Finance Cooperation Between Local Authorities in Developing Countries

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Productions

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Introduction

A common question in many developing countries is the rapid urbanisation. For example, the African Development Bank (ADB) assesses the population growth in African urban areas to about 300 million over the next two decades. This produces substantial needs for infrastructure investments; housing, transportation, streets, water and sewage etc. ADB estimates that African cities' financing needs are about USD 90bn per year. In Asia, India alone is estimated to need a total of around USD 2.2 trillion over the next 20 years to meet the urban investment requirement. Many Latin American countries are also facing similar situations.
One of the ways to meet these challenges is to create Local Government Funding Agencies (LGFA). A LGFA is conduit for financial cooperation between local authorities. The process leading to the creation of such an agency supports the building of local creditworthiness, helps to create local markets and increases transparency in the local decision-making. When the agency is created it has the potential to reduce financing costs, processing costs and limit risks. Furthermore, a LGFA is self-regulating in the sense that it prohibits excessive borrowing.

What is a LGFA?

A LGFA is a cooperation project between local authorities in a country. This means that the local authorities jointly own the agency, sometimes with a minor ownership by the state. The mission of the agency is to pool the borrowing needs of the local authorities and to issue bonds in the capital markets. The proceeds of these bonds are then on-lent to local authorities. The agency is created for the good of the local authorities and does not seek to make profits. Municipal funding agencies work solely (with lending) within the borders of their respective countries.
The rationale behind establishing LGFA's can be divided into the following points:

- Local authorities are by matter of definition small entities. As a large part of the financial markets are closed to small borrowers, whether they are public or private entities, the local authorities need to unite to get better conditions.

- In all of the known cases, the creation of a LGFA has led to cost reductions in financial management for the local authorities. This relates both to interest costs and processing costs.

- The LGFA gives support and incentive to improve the local governments' creditworthiness and amplifies the cooperating group's joint creditworthiness.

- A LGFA has the potential to be a centre for the transfer of knowledge to local authorities in the areas of financing, legal matters and in general administrative questions. Financial expertise is often low in local authorities since their primary focus is on providing appropriate basic services to the public.

- If the LGFA is operating on a free market with no state benefits or privileges competition is boosted. The absence of a LGFA often leads to markets characterised by oligopoly.

A successful LGFA should incorporate the following values:
Equality; all local authorities should be treated **equal**. All exceptions (for example: different margins) should be **logical** and **fair.**
Transparency; the Agency should be as **open** as possible with **information** to the local authorities, and to the financial markets, about the Agency's activities.
Involvement; the local authorities should be made to feel that this is **their project**, for which every local authority has a **responsibility**.

The current situation

In a growing number of countries, local authorities are cooperating in LGFAs. The Scandinavian countries and the Netherlands have had funding agencies for a long time, but now the trend is spreading fast in other parts of Europe. The French local authorities created their agency in 2013 and the English Local Government Association is now studying the possibilities to form an agency. The trend stretches beyond Europe. New Zeeland created their agency a few years ago and the discussion is on its way in Australia. Cooperation within a LGFA has in all known cases resulted in lower borrowing costs, lower transaction costs, lower risks, increased diversification and higher local authority creditworthiness.
Local authority investments are in many cases very important for a country's growth. Among the OECD countries, local authorities are responsible for two thirds of all public investments. This means that, if the level of local investments sinks, there are severe problems for the economy of the country.
As a result of the recent financial crises local authorities have been hit hard. Transfers from central government are unpredictable, but generally sinking. This happens at the same time as local authorities around the world face great challenges as a result of fast urbanisation, which triggers a need for new infrastructure investments and ways to finance these investments.
The downturn of the global economy has led severe consequences for developing countries. Slower growth, or even shrinking economies, all over the world are results of the crises. The developing countries have on top of that experienced lower levels of development aid and foreign investments. Furthermore, unemployment in developed countries has reduced remittances, which play a big role for the economies of many developing countries. All this has led to a situation where growing cities take the hardest hit.
So, the question is: How could growing cities finance new local infrastructure?
The need for such infrastructure is so big that it could only be financed, at least in parts, by public sector borrowing. Some cities have already issued bonds e.g. Ahmedabad and Bangalore in India and Johannesburg and Kigali in Africa.
As noted above, inter-municipal cooperation in financial matter is very frequent and successful in the developed countries. LGFA has the potential to play a prominent role also in developing countries.

Developing creditworthiness and markets

An LGFA, with the characteristics outlined above, would give incentives to raise creditworthiness and, at the same time, restrain the local authorities so that they do not resort to excessive borrowing. This is because an agency for the local public sector, owned by the local public sector, puts a great responsibility on that sector to improve and maintain a good creditworthiness. This can be done by only accepting local authorities with good financial order into the agency and to survey the situation of the existing members in the agency. This puts a substantial peer pressure on local authorities, which has proven to be more effective than central government supervision. It will create a situation where the non-members can see that members are getting a stable access to cost-efficient borrowing and hence the non-members will strive to improve their financial situation so that they can be members.

Local authority borrowing through an agency needs to start with the local currency. The main potential investors could be insurance companies and pension funds. But, there is also, in many developing countries a growing middle class, which would have a need for secure alternative for their savings. In order to attract this money an agency could introduce retail bonds (bonds with smaller denominations). Hence, a successfully created LGFA would be instrumental in the development of local financial markets.

