Understanding Local Finances

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In cooperation with:

UNESCO IHE DELFT

C-WAS Center for Water and Sanitation

CEPT UNIVERSITY

Decentralisation in Federal/Unitary countries

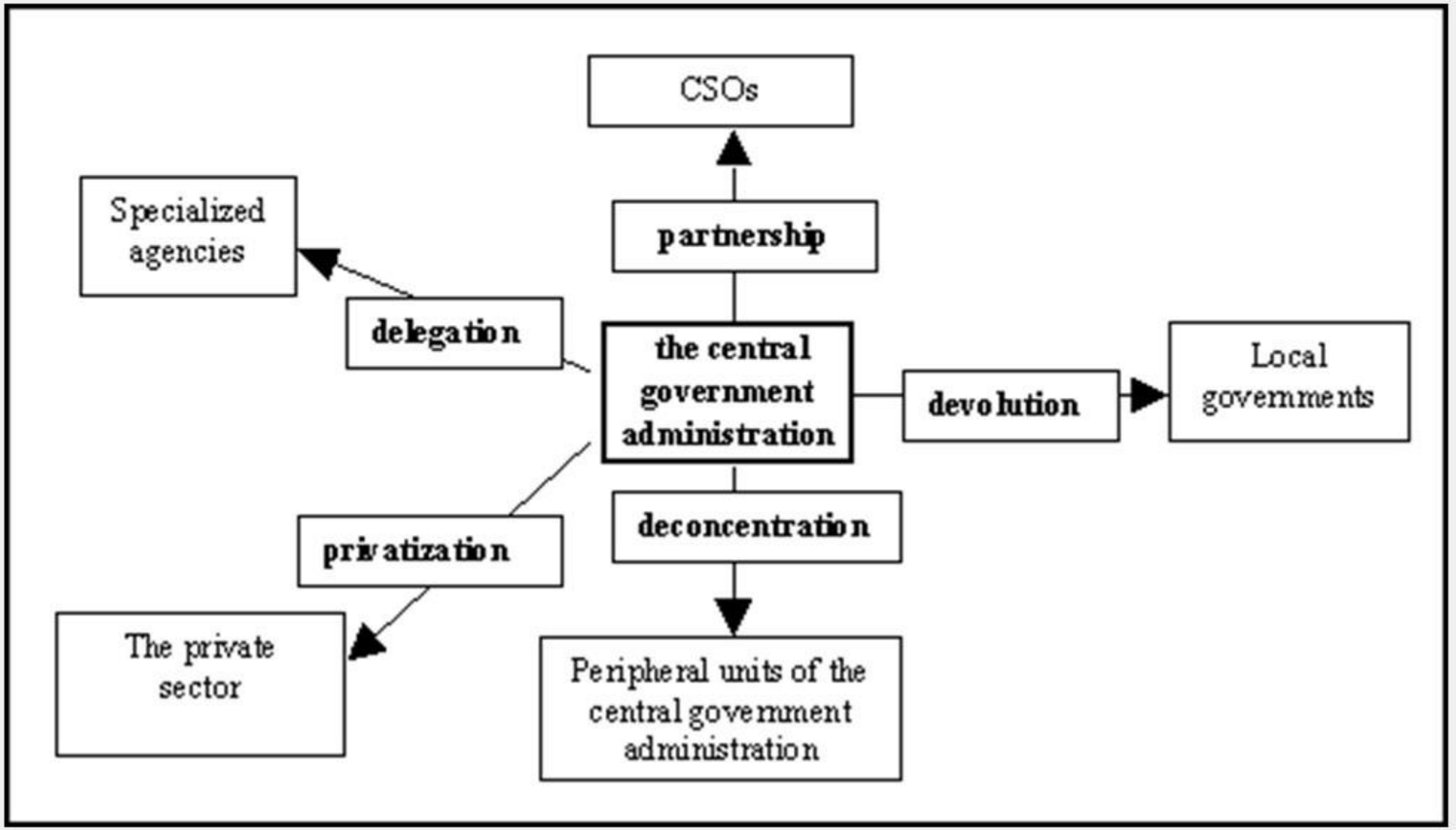
- In a federal system powers of government are divided among three levels of government – the national (federal) government and state governments, and with local governments. Examples: USA, Russia, India, Brazil, Ethiopia, Australia, Canada, Nigeria. Mexico
- In a unitary system, decentralisation maybe by a strong central government creating local governments. Most countries in the world are unitary

Guiding Principle of decentralisation

Strengthening fiscal decentralisation and local authorities financing:

"Fiscal decentralisation is a key factor and driver for successful decentralisation. Support to fiscal decentralisation should aim at strengthening the long-term financial development and sustainability of local governments."

Five forms of decentralization



Types of decentralisation

The term "decentralization" embraces a variety of concepts- Political, administrative, fiscal and market decentralization

- **Political decentralisation** – democratic decentralisation. presence of elected local governments
- **Administrative decentralisation – (functional decentralisation)** – three major forms of administrative decentralization – ***de-concentration, delegation, and devolution***
- **Fiscal Decentralisation –** ensuring appropriate expenditure and revenue responsibilities at local level
  - It is a core component of decentralization
- **Market Decentralisation** – private sector participation, deregulation

Fiscal Decentralization

Four basic building blocks or “pillars”

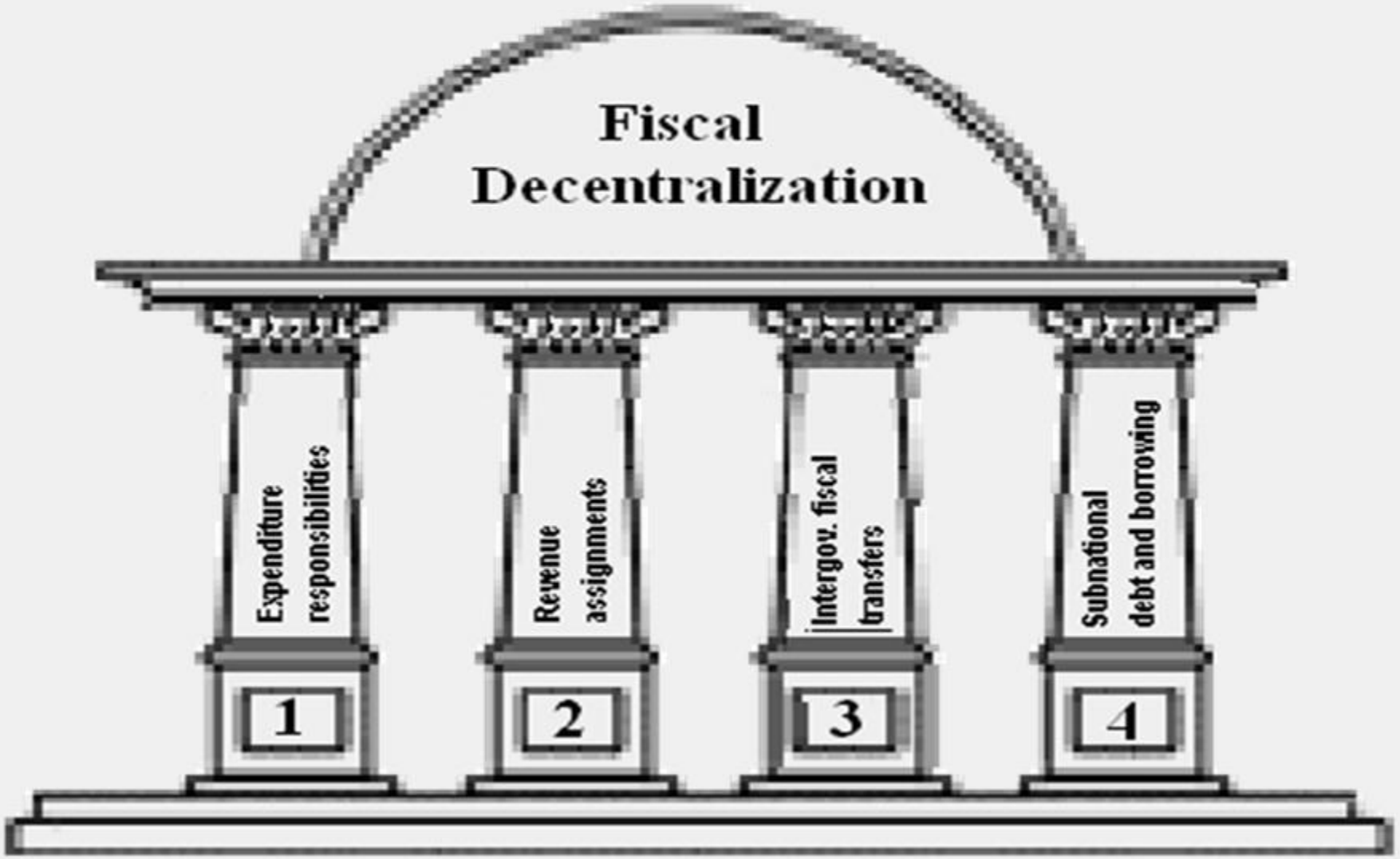
1. **The assignment of expenditure responsibilities** to different government levels: what are the functions and expenditure responsibilities of each level of government?

2. **The assignment of tax and revenue sources** to different government levels: which tax or non-tax revenue sources are be made available to sub-national governments in order to meet their expenditure responsibilities?

3. **Intergovernmental fiscal transfers**: in addition to assigning revenue sources, central governments may provide regional and local governments with additional resources through a system of intergovernmental fiscal transfers or grants.

4. **Sub-national borrowing**: local governments can borrow (in a variety of ways) to finance revenue shortfalls

Fiscal Decentralization - Four pillars



First Pillar: Expenditure assignments

- Assigning services /functions to levels of government

- "Subsidiarity principle". This principle suggests that government functions should be assigned to the lowest level of government that is capable of efficiently undertaking this function (such as providing a good or service).

- *Encompassing principle*: Assignment of governmental responsibility should *encompass* relevant externalities. National externalities and public goods are best dealt with by national governments, local externalities and public goods by local governments.

Local government and services

- Local governments are the closest partners of National Government in implementation of national development agenda

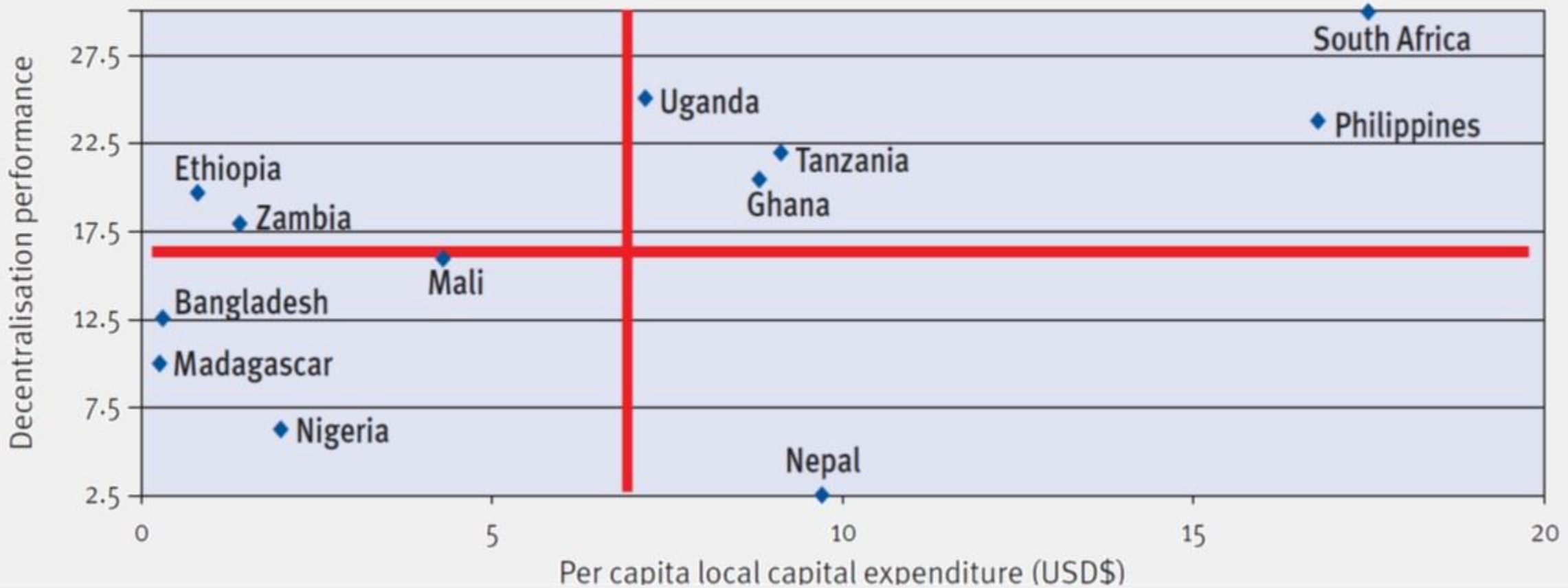
- Motivation for decentralisation has varied, but " improving service delivery is an implicit motivation behind most of these decentralisation efforts"

- When this is done, it is argued, resources will be allocated with the greatest efficiency, accountability, and responsiveness.

- Geographically specific – low externalities/spillovers, e.g. garbage collection, fire services, internal roads, streetlights, etc

Decentralisation and Local Government's role in water and sanitation

Figure 7: Local capital expenditure on water and sanitation versus decentralisation performance[10]



Source: Wateraid (2008), Think local, act local Effective financing of local governments to provide water and sanitation services, London

Fiscal Decentralisation in Southern and Eastern Africa

ANNEX 4:
Fiscal Decentralisation in Eastern and Southern Africa in 2000

	South Africa	Kenya	Uganda
Structure of local government	Provincial – municipal (Type A, B and C)	Local (municipal, town, urban and county)	Local (districts and four levels below)
Size of local government	• Provincial and municipal > 60% of total public expenditures < 15% of total public revenues	• 5% expenditure • 6% revenue (prior to recent reforms)	• 28% expenditure • 8% revenue
Local government expenditures	• Social services (provincial) • Local services (municipal)	• Local services • Some infrastructure	• Social services • Some infrastructure • Local services
Local government own-source revenues	• Road tax/fees, gambling (provincial) • User charges, property rates and RSC levy (local)	• Property rates • User charges • Agricultural cess (rural)	• Graduated personal tax • Property rates • User charges
Intergovernmental tax sharing	Provided for provinces (not yet used)	Income (newly instituted fiscal year 2000)	None
Intergovernmental transfer programs	• Equitable Share (formula-based distribution of an annual ad hoc allocation) • Various capital transfer programs	• Block Transfers (formula-based distribution of income tax share, but reform conditions placed on a portion)	• Unconditional, equalization, conditional (separate formulae)
Local government borrowing	Once substantial in metros, then declined – new framework in development	Once substantial, now virtually gone	None
Central government oversight	• National Treasury • Department of Provincial and Local Government	• Ministry of Local Government • Ministry of Finance	• Ministry of Local Government • Ministry of Finance • Planning and Economic Development
Local government autonomy	Relatively strong legally and in practice	Relatively strong but some control	Strong legally, but weaker in practice
Local government capacity	Mixed (stronger metropolitan)	Mixed across urban and rural	Mixed, generally better in urban

CLGF (2006) Municipal Finance: Innovative Resourcing for Municipal Infrastructure and Service Provision. Available at www.clgf.org.uk

The second pillar : Revenue assignments

- Which revenue sources (tax sources or non-tax revenue sources - including fee revenues) should be made available to subnational governments in order to meet their expenditure assignments?

