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Central and Eastern Europe Local Government and Housing Privatization

MUNICIPAL CREDIT IN EASTERN EUROPE

A BACKGROUND PAPER FOR THE EAST EUROPEAN MUNICIPAL CREDIT SEMINAR

Prepared by

Juliana H. Pigey

Prepared for the Office of Housing and Urban Programs
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Prepared by

Juliana H. Pigey

in collaboration with

George Peterson

The Urban Institute
2100 M Street, N.W.
Washington, D.C. 20037

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ABSTRACT

From June 7 to 10, 1994, a seminar on Municipal Credit in Eastern Europe was held in Budapest, Hungary. Participants included representatives of central government, local government, and domestic banks of the Czech Republic, Hungary, Poland, and Slovakia, as well as representatives of international donor organizations, international private banks, credit-rating agencies, U.S. and Western European local finance experts, and observers from Bulgaria and Romania. This paper was prepared as background for the seminar. It summarizes municipal credit activity in each of the four countries participating in the seminar. The paper examines: the magnitude and growth of municipal credit, the institutional forms of such lending (e.g., bank loans, municipal bond issues, and parastatal lending to local governments), the importance of municipal credit as a source of local government investment finance, central governments' regulatory roles, and the major issues arising in each country regarding the design of future municipal credit systems.

EXECUTIVE SUMMARY

I. INTRODUCTION

Planning and financing of investment needs is a new and difficult task for the local self-governments of the Czech Republic, Hungary, Poland, and Slovakia. Credit sources for financing of local investments have generally been limited. More than half of investments are financed by local government own funds; central government grants finance much of the remainder. In order to accelerate and encourage the availability of longer term investment funds, each of the four countries is currently studying, or in the process of implementing, a national system of municipal credit.

II. CENTRAL GOVERNMENT CHANGES TO SUPPORT MUNICIPAL CREDIT

A. General Overview

For local governments to have recourse to loans for investment finance, there must exist a financial sector with the capital and willingness to lend to local governments or a capital market ready to invest in municipal bonds. The banking and financial systems of these countries are in the process of restructuring and recapitalization. Available funds have served primarily to finance the Central Government and to support commercial-industrial enterprises. Given the rarity of loan financing for municipal investments, the Central government may initiate specific lending facilities for local governments or act to accelerate commercial banking sector lending to local governments.

B. Situation in Each Country

1. Czech Republic Municipalities may contract loans and issue bonds. The same tax rate (25 percent) is applied to interest on municipal and corporate bonds. The State Environmental Fund provides grants and is considering low interest loans for certain types of municipal projects.

2. Hungary Municipalities may contract loans and issue bonds. The OTP Bank, where 95 percent of municipalities keep their deposit accounts, has a considerable competitive advantage over other banks. Budapest Bank is negotiating with donors to create a municipal development bank.

3. Poland Municipalities may contract loans and issue bonds. Annual debt service may not exceed 15 percent of total municipal revenues. Onerous restrictions on bond issuance have limited the development of this market. A withholding and payover of the general subsidy transfer from the Central to local governments may be requested as a form of guarantee from the Ministry of Finance. The National/Volvodship Environmental Funds provide grants and subsidized loans for environmental projects.

4. Slovakia Municipalities may contract loans and issue bonds. Interest on municipal bonds is taxed at a rate of 10 percent, reduced from 15 percent. The State Environmental Fund provides grants and some loans for municipal projects in the environmental sector.

III. MUNICIPAL CREDIT: MAGNITUDE AND ROLE IN INVESTMENT FINANCE

A. Municipal Credit Activity

In general, municipal demand for market-rate loans remains weak, particularly where Central Government grants and subsidized loans have been available for investment finance. Nevertheless, when an investment project is deemed crucial, active local governments have proven their ability to find financing. Overall, municipal credit is rising rapidly, though from a low base.

B. Situation in Each Country

1. Czech Republic Several Czech commercial and privatized banks have provided market rate short-, medium- and long-term loans to local governments and have underwritten a number of bond issues. The city of Prague has recently issued a \$250 million U.S. bond on the London market, rated BBB by Standard and Poor's. A considerable investment effort is registered by Czech local authorities, with 35 percent of total expenditures in 1993 attributed to capital projects. Only 6.6 percent of these expenditures were financed through borrowing.

2. Hungary Lending to municipalities has been dominated by OTP Bank, given its hold on municipal accounts. Other Hungarian banks are trying to enter this market and are proposing financial advisory services, portfolio management, project preparation and finance. Several private placement bonds have been issued. Capital expenditures in 1993 represented 18 to 23 percent of total spending, depending upon the source of information; 10 to 15 percent of investment was financed through loan and bond issuance.

3. Poland Borrowing by local government is almost exclusively through preferential rate loans from the National and Volvodship Funds from Environmental Protection and from the Bank for Environmental Protection. The Polish Development Bank has begun lending to some municipalities, with funds often provided by bilateral or multilateral donors. Only one municipality has so far issued a bond. One-fourth of municipal expenditures is attributed to capital projects; borrowing is estimated at 3 percent of investment financing.

4. Slovakia Borrowing by municipalities has been mostly through the Prvá Komunálna Banka (PBK); this bank also has underwritten one municipal bond. Slovak municipalities have access to considerable grant and some loan funds from the state Environmental Fund. Although official figures on municipal investment were not available, loans provided by PBK may represent as much as 20 to 25 percent of municipal investment financing.

IV. THE LIMITED ROLE OF CREDIT IN FINANCING MUNICIPAL INVESTMENTS

A. Availability of Credits from the Banking Sector

Factors which have limited the capacity of the financial sector to finance municipal infrastructure projects include: non-performing loan portfolios; bank recapitalization needs; restrictive monetary policies by central banks; attribution of available credit to "priority" sectors (central government and enterprises); lack of long term funds due to the short term nature of deposits; and unfamiliarity of banks with project financing and the evaluation of the risk associated with local governments.

B. Demand for Credit from Municipalities

Demand for credit from municipalities may be limited by a number of factors, including: high levels of nominal interest rates, due to high inflation (except the Czech Republic); uncertainty of future revenues which will be available to local governments; limits on local government ability to modify local taxes and fees, either due to central governments' limits or because of political/economic opportunity; the psychological perception of debt as something negative.

C. 1993: A Turning Point?

Borrowing by municipalities increased considerably in 1993 across the four countries of the region. Outstanding municipal debt tripled in the Czech Republic; annual municipal borrowing more than tripled in Hungary. Growth appears to have accelerated in the first half of 1994. Some explanations of this trend may include: the "learning curve" of municipal management after three to four years; the prospect of municipal elections may have pushed some local officials in some countries to complete projects underway; improvement of the conditions of the banking sector, decrease of inflation, and a perception by banks that municipalities represent a low credit risk.

V. MAJOR ISSUES IN ESTABLISHING NATIONAL MUNICIPAL CREDIT SYSTEMS

In the establishment of national municipal lending systems, a number of issues must be addressed: who will establish a lending system?; where and under what form to establish the system?; will only loans be provided, or will the establishment of a municipal bond market be encouraged?; how will the feasibility of municipal projects be established?; what forms of repayment guarantee will be required? Each country has brought its own response to these questions.

1. Czech Republic A number of Czech banks have gained experience in providing medium- and long-term funds to municipalities for infrastructure finance, and have underwritten municipal bond issues. In May 1994, an agreement between USAID and the Czech Republic was concluded to establish a credit line to accelerate municipal lending by the private sector. A Municipal Finance Infrastructure Corporation (MUFIS) will provide credit access to banks for on-lending (loans or bonds) to municipalities with terms of 8 to 15 years. Establishment of a track record of timely and complete loan repayments is regarded as critical to expanding the private municipal credit market.

2. Hungary The municipal credit market is dominated by OTP. Four other major Hungarian banks are developing strategies to capture part of the municipal market from OTP, with an emphasis on obtaining the transfer of deposit accounts. Budapest Bank is in discussion with the EBRD and the Crédit Local de France to establish a small joint-venture municipal bank which would be on-lend donor monies to municipalities. A USAID Housing Guaranty loan signed in May 1994 also contemplates on-lending through commercial banks to finance municipal infrastructure.

