Coping with Urban Fiscal Stress around the World

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Abstract

The economic recession, the end of stimulus funding and central government cutbacks, rising social costs and aging, and the need for infrastructure upgrading for urbanization are putting enormous fiscal stress on cities. The financing capacity of municipalities is greatly affected because of the decline in the tax base, expenditure pressures, and growing and more expensive debt. Today's urban fiscal crisis is similar to that experienced in the 1970s, but the growing urbanization in the world and

massive increase in municipal access to financial markets create a new context. This paper surveys three important topics related to the urban fiscal crisis in developed and developing countries: How do cities finance themselves? When they have access to financial markets, should city managers use loans, own revenues or private-public partnerships to pay for municipal expenditures? And what are the remedies to municipal fiscal crises in case of insolvency?

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Introduction

The global financial crisis has had a profound impact on municipalities as a result of slowing economic growth, the rising cost of borrowing, and deteriorating primary balances. The impact has been delayed in many countries by fiscal stimulus and other transfers from the government and by monetary easing, but financial/fiscal pressures—from the potentially higher cost of capital, the fragility of global recovery, refinancing risks, and sovereign risks—will continue for a while.

Fiscal difficulties faced by municipalities throughout the developed and developing world are not much different today than they were yesterday. They result from a combination of three elements: first, economic recessions have an immediate impact on the revenue of cities and on the fiscal value of real property. Municipal revenue—generated locally or from transfers—decreases because of economic slowdown. Second, public expenditure increases because unemployment and other social needs have to be addressed. Third, the financing capacity of the municipality, measured by rating agencies, i.e., its ability to obtain loans and issue bonds, is greatly affected because of the decline in the tax base, expenditure pressures, and growing and more expensive debt. Moreover, other sources of finance, such as foreign investment to finance infrastructure, dry out so that investment projects have to be cancelled or delayed.

What is new about today's urban fiscal crisis is the fact that, in parallel with the growing urbanization of the world, municipal and sub-sovereign access to financial markets has increased enormously. Private or semi-public capital is increasingly playing an important role in municipal finance. With debt comes the risk of insolvency. When cities run out of funds or follow unsustainable fiscal policy, it can jeopardize their ability to service their debt, the services they provide to citizens, the political system when the government is asked to bailout the city, and the safety of the financial system and the creditworthiness of the country. For example, the runaway provincial debt of Buenos Aires was a factor behind Argentina's sovereign debt default in 2001, and the fiscal stress experienced by many states and cities in India contributes to the increase in fiscal deficits, debt, and contingent liabilities.

Another factor contributing to the urban fiscal crisis today is the close relationship between politicians and capitalist bankers. This is reminiscent of the views of Shefter in his book, *Political Crisis Fiscal Crisis about New York City in the 1970s* (Shefter 1985) and of Rajan and

Zingales (2003) on the capture of the political agenda by capitalists. Their thesis is that “the free market system has been held back because of its reliance on political goodwill for its infrastructure. The threat primarily comes from two groups of opponents. The first are incumbents, those who already have an established position in the marketplace and would prefer to monopolize it and see it remain exclusive. The second group of opponents, the distressed, tends to surface in times of economic downturn. Those who have lost out in the process of ‘creative destruction’ unleashed by markets – unemployed workers, penniless investors, and bankrupt firms – see no legitimacy in a system where they have been proven losers. They want relief, and since the markets offer them none, they will try the route of politics. The unlikely alliance of the capitalist and the distressed unemployed worker is especially powerful amidst the debris of corporate bankruptcies and layoffs. In an economic downturn, the capitalist is more likely to focus on costs of the competition emanating from free markets than on the opportunities they create. And the unemployed worker will find many others in a similar condition and with similar anxieties to his, which will make it easy for them to organize together.” (Rajan and Zingales 2003) Pacewicz (2013) states that “public policies have transformed financial markets, but reliance on financial markets can also transform political institutions in ways that promote further financialization.” Nowhere has this been clearer than in the difficulties faced by cities in Europe because of the collapse of Dexia.

The Dexia affair is a textbook illustration of how the urban fiscal crisis is linked to the financial crisis and how it suffers from the close relationship between politicians and boards of directors of financial institutions. The collapse of Dexia, a bank financing municipal investments created by the merger in 1996 of Credit Communal of Belgium and Crédit Local de France, is today considered the most expensive flop in the history of European banking. Dexia had a very aggressive growth strategy and by 2000 had become the world leader for financial services to the public sector. In 2008-10, it took financial hits in several lines of business, including investments in sovereign debt from Greece and other countries. The biggest drain on its cash stemmed from a series of complex wrong-way bets it made on interest rates related to its municipal lending business. A significant part of Dexia’s business is lending money to these localities at a fixed interest rate for relatively long periods, say 10 years. But, because the interest rate that the bank itself pays to finance its operations fluctuates, that exposes it to potential risk. If its cost of borrowing exceeds the interest it charges on loans outstanding, it loses money. To protect itself, Dexia entered into transactions with other banks. But in doing so, it made major miscalculations and protected itself only if interest rates rose. Instead, interest rates fell, and Dexia had to post billions of euros in collateral to financial institutions on the opposite side of its trades, like Morgan Stanley, Goldman Sachs and Commerzbank of Germany. Considered ‘too big to fail,’ Dexia was bailed out by the Belgian and French governments. By late 2013, its bankruptcy had cost at least €6.6 billion to the French taxpayer and at least as much to the Belgian taxpayer, not to mention the collateral damage experienced by municipalities and other financial institutions.