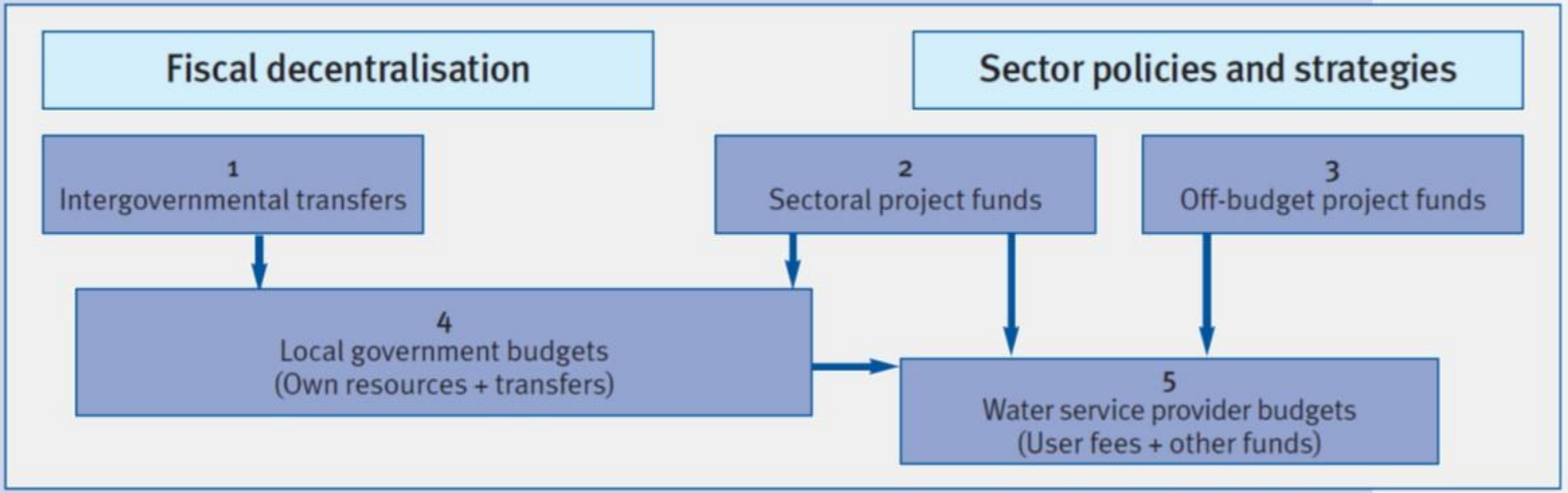
- Taxes that achieve a ‘correspondence’ between the tax and the benefits from local government services – easy for tax payers/citizens to understand

- Relatively easy to administer

- Incidence of local taxes should be equitable

Financing at Local Level

Figure 1: The five funding blocks



Mehta and Mehta (2008), Financing water and sanitation at local levels: Synthesis paper, Water Aid, London……Subsequently published as "Think Local Act Local" by WaterAid

Finance should follow function

Type of Local Services	Examples	Appropriate source of funding
That are 'excludable' and have no spill over	Local utility services (WS, Sewerage), swimming pools, etc	User fees, benefit tax
Not excludable – local spill over	Local parks, local roads, refuse collection	Local general taxes
Spill over between local jurisdiction	District roads, mosquito control	IGTs combined with local taxes
National priority / equity linked programs	Public education, public health care, social welfare	Sectoral / conditional IGTs
Local infrastructure development	Capital development programs for infrastructure	Borrowing, benefit tax, IGT grants

How are local governments financed?

- Transfers / Grants – from higher level of government – State and Central
- Own sources of revenue – taxes and fees
- Borrowings –loans from government/international agencies/donors
- Market borrowing – municipal bonds/commercial projects

Financing local service

DIFFERENT FINANCING TOOLS FOR DIFFERENT SERVICES

Private	Public	Redistributive	Spillovers
Water Sewers Garbage Transit	Police Fire Local parks Street lights	Social assist Social housing	Roads/transit Culture Social assistance
User Fees	Property Tax	Income Tax	Transfers

Source: UN-Habitat (2009), Guide to Municipal Finance. Available at www.unhabitat.org

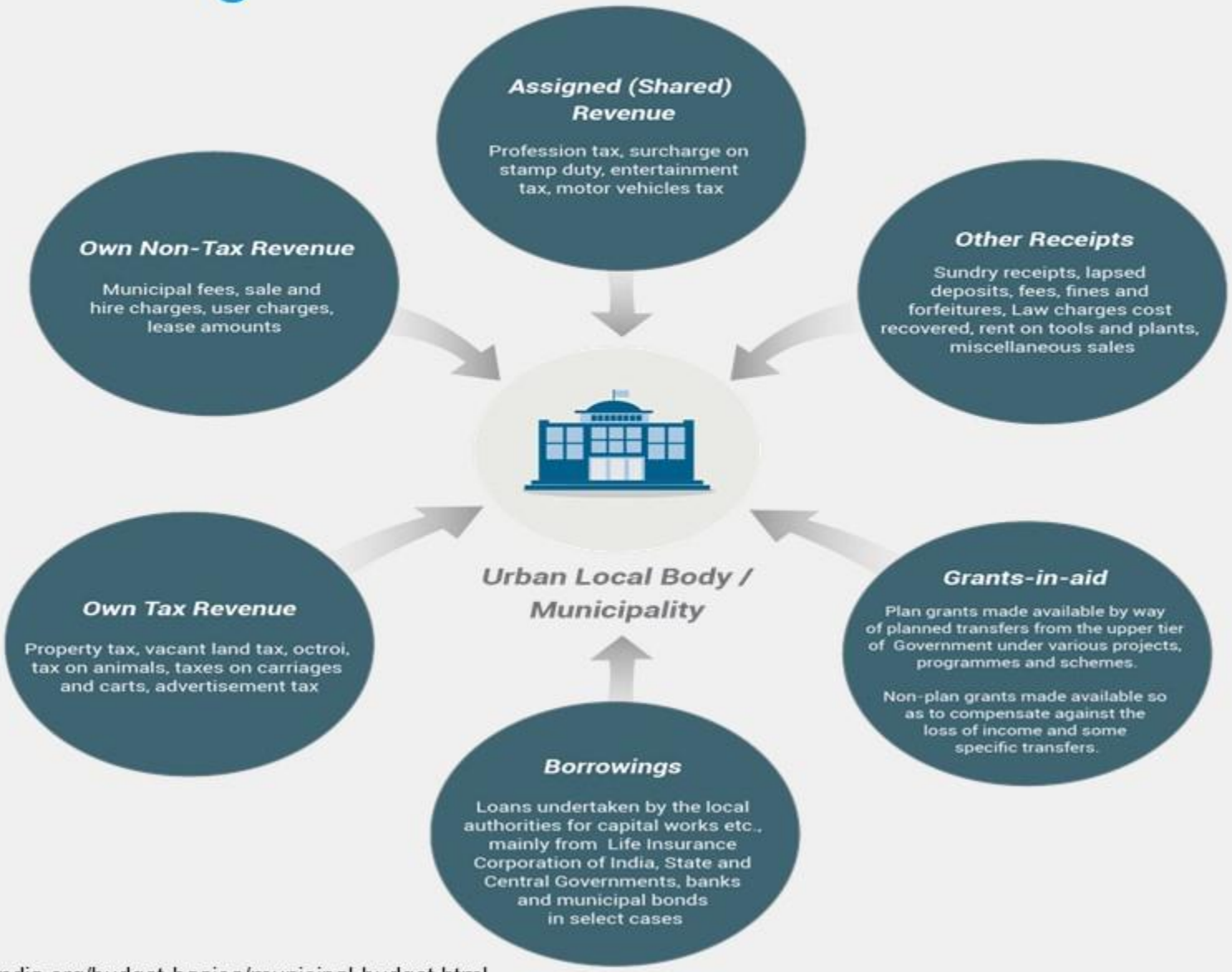
Local government revenues

TABLE 1: **SOURCES OF LOCAL GOVERNMENT REVENUES**

LOCAL GOVERNMENT REVENUES				
INTERNAL SOURCES			**EXTERNAL SOURCES**	
Land-Based Revenues	Non-Land-Based Revenues	User Charges	Inter-governmental transfers	Borrowing
Property Taxes	Taxes on households, vehicles, animals etc.	Service charges (water, parking, sewerage etc)	General purpose grants; Regular transfers or formula-based shared taxes	From governmental sources
Land Fees	License fees for various businesses and occupations	Administrative fees, such as building permits, registration etc.	Grants for specified purposes	From private capital markets (including inter-national markets)

UN-Habitat (2010) Challenges of Municipal Finance in Africa, The Human Settlements Finance Systems Series, Nairobi

Sources of local government finance in India



Source: https://openbudgetsindia.org/budget-basics/municipal-budget.html

Sources of Municipal Finance in select cities

TABLE 8: **SOURCES OF MUNICIPAL OPERATING REVENUES FOR SELECTED CITIES**

	Cape Town 2007-08	Toronto 2007	Madrid 2003	Mumbai 2007-08
	%	%	%	%
Property Taxes	25.4	41.5	12	19
Other Taxes			19	46
Services Charges	40.9	21.8	16	23
Government Grants and Contributions	25.2	20.9	39	4
Other	8.5	15.8	14	8
Total	**100**	**100**	**100**	**100**

Notes: Madrid is the Municipality of Madrid and not the Community of Madrid. Other taxes in Madrid include taxes on vehicles, land value, construction, and business. Other taxes in Mumbai include the octroi (a tax on the entry of goods into a local area for consumption, use, or sale that has been abolished in most parts of India).
Source: Cape Town Budget: (http://www.capetown.gov.za/en/Budget/Documents/Draft_Budget-March_2008/Budget%202008%202009.pdf); Toronto: Ontario Ministry of Municipal Affairs and Housing, Municipal Financial Returns; Madrid: OECD Territorial Reviews: Madrid, Spain, 2007; Mumbai Budget (http://www.mcgm.gov.in/irj/portalapps/com.mcgm.aaboutus_budgets/docs/E13.pdf)

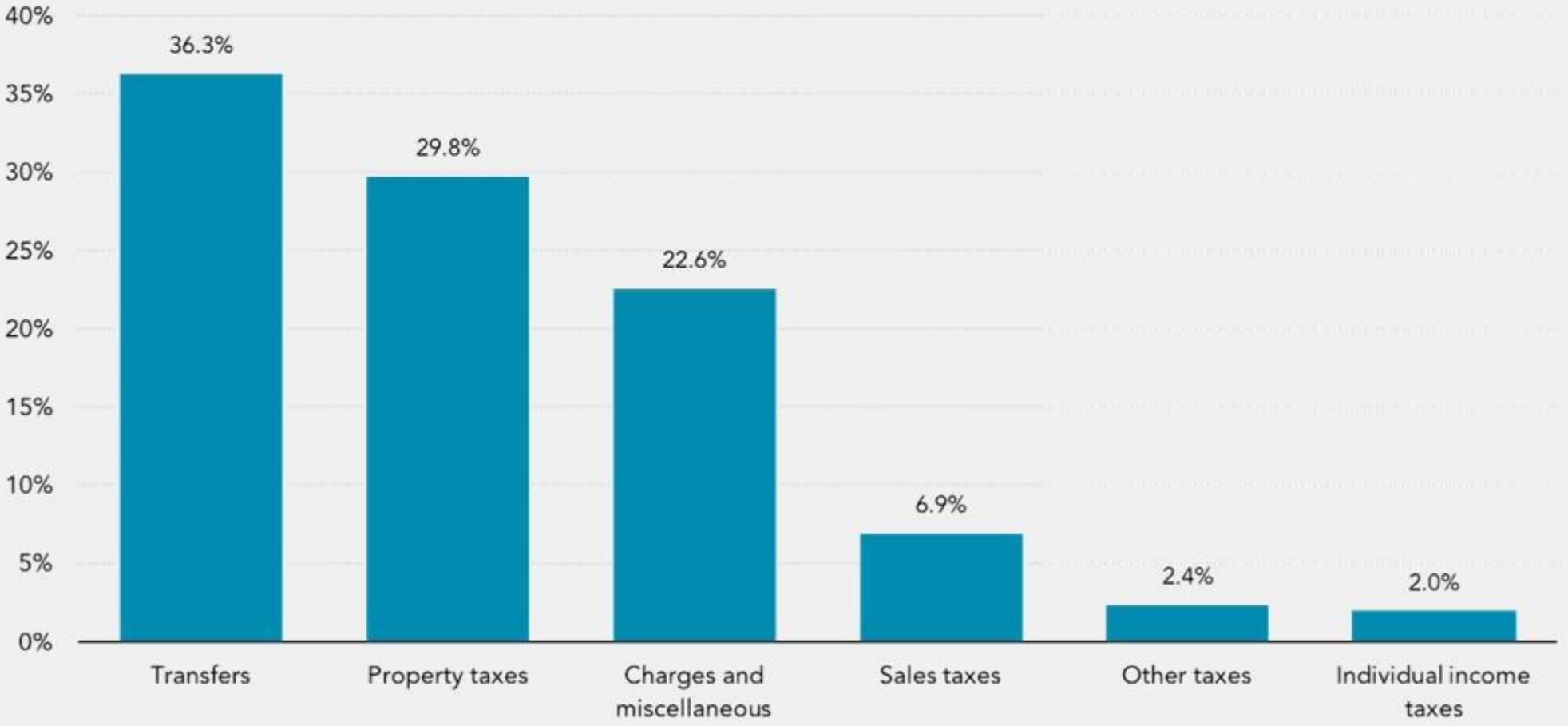
Source: UN-Habitat (2009), Guide to Municipal Finance. Available at www.unhabitat.org

