USAID
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Making Cities Work
Assessment and Implementation Toolkit
Contract No. EPP-I-00-04-00026-00

Municipal Finance

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Municipal Finance

prepared for

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OVERVIEW

Making Cities Work is the goal of the United States Agency for International Development (USAID) Urban Programs Team. The Making Cities Work Toolbox includes assessment methodologies, implementation toolkits, and other resources for three core areas: Managing Municipal Service Delivery, Municipal Finance Services, and Local Economic Development. These materials are designed to help USAID missions from around world better understand the needs of municipalities and the problems they face, so that USAID staff can work with cities to design and implement projects and programs that respond appropriately.

Managing Municipal Service Delivery

Municipal Services – electricity, heating, solid waste, transport, water, and wastewater, – are the basic building blocks of efficient, healthy, and economically vital communities. Although ensuring adequate provision of these services is one of the primary responsibilities of national and sub-national governments, service provision may fall short. Quality of municipal services support the economic development of municipalities, while poor levels of service, interruptions of supply, low coverage rates, and other problems can undermine the quality of life in municipalities, slow economic growth, and reduce trust in local government.

The assessments contained in this toolkit will help USAID missions analyze municipal service management and delivery and lead to potential projects and interventions that can help improve the quality and reach of municipal services.

Municipal Finance

Inadequate financial resources is one of the principal reasons that municipal services are inadequate in almost all developing countries and transitional countries. Even when local governments have been assigned clear service delivery responsibilities, lack of revenue-raising powers and unpredictable intergovernmental transfers often hinder the ability of municipalities from efficiently discharging these functions in a way that is responsive to local constituencies. At the same time, underdeveloped financial markets (both weak capital markets and banking systems) are typically unable to provide long-term financing for essential municipal infrastructure. The amount of project funding that is available from central governments and development banks is almost always inadequate to meet the needs of municipal residents.

The assessments contained in this toolkit will help USAID missions evaluate municipal finances and help them design potential projects and interventions.

Local Economic Development

Cities are engines of economic growth. Traditional approaches to local economic development (LED) are giving way to other strategies, including the development of clusters and competitiveness strategies. Informal economies in slum settlements are a significant and viable economic force, as are small and medium-sized enterprises (SMEs).

This toolkit will support USAID officers in developing innovative approaches to LED in order to maximize productivity growth and improve prospects for LED. This assessment toolkit will enable USAID to develop interventions that help households, including the poor, increase incomes; businesses, including those in both the formal and informal sectors, generate more profits; and municipalities augment revenues to improve the delivery of municipal infrastructure and services.

Using These Materials

Each of the three thematic toolkits is further divided into four or five major issue areas, each with an overview, subtopics, and an assessment methodology. The materials in this toolbox are designed to be used as follows.

- The **Assessment** walks USAID missions through an overview of the topics related to the subject areas. They include an assessment with key questions for each topic.
- The **Resources** include reports and weblinks.
- The **Worksheets**, one for each of the main topic areas, allow USAID staff to record their answers to the assessment questions. They should be filled out as the assessment is completed.
- **Conclusions and Possible Projects** list interventions that USAID missions may wish to consider to address shortcomings identified through the assessments and worksheets. This section should be consulted when the worksheets are filled out to the best of the USAID mission's abilities.

INTRODUCTION

Municipal Finance: Why should USAID get involved?

Municipal finance has an impact on development in several different ways, so it is natural that USAID missions may want to provide assistance to improve the way that municipal finance functions. Municipal finance can affect the development of democratic governance through its impact on the ability of elected municipal leaders to meet the expectations of the local citizenry. Municipal finance affects economic development through its impact on the quality of local services and infrastructure required for expanding commerce and industry as well as its impact on the deepening of financial markets. Municipal finance affects the quality of the natural environment through its impact on municipal services such as water supply, sewage treatment, solid waste management, and public transportation. Municipal finance even affects poverty reduction through its impact on the ability of municipal governments to undertake effective pro-poor programs of social, economic, health, education, and community development.

<u>Local government programs</u> are often an important component of a mission's democracy and governance strategy. When this is the case, it is important to assess whether municipal finance is functioning well enough to provide the level of resources that local leaders need to meet the expectations of the citizens in their communities. Local leaders may not be viewed as credible, perhaps not even legitimate, if they cannot provide a minimally acceptable level of service in the areas for which they are responsible. When local government leaders fail some or all of their citizens, the door may be open to intervention by radical groups pursuing an anti-democratic agenda. Given the worldwide trend toward the decentralization of responsibility for basic services, local government leaders are facing growing pressure to make municipal services work more effectively. This can only be done if local governments have sufficient resources to employ adequate numbers of trained personnel, buy needed supplies, maintain equipment, and expand infrastructure to keep up with growing demand. Unless municipal finance is working, local government leaders will fail in their most basic responsibilities.

<u>Economic growth and private sector programs</u> are another part of a mission's portfolio where municipal finance can have an influence. Business depends on local government services, such as a healthy and educated workforce, good local transportation, and good infrastructure. If there is inadequate water supply, transportation gridlock, or shortage of power, business is less productive. If the local workforce is poorly educated or unhealthy, business is less efficient. For businesses to compete in the global marketplace, their bases of operations need to be in localities providing the services that support efficient production in the short and the long run. For this reason it may be helpful to economic growth and private sector programs to assess the condition of municipal finance in key cities to determine if targeted assistance could improve the

business climate, at least insofar as municipalities are tasked with providing services that are supportive of business.

It also may be appropriate for economic growth and private sector programs to consider assistance that supports greater involvement of financial market institutions in municipal finance. Here the opportunity is to deepen financial intermediation by bringing long term private capital to municipal infrastructure investments. In many developing countries, the emergence of private institutional investors such as life insurance companies, pension funds, and mutual funds is resulting in increased demand for secure long term investment opportunities. At the same time, municipalities and their utilities are looking for long term financing for infrastructure projects. Putting these two sides of the equation together can help develop more robust and diversified capital markets. In addition, U.S. models of municipal finance can be adapted to a developing country context in ways that create opportunities for expansion of U.S. companies that provide financial services, when that is a mission's priority.

<u>Environment and natural resources programs</u> is another place where municipal finance can have an influence The operation of water supply, wastewater treatment, solid waste management, and public transportation has an important impact on the natural environment. If these services are well managed by local government, the impact can be positive. If not, pollution and resource depletion may result. For a mission's environment and natural resources program it is important to know if local government environmental services are adequately funded because this is likely to be the most important factor affecting the quality of service management. Targeted assistance to improve specific aspects of municipal finance can be an important part of an Environment and Natural Resources program, e.g. water tariff reform to reduce wastage, support for debt financing of municipal wastewater treatment projects, or introduction of user charges for solid waste collection and disposal (polluter pays).

<u>Poverty reduction</u> is a common theme in most mission programs. As the level of government closest to the people, local government can play a key role in poverty reduction. The ability of local governments to implement pro-poor policies and programs will be particularly dependent on municipal finance. In most developing countries, the poor are the last people to gain access to essential services and facilities such as potable water, sewer, solid waste collection, schools, and clinics. Unless local governments have the financial resources to expand their services beyond their current clientele, the poor will continue to be marginalized. For many local governments, expanding services to the poor will require investment in new infrastructure. This can only be done if the local government can access long term loans to finance infrastructure projects. In turn, local government borrowing requires the local government to have its financial house in order to be able to qualify for loans. So, improving municipal finance can be an important part of mission efforts toward poverty reduction.

For the purpose of this assessment toolkit, municipal finance refers to the flow of financial resources that local governments use to fund the delivery of services at the municipal level. Local government refers to municipalities (or their equivalent in the local government system of the country) as well as any local government owned utility organizations (e.g., for services such as water, wastewater, power, transportation, etc.) Broadly speaking municipal resources can be classified into three categories: revenues from taxes, user fees, and tariffs; intergovernmental fiscal transfers; and borrowings.

In order for local governments to provide adequate levels of services to their citizens, they usually need to mobilize resources from all three categories in amounts sufficient to operate, maintain, and expand their operations. The following assessment toolkit provides guidance to missions on how to determine whether to undertake assistance designed to improve municipal finance, and if so, what kinds of problems need to be addressed.

A summary of the main issues to be discussed and the questions to be asked during the preliminary and detailed assessment follows this introduction and precedes the body of this assessment toolkit.

Summary of Technical Areas & Assessment Questions

Preliminary Assessment

A. The Enabling Environment for Local Government Autonomy

A.1 Enabling environment for municipal responsibilities

1. Is there an explicit/formal assignment of municipal service responsibilities? If so, what services are the municipalities responsible for providing?
2. Does the municipality have exclusive responsibility for providing these services or is the responsibility shared with higher-level governments? In the cases of shared responsibility, is there clarity in the respective roles of different levels of government?

A.2 Intergovernmental transfer mechanism

1. What transfers does the law provide for the municipality to receive? If so, which level of government provides these transfers?
2. Is the money transferred directly to the municipality? How predictable and reliable are the disbursements?
3. How empowered or constrained is the municipality in deciding how to spend those transfers? In other words, do the transfers come with conditions or are they unconditional grants?

A.3 Enabling environment for municipal revenues

1. What taxes, if any, is the municipality legally authorized to levy?
2. What is the municipality's tax autonomy? Does the municipality have the authority to determine the rates of tax? What about the tax bases?
3. Are the municipalities authorized to administer taxes?
4. Have regulatory structures been established to set utility tariffs, user charges, and rates for other revenue sources?

A.4 Enabling environment for municipal borrowing

1. Are municipalities legally authorized to borrow? If not, is it feasible to change this situation?
2. Are there legal limitations on the amount or purpose of municipal borrowing?
3. Are municipalities restricted to borrowing from particular sources?
4. Do central government policies and procedures encourage or discourage municipalities from borrowing?
5. Is there an established procedure within municipalities for approving borrowing decisions?
6. Is there a creditworthiness rating scale in place?

B. Management of Municipal Financial Resources

1. Are the municipality's budget, summary accounts, and financial reports made available to the public on a regular basis? Are these accounts and reports regularly made available to other levels of government?
2. Have standards for municipal accounting and financial reporting been established?
3. Does the municipality have a financial management and reporting system that enables it to establish meaningful expenditure budgets and revenue projections as well as monitor actual budgetary commitments, expenditures, and revenue collections?
4. Are the municipality's accounts and financial reports audited on a regular basis?

C. Trends in Municipal Finances

C.1 Municipal revenue trends

1. For all the taxes that the municipality is legally authorized to levy and collect, how do actual collections compare to total municipal recurrent revenue?
2. For all fees and user charges (including utility tariffs if applicable) that the municipality is legally authorized to levy and collect, how do actual collections compare to total municipal revenue?
3. What percentage of the municipality's total revenue comes from property taxes?
4. What percentage of the municipality's annual budget comes from transfers from another level of government?

C.2 Trends in financial operating positions of municipalities

1. What is the trend in the municipality's budgets? Are they in surplus or deficit?
2. Does the municipality fund recurrent (operating) expenditures through borrowing?
3. What percentage of total municipal expenditure is for capital expenditures?

C.3 Trends in municipal debt

1. What is the total debt outstanding? How many times has the municipality borrowed, and for what purposes?
2. How does total debt service (repayments of principal and interest) compare to total revenue? How does total debt service compare to total expenditure?
3. What has been the trend in the creditworthiness rating (if available)?

More Detailed Assessment

D. Performance of Municipalities in Raising Revenues

D.1 Trends in revenue collections

1. For all taxes that the municipality is legally authorized to levy and collect, how do actual collections compare to: a) the amount billed, and b) the amount that could be billed if the tax base data were up to date and the municipality could determine its own tax rates?
2. For all fees and user charges (including utility tariffs) that the municipality is legally authorized to levy and collect, how do actual collections compare to the amount billed, and the amount that could be billed if the municipality could determine its own rate structure for fees and user charges?
3. What percentage of the municipality's annual budget is funded by transfers from another level of government? What is the difference, if any, between the amount of transfer payments the municipality is entitled to by law and the actual amount of transfer payments received? If there is a difference, what is the reason?
4. What percentage of the municipality's annual budget is discretionary spending (i.e. not mandated by laws, regulations or contracts)?

D.2 Municipal transfer mechanism

1. What type of transfers does the municipality receive? Equalization grants, conditional grants, capital grants? Are equalization grants generally equalizing?
2. Do conditional grants jeopardize local autonomy? Do they overburden administrative capacity?
3. Do higher level governments provide loan transfers to municipalities?
4. How is the divisible pool of transfers to municipalities determined? Is there an opportunity for increasing the amount in the divisible pool?
5. What is the allocation mechanism of the divisible pool among municipalities? If by formula, is this mechanism used de facto? If ad hoc, how much do allocations fluctuate from year to year?

D.3 Municipal taxes

1. What type of property taxes does the municipality levy? Tax on annual or rental value of the property/capital value of land and improvement/site value of land?
2. What is the extent of coverage of the property tax?
3. What is the rate structure of the property tax? How often is it updated?
4. Is there a record system of landownership in place?
5. Is there an assessment system in place? Are there professionally-trained assessors?
6. Is there a decent collections system in place? Is there a high level of uncollected taxes?

7. How do collection costs compare to collected revenue?
8. Is there evidence of corruption in property tax administration?
9. What other taxes does the municipality levy? And what is the trend in revenue collections for these taxes?
10. Is the tax rate and tax base regularly reviewed (assuming the municipality has the authority to change them)?
11. Are these taxes administered efficiently (assuming the municipality is responsible for administering these taxes)?
12. Is there potential for revenue mobilization through these taxes?

D.4 Regarding user charges and fees

1. Are services delivered on a cost recovery basis? That is, do revenues cover or exceed expenditures (see the "Managing Municipal Financial Services" Assessment and Toolkits)?
2. Are municipal services affordable to poor households? Are all households equally charged for services? If not, does it differ by household income/by region?
3. Are tariffs/charges/rates established on an objective and professional basis?
4. Are the regulator's tariff/charge/rate decisions subject to veto by political leaders at the municipality level or elsewhere?
5. Are tariff/charge/rate decisions adequately enforced and implemented?
6. If there are no regulatory structures, how are tariffs/charges/rates established?
7. To what extent are user fees being collected from customers? Is there a high level of uncollected fess and charges?

E. Municipal Borrowing

E.1 Constraints on the authority of municipalities to borrow

1. Have the municipalities reached their legal borrowing limits, if any?
2. Are the legal borrowing limits established appropriately?
3. Is it prudent to consider relaxing the borrowing limits either selectively or across the board?
4. Are the sources of municipal debt financing constraining municipal borrowing, and if so, what are the reasons for this?
5. Are the sources of municipality debt financing owned or controlled by the government, private sector, or both?
6. Do the sources of municipality debt financing operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?
7. Is there any competition among the sources of municipality debt financing?
8. Where do the sources of municipality debt financing obtain their funding for loans and for operating expenses (e.g. central government, multilateral

development banks and international development agencies, capital market, operating income)?

9. Do Municipalities have authority to borrow in foreign currency? If so, how is the foreign exchange risk managed?
10. Is central government willing to consider relaxing the restriction on sources of municipality debt financing?
11. What are the specific policies and procedures that cause the most problem for municipality, and why do they exist?
12. Are the problematic policies and procedures applied transparently and equitably to all Municipalities?
13. Is central government willing to consider revising their policies and procedures to make them less problematic? If so, under what circumstances?
14. If there are no standard procedures for authorizing a borrowing, is the municipality willing to establish such procedures?
15. If standard procedures exist, are they transparent and applied rigorously in all cases?
16. If standard procedures exist, do they afford local residents the opportunity to affect the decision to borrow?