3. Poland A number of initiatives to increase availability of medium- and long-term loans to municipalities at commercial rates have been proposed. Individual Polish cities have established universal municipal banks, in the expectation that they could serve as a source of credit for municipal projects. The establishment of a Municipal Credit Program (MCP) has been accepted in principle by the Polish government; this program would channel donor monies through a lending window; partner banks would identify projects, assist municipalities in completing the MCP loan application and collect loan payments. The World Bank is initiating the design of a pilot project to launch a municipal credit system and USAID has begun work on designing a pilot project, capitalized by a US\$10 million HG loan to finance municipal infrastructure projects.

D. Slovakia The Prvá Komunálna Banka (PBK) was founded by the city of Zilina (majority shareholder) and by 200 other Slovak towns. The PBK poses the question of a potential conflict of interest between the activities of the bank and the interests of the shareholders, as the latter receive the majority of loans disbursed. In order to ensure the bank's viability, credit decisions need to be free from political pressure. Discussions are underway between the Government of Slovakia, the EBRD and other donors on the transformation of part of the

Environmental Fund into a Loan Fund to channel donor monies and perhaps long-term domestic insurance funds into lending to municipalities. A Guarantee Fund may protect lenders from part of the credit risk.

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LIST OF ACRONYMS

BOŚ	Bank Ochrony Środowiska or Environmental Protection Bank (Poland)
CMZRB	Czechomoravian Guaranty and Development Bank (Czech Republic)
ČOB	Československá Obchodní Banka, a.s. or Czechoslovak Trade Bank (Czech Republic)
CZK	Czech crown
EBRD	European Bank for Reconstruction and Development
HUF	Hungarian forint
MCP	Municipal Credit Program (Poland)
MOF	Ministry of Finance (all countries)
MUFIS	Municipal Finance Company (Czech Republic)
NBH	National Bank of Hungary
NBP	National Bank of Poland
NFOŚ	Narodowy Fundusz Ochrony Środowiska or National Fund for Environmental Protection (Poland)
OTP	Országos Takarékpénztár és Kereskedelmi Bank, R.T. or National Savings Bank (Hungary)
PBR	Polski Bank Rozwoju or Polish Development Bank (Poland)
PKB	Prvá Komunálna Banka - First Communal Bank (Slovak Republic)
PLZ	Polish złoty

RIO	Regionalna Izba Obrachunkowa or Regional Audit Chamber (Poland)
SERIF	State Environmental Revolving Investment Fund (Slovak Republic)
SKK	Slovak crown
SSS	Slovenska Štátna Sporiteľňa, š.p.ú. or Slovak State Savings Bank (Slovak Republic)
VUB	Všeobecná Úverová Banka or General Credit Bank (Slovak Republic)
WFOŚ	Wojewódzki Fundusz Ochrony Środowiska or Voivodship Funds for Environmental Protection (Poland)

INTRODUCTION

Since 1989-90, the Czech Republic, Hungary, Poland and Slovakia have decentralized a portion of their territorial administration, through the creation of independent local self-governments. Hungary has established a two-tier local government system, with cities/towns and counties (megye). The Czech Republic, Poland and Slovakia established a single-tier of local government, although the Czech Republic and Poland were planning to establish a second tier (regions and powiats, respectively).

The political organization, responsibilities, and revenue sources are defined by the respective national legislatures which have created the local governments. Faced with financial uncertainties and with national budgets in deficit (except for the Czech Republic), the partition of fiscal resources between the central and local levels has been continually revised, most often to the detriment of the local governments. These revisions occur through the definition of the national-level taxes attributed to or shared with local governments, the types of subsidies and formulae for distributing these subsidies, and specific taxes and fees which may be administered and collected by local governments. Local governments have also been financially burdened through the transfer of additional responsibilities which are inadequately financed by new revenue sources.

Furthermore, national legislation has placed limits on the rates of taxes and fees which can be collected by local governments, although some rate limits for some services have been phased out in Hungary and Poland. As a result of these financial uncertainties and constraints, short- and medium-term planning is a difficult exercise for local governments.

This is particularly true for planning and financing of municipal investments. Investment needs at the municipal level are considerable, if not enormous, both in terms of rehabilitation of existing infrastructure and the construction of new infrastructure. Sectors requiring particular attention relate to issues of environmental protection (i.e., protection of water sources, sewage treatment, solid waste treatment and disposal or reclamation of polluted land). Investment needs are likely to further increase as other responsibilities are transferred to local governments.

In order to finance their investments, municipalities generally obtain funding from the various sources currently available, which may include : municipal own funds (pay-as-you-go); subsidies from general national funds or from specific targeted funds (direct subsidies or matching grants); contributions from beneficiaries (some direct population and business contributions, which could conceivably evolve into development fees or betterment taxes); grants and subsidized loans from national and regional environmental funds, and less frequently, un-subsidized or market rate loans from commercial banks.

These various sources of investment financing are limited quantitatively, and more than half of investments are still financed by local government own funds; in this way, investments are usually financed when additional resources are available after operating expenditure needs have been met. Given this structure of investment finance, many projects take longer to complete and are more expensive; these additional costs are even more onerous in Hungary, Poland and Slovakia, the three countries still experiencing high rates of inflation.

A means of increasing the scale of investment and accelerating the completion of ongoing investment projects is through credit financing. The majority of credit now available in Poland and Slovakia is through subsidized or very low-interest medium-term loans (generally 3-5 years), provided by national funds for environmental protection. In Hungary, credits available to municipalities are generally short- to medium-term loans at market rates from the National Savings Bank and a few other commercial banks. A more diversified market has developed in the Czech Republic; but even there, only about 10 percent of the 4,000 municipalities had loans outstanding at the end of 1993. It is still rare for municipalities to borrow directly from banks at market rates or to issue municipal bonds on the capital markets.

Increasing municipal recourse to borrowing will depend in part on the availability of medium- to long-term funds, given the nature of the infrastructure which needs to be financed. However, medium to long-term funds are rare in countries with high inflation and with banking sectors in the process of being transformed, recapitalized and privatized.

Should sufficient funds become available at maturities and interest rates concomitant with the types of projects requiring financing, then the willingness of local governments to borrow will depend on the understanding by local officials of the principles of loan financing and the reasons why such financing would be a viable means to constructing municipal infrastructure which will serve more than one generation of municipal residents.

In order to accelerate and encourage the availability of longer-term investment funds to municipalities, the Czech Republic, Hungary, Poland and Slovakia are currently studying or are in the process of implementing a national system of municipal credit. These systems may be initiated by the Central Government through one of its ministries (Czech Republic, Poland, Slovakia), by municipalities themselves (Slovakia), or by the banking sector (Hungary, Czech Republic).

The following paper presents a quick overview of Central Government initiatives which have already been enacted in support of municipal credit (Part I), an estimate of the magnitude of borrowing by municipalities in the four countries (Part II), an explication of why lending has remained limited to date (Part III) and a discussion of major issues which have emerged in establishing national municipal credit systems (Part IV). This quick run-down should help set the framework for debate and discussion during the conference on Municipal Credit in Eastern Europe.

I. CENTRAL GOVERNMENT CHANGES TO SUPPORT MUNICIPAL CREDIT

A. General Overview

The ability of local governments in the Czech Republic, Hungary, Poland and Slovakia to borrow funds for the financing of municipal infrastructure has responded in the first phase to changes by their respective Central Governments on at least two levels. At the first level is the creation of the local self-governments themselves. Parliamentary legislation has generally defined the competencies and responsibilities of these newly independent entities, as well as the revenue sources to which they will have access. Included in potential revenues is the possibility for local governments to contract loans and to issue bonds. For almost all the countries, except Poland, few apparent restrictions have been placed on local governments in the contracting of loans and issuance of bonds, other than general financial regulations which may also be applicable to other actors (i.e., Public Securities Acts which regulate the issuance of bonds).