Sources of Municipal Finance in USA

FIGURE 1

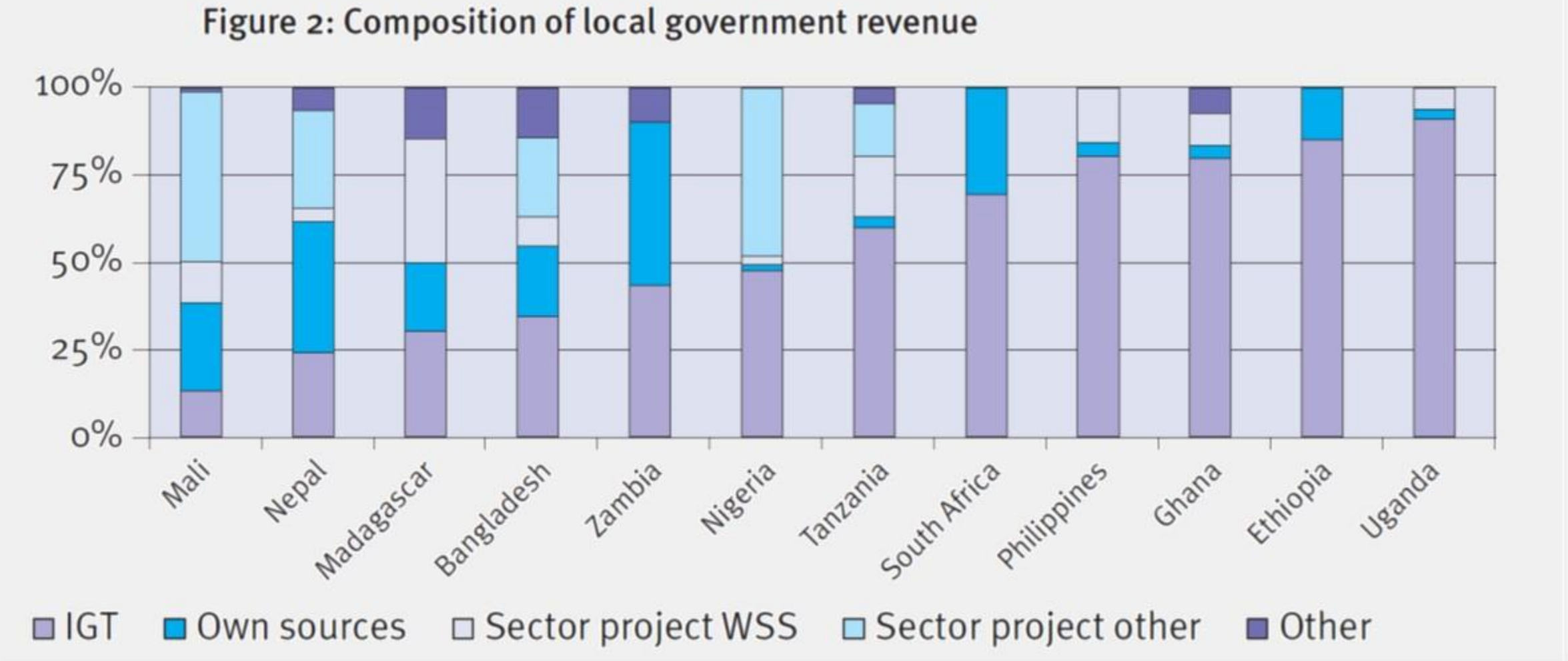
Local General Revenue by Source

2014



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

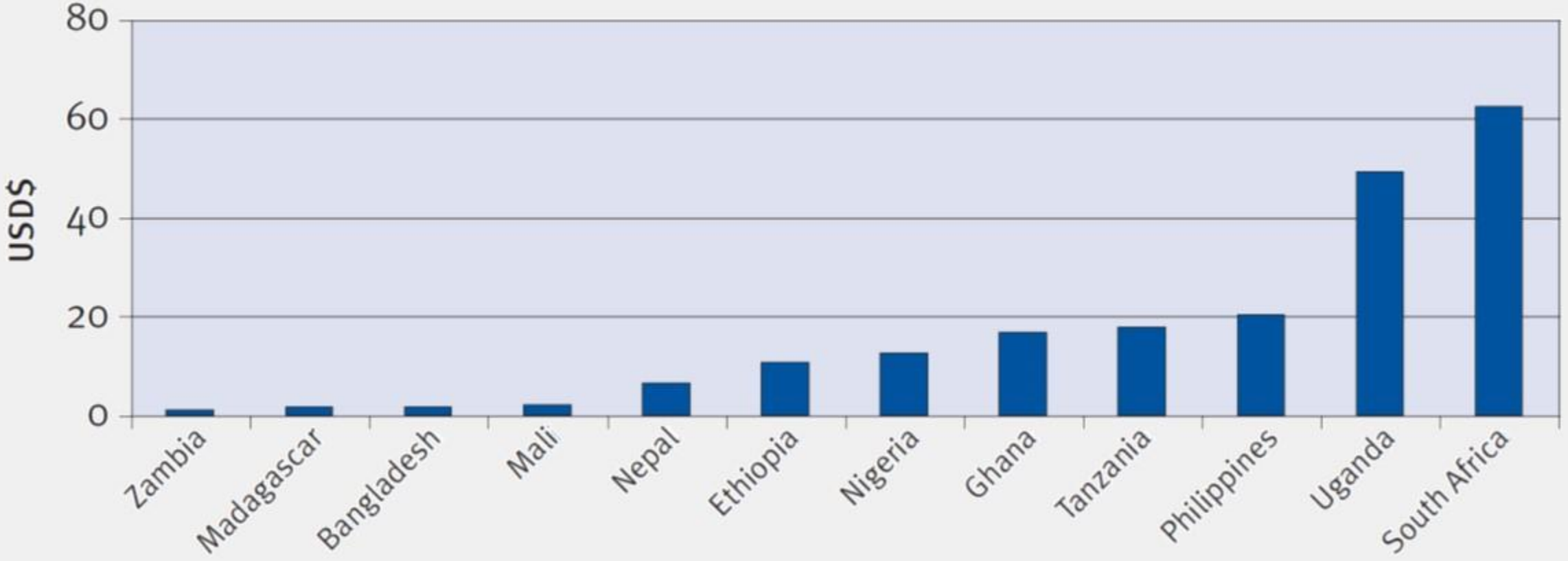
Composition of Local Government Revenue



Mehta and Mehta (2008), Financing water and sanitation at local levels: Synthesis paper, Water Aid, London……Subsequently published as "Think Local Act Local" by WaterAid

Annual per capita revenue of local governments

Figure 3: Annual per capita local government revenue (USD$)



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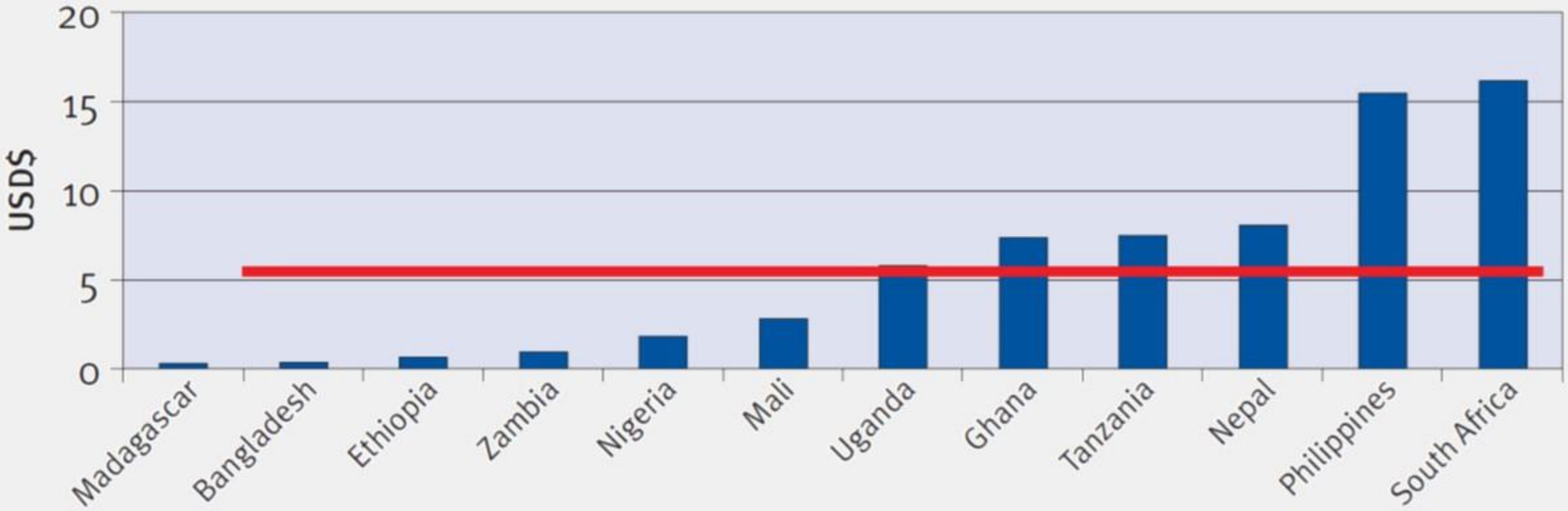
Annual Per Capita Local Government Expenditure

Figure 4: Annual per capita capital expenditure at the local level on WSS (USD$)



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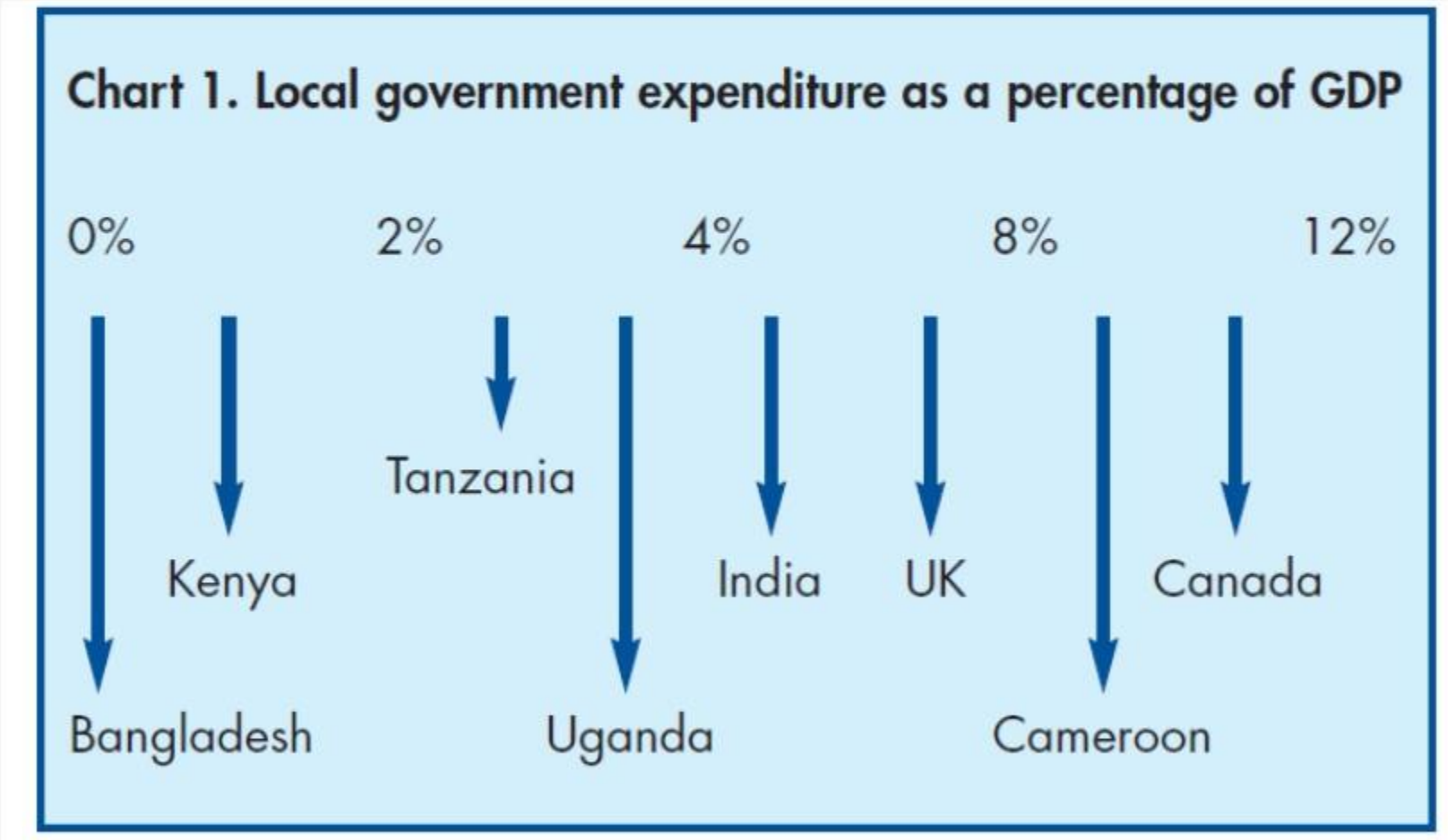
Local government expenditure % GDP



CLGF (2006) Municipal Finance: Innovative Resourcing for Municipal Infrastructure and Service Provision. Available at www.clgf.org.uk

State of Municipal Finance

JOHANNESBURG - More than 40% of South African municipalities do not have enough money to carry out service delivery plans for the current financial year, Finance Minister Nhlanhla Nene revealed on Tuesday.

According to EWN, Nene in a written Parliamentary reply revealed that 112 municipalities have unfunded budgets.

The majority of municipalities come from Limpopo, followed by the Northern Cape and KwaZulu-Natal, the minister told MPs.

