constitution created with substantial inputs from civil society, and (iv) a number of tax (and budgetary) initiatives to generate more revenue resources for local governments.

The new Constitution is the first one to have decentralization as a goal. Article 285 states that all local administrative organizations are required to have a directly elected local assembly and a local administrative committee. The local executive may be directly elected or chosen from the local assembly.

Article 286 enhances direct democracy by allowing members of the local assembly or local administrators to be dismissed at the request of three quarters of participating voters (who must represent at least half the eligible voters). Article 287 allows a group representing at least half the eligible voters to request the chair of the local assembly to issue a local law or regulation. In the past, some local administrators were appointed by the provincial governor, and citizens had no right to recall them or to propose their own laws and regulations.

The 1997 Constitution expands the role of local governments. It mandates the central Government to give autonomy to localities according to the will of the people (Article 282). Any locality that meets the conditions of self-government has the right to local administration (Article 283). Any supervision by higher levels of government will be to protect the interests of local citizens or the nation as a whole and should not substantially affect the principle of self-government (Article 283).

To provide for continuing decentralization, Article 284 calls for a law that defines the plan and procedure for decentralization, which must cover the following: (i) delineation of powers and duties of the state and local organizations in providing and managing public services; (ii) allocation of taxes and duties between the state and local administrative organizations; and most crucial, (iii) creation of a national decentralization committee to carry out the first two tasks. This committee will consist of an equal number of representatives of state agencies[1] and of local organizations, and other experts on decentralization.

In addition, the Prime Minister should preside over the committee to ensure neutrality of state agencies. It will review the delineation of responsibilities and resources every 5 years, and prepare a decentralization plan to be submitted to the Cabinet and Parliament for approval. The plan should undertake the following:

- Define the relationships and functional responsibilities between central and local governments, and among local governments, including the allocation of functions, subsidies, and central budget.
- Define local revenue sources and identify means to improve local taxes and revenue.
- Outline the stages and means to transfer functions from the central to local governments.
- Recommend means of coordinating the transfer of public officials from central agencies to newly assigned functions and resources.
- Propose criteria for allocating resources, including subsidies and central budget, among different levels of government.
- Propose legislation, decrees, regulations, administrative guidelines, and rules to implement the decentralization plan on time.
- Propose a system to promote transparency in government operations and public participation at the local level.
- Monitor the progress of the implementation of the decentralization plan.

The 1997 Constitution's objectives include (i) increasing the share of local government expenditures through transfer of responsibilities from the central Government, (ii) assigning more revenue sources to local governments, (iii) making the system of grant transfer transparent and predictable, and (iv) promoting local accountability. The first task of decentralization is to clearly define central-local expenditure functions, including compulsory and optional local government functions, to eliminate the overlapping of functions and give an idea of the amount of revenue a local government needs. Local governments should be assigned functions most suited to them, while the central Government focuses on giving technical assistance to local governments and on monitoring and regulating the outcomes of such assistance. Duplication of central and local government functions, and functions among local governments, creates confusion in public service delivery and budget allotment. The decentralization law clarified functional assignments, vertically between central agencies and each type of local government, and horizontally across local government entities.

The law provides in detail the functional responsibilities of each type of local government and reclassifies 30 identical functions for municipalities, Pattaya City, and SAOs, and 29 functions for PAOs. BMA can perform all functions of both groups (Table 1).

The law reassigns the same set of revenue sources for municipalities, SAOs, and Pattaya City, and a different set for PAOs. BMA is permitted to mobilize revenue from both groups (Table 2).

The most important feature of the law is the mandatory fiscal target for each local government, based on reclassified revenue sources. The law stipulates that at least 20% of total central government revenue must be devolved to local governments, and this share must increase to not less than 35% in FY2006. The 20% share of local revenue is achievable through revenue transfer or devolution of central revenue sources to local governments. However, fiscal decentralization could lead to macroeconomic problems if financing precedes functional assignment of responsibilities. The Bureau of Budget, under instruction from the central Government, has transferred budgets previously allocated for central agencies to local governments without reassigning the functions to local governments. Actual transfer of functions to local governments cannot proceed as planned due to resistance and lack of knowledge among central government officers.

Local government capacity to generate own revenue should be built up to make local governments self-sustaining and accountable for public services. The law thus categorizes revenue sources for each local government, and groups municipalities, Pattaya City, and SAOs together and assigns them the same 20 revenue sources. Some revenue sources are new, such as the education tax, or provide the opportunity to improve the revenue-generating capacity of local governments (e.g., increasing the surcharge rate of VAT, and of the excise tax from 10% to 30%). However, the major drawback of the law is that it does not overrule previous laws and does not provide ways to improve tax revenue sources. Weaknesses of existing tax revenue sources remain. For example, the law does not resolve the problems of the land and building tax. It should be a major contributor to local revenue but is weakened by many exemptions and poor administration due to out-of-date tax laws, creating a gap in local revenue generation and increasing the burden of central fiscal transfer.

The structure of revenue sources has not changed much, except for the increase

Table 1. Functions of Local Government after the 1997 Constitution

Municipalities, Subdistrict Administrative Organizations, Pattaya	Provincial Administrative Organizations	Bangkok Metropolitan Area
• Provide local development plans • Provide and maintain land ways, waterways, and drainage ditches • Provide and control markets, harbors, bridges, and car parks • Provide public utilities and other construction • Support job training • Support business and investment • Support tourism • Manage education • Conduct social work and promote public welfare • Support the arts, customs, and local innovations and culture • Improve slums • Provide and maintain public parks • Support sports • Support democracy, equality, and people's rights • Support people's participation in local development • Maintain cleanliness • Eliminate garbage, water pollution • Provide public health services • Provide and control graveyards and crematoriums • Control animal breeding • Provide and control animal slaughter • Maintain security and cleanliness in cinemas and other public places • Manage, maintain, and utilize forests, land, natural resources, and the environment • Plan towns • Provide transportation and traffic engineering • Undertake building control • Guard against public danger • Protect life and property • Support other enterprises benefiting local people	• Provide a local development plan and coordinate it with the provincial development plan • Support other local governments in local development • Cooperate with other local governments • Provide subsidy to other local governments • Protect and maintain forests, land, and natural resources • Manage education • Support democracy, equality, and people's rights • Support people's participation in local development • Support appropriate technological development • Build and control systems to remedy water pollution • Eliminate garbage • Manage the environment and pollution • Manage and control land and water transport • Support tourism • Support business and investment, and operate local enterprises • Build and maintain roads and waterways linking local governments • Build and control central markets • Support sports, traditions, and local culture • Provide provincial hospitals and nursing services • Prevent and control infectious diseases • Provide museums • Provide mass communication and traffic engineering • Guard against public danger • Provide a provincial security system • Support the bureaucracy or other local governments in local development • Provide services to private sector, bureaucracy, state enterprises, or other local government • Undertake social work • Operate enterprises under the local government's authority • Perform other functions benefiting local people	• Manage Bangkok according to the Plan and Procedure for Decentralization Act

Table 2. Sources of Local Government Revenue after the 1997 Constitution

Municipalities, Subdistrict Administrative Organizations, Pattaya	Provincial Administrative Organizations	Bangkok Metropolitan Area
• Building and land tax • Land development tax • Signboard tax • VAT • Business tax • Excise tax • Motor and vehicle tax • Gambling tax • Education tax • Animal slaughter duty • Birds' nest tax • Royalty fees from mining • Royalty fees from oil wells • Fees from transfer of real estate • Airport fees • Liquor license fees and gambling license fees • Other fees, license fees, and fines • Underground water fees • Fees from using or benefiting from public services • Other revenue	• Petroleum tax • Tobacco tax • VAT • Business tax • Motor and vehicle tax • Education tax • Birds' nest tax • Royalty fees from mining • Royalty fees from oil wells • Hotel receipt tax • Other fees, license fees, and fines • Fees from using or benefiting from public services • Other revenue	• Building and land tax • Land development tax • Signboard tax • Petroleum tax • Tobacco tax • VAT • Business tax • Excise tax • Education tax • Motor and vehicle tax • Gambling tax • Royalty fees from mining • Royalty fees from oil wells • Animal slaughter duty • Hotel receipt tax • Airport fees • Fees from transfer of real estate • Liquor and gambling license fees • Other fees, license fees, and fines • Fees from using or benefiting from public services • Other revenue