However, in order for local governments to avail themselves of the possibility of borrowing funds or issuing securities, there must exist a financial sector with the capital and the willingness to lend to local governments, or a capital market (domestic or international) ready to invest in municipal bonds. Because only the largest cities would be plausible borrowers on the international markets, the second level of change involves the reform and restructuring of the domestic banking and financial system, in order to allow access of medium- and smaller-sized cities to credit finance. These changes have included the creation of Central Banks, the separation of state-owned banks from the Central Banks, establishment of viable banking practices and procedures, recapitalization of the state-owned and privatized banks, and reduction of non-performing loan portfolios. The rapidity with which banks can improve their financial position will depend to a great extent on the pace of overall economic restructuring, as the non-performing loan portfolios are largely due to the bankruptcy of many of the large state-owned industrial enterprises.

In addition to restructuring of the existing banks, modernization of the banking and financial sector includes the establishment of private banks, the creation of capital markets and exchanges (i.e., stock, options, over-the-counter), and the establishment of pension funds and privatization investment funds. As these new entities affirm their position in the financial sector, they should eventually broaden the access of local governments to investment capital.

Nevertheless, in the short to medium term, the establishment of a more viable financial sector does not automatically ensure that local governments will have access to funds for financing municipal and public utility infrastructure. The banks will need to familiarize themselves with the newly created local governments, understand their budgetary bases and financial condition and evaluate the risks of lending. This process may be difficult as the types of resources and the means of sharing fiscal revenues between Central Government and local governments have not yet stabilized in all the countries. Indeed, the rules of financing municipalities have been modified annually.

Financing municipal infrastructure is not necessarily a priority either of the Central Government or of the banks. Available funds in the financial sector have since 1989-90 served primarily to finance the Central Governments' budget deficits (except for the Czech Republic) and second to financially prop up state-owned enterprises and to support new private-sector enterprises. A third destination of available funds will increasingly go towards households, particularly to finance housing. Thus, in the attempt to raise funds to finance investment, local governments must compete with other sectors of the economy.

However, municipalities do have relations with the banking sector, with municipal accounts placed in domestic banks, often in the national savings banks or other similar large state-owned banking institutions or their privatized successors. Although some of these banks are willing to lend to municipalities, the demand for loans from municipalities themselves is weak, or requested at conditions difficult for the banks to comply with (longer-term maturities and lower, or preferential interest rates).

In a "second phase", given the rarity of loan financing for investments, the Central Government may initiate specific lending facilities for local governments, allow such facilities to be created at the initiative of others, or act to accelerate the commercial banking sector's lending to local governments. In general, the Ministry of Finance may be involved in such initiatives, if only because the funding for such specific lending facilities is provided partly by international or bilateral donor funds. In the four countries, such lending facilities are generally in discussion or on the verge of being created (see IV - Major issues in establishing national municipal credit systems).

An indirect form of Central Government support of lending to municipalities is through the creation of environmental funds. These funds generally provide grants and subsidized loans (low-interest or no-interest) for financing projects related to water supply and treatment, waste water treatment, solid waste disposal and treatment facilities, and protection from air pollution. Although private and public entities can request financing from the environmental funds, local governments have emerged as major recipients of grant and loan funds. It is in large part municipalities which have become responsible for managing and operating many utilities related to environmental protection. Until now, such funds have been available to local governments in Poland, Slovakia and the Czech Republic. The possibility of transforming the environmental fund into a revolving loan fund is currently under discussion in both Slovakia and the Czech Republic.

B. Situation in each country

1. Czech Republic

Czech municipalities are permitted to contract loans and to issue bonds. No official limitations have been placed on the capacity of municipalities to issue debt, other than prudential financial behavior and conformity with legislation pertaining to public securities, for issuance of bonds. An authorization of the Ministry of Finance, primarily for legal form, is required for issuance of municipal as well as other types of bonds. Municipal bond issues are treated in the same manner as corporate bonds and the interest is taxed at the maximum rate of 25 percent.

The Státní Fond Životního Prostředí (State Environmental Fund) provides grants and no-interest or very low interest loans to non-profit entities, including municipalities. Grants are provided up to 40 percent of the cost of the investment, and exceptionally up to 80 percent. Loan conditions include: interest rate of 0 to 1 percent, a maximum grace period of 5 years, 5 year maturity, as long as the period of the loan does not exceed 7 years. The loan amount may not exceed 50 percent of the total cost of the project. These loans are secured with collateral, which may be real estate or a third party guarantee. A loan may be provided simultaneously with a grant, but the entire amount of assistance may not exceed 80 percent of project cost.

A new Municipal Infrastructure Finance Corporation (MUFIS a.s.) has been established by the Czechomoravian Guaranty and Development Bank (CMZRB), with the following shareholders: CMZRB (49 percent), Ministry of Finance of the Czech Republic (49 percent) and the Association of Towns and Communities (2 percent). The objectives of the MUFIS a.s. are to provide commercial banks with long-term funds for on-lending to municipalities in the Czech Republic and to support a private-market system of financial analysis and bond issuance.

2. Hungary

Local governments are permitted to contract loans and to issue bonds, and no official limitations have been defined. Issuance of bonds is regulated by the Act VI of 1990 on Issuing and Public Broking of Certain Securities. Although the majority of bonds issued to date have been private placements, there is clearly an attempt by municipalities to conform to the requirements of this legislation.

Until 1991, Hungarian municipalities were required to keep their accounts with the National Savings Bank (OTP - Országos Takarékpénztár és Kereskedelmi Bank, R.T.). Presently, about 95 percent of local governments have retained their accounts at OTP; thus the bank has a considerable competitive advantage over other Hungarian banks, in terms of their relations with local governments and the knowledge of their financial condition.

In 1992 and 1993, there were discussions between OTP, the EBRD and a French bank, the *Crédit Local de France*, to create a separate municipal development bank, but talks were inconclusive. Negotiations are proceeding with other domestic banks (and particularly with Budapest Bank) to structure such an institution, which would initially channel donor monies to finance municipal infrastructure.

3. Poland

The 1990 Act on Local Self-Government included loans and bonds in the definition of municipal revenues. The local government finance act (revised December 1993) establishes maximum debt limits for municipalities; annual debt service may not exceed 15 percent of total revenues, for both direct loans, securities issued and loan guarantees given to other entities by municipalities. However, loans secured with collateral are excluded from the calculation of this ratio. When a local government solicits a loan from a bank other than the one where it keeps its accounts, the Regional Audit Chamber (RIO - Regionalna Izba Obrachunkowa) is required to issue an opinion on the municipality's capacity for repaying the credit, at the request of the potential lender.

Issuance of bonds by municipalities is regulated by a law of 1988 on the issuance of bonds, as well as by the local self-government act and the act on gmina finances. The capacity for local governments to raise investment revenue through bond issuance is limited by the numerous restrictions which accompany bond offerings. The amount of a bond issue is limited to 20 percent of planned annual income, excluding funds received from the central government and from voivodships. Annual debt service is limited to 15 percent of total revenues (including all other loans held by a municipality). Bonds issued for public circulation with a maturity greater than one year must obtain consent from the Securities Commission (Komisja Papierów Wartościowych). The RIO must issue a public opinion on the intention of a local government to issue a bond. Finally, interest earned from bonds is taxed at the full rate. These regulations have discouraged any municipal bond activity, and only one municipal bond to finance infrastructure projects (by the city of Płock, with a one-year maturity) has been issued to date.

From 1994, the Council of Ministers, through the Ministry of Finance, may guarantee the repayment of loans for municipalities; this guarantee may only apply to loans taken out for investment financing. In case of default, the general subsidy transfer to the local government would be redirected to loan payment. Although a few municipalities have submitted applications to receive this central government guarantee, all were rejected by the Ministry of Finance.