He further revealed that just 14 municipalities have approved financial recovery plans.

https://www.iol.co.za/business-report/economy/40-of-sa-municipalities-are-out-of-cash-minister-nene-14843189

Financial challenges facing South African municipalities

- Current picture a matter of great concern

	2013/14	2014/15
Bankrupt	**4**	**6**
Insolvent	**92**	**96**
Unable to Pay creditors	**32**	**27**
Constrained Liquidity Ratio	**11**	**20**
Short to medium term viability	**123**	**126**
Insufficient Reporting	**16**	**3**
	278	**278**

Source: National Treasury

- **This reality may also explain why some 20 or so municipalities are battling to pay their creditors such as Eskom, Water Boards and others**

Own sources of revenue

Why have local taxation?

- Local governments are often *more accountable* for controlling their spending (expenditure) if they are also responsible for revenues

- Allows tax policy (tax levels and structure) to be *tailored* to the conditions and preferences of local governments

- *Reduces excessive demand on transfers* by local governments from the centre

Land and Property Taxation

- tax on land and buildings is universally levied by cities all over the world? Why?

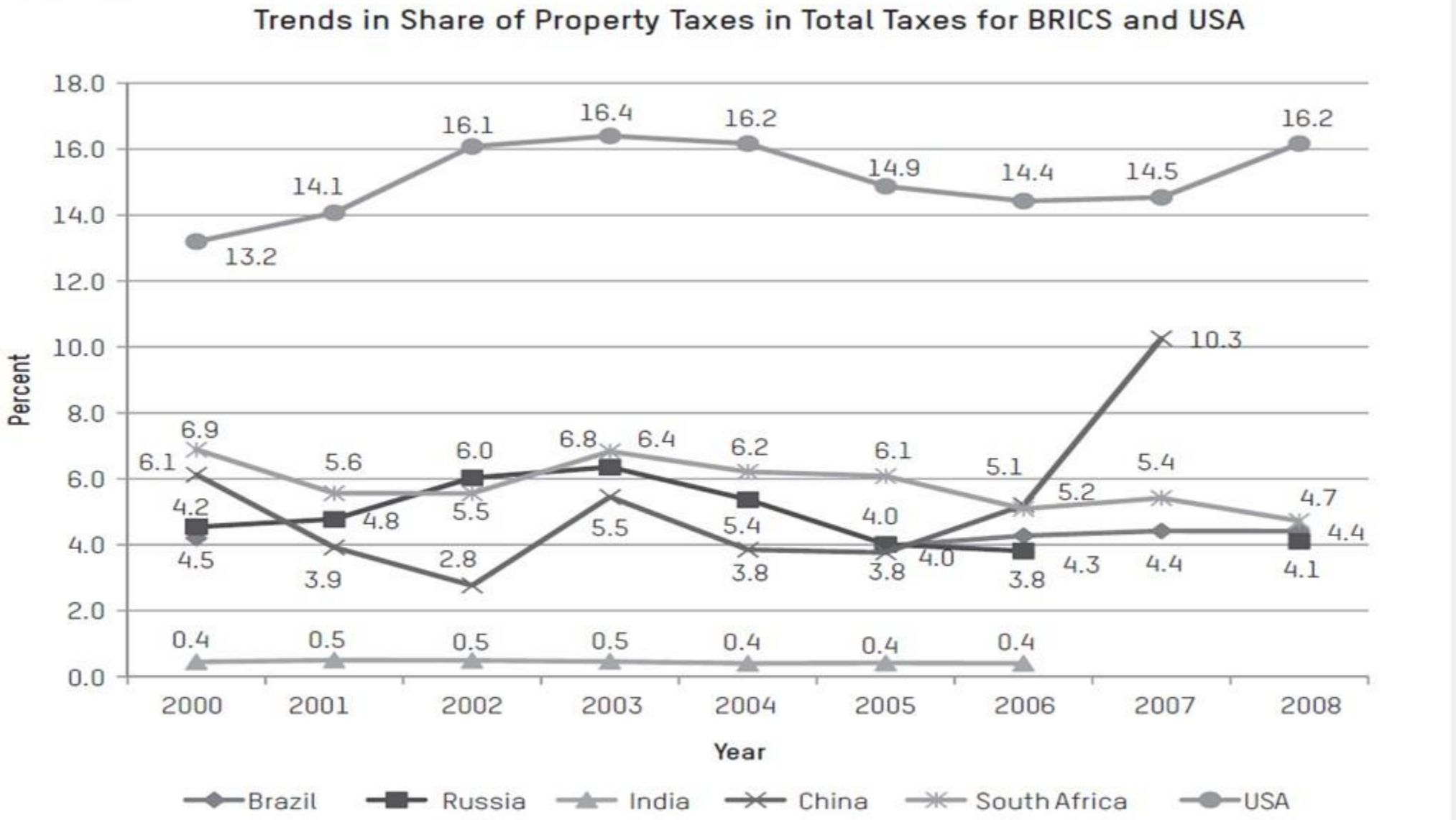
- What is value of land? What makes some land more ‘valuable’ than others?

Property Tax

- Every tax has a basis and a rate
- Tax Base – Relates more to political and social processes and concerns
  - Annual Rental Value
  - Capital Value
  - Area Base Standardisation
- Tax Rate
  - No one way to factor correct rate of tax
  - Important to ascertain whether it is paying --- --- the cost or price of the service

    -- acceptable to people at large

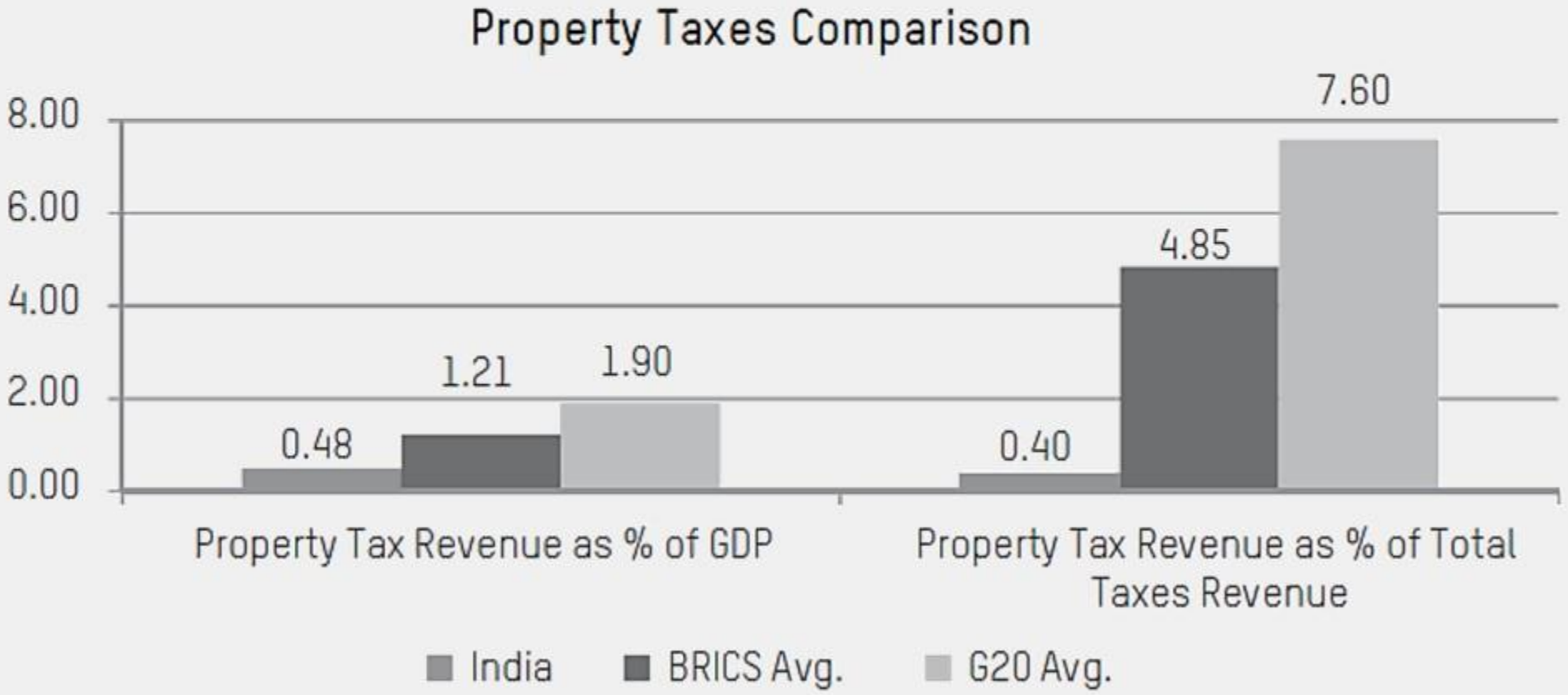
CHART 3.2



Prakash P (2013): Property taxes Across G20 countries: Can india get it right? Oxfam India working papers series January 2013

Property Tax Comparison

CHART 7.2



Prakash P (2013): Property taxes Across G20 countries: Can India get it right? Oxfam India working papers series January 2013

Third Pillar: Inter Governmental Transfer

- Own source revenues are (almost) never enough to cover local expenditure responsibilities

- Central (or regional) governments may provide local governments with additional resources through a system of intergovernmental fiscal transfers

- In most countries, transfers are (by far) the main funding source for local government, esp. for social sector services

Objectives of Intergovernmental fiscal transfers

- "Vertical" fiscal balance (providing additional resources to the local level, so that there is a balance between the fiscal needs and resources available to different levels of government – centre-state-local);

- "Horizontal" fiscal balance (ensuring fiscal balance in resource allocations between government units at the same level of government) – regional /Local Government equalization;

- The funding of specific national or state priorities

Types of Inter Government Transfers

TABLE 10: **TYPES OF INTERGOVERNMENTAL FISCAL TRANSFERS**

Type of Transfer	Characteristics
Unconditional	No conditions attached to use; lump sum
Unconditional (equalization)	No conditions attached to use; lump sum; based on fiscal capacity and sometimes expenditure need
Conditional Non-Matching	Has to be spent on specified functions; lump sum
Conditional Matching	Has to be spent on specified functions; municipality is required to match provincial funds

Source: UN-Habitat (2009), Guide to Municipal Finance. Available at www.unhabitat.org

Intergovernmental Transfers

Shared taxes

- – VAT and sales taxes
- – Personal income tax
- – Corporate income tax

Unconditional transfers

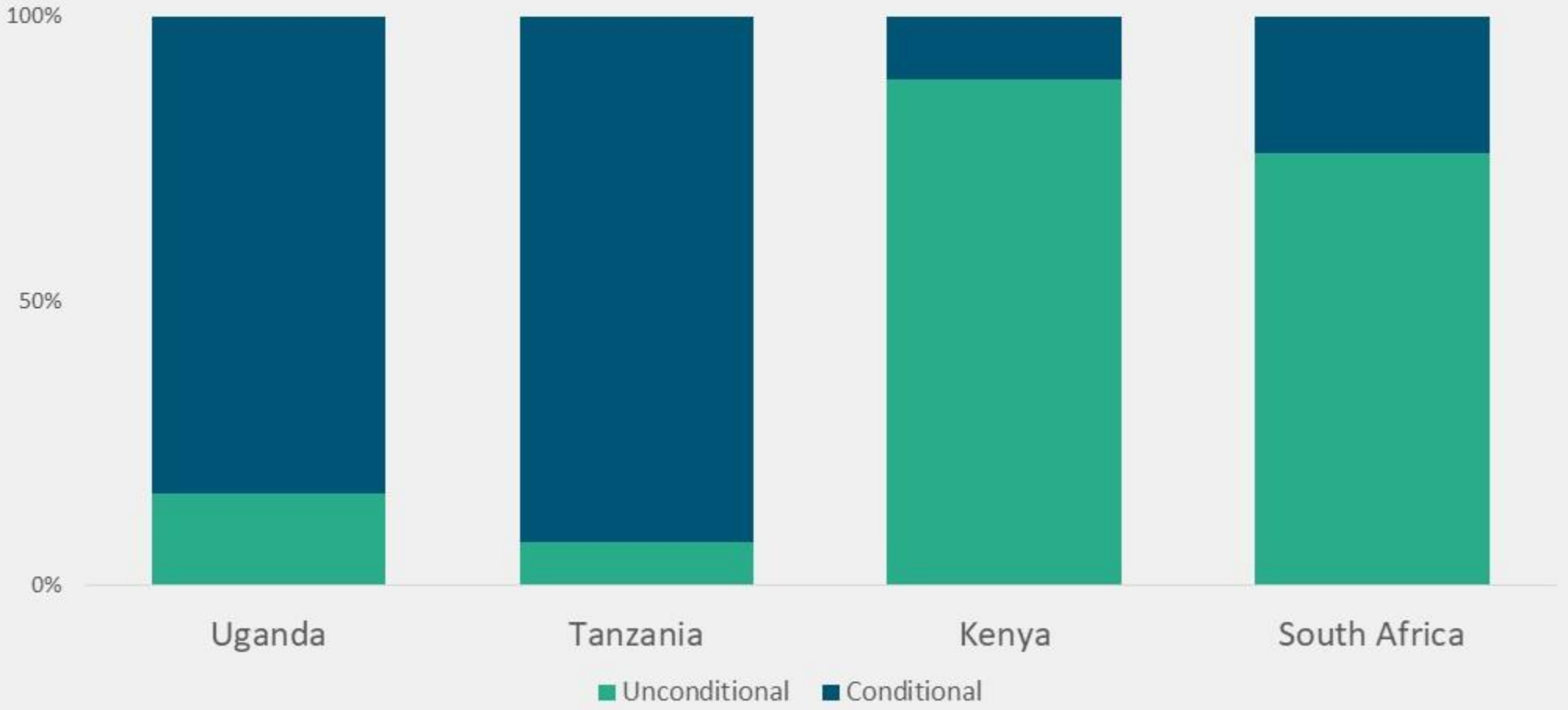
- – Operating transfers (equalization grants)
- – Investment grants (general)

Conditional transfers (earmarked)

- – Road rehabilitation grant
- – Education subsidy
- – Social welfare subsidy (poor households)
- – Special grant for salaries (ad hoc)

Catherine Farvacque-Vitkovic and Mihaly Kopanyi, (Editors), Municipal Finances: A Handbook for Local Governments, World Bank, 2014

Conditional Grant and Unconditional Grants: Africa



Source: UN-Habitat (2009), Guide to Municipal Finance. Available at www.unhabitat.org