Finance Follows Function Follows Governance

Around the world, a large city (i.e., metropolitan area) is usually a mixture of three things: jurisdictional fragmentation (autonomous municipalities within a metropolitan area), functional fragmentation (single-purpose public enterprises), and metropolitan-wide government (Bahl and Linn 1992). Different countries adopt different solutions, depending on how they value local autonomy, on politics and on technical efficiency. At one extreme are cities like São Paulo, which includes 39 autonomous municipalities, and Mexico City, where services are delivered by two states, a federal district, and more than 50 local governments. At the other end of the spectrum are cities like Johannesburg and Cape Town that deliver their assigned services with little autonomy at the sub-metropolitan level. In between there are cities like Manila (17 cities and municipalities overlaid by a metropolitan government with area-wide responsibilities) and Mumbai (which relies on central- and state-owned parastatals for metro-wide service delivery).

In developing countries, there is a great diversity of arrangements and all them “work” in the sense that local services do not collapse. Cities are having a much tougher time than in rich countries because population growth is faster, resources scarcer and movement away from fiscal centralization is proving to be difficult. It will be a long time before governance in a metropolitan area such as Mumbai or Mexico City settles into a structure like those adopted by Toronto or Copenhagen (Bahl, Linn and Wetzel 2013).

Most metropolitan areas comprise numerous local governments. The boundaries of these jurisdictions do not change often or easily. To a large extent, the assignment of expenditure responsibilities to local governments conforms to these boundaries, as does the financing. Most of the fragmented local government structures in metropolitan areas are highly dependent on intergovernmental transfers or on vertical program spending by higher-level governments.

Metropolitan-wide government, on the other hand, allows externalities for many public services to be internalized and a broader range of services to be assigned to the metro-level agencies. Financing of a metropolitan city government will include property tax and user charges, but other taxes, often those reserved for state-level authorities, should be considered in the mix, while intergovernmental transfers will become less dominant in the revenue structure.

The lesson here is “finance follows function follows governance” (Bahl, Linn and Wetzel 2013). Discussions of how to finance innovative city services must begin with recognition of the limits of existing governance structures and an assessment of how they might be changed to accommodate service delivery in the metropolis, and hence regional taxation. Efforts to build metropolitan councils and to draw on new e-technologies for accountability and transparency may also help to support more effective management of metro areas, when it may be politically difficult to alter formal governance structures.

The defining feature of public finance and governance in most developing countries is centralization. Central governments raise most of the tax money, spend the largest share of the public budget, and make the rules for lower-level governments (e.g., expenditure assignment, taxing and borrowing powers). To a large extent, the success of city finances depends on how vertical intergovernmental relations are structured. In particular, three issues are of great importance:

- Whether metropolitan cities are treated the same as other local governments in the country or given a differential fiscal treatment.
- Whether and how service delivery within the urban area is coordinated by the central or state government.
- The degree to which the actions of metropolitan local governments are regulated by higher-level government ministries. More problematic are the controls imposed by sector ministries (e.g., in infrastructure, education, and health), which can significantly limit local government expenditure discretion, as in Colombia and Peru.

Depending on the development of the local debt market, three situations are possible for municipal finance:

- When the domestic debt markets are yet to mature and the legal framework for devolution is weak,² cities should use a mix of loans and grants while improving the devolution system.
- When debt markets are constrained by fiscal space,³ but devolution has been successfully implemented, municipalities can work with domestic financial institutions to lengthen maturities and reduce transaction costs.
- When credit markets are mature and devolution is secure, there can be provision of instruments to link city financing with domestic markets, especially for small and medium cities.⁴

In developing countries, even when municipal credit markets exist, it is often hard to find useful and reliable information on the creditworthiness of local governments—in part because of a lack

² Devolution means that local governments are constitutionally independent and have responsibility for the delivery of public services along with the authority to impose taxes and fees to finance these services. Devolved governments have considerable flexibility to select the mix and level of services and, in some cases, plenary authority to generate own revenues. Citizens have the ability to elect their local governments to express their preferences on public services and local taxation. The result of devolution is supposed to be a more efficient utilization of resources than would occur if the decisions of the mix and level of local tax and spending policies are made centrally.

³ Many countries do not have the fiscal space required to fund necessary infrastructure improvements. This is the case for most low-income countries but also for many countries whose fiscal positions have deteriorated markedly as a result of the recent global financial crisis.

⁴ Viability also requires the requisite legal framework for borrowing, such as the Municipal Finance Management Act (MFMA) in South Africa, Urban Local Bodies Act in Tamil Nadu, and Master Trust Structure in Mexico.

of transparency in municipal government operations (Kaganova 2011). In developed countries, information on creditworthiness is available in the form of bond ratings.

Colombia has promoted transparency by publishing “traffic-light ratings” of local payment capacity reflecting a combination of liquidity and solvency indicators. To rate municipalities’ subnational debt, a red light identifies those whose ratio of interest to operational savings exceeds 40 percent and those whose ratio of debt stock to current revenues exceeds 80 percent. Red-light municipalities cannot borrow. Green-light municipalities can. Yellow-light municipalities can borrow only after obtaining the approval of the central government.

In 2010, the Municipality of Lima, Peru, obtained a loan to finance urban infrastructure. As a first step, the city received donor-supported technical assistance to apply for a credit rating from an international rating agency. The outcome was a \$70 million commercial bank loan from BBVA Banco Continental to the municipality. This loan took Lima a large step forward to securing long-term financing—its maturity was double that of the city’s previous debts, making debt service payments more affordable and freeing municipal revenues to cover critical operating expenses. The loan was partially backed by a \$32 million guarantee from the International Finance Corporation.

Given that the excessive use of debt financing has long-term implications for a city’s financial standing, it is very important to understand the benefits and risks of incurring and managing debt. In many countries, national legislation does not allow cities to borrow or set limits on local borrowing. Some capital investment needs can be addressed through the use of nonfinancial or nontraditional solutions. On the demand side, governments can reduce the need for new infrastructure by planning for higher density land uses in growing cities. On the financing, building, and operating side, engagement of the private sector in the process through various forms of public-private partnerships is a growing trend, at least in large cities. In some special cases, the use of nontraditional instruments such as land-based financing can enhance a government’s financial capacity. This involves mobilization of the economic value of the government-owned land and government’s power to impose fees and charges, in particular on developers, or to sell “development rights” to generate additional revenues.