A system of grants and loans to finance environmental infrastructure has been established through the creation of the National Fund for Environmental Protection, 49 Voivodship Funds for Environmental Protection and a universal bank, the Bank for Environmental Protection. Any entity may apply for funds, including enterprises, local governments, voivodships (deconcentrated representatives of the Central Government) and individual households (for boiler conversion to reduce air pollution). Municipalities receive loan financing for projects related to water/sewer treatment and supply and

solid waste disposal and treatment. Grants are awarded more for actions related to education about the environment and social/health activities, such as vacations for children in areas with high pollution. Loans are usually with maturities of 3 to 5 years, at an interest rate of 0.2 to 0.6 of the National Bank of Poland refinancing rate (which currently comes to a 7 to 21 percent rate for local governments) and a grace period of 1-2 years. In addition, if projects are completed on time or ahead of scheduled completion date, 50 percent of the loan amount may be forgiven.

4. Slovak Republic

Slovak municipalities are permitted to contract loans and to issue bonds. No legal restrictions are placed on the capacity of municipalities to issue debt, other than prudential financial behavior and conformity with legislation pertaining to public securities, for issuance of bonds. An authorization of the Ministry of Finance is required for issuance of municipal bonds. Only one Slovak municipality, Žilina, has to date issued a bond, although a second bond issue is scheduled for July 1994. Interest from municipal bonds is taxed at a reduced rate of 10 percent (this was reduced from 15 percent after the Žilina issue). The MOF of the Slovak Republic considers that it is not its role to monitor borrowing by municipalities. It is local officials who must take the responsibility for the consequences of their borrowing decisions.

The State Environmental Fund is a major source of funds for municipal investment projects. Investments may be financed in one of four sectors for which user fees and pollution fines are collected : water quality and water use rationalization, air pollution, solid waste and protection of the natural environment. In addition there is a "general" sector, whose revenues may be allocated to projects in one of the four specific sectors. Municipalities are the largest recipient of grant monies from the Environmental Fund and also receive loans for their projects.

II. MUNICIPAL CREDIT : MAGNITUDE & ROLE IN INVESTMENT FINANCE

A. Municipal Credit Activity

Parliamentary legislation, Central Government initiatives, and steps to modernize the banking and financial sector have set a framework more or less conducive to borrowing by municipal authorities. This framework does not guarantee that local governments will have recourse to loan finance for investment needs. Demand by local governments for loan financing has been weak, particularly when Central Government grants for investment finance have been available.

Nevertheless, when an investment project has been deemed sufficiently crucial to warrant immediate completion, a few particularly active local governments have proven their ability to find necessary financing from the sources that are available to them. Borrowing by local governments has taken the form of subsidized loans from environmental funds, unsubsidized loans from domestic or international banks, private-issue municipal bonds and public-issue municipal bonds. Sources of funds have included the domestic banks of the Czech Republic, Hungary, Poland and Slovakia, foreign banks, bilateral and multilateral funds, investors in municipal bonds and environmental user charges and penalties collected by the environmental funds.

Estimating the magnitude of lending to local governments and the percent of investment expenditures such lending may represent is generally difficult; when information is available, cross-checking of data from different sources often reveals disparities. Thus, some of the information presented below should be taken as general estimates; the ratios at least provide an idea of the extent to which credit funds are flowing to local governments.

One main source of information includes banks and financial institutions which lend directly to municipalities. However, and especially in a competitive or threatened market, banks may not always be willing to furnish data on disbursements and outstanding loans, as this information may be considered "strategic". The National Banks of each country are a second source of data on the magnitude of lending to local governments, particularly in Hungary and Poland. A third source are the Ministries of Finance, particularly in the countries where local governments submit budget reports to this Ministry.

A general picture of lending to local governments in each of the four countries is summarized in Table 1 below, which indicates the role of investment in overall local expenditures and the percent of investment currently financed by credit.

Table 1: Municipal investment and credit financing in each of the four countries

	Czech Republic	Hungary	Poland	Slovak Republic
Investment as % of total expend.	35 percent (1993)	18 percent (1992)	25 percent (1993)	20 percent (1993 estimate)
Borrowing as % of total investmt.	6.6 percent (1993)	10 to 15 percent (MOF estimate, in general)	3 percent (1993)	23 percent (1993 estimate, PKB only)

B. Situation in each country

1. Czech Republic

Recourse to credit by Czech municipalities has been increasing rapidly since 1992. Borrowing by local governments includes short-term cash flow advances and bridge loans, medium-term loans to finance investment projects, issuance of longer-term municipal bonds and no-interest loans from the State Environmental Fund.

A number of Czech commercial banks have experience in lending to Czech municipalities. These include Československá Obchodní Banka, a.s. (ČOB or Czechoslovak Trade Bank), Česka Spořitelna, a.s. (Czech Savings Bank), the Komerční Banka a.s. (Commercial Bank) and the Postal Bank (now consolidated with Investnici Bank).

The Československá Obchodní Banka was indicated as having eleven outstanding (primarily medium-term) municipal loans at 31 January 1994. In 1993, ČOB underwrote the first municipal bond issue by a Czech municipality, for the town of Sumperk (CZK 20 million, to finance a pedestrian zone and the completion of an indoor swimming pool), with a five-year maturity and an 18 percent interest rate.

Komerční Banka is a main bank where many local governments keep their accounts. Activity by the Komerční Banka in lending to local governments seems limited primarily to date to short-term (less than one year) loans to cover cash-flow shortages; despite the short-term and "bridge financing" nature of these loans, the bank (like other Czech banks) requires collateral, such as a building, equipment, financial securities or a third-party guarantee, for all municipal loans. Those municipalities which keep their accounts with Komerční Banka are given priority for such short-term lending. The bank is also currently preparing bond issues for three Czech cities : Pardubice, Mariánské Lázně and Rychnov nad Kněžnou.

A third Czech bank which has the greatest volume of municipal lending activity and also has the largest number of municipal accounts is Čéska Spořitelna, the privatized former State Savings Bank. During privatization, 20 percent of the bank's shares were transferred to municipalities. Čéska Spořitelna provides short-, medium- and long-term loans to local governments; 57 percent of all loans to municipalities were issued by Čéska Spořitelna, with CZK 1.7 billion outstanding at 31 March 1994, for over 260 loans provided. Examples of loans issued by Čéska Spořitelna include two loans contracted by the city of Ostrava: CZK 68 million to finance heating meters for apartments and CZK 93 million to finance heating meters for commercial buildings¹. These two loans are medium-term, with four year maturities. The interest rate is fixed at the Bank Base Lending Rate + 2 percent.

In mid-January 1994, Čéska Spořitelna brought two municipal bond issues to market: CZK 100 million for the city of Liberec (5 year maturity and 14.25 percent interest rate, plus 1 percent underwriting fee) and CZK 115 million for the city of Smržovka (7 year maturity and 14.25 percent interest rate plus 1 percent underwriting fee); a second tranche of CZK 85 million is to be issued in December 1994. Both of these bonds are traded on the Prague registered stock and bond market.

The city of Prague issued a CZK 7.5 billion bond (US 250 million) directly in London. The date of issue was 29 March 1994, with a 5 year maturity, and a 7.75 percent coupon rate. The introduction to market in London was 14 April 1994 and the issue sold immediately. The underwriter of the bond is Nomura International and a rating of BBB was issued by the Standard & Poor's rating agency. The proceeds of the bonds are to finance investments with a return (1/3), investments without a return (1/3), with the remaining third to be placed in a reserve fund.

Another source of investment financing available to Czech municipalities are no-interest or low-interest loans from the State Environment Fund (Státní Fond Životního Prostředí). Projects may be financed in the sectors of water treatment, air treatment, waste treatment and landscape.

Czech municipalities are undertaking an important investment effort. Territorial budgets (municipalities and district authorities) provided by the Ministry of Finance indicate rates of investment of 39 percent of total expenditures in 1992 (CZK 30.2 billion) and 35 percent in 1993 (CZK 31.6 billion). This proportion of investment in total expenditures is the highest for the four countries examined and is also higher than in other Western countries, such as France² (of course, the investment ratio can be expected to vary across countries, partly in relation to the function local governments perform).