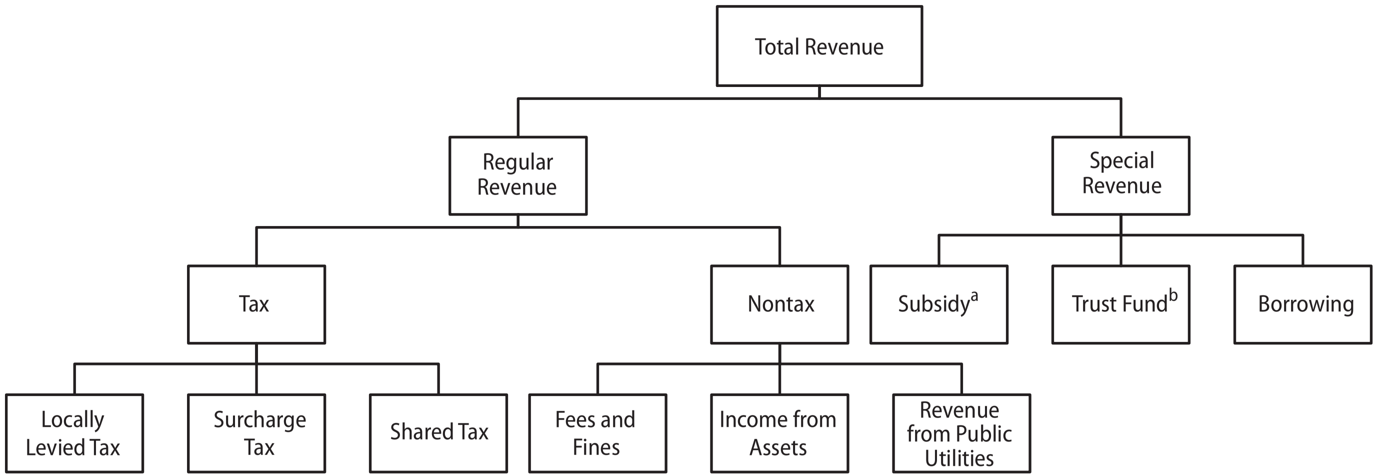
VAT = value-added tax.

of the local government revenue share in total central government revenue, and the formula for distribution of revenue among local governments. Weaknesses of local tax revenue remain. Many new taxes have been proposed, but none so far has materialized.

Local Finance System

The local government revenue structure is composed of regular and special revenues. Tax and nontax revenue sources are regular revenue, while subsidies, trust funds, and borrowings are special revenue. Tax revenue sources for local government include locally levied taxes and shared taxes. There are also many nontax revenue sources. The following paragraphs investigate the details of the taxation structure in local government financing (Figure 1).

Figure 1. Revenue Structure of Local Government



[a] Subsidy or grants include (i) general grants, and (ii) selective grants.
[b] Provident fund. By law, local government expenditure can not be more than 97% of the 3-year average of previous revenues plus central government grants. The balance of 3% each year is called the trust fund.
Source: Based on various laws of local government entities.

Structure of Locally Levied Tax for Local Government

Tax Revenue

Local tax revenue comprises locally levied taxes and shared taxes. Locally levied taxes include those on land and buildings, land development, signboards, and animal slaughter. The shared tax revenues are those collected by the central Government and distributed to local governments: VAT, excise tax, motor and vehicle tax, and revenue from natural resources.

Nontax Revenue

Nontax revenue consists of fees, fines, permits, and revenue from assets and utilities. Collection of some fees, fines, and permits are assigned to local governments to control and regulate local affairs, such as parking and control of building construction. The rates of all fees and fines are specified under many laws and regulations. Existing rates are very low and out of date, which is why collecting these revenues has never been important to local governments.

Local Borrowings

Local governments may legally borrow to finance their expenditure but are prohibited from borrowing from private financial institutions, except from trust funds, which are essentially local government savings imposed by law, created for each type of local government. Every local borrowing must be approved by the Ministry of Interior, which scrutinizes all borrowing proposals. All local governments are required by local budget regulations to set their expenditure at not more than 97% of the 3-year average of previous total revenue. This means that every local government has a budget surplus every year. The total amount of budget surplus is accumulated under the trust fund, which the local government can use for contingency purposes. Afterward, 10% of the trust fund must be contributed to the local development fund for each type of local government. An LGU can borrow only from this development fund.

A committee, composed of representatives from the local government and Ministry of Interior, manages the trust fund and local development fund. The committee scrutinizes proposals from each local government seeking to withdraw from the trust fund, and sets conditions for withdrawal, e.g., (i) local governments can borrow from the fund in case of emergency to finance unanticipated spending, such as a natural disaster, or if the estimated budget cannot cover expenses for personnel, and (ii) if in the first 3 months of the local fiscal year, local revenue generated is not enough to cover spending, the local government can borrow from the trust fund to spend on salaries and wages, remuneration services, materials, and utilities.

Intergovernmental Transfer Revenue

In addition to own-tax and shared tax revenues, local governments receive general and specific grants from the central Government. However, the amount available each year from the grant system is unpredictable, making it difficult for local governments to plan expenditures. The criteria for allocating grants are not systematic. Over 70% of intergovernmental transfers are allocated for specific purposes. The Ministry of Interior allocates these grants in an ad hoc and highly politicized manner. Although there are criteria for allocation (Table 3), the results of allocation diverge greatly from the formula. Recent reform proposals aim to reduce some of these problems. First, the size or pool of grant will be made more predictable each year by tying it to a stated (but increasing) share of central government expenditures. Second, specific grants will be phased down and be limited to areas that the central Government considers high priority. Third, the allocation formula for general grants will be made explicit and based on a number of income and demographic indicators, and performance indicators such as fiscal effort, cost recovery, and project evaluation.

Impact of Decentralization on Local Government Finance

Under the law, central agencies must transfer their functions to local governments, trim down central budgets, and, most important, transfer central agency employees to local governments. Financially, the local government must cope with its old and new functions. The central Government is bound by law to transfer enough revenue sources to support the expected increase in local expenditure. The first obvious impact of decentralization on local finances is the broader base of local revenue sources and increased opportunities for local governments to mobilize new revenue sources. Initially, the expansion of existing revenue sources increased the local government revenue share in the central budget from around 11% annually before decentralization to over 20% in FY2001. This share was to increase to around 22% in FY2002.

The second impact is the greater disparity in the fiscal positions of local governments after the central transfer. The revenue distribution formula has focused on the aggregate level of local revenue without considering the contribution of local own revenue. Disparity in local government revenue is due to vast differences in socioeconomic conditions, such as population and own-revenue base. These were not used as criteria in the revenue allocation formula, resulting in vertical and horizontal imbalances in revenue allotment among local governments. Some local governments either gain or lose from the allotment formula. Municipalities and PAOs are obvious losers, while SAOs are gainers. Not only are there more SAOs than municipalities

Table 3. Types of Grants Allocated to Local Government

	Type of Grant	Allocation Criteria	Additional Payment
General Grant	For municipalities	• B150 per head for general-purpose spending • Five levels for general-purpose spending depending on class of municipality (B700,000, B800,000, B1.2 million, B1.3 million, and B1.4 million)	
	For sanitary districts	• B100 per head for general-purpose spending • B300,000 for any subdistrict administration whose revenue (excluding grant) is below B300,000	
Specific Grant	For specific municipalities and sanitary district development projects	• To receive the grant they must meet the following criteria: (i) follow central policy (20%); (ii) fulfill local needs (30%); (iii) have appropriate geographical conditions, population, and local revenue (30%); and (iv) be efficient (20%)	
	For areas facing pollution or development problems, or areas with high potential to become tourist spots	• For special municipalities and sanitary districts: amount of grant depends on size of project, and on central government discretion	
	For water supply provision	• For municipalities and sanitary districts that have a water supply shortage	
	For municipal office buildings	• For municipalities just established in new emerging provinces and in border areas	50% of construction costs must be matched by municipal funds
	For garbage collection and disposal	• For municipalities and sanitary districts that lack equipment and need to replace obsolete equipment	
	For Pattaya City development projects	• For Pattaya City	

and PAOs combined, but SAOs, which have poor revenue-generating capacity, receive most of the devolved functions.