How Should City Managers Select the Source of Finance?

In most developing country cities, municipal services are lacking and/or of poor quality, and expenditures vastly exceed municipal sources of finance. The problem is linked to a combination of an inadequate revenue base, expenditure mandates emanating from the law or from higher levels of government (state or province, federal government), lack of capacity, inadequate management systems and inability to capture economies of scale. However, there are some cities that have developed the capacity to deliver services. A review by the World Bank of

190 of its municipal development projects, covering about 3,000 municipalities, reports significant improvements in urban public management in recent years. Half of the projects surveyed had substantial results in financial management. Large municipalities—such as Kazan, Maputo, and Tianjin—unified accounts and integrated financial management across their large organizations. Half also achieved substantial results in enhancing revenue mobilization, updating tax records, expanding the coverage of cadastres or land registers, and improving tax collections. Weaker results for eight projects in Brazil, Indonesia, Mozambique, and Zimbabwe arose from political reluctance by some municipalities to raise taxes. Only six projects wanted to “bring municipalities to market.” Colombian municipalities were particularly successful in establishing a local credit market, complete with recognized credit ratings of active municipalities; some became able to issue municipal bonds for the first time. Only five projects wanted to stimulate private finance of municipal services and only one (in Colombia) yielded substantive results through private funding of water, gas, and solid waste services in several municipalities. The less-successful projects promoted privatization of solid waste operations in Sri Lanka and Uzbekistan; these did not go far, given poor financial performance and uncertain regulatory environments (World Bank 2009). In metropolitan cities, the quality of public services delivered is far better than that provided in the rest of the country. The coverage of basic water and sewer services is higher, health clinics are more accessible, and the scope of services provided is broader. This has been explicitly recognized in countries such as Colombia, where the large cities have been given more expenditure responsibility and autonomy (Bahl Linn & Wetzel 2013).

City managers have essentially four major sources of finance to choose from: own resources (budget and balance sheet); grant funds; loans; and public-private ventures. Each method of financing city expenditures has associated costs and benefits, and no single approach dominates the others at all time. In recent years, innovative financing to finance municipal investments by leveraging domestic capital have emerged.

Own Revenue

Using own resources (budget and balance sheet) is the simplest solution because there usually are no strings attached. However, the amounts spent for public services provided in most metropolitan areas are much larger than own-source revenues of local governments, which means that much of the job of financing local services is left to the intergovernmental transfer system and to vertical programs. Some policy analysts see this as an inevitable outcome in developing countries and stress the need to sharpen the structure of transfers so that they can better match the goals that have been set for them.

Buenos Aires, São Paulo, and Bogotá are examples of metropolitan areas that have done well with own revenue mobilization. But in most developing countries, cities are less successful.

Own-source revenues of all subnational governments in developing countries are equivalent to less than 3 percent of GDP. However, there are plenty of viable revenue options, including improved property taxation, selective use of non-property taxes, and user charges.

The extent to which large cities depend on transfers varies greatly. Cities like Buenos Aires have been assigned significant taxing powers and finance nearly 70 percent of their budget from own-source revenues. But most large urban areas appear to depend much more on intergovernmental transfers. Elected politicians do not like to give more taxing powers to the local level. Indeed, control of transfers and direct spending in metropolitan areas is a tool often used by central authorities to encourage the “good behavior” of key cities. By keeping metropolitan governments dependent on transfers (vs. local taxes) and denying cities access to the more productive tax bases, the government can draw funds away from the metropolitan area to use for equalization grants and for its own direct expenditures. Moreover, local government officials are not anxious to impose politically unpopular taxes and often would rather lobby the national parliament for discretionary grants (Bahl Linn and Wetzel 2013).

Chinese metropolitan governments have been particularly innovative and have engaged heavily in land sales (long-term leases) as a method of mobilizing resources to finance infrastructure.⁵ For all local governments in China, land leases now account for about 30 percent of revenues.

⁵ China has been investing about 10 percent of its GDP annually in infrastructure, with Provinces and Municipalities accounting for the bulk of these investments. Municipalities rely on central government on-lending and their own off-budget vehicles—Urban Development and Investment Corporation (UDIC) which borrow from financial markets—and land assets-based finance to develop urban infrastructure. The limitations of these instruments became evident in the 2000s. Municipalities have no market interaction with creditors when they on-lend from the central government and the borrowing power and payment obligations are not linked. UDIC off-budget debts are not transparent. Financing infrastructure through land lease is not sustainable in the long run, because leasing fees need to be collected up-front. In 2009, China started reforming the system to allow the issuance of provincial bonds and later to pilot municipal bonds. At that time, policymakers recognized that Provinces and Municipalities had no market access experience and that important preconditions for the issuance of bonds did not exist. The central government acted as the issuing agency, with Provinces and Municipalities participating in the auctions. Between 2009 and 2011, RMB 600 billion (US\$90 billion) of provincial bonds was authorized and issued. In 2011, the State Council approved as a pilot direct bond issuance by four cities (RMB 23 billion) without the central government acting as the issuing agency. The reform helped Provinces and Municipalities finance the subnational matching part of investment projects in which the center co-invested in response to the 2008–09 global financial crisis. The new debt instrument significantly lowered the financing costs for Provinces and Municipalities, enabled them to start acquiring market access skills, and linked them as debtors with their debt service obligations. Piloting municipal bonds without the central government as the issuer is one step further to access the market. The issuance of local bonds has been supported by developing legal, institutional, and market infrastructure. The reforms in fiscal management (including the single Treasury account and expenditure reforms) and separating management from ownership of public enterprises have laid the groundwork for the piloting of provincial bonds. The new bond instrument to finance capital outlays under newly developed budgeting procedures will facilitate the development of a framework for medium-term capital budgeting for infrastructure investments. The audit of, and the ongoing efforts to better classify, UDIC debt will facilitate the development of different bond instruments with different risks and securitization profiles. Further regulatory reforms can support sustainable market access, as would complementary reforms in strengthening intergovernmental fiscal systems, enhancing fiscal transparency, and deepening financial markets.