Tanzania: dependence on intergovernmental transfers

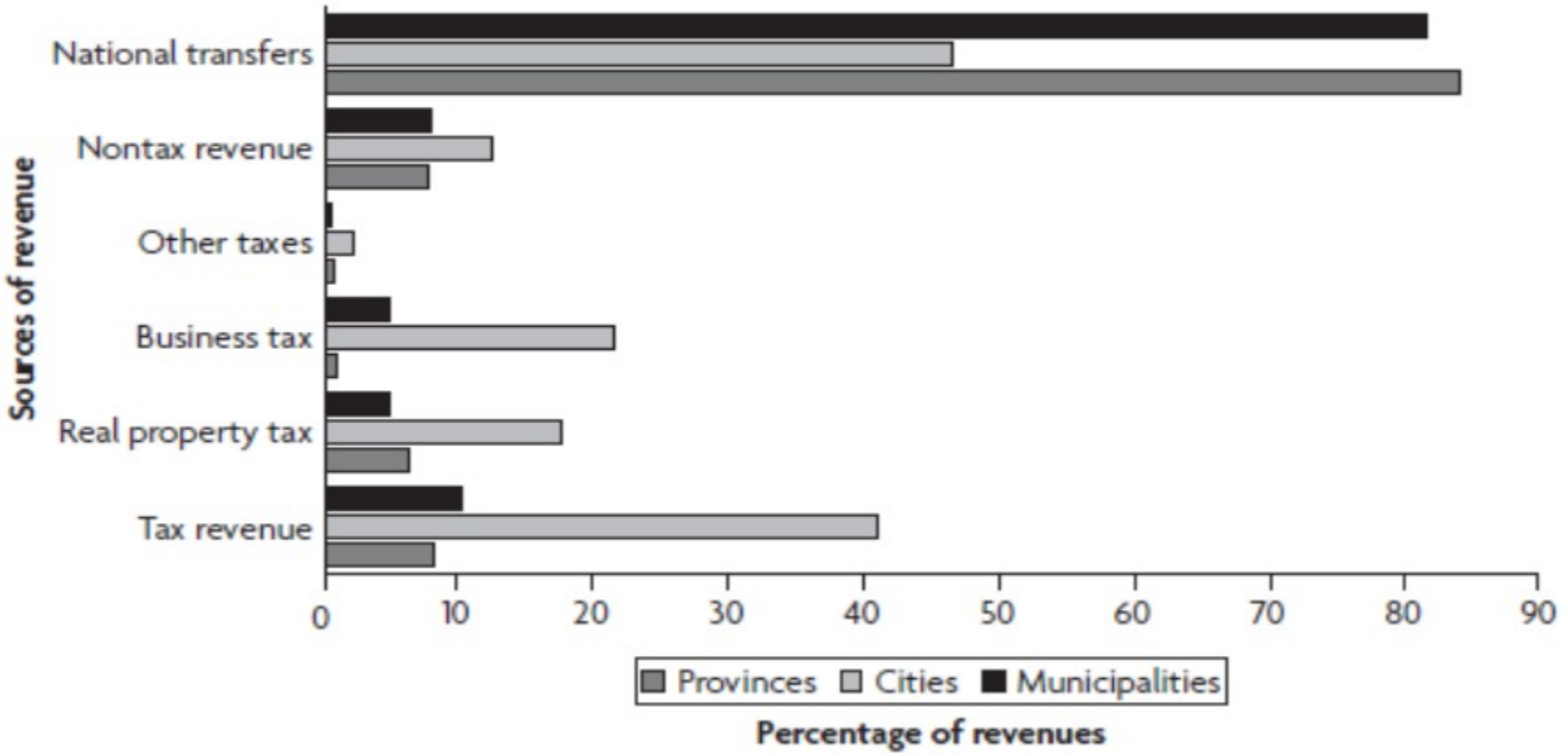
Table 1: Local Government Revenue Sources (in billions of Tanzania shillings) for FY2010/2011–FY2012/2013[α]

Fiscal Year	2010/2011	2011/2012	2012/2013.
Total Revenues	2,251	2,439	2,988
Intergovernmental Transfers	2,084	2,243	2,733
Own Revenues	158	195	240
Intergovernmental Transfers as % of Total Revenues	92.59%	91.97%	91.47%
Own Revenues as % of Total Revenues	7.03%	8.02%	8.06%

Source: Takaaki Masakiy (2017), The Impact of Intergovernmental Transfers on Local Revenue Generation in Africa: Evidence from Tanzania, UN-WIDER (mimeo)

Philippines – local government finance

Figure 11.2 Composition of Revenues by Type of Local Government Unit, 2009



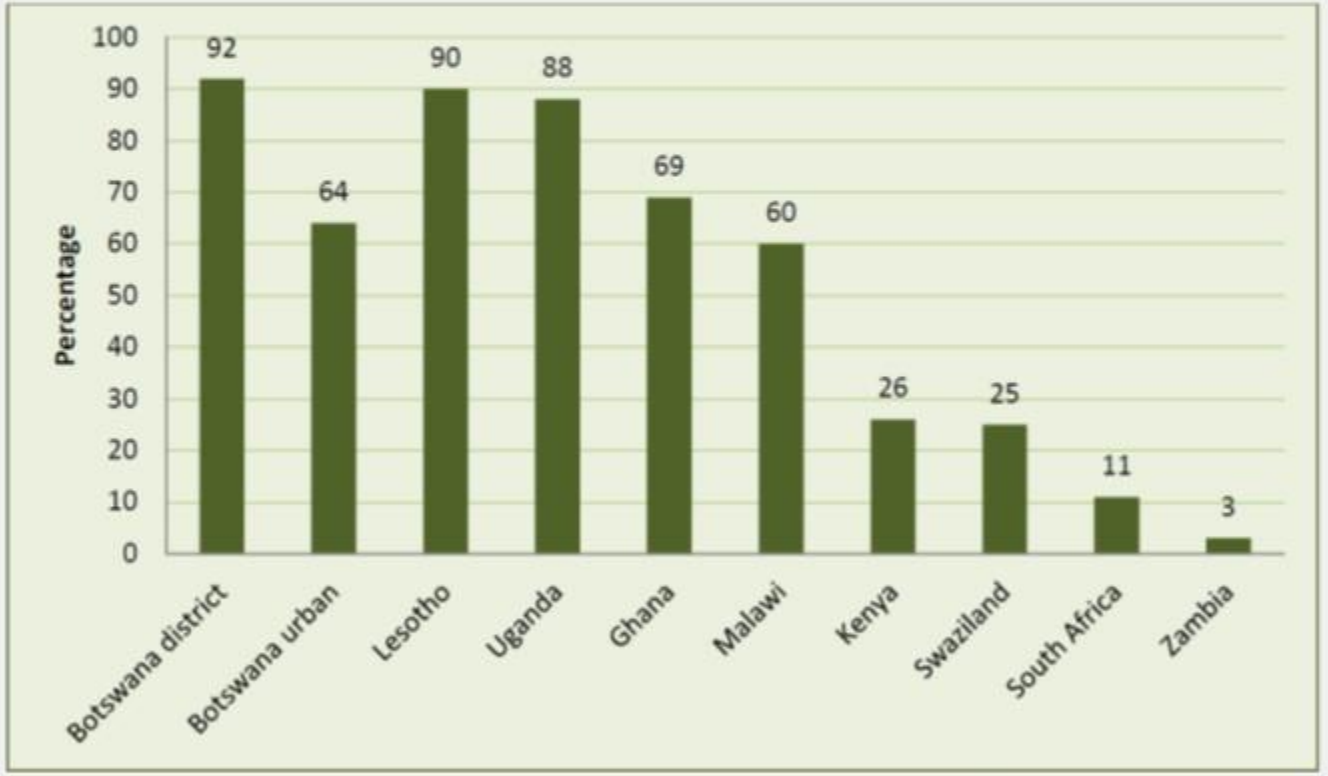
Source: Bureau of Local Government Finance.

Lili Liu, Gilberto Llanto, and John Petersen (2013), The Philippines: Recent Developments in the Subnational Government Debt Markets, in Otaviano Canuto and Lili Liu (eds) Until Debt do us Part, World Bank, Washington

Dependency of Local Government on Transfers in Africa

Local government are entrusted with the task of WASH delivery. However, in Botswana, Uganda, Ghana and Malawi, local governments are dependent on national government for resources

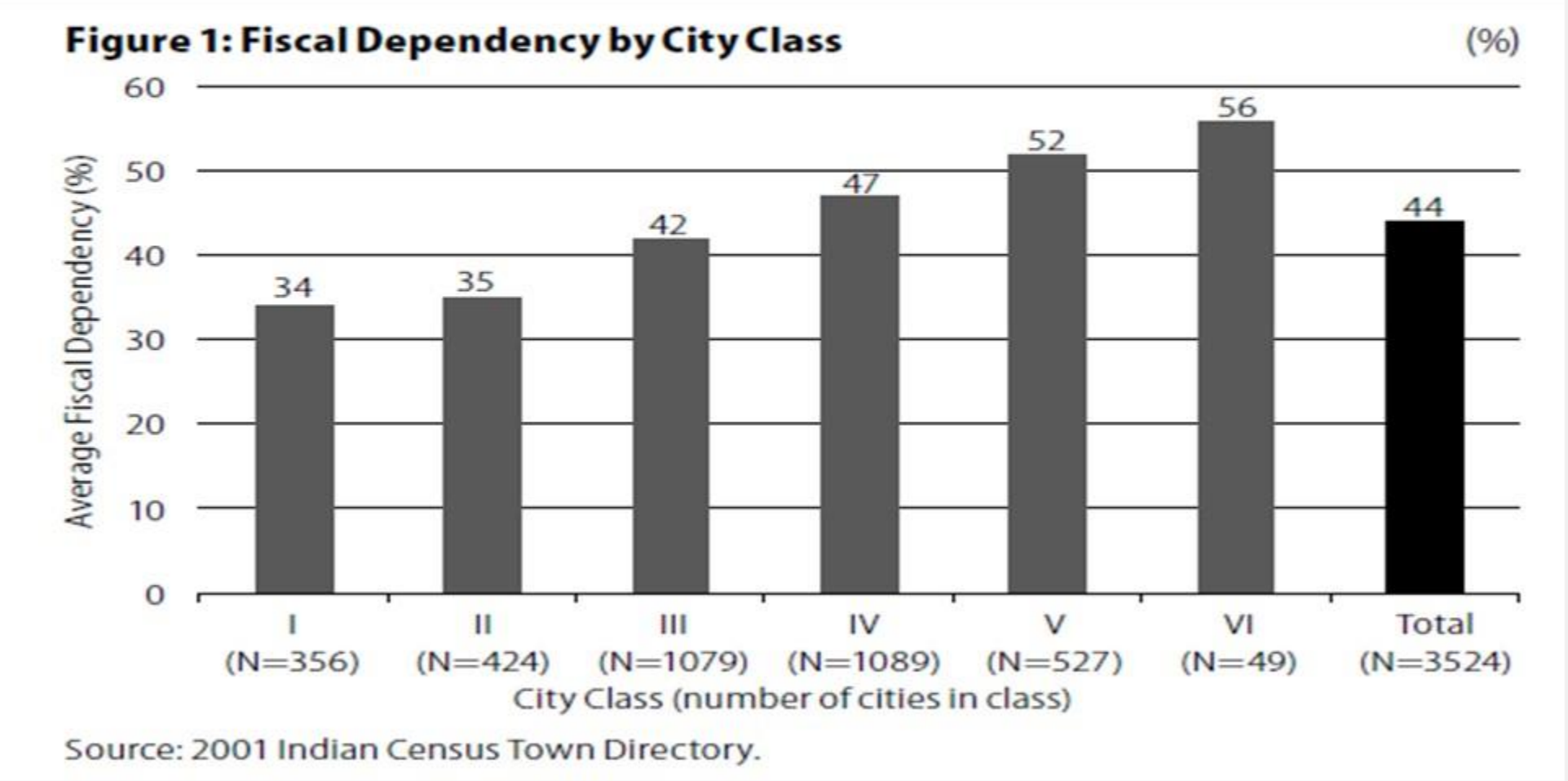
Figure 1: Intergovernmental transfers in percent of total local revenues in some East and Southern African countries (2007)



Source: Adapted from Chitembo (2009:11) citing Commonwealth Handbook 2007.

Source: Fjeldstad Odd-Helge and Kari Heggstad (2012), Local government revenue mobilisation in Anglophone Africa, WP 2012: 6, October 2012, Bergen: Chr. Michelsen Institute

Fiscal dependency of Indian cities



Pierce G, (2016), Fiscal Transfers and Urban Policy: magnitude and mechanisms of urban dependency, Economic and Political Weekly, October 15, 2016

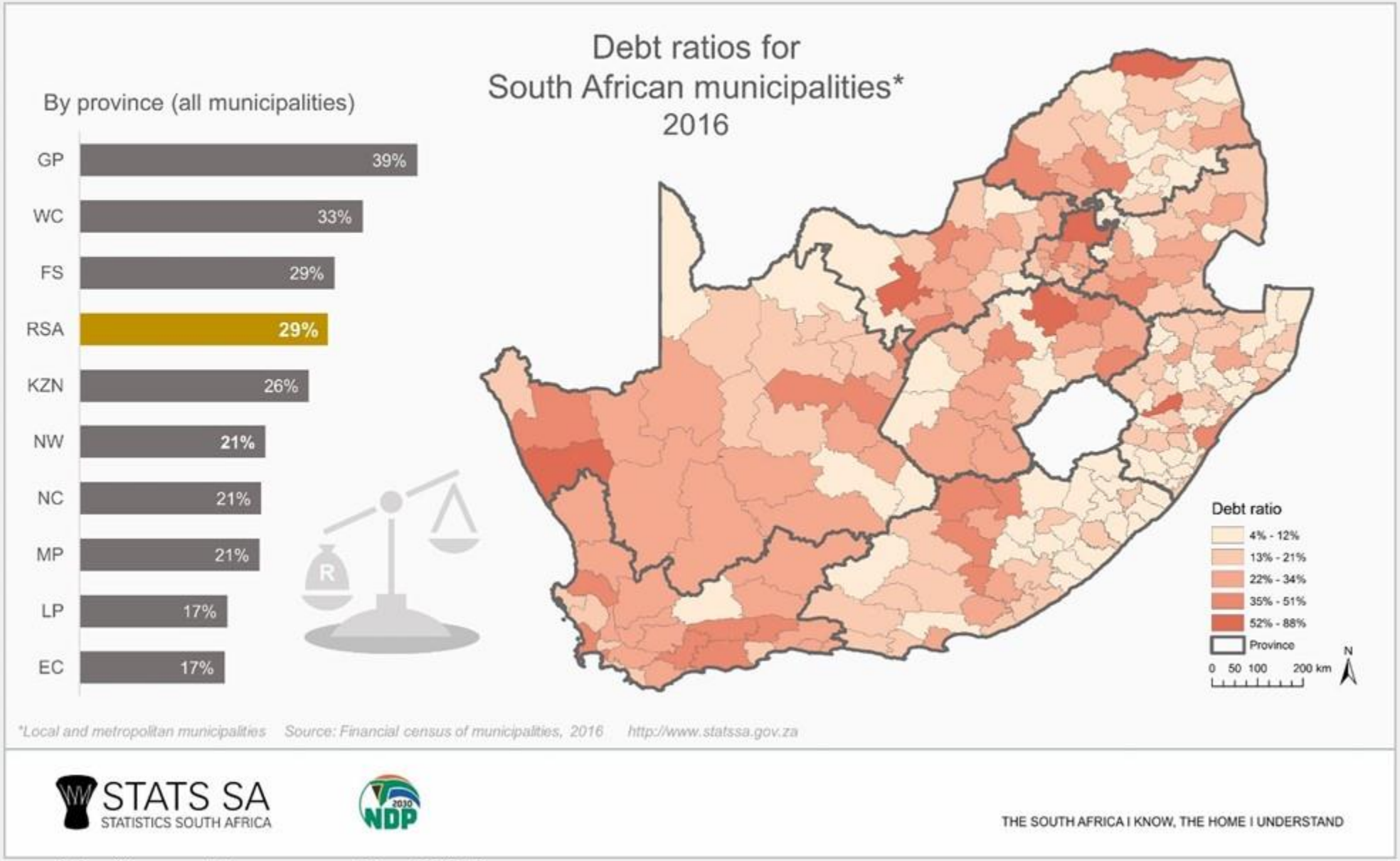
Municipal Infrastructure Grant – South Africa