E.2 Municipal experience with borrowing and potential demand for credit

1. How many borrowings have been done and what are the characteristics of the borrowings (i.e. purpose, amount, source of financing, term, interest rate, current annual payment due)?
2. How does debt service on all borrowings compare to total revenue on an annual basis? How does total debt service compare to net revenue (revenue minus expenditure) on an annual basis?
3. How does the level of current liabilities compare to total operating revenue?
4. How does long-term debt compare to the assessed valuation of real property?
5. What is the level of contingent liabilities (i.e. numerous and weak municipally owned companies, large number of guarantees issued by municipalities, and un-funded pension liabilities)?
6. Is the municipality up to date on all of its repayment schedules? If not, why not?
7. If the municipality is up to date on its repayments, has it had to seek any external support to remain up to date? If so, what are the characteristics of the support (i.e. debt forgiveness, debt rescheduling, call upon guarantor, ad hoc revenue supplement) and how frequent has the support been?
8. What are the descriptions of the projects (i.e. purpose and estimated cost)?
9. Are the projects related to a formal city development strategy (or similar long term vision of the future)?

10. Are the projects part of a formal capital investment plan. or similar document?
11. What stage of the project cycle has each of the projects reached (i.e. pre-feasibility, feasibility, detailed engineering/costing, financial structuring, and negotiation of financing)?
12. Have the projects been developed with the participation of local stakeholders most directly affected?
13. Has the municipality identified a source of revenue for the repayment of the debt to be incurred in building each project? If not already identified, is there a potential source of revenue?
14. Has the municipality requested financing for the projects from any source? If so, which sources and what has been the response?
15. Is the cost of each project large enough to attract the interest of any of the sources of financing available to the municipality? If not, could the projects be pooled with other projects (including projects of other Municipalities) to make the financing attractive to investors?

E.3 Enabling environment for municipal borrowing

1. If there is liquidity in the markets, are there any legal or regulatory constraints that prevent institutions (banks, investment companies, insurance companies, and pension funds) from investing in municipality debt instruments? What are the reasons for these constraints?
2. If there is no liquidity in the markets, what is the reason? Is this situation expected to change in the near term?
3. What types of long term investments are they currently making? What is their annual level of investment?
4. What is the minimum investment quality (credit rating) they are willing to accept into their portfolio? What other factors (e.g. term, liquidity, etc.) affect their investment decisions?
5. Are they willing to invest in municipality debt securities if they met their minimum investment quality standards, or are there other constraints to such investments? If there are other constraints, what are they and how could they be relaxed?
6. What is the trend in volume of lending by these specialized financial institutions over the past several years? Do they have a significant backlog of loan applications on which they have not yet decided?
7. What is the average time take to decide to approve or disapprove a municipality loan application?
8. Do any of these specialized financial institutions have policies that constrain the nature of municipality loans they make (e.g. loans only for certain purposes, maximum or minimum amounts, maximum or minimum term. etc.)?
9. Are these specialized financial institutions owned and operated by the private sector or the public sector?

10. Do these specialized financial institutions have access to capital at rates below market rates, and/or do they receive other subsidies that give them an advantage over other lenders in the market?
11. Do these specialized financial institutions operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?
12. Who regulates these specialized financial institutions, and are the regulators willing to consider reforms that would be necessary to make municipality lending a more competitive business?
13. To what extent do Municipalities currently make use of their services? If demand from Municipalities is currently low, what is the reason?
14. Are they in the private sector, public sector, or both?
15. Do they cover all of the kinds of services required or are there gaps? Are they limited to only certain subjects (e.g. water, electric power, etc.)?
16. Do they operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?
17. Do they have experience in rating Municipalities and their projects? If not, are they willing to develop such capacity in the country?
18. Do they provide ratings on a “national rating scale” or only on an international scale? If not currently available, what would be required to establish a national rating scale?
19. To what extent do Municipalities currently make use of their services? If demand from Municipalities is currently low, what is the reason?
20. Are they in the private sector, public sector, or both?
21. Do they cover all of the kinds of services required or are there gaps?
22. Do they operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?

PRELIMINARY ASSESSMENT

Can a USAID program benefit from a municipal finance project?

A. THE ENABLING ENVIRONMENT FOR LOCAL GOVERNMENT AUTONOMY

The first step in evaluating whether a municipal finance project/component would be beneficial to a USAID program is to determine the role of municipalities in the host country. The services that are the responsibility of municipalities vary from country to country, as does the statutory authority of municipalities to levy taxes and user fees, and to borrow to finance infrastructure projects. A project to strengthen the ability of municipalities to raise revenue only makes sense when the enabling environment is already in place or being appropriately reformed. This section provides a sequence of questions to determine whether an adequate enabling environment is in place.

A.1 Enabling environment for municipal responsibilities

An important factor in municipal finance is a clear and stable assignment of expenditure responsibilities. A formal assignment of expenditure responsibilities informs the municipality about its economic role and responsibility for delivering services. While some functions may be exclusive to the municipality, there also may be shared responsibilities with other levels of government. In such cases there is an even greater need to be explicit about the assignment. In this assessment, knowing what services the municipalities are responsible for providing will aid in determining what municipalities need to finance. As public finance specialists often say, ‘finance follows function.’

Is there an explicit/formal assignment of municipal service responsibilities? If so, what services are the municipalities responsible for providing?

Assessment methodology

Analyze the legal framework and regulations that govern the operations of the municipality. If no legal framework exists, analyze how the arrangement of municipal service provision is determined. For example, in the U.S., such operations are often governed by long standing traditions.

Expenditure responsibilities should be specified in the law. Some countries do so in the constitution but many others do so in particular laws such as the law on the budgetary system or the law on sub-national budget and self-government. Also, check information provided in “Managing Municipal Service Delivery” under legal and regulatory framework for service delivery.

<u>Data needs</u>

- Constitution
- Budget Law
- Local Government Law
- Sectoral Laws
- Chartering documents
- Other laws?

<u>Potential sources of data</u>

- Municipal library
- Municipal service provider files
- Interviews with central and local government staff
- Parliamentary website

1. Does the municipality have exclusive responsibility for providing these services or is this responsibility shared with higher-level governments? In the case of shared responsibility, is there clarity in the respective roles of different levels of government? Do municipalities work with lower level governments, i.e. neighborhood groups. Does the municipality provide services exclusively within its borders or does it also provide services outside its borders, such as slums in exurban or periurban areas?

<u>Assessment methodology</u>

After analyzing the legal framework and regulations and listing the responsibilities of the municipality, further investigate if each responsibility is exclusive or shared with other levels of government. If shared, is there clarity in the role of the municipality or a legally set mechanism of co-responsibility (e.g., by attributes such as regulation, financing, and deliver of service)? For example, primary education includes financing, delivery of service, building and maintaining the necessary infrastructure (school buildings), curriculum development, establishing and monitoring standards, etc. A municipality may have exclusive responsibility for all of these functions, or these functions may be divided among different levels of government. The greater the clarity regarding which level of government is responsible for given functions the better. Also, check information provided in “Managing Municipal Service Delivery” under legal and regulatory framework for service delivery.

<u>Data needs</u>

- Constitution
- Budget Law
- Local Government Law
- Sectoral Laws
- Chartering documents
- Other laws?

Potential sources of data

- Municipal library
- Municipal service provider files
- Interviews with central and local government staff
- Parliamentary website

2. How much autonomy does the municipality enjoy in making service delivery decisions?

Assessment methodology

Analyze the extent of decentralization and local government autonomy. Also, check information provided in "Managing Municipal Service Delivery" under legal and regulatory framework for service delivery.

- To what extent does the municipality have control over its finances, organization, and operations?
- Are there special provisions for capital expenditures?
- Does the municipality have the autonomy to
    - Decide on the amount to be spent?
    - Define the structure of the expenditure?
    - Supervise and set standards?

Data needs

- Constitution
- Budget Law
- Local Government Law
- Sectoral Laws
- Chartering documents
- Other laws?
- Parliamentary website

Potential sources of data

- Municipal library
- Municipal service provider files
- Interviews with local government management and staff
- Existing manuals, systems, and procedures
- Existing reports
- Regulations chartering documents, laws

3. Assessment worksheets: see Annex I.

4. Resources

- McClure, Charles E., "The Tax Assignment Problem: Conceptual and Administrative Considerations in Achieving Subnational Fiscal Autonomy", Hoover Institution, Stanford University, Stanford California.

- Martinez-Vazquez, Jorge, "The Assignment of Expenditure Responsibilities", Andrew Young School of Policy Studies, Georgia State University.
- World Bank Institute: Intergovernmental Fiscal Relations & Local Financial Management Program available online at: http://www1.worldbank.org/wbiep/decentralization/Course%20Topics.htm

5. Interpreting the implications of the answers.

A project to strengthen municipal finances will be most effective if the enabling legislation for local government is in place or being put in place and is supportive of genuine local government autonomy. In some cases, the enabling legislation is supportive of local government autonomy, but the legislative design may not be followed in practice, perhaps due to bureaucratic resistance at the national level. Therefore, judgment will be required to determine whether the enabling legislation is supportive of genuine local government autonomy, and local governments are indeed exercising that autonomy. If the enabling legislation is non-existent or flawed, or there is tremendous resistance to allowing local governments to exercise their statutory powers, then this may not be an opportune time to strengthen municipal finances. However, some governments may wish to use pilot programs in a number of municipalities before revising their enabling legislation or to overcome bureaucratic resistance. In such cases, a project to strengthen municipal finances as part of a pilot study may be very helpful. Alternatively, USAID may wish to consider assisting the national government in revising the enabling legislation for local government.

A.2 Intergovernmental transfer mechanism

Providing municipalities with autonomy to make decisions regarding service levels can strengthen democracy and governance if residents have a say in local government decision making. It is also true, however, that municipalities may lack sufficient revenue raising capacity to deliver municipal services. Furthermore, regional disparities in income levels may result in unacceptably high regional variation in the quality of service delivery. National and regional governments can address these issues through intergovernmental transfers. Thus, intergovernmental transfers play an important role in supplementing the local government's own revenues, equalizing fiscal capacity among municipalities and thus reducing disparities in service delivery among municipalities.

1. What transfers does the law provide for municipalities to receive? Which level of government provides these transfers?

<u>Assessment methodology</u>

An over reliance on transfers or 'transfer dependency' can undermine the efficiency of municipal governments.

- What proportion are transfers in total municipal revenues?
    - Are they earmarked or not?
    - Are they timely?
    - Are the equalization formulas understood by the local government officials?
    - Is the system free of political interference?

- Is the transfer system transparent and relatively simple?
- Are these transfers grants or loans?

Data needs
- Constitution
- Budget Law
- Local Government Act

Potential sources of data
- National and (sample of) municipal budgets
- Interviews with members of the finance commission
- Interviews with key personnel in the ministry of finance
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in local government

2. Is the money transferred directly to the municipality? How predictable and reliable are the disbursements?

Assessment methodology
The budget autonomy of municipalities is enhanced if intergovernmental transfers go directly to the municipality and are predictable and reliable.
- Determine whether transfers go directly to municipalities?
- Is their a schedule (i.e., 1st week of every fiscal quarter) for making transfers?
- Does the government follow this schedule?
- Are the transfers predictable from year to year?

Data needs
- Schedule for transfers
- Accounting record of actual disbursements to municipalities

Potential sources of data
- Interviews with members of the finance commission
- Interviews with key personnel in the ministry of finance
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in local government

3. How empowered or constrained is the municipality in deciding how to spend intergovernmental transfers? In other words, do the transfers come with a lot of conditions or are they generally unconditional grants?

Assessment methodology
Higher level governments providing transfers often place conditions on the use of these resources. In some cases, conditional grants can undermine the autonomy of municipalities to establish their own spending priorities.
- Determine (roughly) the proportion of total transfers that are unconditional.

- Determine the total number of grant programs.
- Determine the level of satisfaction with the transfer system currently in place.

Data needs
- Description of transfer system
- National and (sample of) municipal budgets

Potential sources of data
- Interviews with members of the finance commission
- Interviews with key personnel in the ministry of finance
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in local government

4. Assessment worksheets: see Annex I.

5. Resources

- Bird, Richard M. (2003), "Fiscal Flows, Fiscal Balance, and Fiscal Sustainability", ISP Working Paper Number 03-02, Georgia State University, Atlanta, GA. Available at http://isp-aysps.gsu.edu/papers/ispwp0302.html
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- World Bank Institute: Intergovernmental Fiscal Relations & Local Financial Management Program available online at:
  http://www1.worldbank.org/wbiep/decentralization/Course%20Topics.htm

6. Interpreting the implications of the answers.

Intergovernmental transfers play a critical role in municipal finance. Local governments often lack the fiscal capacity to provide adequate services, and often there are fiscal disparities among local governments. Intergovernmental transfers are used to mitigate these problems. Municipal governments usually have the fiscal capacity to levy certain taxes and user fees, such as taxes on land and buildings and vehicles. However, the enabling legislation must give them the statutory authority to levy such taxes and user fees. In short, over reliance, particularly by municipalities, on intergovernmental transfers as a source of revenue, or transfer dependency, may result in unresponsive and inefficient local governments. There is no bright line that defines an unhealthy degree of transfer dependency. However, if the ratio of transfers to total revenues exceeds 70 to 80 percent, then transfer dependency certainly warrants concern. Of course, strengthening municipal finance may be a way to wean them off of an unhealthy degree of transfer dependency.

A.3 Enabling environment for municipal revenues

A sound framework for local government finances should be based on the adage 'finance follows function.' This phrase provides guidance regarding the extent to which local government activities should be funded from local taxes or other local government revenue sources, as opposed to, for instance, funding through intergovernmental grants. However, intergovernmental transfers are the dominant source of revenues for municipal governments in most developing countries. While grants and transfers are generally inevitable, over reliance on transfers can jeopardize fiscal discipline and undermine the autonomy of the municipality to establish their own budget priorities. Thus, it is important that municipalities have an appropriate assignment of taxing powers or revenue autonomy.

1. What taxes, if any, are the municipalities legally authorized to levy?

<u>Assessment methodology</u>
Analyze the legal framework and regulations to identify own taxes of municipalities.
- What taxes are municipalities legally authorized to levy?
- Are municipalities levying and collecting taxes and/or fees that they are not statutorily authorized to levy and collect?

<u>Data needs</u>
- Constitution
- Budget Law
- Local Government Law
- Chartering documents
- Tax Law

<u>Potential sources of data</u>
- Municipal library
- Budget documents
- Interviews with central and local government staff

2. What is the degree of municipal revenue autonomy? Do municipalities have the authority to determine tax rates? Can they define tax bases?