Land sales have great advantages: revenue potential and low political cost. But even in a unique setting like China, there are drawbacks, including sensitivity of land revenues to the real estate cycle; riskiness of land value collateral for loans; the temptation of “easy money” leading to overspending in local government budgets; underestimating opportunity costs of converting land to urban use; and the exhaustible nature of government-owned land as a resource.

Intergovernmental Transfers

In countries that decentralize revenue raising to a lesser extent, capital transfers may be used directly to fund infrastructure projects. These are usually ad hoc grants that are earmarked for specific capital purposes, as is done, for example, in São Paulo. Direct transfers earmarked for infrastructure are also used in India. South Africa makes use of a more formal municipal infrastructure grant, designed primarily to improve services in poor neighborhoods, and about 24 percent of the allocations go to metropolitan-area local governments (van Ryneveld 2007). Another approach is to dedicate a share of intergovernmental transfers to debt repayment, as has been done in Mexico.

Grant Funding

Next comes grant funding—for instance, from the structural funds of the European Union or from major international donors like DfID, AfD or USAID to low-income countries—which is free money but has certain disadvantages. Most grant funds have specific goals which do not necessarily correspond to the highest priorities on the municipality’s list. For example, the European Union may provide grants for environmental protection investments and therefore wish to finance a wastewater treatment plant, whereas for the city, investing in water supply may be a higher priority. Moreover, grants usually do not pay for future maintenance, repair, and operations costs. Long-term debt results in infrastructure that is used by more than one generation also being paid for by more than one generation.

Debt Financing

Infrastructure needs on the order of 5 percent of GDP are well beyond the financial reach of most metropolitan areas in developing countries.⁶ However, there is space for significantly increasing the resource base for infrastructure through debt financing. The focus might be to increase revenue mobilization from loans, leveraging or public-private partnerships.

The success of metropolises in attracting the investment necessary to sustain economic growth, offering the amenities to attract and retain high-quality human capital, and providing minimum acceptable levels of public services to the population will depend to a large extent on the quality

⁶ On the concept of “infrastructure need” see Fay, Toman, Benitez and Csordas (2011) and Dethier and Moore (2012)

of the metropolitan infrastructure (roads, schools, etc.). Better infrastructure can attract investment that leads to new revenue streams and can draw private investors, foreign capital, and donor support, thereby increasing the pool of available resources. But the provision of infrastructure in large urban areas suffers from enormous backlogs and new demands generated by rapid population and income growth.

For the use of debt financing, the golden rules are (1) use debt finance only for strategic infrastructure projects that service mandatory municipal functions; (2) the life of a loan should not exceed the useful life of the asset acquired with the loan; (3) use loans to cover any gaps in financing after own sources and grants (in other words, city managers should prefer grant financing to loans); and (4) forecast the capacity to repay the loan because even legal limitations on borrowing can be insufficient to prevent the municipality from over-borrowing. A municipality that has not exceeded its legal debt limits still may not be able to repay its debt.

For public assets that have a long life, it can be argued that loans are the most efficient financing mechanism. By matching payment for the infrastructure with the time pattern of benefits received, managers can capture the returns from infrastructure investments while deferring the payment. Large municipalities often are in a good position to make use of debt markets to fund long-lived public assets. Their economic bases are stronger and more diversified and there is an unmet demand and willingness to pay for better services.

However borrowing by municipal governments can be problematic (Prud'homme 1995, Tanzi 1996). The revenue stream of municipalities may not be large enough to sustain repayment, but borrowing may go forward anyway in anticipation of some form of bailout. This has led to overborrowing and to some form of bailout in such metropolitan cities as Buenos Aires, São Paulo, and Johannesburg, and more recently in China. Many countries attempt to control for overborrowing with various forms of fiscal responsibility legislation (Liu and Webb 2011), though these programs have met with varying degrees of success. Another problem is that the capacity of subnational governments to manage, plan, and deliver local services may be limited, and this may compromise both the quality of the services provided and the repayment plan.

Intergovernmental arrangements may be a further complicating factor in metropolitan areas with fragmented government structures. In these cases, the best possibilities for debt finance will involve enterprises that operate on a region-wide basis but are independent of the underlying municipal governments.

The practice of borrowing by city governments in developing countries and the success with debt finance vary enormously. South African metropolitan governments borrow from a government-owned bank and through a privately owned intermediary but without repayment guarantee from the central government (van Ryneveld 2007). At the other extreme are Chinese local governments, which cannot borrow but create a backdoor route with special-purpose urban

investment companies that borrow on behalf of the municipal government and are supported by assets pledged by the municipal government.

Public-Private Partnerships (PPPs)

Public-private partnerships (PPPs) have contributed to improvements in productivity in cities. However, whether they are a reliable source of finance is debatable: it depends on the potential for cost recovery and the quality of the regulatory framework. Overoptimistic expectations of private sector participation in the financing of infrastructure have led to major calls for “fiscal space” in public accounts (i.e., less stringent fiscal rules) to finance needed investments. There is increasing evidence that standard fiscal rules adopted to ensure debt sustainability have resulted in a disproportionate reduction in infrastructure spending and that the current political and ideological climate encourages policy makers to postpone large and costly infrastructure investments.

For water, energy and transport (buses, metros, etc) the dominant source of financing in most countries is the public sector (central/federal government, municipalities or parastatals). Such investments are largely financed through tax revenues and sometimes user fees. Operation and maintenance costs often rely on user fees. For poor countries that cannot access capital markets, concessional loans and grants for public infrastructure have been substantial. Following the 2008 financial crisis, there was a short-lived increase in concessional loans, infrastructure being seen by many donors as a promising stimulus measure, but levels like those seen in 2008-09 are unlikely to be sustained.