Budget data on Czech municipalities provided by the Ministry of Finance indicate that for aggregated territorial budgets in 1993, total loan revenues were CZK 2.1 billion. Given the high level of investment, these loan revenues were sufficient to finance only 6.6 percent of investment expenditure.

¹ Loans such as these, to finance meters are particularly interesting in that they enhance the possibility for cost recovery and debt repayment in the future.

² Where local government investment represents 15-20 percent of total expenditures.

Thus Czech municipalities still largely rely on their own budgetary sources to finance the huge investment effort they have been engaging in. However, recourse to financing accelerated considerably in 1993, as total outstanding municipal debt stood at CZK 2.9 billion at the end of the year, which is triple the amount of outstanding debt at end 1992. This indicates that not only are Czech municipalities having greater recourse to borrowing, they also seem to be doing so at longer rates of maturity.

2. Hungary

In Hungary, lending to municipalities has been dominated by the OTP Bank, which had the monopoly of local government accounts until 1991. Over 95 percent of Hungarian local governments still hold their accounts at OTP, thus making it easier for the bank to identify good credit risk at the municipal level, and to place a lien on local government accounts in case of payment default. The larger part of lending has consisted of short-term loans and treasury advances (less than 1 year), with HUF 10.1 billion disbursed in 1993. Nevertheless, lending activity for medium-term loans (2-5 years) accelerated considerably in 1993, with HUF 6.8 billion of disbursements and an outstanding balance of HUF 16.1 billion. A third type of loan granted by OTP are "association loans"; these are subsidized loans given to neighborhood associations which are formed to finance part of the cost of certain municipal utility networks (gas, sewer, heat, telephone). Disbursements for association loans reached only HUF 750 million, with HUF 5.4 billion in principal outstanding at end 1993.

Other Hungarian banks, such as Budapest Bank, Kereskedelmi & Hitel Bank (Commercial and Credit Bank) and Magyar Külkereskedelmi Bank (Hungarian Foreign Trade Bank) are trying to enter the market for loans to municipalities, but have had a difficult time breaking the OTP hold. These banks also propose short-term and medium-term loans, but generally prefer to obtain the transfer of local government accounts before granting loans. In the immediate term, in order to enter the municipal finance market these banks may concentrate on proposing other types of services, such as financial advisory services, portfolio management services, the establishment of public-private partnerships and project preparation and finance.

Issuance of bonds by municipalities had taken place through the 1980's, until the acceleration of inflation, which wiped out the bond market. Since 1992, there has been a revival of the bond market, with an initial private placement by five municipalities in April 1992, for a total of HUF 740 million, guaranteed by the State. This guarantee was in virtue of a law from 1982; as the Central Government did not wish to continue issuing guarantees for municipal securities, the law was abolished in May 1992. Since then all other municipal bonds have been issued only with the guarantee of the municipality. There have been approximately 20 issues, all but one (by the city of Debrecen) by private placement. These private placements are estimated to represent 10 percent of outstanding capital lent to local governments for investment purposes.

In 1993, total local capital expenditures were 18 percent of total expenditures. This ratio indicates a relatively low level of investment compared to the other countries studied in this paper, although

this figure is distorted by the fact that Hungarian municipalities have responsibility for primary and secondary education and health care, which have high labor intensities. The Hungarian Ministry of Finance and OTP Bank estimate that borrowing by municipalities represents 10 to 15 percent of total investment.

In Hungary, a system of centrally-funded targeted investment grants may have slowed down the investment process, by requiring local governments to put aside matching funds until the grant is actually distributed. These subsidies may have also inhibited borrowing, as the availability of free money discourages municipalities from taking on more risky debt. These grants are awarded for projects in certain sectors of investment based on national priorities (i.e., sewage treatment, water supply, primary and secondary education facilities, medical equipment). The grant may represent from 25 to 90 percent of total project cost, and the remaining funds must be provided by the municipality³. However, the amount of these grants is decreasing annually, and most of the funds available are attributed to projects in progress, with very few funds (12 percent out of HUF 28.7 billion) available for new projects.

Municipalities have also relied on population participation to finance public utility network investments (gas, sewer, telephone, heat); inhabitants that decided to contribute, in the form of neighborhood association or construction communities were eligible for subsidized loans from OTP. From January 1994, subsidized loans for population participation, except those for neighborhood associations, were eliminated.

3. Poland

Borrowing by local governments has been essentially through preferential rate environmental loans for specific types of projects (sewage treatment facilities, solid waste disposal and treatment systems) from the National Fund for Environmental Protection (NFOŚ or Narodowy Fundusz Ochrony Środowiska), the 49 Voivodship Funds for Environmental Protection (WFOŚ or Wojewódzki Fundusz Ochrony Środowiska) and the Environmental Protection Bank (BOŚ or Bank Ochrony Środowiska). The NFOŚ and WFOŚ obtain funds through environmental user charges and penalties, which are distributed 40 percent to NFOŚ and 60 percent to the WFOŚ⁴. About half of available resources are distributed as grants and 50 percent as subsidized loans (the interest rate for municipalities is 0.2 to 0.6 of the National Bank of Poland (NBP) refinancing rate).

³ Complementary financing could conceivably be provided by loans, but the grant system does not directly encourage this option. In fact, the system has led municipalities to prioritize their investments based on the types of projects eligible for grants.

⁴ After an initial distribution of 10 percent of the funds to municipalities where fees/penalties for elimination of underbrush are collected.

The BOŚ is a universal bank, with emphasis on providing financing for projects related to environmental protection. Although funds available to BOŚ are obtained at market rates, through deposits and borrowing on the interbank market, loans to municipalities are provided at preferential rates. The difference in interest rate for the BOŚ is financed by an interest rate subsidy from NFOŚ.

There is no one major bank in Poland where local governments keep their accounts. Larger municipalities generally use one of the nine regional banks which were spun off from the NBP in 1989⁵. Medium and smaller-size towns may have accounts at either the regional banks or at PKO B.P., the national savings bank. Rural municipalities often turn to cooperative banks for their banking needs. All of these financial institutions generally provide short-term cash advances and bridge loans to municipalities, but there is little capital outstanding for loans of 1 to 5 years.

The Polski Bank Rozwoju (PBR or Polish Development Bank) has begun lending to local governments; some of these loans are funded through international and donor monies, particularly from German banks. It is the PBR which takes the credit risk on the municipality, rather than the German banks.

Given the rigid requirements for issuance of municipal bonds there has been practically no activity, with only one known municipality which issued a bond to finance infrastructure, the city of Płock⁶. Although the offering was for PLZ 2 billion, only PLZ 800 million sold, with 65 percent of this amount purchased by the largest enterprise in the city. The bonds have a one-year maturity, in order to avoid the requirement of an authorization from the Securities Commission, which is said to be time-consuming and costly.

The proportion of investment expenditure in municipal budgets increased to 25 percent in 1993, from 23 percent in 1992. Thus, Polish municipalities are sustaining the considerable investment effort which has been registered since at least 1991.

According to the National Bank of Poland, loan capital outstanding to municipalities was PLZ 785 billion at end 1993, with 72 percent for loans of 1-5 years. This compares to PLZ 288 billion outstanding twelve months earlier, when medium-term loans represented less than 50 percent of total outstanding credit. Thus 1993 presents a significant change in municipal borrowing patterns, with a more-than three-fold increase in medium-term borrowing for investment. Outstanding capital for 1-5 years stood at PLZ 566 billion at end 1993, although only PLZ 146 billion one year earlier.

⁵ Two of these banks, the Wielkopolski Bank Kredytowy of Poznań and the Bank Śląski of Katowice have already been privatized.

⁶ There have been several municipalities which have issued "housing bonds", but these are attempts to privatize the housing stock more quickly, rather than to raise funding for investment projects.

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For medium-term loans, less than 5 percent of outstanding capital was provided by 14 commercial banks specified by the NBP (9 regional commercial banks spun-off from the NBP, PKO B.P., PKO S.A. (Foreign Trade Bank), Bank Handlowey, Bank for Food Economy and the Export Development Bank). Thus 95 percent of outstanding capital to municipalities was provided by other sources, essentially the BOŠ, the NFOŠ and the PBR (the WFOŠ only began lending activities in late 1993).

