

UNITED NATIONS ECONOMIC AND SOCIAL COUNCIL



49635

Distr: LIMITED
E/CN.14/UAP/51(b)
5 September 1966
Original: ENGLISH



ECONOMIC COMMISSION FOR AFRICA
Seminar on Local Government Finance
Addis Ababa, 5 - 17 September 1966

CAPITAL FINANCE IN LOCAL GOVERNMENT^{1/}

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Capital Finance in Local Government

Capital Finance in General

- (1) The distinction in Public Finance between revenue and capital financing is well known:
Revenue finance is of a constantly recurring nature, capital finance produces objects of lasting value.
The term "capital finance" means for purposes of this paper all measures and techniques to meet the requirements for physical investment of local authorities.
- (2) The distinction of revenue and capital financing should be clearly expressed by the budgeting management and accounting procedure. The usual method is the separation of an ordinary budget (revenue budget) from an extraordinary budget (capital budget, productive budget).
- (3) Capital expenditure may be performed on all levels of public administration. Which level performs which investments depends on the general political, social and administrative set-up of a country. Where a sufficient minimum of Local Government is developed, local autonomy includes the right of capital outlay by decision of local Councils. The ratio of current and capital expenditure in its division between central and local level indicates strength or weakness of Local Government in a similar way as the ratio between own resources and financial means granted out of central funds.

- (4) The field for capital investment by local authorities is dependent on the competence of Local Government. Local Government investment usually includes projects which are very near to the direct use and benefit of the population and which are more economically administered locally. Typical for Local Government capital outlay are: streets, roads, sewerage and drainage systems, public utilities, schools, hospitals, social services, electricity, and water supply.
- (5) Different classes of capital outlay should be distinguished:
- (a) production of realizable assets (e.g. purchase of property, erection of dwelling houses)
 - (b) reproductive assets (self-liquidating assets), which are not realizable on a free market, but which produce special income esp. in the field of trading services (e.g. water pipes).
 - (c) social investments, the bulk of public installations, which give no direct calculable proceeds (e.g. schools)
 - (d) investment for display (e.g. monuments)
 - (e) "deferred charges", e.g. administrative capital expenditure producing no physical asset.

A clear distinction of these types of capital investment is essential for the analysis and judgement of capital expenditure policy of a local authority; the classes of investment should be clearly distinguished in the statements of assets of a local corporation.

Methods of Capital Financing

- (6) There are 4 "classical" methods of capital financing for Local Government. Capital expenditure may be met by
- (a) utilization of current revenue

- (b) utilization of reserve and other funds
 - (c) grants-in-aid
 - (d) borrowing
- (7) Utilization of current revenue or the transfer of a certain amount from the revenue budget to the capital budget (or the pay-as-you-go-method) is cheap, simple and rare.
- (a) It is cheap, because it saves interest.
 - (b) It is simple, because the project so financed is practically "written off" in the moment of erection.
 - (c) It is rare, because the available margin in the revenue budget is relatively small in all Local Government budgets in the world. At any rate, small projects and assets of a relatively short life should be **financed exclusively in this way**. For other projects a settled policy of local Councils is advisable that a portion of whole requirements for capital outlay is met by transfers from current revenue, either to capital budget or to reserve funds.
- (8) The formation of reserve or capital funds by local authorities is the method of public saving. Its advantages are:
- (a) Interest for borrowing capital as a source of recurrent expenditure is avoided.
 - (b) A fund brings additional interest as long as it is accumulated.
 - (c) An active reserve fund policy of Local Government is a support for the formation of a national capital market, which is of outstanding importance in a developing country. The formation of reserve funds should not be limited by legal provisions as to maximum amount or annual transfers.
- Capital reserves, capital funds or special reserve funds, e.g. renewal and repair funds are usually filled by revenue, by transfer of surplus or by sale of property.