Transfer of knowledge

Besides, leading to lower interest costs, lower transaction costs, lower risks, an LGFA, and the process leading up to an agency, is ideal for transfer of knowledge to local authorities. An agency has the possibility to employ financial experts to run the activities. This does not rule out the fact that an agency also needs people with a thorough understanding of the local government sector. Both the Swedish LGFA, Kommuninvest, and the French, Agence France Locale, have implemented a structure of governance that takes these matters into consideration. These agencies are organised in two separate levels. The upper level consists of a parent company/cooperative society where local authorities are shareholders/members. In the board of the upper level local politicians occupy all seats. The lower level is a limited company, where all financial transactions are carried out. The board of this company has a majority of professionals with experience from financial market and the public sector.

Kommuninvest works actively with the transfer of knowledge to the involved local authorities. The transfer of knowledge takes place both in daily activities and at various events or activities. The Board of Kommuninvest Cooperative Society, consisting of local politicians, is offered a training program. Discussion within the board provides additional knowledge of the possibilities and conditions of the financial markets. The board is also an arena for exchange of knowledge on best market practices and solutions for the local authorities that the board members represent. The Swedish agency has also a Credit Research & Financial Committee, were the members are appointed by the annual General Meeting of the Cooperative Society. The Committee is responsible for monitoring the financial status of member municipalities as well as developments in the municipal sector as a whole. It is also tasked by the Society's Board to process new membership applications. The committee is made up of financial directors in local authorities that are members of Kommuninvest. The Committee's instructions state that it shall represent different parts of Sweden, have experience from different types of municipalities and knowledge of funding operations. This committee is important instruments for the activities of Kommuninvest, but also a way to spread knowledge and awareness of questions related to financial markets and instruments, risks and creditworthiness.

Furthermore, Kommuninvest arranges every year a number of seminars on subjects related to their activities. Both local politicians and officials attend these seminars. The Swedish agency also arranges yearly so-called Member Consultation. These are conferences, in all parts of Sweden, where the overall strategy for Kommuninvest, as well as current issues, are discussed.

Communication is one of the most important areas for an LGFA. An agency has the role of an interpreter between the international financial markets and the local authorities. It is obvious that great efforts have to be applied to inform the investors of the financial markets of the agency, its clients and its activities. An extensive programme of road shows has to be implemented. But, it is also crucial to inform the local authorities and to “teach” them about financial markets, financial instruments and, maybe above all, risk management.

The value of the process

All use of financial markets for borrowing purposes is build upon good creditworthiness. The situation for local authorities varies a lot between different countries. For some developing countries an LGFA is perfectly feasible, while other countries local authorities lack steady income streams and a solid regulatory framework. Nevertheless, all countries and their local authorities could make substantial gains from the process towards a LGFA.
A project that aim to put in place a financial cooperation between cities in a developing country, addresses almost all the questions that are vital for well functioning local authorities, i.e.:

- Relationship between local authorities and central government, both legally and financially.

- Flow of income; stability, predictability, diversification, trends (especially of tax-bases), system for collection, collection rates and the possibilities to tap new local taxes.

- Cost-structure; steering and control.

- Debt; size, interest payments, maturities, payment record and central government restrictions.

- Institutional factors; organisation, accounting system, audit, level of knowledge and skills.

All the above constitutes a well functioning local authority with high creditworthiness.
Putting these questions in connection with a project that aim to solve a major problem, finance infrastructure investment, can be very efficient. You would be able to put the needed reforms in the context of a vision for the future. A project could be organised in a way that it takes account of the inter-relations between different steps towards a stronger city. The fact that this kind of project encompasses a group of cities the demand on the central government could be stronger and more stringent. The negotiating power of such a project would gather is great, because it strives to resolve an undisputable need for financing for local infrastructure and it would be a group of strong local authorities with a comparably high creditworthiness.

Support from central government

Today we see a desire to decentralise powers to local authorities in many countries, including developing countries. Central government support in the process of creating LGFA could prove to be one of the most efficient ways to decentralise in an orderly fashion. As we can see from the list of creditworthiness determinants, there are many questions that can be solves by central governments. Additionally, central rules of local authority borrowing are important. In the report “Municipal Finance: Innovative resources for municipal infrastructure and service provision” by Ilias Dirie for the Commonwealth Local Government Forum (2006), this question is summarised in the following way: *“To date few countries have introduced clear rules on local government borrowing. It should be stressed that local government borrowing should mainly be regulated by lender/the market, based on the creditworthiness of councils”.* The market is generally a much more efficient regulator of debt than central government controls.

Finally, there needs to be a full commitment to decentralisation from both central and local level.

Conclusion

Each country has its own circumstances that would determine the possibilities to create a LGFA. But, in view of the big financial need almost all developing countries have as a result of fast urbanisation, this route should be examined. Local authorities working together has a far better chance to meet the challenges and, with the support of central government, a LGFA could lead to better financing opportunities and stable and long-term cooperation between local authorities. The process towards creating a LGFA could also be as beneficial in structural terms as an up and running agency would be in financial terms.

Lars M. Andersson

Lars M Andersson initiated the creation of Kommuninvest, the Swedish Local Government Funding Agency in 1986, and became the agency's first president. He developed its operations until 2001.

During the last 20 years, he has worked as an advisor to local authorities in many parts of the world; recently, in projects to create Municipal Bond Agencies in France and the UK.

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