4. Slovak Republic

There is some medium-term borrowing activity by Slovak municipalities, mostly through the Prvá Komunálna Banka (PKB or First Communal Bank) and one municipal bond issue in 1993, also underwritten by PKB. Slovak municipalities do not provide budget reports to the Ministry of Finance and the National Bank of Slovakia has not yet included data on lending to municipalities in their monthly bulletin, although this information may appear in the future.

It is known that the majority of local governments hold their deposit accounts at one of two main banks: Všeobecná Úverová Banka (VUB or General Credit Bank) and Slovenska Štátna Sporiteľňa, š.p.ú. (SSS or Slovak State Savings Bank). Local governments are likely to obtain short-term treasury advances in case of cash shortfalls from these banks, but it is not known whether any medium-term loans for investment purposes have been generated.

In order to respond to the need for access by Slovak municipalities to medium-term funds for capital projects, the Prvá Komunálna Banka (PKB) was created with the objective of providing specialized services for Slovak municipalities. The bank, which began operations in January 1993, is majority owned by the city of Žilina (64 percent of outstanding shares) and 35 percent by other towns and districts of Slovakia.

In 1993, PKB received 170 loan applications from local governments, of which 160 were approved. For these 160 loans, approximately SKK 720 million of funds were disbursed, with 75 percent of the loans at medium-term (4 years). Interest rates offered (from 15.8 to 19.9 percent), are lower than the 23 percent rate of inflation in 1993, concomitant with other lending rates practiced by Slovak banks⁷. The types of municipal projects financed by PKB include water/sewer projects (21 percent), building construction and rehabilitation (19), gas piping (14.5), roads (14.7), heating (8.5), solid waste (6) and other sectors (15.7). In 1994, lending activity is being limited by the tight credit policy of the National Bank of Slovakia, although the bank is negotiating to have its credit ceiling increased from SKK 500 million to SKK 1,000 million in the second quarter of 1994.

⁷ The discount rate was 9.50 percent through 1993 and raised to 12 percent in mid-December 1993. Average interbank deposit rates were in the 14-15 percent range in early 1993 and have risen to 16-17 percent by January 1994. Given the inflation rate of 23 percent in 1993, net interest rates in Slovakia are negative.

Prvá Komunálna Banka also organized and underwrote the first municipal bond by a Slovak municipality, a 5-year, SKK 100 million issue for the city of Žilina, to finance an electric trolley system; it appears that only 40 percent of this issue was placed with outside investors. Although interest was fully taxed at 15 percent at the time of issue, the Central Government later reduced the taxation rate to 10 percent, to encourage placement of the issue. Istrobanka has announced its intention to issue a second municipal bond for the town of Detva.

Slovak municipalities also have access to considerable grant and loan funds from the State Environmental Fund. In 1993, this fund disbursed SKK 2.03 billion in grants and SKK 2.67 billion in loans; the percentage of these funds which were attributed to municipalities was not indicated.

As PKB is currently one of the more significant sources of credit for municipal investment, the role of these loans in the overall investment financing picture of Slovak municipalities may be important. This role is difficult to estimate, as municipal budget reports are not provided by local governments to the Ministry of Finance. However, the MOF has estimated that total municipal expenditures in 1993 were SKK 11.5 billion (unofficial figures). If the proportion of investment in total spending is about 20 percent, or perhaps SKK 2.3 billion, then the approximately SKK 540 million of medium-term loans provided by PKB would represent about 23 percent of Slovak municipal investment financing⁸ (excluding the bond issue by Žilina). This ratio of financing municipal investment through loan resources would be the highest among the four countries examined.

⁸ This is only a rough estimate, as MOF data represents unofficial estimates. The 20 percent weight of investment in overall spending is realistic, compared to Hungary and Poland (the ratio of investment in the Czech Republic is quite high).

III. THE LIMITED ROLE OF CREDIT IN FINANCING MUNICIPAL INVESTMENTS

Compared to the level of investment expenditures undertaken by municipalities in the Czech Republic, Hungary, Poland and Slovakia, recourse to credit finance for these investments is modest (except perhaps for the Slovak Republic). When credit is used, it is often provided at preferential rates. However, in all four countries, 1993 marked a considerable acceleration in borrowing by municipalities, with outstanding debt often increasing by two- or three-fold. Prague's 1994 municipal bond issue alone is equal to 2.5 times all municipal debt outstanding at year-end 1993.

Several elements, involving both the supply of credit by banks and financial institutions and the weak demand for credit by the local governments themselves may explain the low level of borrowing by municipalities until 1993. However, a conjunction of factors, many of which may have been set in motion in the previous years has resulted in an acceleration in the trend to use credit for investment finance from 1993. One factor common to all four countries is the scheduling of local elections in 1994; the effect of the electoral cycle on the acceleration of investments does not appear to be negligible.

A. Availability of credits from the banking sector

In at least three of the four countries examined (except perhaps the Czech Republic), the domestic banking sector is still in the process of transformation and modernization, and is still faced with the difficulty of resolving non-performing loan portfolios, due largely to bankrupt state-owned industrial enterprises. In order to improve their financial situation, at least two measures must be taken: financial restructuring or liquidation of the bankrupt enterprises, as well as work-outs of the problem loans and capital injections into the banks. This is particularly important, as banks need to align their accounting standards with international practices and bring their capital adequacy ratios to the required 8 percent. For example, at end 1993, before the implementation of the bank consolidation program in Hungary, some of the largest domestic banks registered net negative capital adequacy ratios. In contrast, all of the large banks in the Czech Republic now meet capital adequacy standards.

Access of local governments to credit is even further restrained by the overall macroeconomic situation, resulting in restrictive monetary policies by the Central Banks in all four countries, in order to reduce inflation. In a system of credit restriction, what available credit there is is in general first attributed to "priority" sectors - Central Government deficit financing and enterprises.

One example is the tightening of monetary policy by the National Bank of Hungary (NBH) at the end of 1993. Given twin deficits in the current account and the central budget, as well as an inflation rate of over 22 percent, the NBH responded by increasing overnight open market rates by six-hundred basis points from 17 to 23 percent and the average yield of discount treasury bills by 250 basis points,

from 22.5 to 25 percent. A second example is in Slovakia, where the National Bank of Slovakia has restricted credit during the first two quarters of 1994; this policy has affected the availability of credit for municipalities in at least one important case, by preventing the Prvá Komunálna Banka from responding to all the requests for loans it has received since the beginning of the year.

However, even if all the elements indicated above do not pose too great an obstacle, there is also the fact that long-term funds (at least 5-10 years) are not available. Given high levels of inflation in three of the countries (more than 20 percent in Hungary and Slovakia and more than 30 percent in Poland), deposits available to banks are essentially short term in nature and rarely greater than one year. In order for local governments to finance major infrastructure such as sewage treatment plants or solid waste treatment facilities, they will require loans of at least five years and often up to 10 years or more. Given their deposit sources, domestic banks are unable to provide medium- to long-term loans, as such lending would create asset and liability maturity mismatches or imbalances which would negatively affect bank balance sheets.

Many domestic banks are also quite simply unfamiliar with local governments, especially as their independence is quite recent. Municipal budgets and the budget process, as well as relations between the municipal government and various satellite or budgetary units may not always be well understood. The banks may also have doubts as to the capacity and willingness of municipalities to reimburse loans and manage debt. Even if the banks are familiar with the operations of local governments, they may not be familiar with project finance and evaluation of the risk associated with the non-payment of loans by municipalities. Thus they often establish a number of limitations in order to protect against payment defaults, such as refusing to lend unless a municipality keeps its principal account with the bank. Banks further try to insure themselves through the use of collateral; pledged municipal assets often represent 150 percent or more of the loan value.

In addition to reluctance on the part of some actors of the domestic banking sectors to lend to municipalities, there is also a hesitation on the part of municipal officials to take on debt.