There is also a revenue allotment disparity between old and new municipalities. Old ones have established revenue bases and efficient collection systems, making them relatively self-sustaining. New ones, however, are poorer. The revenue allocation formula based on equality adversely impacts local government efficiency and causes fiscal imbalance. However, old municipalities that have more responsibilities and greater revenue requirements receive a smaller revenue allotment under the present fiscal decentralization system, adversely affecting and disrupting the public service delivery of large local governments.

The third impact is that the increment in local revenue was substantially a result of transfer payments from central grants and shared taxes. The contribution of local own-revenue sources was insignificant, meaning revenue collection and expansion did not improve for many years. Before the 1997 Constitution, local governments had the same revenue sources, but did not exploit their potential. Local governments simply relied on central finance instead of their own revenue. Even the decentralization law has no guidelines on how to generate the 20% revenue share of local governments. Local authorities presume that their budget will increase to at least 20% from central distribution rather than from locally mobilized revenue sources, and that the central Government will guarantee the gradual increase in local revenue. Decentralization has not, therefore, promoted financial self-reliance under the revenue transfer scheme.

Finally, during the initial years of decentralization, time was insufficient to build local capacity and improve local public administration. To avoid duplication of budget allocation, the initial budget transfer under decentralization passed through central agencies, otherwise the local government budget could not be disbursed. Local governments merely submitted budget disbursement requests to the central agencies, and actual functional responsibilities were still performed by central agencies. This meant that fiscal devolution to local governments was not realized during the initial years. Local authorities were reluctant to restructure the local bureaucratic system. To avoid disruption of public services, transfer payments were spent on functions predetermined by central agencies.

Local Revenue Capacity-Building Schemes

The problems of traditional local government revenue sources have remained without any short-run solutions in sight. If revenue capacity of local governments is not widened, the central Government alone will bear the heavy fiscal burden. Solutions may include the following:

Enhance locally generated revenue from property taxes (land and building tax and land development tax). A new property tax should base its collection on capital value at the market rate, and not exempt owner-occupied properties. The tax would exempt, or impose a lower rate on, manufacturers of equipment to support domestic investment. The tax rate should vary according to type of local government. Local authorities should have the discretion to determine the tax rate. Combining the two existing property taxes into a uniform property tax will ease tax administration and enhance taxpayers' compliance.

A significant advantage of moving to a capital value system is that it provides the same assessment basis for owner-occupied, rented, and nonresidential properties, thereby substantially improving horizontal and vertical equity. Including owner-occupied properties in the proposed property tax will enhance not only revenues but also administration and equity of the tax since all buildings will be subject to tax. The tax base must be clearly defined, and the tax based on the concept of land, including all its improvements and buildings.

To promote local fiscal autonomy, discretion in setting property tax rates should be devolved to local governments for the accountability of local officials, who must have a certain level of control over the revenues that they collect. Exemption has been a major loophole in property taxes and should be minimized, but may still be needed to solve the equity problem of low-income owners. Property tax structures and the valuation process should be clearly separated not only to enhance the overall system but also to diminish potential corruption. Valuation should be standardized. The Central Valuation Agency within the Land Department should strengthen the base of the new property tax.

Base local user charges on market-oriented rates so that they recover the costs of local capital investment. User charges must reflect the investment and operating costs of public services. Unfortunately, central agencies still determine user charges. The Ministry of Interior issues regulations and ordinances to guide local governments in setting user charges. The ability to set user charges is the first step for local governments to mobilize revenue from investment.

Small SAOs should be merged to deliver efficient and effective public service. Many SAOs are too small to achieve financial self-reliance. Basic criteria to qualify for local autonomy must be defined and strictly enforced, otherwise SAOs will burden the central Government. Local governments should be given the discretion and autonomy to determine tax rates and tax bases to enhance accountability to their citizens.

Establish a consistent formula for intergovernmental transfer payments. The formula will help local governments estimate the transfer payments that they need so as to be able to plan expenditures. Fiscal transfers should be based on objectives and a widely accepted allocation formula free from political influence and made by a neutral organization or official intergovernmental committee. Central government fiscal transfers should be stable every year so that local governments can draw up appropriate budgets, and be flexible to prevent macroeconomic instability. The formula must be reviewed regularly and kept as simple as possible.

Improve all aspects of local tax administration. Local tax mapping must be updated regularly and used as a basic instrument to improve tax collection efficiency.

Local Government Finance

Local Government Revenue

Table 4 presents data on Thailand's revenue structure. Surcharges and shared taxes had an average share of around 40% of total local government revenue during 1996–2001. Locally levied taxes had an average share of only around 10%, with a declining trend during the same period.

The building and land tax contributed the largest share—about 8% in 1996 but only 5% in 2001. The rest of locally levied taxes were insignificant, implying that local governments have remained heavily dependent financially on the central Government. VAT and excise tax contributed significantly to total tax revenue. In 2001, a new VAT was introduced. It added to the existing one and has been used as other transfer revenue along with grants to meet local revenue requirements. Total local revenue, as mandated by the 1997 Constitution, must be at least 20% of total central government revenue. Another source of local revenue is central grants. Their share to total local government revenue increased from 26.2% in 1996 to 47.7% in 2001. Specific grants showed a rising trend during the period of analysis but were replaced by new transfer revenues that were introduced in 2001. The amount of transfer payments accounted for over 20% of total local budgets in 2001. Unfortunately, transfer payments to each local government are not broken down, but SAOs probably received most of the allocation.

Local governments have little access to outside financial sources due to prohibitions under local budgeting laws and regulations. The share of borrowings has remained insignificant throughout the period of analysis.

A breakdown of revenue sources for each type of local government shows that the revenue share significantly increases with the size of the local entity. Before decentralization, BMA received the largest proportion of revenue relative to other local entities (Table 5). BMA used to have a share of around 45% of total local

Table 4. Total Local Government Revenue, 1996–2001 (B million)