- Consolidation of many small grants and schemes into one major capital grant with control by local authorities

- Matching national and local objectives

Source: based on DPLG (n.d.), "Municipal Infrastructure Grants 2004-2007: From projects to sustainable services"

Municipal Debt outstanding –South Africa



How solvent are South African municipalities? To answer that question, we turn to a financial ratio called the debt ratio. The debt ratio is calculated by dividing the total amount of municipal debt (or liabilities) by the total value of assets, and is expressed as decimal or percentage.

http://www.statssa.gov.za/?p=10152

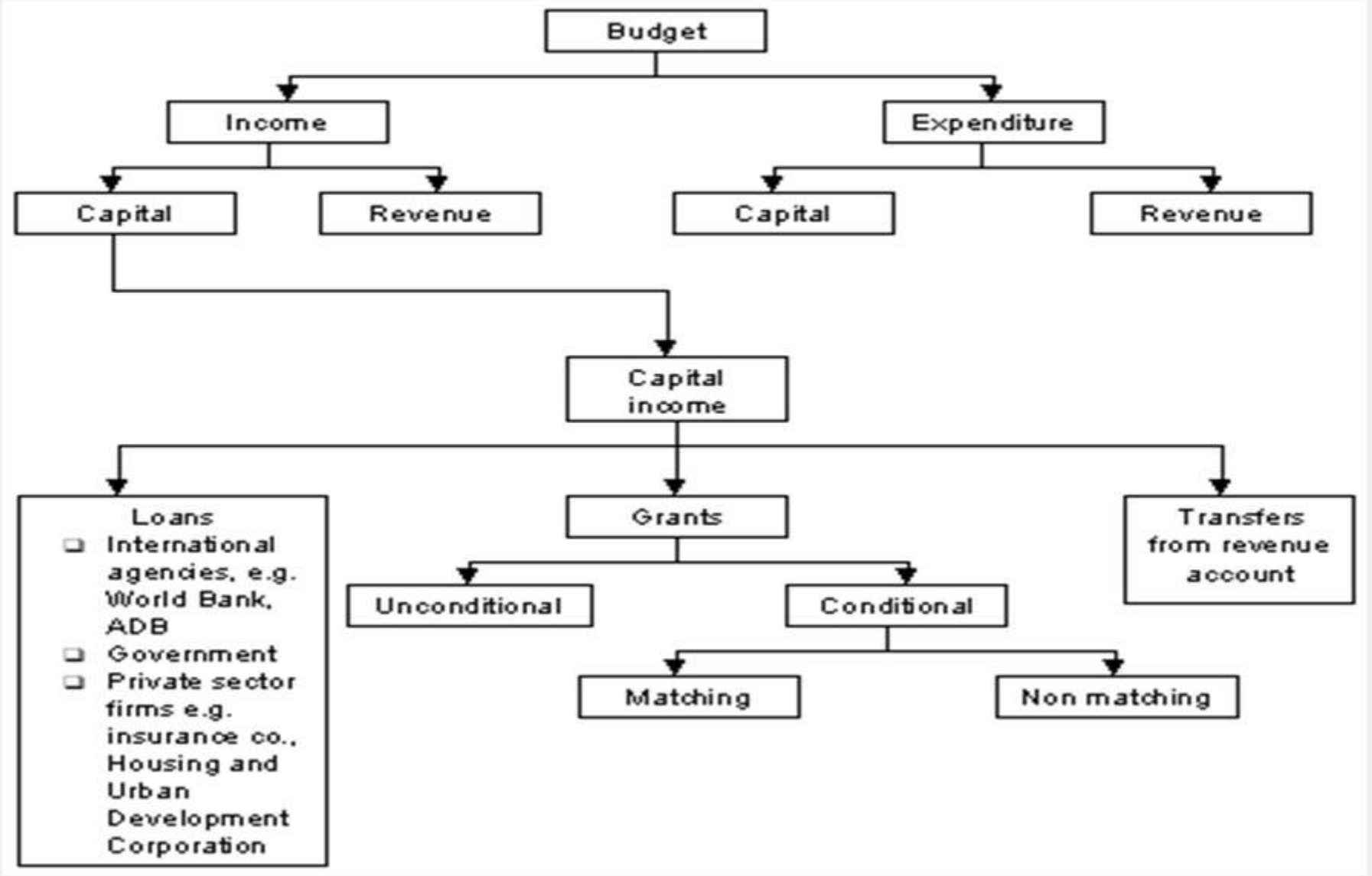
Municipal Budget

Financial management

Figure 3.1 The Pillars of Financial Management

Catherine Farvacque-Vitkovic and Mihaly Kopanyi, (Editors), Municipal Finances: A Handbook for Local Governments, World Bank, 2014

Municipal Finance - Components



Basic Accounting Framework

- Income
- Expenditure

- Assets
- Liability

Income & Expenditure Account

Balance Sheet

Income & Expenditure Heads

Income Heads

1. Tax Revenue
2. Assigned Revenue & Compensation
3. Rental Income from Properties
4. Fees & User Charges
5. Sale & Hire Charges
6. Revenue Grants, Contributions, Subsidies
7. Income from Investments
8. Interest Earned
9. Other Income
10. Prior Period Income

Expenditure Heads

1. Establishment Expenditure
2. Administrative Expenditure
3. Operation & Maintenance
4. Interest & Finance Charges
5. Programme Expense
6. Revenue Grants, contributions, subsidies
7. Provisions & Write Off
8. Misc. Expenses, losses, refunds
9. Depreciation
10. Prior Period Expenditure, Transfer to Reserves

Assets & Liability Heads

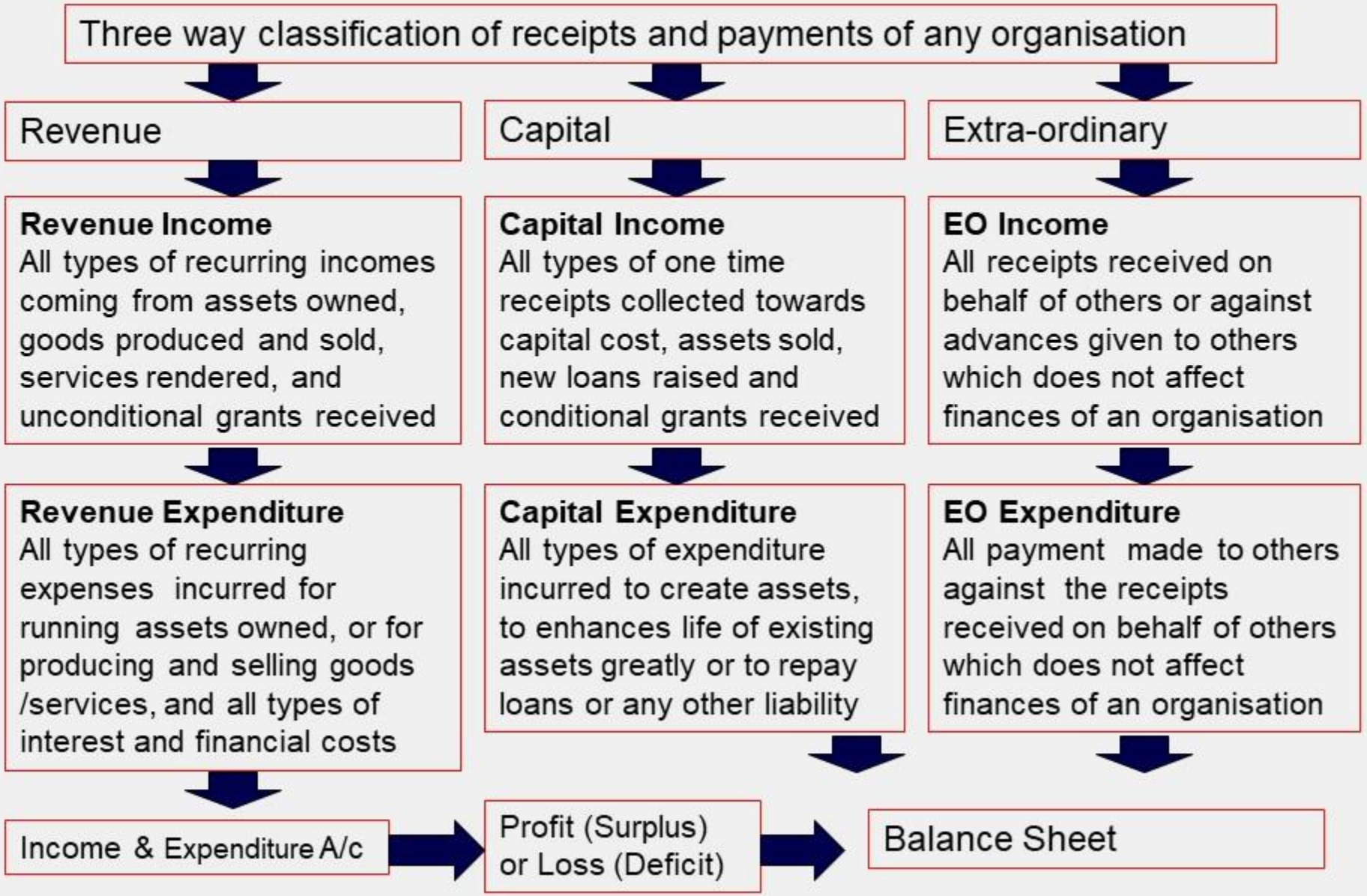
Liability Heads

1. Municipal Fund
2. Earmarked Funds
3. Reserves
4. Grants Contributions Received for specific purpose
5. Secured Loans
6. Unsecured Loans
7. Deposits Received
8. Deposit Works
9. Other Liabilities/provisions
10. Prior Period Expenditure, Transfer to Reserves

Asset Heads

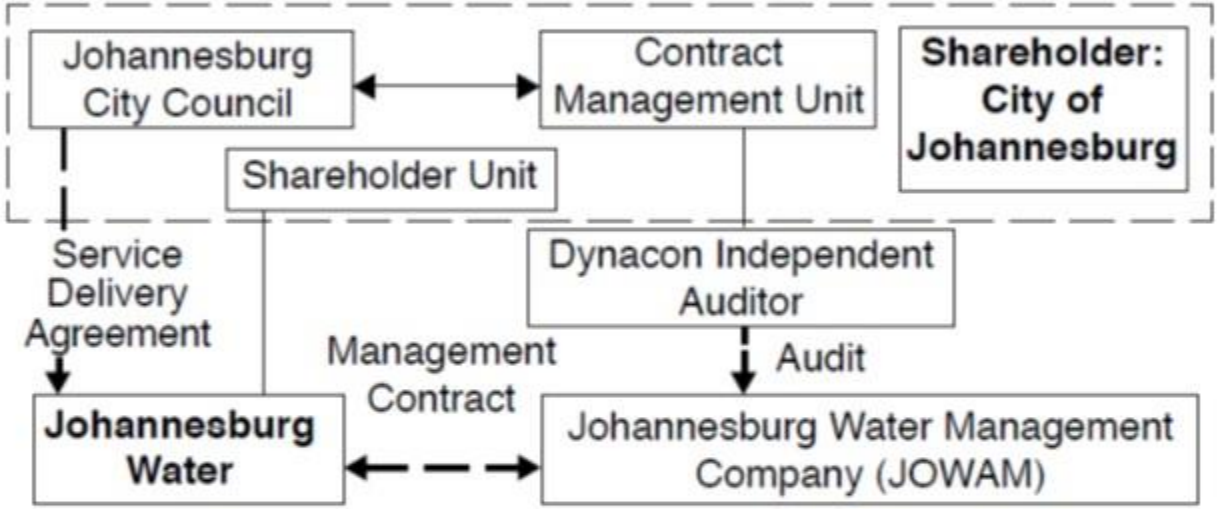
1. Fixed Assets
2. Accumulated Depreciation
3. Capital Work in Progress
4. Investment
5. Stock in Hand
6. Sundry Debtor (Receivables)
7. Accumulated Provisions against debtors (Receivable)
8. Cash & Bank Balances
9. Loans & Advances and Deposits with others
10. Accumulated Provisions against assets, Pre-paid Expenses, Miscellaneous Expenditure to be written off