<u>Assessment methodology</u>
Analyze the legal framework and regulations that govern own-source revenue of the municipalities. If no legal framework exists, analyze whether municipalities can set tax rates and/or define tax bases. For each tax that municipalities are legally authorized to levy there are the following possibilities. Municipalities can
- Set the tax rates and define the tax bases (for one or more taxes)
- Set tax rates only (for one or more taxes)
- Define tax bases only (for one or more taxes)
- Set neither the tax rates or define the tax bases

- Tax is shared/or piggybacked (see intergovernmental transfers)

Data needs
- Constitution
- Budget Law
- Local Government Law
- Chartering documents
- Tax Law

Potential sources of data
- Municipal library
- Existing reports
- Interviews with central and local government staff

3. Are municipalities authorized to administer taxes?

Assessment methodology
Investigate whether municipalities administer (assesses and collects) its own taxes.
- Are there municipal departments of revenue administration?
- Among the taxes that municipalities are legally authorized to levy, are there taxes that municipalities do not administer?
- What are the consequences if municipal residents do not pay their taxes?
- What type of enforcement mechanisms are there?

Data needs
- Local tax law or other laws
- Municipal Tax Law
- Tax rules

Potential sources of data
- Municipal library
- Municipal reports
- Interviews with local government staff

4. Have regulatory structures been established to set utility tariffs, user charges, and rates for other revenue sources?

Assessment methodology
A tariff structure is a set of procedural rules used to determine the conditions of service and monthly bills for, say, water users in various categories or classes. Having the proper regulatory structure in place is a key prerequisite for improving the quality and cost-efficiency of municipal infrastructure and services and attracting private investment and involvement. Analyze the legal framework and regulations that govern user charges and fees. Does the framework specify: policies, procedures, pricing rules, regulatory system, billing and collection systems, and periodic reviews and updates?

Data needs
- Local Government Law
- Municipal Act
- Tax Rules and Regulations
- Financial data from financial statement of municipal service providers
- Other law?

Potential sources of data
- Municipal library
- Municipal service provider files
- Existing reports
- Local experts
- Interviews with local government staff
- Billing department of municipal service providers

5. Assessment Worksheets: see Annex I.

6. Resources

- Bahl, Roy (2001), “Fiscal Decentralization, Revenue Assignment, And The Case for The Property Tax In South Africa”. International Studies Working Paper Series, Working Paper Number 01-7, Andrew Young School of Policy Studies, Georgia State University. Available online at: http://isp-aysps.gsu.edu/papers/index.html
- Bird, Richard M. 1999. "Subnational Revenues: Realities and Prospects."
- Fox, William and Kelly Edmiston (2000), “Fiscal Decentralization, Revenue Assignment, and the Case for The Property Tax In South Africa”. International Studies Working Paper Series, Working Paper Number 00-4, Andrew Young School of Policy Studies, Georgia State University. Available online at: http://isp-aysps.gsu.edu/papers/index.html
- Georgia State University, Fiscal Policy Resource Center, Principles of Fiscal Decentralization. Available online at: http://isp-aysps.gsu.edu/fprc/
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7. Interpreting the implications of the answers.

The ability to raise own-revenues is the essence of genuine local government autonomy. Without this ability, local governments cannot make autonomous decisions regarding their spending priorities. Also, allowing local governments to raise own revenues is the surest way to establish the nexus between the cost and benefits of municipal services. This nexus promotes efficiency and responsiveness among local governments and creates interest among citizens in the activities of local government officials. At a minimum, the enabling legislation should provide local governments with the authority to establish the rate of some important taxes. Unless the enabling legislation currently provides such authority or the government is committed to revising the laws to provide for it, a project to strengthen municipal finances would not appear to be effective at this time.

Municipalities may be given the following authorities:
a) Set tax rate(s) and define the tax base(s);
b) Set tax rate(s) only;
c) Define the tax base(s) only; and
d) Unable to set either the tax rate(s) or define tax base(s).

If municipalities are granted authorities a) through c), then they have significant control over its taxes. In the remaining case, municipal revenue autonomy is very limited or non-existent. It is very important that local governments control at least the tax rate and are able to access a set of productive taxes.

A.4 Enabling environment for municipal borrowing

Borrowing is a way for municipalities to mobilize resources beyond the amounts they raise through taxes, other revenue sources, and intergovernmental transfers. Of course, borrowings must be repaid. This requires a municipality to have a surplus of revenues over expenditures in order to service their debt. In principle, municipalities should only borrow to finance capital improvements that provide benefits to the residents of the municipality (e.g. a better water system or a new school building) but which can not be paid for out of a single annual surplus. It is also important that the residents of the municipality are willing to pay for these capital improvements over time through taxes or user charges.

1. Are municipalities legally authorized to borrow? If not, is it feasible to change this situation?

<u>Assessment methodology</u>
Because municipalities are a lower level of government their authority to borrow has to be provided by a higher level of government, typically the central government. The chief legal officers of municipalities will be well aware of whether municipalities have the legal authority to borrow. Ask them to direct you to the laws or regulations which address the question of whether municipalities are authorized to borrow. If borrowing is not authorized, officials in the Ministry of Local Government and the Ministry of Finance will

be able to discuss the reason for this situation and the conditions under which borrowing might become legally authorized.

Data needs
- Constitution
- Local Government Act
- Regulations established by the central government regarding municipal borrowing

Potential data sources
- Interviews with the chief legal officer of a municipality
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in the ministry of finance

2. Are there legal limitations on the amount or purpose of municipal borrowing?

Assessment methodology
It is unlikely that municipalities will have completely unrestricted borrowing authority. At the very least, there should be restrictions on the amount of debt that municipalities can incur. The chief financial officers of municipalities should be well informed about any restrictions on municipal borrowing. Ask them about:
- How much they can borrow?
- For what purposes they can borrow?
- Are they restricted to borrowing in local currency?
- What laws or regulations set out these restrictions?

Ask key officials of the Ministry of Local Government and the Ministry of Finance to list the restrictions on municipal borrowing and the rationale for these restrictions.

Data needs
- Local Government Act
- Regulations established by the central government regarding municipal borrowing

Potential sources of data
- Interviews with chief financial officers of municipalities
- Interviews with key officials of the Ministry of Local Government
- Interviews with key officials of the Ministry of Finance

3. Are municipalities restricted to borrowing from particular sources?

Assessment methodology
In some countries municipalities only borrow from government-owned development banks. It is important to understand whether this practice is a legal or regulatory requirement, or whether it results from the lack of alternative sources of credit. Discussions with the chief executive officers of municipalities that have borrowed in the past will identify:
- whether there are any formal restrictions on their sources of financing, and

- whether borrowing from private financial institutions is an option for them.

Discussions with key officials in government development banks that have provided loans to municipalities will help identify why they have been successful in obtaining this business.

Data needs
- Sources of past loans to municipalities.
- Regulations established by the central government regarding municipal borrowing.

Potential sources of data
- Interviews with chief executive officers of municipalities.
- Interviews with key officials in government development banks that are lending to municipalities.

4. Do central government policies and procedures encourage or discourage municipal borrowing?

Assessment methodology
The policy climate created by the central government will have a significant impact on the degree to which municipalities engage in borrowing.
- Identify the number and value of municipal borrowing transactions that have taken place over a recent year.
- Compare the number of transactions to the number of municipalities that are potentially eligible to borrow.
- Compare the number of transactions to the number of major municipalities in the country (population defined as appropriate to the country)
- Well-financed municipalities need to borrow for capital improvements every three to five years. If the number of transactions is less than 25 percent of the number of municipalities, this is low. This is especially true if compared to the number of major municipalities. If the number of transactions is near 100 percent, this is high.

Discussions with chief executives of municipalities will provide their perspective on the impact of central government policies and procedures on their ability to borrow. Subsequent discussions with key officials of the lenders, Ministry of Local Government and Ministry of Finance help you ascertain whether the impacts of central government policies identified during your interviews with local government stakeholders are intentional or unintended consequences of their policies and procedures.

Data needs
- Number and value of municipal borrowings.
- Number of municipalities.
- Population size of municipalities.
- Identified policies and procedures that encourage or discourage borrowing.

Potential sources of data

- Records of municipal borrowings kept by the ministry of local government, ministry of finance, or lenders.
- List of municipalities kept by the ministry of local government.
- Interviews with chief executive officers of municipalities.
- Interviews with key executives in lending institutions.
- Interviews with key officials in the ministry of local government.
- Interviews with key officials in the ministry of finance.

5. Is there an established procedure within municipalities for approving borrowing decisions?

Assessment methodology

Borrowing for capital improvements commits a municipality to a multiyear repayment schedule. It is essential that the municipality's commitment is undertaken with the full knowledge and approval of its political leadership. It is best if the capital improvement and the related debt is also understood and agreed by the public at large. In addition, in some countries, it may be necessary for municipalities to have approval from higher levels of government before contracting a debt. There need to be standard procedures for securing the approvals necessary before a municipality enters into a borrowing. Discussions with the chief executive officers of municipalities, key executives in lending institutions, and key officials of the Ministries of Local Government and Finance should focus on:

- Municipal and central government laws and regulations pertaining to approval of municipal borrowings.
- The procedures that municipalities follow to achieve the necessary approvals for a municipal borrowing.
- How the public at large is involved in the process of deciding on capital improvements and their related financing.

Data needs

- Local Government Act
- Regulations established by higher levels of government regarding municipal borrowing.
- Charter or basic law of a typical municipality.
- Regulations established by a typical municipality regarding municipal borrowing.
- Step by step procedures actually followed by a typical municipality to secure approval for a borrowing.

Potential sources of data

- Interviews with chief executive officers of municipalities.
- Interviews with key executives in lending institutions.
- Interviews with key officials in the ministry of local government.
- Interviews with key officials in the ministry of finance.

6. Is there a creditworthiness rating scale in place?

Assessment methodology

Municipalities should not be borrowing unless they are creditworthy, i.e. can be expected to repay their debts. In some countries credit rating agencies or other institutions analyze corporate and government organizations to assess their creditworthiness and assign them a debt risk rating that can be used to compare the relative risk of non-repayment of debts across all rated institutions. This greatly facilitates long term borrowing. The potential to have such ratings for municipalities increases the possibility of mobilizing local private capital for municipal borrowing. Officials at the Ministry of Finance or the capital market regulatory agency should be aware if credit ratings are being prepared on corporations, banks, or other institutions in the country using a country-specific rating scale. Discussions with representatives of rating agencies can identify whether such ratings are (or could be) extended to municipalities.

Data needs

- Information on credit rating taking place in the country.

Potential sources of data

- Interviews with key personnel in the Ministry of Finance
- Interviews with key personnel in the Capital Markets Regulatory Agency
- Interviews with executives of credit rating agencies (Standard and Poor's, Moody's, and Fitch) or similar institutions

7. Assessment Worksheets: see Annex I.

8. Resources

- Alm, James and Sri Mulyani Indrawati (2002), "Decentralization and Local Borrowing in Indonesia". Prepared for *Can Decentraliztion help Rebuild Indonesia?.* A Conference Sponsored by the Andrew Young School of Policy Studies, May 1-2, 2002, Atlanta, Georgia. Available online at: http://isp-aysps.gsu.edu/fprc/ino/alm.pdf
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9. Interpreting the implications of the answers.

If municipalities in the country are not authorized to borrow, this is a major problem in municipal finance. Unless the central government is willing to work with USAID to rectify this problem, municipalities will be unable to take responsibility for essential capital improvements. When municipal borrowing is restricted (but not prohibited), there will be opportunities for USAID to assist the central government in reforming their municipal borrowing regulations to allow increased access to financing on a fiscally prudent basis. Regulations that restrict municipalities to borrowing from only one (or a few) public sector banks may represent a significant problem. If the central government and banking/financial authorities are willing to encourage market based municipal finance, USAID assistance can focus on encouraging the mobilization of local long term private capital to finance municipal improvements.

It will be a judgment call to determine if municipal borrowing appears to be too low or too high. Municipalities should feel able to access the financing they need and can afford but borrowing should never become a substitute for adequate revenue mobilization. Because municipal borrowing is typically for the long term, it is important to have laws, regulations, and procedures that assure the borrowing decision is carefully considered at both the municipal level and higher levels of government. Encouraging public participation in the process through open hearings, transparent and participatory budgeting, and even referenda is a useful USAID intervention if the public is not found to be adequately involved. Finally, municipal borrowing requires municipalities to be creditworthy. While the availability of local credit rating services in developing and transitional countries may be limited, encouraging the use of municipal credit ratings is a USAID intervention that can have a very positive impact on municipal borrowing and, more generally, sub-national fiscal discipline.

B. MANAGEMENT OF MUNICIPAL FINANCIAL RESOURCES

The second step in the preliminary assessment is to determine whether certain necessary pre-conditions regarding standards of accounting and financial management are in place and functioning well. Strengthening the resource mobilization capacity of municipalities only makes sense if financial management operations are in place and functioning well or can be substantially improved with USAID assistance.

1. Are the municipality’s budget, summary accounts, and financial reports made available to the public on a regular basis? Are these accounts and reports regularly made available to other levels of government?

Assessment methodology

Budgeting and financial management procedures are simply the accounting manifestation of public policy. In particular, proper public financial management must adequately control the total level of revenue and expenditure; appropriately allocate public resources among sectors and programs; and ensure that governmental institutions operate as efficiently as possible. An essential first step is to have in place sound budgetary and financial procedures. Municipal budgets should be comprehensive, accurate, periodic, authoritative, timely, and transparent. A strong budgeting and financial system along these lines satisfies several essential requirements of good government: i) it establishes the basis for financial control; and ii) it provides for accurate, uniform, and timely financial information.

- Determine whether municipal budgets are generally available to the pubic, either in print or on-line

Data needs

- Accounting and Financial Management Act
- National and (sample of) municipal budgets

Potential sources of data

- Interviews with key personnel in the ministry of finance (budget office)
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in local government

2. Have standards for municipal accounting and financial reporting been established?

Assessment methodology

The central government, non-governmental organizations, citizens, and other stakeholders can better monitor the performance of municipalities if financial reporting is done in a uniform and consistent manner. This is usually accomplished by the central government issuing accounting and financial reporting requirements.

- Determine if there are municipal accounting and financial reporting standards
- Determine if the municipalities follow these standards
- Determine if the accounting system meets the requirements of Generally Accepted Accounting Principles (GAPP)

Data needs

- Budget Law
- Financial Reporting Act
- Financial management manual

Potential sources of data

- Interviews with key personnel in the ministry of finance
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in auditor generals office
- Interviews with key personnel on local government staffs

3. Does the municipality have a financial management and reporting system that enables it to establish meaningful expenditure budgets and revenue projections as well as monitor actual budgetary commitments, expenditures, and revenue collections?

Assessment methodology

Budgeting and financial management procedures are simply the accounting manifestation of public policy. Municipal budgets should be comprehensive, accurate, periodic, authoritative, timely, and transparent. A strong budgeting and financial system satisfies several essential requirements of good government: i) it establishes the basis for financial control; and ii) it provides for accurate, uniform, and timely financial information.

- Determine whether municipal budgets are available in print or on-line
- Determine whether municipal budgets provide useful information on expenditures by program and sources of receipts by type of tax, fee, etc.

Data needs

- Municipal budgets (sample of)

Potential sources of data

- Interviews with key personnel in the ministry of finance (budget office)
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in local government

4. Are the municipality's accounts and financial reports audited on a regular basis?

Assessment methodology

Proper public financial management must adequately control the total level of revenue and expenditure; appropriately allocate public resources among sectors and programs; and ensure that governmental institutions operate as efficiently as possible.

- Determine whether municipal accounts and financial accounts are audited on a regular basis.
- Determine whether there is an internal auditor, an external auditor, or both.