Governments still play a large role directly providing infrastructure in most developing countries, in addition to their role of regulator of the private (or privatized) sector. Studies have highlighted the efficiency gains from privatization, with telecommunications often noted as an important example. But PPPs have added relatively little to urban capital financing in developing countries in the 1990s and 2000s (Alm 2010). Less than 10 percent of investment has been in the high-priority water/sewer sector, and an even smaller share has been in the form of full or partial privatization. To the extent that PPP has been used, it has focused more on the energy, telecommunications, and transport sectors. There is a weak record of full cost recovery and often an unwillingness of local governments to stand behind the kinds of tariff levels and regulatory arrangements needed to attract private investors. For the public sector, there is the risk that services provided may not be what the public wants. There is also the risk that the private partner will fail and the public sector will have to take on the obligation in full.

The central question is whether public ownership and operation of roads or public utilities improves living standards and enterprise productivity. On the service delivery side, low-income consumers facing public monopolies have little choice or voice in seeking improvements in access or quality. When prices are kept low by government subsidies before privatization, the

benefits often accrue to middle-income and rich people rather than poor people. Evidence also shows that traditional cross-subsidies associated with monopoly state-owned firms (where some consumers are charged a price much further below marginal cost than others) often benefit the better off more than poor people (Stern Dethier & Rogers 2005, p. 350). In addition, fiscal constraints on subsidized monopolies often lead them to invest too little in expanding or maintaining services—so marginal, usually poorer, neighborhoods have little or no physical access to a variety of public services.

In many cases, it is cheaper for the government to raise infrastructure funds itself rather than rely on private finance. This is true when the government has greater access to concessional finance, and when private investors make excess profits. This last point highlights that what is important from a value-for-money perspective is not the cost of private capital per se (captured by the WACC)⁷ but the price the government pays for it (captured by the IRR, internal rate of return).

If the cost of private capital *is* greater than public capital, properly adjusted for risk, the case for seeking private investment *for a given project* rests on efficiency gains. Private investment may be a way of ensuring that the best projects are selected and that access is expanded. A large volume of work has compared the efficiency of private and public infrastructure providers, with the general consensus being that private investment has typically brought efficiency gains. Evidence from Latin American reforms for example suggest significant efficiency gains on average, after the introduction of concession contracts, ranging from 1 to 9 percent per year (Guasch 2004). A number of studies on energy find that private investment has resulted in greater efficiency — 5 to 7 percent per year in Latin America for example. The studies analyzing efficiency in the water and sanitation sector are too few to draw any conclusions. In transport, the evidence suggests that private operators have tended to perform more efficiently. In telecommunications, the general consensus is that there have been significant improvements resulting from private investment.

A more important determinant of performance than private ownership is the degree of competition and the incentives created by the market structure. Estache, Perelman and Trujillo (2005) state that “across sectors, the more relevant variables include the degree of competition, the design of regulation, the quality of institutions and the degree of corruption”. Generally the evidence suggests that private participation tends to result in efficiency gains but is not a sufficient condition, depending on market and institutional conditions. This presentation has focused on market determinants but institutional determinants are also important. Estache and Kouassi (2002) for example find that quality of governance significantly increased efficiency in African water and sanitation services, while the level of corruption significantly decreased efficiency.

⁷ The weighted average cost of capital (WACC) is the rate of return that an investor can otherwise earn at the same level of risk as the investment it is considering, i.e., the opportunity cost of capital.

Value for money analysis is a means of comparing the cost of various approaches to delivering a given project though it is not primarily concerned with other important issues such as the selection of projects and the expansion of access. Raising prices to cost covering levels is a useful way to ensure that the best investments are undertaken. It also argues that they can help in expanding access as utilities become more financially sustainable and therefore have more capital to invest.

Private participation itself can help in expanding access if there is a potential for a return on new investments. Even with cost covering prices, private providers may exert more effort in opening up new markets. Physical access to water, telephone, sanitation, and electricity services has indeed improved after privatization in a number of countries, simply through renewed investment in physical networks by the new private owners. Economic access—through affordable prices for poor people—is a more complicated issue because it involves the more difficult institutional and design issues associated with regulating prices or designing directed subsidies for poor people. In any case, the scope for improved access will depend on the success in achieving efficiency gains—some increased surplus—that can be passed on to poor people. Thus, in principle, with appropriate regulatory institutions, privatization and concession contracts can deliver both improved access to goods and services for poor people and better financial performance for the company.

Practical difficulties can arise with privatization. With limited government finances, direct subsidies for low-cost services for poor people may be difficult to finance. So there is a risk in terms of whether government will be able to sustain transparent subsidies after privatization. These subsidies will compete with other budget demands, while the indirect subsidy of underpricing—and the accompanying losses in government-owned utilities prior to privatization—often can be hidden for years. There is also a risk that the privatization could empower rich people rather than poor. Poorly designed auctions can lead to one-off transfers of wealth from the public sector (taxpayers) to the new investors (domestic elite or foreign investors). If privatized assets are purchased by foreigners, foreign ownership can provoke a political backlash. Infrastructure services often involve some degree of necessity, and people may feel particularly vulnerable to the whims of a private foreign owner. When their government is the owner, they may feel that they have some leverage, even if low prices charged by a state-owned firm come with very low quality. Governments sometimes exacerbate consumers' frustration with private providers, as when they postpone needed price increases until after privatization—so that private firms, often foreign, get the blame.

Municipal Development Funds and Other Innovative Forms of Financing

Innovative ways to finance municipal investments by leveraging domestic capital have emerged since the 1990s. Sustainable financing strategies depend on the size and institutional strength of the municipality (Viking 2006). In the early stages of development, when devolution is inconsistent and legal frameworks for borrowing are weak, successful urban financing is often

based around loans and grants while such institutions are strengthened. As these institutions mature, more complex financing schemes become available, and various instruments can link urban systems of finance to both domestic and foreign capital markets.