B. Demand for credits from municipalities

Even when capital funds are available, local governments themselves may be reluctant to borrow. Three reasons most cited by local officials in explaining this reluctance include: perceived high interest rates due to the high inflation levels, particularly in Poland, Hungary and Slovakia; uncertainty about future revenues, as the rules on transfer of fiscal revenues and subsidies from the central to local level have been modified frequently; difficulty in raising additional revenues to repay loans, such as water and sewer charges (price liberalization is at different stages in the four countries).

Loans available from commercial banks for municipalities often carry an interest rate equal to the National Bank base lending rate plus 200 to 500 basis points. As nominal interest rates are quite high (an average of 18-19 percent in Slovakia, 25 percent in Hungary and 35 percent or more in Poland) local governments are unwilling to contract funds at what are perceived to be very high rates of

interest. Rather than contract short term loans, local officials often opt to finance investment needs directly from budget sources to avoid paying large amounts of money for interest; this may be especially true when there will be few immediate revenues from the project underway.

Although real interest rates are low (negative in the Slovak Republic), local government officials may also harbor expectations of future decreases in inflation and therefore in the nominal interest rate. In this case, they may feel it is preferable to continue following a pay-as-you-go policy on investments, while waiting for interest rates to decrease and perhaps for loan maturities to increase.

A second major obstacle is the uncertainty as to future revenues which will be available to local governments. The types and percentage of fiscal sources the Central Government elects to share with municipalities changes every year. For example, in 1993, the Hungarian government reduced the municipal share of the personal income tax from 50 percent to 30 percent. This represented an important loss of revenue for local governments. Rules and definitions of general subsidy transfers are also frequently modified. Often, local government do not know how much they will receive in transfers until well into the second or third month of the fiscal year. Such uncertainty creates a major brake on the capacity of municipalities to take on debt, as they are never certain whether their revenue sources will be renewed or reduced for future years.

Third, local governments are often prevented from making up for reductions in Central Government financial support by increasing rates for user charges and local taxes. Many rates for fees and taxes are still regulated by the Central Government; even when there is some nominal freedom by municipalities, nationally defined tax exemptions or ceiling rates still limit municipal revenues. For example, in the Czech Republic local officials currently do not have discretion regarding any local tax bases or local tax rates and cannot change any of the major fees. Even where local governments do have more freedom to determine local rates (such as Poland and Hungary), there is still reluctance by municipalities to exercise this freedom, in light of the economic stresses suffered by large sectors of the population.

A fourth reason may be largely psychological. Debt is perceived as something "negative" by local officials and not viewed as a means of financing a necessary good in the immediate future and spreading the payment burden over the different generations of municipal inhabitants who will benefit from the infrastructure. Rather, local officials are concerned about not leaving a burden of debt to future generations. They do not perceive one of the immediate negative trade-offs of such an approach, namely, that using a pay-as-you-go basis increases the overall cost of projects, as construction proceeds in fits and starts as money is available from own budget sources.

C. 1993 : A turning point?

Borrowing by municipalities increased considerably in 1993 in all four countries of the region. This trend may be explained by several factors. After three years of municipal management, a greater number of local officials may feel more comfortable with managing municipal finances and with their capacity to reimburse debt. This could be described as a "learning curve" effect.

Municipal elections will be held in the four countries in 1994; in some of the countries, additional borrowing may be tied to the electoral cycle. This perspective may have pushed some local officials in some countries to accelerate completion of projects underway, in order to present a favorable image of positive results and actions to their constituents.

This need and willingness by municipalities to borrow larger amounts of capital may also have corresponded to more favorable trends in the banking sector : improvement of overall banking sector situation and balance sheets; a greater familiarity and experience with local governments, especially as few payment defaults have been recorded for existing loans, and slight decreases in interest rates, with improvements in the inflationary picture, compared to the preceding three years.

IV. MAJOR ISSUES IN ESTABLISHING NATIONAL MUNICIPAL CREDIT SYSTEMS

In light of the need to rapidly improve the municipal infrastructure situation and the, to date, low level of recourse to borrowing, all four countries examined are in the process of discussing and/or establishing some form of a national municipal credit system.

The conception of such systems will have to respond to a number of basic questions, which are discussed immediately below. Each country has brought its own response to these questions.

The first issue is who will establish a lending system targeted to municipalities and the financing of municipal infrastructure. The impulsion and actions undertaken for establishing such a system may originate with the Central Government through the Ministry of Finance (Czech Republic) or a technical line ministry, such as the Ministry of the Environment (Slovak Republic) or the Ministry of Construction (Poland). Local governments may also take matters into their own hands and set up a specific bank or other institution, such as the Prvá Komunálna Banka in the Slovak Republic, or various communal banks which have been established by larger Polish cities (for example, Bydgoszcz⁹, Gdynia, and the city of Warsaw¹⁰) and is pending Government approval in Prague. Or, if certain establishments in the banking sector have understood the strategic place of municipalities in the economy, they can take the initiative of making commercial loans directly to municipalities or setting up specialized agencies to do so (Czech Republic, Hungary).

However, the growth of a municipal lending system that provides access to long-term loans is directly tied to setting up credit lines of longer-term funds from international bilateral and multilateral donors because of the lack of such funds in the domestic banking sector. Then the issue to address is where and under what form to establish a municipal lending system. Should there be recourse to existing institutions or banks or should a temporary agency or lending window be established to accelerate bank entry into the municipal market or to extend municipal loans until banks are ready to do so? The response to this issue will depend to what extent any existing institution is willing and able to invest in and expand its activities toward local government credits.

When an external credit line is available, then the advantages and disadvantages of giving preference to one specific bank for credits to local governments, such as the creation of a municipal development bank (Hungary, Slovakia) should be analyzed. Or is it preferable to foster competition among different banks to give more of a choice to municipalities and avoid creating a monopoly situation (Czech Republic, Poland)?

⁹ Although the National Bank of Poland has already withdrawn the banking license of the Bydgoszcz Communal Bank.

¹⁰ The Warsaw communal bank, which includes participation by Warsaw district governments, has not received final authorization from the National Bank of Poland as of June 1994.

Will credits in the form of loans constitute the main form of investment financing, as is generally the case for many West European municipalities, excluding Scandinavia? Or should the creation of a domestic municipal bond market be fostered (U.S. municipal financing model)? The response to these issues will depend in part on the maturity of domestic capital markets and the creation of a large pool of potential investors. There could also be the possibility for municipalities to issue paper in the international capital markets, with the inherent foreign exchange risk (although this risk also exists for loans to municipalities from multilateral and bilateral donors).

Once the institutional, operational and general financial questions have been addressed, then the analysis of feasible projects which would be eligible for financing¹¹ must be addressed and the means of guaranteeing repayment of the debt ensured. Loans and bonds could constitute a general obligation of the municipality. In this case, thorough financial analysis and credible forecasting of municipal revenues and expenditures, as well as close surveillance of municipal financial performance would constitute the basis for guaranteeing repayment (model for some Czech loans, private placement Hungarian municipal bonds, loans extended by the Prvá Komunálna Banka).

A second form of ensuring debt payment is the pledging of municipal property as collateral (practiced in all four countries). Several questions may arise with these mortgages. The first is the problem of resolving property rights and transfers of property; although this issue is largely settled, there are still some areas where not all property claims have been settled. The second is establishing the value of the property, which is not always simple, when property markets have not yet been fully developed. Third, is the nature of the property which is being mortgaged; it is difficult to conceive of municipalities securing a loan with mortgages on school or health facilities, or public transportation means; for this reason it has become customary to pledge only discretionary or non-essential property. Finally, continued use of municipal property as loan collateral will depend on the continued availability of such property; in order to raise additional revenues or to rationalize local government's role in service provision, local governments are taking recourse to selling their property.

Loan guarantees may be structured through payment guarantees from the Ministry of Finance by redirecting central transfers for loan payments, in case of default. Such guarantees would be a form of last resort, when all other attempts to obtain loan payments have failed (Poland). Another form of payment guarantee, in the case of public utilities, would be to construct a "black box", or special bank account, into which revenues would be paid (such as from user charges). Loan payments would be assured from the revenues accruing to the "black box". In other countries, utility loan recipients or bond issuers often are required to automatically adjust tariffs so as to maintain a minimum margin of revenues for loan repayment obligations.