	1996		1997		1998		1999		2000		2001	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
General Revenue												
Building and Land Tax	5,563.4	8.0	7,210.1	7.7	7,251.9	7.0	7,696.1	7.3	8,325.9	8.9	8,042.5	5.2
Land Development Tax	253.8	0.4	868.8	0.9	801.3	0.8	752.1	0.7	767.1	0.8	717.1	0.5
Signboard Tax	701.0	1.0	840.2	0.9	818.7	0.8	814.3	0.8	833.9	0.9	787.1	0.5
Animal Slaughter Duty	42.7	0.1	57.6	0.1	56.7	0.1	68.2	0.1	52.4	0.1	75.3	0.1
Total Locally Levied Taxes	6,561.0	9.4	8,976.8	9.6	8,928.6	8.6	9,330.7	8.9	9,979.3	10.6	9,622.0	6.2
VAT and Business Tax	16,813.6	24.2	17,755.4	19.0	22,119.0	21.4	16,231.3	15.5	16,467.1	17.5	18,117.2	11.7
VAT and Business Tax (under decentral. plan)					0.0	0.0	0.0	0.0	0.0	0.0	11,532.3	7.5
Liquor Tax	2,158.6	3.1	3,505.9	3.8	3,544.0	3.4	3,895.2	3.7	3,186.9	3.4	2,719.6	1.8
Excise Tax	6,493.4	9.3	10,385.7	11.1	9,172.1	8.9	8,462.3	8.1	9,117.8	9.7	11,488.1	7.4
Gambling Tax	119.6	0.2	133.5	0.1	164.0	0.2	142.6	0.1	137.7	0.2	150.0	0.1
Motor and Vehicle Tax	8,631.9	12.4	9,724.9	10.4	9,634.6	9.3	9,965.3	9.5	10,814.5	11.5	10,085.1	6.5
Miscellaneous					425.1	0.4	585.6	0.6	95.8	0.1	630.0	0.4
PAO Taxes[a]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1,309.2	1.4	1,250.0	0.8
Total Surcharge and Shared Taxes	34,217.0	49.2	41,505.3	44.5	45,058.8	43.5	39,282.1	37.4	41,129.0	43.8	55,972.2	36.2
Birds' Nest Tax	—	—	42.1	0.1	3.8	0.0	170.6	0.2	79.1	0.1	200.0	0.1
Royalty Fees[b]	—	—	150.7	0.2	535.3	0.5	621.1	0.6	1,187.6	1.3	1,483.0	1.0
Fee from Transferring of Real Estates	—	—	5,782.8	6.2	3,451.7	3.3	2,814.0	2.7	3,726.5	4.0	7,000.0	4.5
Total Revenue from Natural Resources	—	—	5,975.5	6.4	3,990.8	3.9	3,605.8	3.4	4,993.2	5.3	8,683.0	5.6
Total Revenue from Taxes and Duties	40,777.9	58.6	56,457.6	60.5	57,978.1	56.0	52,218.7	49.7	56,101.5	59.7	74,277.2	48.0
Fees, Fines, and Permits	1,319.4	1.9	1,602.4	1.7	1,618.8	1.6	1,347.4	1.3	1,645.2	1.8	1,504.2	1.0
Revenue from Assets	3,751.2	5.4	4,559.7	4.9	5,242.6	5.1	4,472.1	4.3	2,222.5	2.4	3,566.6	2.3
Revenue from Utilities	174.9	0.3	191.0	0.2	235.1	0.2	242.1	0.2	330.8	0.4	265.8	0.2
Miscellaneous	695.5	1.0	1,561.6	1.7	1,119.2	1.1	2,209.9	2.1	1,824.8	1.9	1,289.5	0.8
Total Nontax Revenue	5,941.0	8.5	7,914.7	8.5	8,215.7	7.9	8,271.5	7.9	6,023.4	6.4	6,626.1	4.3
Special Revenue												
General Grants	8,452.7	12.1	13,493.5	14.5	16,845.0	16.3	14,514.8	13.8	13,140.7	14.0	41,390.2	26.8
Specific Grants	9,783.3	14.1	7,609.3	8.2	15,473.7	14.9	23,612.4	22.5	18,443.6	19.6	0.0	0.0
Transferred Budget for Decentral. Functions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	32,339.6	20.9
Total Transfer Revenue and Grant	18,236.0	26.2	21,102.8	22.6	32,318.7	31.2	38,127.1	36.3	31,584.3	33.6	73,729.8	47.7
Trust Fund	2,919.1	4.2	7,180.9	7.7	4,467.7	4.3	6,131.2	5.8	190.8	0.2	—	—
Loans	279.7	0.4	692.9	0.7	623.9	0.6	287.9	0.3	19.5	0.0	—	—
Others	1,463.1	2.1	—	—	—	—	—	—	—	—	—	—
Total Other Revenue	4,661.9	6.7	7,873.8	8.4	5,091.7	4.9	6,419.0	6.1	210.3	0.2	0.0	0.0
Total Special Revenue	22,897.9	32.9	28,976.6	31.0	37,410.3	36.1	44,546.2	42.4	31,794.6	33.9	73,729.8	47.7
Total Revenue	**69,616.9**	**100.0**	**93,348.9**	**100.0**	**103,604.1**	**100.0**	**105,036.3**	**100.0**	**93,919.4**	**100.0**	**154,633.1**	**100.0**

— = data not available, PAO = provincial administrative organization, VAT = value-added tax. [a] These revenues are surcharges on sales of petroleum and tobacco, and hotel revenue for PAO under the PAO Act of 1997. [b] Including royalty fees from fisheries, mining, oil drilling, timber permits, and natural park permits.

Source: Department of Local Administration, Ministry of Interior.

Table 5. Local Government Revenue by Entity (B million)

Entity	1994	1995	1996	1997	1998	1999	2000	2001	2002
PAO	11,283	10,175	8,158	6,496	5,510	5,549	6,256	11,589	13,231
(%)	19.7	16.3	11.7	7.0	5.3	5.3	6.7	9.5	10.1
MA	14,223	17,478	21,139	22,689	35,069	33,487	30,100	38,109	40,702
(%)	24.9	28.0	30.4	24.3	33.9	31.9	32.1	31.2	30.9
SDA[a]	5,671	6,591	7,615	9,295					
(%)	9.9	10.6	10.9	10.0					
SAO				27,051	27,827	31,069	27,472	40,292	40,188
(%)				29.0	26.9	29.6	29.3	33.0	30.5
BMA	25,506	27,920	32,353	27,530	34,906	34,585	29,783	31,606	36,522
(%)	44.6	44.7	46.5	29.5	33.7	33.0	31.7	25.8	27.8
Pattaya	544	336	352	288	293	346	308	698	970
(%)	1.0	0.5	0.5	0.3	0.3	0.3	0.3	0.6	0.7
Total	**57,226**	**62,500**	**69,617**	**93,349**	**103,604**	**105,036**	**93,919**	**122,294**	**131,613**
(%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

BMA = Bangkok Metropolitan Administration, MA = municipal administration (municipality), PAO = provincial administrative organization, SAO = subdistrict administrative organization, SDA = sanitary district administration.

[a] After 1998 all sanitary districts were upgraded to municipalities.

Source: Ministry of Finance.

revenue, but this declined over the years. In 2001, BMA's revenue share declined due to the central government policy of increasing financial support to other local governments, particularly SAOs and subdistrict councils. BMA collected most of the locally levied revenues and received the largest share of surcharge and shared taxes from central Government before decentralization. Afterward, PAOs received a larger proportion than other LGUs.

Other revenues come from trust funds and borrowings. Revenue from trust funds in 1996 made up about 4.2% of total local revenue but sharply increased in 1997 due to the economic crisis, which made central grants unavailable. Local governments had to withdraw from their own reserves in the trust funds. Loans remained insignificant. The breakdown of loans and trust funds for each LGU is only available for FY1999 (Table 6), when the total local government trust fund was B6,131 million, which accounted for about 5.8% of local government revenue. Of this amount, B219.4 million came from PAOs (3.6%), B1,835.6 million from municipalities (29.9%), B2,395.2 million from SAOs (39.1%), B40 million from Pattaya City (0.7%), and B1,641 million from BMA (26.8%).

Table 6 also shows that SAOs have taken the most local revenue from the trust fund, followed by municipalities and BMA.

Borrowing has remained insignificant since the only fund that local govern-

Table 6. Local Revenue from Trust Fund and Loans, FY1999 (B million)

Entity	Trust Fund		Loans		Total	
	Amount	%	Amount	%	Amount	%
PAO	219.4	3.6	19.5	6.8	238.9	3.7
Municipalities	1,835.6	29.9	267.9	93.1	2,103.5	32.8
SAO	2,395.2	39.1	0.0	0.0	2,395.2	37.3
Pattaya City	40.0	0.7	0.4	0.1	40.4	0.6
BMA	1,641.0	26.8	0.0	0.0	1,641.0	25.6
Total	**6,131.2**	**100.0**	**287.8**	**100.0**	**6,419.0**	**100.0**

BMA = Bangkok Metropolitan Administration, PAO = provincial administrative organization, SAO = subdistrict administrative organization.
Source: Department of Local Administration, Ministry of Interior.

ments can borrow from is the local development fund. Local government borrowings, taken together, registered less than 1% of total local revenue. Only PAOs, municipalities, and Pattaya City borrow. Municipalities accounted for 93% of all borrowings. However, borrowings accounted for only 0.8% of municipal expenditures in 1999. Surprisingly, SAOs, the main players in trust funds, did not borrow at all in 1999.