Data needs

- Accounting and Financial Management Act
- Report of the auditor general

Potential sources of data

- Interviews with key personnel in the ministry of finance (budget office)
- Interviews with key personnel in the ministry of local government
- Interviews with key personnel in local government
- Interviews with key personnel in the auditor generals office

5. Assessment Worksheets: see Annex I.

6. Resources

- Alm ,James and Jorge Martinez-Vazquez (2002), "The Use of Budgetary Norms as a Tool for Fiscal Management", ISP Working Paper Number 02-15, Georgia State University, Atlanta, GA. Available at: http://isp-aysps.gsu.edu/papers/ispwp0215.html
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- Schaeffer, Michael (2000), "Municipal Budgeting Toolkit", Report No. 4, Urban and Local Government, World Bank, Washington, D.C. Available at: http://www.worldbank.org/html/fpd/urban/mun_fin/toolkit/budgeting_toolkit.html
- World Bank Institute: Intergovernmental Fiscal Relations & Local Financial Management Program available online at: http://www1.worldbank.org/wbiep/decentralization/Course%20Topics.htm

7. Interpreting the implications of the answers.

Municipalities must have strong financial controls in place. Otherwise, they cannot account for or control expenditures. Absent strong financial controls, municipalities are much more likely to spend wastefully, and/ they are much more vulnerable to corrupt practices. If the management of municipal resources is ineffective or highly corrupt, then a project to strengthen the ability of ineffective and/or corrupt municipalities to mobilize additional revenues may be counterproductive. Unless, there is a genuine commitment to strengthening financial controls, it is not advisable for USAID to sponsor a project to strengthen municipal finances.

C. MUNICIPAL FINANCE TRENDS

The final step in the initial assessment is to evaluate the financial condition of the municipalities or a sample of them, by using fiscal indicators. This evaluation will help to determine whether a reform of municipal finances will help municipal governments to improve the quality, reliability, and extent of service delivery.

C.1 Trends in municipal revenue

Own-source revenues should constitute a very significant share of total municipal revenues. Municipalities spend more wisely and are more accountable for money that they are responsible for raising from own sources. Citizens can be more willing to pay local taxes because they can make the link between service delivery and their taxes paid. Own-source revenues also give local control. Many times, municipalities are given the slowest growing revenue sources, which fail to keep pace with expenditure growth. Municipalities need adequate revenue sources that will keep pace with expenditures.

1. For all the taxes that the municipality is legally authorized to levy and collect, how do actual collections compare to total municipal recurrent revenue?

Assessment methodology
Estimate the financial condition of municipalities or a sample of them, based on revenue sources. Collect current and historical statements of budget execution for the past several years taking into consideration particular categories or sources of budget revenues. The data used should be reliable. The most reliable source of data is official statements accepted by the municipality with respect to the law. If municipalities do not meet the pre-conditions of financial reporting indicated in Section B, then you may be unable to obtain these data.

Data needs
- Total municipal recurrent revenues (including intergovernmental transfers)
- Total own source municipal revenues (tax and non-tax)

Potential sources of data
- Municipality’s budget / summary accounts
- Government financial reports
- Central or regional financial reports
- National institute for statistics

2. For all fees and user charges (including, where applicable, utility tariffs) that the municipality is legally authorized to levy and collect, how do actual collections compare to total municipal revenue liabilities? Are their large inventories of accounts receivable? Is this inventory being worked by people responsible for collections?

Assessment methodology
Estimate the financial condition of municipalities or a sample of them, based on own non-tax revenue sources. Collect current and historical statements of budget execution for the past several years, taking into consideration particular categories of sources of budget revenues. The data used should be reliable. The most reliable source of data is official statement accepted by the municipality with respect to the law. If the municipality does not meet the pre-conditions of financial reporting indicated in Section B, then you may be unable to obtain these data.

Data needs
- Total municipal revenues (including intergovernmental transfers)
- Total non-tax own source municipal revenues from service charges and fees, including utility tariffs if applicable.

Potential sources of data
- Municipality's budget / summary accounts
- Municipal service provider financial statements
- Government financial reports
- Central or regional financial reports
- National institute for statistics

3. What percentage of the municipality's total revenue comes from property taxes?

Assessment methodology
Estimate the financial condition of municipalities or a sample of them, based on revenue from property taxes. Collect current and historical statements of budget execution for the past several years taking into consideration particular categories of sources of budget revenues. The data used should be reliable. The most reliable source of data is official statement accepted by the municipality with respect to the law. If the municipality does not meet the pre-conditions of financial reporting indicated in Section B, then you may be unable to obtain these data.

Data needs
- Total municipal revenues (including intergovernmental transfers)
- Total property tax revenue

Potential sources of data
- Municipality's budget / summary accounts
- Municipal service provider financial statements
- Government Financial reports
- Central or regional financial reports
- National institute for statistics
- Local tax administration department

4. What percentage of the municipality's annual budget comes from transfers from another level of government?

Assessment methodology
Estimate the financial condition of municipalities or a sample of them, based on reliance on intergovernmental transfers. Collect current and historical statements of budget execution for the past years taking into consideration particular categories of sources of budget revenues. The data used should be reliable. The most reliable source of data is official statements accepted by the municipality with respect to the law. If the municipality does not meet the pre-conditions of financial reporting indicated in Section B, then you may be unable to obtain these data.

Data needs
- Total municipal revenues (including intergovernmental transfers)
- Total municipal expenditures
- Total grants and intergovernmental transfers

<u>Sources of Data</u>

- Municipality's budget / summary accounts
- Municipal service provider financial statements
- Government financial reports
- Central or regional financial reports
- National institute for statistics

5. Assessment Worksheets: see Annex I.

6. Resources

- Bird, Richard M. (1999) "Rethinking Tax Assignment: The Need for Better Subnational Taxes," Working Paper No. 165, Fiscal Affairs Department, International Monetary Fund.
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7. Interpreting the implications of the answers.

A large inventory of uncollected taxes and fees suggests that municipalities may benefit from a project to strengthen municipal finances, particularly tax administration. However, large and growing inventories of uncollected taxes may reflect the lack of political will to collect taxes and is symptomatic of transfer dependency. If the determination is made that these unsatisfactory trends reflect the lack of political will to collect taxes, transfer dependency, and/or some other structural flaw (i.e., resistance to paying tax by the public because of the low quality of services and/or the perception of corruption), then these structural issues must be addressed for a municipal finance project to be effective. In the case of a project to facilitate borrowing by municipalities, these trends need to be favorable as they are a pre-condition for municipalities to be able to service their debts. Developing countries often underutilize user fees, often out of a mistaken concern for equity. The concern is that poor people will not be able afford to pay for water, electricity, or healthcare. However, pricing schemes can be developed that allow poor people to pay a nominal amount or even receive the services for free while charging higher income people the full cost of service delivery. However, such policies require ingenuity, and, more importantly, the political will to implement user fees in an environment where the rich and poor alike are accustomed to receiving these services for free. Finally, the property tax is an ideal tax for municipalities, even in developing countries. However, they are somewhat difficult to administer and are prone to corruption, for example, through generous valuation of properties owned by political allies or favorable valuations made be provided for side payments or bribes. A municipal finance project can grow the share of user fees and property taxes, but it requires the political will to implement such unpopular policies.

C.2. Trends in financial operating positions of municipalities

Evaluating the operating position of the municipalities is important in determining the financial performance of municipalities. The use of certain financial indicators can aid in determining the municipality's fiscal health. Indicators generally express the financial information of a municipality as a ratio or percent obtained by dividing one set of financial data by another. They are a useful tool for comparing financial information of a municipality over a multi-year period; to compare across municipalities; and to compare to certain benchmarks regarding the financial strength of a municipality.

1. What are the trends in municipal budgets? Are they in balance/surplus or deficit?

<u>Assessment methodology</u>
Estimate the financial condition of the municipality based on budget deficits/surplus. This indicator is determined on whether revenues were equal / exceeded / fell short of expenditures for the current and capital budgets. The indicators are as follows:

- [Total Expenditures / Total Revenues] × 100
- [Operating Expenditures / Recurring Revenues] × 100

Multiplying the above indicators by 100 transforms them into percentages. If the above indicators are equal to 100, then the budget is said to be balanced. If the indicator is greater than 100, the budget is in deficit; and less than 100, the budget is in surplus.
Collect current and historical statement of budget execution for the past years. The data used should be reliable. The most reliable source of data is official statements accepted by the municipality with respect to the law. If the municipality does not meet the pre-conditions of financial reporting indicated in Section B, then you may not be able to obtain these data. For example, suppose that total municipal expenditures is 1,153 million shillings and total municipal revenues are 1,000 million shillings. The ratio of these two figures multiplied by 100 is approximately 115, meaning that municipalities are running deficits in aggregate.

<u>Data needs</u>

- Current budget balance / or total current revenues and total current expenditures
- Capital budget balance / or total capital receipts and total capital expenditures

<u>Potential sources of data</u>

- Municipality's budget / summary accounts
- Government financial reports
- Central or regional financial reports
- National institute for statistics

2. Does the municipality fund recurrent (operating) expenditures through borrowing?

Assessment methodology
Determine the financial condition of municipalities in terms of whether they are generally running budgets that are in balance/surplus budgets or deficit. In other words, do municipalities borrow or run arrears to finance their recurrent budget because they do not have sufficient resources to fund recurrent expenditures. This indicator may not be explicitly reported in financial statements and reports; however, there are ways to determine whether the municipality may be engaging in this practice. Based on the previous assessment question, determine whether the operating budget is in deficit and how long it has been in deficit. When current revenues are not able to cover current expenditures, the municipality must borrow to finance current expenditures or accumulate payment arrears. This deficit represents municipal consumption expenditures that should be used to finance capital investments in infrastructure. To determine the extent to which borrowed funds are used to finance current expenditures calculate the ratio of current deficit to net inflow of borrowed funds.

Collect current and historical statements of budget execution for the past several years. The data used should be reliable. The most reliable source of data is official statements accepted by the municipality with respect to the law. If the municipality does not meet the pre-conditions of financial reporting indicated in Section B, then you may not be able to obtain these data.

Data needs
- Current budget balance (from previous assessment question)
  To calculate the extent of financing to fund current expenditures:
- Net borrowings = capital receipts – non-debt capital receipts

Potential sources of data
- Municipality's budget / summary accounts
- Government financial reports
- Central or regional financial reports
- National institute for statistics

3. What percentage of total municipal expenditure goes to capital expenditures?

Assessment methodology
Estimate the financial conditions of municipalities or a sample of them, based on the composition of the municipality's expenditures. Capital expenditures as a share of total municipal expenditure are particularly important.

Collect current and historical statements of budget execution for the past several years taking into consideration particular categories of expenditure. The data used should be reliable. The most reliable source of data is official statements accepted by municipalities with respect to the law. If municipalities do not meet the pre-conditions of financial reporting indicated in Section B, then you may not be able to obtain these data.

Data needs

- Total municipal expenditure
- Total municipal capital expenditure

Potential sources of data

- Municipality's budget / summary accounts
- Government financial reports
- Central or regional financial reports
- National institute for statistics

4. Assessment Worksheets: see Annex I.

5. References:

- Bird, Richard M. and Almos Tassonyi. (2000) "Constraining Subnational Fiscal Behaviour in Canada:Different Approaches, Similar Results? " Chapter 4 in in "Fiscal Decentralization and the Challenge of Hard Budget Constraints", edited by Jonathan Rodden, Gunnar S. Eskeland, and Jennie Litvack. The World Bank, Washington D.C.
- Martinez-Vazquez, Jorge and Jameson Boex (2000), "Budgeting and Fiscal Management in Transitional Economies". International Studies Program, Working Paper Number 00-6, Andrew Young School of Policy Studies, Georgia State University.
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6. Interpreting the implications of the answers.

Operating or recurrent budgets should be balanced, and, in particular, should not be in deficit. Just like a family should not borrow to pay for groceries, local governments should not borrow to fund recurrent expenditures. If municipalities are borrowing to finance recurrent expenditures, this may reflect a structural problem with the intergovernmental fiscal system, such as transfer dependency or perverse incentives in the transfer system that encourage borrowing. If it is determined that borrowing to finance recurrent expenditures is due to structural problems, then these structures issues must be addressed for a municipal finance project to be effective. If, on the other hand, these problems do not appear to have their original in the structure of the intergovernmental fiscal system, and there is the political will to increase tax effort, then a project to strengthen municipal finances may be helpful. In the case of a project to enable municipal governments to borrow, then municipal finances need to be in reasonably good shape, or there is reasonable confidence that they are being put in good shape. Finally, assuming municipal finances are in reasonably good shape, the lack of expenditure on infrastructure as a share of total municipal expenditures –

recurrent and capital – suggests that a project to enable municipalities to borrow may be helpful.

C.3 Trends in municipal debt

Municipalities typically need to borrow in order to finance major capital expenditures for infrastructure such as bridges, hospitals, roads, public transportation, schools, solid waste disposal, wastewater treatment, and water supply. If municipal finances are functioning well, municipalities can build the infrastructure they need using long term debt financing that does not overwhelm their budget. Debt financing makes it possible for municipalities to pay for infrastructure over time, while they derive contemporaneous services from the infrastructure.

1. What is total municipal debt outstanding? How often have municipalities or a sample of them borrowed, and for what purposes?

<u>Assessment methodology</u>
Estimate the financial condition of municipalities or a sample of them, based on their borrowing histories. Collect information on municipal debts incurred over the past several years (for a defined multiyear period) -- number of borrowings, amount of each borrowing, and purpose of each borrowing.

Obtain data on the total amount of municipal debt outstanding (principal not yet repaid) for the same period of time. The most reliable source of data is official statements accepted by municipalities with respect to the law. If municipalities do not meet the pre-conditions of financial reporting indicated in Section B, then you may not be able to obtain these data.

<u>Data needs</u>
- Amount and purpose of debts contracted during a defined multiyear period.
- Current total municipal debt outstanding.

<u>Potential sources of data</u>
- Municipal financial records.
- Municipal summary accounts or annual financial report.
- Government financial reports.
- Central or regional financial reports.
- Interviews with chief financial officers of municipalities.

2. How does total debt service (repayments of principal and interest) compare to total revenue? How does total debt service compare to total expenditure?

<u>Assessment methodology</u>
Estimate the financial condition of municipalities or a sample of them, based on their debt service burdens. Collect information on the amounts that municipalities repay on their debt over the same years as in question 1 above. Compare these amounts to the

total revenues available to municipalities in each of year (see C.1 question 1). Compare the debt service amounts to the total municipal expenditures in each of those years (see C.2 question 1).

Data needs
- Municipality's annual debt service payments during a defined multiyear period.
- Municipality's annual total revenues for the same years.
- Municipality's annual total expenditures for the same years.

Potential sources of data
- Municipal summary accounts or annual financial report.
- Government financial reports.
- Central or regional financial reports.

3. What are the trends in municipal creditworthiness ratings (if available)?

Assessment methodology
If there is a credit rating history for municipalities, estimate the financial condition of the municipality based on these ratings. Once a municipality has been credit rated, the rating agency conducts a periodic review to determine if its rating should be changed. Collect information on trends in municipal creditworthiness ratings.

Data needs
- Credit ratings of the municipality from the current and prior reviews.