Municipal Development Funds

Some financing mechanisms invest in infrastructure and simultaneously bolster city revenue and strengthen the financial management capacity of the city. An illustration is Ethiopia's Public Sector Capacity Building Program, started in 2004, supported by the World Bank. Under this program, performance-based grants have enabled urban governments to strengthen finance capacity and implement systematic reforms. Using this transparent and predictable source of funding, cities have computerized financial reports and strengthened systems of financial management, enabling the delegation of revenue collection to sub-cities, and an expansion of tariffs and service fees. Another example is India's Jawaharlal Nehru National Urban Renewal Mission (JnNURM), which ties municipal funding to obligatory reforms, including the adoption of modern accounting systems, property tax reforms, and user fees for municipal services. This program will distribute up to US\$ 14.43 billion in seven years to eligible municipal governments. Similar lending practices have achieved similar improvements in urban financial capacity in Mali, Macedonia, Ghana, Nepal, and elsewhere.

As basic financial institutions improve, cities—especially small and medium cities—can benefit from these mechanisms which facilitate access to domestic and foreign capital markets. In Colombia, El Salvador, Georgia, the Philippines, and Morocco, but also in the United Kingdom and many other nations, municipal development funds have accomplished precisely this goal.⁸ By pooling the borrowing capacities of municipalities, these funds are able to obtain more competitive financing rates than cities could individually. Funds raised can then be redistributed to cities on a retail basis, and the cities in turn can utilize both fees and (when appropriate) carbon financing to mitigate all costs incurred. At a time when credit markets are tightening and urban borrowing capacities have been weakened, these funds provide an invaluable tool to bolster municipal budgets.

Similar funds can be implemented at national, regional or local levels. Chinese local authorities, for example, have overcome legal restrictions on borrowing by creating Urban Development and Investment Corporations (UDICs), which are able to finance urban investments through bank loans, public-private partnerships, issuing bonds, and property development. Ho Chi Minh City and other local governments in Vietnam have developed similar local funds which are able to issue bonds to create an additional source of revenue. In contrast, regional and state-level

⁸ Serageldin et al (2008), Viking (2006), Paulais and Pigey (2009), World Bank (2009).

financing vehicles have enabled cities to access to capital markets in countries like Mexico, India and Brazil.⁹

In India, some municipal corporations fund urban infrastructure projects, partnering with local governments. Sridhar and Reddy (2010), examining four Indian cities, find that “if revenues from land leasing and sales by the urban development authorities were to accrue to municipal corporations... there could be an increase in municipality’s total revenues to the extent of 33 percent, own source revenues to the extent of 90 percent, and property tax revenues to the extent of nearly 930 percent.” Poor coordination between these two entities usually prevents such revenue streams from being realized, but the experience from Lavasa in India provides an example where these institutional barriers are being overcome. The Lavasa Corporation Ltd. has developed a novel public-private partnership, using real estate sales, annuities from joint venture PPPs, and private negotiations to fund urban infrastructure creation. The success of this program derives precisely from this collaboration between local authorities and businesses, and this collaborative approach can provide a model for other developing cities facing revenue shortages.

Tax Incremental Financing

While development funds can open much-needed channels for cities to access capital markets, cities may still require additional revenue streams to satisfy short-run capital needs and ensure long-run financial stability. In such situations, a range of other innovative financial mechanisms have proven useful. Tax incremental financing (TIFs) allow governments to issue bonds on the future tax revenues they expect to make from a neighborhood, then invest the capital raised in improving that area. This type of financing usually leverages additional private capital from investors interested in preserving property tax rates in the selected area. As Pacewicz (2013) notes, “cities initially used TIF as a last-resort financing strategy, but the practice has transformed urban politics by creating opportunities for economic development professionals to exercise jurisdiction over municipal budgets. Further, TIF structures other roles that development professionals play by giving them incentives to use TIF in ways that are not aligned with the city's fiscal outlook and lock them into ever-higher rates of TIF spending.”

Value Capture Finance

Value capture finance is similar to TIFs in that it allows municipalities to finance urban renewal projects by internalizing the (future) positive externalities generated by these investments. For example, a government could finance a public transportation project by increasing property taxes, or selling land, in the areas directly adjacent to a project. This practice has had success in London, Barcelona, Istanbul, Berlin, Hamburg, and Copenhagen for projects ranging from sports

⁹ USAID (2011), Serageldin et al (2008)

stadiums to row houses to metro development,¹⁰ as well as in Hong Kong SAR, China; Singapore; and Tokyo.¹¹ In different cities, service fees, land sales, and private investment have helped governments recover the initial expenditures associated with projects.

Community Development Corporations and Land Banks

Specialized development organizations can also help coordinate the financing and planning of urban infrastructural investments. Community development corporations have been created to purchase land, improve the land—often through the construction of affordable housing—then sell access to these improvements while retaining ownership of the underlying land. These entities can therefore reduce the costs of access to housing or other goods while minimizing speculation on land prices. Land banks fulfill a similar purpose. These public-private funds can hold land and direct investment toward the most profitable use of the land, using these profits to fund additional improvements on the land. Land banks can therefore act both as a short-term source of municipal revenue, as well as a tool to direct long-term urban development.