Municipalities borrowed most from the local development fund. According to the Ministry of Interior's Regulation on Municipality Development Fund 1997, the fund is mobilized from a portion of the annual budget surplus. The formula used requires that 10% of the excess budget must be transferred to the fund within the first 3 months of the fiscal year. Each municipality could borrow from this fund to invest in public utilities or other municipal public services, with a payback period of 15 years.

Projects that can be funded from the municipality development fund are:

- investment projects for public utility services, such as electricity and running water (4% interest);
- public service projects, such as road construction and maintenance, sewage system construction and maintenance, bridges and waterways, and trucks and machinery (4% interest);
- profit-oriented projects with a short payback period, such as construction of markets, docks, hotels, and commercial buildings (7% interest);
- public welfare projects with return benefits, such as pawnshops (6% interest); and
- other types of projects (8% interest).

To control disbursement from accumulated and development funds, the Ministry of Interior's permanent secretary is appointed chair of the committee that scrutinizes withdrawals from the funds to prevent local financial bankruptcy and fiscal mismanagement.

Local Government Expenditure

Local governments are much smaller than the central Government and have no major role in public service provision (Table 7). Local government registered only 7.4% of total central government expenditure in 1996. However, the share of local expenditure increased in 1996–2000. Local government expenditure falls under the categories of central, regular, investment, or special. Central expenditures consist of debt repayments, interest payments, other committed budgets, temporary assistance funds, and contingency funds. Regular expenditures are salaries, wages, remuneration, utilities, materials cost, and grant payments. Investment expenditures are cost of construction and land development. Special expenditures are those from specific grants, trust funds, and loans. Data reveal a consistently large share of local revenue from central specific grants. Such categories make it difficult to get a clear picture of the patterns of expenditure since there are no data on local government expenditures by function (e.g., education, roads). All are by economic classification. Table 7 illustrates the trend in total local government expenditure since 1996, revealing little except that regular expenditure is the largest item of local government expenditure, followed by construction. The two items absorb over one half of the total budget. Unfortunately, nothing shows how the budget is allocated for infrastructure investment.

Trends for local government expenditure are in Table 8. The main point is that BMA, with only 10% of the population, absorbs more than a third of local government expenditure. Municipalities receive the second-largest share. The second point is that an increasing share is going to SAOs, but at the expense of provinces or PAOs. Third, local governments' share of expenditure is unchanged, indicating a weak fiscal position and insufficient own-revenue resources.

Inadequate revenue is the major obstacle to local government autonomy. Borrowing can be an important source of funds. A good indicator of the problem may be the size of transfer payments from the central Government, which include surcharges and shared taxes and grants, and account for more than 50% of total local government revenue (Table 4). Expanding the scope of local expenditure is also impeded by regulations that require local governments to run a budget surplus.

The decentralization law has opened channels for local government borrowing through the ministries, bureaus, public entities abroad, or international organizations.

Table 7. Total Local Expenditure, 1996–2000 (B million)

	1996		1997		1998		1999		2000 (P)	
Expenditure Item	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Debt Repayment and Interest Payment	123.5	0.3	331.9	0.4	341.6	0.4	358.1	0.4	364.7	0.4
Committed Expenditure	831.1	1.7	559.9	0.7	467.0	0.6	503.5	0.5	466.8	0.5
Specific Assistance Fund	52.8	0.1	130.9	0.2	139.5	0.2	151.0	0.2	114.5	0.1
Contingency Expenditure	1,800.2	3.7	1,761.7	2.2	304.7	0.4	572.0	0.6	1,633.5	1.6
Miscellaneous					1,787.5	2.2	1,985.8	2.1	1,256.3	1.2
Total Central Fund	2,807.5	5.7	2,784.4	3.5	3,040.3	3.8	3,570.3	3.8	3,835.9	3.8
Salaries and Wages	9,412.0	19.2	8,939.4	11.3	9,823.8	12.3	9,655.6	10.4	11,794.9	11.6
Temporary Wages	2,712.7	5.5	3,184.2	4.0	3,530.8	4.4	3,527.3	3.8	4,053.1	4.0
Remuneration	8,083.9	16.5	11,083.9	14.0	11,638.2	14.6	13,193.0	14.2	14,549.4	14.3
Utilities Expenditure	549.7	1.1	667.9	0.9	820.6	1.0	1,389.0	1.5	2,283.9	2.3
Grant	460.6	0.9	771.6	1.0	1,478.6	1.9	3,592.5	3.9	3,039.5	3.0
Other Expenditure	1,489.4	3.0	1,510.3	1.9	1,748.7	2.2	2,542.2	2.7	0.0	0.0
Total Regular Fund	22,708.1	46.3	26,157.3	33.1	29,040.7	36.3	33,899.5	36.4	35,720.9	35.1
Materials, Construction, and Land	15,123.1	30.8	24,070.1	30.5	22,887.5	28.6	17,913.4	19.3	25,492.2	25.1
Investment Expenditure	15,123.1	30.8	24,070.1	30.5	22,887.5	28.6	17,913.4	19.3	25,492.2	25.1
Total Regular and Capital Investment	37,831.2	77.1	50,227.4	63.6	51,928.1	65.0	51,812.9	55.7	61,213.1	60.2
Specific Grant Expenditure	8,133.4	16.6	18,768.3	23.8	18,099.5	22.7	18,407.0	19.8	18,579.1	18.3
Reserve Fund	68.6	0.1	6,534.5	8.3	4,181.1	5.2	10,287.1	11.1	16,229.5	16.0
Loans	54.7	0.1	647.4	0.8	577.1	0.7	1,318.7	1.4	1,784.2	1.8
Miscellaneous	190.0	0.4	0.0	0.0	2,084.3	2.6	7,681.5	8.3	69.5	0.1
Total Special Fund	8,446.7	17.2	25,950.1	32.9	24,942.0	31.2	37,694.3	40.5	36,662.3	36.1
Total Local Expenditure	**49,085.3**	**100.0**	**78,961.9**	**100.0**	**79,910.4**	**100.0**	**93,077.5**	**100.0**	**101,711.2**	**100.0**
Memo Item: Total Central Expenditure	843,200		925,000		830,000		825,000		860,000	

P = provisional.

Source: Department of Local Administration, Ministry of Interior.

Table 8. Local Government Expenditure by Entity, 1994–2000 (B million)

Entity	1994	1995	1996	1997	1998	1999	2000
PAO	10,658	9,903	7,577	4,614	4,507	5,366	5,490
(%)	22.2	18.6	15.4	5.8	5.6	5.8	5.4
Municipalities	13,181	16,949	18,838	20,437	29,971	32,997	39,038
(%)	27.5	31.9	38.4	25.9	37.5	35.5	38.4
SDA[a]	5,078	5,893	4,378	7,588			
(%)	10.6	11.1	8.9	9.6			
SAO				19,951	22,491	25,887	21,154
(%)				25.3	28.2	27.8	20.8
BMA	18,519	20,157	17,970	26,093	22,661	28,482	35,703
(%)	38.6	37.9	36.6	33.1	28.4	30.6	35.1
Pattaya City	532	316	332	278	281	346	326
(%)	1.1	0.6	0.7	0.4	0.4	0.4	0.3
Total	**47,968**	**53,218**	**49,095**	**78,961**	**79,910**	**93,077**	**101,711**
(%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0

BMA = Bangkok Metropolitan Administration, PAO = provincial administrative organization, SAO = subdistrict administrative organization, SDA = sanitary district administration.

[a] After 1998, all sanitary districts were upgraded to municipalities.

Source: Ministry of Finance.

The only condition is that borrowing must be approved by the Cabinet. However, under the present system, local governments can only borrow from the development fund, with predetermined terms of repayment and interest rates.

There are two problems in developing local borrowing: (i) moral hazard, particularly under the decentralization program; and (ii) lack of local financial management capacity. Moral hazard originates from the limitation of fiscal autonomy. Local governments generate only a small share of their own-revenue bases and have little authority to adjust the bases and rates to fit local economic conditions. If local governments can borrow freely but have limited own revenue, moral hazard arises because local governments can shift their debt obligations against transfers from the central Government, thereby negating the need to broaden their own-revenue base to meet debt service payments. The grant allocation formula, which lacks transparency, also creates moral hazard.