Potential sources of data
- Rating agency reports

4. Assessment Worksheets: see Annex I.

5. References:

- Braun, Miguel and Mariano Tommasi (2002). "Fiscal Rules for Subnational Governments: Some Organizing Principles and Latin American Experiences." Prepared for the IMF/World Bank Conference on Rules-Based Fiscal Policy in Emerging Market Economies. Oaxaca, Mexico, February 14-16, 2002.
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6. Interpreting the implications of the answers.

The existence of a history of municipal borrowing suggests that there is at least some access to financing for capital expenditures. If there are a reasonable number of borrowings for infrastructure improvements of significant value, this begins to suggest a financially healthy and well functioning municipality. If borrowings are very rare, or they are not clearly linked to well defined capital expenditures (i.e. borrowing to cover budget deficits – see C.2 question 2), this suggests that municipal finance is not functioning well. Of course, frequency and volume of borrowing is not the whole story. Debt service must be kept at manageable levels. If there has been a trend of debt service increasing rapidly compared to total revenues, this signals serious trouble because debt service may be reducing the funds available for other essential expenditures. If the comparison of debt service to other expenditures shows a decline in those other expenditures, the problem is confirmed. In a financially healthy municipality, debt service only increases to the extent that total revenue increases enough to cover additional debt service requirements without reducing other expenditures. In the event that municipal credit ratings are available, trends in municipal ratings will indicate if municipal financial conditions are improving or deteriorating.

MORE DETAILED ASSESSMENT

Assuming that the results of the preliminary assessment suggest that it is worthwhile to take a more in-depth look, the next step is to analyze certain issues regarding municipal finances that are important in determining the feasibility and appropriateness of potential projects and interventions. The questions in Sections E and F are intended to be answered by specialists familiar with municipal finance. As such, they are provided to assist USAID in developing a scope of work for specialists to do a more in-depth assessment and to help USAID understand the implications of the information that is uncovered by the specialist.

D. PERFORMANCE OF MUNICIPALITIES IN RAISING REVENUES

To determine whether a municipal finance activity/project would be appropriate in one or more municipalities, it is necessary to evaluate further the performance of municipalities in resource mobilization. Since the lack of sufficient own municipal revenue is a problem that is all too common in developing and transitional countries, USAID may want to help municipalities gain access to revenue yielding taxes or to help explore further their taxing powers in order to be able to access long term financing for capital expenditures. Building off of the preliminary assessment of local government revenue previously completed (see A.2, A.3, and C.1 above), the following questions enable USAID to assess the problems and constraints that need to be addressed through an assistance program. The questions are designed to guide an assessment conducted by specialists with experience in municipal revenue mobilization. The sections on “interpreting the information” are designed to help USAID better understand the implications of the assessment for assistance programming purposes.

D.1 Trends in revenue collections

There may be a variety of factors that constrain a municipality’s ability to raise revenue and exploit its taxing powers in order to provide better services and fund the capital expenditures needed to build essential infrastructure. Analyzing these constraints will suggest whether there are ways that USAID assistance can help overcome these problems.

⇒ If the municipality is legally enabled to raise revenue (focusing on one or several municipalities of interest to USAID):

1. For all taxes that the municipality is legally authorized to levy and collect, how do actual collections compare to: a) the amount billed, and b) the amount that could be billed if the tax base data were up to date and the municipality could determine its own tax rates?
2. For all fees and user charges (including utility tariffs) that the municipality is legally authorized to levy and collect, how do actual collections compare to the

amount billed, and the amount that could be billed if the municipality could determine its own rate structure for fees and user charges?
3. What percentage of the municipality's annual budget is funded by transfers from another level of government? What is the difference, if any, between the amount of transfer payments the municipality is entitled to by law and the actual amount of transfer payments received? If there is a difference, what is the reason?
4. What percentage of the municipality's annual budget is discretionary spending (i.e. not mandated by laws, regulations or contracts)?

-- Interpreting the Information –

If the assessed municipalities are not already raising revenue to their full potential, there may be opportunities for USAID assistance to promote additional revenue mobilization. Exploring revenue mobilizing strategies is an option for these municipalities and further assessment is needed to identify whether there is potential for greater revenue mobilization and how to help municipalities take full advantage of their taxing powers. If however, the legal taxing powers constrains the municipality from raising own revenues, then municipalities probably should not be allowed to borrow. A project to strengthen the ability of municipalities to borrow to finance capital expenditure projects assumes that certain competencies are already in place: municipal governments should be relatively successful at raising own revenues and managing fiscal resources.

D.2 Municipal transfer mechanism

There may be a variety of factors that constrain a municipality's ability to receive adequate grants and transfers. Many times, the transfers they receive are not timely, and they come with numerous restrictions on their use, which constrains the municipality's ability to establish its own budget priorities. In addition, administering conditional grants may unduly burden the administrative capacity of municipalities. Analyzing these constraints will suggest whether there are ways that USAID assistance can help overcome such issues.

⇒ If there are limitations on the municipality's ability to receive adequate revenues from transfers (focusing on one or several municipalities of interest to USAID):

1. What type of transfers does the municipality receive? Equalization grants, conditional grants, capital grants? Are equalization grants generally equalizing?
2. Do conditional grants jeopardize local autonomy? Do they overburden administrative capacity?
3. Do higher level governments provide loan transfers to municipalities?
4. How is the divisible pool of transfers to municipalities determined? Is there an opportunity for increasing the amount in the divisible pool?
5. What is the allocation mechanism of the divisible pool among municipalities? If by formula, is this mechanism used de facto? If ad hoc, how much do allocations fluctuate from year to year?

-- Interpreting the Information –

As previously discussed, intergovernmental transfers play an important role in modern intergovernmental fiscal systems. The concern is that over reliance of transfers or transfer dependency and an excessive number of grants with numerous restrictions on the disposition of the funds undermine the budget autonomy of municipal governments. Unless municipalities are able to raise their own revenues, they really are not free to establish budget priorities. The assessment should determine whether these issues are present and whether a project or intervention by USAID has a reasonable chance of overcoming these issues.

D.3 Municipal taxes

There may be a variety of factors that constrain a municipality's ability to raise revenue and exploit its own taxes and user fees. Analyzing these constraints will suggest whether there are ways that USAID assistance can help overcome these problems.

⇒ If the municipality levies a property tax (focusing on one or several municipalities of interest to USAID):

1. What type of property taxes does the municipality levy? Tax on annual or rental value of the property/capital value of land and improvement/site value of land?
2. What is the extent of coverage of the property tax?
3. What is the rate structure of the property tax? How often is it updated?
4. Is there a record system of land ownership in place?
5. Is there an assessment system in place? Are there professionally-trained assessors?
6. Is there a reliable collections system in place? Is there a high level of uncollected taxes (Are uncollected taxes greater than 10 percent of total collections per annum)?
7. How do collection costs compare to collected revenue?
8. Is there evidence of corruption in property tax administration?

-- Interpreting the Information –

The property tax plays an important role in financing municipal expenditures. In many countries, the property tax is the largest single revenue source for local governments, particularly municipalities. Owners of real property pay taxes on their land and structures. Property taxes create an incentive for local governments to offer services and build infrastructure that increase the value of the properties and thus increase tax revenues. There are four critical aspects in administering a property tax: property identification, record keeping, tax assessment, and tax collection. These are all important and they should all be considered when undertaking an administrative reform. Both the property tax system and tax administration can affect the performance of this important revenue source for municipalities. Tax administration is just as important as the tax structure itself. Especially in developing countries, problems related to faulty tax administration are particularly severe due to shortages of skilled staff, poor recordkeeping, and corruption. Very often, bad tax administration diminishes the revenue potential of this tax. Corruption in tax administration, for example, can reduce potential revenue generation of the municipality. Additionally, corrupt practices may impose additional tax burdens on ordinary citizens when tax officials collude with individuals or businesses to reduce their tax burden. The lost revenue must be made up somewhere and often by raising the rates of ordinary citizens. The purpose of this set of questions is to evaluate the feasibility of strengthening the property tax system through administrative and/or policy reforms.

⇒ If the municipality levies other taxes (focusing on one or several municipalities of interest to USAID):

9. What other taxes does the municipality levy? What are the trends in revenue collections for these taxes?
10. Are the tax rates and tax bases regularly reviewed (assuming the municipality has the authority to change them)?
11. Are these taxes administered efficiently (assuming the municipality is responsible for administering these taxes)?
12. Is there potential for revenue mobilization through these taxes?

-- Interpreting the Information –

Local revenue mobilization is crucial for a municipality to deliver services and meet its financing needs. Many times local revenue mobilization is weak, generally because information regarding the revenue base is incomplete, collections are low, and enforcement is very weak. Although policy can be fine-tuned, many times the primary obstacle to successful local revenue mobilization is weak administration and/or lack of political will to levy and collect taxes. Weak administration, combined with a lack of political will to levy and enforce local taxes, generate a low level of local revenue mobilization. After assessing the property tax and local tax administration in the previous questions, assess whether there is potential for improvement and for greater revenue mobilization through other taxes. Finally, it is important to uncover any unexploited taxes with heretofore unexploited potential revenue yield for municipalities.

D.4 User charges and fees

There may be a variety of factors that constrain a municipality's ability to raise revenue with user charges and fees. Analyzing these constraints will suggest whether there are ways that USAID assistance can help overcome these problems.

⇒ If there are regulatory structures enabling municipalities to set utility tariffs, user charges, and other rates for revenue sources (focusing on one or several municipalities of interest to USAID):

1. Are services delivered on a cost recovery basis? That is, do revenues cover or exceed expenditures (see ”Managing Municipal Financial Services”)?
2. Are municipal services affordable to poor households? Are all households equally charged for services? If not, does it differ by household income/by region?
3. Are tariffs/charges/rates established on an objective and professional basis?
4. Are the regulator’s tariff/charge/rate decisions subject to veto by political leaders at the municipality level or elsewhere?
5. Are tariff/charge/rate decisions adequately enforced and implemented?
6. If there are no regulatory structures, how are tariffs/charges/rates established?
7. To what extent are user fees being collected from customers? Is there a large inventory of accounts receivable, i.e. uncollected fees and charges?

-- Interpreting the Information –

User charges and fees not only help finance government services, but they also can make government services more effective and efficient. Generally, municipalities set tariffs for the provision of services. Establishing a rational system for setting tariffs is not easy, at times it is highly politicized. tariffs and fees should be regulated and reviewed often to adjust for inflation and other factors. Local politicians generally tend to favor free provision of as many public services as possible. This arrangement maximizes their ability to provide patronage, at least as long as they have a say in how the service is provided. Politicians are likely to attempt to minimize the burden of both general local taxes and local user charges, especially on those from whom they receive political support. However, it is important for the municipality to set user fees and charges on a cost recovery basis and to keep uncollected fess and charges to a minimum. High levels of uncollected user fees are not uncommon in developing countries, but they are an indicator of high risk in the sense of creditworthiness.

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E. MUNICIPAL BORROWING

Since the lack of essential municipal infrastructure is a problem that is all too common in developing and transitional countries, USAID may want to help municipalities gain access to long term financing for their capital expenditures. Building off of the preliminary assessment of local government borrowing previously completed (see A.4 and C.3), the following questions enable USAID to assess the problems and constraints that need to be addressed through an assistance program. The questions are designed to guide an assessment conducted by specialists with experience in municipal infrastructure finance. The sections on "interpreting the information" are designed to help USAID explore the implications of the assessment for assistance programming purposes.

E.1 Constraints on the authority of municipalities to borrow

There may be a variety of factors that constrain a municipality's authority to borrow the capital it needs to build essential infrastructure. Analyzing these constraints will suggest whether there are ways that USAID assistance can help overcome these problems.

⇒ If there are legal limitations on municipality borrowing (focusing on one or several municipalities of interest to USAID):

1. Have the municipalities reached their legal borrowing limits, if any?
2. Are the legal borrowing limits appropriate?
3. Is it prudent to consider relaxing the borrowing limits either selectively or across the board?

-- Interpreting the Information –

If the assessed municipalities have not already borrowed up to the legal maximum, there may be opportunities for USAID assistance to promote additional borrowing. If, however, the legal borrowing limits appear to be set too high, then municipalities should not be encouraged to borrow beyond their ability to manage the repayments. Since the legal/regulatory limitations on borrowing are not the immediate constraint, further assessment may be needed to identify why the municipalities have not taken full advantage of their authority to borrow.

If the assessed municipalities have already borrowed the maximum permitted under current laws or regulations, then there is little that USAID can do to encourage additional borrowing unless the government is prepared to consider revising the borrowing limits. If the borrowing limits are established appropriately to prevent fiscal mismanagement and over-indebtedness, then it would not be prudent for USAID to encourage a relaxation of the limits. However, if the borrowing limits appear to be arbitrary or unrealistically low, then USAID may want to discuss possible revisions with the appropriate central government authorities including the ministries of finance and local government.

⇒ If municipal borrowing is restricted to specific sources of financing:

4. Are the sources of municipal debt financing constraining municipal borrowing, and if so, what are the reasons for this?
5. Are the sources of municipal debt financing owned or controlled by the government, private sector, or both?
6. Do the sources of municipal debt financing operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?
7. Is there any competition among the sources of municipal debt financing?
8. Where do the sources of municipal debt financing obtain their funding for loans and for operating expenses (e.g. central government, multilateral development banks, international development agencies, capital market, and/or operating income)?
9. Do municipalities have authority to borrow in foreign currency? If so, how is the foreign exchange risk managed?
10. Is central government willing to consider relaxing the restriction on sources of municipal debt financing?

-- Interpreting the Information –

Restricting the sources from which municipalities can seek financing may constrain municipal borrowing. If this is the case, the constraint may be due to a lack of capital available for lending, high cost of financing due to lack of competition among sources, or lender policies and procedures that make it very difficult for municipalities to obtain financing. All of these problems can be corrected with USAID assistance, but the central government must be willing to consider changes to current restrictive policies.

If all of the sources of municipal debt financing for municipalities are owned or controlled by the government, there is a substantial danger that they may be both undercapitalized and operate in a non-transparent and unprofitable manner. If that is verified by the assessment, USAID may want to provide assistance designed to bring private sector investors into the municipal debt financing business to increase available capital and promote competitive, profitable lending. A well developed system for municipal debt financing funds its operations with capital from the local capital market and income from its lending. It does not rely on funding from central government, multilateral development banks, or international development agencies, except in very special purposes.

If all of the sources of municipal debt financing are in the private sector (especially if there is only one private sector source), the financing constraint may be the result of monopolistic or non-competitive behavior by the lender(s). If that is verified by the assessment, USAID may want to focus assistance on measures that bring additional private sources of financing into the business, including government regulation to promote greater competition.

Since municipalities usually do not earn revenues in foreign currency, they should not undertake debts that have to be repaid in foreign currency. Since foreign exchange rates fluctuate unpredictably, debt service paid in foreign currency requires an unpredictable amount of local currency for each payment. If the assessment reveals that municipalities have foreign currency debts, this is a serious problem unless the municipality's repayments are fixed in local currency and some other entity (such as the central government) bears foreign exchange risk. USAID should discourage the idea of using foreign borrowing as a source of municipal debt financing.

⇒ If central government policies and procedures discourage the municipality from borrowing:

11. What are the specific policies and procedures that cause the most problems for municipalities, and why do they exist?
12. Are the problematic policies and procedures applied transparently and equitably to all municipalities?
13. Is central government willing to consider revising their policies and procedures to make them less problematic? If so, under what circumstances?