Revenue and Capital - Concepts

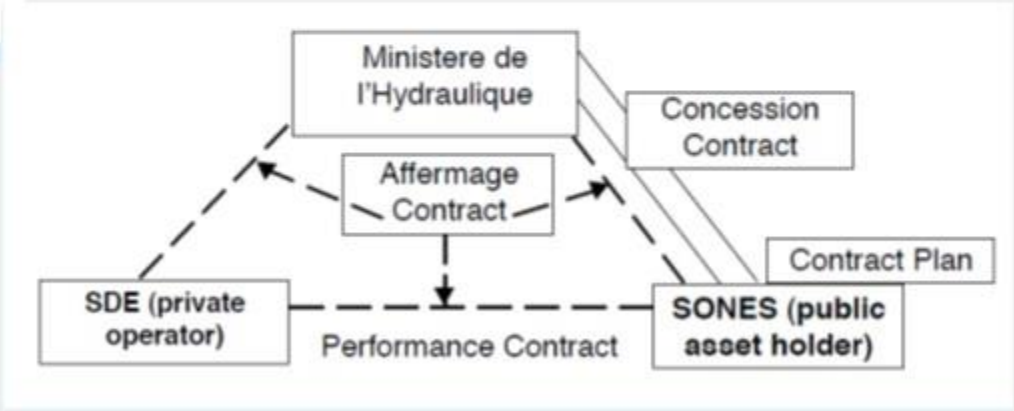


Water and Sanitation Utilities

Utilities in Africa



Senegal



Meera Mehta, Thomas Fugelsnes and Johan Kruger (2009), Water Utilities in Africa: Case Studies of Transformation and Market Access, WSP, World Bank

Potential source of Finance for Utilities

Transaction Types and Sizes and Potential Sources of Finance				
	Type of Investment	**Range of Costs**	**Sources of Finance**	**Nature of Technical Support Required**
Small	Working capital loans	<US$1 million	Local banks	None
Medium	Performance-linked investments (e.g., for vehicles, meters)	US$1-15 million	Local banks/ financial institutions	Support for: i) selection of banks/financial institutions; and ii) strategic plans for performance improvement
Large	*Moderate expansion* and rehabilitation	*US$20-50* million	*Local banks/* financial institutions or capital markets	*Support for: i) project* development; ii) credit assessment; and iii) credit enhancements
Very large	Significant infrastructure investments and system upgrades	>US$50 million	Development banks and local market finance	i) Donor projects require cofunding from market institutions in early reforms; and ii) support in strategic plans and marketing for mature reform contexts

FINANCING OPTIONS for Utilities

- Loans
- Direct Grants
- Government Budget provisions.
- Private Sector
- Internally Generated Resources (User fees/Tariffs)
- Market Finance
- Output Based Aid

Dr. William T. Muhairwe, Managing Director, NWSC-Uganda, "Financing Options for Water and Sanitation Utilities: NWSC's Experience" Presentation at Stockholm Water Week, 2009

LOANS

- Historically, loans extended to sovereign Governments from multi-lateral and bi-lateral funding agencies
- These passed on to Utilities on more stringent terms
- In Uganda case **Commercial rates + 3%**
- Resulted into huge unsustainable debt of about US $ 86 million.

End Result:

- Government restructured the debt into equity to allow the Corporation plough back surpluses and leverage finance from the financial markets.
- Therefore, Loans may not be sustainable given the utilities we are talking about

DIRECT GRANTS

- Extended to the Corporation after realizing the huge debt obligation.
- Some Development partners made it a condition for funding the sector .
- Grants are very welcome

But, How sustainable are Grants?

- Today, we are witnessing a dwindling and unpredictable envelope of Grant funds.
- If available, channeled to more pressing needs such as the Health (AIDS grants).

GOVERNMENT BUDGET PROVISIONS

- Governments recognize the need to support the Water Sector in General.
- This is based on the need to uphold the principles of Social Equity and Commercialization.
- In past provided counter part funding and funding for pro-poor activities for the NWSC.

But, What is the reality today?

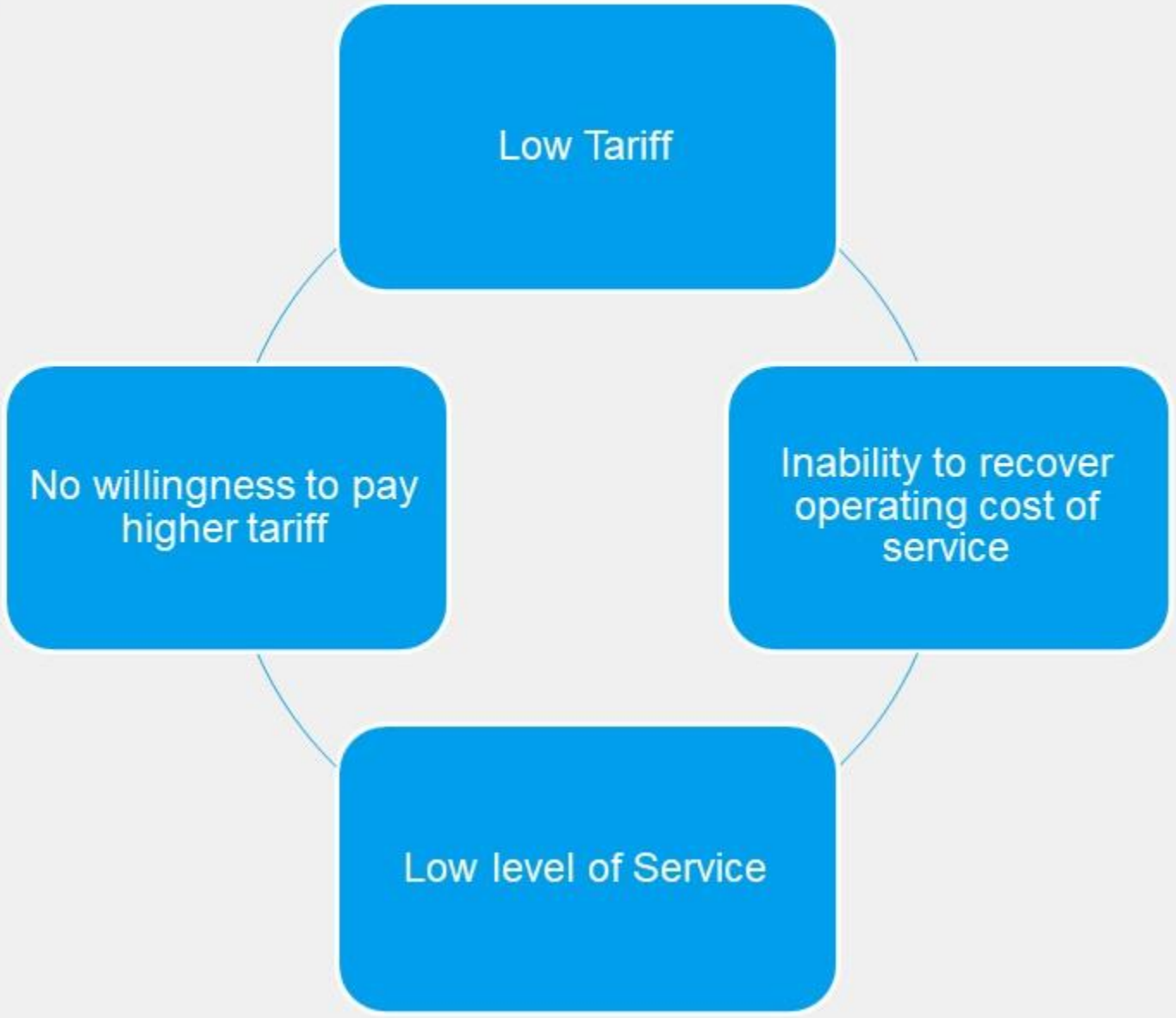
- Not uncommon to find budget allocations to the Water and Sanitation sector very low. (**2.8% in Uganda**)
- Further more, the utilities are receiving less money, because of the competing needs from the other subsectors, i.e. Rural, Water for Production etc.
- **Therefore, Government funding is also not reliable**

UTILISATION OF INTERNALLY GENERATED FUNDS: USER FEES/TARIFFS

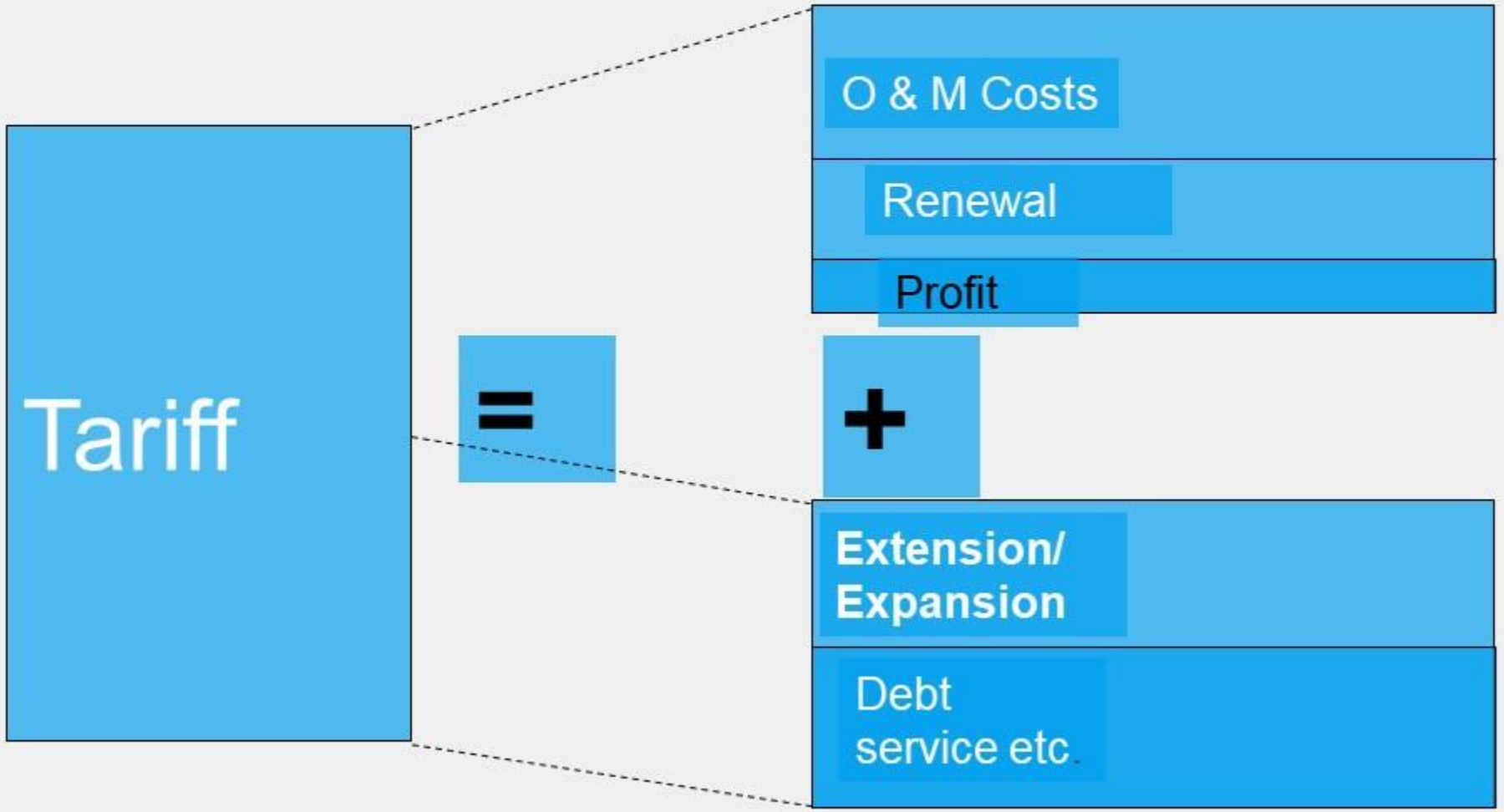
- With what we have seen so far, this leaves us no option, but to explore use of internal resources as a financing option
- With operational and financial improvements, NWSC is now able to cover:
  - O&M costs
  - Depreciation Costs
  - Minor Investments from its cash flow
- However problem still remains that the Tariff is still **not a Full Cost Recovery Tariff. (** i.e. cannot cover all investments).
- **Full Cost Recovery Tariffs** remain a myth in most developing countries, otherwise would imply significant increase in the tariffs, which cannot be afforded by the citizens

User charges, Pricing and Tariff setting

Low level equilibrium



Composition of the Tariff Rate



Basic Types of Tariff Structures

- Single-part tariff

  consists of either

  - Fixed charge – monthly bill is independent of the volume consumed
  - Volumetric charge Two part tariff (based on measured use)

- Two-part tariffs

  (includes both fixed charge and use charges)

Volumetric Charges

- Uniform price volumetric tariff
- e.g. All units of water/electricity billed at same price
  - Increasing linear tariff - unit charge increases linearly as water use increases