- (9) Grants-in-aid as an instrument of capital financing is often a symptom for the fact that revenues are not properly allocated to the different levels of administration. Beyond this indication which may be deplored by Local Government leaders, there remains need for a certain central assistance to Local Government capital finance:
- (a) Grants-in-aid as well as block grants are an instrument of equalization, especially to diminish the difference in outfit between rich and poor corporations and to lessen the imbalance between urban and rural, central and outlying areas.
 - (b) Grants-in-aid are a well-known instrument of national policy. By its application priorities can be established in the performance and co-ordination of national and local plans.
- (10) The scope of Local Government autonomy includes the power of taxing and the power of borrowing. If a local body has no access to credit facilities in whatever organisational form, local autonomy is imperfect and cannot fulfill its duties - or it has no real administrative and financial responsibility. This statement implies that borrowing as an instrument of capital financing cannot be avoided in Local Government. The main reasons for this fact are:
- (a) The amounts for required capital schemes in a progressive society and under modern technical auspices are too large to be met by revenues or grants alone.
 - (b) A corporation without borrowing performs either too little for the future or levies too heavy a burden on the living generation.
- (11) The methods of capital financing should be adequate to the projects financed. The more a project is reproductive, the more financing by borrowing is permitted. On the other hand, the period of a loan should not exceed the service life of an asset. The usual way of

financing is a mixture of all or more of the above mentioned methods. In Germany and in other countries a combination of loans and grants-in-aid, both granted by Central Government bodies, loans on a cheap interest basis, is a common way of financing in sectors of national importance and priority. This "sectoral assistance" is in Germany usually financed on these lines:

- (a) A certain amount for the individual capital project is expected from the local unit itself, either by transfer from revenue or from reserve funds. This required "quota" is often expressed by a ratio of the tax capacity of the local unit.
- (b) A grant-in-aid may also be expressed by a ratio to the local tax capacity, e.g. in school building.
- (c) Grants-in-aid are often combined with cheap loans granted by Central Government agencies, especially if special fees and charges may cover a part of capital costs, e.g. sewerage and drainage systems.
- (d) Remaining loans floated on the capital market may be subventioned by central funds as to the interest charges. Land improvement in agricultural areas is often not able to bear the full interest terms of the free market; on the other hand it brings a profit for the area in the long run. Therefore central funds cut the interest charge down to a bearable rate, sometimes for a transitory period.

Local Government Borrowing

- (12) Local Government borrowing needs further consideration as to these essential questions:
- (a) What is more advantageous, financing with borrowed funds, or with own revenues or accumulated funds?
 - (b) What is a reasonable period for loans?
 - (c) How should loans accounts be managed?

- (d) By what means can the "debt paying capacity" of a local authority be measured?
 - (e) Can and should interest levels be manipulated?
What local activities need preferential rates of interest?
 - (f) How shall local borrowing be controlled by Central Government?
- (13) Capital financing by borrowing, by revenues or by previous accumulation of funds

There is no doubt that financing by current revenue settles capital requirements in a quick and comfortable way - as far as the administrative side is concerned. On the other hand the taxpayer and the needs of economic life mark a limitation for taxation. The issue cannot be "either - or", but only "as well - as". Cities and boroughs have financed their capital outlay both by taxes and by loans since medieval times. The requirements of modern society and the infra-structure, especially in urban areas, require today such sums, which cannot be met by current income alone. On the other hand, modern public investment is of a reproductive nature to such an extent that growing capacity to pay for debts can be expected and calculated on long-term basis. Very expensive investment for education and scientific progress is performed on credit basis in all countries and is regarded as a remunerative or profitable employment of funds; a coming generation which will enjoy the benefits of such investment can and should bear its part: loan policy is so a justified equalization of burdens between the generations. Loan policy presumes credit facilities. Its creation and cultivation is of high priority in countries of accelerated growth. Because credit facilities are not sufficiently opened in developing

countries! a comparatively high part of investment is financed out of current revenues.

The previous accumulation of funds for future investment is often called in question. Business men do not see that the formation of reserve funds in the field of public financial administration is just what "writing off" means in mercantile management. Councillors happen to criticise the formation of funds with a hidden side-look on future devaluation of currency or even inflation; as politicians they should know that the best way to avoid such a devaluation is saving also in public sectors.

The main argument for the accumulation of capital funds by Local Government even besides an active loan policy are:

- (a) It avoids future long-lasting loan charges. A capital of 1000 at an interest rate of 6% costs (if repaid by equal annual instalments of principal and interest combined):

	<u>Annually</u>	<u>In total</u>
In 10 years	135.87	1358.70
In 20 years	87.18	1743.60
In 30 years	72.65	2179.50

A project of 300,000 value needs for 8 years the annual accumulation of 30,000; the same annual amount has to be paid as loan charge for 20 years.