-- Interpreting the Information –

Central government policies and procedures that discourage municipal borrowing may be reasonable or unreasonable. If the policies and procedures are focused on maintaining the financial integrity of the municipality and/or its lenders, and they are applied to all municipalities in a transparent manner, then they are probably reasonable. Nevertheless, it may be possible for USAID assistance to help find ways to make them less burdensome to municipalities while maintaining the overall good intent of such policies.

If policies and procedures appear to be intended to exert central government control over project selection and other matters better left to municipal leaders, or if they are applied on the basis of political considerations and/or corrupt practices, then they are not reasonable. Unless the central government is willing to work with USAID to reform their problematic policies and procedures, they will remain a constraint on municipal borrowing.

⇒ Regarding municipality procedures for approving the decision to borrow (focusing on one or several municipalities of interest to USAID):

14. If there are no standard procedures for authorizing a borrowing, is the municipality willing to establish such procedures?
15. If standard procedures exist, are they transparent and applied rigorously in all cases?
16. If standard procedures exist, do they afford local residents the opportunity to affect the decision to borrow?

-- Interpreting the Information –

Standard procedures within a municipality for approving a borrowing are essential, and they need to be applied rigorously in all cases. If the assessment reveals that this is not the case, the ability of the municipality to borrow is impaired. If a municipality has little or no experience with borrowing, they may need USAID assistance to develop appropriate internal procedures to approve borrowings. If the assessment reveals that existing procedures (or lack of their consistent application) deny local residents adequate opportunity to influence the borrowing decision, this needs to be addressed.

E.2 Municipal experience with borrowing and potential demand for credit

In order to assist municipalities to finance their capital improvement projects through borrowing, USAID needs to understand their prior borrowing experience and their current financial condition. These two factors will have a major impact on the ability of municipalities to borrow in the future. In addition, USAID needs to understand what kinds of projects the municipalities want to finance and their state of development. Municipalities typically lack experience in developing their capital improvement projects in ways that meet the investment criteria of potential financiers. USAID assistance can often help overcome these problems once they are understood. Expanding the use of borrowing among municipalities will require organizing enough well conceived demand for financing to justify lenders/investors taking an interest in developing a business in municipal lending.

⇒ If there is a history of municipal borrowing (focusing on one or several municipalities of interest to USAID):

1. How many borrowings have been done and what are the characteristics of the borrowings (i.e. purpose, amount, source of financing, term, interest rate, and current annual payment due)?
2. How does debt service on all borrowings compare to total revenue on an annual basis? How does total debt service compare to net revenue (revenue minus expenditure) on an annual basis?
3. How does the level of current liabilities compare to total operating revenue?
4. How does long-term debt compare to the assessed valuation of real property?
5. What is the level of contingent liabilities (i.e. numerous and weak municipally owned companies, large number of guarantees issued by municipalities, and un-funded pension liabilities)?
6. Are municipalities up-to-date on all of their repayment schedules? If not, why not?
7. If the municipalities are up-to-date on their repayments, have they had to seek any external support to remain up-to-date? If so, what are the characteristics of the support (i.e. debt forgiveness, debt rescheduling, call upon guarantor, and/or ad hoc revenue supplement), and how frequent have they received such support?

-- Interpreting the Information –

The borrowing history of municipalities will provide a sense of how experienced they are in financing their capital investment projects. If the borrowings are few in number, small in amount, for only one or two purposes, or borrowed only from one source (such as a government development bank), then the municipalities have only limited experience with borrowing. In such cases, the municipalities are likely to need more hands-on technical assistance to finance major projects than if they have extensive and varied borrowing experience. Information on municipalities' existing debts (repayment terms, interest rates, and annual payments due) provide basic information needed to assess their ability to take on additional debt, and/or if it is appropriate for them to consider re-financing existing debt on better terms currently available.

By comparing the total debt service burden of a municipality (sum of the annual payments on all outstanding debts) to the municipality's revenues and net revenues, the potential for future borrowing becomes clear. Unless net revenues exceed current total debt service, the municipality will have to either increase revenues or reduce expenditures in order to borrow more. If debt service already represents a substantial use of total revenue, and/or total debt is large in comparison to total assessed valuation of property for tax purposes, then it is unlikely that the municipality can afford to do more borrowing. Even if the current debt situation looks encouraging on the surface, information on contingent liabilities will reveal whether there are potential problems lurking in the future.

Municipalities that have a good record of debt repayment will have an easier time borrowing in the future. It is not appropriate for municipalities to seek new debt financing unless they are up-to-date on current debt repayments. Municipalities that have had to resort to outside support in order to remain up-to-date on their payments are also not the best candidates for additional financing (especially not if such support has been frequent). Of course, there may be extraordinary circumstances that caused repayment problems in the past, but USAID should be very cautious about providing assistance to promote borrowing by municipalities that have not managed their repayments well in the past.

⇒ If there are projects that municipalities would like to finance by borrowing (focusing on one or several municipalities of interest to USAID):

8. What are the descriptions of the projects (i.e. purpose and estimated cost)?
9. Are the projects related to a formal city development strategy (or similar long term vision of the future)?
10. Are the projects part of a formal capital investment plan (or similar document)?
11. What stage of the project cycle has each of the projects reached (i.e. pre-feasibility, feasibility, detailed engineering/costing, financial structuring, and negotiation of financing)?
12. Have the projects been developed with the participation of local stakeholders most directly affected?
13. Has the municipality identified a source of revenue for the repayment of the debt to be incurred in building each project? If so, what is the source? If not already identified, is there a potential source of revenue?
14. Has the municipality requested financing for the projects from any source? If so, which sources and why have they not been successful?
15. Is the cost of each project large enough to attract the interest of any of the sources of financing available to the municipality? If not, could the projects be pooled with other projects (including projects of other municipalities) to make the financing attractive to investors?

-- Interpreting the Information –

The size and type of projects that municipalities are considering can be compared to the size and type of projects they have financed in the past. (see question 1 above). If they are substantially larger or more complex than in the past, then USAID assistance may be crucial to their success. Such assistance should start by assuring that the projects are considered in the context of a broader municipal development strategy (such as a city development strategy – CDS) and a municipal capital investment plan. These strategies and plans are needed to make sure that projects have been adequately vetted by stakeholders and that the most important capital improvement needs of the municipality are prioritized for financing.

By understanding the stage of development that projects have reached, USAID can determine the types of assistance that are still needed to move those projects to financing and implementation. It is not uncommon for projects to be little more than a general concept that still needs to progress through all of the stages of development. The project development process should engage affected stakeholders to the maximum extent possible. History shows that there is a direct relationship between projects developed with broad participation and the project's ultimate technical and financial success. If the assessment shows insufficiently broad participation in the project development process, then USAID assistance should emphasize ways to correct this problem.

To attract financing for projects, municipalities must be able to demonstrate to lenders/investors that they know from where the money to repay the debt will come. This may be from the current general revenue (surplus) of the municipality, or from new revenues generated by the project itself once completed. The more well established the source of repayment, the more secure the lenders/investors will feel, and the more reasonable their financing terms will be. If municipalities cannot readily and clearly identify the source of debt repayments, then USAID assistance needs to address this issue during the project development process.

Municipalities may have already started to seek financing for their projects, without success. Understanding why they have been unsuccessful can help USAID design assistance that addresses their problems. Smaller municipalities may have a special problem because the projects they can afford to finance are also small. The assessment may be able to identify ways to combine smaller projects across several municipalities to create a single financing of a size that interests lenders/investors.

E.3 Enabling environment for municipal borrowing

Until now, the assessment has focused on the "demand" for financing by municipalities. Now it is time to look at the factors affecting the "supply" of financing and the institutions needed to facilitate the transactions that bring together demand and supply. USAID can have a positive impact on the supply factors and the institutional landscape with technical assistance and policy dialogue.

⇒ Regarding liquidity in the financial and capital markets:

1. If there is liquidity in the markets, are there any legal or regulatory constraints that prevent institutions (banks, investment companies, insurance companies, and pension funds) from investing in municipal debt instruments? What are the reasons for these constraints?
2. If there is no liquidity in the markets, what is the reason for this? Is this situation expected to change in the near term?

-- Interpreting the Information –

Most developing and transitional countries have very liquid financial markets. Shortages of capital are rare, but there may be many reasons why available capital cannot be invested in municipal debt (i.e. loans or bonds). If the reasons are legal or regulatory prohibitions, USAID may be able to provide model laws or regulations that address central government concerns while permitting greater investment in municipal debt. Understanding the reasons behind existing laws and regulations will suggest if and how they can be changed. Unless the central government is determined to intentionally limit municipal borrowing to low levels, USAID assistance can make a major contribution to freeing up the supply of capital to municipalities. If there really is no liquidity in the country's financial markets, USAID will have to postpone assistance to increase municipal borrowing until the crisis has ended.

⇒ If there are long term institutional investors (life insurance companies, investment companies, and pension funds) operating in the local capital market:

3. What types of long term investments are they currently making? What is their annual level of investment?
4. What is the minimum investment quality (credit rating) they are willing to accept into their portfolio? What other factors (e.g. term, liquidity, etc.) affect their investment decisions?
5. Are they willing to invest in municipal debt securities if they met their minimum investment quality standards, or are there other constraints on such investments? If there are other constraints, what are they and how could they be relaxed?

-- Interpreting the Information --

Long term institutional investors that operate in the local economy are an often overlooked source of municipal debt financing in developing and transitional economies. If these local capital market institutions are currently investing in only a few types of long term assets while investing large sums each year, then there is a good opportunity for USAID to help them diversify their portfolios by introducing municipal bonds (or arranging long term loans if that is their preferred approach). In order to be able to attract such investors to municipal bonds (or loans), it is essential to understand their investment policies and priorities. The assessment will identify the type of investments these capital market investors prefer, and this information can be used to decide if USAID assistance can help structure municipal borrowings to fit the investors' preferences.

If the assessment finds that local capital market institutions are willing to consider investing in municipal debt, then the impact of any other constraints needs to be reduced. There may be central government or central bank regulations that currently prevent investment in municipal debt. There may be problems of assessing the risks associated with these new investments. Whatever the constraints may be, USAID can decide if technical assistance, training, or other types of assistance can overcome these constraints.

⇒ If there are any financial institutions that specialize in lending to municipalities:

6. What is the trend in volume of lending by these specialized financial institutions over the past several years? Do they have a significant backlog of loan applications on which they have not yet decided?
7. What is the average time taken to decide to approve or disapprove a municipal loan application?
8. Do any of these specialized financial institutions have policies that constrain the nature of municipal loans that they make (e.g. loans only for certain purposes, maximum or minimum amounts, maximum or minimum term. etc.)?
9. Are these specialized financial institutions owned and operated by the private sector or the public sector?
10. Do these specialized financial institutions have access to capital at rates below market rates, and/or do they receive other subsidies that give them an advantage over other lenders in the market?
11. Do these specialized financial institutions operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?
12. Who regulates these specialized financial institutions, and are the regulators willing to consider reforms that would be necessary to make municipal lending a more competitive business?

-- Interpreting the Information --

Specialized financial institutions are frequently a source of long term capital for municipalities (e.g. municipal development funds, infrastructure development banks, investment banks, etc.). If the assessment reveals a low level of lending by these institutions and/or a growing backlog of applications for loans, there is a serious problem in the supply of capital to municipalities. Lengthy internal procedures and/or restrictive investment policies are usually another manifestation of specialized financial institutions that are not able to supply adequate amounts of capital to municipalities.

Specialized financial institutions are usually more successful in mobilizing the volume of capital needed to keep up with the demand for municipal infrastructure if they are owned and operated with substantial private sector involvement. If the institutions depend heavily on access to capital at below market interest rates, or other types of operating subsidies they are unlikely to be able to supply the volume of capital required to meet future demand. These institutions need to be politically independent, transparent and profitable in order to be effective and reliable suppliers of capital to municipalities. In this regard, the country's financial market regulators should be overseeing the specialized financial institutions. If the regulators are prepared to increase competition in municipal lending, then USAID assistance may be able to help increase the volume of capital available to municipalities by encouraging private sector participation in existing institutions and/or greater diversification of lending sources.

⇒ If there are organizations that can provide support services for municipal project development, financial structuring, and financial packaging:

13. To what extent do municipalities currently make use of these services? If demand from municipalities is currently low, what is the reason?
14. Are they in the private sector, public sector, or both?
15. Do they cover all of the kinds of services required or are there gaps? Are they limited to only certain subjects (e.g. water, electric power, etc.)?
16. Do they operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?

-- Interpreting the Information –

Municipalities need the assistance of planners, engineers, financial advisors, lawyers, and other specialists to prepare their projects for financing. If there are problems in the supply of such services, municipal borrowing will not be able to grow sufficiently to keep up with the need for capital investment in infrastructure. However, it is more common to find that municipalities do not make sufficient use of available services. The assessment should point to the reasons that municipalities are not making adequate use of project development services. USAID can then decide if their assistance can help overcome these problems.

A common problem is that municipalities are inexperienced in organizing the project development process and understanding what support services they need. A related problem is the cost of the project development services themselves. If the assessment reveals such problems, USAID may be able to assist by creating a "project development organization". Such an organization would help municipalities organize the process, select consultants/advisors, and pay for the services (in whole or in part). Public – private partnerships are potentially a very useful structure for such organizations.

⇒ If there are credit rating organizations operating in the country:

17. Do they have experience in rating municipalities and their projects? If not, are they willing to develop such capacity in the country?
18. Do they provide ratings on a "national rating scale" or only on an international scale? If not currently available, what would be required to establish a national rating scale?

-- Interpreting the Information –

Establishing credit ratings for municipalities and their borrowings is an important step toward enabling municipalities to attract local long term private capital. If the credit rating organizations operating in the country are not rating municipalities, USAID could encourage them to begin by paying for the first few ratings as a means of developing local expertise and methodologies. Since local capital market investors need to compare the risk level of municipal debt to the risk level of other local investment opportunities (rather than international investments that require hard currency), the credit rating organization needs to have established a "national" rating scale that allows for such comparisons. If the assessment reveals the lack of a national rating scale, USAID can promote such a scale by helping to fund its development.

⇒ If there are specialized services organizations experienced in managing and executing securities transactions (e.g. for stocks and bonds):

19. To what extent do municipalities currently make use of these services? If demand from municipalities is currently low, what is the reason?
20. Are they in the private sector, public sector, or both?
21. Do they cover all of the kinds of services required or are there gaps?
22. Do they operate in a transparent and financially sound manner (e.g. are they politically independent and profitable)?

-- Interpreting the Information –

Municipal bonds can be an important means of mobilizing a larger supply of local long term capital for municipalities. If USAID is considering support for the development of municipal bonds, then municipalities will need the services of organizations specialized in securities transactions. It is unlikely that municipalities are currently using such services, but USAID should consider all of the country specific reasons why this is so. If the assessment reveals that the country lacks competent and ethical securities lawyers, bank trust departments, paying and transfer agency facilities, and securities brokers all operating in the private sector, then USAID assistance should develop this capacity.

F. WHAT MUNICIPAL FINANCE ACTIVITY WOULD BE MOST USEFUL?

F.1 Potential projects for democracy and governance program

When the strengthening of local government is an important objective of a USAID mission's democracy and governance program, improving municipal finance could be one of the principal components of the program. Enabling local governments to become fiscally sound and financially independent of central government, empowers them to respond more effectively to their citizens' needs. In every country this will require a different combination of interventions to address the specific problems identified through the municipal finance assessment.