Remedies to Municipal Fiscal Crises

Around the world, municipalities are facing increasing financial distress. Future projected trends suggest increasing challenges going forward. Some of the causes include the continued economic recession; the end of stimulus funding; central budget cutbacks; rising pension, medical and other costs; an aging workforce and more retirees; increasing operational and other costs; deteriorating credit ratings and potential increased borrowing costs; reduced state and local tax revenues and fees; aging and/or inefficient facilities and infrastructure; unfavorable contracts or interest rate swaps; and sometimes having to deal with fraud or misappropriation.¹²

In the United States, the tools available to address financial distress vary from state to state. Many states have not authorized municipalities to file for Chapter 9 federal bankruptcy proceedings. Some states that have authorized Chapter 9 cases require municipalities to satisfy certain preconditions, such as approval of the governor to file Chapter 9 or showing that negotiations were attempted. Other states have their own state law insolvency regimes, usually either an emergency manager (receiver) or fiscal oversight board appointed by the state. A few states have no Chapter 9 or formal state law insolvency option. For now, negotiated solutions or petitioning the state legislature for custom relief appear to be the best options in such states. Even in states where Chapter 9 or state law insolvency is available, many local governmental units prefer trying negotiated solutions first, which may help preserve future credit ratings and allow the local government more control over the process. The three types of remedies to address

¹⁰ Huxley (2009)

¹¹ Salon and Shewmake (2011)

¹² Association of Corporate Counsel (2012)

municipal fiscal and financial crises represent a distinct approach to the problem of local insolvency, and each places the burden of the crisis on a different entity (Kimhi 2008).

- Creditors' remedies require the residents to pay the municipal debts by raising local taxes. In this approach, since the residents enjoy the services the locality provides, they should also be the ones financing the local obligations with the taxes they pay.
- Chapter 9 of the Bankruptcy Code allows an insolvent municipality to shift part of its costs onto its creditors by discharging part of the local debt in bankruptcy. This approach places the burden on the creditors, in an attempt to help the municipality increase its productivity and recover.
- State financial boards are a way to deal with the crisis with the help of the state. The state intervenes in the distressed municipality's fiscal affairs and tries to help it recover. This third remedy places the burden of the crisis on the state, as opposed to the residents or the creditors. It has the ability to prevent potential crises and to minimize their harmful effects. Neither creditors nor local residents can avoid looming crises, because often the causes of these crises are outside their (and the local officials') realm of control. The state, on the other hand, has both the legal authority and the political power to deal with the causes of urban crisis, and thereby to rehabilitate ailing localities.

Fiscal crisis implies fiscal adjustment by debtors, and the latter requires difficult political choices to bring spending in line with revenues and borrowing in line with debt service capacity. In each case, finding a way out of a fiscal crisis implies making four choices (Canuto and Liu 2013):

1. Finding a balance between the contractual rights of creditors and the need for maintaining public services in the event of subnational insolvency;
2. Clarifying the roles of different levels and branches of government in resolving insolvency;
3. Developing a framework for debt resolution; and
4. Choosing an approach—judicial, administrative, or hybrid—which, in turn, depends largely on the existing legal, constitutional framework in the country.

A good resolution of the crisis implies discouraging free riders, eliminating (or at least minimizing) the moral hazard of defaults, and moving toward sustainable fiscal policies (or at least minimizing unsustainable fiscal policies that would burden future generations). Free riding is very common when it comes to subnational policy (whether municipal/local or province/state level) since subnational entities have interests that diverge from the national interest. Municipal borrowers might have an incentive not to repay their creditors, and creditors might lend without

risk differentiations, if they perceive that defaulting debtors could be bailed out by the central government.

Fiscal adjustment by debtors requires difficult political choices to bring spending in line with revenues and to bring borrowing in line with debt service capacity.

Municipalities may not freely adjust their primary balance due to legal constraints on raising their own revenue, dependence on central government transfers, or the central government's influence on key expenditure items such as wages and pensions.

Debt restructuring and debt discharge are complex processes but can be distilled into two basic questions: whether the creditors and the debtor can reach agreement on debt resolution; and who holds the cram down power when both sides fail to reach an agreement (Liu and Waibel 2009).¹³ In the United States, as well as other countries like Hungary, the courts hold cram down power when local governments and creditors negotiate. In Brazil and Mexico, the central government leads debt restructuring, and there are no debt write-offs.

The lack of a framework may lead to the “holdout problem”: some creditors may demand preferential treatment and threaten to derail debt restructurings negotiations. The lack of clear rules for insolvency is likely to raise borrowing costs, and may limit market access for creditworthy borrowers. The tension between maintaining essential services and creditors' contractual rights would imply that the pain has to be shared between creditors and debtor. The insolvency mechanism needs to balance these competing interests and guide the priority structure of settling competing claims (Liu and Waibel 2009).

There are essentially two approaches to find a resolution to insolvency: the judicial and the administrative. Courts make decisions to guide the restructuring process in the judicial approach, which has the advantage of neutralizing political pressures during the restructuring. However, the courts' ability to influence fiscal adjustment is limited because mandates for budgetary matters usually rest with the executive and legislature. That is why, in the administrative approach, some higher-level government body is given the temporary direct political responsibility for financial management and for restructuring the city's debt obligations into longer-term debt instruments. There are, of course, some hybrid approaches. For instance, in South Africa, the law blends administrative intervention with the role of courts in deciding debt restructuring. The federal government in Mexico restructured the public debt after the Tequila Crisis, and a few years later introduced regulations on the lenders that effectively constrained the borrowers as well (Canuto and Liu 2012).

¹³ The cram down power is the ability to force dissenting minority creditors to accept an agreement between a majority of creditors and the debtor.

Insolvency Systems in Other Countries

The first country to introduce legislation about municipal insolvencies was the United States, which introduced in 1937, in response to widespread municipal defaults during the Great Depression, what is today known as Chapter 9 of the US Bankruptcy Act. Many countries today have systems to deal with municipal insolvency and bring to the table all the affected parties, i.e., the creditors, shareholders, municipal employees (like firefighters, teachers, etc.) and their union representatives. The main purpose is to provide a credible framework to restructure the municipal debt, to ensure that essential public services (police, fire protection, and water and sewer, etc.) continue to function during the restructuring. Most countries (and, in fact, most states in the United States) do not allow municipal bankruptcies but virtually all countries have systems that permit workouts in cases when a municipality has expenditures that vastly exceed its revenues and is incapable of fulfilling its legal financial obligations. An excellent overview is provided in Liu and Waibel (2008). The three different experiences of France, Hungary and Colombia are summarized below. The paper by Liu and Waibel, from which this information is drawn, also provides other country studies.