- (b) if necessary a reserve fund may be used for internal borrowing;
- (c) the accumulation of funds - the public form of saving - is essential in developing countries for the formation of a credit market, may it be for public or private economy, may it be exclusively for local Government credit.
- (14) Reasonable periods for loans

The German Local Government practice follows these principles:

- (a) Loans are classified in:
- | | |
|-------------|----------------------|
| Short-term | (up to 1 year) |
| Medium term | (up to 10 years) |
| Long-term | (more than 10 years) |

- (b) The period of a loan should not be longer than the service life of the asset financed.
- (c) The less own resources can be invested in a project, the shorter a period of a loan should be.
- (d) As to debt service these types of loans are applied (except the rare loans on the basis of negotiable instruments):
 - (i) Repayment by equal instalments of principal
 - (ii) Repayment by annuity method
 - (iii) Repayment in a lump sum ("maturity loans").

The annuity method is especially advisable, because it enables equal charges on the sinking fund table and a rational administration.

- (e) A maximum period for loans is not known in German legislation. The normal maximum period is indicated by an instalment on principal of 1%; in application of the annuity method this means a period of service of about 30 years.
- (f) Temporary borrowing on short term basis (non-consolidated loans) are dangerous for a corporation in case of crisis or credit restriction. The German legal provisions - developed in the depression period of 1930 - authorise Local Councils only to raise cash advances in anticipation of ordinary revenue; financing of capital outlay with non-consolidated loans is not allowed. Other countries limit temporary borrowing to a certain ratio of total outstanding debt or of capital expenditure in a certain period.

(15) The Management of loans accounts

It is a general practice that administration of loans accounts is concentrated in the treasurers' department. This organisational principle corresponds to the fact that all revenues of a corporation cover and secure all debts. The methods of management and accounting technique differ to a high degree as budgeting methods do.

- (a) The provisions of German Local Government have been set up under the auspices of the economic crisis in the thirties. Temporary borrowing is excluded from capital financing. The charges for fixed loans are allocated to the various "operating accounts" of the revenue budget. This technique lacks flexibility and proposals for reforms are in store; but it must be taken into account, that the existence of a local municipal bank takes over partly the function of "pooling".
- (b) The "sinking fund" system is applied in other countries including Germany as far as "maturity loans" are concerned.
- (c) The most modern technique is the pooling or consolidating of loans. The fund thus formed works as a transformer between (outside) lenders and (inside) borrowing accounts of operating departments. The conditions of debt service may even be adjusted to the various and varying needs and capacities of the borrowing accounts. On the other hand a loans pool can operate in a more adaptable way in floating loans ("collective loans"). Other reserve funds may also be invested in such a loans pool. It is clear that the functions of a consolidating loans fund are partly performed by an own municipal bank if existing.
- (16) The debt paying capacity
- The credit-worthiness of local corporations is essential not only for the individual Council, but for the whole Local Government system. It must be cultivated by Local Councils as well as by sanctioning authorities of Central Government. The ideal result of a good and steady credit policy may be (as it is usual in Germany) that a lender relies on the decision of the Council and the sanction of a supervising body without further own investigation as to the financial status or capacity.

Such an aim presumes that the debt paying capacity of a local authority is measured by the public side in an objective way. In trade and industry certain "golden rules" for analysing balance sheets as to soundness of an enterprise are well known, e.g. that the capital resources and long term borrowing together should exceed the fixed assets, the current assets should exceed the short term advances. In the public sector, especially in the field of Local Government, such rules have not yet been fixed to such an undoubted precision that they could govern a settled policy.

- (a) The number of population does not express the financial capacity of an area.
- (b) The list of assets and liabilities is useful but not decisive for the future capacity to pay; most of physical assets are engaged for a public service and can scarcely be realised.
- (c) The valuation of taxable property may be a better criterion; but it depends on the tax structure and does not take into account revenues of a community, which are independent of property.
- (d) The ratio between current amortisation and the total debt is the basis for a rule in USA practice: at least 25% of the principal should be due for amortisation in a 5-year period.
- (e) The relation between current income and debt charges is the leading pointer in German practice, because the absolute figure of outstanding loans is less decisive than the current charge arising from loans; the total current income of a corporation gives a better basis than rateable values alone.