The lack of local financial management capacity is seen from the generally weak accounting and budgeting practices of local governments. Accounting is on a cash basis and does not clearly distinguish between current and capital expenditures, making it difficult to ensure that borrowing is for capital investments. The present budget system of local governments still applies the year-to-year process, making it extremely difficult to thoroughly assess the long-term effect of investment plans and alternative financial schemes. In addition, there is no accurate valuation of local assets, thus preventing local governments from using asset-liability management to optimize their financial conditions and decisions.

To train local governments in borrowing, a pilot program for lending has been introduced to provide long-term loans at market rates to municipalities—RUDF, operated by the Government Savings Bank (Box 2). Before any loan extension, RUDF employs learning-by-doing for local administrators to participate in project evaluation and a feasibility study. This method is expected to improve local administrators' financial management capability. Few municipalities can access this fund because of the many conditions that they must meet before the loan can be given. This may be because the fund is not a "loan giver" but a technical training ground for borrowing. An impediment to developing the role of RUDF is the specific grants allocated by the central Government to local governments based on local investment projects. Many municipalities may qualify for RUDF but may choose not to join the program and instead request specific grants from the central Government.

Box 2. Regional Urban Development Fund

To develop the foundation for decentralization and local borrowing, the Department of Local Administration, in cooperation with the Government Savings Bank and with the support of the World Bank, initiated the Regional Urban Development Fund (RUDF) as a revolving fund for local borrowing, especially by municipalities. RUDF was first established in 1999 as part of the Social Investment Project to serve as an alternative source of loanable funds for municipalities. RUDF's objective was to solve social problems by funding long-term development programs that have a social impact. RUDF was set at $30 million, to be spent as an initial fund for 15-year loans for income-generating public infrastructure and services. RUDF was a pilot program to support municipalities' investment programs.

Local governments are provided with considerable technical assistance to strengthen their capabilities in preparing and managing projects, financial reporting, and enhancing local accountability. Establishing a framework for responsible borrowing will require setting aggregate limits on local indebtedness, drawing up local bankruptcy regulations, and setting up other mechanisms to promote responsible borrowing.

Regulatory and Institutional Framework for Bond Market Development

Local bond issuance regulations appear in laws establishing local governments.[2] The details of the regulatory and institutional frameworks for local government bond markets are in various laws of local government entities. However, the laws and regulations to control and monitor local government bond issuance are not synchronized. SAOs and Pattaya City may not float bonds, while municipalities, PAOs, and BMA may. Generally, local bond issuance is not explicitly prohibited under local government laws, but it is impeded by the need for approval from various central agencies. BMA bond financing proposals must have approval of the Cabinet, partly because it is not under direct control of any ministry, and the size of funds borrowed may affect the national fiscal position. Municipality bond issuance is decided mainly by the Minister of Interior. PAOs may issue bonds, but the Ministry of Interior has not issued a single ordinance to make it possible. The decentralization law tightens bond issuance and local borrowing by requiring all local borrowing to be approved by the Cabinet to prevent the local authority from mismanaging the borrowed funds, which could affect the national economy.

The financial market has witnessed significant growth during the last two decades. Many new financial instruments have emerged, the volume of financial transactions has increased, and the number of investors from home and abroad has grown. With the growth of these transactions, many regulatory institutions have come onto the scene to facilitate and regulate the market to meet international standards. Securities trading grew until the financial crisis of 1997, after which traditional bank loans grew rapidly and equities trading declined sharply (Table 9). Domestic bond trading increased from B262 million to almost B2 billion in a decade. Private financial sector growth provides new opportunities for many government agencies to finance their long-term capital investment. Thus, the central Government issued regulations on public agency borrowing from the private financial sector to prevent a public debt crisis. Some regulations have affected the development of local bond financing under fiscal decentralization.

Table 9. Size of Financial Market (B billion)

Item	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Bank Loans[a]	2,669.1	3,430.5	4,230.5	4,825.1	6,037.5	5,372.3	5,119.0	4,585.9	4,298.9	4,359.7[b]
Equities[c]	3,325.4	3,300.8	3,564.6	2,559.6	1,133.3	1,268.2	2,193.1	1,279.2	1,607.31	1,814.01[d]
Domestic Bonds (at par)	262.0	339.0	424.4	519.3	546.8	941.3	1,388.6	1,634.8	1,882.9	1,970.1[d]
GDP (current prices)[e]	3,170.3	3,634.5	4,192.7	4,622.8	4,740.3	4,628.4	4,615.4	4,900.3	5,057.1	5,259.4
GDP Growth (%, 1988 prices)[e]	—	9.0	9.3	5.9	-1.4	-10.8	4.2	4.4	1.5	2.0

— = data not available, GDP = gross domestic product.

[a] Bills, loans, and overdrafts, excluding interbank loans. [b] February. [c] Stock Exchange of Thailand market capitalization. [d] September. [e] Forecast by National Economic and Social Development Board.

Sources: Bank of Thailand; National Economic and Social Development Board.

Aside from laws established for each local government, the central regulatory acts that affect local borrowing are the Government Budget Procedures Act of 1949, and amendment of 1950; Bank of Thailand Act of 1942; and Securities and Exchange Act of 1992.

The Budget Act authorizes eligible public agencies to issue public debt and to set ceilings on annual government borrowing. To maintain fiscal discipline, the laws require all public entities to get approval or endorsement from the Ministry of Finance, which oversees fiscal policy, including maintaining the national public debt level. The Ministry of Finance and Bank of Thailand must coordinate in designing a public borrowing scheme for public agencies. The Budget Act and Bank of Thailand Act, however, do not include local government entities among eligible public agencies.

Many financial organizations have been established under the Securities and Exchange Act to serve the growing domestic financial market. Many banking and financial organizations provide services for money and capital instruments. The Stock Exchange of Thailand (SET) was established more than 20 years ago along with the Securities and Exchange Commission (SEC) to enforce securities trading rules and regulations. Other institutions established to develop the capital market include 51 registered financial advisors, 33 registered property appraisal agencies, 18 registered private auditors, 7 registered trustees, 35 independent property assessors, 70 private auditors, and 2 independent credit-rating companies. Recently, a secondary market for bond transactions was established (Box 3).

Under the regulatory framework for financial operations, the Bank of Thailand supervises banking and finance operations, while SET and SEC supervise the primary and secondary markets for securities, and bond issuance governed by the Securities and Exchange Act. In 1998, SEC licensed the Thai Bond Dealing Center (Thai BDC) to facilitate bond trading, monitor trade, and disseminate information on the secondary bond market. Thai BDC is also a self-regulatory organization.

The growth of the domestic financial sector has encouraged resource mobilization and strengthened the foundation for economic growth. However, the benefits of an expanding financial sector are still out of reach of local governments. Government debt securities that can be traded in the market are the following:

- treasury bills—short-term debt instruments with maturity of less than 1 year;
- government bonds—medium- to long-term debt instruments issued by the Ministry of Finance;
- Bank of Thailand bonds—bonds issued by the Financial Institution Development Fund and Property Loan Management Organization, which, however, are no longer issued; and

Box 3. Thailand Bond Market Development

The Thai Bond Dealing Center (Thai BDC) facilitates the operation of the secondary market for bond trading and is a forum to discuss bond market development issues. While the Thai BDC officially opened in April 1998, its formation can be traced to 1994, when the Securities and Exchange Commission appointed the Association of Securities Companies (ASCO) to study the establishment of a secondary market for debt instruments. In September 1994, the Bond Dealers' Club was formed within ASCO and commenced trading on 1 November. To create a larger bond market catering to a full range of Thai debt instruments, the Bond Dealers' Club was transformed into a full bond exchange and renamed Thai BDC in April 1998.

Thai BDC significantly improved bond trading. The number and value of registered bonds increased from 29 issues worth B32.5 billion in 1994 to 381 issues worth B1,084 billion at the end of 1999, and 470 issues worth B1,269 billion at the end of 2000. Average daily turnover rose from B209 million in 1995 to B1,760 million in 1999, and to B5,494 million in 2000.