France

During 1982–83 and 2003–04, two waves of decentralization in France devolved powers to municipalities, departments and regions. This new institutional framework has enabled these subnational governments to enjoy a greater degree of autonomous expenditures, to raise their own taxes, and to borrow from financial markets within ex-ante rules established by the central government. They are subject to ex-post controls by the Prefect and the Regional Chambers of Accounts, and to ongoing controls by the Public Accountants.

The ex-ante fiscal rules and regulatory framework for managing subnational fiscal risks were established after a period of unregulated borrowing by municipalities following the decentralization and subsequent debt stress in the early 1990s. The regulatory framework combines the laws and regulations with three sets of institutions, while preserving considerable fiscal autonomy. The laws and prudential rules regulate debt, liquidity, and contingent liabilities. The state exercises strong supervision and monitoring of subnational financial accounts through the Prefect, the Regional Chamber of Accounts, and Public Accountants. By law, subnational governments cannot go bankrupt and public assets cannot be pledged as collateral. If a municipality, department or region is insolvent, the central government will enforce fiscal adjustment and facilitate debt negotiations between creditors and borrower. Subnational accounts may be placed under the control of the Prefect and the Regional Chamber of Accounts for failure to present a balanced budget, deficits exceeding 5 percent of operating revenues, or failure to make provisions in the budget for compulsory expenditures including debt services.

There was anxiety in 2011 when the sustainability of the sovereign debt of some Euro countries led to tensions in financial markets. The interest rates of the Greek, Spanish and Italian sovereign debt increased sharply. The deficit reduction plans of these countries and ECB intervention helped ease tensions. In that environment, France maintained an annual growth of GDP to 1.7% in 2010 and 2011 but the situation of public finances is worrisome. The overall public debt of France stood in 2011 at €1,717 billion or 86% of GDP (higher by 4% than in 2010). Since 2000, the debt of the 36,700 cities in France has increased by €10 billion to €60.7 billion in 2012. Levallois-Perret (in the suburbs of Paris) is the city with the highest debt per capita in France (€11,447) followed by Cannes (€3,733). Among large cities (those with more than 20,000 inhabitants), the most indebted in 2012 were Paris (€3.2 billion) followed by Marseille and Levallois-Perret (see *le Figaro*, September 26, 2013). Of course, city debt levels are not comparable. Cannes has to maintain a tourist infrastructure, which may justify more investment and more debt. High debt levels are not necessarily a sign of mismanagement. It depends on the use that is made of the loan and on the revenues that it will generate.

Hungary

Following the fall of communism, the 1990 Law on Local Government in Hungary granted local governments unfettered freedom to manage their finances. They borrowed for commercial activities and long term to finance short-term operating deficits. The deterioration of the macroeconomic situation in the mid-1990s exposed the seriousness of subnational financial distress (Dethier and Bokros 1998). Imprudent lending by public banks without proper evaluation of local creditworthiness was attributed to the guarantee of the debt of local governments given by the central government. Several local governments successfully lobbied for central government grants. This threatened to set a bailout precedent, raising concerns of adverse incentives for debtors and creditors.

Several options were debated at the time, including informally negotiating a restructuring of the debt between creditors and local governments. The deteriorating finances of local governments concerned the central government because of the contingent liabilities that the guarantees created. The government eventually opted for a formal insolvency mechanism. Transparency and predictability were viewed as central to an effective subnational insolvency mechanism. The Law on Municipal Debt Adjustment was approved by the Hungarian Parliament in 1996 at a time when the country was trying to come out of a major macroeconomic slump. It gives courts the central role in fiscal and debt adjustment for insolvent local governments.

The implementation of the law has exceeded the expectations of the framers of the law. The legal procedure is transparent, the moral hazard of bailouts has been minimized, and essential services have been maintained. The debt adjustment procedure allows participating municipalities to have a clean slate and to move forward. Many insolvency cases were resolved through informal

negotiations. While bilateral negotiations are an integral part of all insolvency regimes, the non-transparency and potential asset stripping could negatively affect less-informed or smaller creditors and the public interest. Discussions are ongoing among stakeholders on making the pre-bankruptcy negotiated restructuring more transparent (Canuto and Liu 2013; Dethier and Bokros 1998).

Colombia

In the late 1980s and 1990s, the trend toward political decentralization in Colombia was accompanied by more freedom for subnational borrowing. States and municipalities experienced debt stress in the late 1990s/early 2000s, exacerbated by the economic downturn. Contributing factors included weak bank supervision, excessive reliance on transfers, and permission to borrow for current expenditure which blunted incentives for fiscal discipline. Although the local debt level was not high by international comparison, the arrears had been increasing by the late 1990s, and local capacity for debt service had weakened, due primarily to the decline in own revenues and fiscal transfers. The debt stress led to an episode of public finance reform. Colombia enacted several laws between 1998 and 2003 regulating the origination of municipal and state-level debt and encouraging fiscal responsibility. Law 550 (1999) deals explicitly with bankruptcy proceedings for states and municipalities. The essence of the proceedings is to evaluate and reconcile competing claims against subnational debtors, according to a defined priority structure. The procedures in Colombia are administered by the Superintendencia de Corporaciones (SOC) in coordination with central government institutions. The SOC was created in the 1930s, in a historical context in which the court system was weak. The SOC administers bankruptcy procedures for both corporations and most government entities. The implementation of Law 550 and other fiscal legislation has taken place in the context of improving macroeconomic performance of the country since 2003. There has been little divergence between the law and its practice. The protection offered by bankruptcy Law 550 enables insolvent states and municipalities to reach orderly debt restructuring agreements with creditors. Focusing on debt workouts, Law 550 has limited ability to address the root causes of fiscal stress and debt. Other complementary laws—mainly Laws 358, 617, and 819—work in several ways by limiting borrowing, promoting fiscal transparency, strengthening the budgetary process, and helping to finance debt restructuring (Canuto and Liu 2013).

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