A common German way of investigating an account as to the debt paying capacity is the following:

- (i) Those special sub-heads of an account are eliminated, where the debt charges for a special service are covered by special income (charges and fees), e.g. sewerage system, refuse removal.
 - (ii) "Transitory loans", i.e. loans floated by a corporation for special trading services, which cover the debt charges out of own income, are excluded in the same way.
 - (iii) The remaining annual debt charges are compared with the "general resources". These resources are rates, taxes, paying over from trading services and block or key grants of Central Government.
 - (iv) It is a settled policy of many Councils and of supervising authorities that remaining debt charges so found should not exceed 10% of the "general resources".
- (17) The role of interests

It goes without doubt that the interest rate expresses in an objective manner the price for capital and should follow economic laws more than manipulative measures of fiscal policy. Therefore it should be a general rule that public bodies should calculate and accept the conditions offered by the money market.

The usual free-market sources for public loans, mainly banks, are sometimes met by provisions or demands that a certain proportion of their deposits should be granted as loans to public budgets as a sort of compulsory delivery. This problem belongs more to the consideration of credit facilities. As far as interest rates are concerned, it is a fact that manipulation of loan conditions has become a widespread instrument of planning and financial policy in the last decades. Loans at reduced rates of interest and interest subsidies are important sectoral incentives in modern public finance.

It should be acknowledged that the banking system itself can only cooperate in such activities as agent but never as a real supporter who is met by the financial burden. Otherwise the confidence of the depositors, the main basis for capital accumulation at all, would dwindle away very soon. Even the German Municipal Savings Banks which so closely cooperate with the local Councils do not grant loans with preferential rates; in so far economic efficiency protects the saver and his confidence.

(a) Loans on a reduced rate of interest or even without any interest are granted out of Central Government funds or out of special funds. This is the proper field of Municipal Credit Agencies.

(b) Interest charges for loans floated on the capital market are subsidized for the full or a part of the period. In both cases the budgets on a higher level are met by the expenses; banks or municipal savings institutions may participate in the procedure as agencies or intermediaries ("transmitted monies").

These methods of facilitating Local Government credit are a legitimate and necessary instrument both in developed and developing countries. Politicians are especially inclined to grant interest subsidies, because relatively small resources allow large investments. But just the ease of this method asks for a cautious application: the effects of a measure of fiscal policy on general monetary and economic policy cannot be disregarded; the burden for ordinary revenue budgets to come may lead to immobility. These measures for Local Government finance will be directed to specific objectives. Priority should be given to social

overhead investment, to what is called "infra-structure". Self-liquidating projects can only expect an incentive for a starting period. The "sectoral assistance" is especially appropriate for meeting the imbalance of central and outlying areas, one of the outstanding problems in developing countries.

(18) Central control: loan sanction

It is a common rule that Local Government borrowing needs central approval. This instrument of supervision serves different purposes:

- (a) Local Government investment must be worked out on the lines of national economic and currency policy. In periods or countries of a restricted capital market this may lead to a loan ceiling.
- (b) Local Government investment, which is financed by loans, must fit into general development planning. This principle is the more important the weaker capital facilities are.
- (c) A sanctioning authority has to examine the ability of a Council to serve the debt. This examination is a protection for the individual Council and for Local Government as a whole as to reliability and creditworthiness.
- (d) A sanctioning authority has to examine the conditions of a single loan, especially as to period of repayment and interest charges. This again is a safeguard for a borrowing Council.

The sanctioning procedure should follow these principles:

- (a) One department within Central Government should be competent for sanction, usually the Ministry of Interior or for Local Government. If other departments are concerned they should participate through the leading department.
- (b) The general level for future borrowing should be known to a Council when it submits the application for an individual project. A quick decision may be thus enabled.

The German procedure works in this way:

- (a) Capital projects are estimated in an extraordinary budget.

It fixes the whole amount of loans needed. Together with the whole budget the supervising authority, usually the Minister of Interior, examines the capacity of the Council to serve the planned loans and whether they are within a ceiling provision.

- (b) The (generally given) sanction remains valid for 2 years.

- (c) A single loan, offered within this period, is submitted to the supervising authority, which confines itself to the examination of the conditions of the individual loan.