Thai BDC's goals are to provide an environment for fair and secure trading, to monitor trade, and to disseminate information on the secondary bond market. Its specific objectives are to increase market transparency; improve communication and trading facilities; improve data delivery, accuracy, and analysis; and strengthen the clearing and settlement process.

The corporate sector began to issue bonds and to trade in Thai BDC after the Securities and Exchange Act was passed. State-owned enterprise bonds accounted for most of the outstanding value of domestic bonds before the economic crisis, after which the central Government issued bonds to address this issue.

- state-owned enterprise bonds—medium- to long-term debt instruments, which may be guaranteed (or not) by the Ministry of Finance. Guaranteed bonds account for 86% of the total value of bonds issued, but budget regulations set government debt guarantee at not more than 10% of total budget expenditure.

Local Borrowing Schemes

Local governments have some borrowing options as the financial market is relatively well developed. However, the crucial elements in linking local government entities to the financial markets are financial disclosure and reporting. Local government bond and debt financing must observe standard market practices for general government obligation (general revenue support), limited obligation (bond financing), and project financing.

Under general government obligation, the local government uses its revenue to support debt service payments, owns and operates the project, and pledges its own revenue. The project is not specifically tied to debt repayment. Without central government guarantee, however, the local government's creditworthiness would diminish. The high dependence of local government on intergovernmental fiscal assistance raises the question of security for investors, including what remedies are available in case the local government fails to pay the debt on time and in full.

Under limited obligation (bond financing) the debt is secured primarily on earnings of the project to be financed. General revenues are typically not pledged directly. The money from issued bonds produces revenue (through charges and fees from the project) used to defray the costs of debt service. The debt is secured either by the project itself or by the general local revenue on behalf of the project. The central Government need not pledge full support to repay the debt.

Bonds provide investors with greater diversification and liquidity than direct loans. Unless restricted in secondary market trading, the bond can be put up for sale, thereby giving the holder liquidity before maturity. The market provides a venue to develop local bond issuance, but preconditions such as building the local government's financial capacity to repay debt, analyze credit, etc. must be set to control local borrowing and prevent bankruptcy. The local government must observe the following before participating in the financial market.

Financial Disclosure. Fundamental to disclosure is the timely production of financial statements that consistently follow accounting standards and are readily available to investors. Local governments must have uniform accounting standards. Present accounting systems are in transition and under review for improvement. The cash accounting method used by local government is oriented to controlling expenditure and revenue, focusing on receipts and outlays and ignoring the economic purpose of expenditure. Cash accounting focuses on short-term assets and liabilities, which prevents the method from observing the local government's accurate and actual financial performance in the long run.

Timely Audit and Independent Auditors. Bureaucrats rely only on the central auditing agency. The audit system is understaffed and underfunded and employs a random system that usually checks for wrongdoing rather than reviews local government financial conditions. The new auditing system must conduct thorough and regular audits. Local government financial records are not publicly available, which impedes full financial reporting.

Creditworthiness, Credit Analysis, and Credit Ratings. Credit analysis is a process by which investors examine the available information on the bond issuers and their obligations. Based on this information, investors judge the rewards and risks of their investments. Information can be gathered from various sources, such as central government statistical reports, and local government financial reports to the central Government, etc. Credit analysis demands resources and analytical skills, of which many investors, especially smaller institutions and individual investors, do not have enough to justify a particular bond issuance. Thus, they prefer to rely on the opinion of experts, particularly commercial credit-rating agencies. Thailand has two such agencies—Thai Rating and Information Services (Box 4) and the newly established Fitch Rating Service. An independent, objective, and high-quality system of credit rating is essential to develop a vibrant private capital market. However, the existing credit-rating agencies will be unable to rate all local governments if they are allowed to issue bonds. Trained analytical staff are lacking. The concentration of opinion in a few hands using methods that are proprietary and not fully disclosed can lead to a dangerous dependence on a few experts that can influence the markets without check. Bonds should be rated before they are listed on the exchanges or sold to the public.

Impediments to Local Bond Market Development

Local governments face various regulatory, legislative, administrative, and structural constraints in issuing bonds.

Regulatory Constraints. Due to regulatory constraints, bond financing is never explored as an alternative revenue source for local governments. The Budget Act does not specify a central government debt guarantee for local government bond issuance, which impedes the development of local government bonds, especially at the initial stage when their creditworthiness is doubted by the general public, particularly the financial sector. Rules and regulations of financial and regulatory institutions (Thai BDC, SET, etc.) have no clear guidelines on how to introduce local bonds to the market, or on how local government can be eligible to participate in the market. Introducing local government bonds in the market must have the approval of the Ministry of Finance and Bank of Thailand.

Legislative Constraints. Local budgeting is highly committed to current expenditure. Under the budget ordinance procedure of the Ministry of Interior, all local governments must have a surplus budget. This prohibits any deficit and discourages local governments from undertaking capital-intensive investment. Any project that requires a high level of investment is carried out through a central subsidy. Local governments must be allowed to have a deficit budget first and to design a financial scheme for local financial conditions.

Administrative Constraints. Local governments are not exposed to the financial market. Their staff have no experience in how to exploit the benefits of issuing bonds. Elected executives are afraid to inherit the indebtedness of previous administrations. The financial reporting of local government is poorly developed, and does not meet

Box 4. Thai Rating and Information Services

On 27 July 1993, Thai Rating and Information Services (TRIS), Thailand's first credit-rating agency, was established by the Bank of Thailand. TRIS received 3 years of technical assistance from Standard and Poor's (S&P) to develop a credit-rating methodology and improve administration. TRIS determines a rating after an in-depth analysis of quantitative and qualitative factors. TRIS' methodology considers two sectors: general corporates and financial institutions. To ensure that all salient factors are considered, TRIS's analytical framework includes industry, business, and financial analyses. Each considers several rated variables. However, no formula combines them. The overall rating judgment is determined by the rating committee. Below are examples of the rating methodology profiles.

Rating Profile for General Corporates

Industry Analysis. Each rating analysis begins with an assessment of the company's operating environment. The analysis focuses on industry prospects, patterns of business cycles, nature of industry, regulatory restrictions, and competitive factors.

Business Analysis. This concentrates on corporate strategy, management evaluation, market position, diversification, and operating efficiency.

Financial Analysis. In assessing a company's financial position, TRIS reviews financial policies, profitability and efficiency, capital structure, cash-flow adequacy, and financial flexibility. For instance, TRIS reviews a company's financial policies pertaining to leverage tolerance, dividends, acquisition, and disposition strategies.

Additional Specific Analysis for Real Estate Companies. TRIS focuses on the quality of the real estate investment portfolio. Asset quality includes the age and physical condition of the properties, investment status of particular properties, and type of investment. Income recognition and differentiation of financial statements must be adjusted to get a clear picture of the real estate firm's cash stream. All financial ratios are calculated on an adjusted cash-flow basis.

Rating Profile for Financial Institutions

Industry Analysis. TRIS assesses the relationship of the industry to the economy and the possible impact of various economic scenarios, including changes in law or policies of the Bank of Thailand or Ministry of Finance.

Business Analysis. This comprises four elements: (i) asset quality, which includes the characteristics of basic receivables (consumer versus commercial, subportfolios, size, off-balance-sheet risk); diversity (geographical, customer base, product type); lending criteria; audit procedures and controls; credit quality; reserve adequacy; and liquidity; (ii) asset and liability management, which includes an examination of the company's philosophy, and management of assets and liabilities with regard to maturity and interest rate sensitivity; (iii) ownership and affiliation, which examines the degree of strength derived from parent company support; and (iv) management, which evaluates management's performance, policies, controls, and planning.

Financial Analysis. This includes analysis of a company's performance, based on profitability measures, capital leverage, liquidity, financial policy, and flexibility. The key ratios that TRIS uses to analyze credit strength are liquidity, capital structure, profitability, cash-flow adequacy, growth, efficiency/activity, and industry-specific indicators.

the general standards of the private sector. The accounting system does not reflect actual financial conditions.