Democracy and governance programs should address municipal finance broadly by combining (as needed) activities that deal with:

- The constitutional and legal framework for municipal finance in support of fiscal decentralization,
- The development of transparent and equitable systems of intergovernmental transfers to depoliticize revenue sharing and sustaining basic services while avoiding transfer dependency,
- Accountability in the development, management, and reporting of budgets as a means of enabling citizens and civil society to participate in local government decision making,
- Enhancing revenue mobilization thus enabling municipalities to improve service delivery, and
- Greater use of municipal borrowing to finance high priority infrastructure development that expands service delivery capacity to meet current and future demand.

F.2 Potential projects or interventions for an economic growth program

When inadequate local government services (such as water, sewage treatment, solid waste disposal, transportation, education, and health care) seriously reduce business productivity, efficiency, and competitiveness; improving municipal finance should be part of a USAID mission's economic growth program. Alternatively, when deepening financial market intermediation is an objective of the economic growth program, improving municipal finance can help develop local debt markets. Financially sound local governments are able to maintain adequate services, and their long term borrowing in local capital markets provides new debt instruments to diversify the portfolios of institutional investors. The municipal finance assessment identifies the key problems to be addressed in each specific country context.

Economic growth programs should focus on activities that have the greatest impact on improving local government service delivery (especially the services that most affect business development) and municipal borrowing in local capital markets. These include:

- Enhanced revenue mobilization to provide the resources needed to improve upon (selected) current levels of service delivery,

- Improved creditworthiness of municipalities on a basis that enables potential investors to understand their financial condition and their prospects,
- Development of the legal, regulatory, and institutional environment to facilitate the supply of local long term capital to municipal borrowers while protecting the interests of private investors, and
- Greater use of municipal borrowing to finance high priority infrastructure development that expands service delivery capacity to meet current and future demand.

F.3 Potential projects or interventions for an environment program

When the natural environment is adversely affected by the way local governments manage services such as water supply, sewage treatment, solid waste disposal, and public transportation; improving municipal finance could be part of the USAID mission's environmental program. Inadequate funding is typically one of the root causes of poor environmental stewardship at the local government level. There are a significant number of measures that simultaneously improve local government funding and improve the local environment. Major investments in infrastructure for water supply, sewage treatment, solid waste management, and public transportation are typically needed to mitigate a local government's impact on the environment. A municipality's ability to borrow will be a determining factor in whether those infrastructure investments are implemented. A "municipal finance assessment" should identify ways to improve the environment while improving municipal finance.

Environment programs should focus activities on the municipal finance problems that are causing unnecessary pollution and wastage of natural resources. Such activities include:

- Enhanced revenue mobilization through increased tariffs and user charges for water supply, sewage treatment, and solid waste management.
- Support for project development related to municipal investments that will have a positive impact on the environment to assure that they are financed, and
- Greater use of municipal borrowing to finance high priority environmental infrastructure that expands service delivery to meet current and future demand.

ANNEX I - PRELIMINARY ASSESSMENT WORKSHEETS

Municipality: ____

A. THE ENABLING ENVIRONMENT FOR LOCAL GOVERNMENT AUTONOMY

A.1 Enabling Environment for Municipal Responsibilities

1. Fill out the following:

	YES	NO
Is there an explicit/formal assignment of municipal service responsibilities?		

If yes, where is this assignment found? ___________________________________

Check what applies:

The Constitution lists the functions to be covered by the national government. All the other functions are assigned to other levels.	
The Constitution lists both the functions to be covered by the national government and the concurrent responsibilities. All the other functions are assigned to other levels.	
The Constitution lists the functions to be covered by sub-national governments. All the other functions are assigned to national government.	
The Legislature may delegate specific functions to sub-national through specific legislation.	
Other, please specify:	

If no, how does the municipality know what its responsibilities are? Describe.

____

What services is the municipality responsible for providing? The most common municipal responsibilities are listed below. Check all responsibilities that apply to the municipality being assessed. If known, check E (for exclusive responsibilities) or S (for shared responsibilities). Write down any other responsibility not listed in the table.

Responsibility	√ / E / S	Comments
Natural Resources		
Environment		
Social Welfare		
Pre School		
Primary & Secondary Education		
Higher & Adult Education		
Hospitals		
Other Health services		

Family Welfare Services		
Housing		
Libraries		
Parks and Recreation		
Electricity Supply		
Gas		
Water Supply		
Sewer		
Refuse Collection & Disposal		
Fire Protection		
Police Services		
Public Transportation		
Local Roads & Maintenance		
Highways		
Culture		
Local Markets		

2. Relationship with higher level government:

	YES	NO
Does the assignment of responsibilities differentiate between exclusive and shared responsibilities?		

(If yes, you should check E (exclusive) or S (shared) in the previous table of municipal service responsibilities)

In the cases of shared responsibility, is there clarity in the respective roles of different levels of government? Describe.

What role does the national government have in regard to shared expenditure by lower levels of government?

	YES	NO
There are shared responsibilities: National government sets the policy strategy and lower levels decide on public services within that context.		
There are shared responsibilities: The national government sets the nation-wide standards and the sub-nationals decide on public services with those constraints.		
National and sub-national governments' responsibilities overlap. Programs implemented in the same sectors by different levels create duplications.		

There is a central assignment of responsibility and a decentralized provision of public services.	YES	NO

3. How much autonomy does the municipality enjoy in making service delivery decisions?

Describe the relationship between the municipalities with higher level governments regarding:

Municipal control over finances, organization, and operations. ____________________
____

Are there special provisions for capital expenditures?___________________________
____

Does the municipality have the autonomy to decide on the amount to be spent?______
____

Does the municipality have the autonomy to define the structure of the expenditure?
____

Does the municipality have the autonomy to execute the expenditure?
____

Does the municipality have the autonomy to supervise and set standards?
____

A.2 Intergovernmental Transfer Mechanism:

1. What transfers does the law provide for the municipality to receive?

   ____

   If so, which level of government provides these transfers?

   ____

   Is the transfer system transparent and relatively simple?

   ____

   Are these transfers grants or loans?

   ____

2. Is the money transferred directly to the municipality?

   ____

   How predictable and reliable are the disbursements?

Is their a schedule (i.e., 1st week of every fiscal quarter) for making transfers?

Does the government follow this schedule?

Are the transfers predictable from year to year?

3. How empowered or constrained is the municipality in deciding how to spend these transfers? In other words, do the transfers come with a lot of conditions or are they unconditional grants.

Determine (roughly) the proportion of total transfers that are unconditional.

Determine the total number of grant programs.

Determine the level of satisfaction with the transfer system currently in place.

A.3 Enabling Environment for Municipal Revenues

1. What taxes, if any, is the municipality legally authorized to levy?

Check all that apply. Add any not listed below.

Tax Assignment	√	Comments (Level of tax autonomy)
Tax on:		
Personal Income		
Business Income		
Land & Property		
General Sales Tax		
Industry		
Commerce		
Professions		
Entertainment		
Licenses & Fees (marriage, Business, vehicle)		
User charge on:		
Water		

Electricity		
Gas		
Sewerage & drainage		
Collecting & disposing solid waste		
Excises (fuel,alcohol, etc.)		

2. What is the municipality's tax autonomy?
In the table above, for each tax that the municipality levies, in the comment boxes, indicate with the appropriate letter which level of autonomy applies to each of the taxes as follows:

Levels of Tax Autonomy	
Set the tax rate and tax base	**A**
Set the tax rate only	**B**
Set the tax base only	**C**
Set neither the tax rate or tax base	**D**
Tax is shared/ or piggybacked	**E**

Other, please specify:____

3. Check what applies:

	YES	NO
Are the municipalities authorized to administer its taxes?		
Is there a municipal department of revenue administration		
From the taxes that the municipality is legally authorized to levy, are there taxes that the municipality does not administer? If yes, which are these? ____________________________ ____		

4. Have regulatory structures been established to set utility tariffs, user charges, and rates for other revenue sources? Does the framework specify: policies, procedures, pricing rules, regulatory system, billing and collection systems, periodic reviews and updates? Describe. ____
____
____
____

A.4 Enabling Environment for Municipal Borrowing

1. Fill out the following about municipal authority to borrow:

Are municipalities legally authorized to borrow?	YES	NO
What law specifies the authority to borrow?		
If not authorized to borrow, is it possible to change this situation? Explain.		

2. Fill out the following regarding the legal limitations on municipal borrowing.

Are there legal limitations on the amount or purpose of municipal borrowing? (Most probably the answer is YES)	YES	NO
What laws or regulations set out these restrictions?		

List the restrictions on municipal borrowing and the reasons for the restrictions. Add any other restriction(s) not listed below.

Are there restrictions on:	X		Reason
	YES	NO	
Amount they can borrow			
	YES	NO	
Purpose of borrowing			
	YES	NO	
Borrowing in local currency			
	YES	NO	
	YES	NO	
	YES	NO	

3. Fill out the following regarding restrictions on municipal borrowing sources:

Are municipalities restricted to borrowing from particular sources?	YES	NO
What laws or regulations set out these formal restrictions?		
Is borrowing from private financial institutions an option? Explain.		

4. Fill out the following regarding the policy climate created by the central government on municipal borrowing:

Do central government policies and procedures encourage or discourage municipalities from borrowing? Explain.

____

____

Fill out the following regarding country-wide municipal engagement in borrowing:

- Identify the number and value of municipal borrowing transactions that have taken place over a year.

	Year:	**Year:**	**Year:**
Number of municipal borrowing transactions			
Value of municipal borrowing	$	$	$

- Compare the number of transactions to the number of municipalities that are potentially eligible to borrow.

	Year:	**Year:**	**Year:**
(1) Number of municipal borrowing transactions			
(2) Number of municipalities potentially eligible to borrow			
(1) / (2) (in percent)			

- Compare the number of transactions to the number of major municipalities in the country (population defined as appropriate to the country)

	Year:	Year:	Year:
(1) Number of municipal borrowing transactions			
(2) Number of major municipalities (population > ___________)			
(1) / (2) (in percent)			

5. Answer the following regarding approval procedures for municipal borrowing:

Is there an established procedure within municipalities for approving borrowing decisions?

___

What municipal and/or central government laws and regulations pertain to approval of municipal borrowings?

___

What procedures do municipalities follow to achieve the necessary approvals for municipal borrowing?

___

How is the public (at large) involved in the process of deciding on capital improvements and their related financing? Explain.

___

6. Answer the following regarding municipal credit rating:

Are credit ratings being prepared on any municipalities, corporations, banks or other institutions using a country-specific rating scale? List.

___

If yes, who is doing the credit ratings?

___

If municipalities are not currently being credit rated, are any credit rating agencies willing to prepare such ratings on a country-specific rating scale? Explain.

___

B. MANAGEMENT OF MUNICIPAL FINANCIAL RESOURCES

1. Are the municipality's budget, summary accounts, and financial reports made available to the public on a regular basis?

   ___

   Are these accounts and reports regularly made available to other levels of government?

   ___

2. Have standards for municipal accounting and financial reporting been established?

   ___

   ___

3. Does the municipality have a financial management and reporting system that enables it to establish meaningful expenditure budgets and revenue projections as well as monitor actual budgetary commitments, expenditures, and revenue collections? Explain.

   ___

   ___

4. Are the municipality's accounts and financial reports audited on a regular basis?

   ___

   ___

C. TRENDS IN MUNICIPAL FINANCES

C.1 Municipal Revenues Trends

Fill out the following table. Data from this table will be used to answer questions 1 through 4 in section C.1 and, and question 1 through 3 in section C.2.

Own Source Revenue:	Year:	Year:	Year:	Year:	Year:
(A) Own Tax Revenue					
(B) Revenue from Property tax					
(C) Revenue from User fees and charges					
(D) Total Own source revenue					
Transfers :					
(E) Grants and transfers					
(F) Total Recurrent Revenue					
(G) Total Revenue					
Expenditures:					
(H) Operating Expenditures					
(I) Capital Expenditures					
(J) Total Expenditures					

Source(s) of information:____

1. For all the taxes that the municipality is legally authorized to levy and collect, how do actual collections compare to total municipal revenue? Fill out the following table based on data from the table above.

	Year:	Year:	Year:	Year:	Year:
Own Tax Revenue / Total Revenue **[A / G] * 100**					

2. For all fees and user charges (including utility tariffs if applicable) that the municipality is legally authorized to levy and collect, how do actual collections compare to total municipal revenue? Fill out the following table based on data from the table above.

	Year:	**Year:**	**Year:**	**Year:**	**Year:**
Revenue from user fees and charges / Total Revenue **[C / G] * 100**					

3. What percentage of the municipality's total revenue comes from property taxes? Fill out the following table based on data from the table above.

	Year:	**Year:**	**Year:**	**Year:**	**Year:**
Revenue from Property Taxes / Total Revenue [**B / G] * 100**					

4. What percentage of the municipality's annual budget comes from transfers from another level of government? Fill out the following table based on data from the table above.

	Year:	**Year:**	**Year:**	**Year:**	**Year:**
Total Grants and Transfers / Total Revenue **[E / G] * 100**					
Total Grants and Transfers / Total Expenditures **[E / J] * 100**					

C.2. Trends in Financial Operating Positions of the Municipalities

1. What is the trend in the municipality's budgets? Are they in surplus or deficit?

	Year:	Year:	Year:	Year:	Year:
Total Expenditures / Total Revenues **[J / G] * 100**					
Operating Expenditures / Recurring Revenues **[H / F] * 100**					

2. Does the municipality fund recurrent (operating) expenditures through borrowing?

From the previous question indicate whether the current budget is in surplus deficit or balanced, if:

> 100, then deficit (-)
< 100, then surplus (+)
= 100, then balanced (=)

	Year:	Year:	Year:	Year:	Year:
Operating Expenditures / Recurring Revenues **[H / F] * 100**					

Describe whether there are other sources that indicate that the municipality is funding current expenditures through borrowing. Explain.

____

____

____

3. What percentage of total municipal expenditure is capital expenditure?

	Year:	Year:	Year:	Year:	Year:
Capital Expenditures / Total Expenditures **[I / J] * 100**					

C.3 Municipal Debt Trends

1. Answer the following regarding debt trends of the municipality being assessed:

What is the total debt outstanding?

	Year:	Year:	Year:	Year:
Debt outstanding				

Municipal borrowing record:

Loan Transaction	Amount	Year	Purpose	Principal Outstanding
	$			$

2. How does total debt service (repayments of principal and interest) compare to total revenue? How does total debt service compare to total expenditure?

	Year:	Year:	Year:	Year:	Year:
(K) Repayments on Principal and Interest					
Debt Service/Total Revenue [K / G] * 100					
Debt Service/Total Expenditure [K / J] * 100					

3. Fill out the following on the trend on the municipality's creditworthiness rating (if available):

Year	Rating	Rating Agency

GLOSSARY

ACCOUNTING SYSTEM. The total structure of records and procedures which discover, record, classify, and report information on the financial position and operations of a governmental unit or any of its funds, balanced account groups, and organizational components.

ACCRUE. To record revenues when earned and to record expenditures as soon as they result in liabilities for benefits received, notwithstanding that the receipt of cash or payment of cash may take place, in whole or in part, in another accounting period.