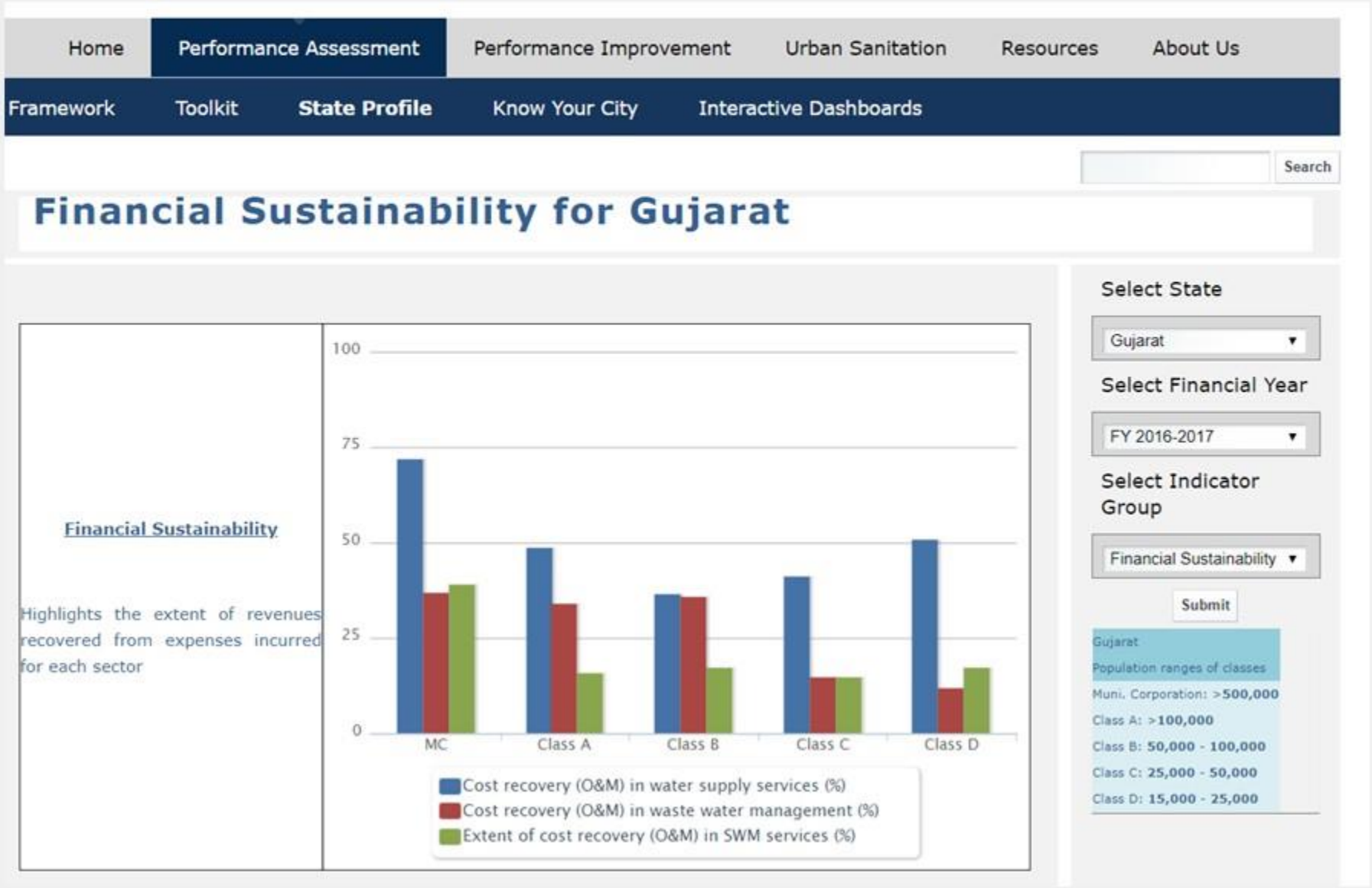
- Block-type structures - two or more prices, each applies to use within a defined segment (block) of monthly use- unit charge is constant over a specified range of water use and then shifts as use increases
  - Decreasing block - block price falls as use rises
  - Increasing block (IBT) - block price rises as use rises

Tariff Models

Table 6.2 Evaluation of tariff models

Tariff structure	Cost recovery	Economic efficiency	Equity	Affordability
Fixed charge	*Adequate* Provides stable cash flow if set at appropriate level	*Poor* Does not send a message about the cost of additional water	*Poor* People who use large quantities of water pay the same as those who use little	*Adequate* If differentiated by having different tariffs depending on ability to pay
Uniform volumetric charge	*Good* If set at appropriate level. Moreover adjust automatically to changing consumption	*Good* If set at or near marginal cost of water	*Good* People pay according to how much they actually use	*Average* However it is possible to differentiate set of consumers by geographical/ social barriers
Increasing block tariff	*Good* Only if the size of the blocks are well designed	*Good* If water is sold at marginal cost or near to marginal cost	*Average* Normally people do not pay according to the costs their water use imposes on the utility	*Poor* Penalise poor families with large households and/or shared connections
Decreasing block tariff	*Good* But only if the sizes of the blocks are well designed	*Good* If water is sold at marginal cost or near to marginal cost (Applicable only when there is no water scarcity)	*Poor* People do not pay according to the costs their water use imposes on the utility	*Poor* This would only facilitate higher consumption categories with better affordability and goes against the category with less affordability

WSS not always possible to recover costs



Cross - Subsidies

- What is a cross-subsidy?

- Some users pay below average tariff (subsidized), while others pay above average tariff (subsidizers)

- Cross subsidies are often used to help the poor. But do they ?

- Differential rates & increasing block tariffs are all cases of cross-subsidies

Fourth pillar
sub-national debt and borrowing

the fourth pillar of sub-national finance: local borrowing

- In many developed economies, local borrowing is an appropriate way for local governments to fund capital infrastructure:
- (i) it corrects the inter-temporal mismatch between costs and benefits (in terms of efficiency, equity, timing and practicality)
- (ii) there are numerous mechanisms to ensure responsible borrowing
- An example of the USA – in 2012 the municipal bond market was estimated to be $3.7 trillion – about 10% of total bond market size

Source: for US municipal bond market size: http://www.sec.gov/spotlight/municipalsecurities.shtml, accessed on 12/2/2015

Sub-national borrowing

- borrowing for long-term capital development projects is relevant –
- Relevant in countries that have relatively well developed financial markets
- Need for a well-defined local government framework for borrowing and issuing bonds
- Development of Credit assessment and rating of local government issues Emergence of a municipal bond system, pooled finance

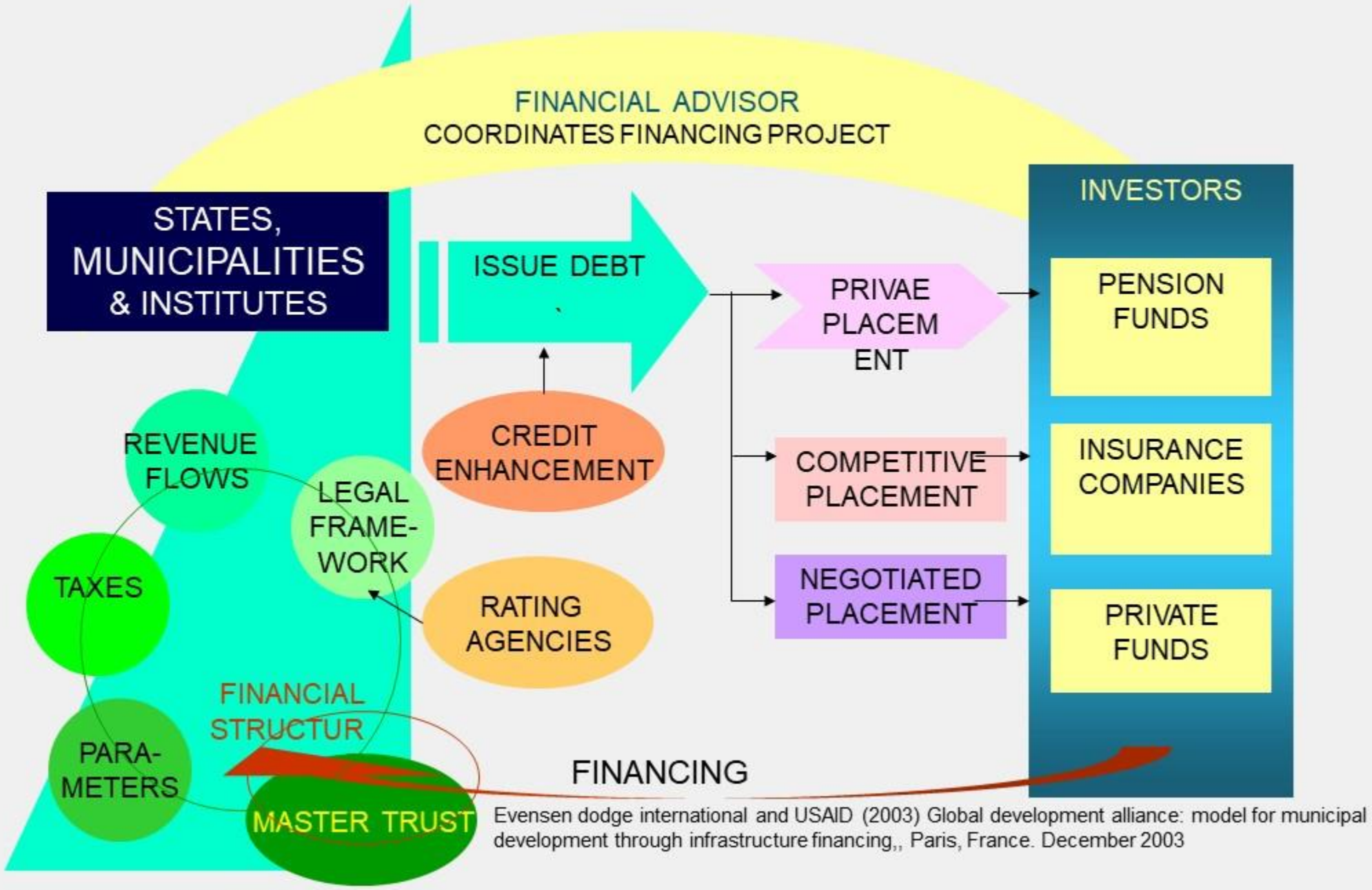
Restrictions on borrowing

In many countries, the absence of market-based mechanisms to enforce a 'hard budget constraint' requires restricting local borrowing:

- Rules-based restrictions – on debt limit, etc
- Permission required – though this tricky !!
- Only from local government bank / loan fund
- No borrowing allowed

- Experience from Brazil, China suggested that un-regulated sub-national borrowings can affect national economy

A SUBNATIONAL FINANCING MODEL



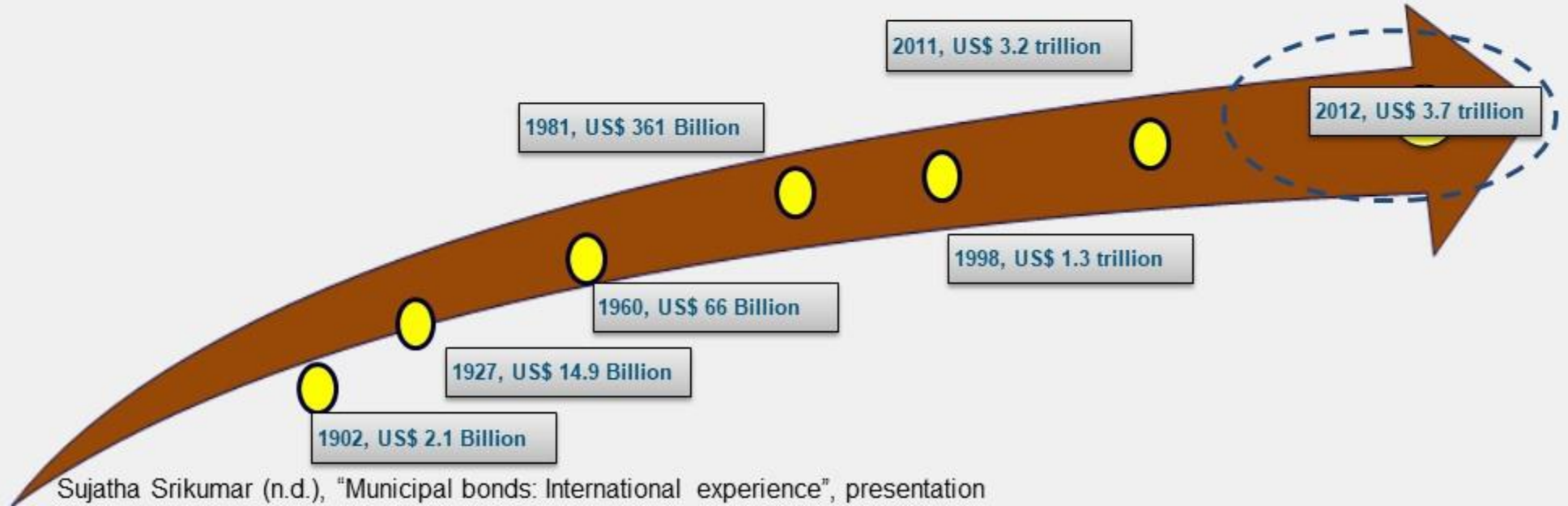
Evensen dodge international and USAID (2003) Global development alliance: model for municipal development through infrastructure financing,, Paris, France. December 2003

Market borrowing– Municipal bonds

Municipal Bond Market in U.S.

- In USA, the term municipal bond is applied for instruments used to finance municipal infrastructure and services by a public agency and not only those issued by the government.
- **More than half the funding for local public construction projects** comes directly from municipal bonds.

Timeline of Outstanding Municipal Debt in USA



Sujatha Srikumar (n.d.), "Municipal bonds: International experience", presentation

Market borrowing through “Municipal Bond”

- What are municipal bonds?
- Municipal bonds are instruments of debt issued by civic entities such as cities and specialised agencies to finance long-term capital expenditures, and/or fund specific municipal projects

- The investors lend money to an issuer who promises to pay the investors a specified amount of interest (usually paid semiannually) and return the principal on a specific maturity date

- They are generally classified according to the source from which the issuer intends to reimburse bond payments.

What is Credit Rating?

Credit Rating is an opinion on the relative degree of safety regarding debt obligations being met on time.

- It is an opinion, not a recommendation
- Relative degree of safety vis-a-vis other debt instruments
- Timeliness is key
- Instrument-specific – could be different for a structured instrument and stand-alone
- Assigned by a committee of experts in finance, management & economics, after a detailed and in-depth discussion

Kudwa Roopa (2004), "Financing Municipalities and relevance of Credit Rating - the Indian experience", CRISIL, Presentation made at *International Conference on Financing Municipalities and Sub-National Governments, Washington*

Rating scales by credit rating agencies

Long-term debt symbols

Moody's	*Standard & Poor's*	*Fitch IBCA*	*Duff & Phelps*	*Interpretation*
Aaa	AAA	AAA	AAA	Highest quality
Aa1, Aa2, Aa3	AA+, AA, AA-	AA+, AA, AA-	AA+, AA, AA-	High Quality
A1, A2, A3	A+, A, A-	A+, A, A-	A+, A, A-	Strong payment capacity
Baa1, Baa2, Baa3	BBB+, BBB, BBB-	BBB+, BBB, BBB-	BBB+, BBB, BBB-	Adequate payment capacity
Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-	BB+, BB, BB-	Likely to fulfil obligations; ongoing uncertainty
B1, B2, B3	B+, B, B-	B+, B, B-	B+, B, B-	High-risk obligations
Caa, Ca	CCC+, CCC, CCC-	CCC, CC, C	CCC	Current vulnerability to default
D	D	DDD, DD, D	DD, DP	

Source: Interpretation from Richard Cantor and Fred Packer. Federal Reserve Bank of New York. Readers should note that individual credit agencies may not agree with this interpretation. Rating agencies do not design their rating scales to conform with each other or with easy summaries.

Note: in 2000 Fitch IBCA acquired Duff & Phelps. [Source: Credit Rating and Bond Issuing at the Subnational Level, a Training Manual, The World Bank 1999]

Based on Barry Jackson (n.d.), "Obtaining a municipal credit rating", CLGF research series.

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Understanding Local Finances

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