Structural Constraints. Although the capital market is equipped with primary and secondary bond market trading, market players have limited understanding of local financial conditions. More financial market experts should be groomed to handle more bond transactions. Thailand may have to establish more agencies or to restructure existing agencies to assist in local bond issuance. Local governments must improve internal auditing, prepare financial disclosure reports that meet high standards, and change the accounting system to capture all local financial activities and commitments.

Roadmap for Local Bond Financing Development

Risks to investors need to be reduced. Local governments must observe standard requirements and develop creditworthiness by improving fiscal management and strengthening financial capability. To meet the prerequisites for local bond financing, the following measures should be undertaken:

- Designing a new accounting system to separate current and capital expenditures; a legislative framework that designates local assets; and an auditing system for local government accounts, regulation procedures, and formats for financial disclosure.
- Raising local revenue and diversifying the revenue base. The central Government may need to redesign its revenue transfer system. Local governments must also improve their financial planning and fiscal capability, and create a simple budget system that can forecast or estimate future budget needs.
- Improving the local budgetary system. Two things need to be done: (i) the budgeting process must permit unconventional financing such as borrowing; and (ii) the budgeting system should be multiyear, with plans for budget expenditure for longer than 1 year. Multiyear budgeting will provide a longer perspective for investment requirements.
- Improving local accounting and financial practices to make financial reports transparent. This includes introducing simple accrual financial and cost accounting. In the long run, the accounting system will provide local staff with better information on financial planning, budgeting, and control.
- Improving the internal auditing system. The system does not work at present because local staff do not have auditing skills and do not realize the importance of audits. Accounting reports and information needed for internal auditing should

also be improved. Any new internal audit system should serve to meet the needs of financial and performance assessment, not just counting money.

- Improving the external audit system with two parallel systems: professional and popular. The first is conducted by a professional auditing agency. The second is a process of community participation. Residents can audit their local administration through such activities as public hearings, consultations, and meetings.
- Changing the local government financial reporting system to make it transparent and to meet the standards required by the financial market.
- Establishing an intermediate institution to help develop local government bonds at the initial stage. The central Government may be reluctant to guarantee local government bonds due to economic problems, including public debt. Local governments may have to rely on a special kind of guarantee for their bond financing, such as the trust fund.
- RUDF should be strengthened to provide a training ground for local administrators. RUDF can serve as guarantor for local government in accessing private financial institutions. RUDF can also pool credit from private financial institutions interested in extending credit to local governments. Under the supervision of the Ministry of Finance, RUDF may issue bonds to mobilize funds from domestic or international financial institutions and extend loans to local governments.
- Local authorities must reorient and train local staff and administrators. Financial management practices should focus on costs and effective asset management.

Various regulatory and supervisory frameworks for local government bond financing need to be established:

- Basic regulations for local government bond issuance must be made part of the securities laws. All regulations pertaining to issuance, initial and continuing disclosure, and other matters that are applicable to corporate securities should also apply to local bond issuance. Issuance regulations should contain directives that require presentation to the market of all local financial information, including local government accounting and financial frameworks.
- The central Government should establish a regulatory environment that will give institutional investors the freedom to invest in a broad range of financial instruments, including local bonds.
- The central Government should provide tax exemptions for local bonds at the initial stage of development, to encourage investors.

Recommendations

The recommendations are divided into two groups: one aims for fiscal decentralization in general, the other for local bond financing development specifically. The two areas are interrelated and this must be emphasized in creating a prudent local fiscal system.

One function of intermediary financial institutions is to raise "loanable funds" from savers or from the capital market and to lend them to borrowers. The numerous impediments to borrowing should be eliminated. There should be a sound policy for extending loans to local governments. Before any loan is extended, a set of reforms must be applied to build the creditworthiness of local governments and to establish a prudent fiscal system for them. The set of policy reforms required to develop local fiscal capacity of emerging countries is also applied to Thailand (Peterson 2000, pp.54–55).

The recommendations for local bond financing development are categorized into short and long term.

Short-Term Policy Recommendations

- Improving local accountability. Local governments must be responsible for their own revenue collection, which is a prerequisite for fiscal decentralization and building up local creditworthiness. Greater local revenue collection will allow sustained self-financing and long-term repayments.
- Changing central government policy on intergovernmental revenue transfer. There should be a formula-based system of revenue transfers to local governments. This system must be transparent and predictable. The formula must take into account the wide differences in population and revenue-generating capacity of local governments. However, the revenue transfers under the formula-based system should not focus on infrastructure investment, otherwise the role of bond financing for local infrastructure development will be defeated by the revenue transfer.
- Reassigning public service responsibilities between central and local governments. The central Government can design public services for local governments. Local government functions should be clearly demarcated to allow local governments to determine what investment the central Government will finance (or cofinance) through the transfer payment system. A clear policy will also help the central Government determine the limits of its obligation to finance local investments and to identify the true credit needs of local governments.

Long-Term Policy Recommendations

- Developing local government staff skills and expertise in bidding procedures, project cost assessment, etc.
- Reforming the local accounting and auditing systems, including the disclosure of local financial conditions. The central Government can help establish a comprehensive accounting system for all local government entities. An accrual accounting system should replace the cash-based accounting system to collect information on financial conditions of local government bodies.
- Undertaking strategic budget planning for local governments. The local budgetary system must be based on strategic budget plans that cover several years to determine future capital and infrastructure investment needs. These plans will indicate how investments will be funded, how the funds will be raised, and how loans will be repaid.
- Redesigning local government financial control and auditing to ensure prudent financial management practices.
- Broadening the legal framework for credit market development to allow local governments easier access to the credit market. The framework should cover subjects such as the types of collateral that local governments can provide for loans and how to assess the collateral, and legal procedures in case of local insolvency.

Assistance from the Asian Development Bank

The Asian Development Bank (ADB) can help promote local bond financing in Thailand in the following areas:

- Strengthening the capability of the central Government to design and implement legal, regulatory, and supervisory reforms to develop local bond financing through technical assistance.
- Increasing the revenue-generating capacity and improving the creditworthiness of local governments. Decentralization requires financial and technical resources that most local governments do not have. Areas that need attention are fiscal reform, tax reform, and reorientation of user charges to reflect the actual cost of services. To promote local fiscal reforms and modernize fiscal management, ADB can help develop a suitable intergovernmental transfer allocation formula.
- Training local authorities and staff in financial management and basic principles of local bond financing.

- Strengthening the local government accounting system by shifting from cash to accrual accounting, developing a multiyear budgeting system, and strengthening local financial management through asset-liability management.
- Reforming trust funds to make them guarantee instruments in local government bond issuance. ADB can help design the system of guarantee.
- Strengthening the capacity of central agencies to design and implement legal, regulatory, and supervisory reforms in support of local government participation in the financial market. ADB can help design the regulatory framework to broaden local government borrowings. Such a regulatory framework requires a deep understanding of the role of local authorities in infrastructure development.
- Strengthening the role of the private sector in providing basic public services (e.g., water supply, sewerage, and other infrastructure) to local areas. Private investors may be encouraged to enter into joint local capital investments or into syndicated schemes with local governments to provide public services. Regulatory reforms can help pave the way for greater private sector participation in local development.

Endnotes

[1] Members of the national decentralization committee include the Prime Minister, interior minister, and finance minister; permanent secretaries of the ministries of interior, finance, education, and public health; secretaries of the State Council Committee, Civil Servant Committee, and National Economic and Social Development Board; director of the Budget Bureau; director general of the Local Development Department; 12 representatives of local entities; and 12 experts from various fields related to local and public administration.

[2] Municipal Act of 1953, Amendment to the Municipal Act of 2000, Municipal Revenue Act of 1997, Provincial Administrative Organization Act of 1997, Bangkok Metropolitan Administration Act of 1985, Amendment to the Bangkok Metropolitan Administration Act of 1999, and Plan and Procedure for Decentralization Act of 1998.

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