AD VALOREM TAX. A tax specified as a percentage of the value of the tax base. For instance, a sales tax of 5 percent of the value of sales is an ad valorem tax.

ALLOCATION FORMULA. A formula used in a formula-based grant system to distribute or allocate grant resources among different sub-national government jurisdictions, also referred to as a horizontal allocation formula.

ALLOCATION FACTOR. A measurable variable used as part of an allocation formula. Sound allocation factors have a number of desirable statistical characteristics.

ANNUAL VALUE PROPERTY TAX SYSTEM. Still used in most former British colonies. In an annual value system the base is identified as the expected or notional rental value of a property. Typically, property assessment is according to an estimate of rental value or net rent.

ASSETS. Financial representations of economic resources owned by an organization or individual.

AUDIT. The examination of documents, records, reports, systems of internal control, accounting and financial procedures, and other evidence for one or more of the following purposes:

a. To ascertain whether the statements prepared from the accounts present fairly the financial position and the results of financial operations of the constituent funds and account groups of the governmental unit in accordance with generally accepted accounting principles and on a basis consistent with that of the preceding year.
b. To determine the compliance with applicable laws and regulations of a governmental unit's financial transactions.
c. To review the efficiency and economy with which operations were carried out.
d. To review effectiveness in achieving program results.

AUTONOMY. Independence or freedom; the right of self-government.

BENCHMARK. It is a target of performance which is based on certain standards, or in the absence of standards, on proven historical trends or comparative data.

BLOCK GRANT. A block grant is an intergovernmental fiscal transfer that is non-matching in nature. Block grants may be unconditional, sectoral, or earmarked grants. Contrast to matching grant.

BUDGET. A plan of financial operation embodying an estimate of proposed expenditures for a given period and the proposed means of financing them. Used without any modifier, the term usually indicates a financial plan for a single fiscal year.

BUDGET DEFICIT. The amount by which the government's total outlays exceed its total revenues for a given fiscal year.

BUDGET SURPLUS. The amount by which the government's revenues exceed its outlays for a given fiscal year.

CAPITAL BUDGET. A plan of proposed capital outlays and the means of financing them for the current fiscal period. It is usually a part of the current budget. A capital budget segregates capital spending from all other spending, usually considered the ‘operating budget.’ In a capital budget, spending and receipts in the capital budget are excluded from the operating budget and are not included in the operating budget's deficit or surplus calculations. A capital budget would include spending only for capital assets.

CAPITAL VALUE PROPERTY TAX SYSTEMS. A tax on wealth where the tax base may be defined as the assessed value of land and improvements, or as only the assessed value of land under the site value version.

CONCURRENT (SHARED) POWERS. Duties shared by both the national government and sub-national governments, such as collecting taxes, building roads, and making/enforcing laws.

CONDITIONAL GRANT. An intergovernmental fiscal transfer to which certain conditions are attached by the central government. Conditional grants range from highly conditional earmarked grant to much more permissive sectoral grants. Contrasts with Unconditional Grant

CONSUMPTION TAXES. Taxes imposed on the consumption of goods and services. Examples of consumption taxes include general sales and use taxes, VAT, and excise taxes.

COVERAGE RATION. Defined as the amount of taxable property captured in the fiscal cadastre, divided by the total taxable property in a jurisdiction, measuring the accuracy and completeness of the valuation roll information.

CURRENT ASSETS. Those assets which are available or can be made readily available to meet the cost of operations or to pay current liabilities. Some examples are cash, temporary investments, and taxes receivable which will be collected within about a year from the balance sheet date.

CURRENT BUDGET. The annual budget prepared for and effective during the present fiscal year; or, in the case of some state governments, the budget for the present biennium.

CURRENT LIABILITIES. Liabilities which are payable within a relatively short period of time, usually no longer than a year.

CURRENT REVENUE. Revenues of a governmental unit which are available to meet expenditures of the current fiscal year.

DECENTRALIZATION. The process of shifting responsibility for providing certain services from the central government to local government bodies that are not wholly controlled by the central government. Decentralization is the empowerment of local communities by the empowerment of local governments. Deconcentration, delegation, and devolution provide progressively decentralized approaches to organizing the public sector. Decentralization can be divided into political decentralization, fiscal decentralization, and administrative decentralization.

DEFICIT. (1) The excess of liabilities and reserved equity of a fund over its assets. (2) The excess of expenditures over revenues during an accounting period; or, in the case of Enterprise and Internal Service Funds, the excess of expense over income during an accounting period.

DEVOLUTION. The process of assigning substantive responsibility for the delivery of a public good or service to a sub-national government level. Either the central government could devolve the responsibility to provide a central government service to the local government level, or the central government could devolve responsibility over all aspects of a functional responsibility. (Also see expenditure assignment).

DIRECT TAXES. Originally denoted taxes whose burden is intended to be borne by the very subject who pays these taxes. In practice is used to denote taxes which are levied on permanent and recurring occasions (e.g., on income or property) regardless of the ultimate incidence of the burden. Compare to indirect taxes.

DISCRETIONARY SPENDING. A category of spending (budget authority and outlays) subject to the annual appropriations process.

EARMARKED GRANT. An earmarked grant is a conditional intergovernmental fiscal transfer that is required to be spent on a specific program or for a specific purpose. (At times, earmarked grants are used to fund a specific item such as a particular capital project).

EFFICIENCY. Economic efficiency is achieved when a society produces the combination of outputs with the highest attainable total value to society, given its limited resources. For economic efficiency to be achieved, three separate notions of efficiency need to be satisfied: allocative efficiency, productive efficiency, and distributive efficiency.

EFFORT (REVENUE EFFORT OR FISCAL EFFORT). The degree of effort with which a sub-national government pursues revenue collections, given the revenue instruments and tax bases that are available to it. Typically measured as the ratio of collections to the underlying tax base. Also referred to as Revenue Performance.

EQUALIZATION. Policy of the higher-level government aimed at equalizing capacities of sub-national governments to discharge functions assigned to them.

EQUITY. The principle that a tax system should be designed so as to be fair. Also see ability to pay principle; benefits principle; vertical equity, horizontal equity.

EXCISES. An excise tax is a duty levied on specific goods and services – usually luxuries and “sin” goods, such as alcohol, tobacco, gasoline, etc.

EXPENDITURE ASSIGNMENT (REPONSIBILITY). The delineation of roles and functional responsibility among levels of government for regulating, financing, administering, and producing public goods and services.

FISCAL CAPACITY. Fiscal capacity reflects the ability of a jurisdiction to raise revenue for public spending. This capacity is determined both by the level of economic activity within the boundaries of the jurisdiction and the government’s ability to translate this economic activity into public revenues. The ability to transform the economic base into public revenues is determined with legally available taxing powers (such as authority to tap particular taxable bases or to set tax rates) and tax administration capacity.

FISCAL DECENTRALIZATION. The empowerment of local communities by the fiscal empowerment of their local governments. *See Decentralization.*

GENERAL FUND. A fund used to account for all transactions of a governmental unit which are not accounted for in another fund. The General Fund is used to account for the ordinary operations of a governmental unit that are financed from taxes and other general revenues.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES. (GAAP) The body of accounting rules, methods, and procedures that is sanctioned by the accounting profession, either by convention or by the authoritative literature, as a guide to the preparation of financial statements.

GRANT. *See intergovernmental fiscal transfer.*

INCOME TAXES. Taxes imposed on the income of households and business firms. *Examples of income taxes include the personal income tax, the corporate income tax and may include local income taxes.*

INDIRECT TAXES. Originally denoted taxes whose burden is expected or intended to be ultimately shifted to someone other than the subject who statutorily pays these taxes. In practice, this term is used to denote charges on occasional and particular events (e.g., consumption purchases, the import of goods, etc.) regardless of the ultimate incidence of the burden. Compare to direct taxes.

INTERGOVERNMENTAL FISCAL RELATIONS. Intergovernmental fiscal relations relates to how different levels of government interact with each other on fiscal issues. Intergovernmental fiscal relations comprise four broad dimensions, including expenditure assignments, revenue assignments, intergovernmental fiscal transfers and the framework for local government borrowing and debt.

INTERGOVERNMENTAL FISCAL TRANSFER. A non-compulsory, non-repayable financial payments between government units; typically (although not always) from a higher-level government to a lower-level government unit. Usually intergovernmental fiscal transfers are aimed at achieving vertical fiscal balance, horizontal equalization, or other specific objectives of the payer.

LEVY. The imposition or collection of an assessment. The term levy is frequently used to refer to a tax levied on a specific object, or to a revenue source collected for a specific purpose.

LIABILITIES. Debt or other legal obligations arising out of transactions in the past which must be liquidated, renewed, or refunded at some future date.

LOAN GUARANTEE. Any guarantee, insurance, or other pledge with respect to the payment of all or a part of the principal or interest on any debt obligation.

MATCHING GRANT. Intergovernmental transfer that matches at a predetermined rate every dollar of the recipient government's own funds allocated for a specific purpose.

NOMINAL (SPECIFIC) TAX. A tax or charge that is determined as a nominal or specific amount. As opposed to an ad valorem tax.

NON TAX REVENUE. Government receipts that generally involves a quid pro quo (Latin: "this for that") provided to the payer in exchange for the payment, such as a benefit, good, or service. Non tax revenues include licenses, fees, charges, as well as other revenues, such as rent, sales of property, and interest. In addition to these revenue sources, this category also includes fines that are compulsory and do no involve any benefits in exchange.

NUISANCE TAX. A low-yielding tax for which the collection costs exceed the revenue yield of a tax. *Examples of typical nuisance taxes include taxes of fountain drinks, bowling, haircuts, movie tickets, dry cleaning, parking, and shoe repairs. A broader definition of the term defines a nuisance tax as a small excise tax levied on separate purchases and collected directly from the purchaser.*

OWN SOURCE REVENUE. Indicates a revenue source over which a sub-national government has substantive control. Economists consider this to mean a tax a tax for which (a) the collections flow to the local level and (b) over which local government jurisdictions have control over the marginal tax rate, either through policy discretion or through direction over its collection. *See Revenue assignment.*

OPERATING BUDGET. A budget which applies to all outlays other than capital outlays.

OPERATING EXPENSES. (1) As used in the accounts of governmental enterprises, the term means those costs which are necessary to the maintenance of the enterprise, the rendering of services, the sale of merchandise, the production and disposition of commodities produced, and the collection of enterprise revenues. (2) The term is also sometimes used to describe expenses for general governmental purposes.

ORDINANCE. A local statute passed by a town, city, or county government.

PIGGY-BACK TAX. A tax that is legislated and collected by the central (or other higher-level) government as a surtax on a central government tax, while local governments are allowed to set the rate for the surtax and receive the proceeds from the sub-national surtax on a derivation basis. Common forms of piggy-back taxes include piggy-back sales taxes and income taxes. As a result of the local control over the tax rate, a piggy-back tax is considered a local government revenue source.

PROGRESSIVE TAXES. A tax for which the liability as a percentage of taxpayer's income or wealth increases with the level of income or wealth. Compare to proportional and regressive taxes.

PROPERTY TAX. A type of tax for which the liability of the tax stems from ownership of assets. Usually the taxable assets are limited to "real property" which includes land, buildings, structures, and other improvements that are constructed on or in the land, attached to the land, or placed upon a foundation. However, in some countries taxable property extends to boats, vehicles, aircraft and even business inventories.

PROPORTIONAL (FALT RATE) TAXES. A tax that has the same liability as a percentage of taxpayer's income or wealth regardless of the level of income or wealth. Compare to progressive taxes and regressive taxes.

PUBLIC GOOD. A good that is non-rival and non-excludable. Non-rival means that a person can enjoy the benefits of a good without reducing the benefit received by others; non-excludable means that a person cannot be excluded (or it is prohibitively expensive to exclude him/her) from enjoying the benefits of the good. Good examples of pure public goods are national defense and radio transmissions.

REGRESSIVE TAXES. A tax which requires lower-income taxpayers to pay a greater percentage of their income in tax than upper-income taxpayers. Compare to progressive and proportional taxes.

REVENUE. The addition to cash or other current assets of governmental funds (receipts) which do not increase any liability or reserve and do not represent the recovery of an expenditure, i.e., reimbursements. Generally, revenue is derived from taxes, licenses and fees, and the like.

REVENUE ASSIGNMENT. A comprehensive definition of a revenue assignment considers which government level (1) legislates each tax; (2) defines the tax base (and exemptions); (3) determines the tax rate; (4) collects/administers the tax; and (5) receives the revenues from the tax. *See Own source revenue.*

REVENUE AUTONOMY. The extent of control that sub-national governments are able to exercise over the sources of their revenue. Revenue autonomy is determined by the local governments' discretion to determine taxable bases, determine rates, introduce the tax, or any combination of these three.

REVENUE SHARING. Transfer of revenues generated at one level of government to finance a portion of expenditures carried out by another level of government. Revenue sharing can be done on a derivation-basis based on a predetermined, uniform sharing rate; on a derivation-basis using "regulated" sharing rates or formula-driven sharing rates; or on a formula basis. Usually revenue sharing aims at rectifying the mismatch in the vertical division of expenditure responsibilities and revenue sources. When shared revenue sources are collected by the higher-level government, revenue sharing should be considered a type of intergovernmental transfer, since the sub-national government has no control over the tax rate, base or collection.

SECTORAL GRANT. Intergovernmental transfer targeted toward funding activities in a particular sector of public services, such education, healthcare, etc.

SITE VALUE PROPERTY TAXATION. This is a special case of capital value property taxation where only land is taxed.

SUBVENTION. *See Intergovernmental fiscal transfer.*

SURTAX/SUBNATIONAL SURTAX. *See Piggy-back tax.*

TAX. An involuntary payment to a government (by households and business firms) that does not involve a *quid pro quo* (Latin: "this for that") benefit. Common categories of taxes include income taxes, consumption taxes, property taxes and transaction taxes. Tax instruments can be regressive, proportional or progressive.

TAX BASE. Collective value of assets and activities that are subject to a tax.

TAX COLLECTOR. An official responsible for the collection, management, and distribution of delinquent real estate tax money.

TAX COVERAGE. The share of the potential taxpayers in a universe that are covered by a tax instrument. *For instance, x % of households in the municipality are subject to the Personal Income Tax.*

TAX RATE. The ratio, scale, or standard at which a tax liability is determined in relation to the tax base. *Compare with Effective Tax Rate.*

TRANSACTION TAXES. A type of tax for which the liability of the tax stems from a specific transaction, such as the sale of property assets, or the import or export of a good or service.

TRANSFER. *See Intergovernmental fiscal transfers.*

TURNOVER TAXES. A tax imposed on business firms on the basis of the firm's turnover (sales revenue). Turnover taxes are often considered to be inefficient – particularly in developed economies- because they can have a cascading or "snowballing" effect as each stage of production is fully taxed.

UNCONDITIONAL. An intergovernmental transfer provided without any specific conditions attached. Contrast with conditional grant.

VALUATION RATIO. Defined as the value on the valuation rolls divided by the real market value of properties on the valuation roll. This measures the accuracy of the property valuation level.

VALUE-ADDED TAX (VAT). A tax imposed on business firms on the basis of the value added by the firm. Value-added taxes avoid the cascading effect of turnover taxes.

USER FEE. A charge made to persons for using a governmental service such as water.