¹¹ There is also the issue of the technical capacity of municipalities to prepare bankable investment projects; in such cases, a program of technical assistance could be proposed to accompany a proposed credit program (for example, the Municipal Development Agency being established in Poland).

Finally, there is the possibility of carving out revenue streams from the projects which are being constructed. This option will depend on the extent to which certain types of fees are in the domain of the local governments and also on the freedom which local governments have to determine the rates of these user fees.

A. Czech Republic

Although Czech municipalities appear to have greater access to medium-term loans to finance municipal infrastructure, less than 10 percent of total investment spending is financed by credit. This reflects a conservative reluctance by mayors to assume debt, as much as limitations on the supply side of the market.

Bank lending to municipalities is dominated by *Česka Spořitelna*. However, most of the other large commercial banks have at least limited experience in making loans to municipalities and, like *Česka Spořitelna* have indicated that they intend to expand this market. For the commercial banks, the primary appeal of financial involvement with municipalities often is gaining access to their relatively stable deposits and earning fees on municipal financial transactions. Thus banks typically either require as a pre-condition to a municipal loan that they handle all of a municipality's financial business, or give strong preference to municipalities with which they have other commercial relations.

Banks also have taken the lead in underwriting municipal bonds in the Czech Republic. Originally, bonds were purchased for the banks' own accounts, but a secondary market has developed that allows them to be traded.

On May 16, 1994 an agreement was signed between USAID and the Czech Republic to establish a credit line to be used to accelerate municipal lending by the private sector. The agreement starts with a US \$20 million commitment which may be expanded to US \$100 million. As part of the agreement, a Municipal Finance Infrastructure Corporation (MUFIS) was established which will provide credit access to banks and other financial institutions for municipal on-lending.

The program is specifically designed to serve as a transitional bridge to full private market lending. Therefore, all municipal loans will be made by private financial institutions, which will assume 100 percent of the credit risk. MUFIS will provide access to longer-term, fixed-rate funds which in turn will allow banks to extend to municipalities loans of 8 to 15 years, adequate to finance substantial infrastructure projects.

Banks may also underwrite and purchase municipal bonds under the program. All banks and other financial institutions that meet eligibility standards will have access to the MUFIS credit lines.

The intent of this program is to support the private municipal lending market in its natural development in the Czech Republic. It encourages broad participation of a number of banks, which have expressed their intent to make loans under the program. It supports both bank loans and

municipal bonds as credit instruments. MUFIS capital can be augmented in the future by other external loans or by issuance of domestic bonds. The Czech Republic intends to preserve the right to pre-pay the external 30-year loan so that MUFIS can be phased out quickly if the private market proves capable of meeting municipalities' financial requirements without further support from a parastatal agency. Establishment of a track record of timely and complete loan repayments is regarded as critical to expanding the private municipal credit market.

B. Hungary

In Hungary, the municipal credit market is dominated by the OTP, which retains the advantage of concentrating about 95 percent of local government accounts. The situation is likely to evolve toward a fierce competition between the OTP, which would like to retain this monopoly, and other major Hungarian banks, which would like to capture part of the municipal finance business, as municipal accounts are viewed to be extremely lucrative (according to OTP, one-third of its profit originates in the local government sector). The key to keeping or capturing municipal accounts in the future is likely to be the availability of credit, or of other services tied to the implementation of municipal infrastructure projects (financial advisory, fostering of public-private partnerships, project finance).

In recognition of this evolution, from 1992, OTP entered into discussions with the EBRD and a French bank, the *Crédit Local de France*, to establish a joint-venture municipal development bank, which could channel OTP deposits and a projected EBRD credit line to the financing of municipal investments. Discussions on this issue collapsed at end 1993, most likely due to the preference of OTP to keep the municipal accounts in the main bank, and farm out (some) lending to a separate agency; ultimately, the municipal development bank established through the joint venture would have competed with OTP in its local government domain.

Four other major Hungarian banks have begun to develop strategies to capture part of the municipal market from OTP. The majority of these banks have premised the development of their activities towards the local governments on the transfer of their deposit accounts. Although municipalities are seen as good clients and as relatively lower-credit risks, the banks still prefer to insure payments through deposit accounts, on which they could have the possibility of placing a lien in case of default.

Nevertheless, Budapest Bank is now in discussions with the EBRD and the *Crédit Local de France*, in consortium with other West European municipal banks (Belgian), to establish a small joint venture municipal bank which would on-lend donor monies to municipalities, and eventually serve as a relay once Budapest Bank would have access to longer term funds to lend to local governments. The Ministries of Finance and the Interior are kept informed of the discussions, as the EBRD credit line is likely to require a Central Government guarantee. An USAID Housing Guaranty loan signed in May 1994 also contemplates on-lending through commercial banks to finance municipal infrastructure investment.

C. Poland

Although Polish municipalities keep their main accounts in a wide variety of domestic banks, almost no medium-term funds are available from these banks to finance municipal infrastructure investment. The largest source of medium-term loan funds now available to Polish municipalities are through preferential rate loans from the National Fund and Voivodship Funds for environmental protection (NFOŚ and WFOŚ), as well as the Bank for Environmental Protection (BOŚ). For the NFOŚ and the WFOŚ, future availability of funds for on-lending to municipalities and to other entities will depend on the capacity of industrial or other enterprises to continue paying assessed environmental fees and charges, the principle source of revenues of the environmental funds.

Within the Polish domestic banking system, a few Polish banks have received lines of credit from multilateral and bilateral donors, such as a line of credit from the World Bank for district heating projects through the Wielkopolski bank. However, the distribution of these credits to finance specific projects has been extremely slow.

In order to increase the availability of medium- to long-term funds for the financing of municipal infrastructure projects, both national (Council of Ministers, Ministry of Finance, Ministry of Physical Planning and Construction) and local (Association of Polish cities, Association of local assemblies, individual municipalities) actors have been proposing different forms of municipal credit systems.

Individual Polish cities have established universal municipal or communal banks, in which the founding municipality is the largest shareholder. These banks, which accept deposits from local population and enterprises, were created in the expectation that they could serve as a source of credit funds to finance the founding municipality's investment projects. Nevertheless, the principal deposit accounts of the city are not always kept at the communal bank. Cities which have created such banks include Gdynia and Bydgoszcz and the establishment of a Warsaw communal bank is underway (jointly held by the municipality of Warsaw and by Warsaw districts).

One proposal of the Association of Polish Towns would be to create a national municipal bank to federate all the local municipal banks which have been established (or which would be created in the near future).

Another proposal under discussion would be the establishment of a specific line of credit to finance municipal infrastructure, with funds potentially available from multilateral and bilateral donors. The "Municipal Credit Program" (MCP) has been proposed to be set up as a "lending window" under the form of a State Agency. The MCP would identify partner banks who would be responsible for establishment of relations with the municipalities, identification of potential projects, assistance to municipalities in completing the MCP loan application and collection of loan payments (for which the partner banks would receive a fee). The long-term objective of the program is to enable Polish commercial banks to establish relations with the municipalities and to foster their ability to continue lending to municipalities, once the donor credit lines have ceased.

In June 1994, the Polish government established a Municipal Development Foundation, whose initial tasks would be the preparation of ten to fifteen municipal investment projects for financing, initiate a set of training programs on municipal project preparation and debt management, and monitor government legislation in the municipal sector to propose policy reforms. In conjunction with the creation of the Municipal Development Foundation, the World Bank is initiating the design of a pilot project to launch a municipal credit system.

From May 1994, USAID has begun work on designing a pilot project to finance municipal infrastructure projects; this pilot project will be capitalized by a US \$10 million HG loan and will be set up within the context of the development of a long term municipal credit system.

D. Slovak Republic

To date, Slovak municipalities have financed their investment needs through two (limited) sources, grants and loans from the State Environmental Fund and since 1993, medium-term loans, as well as one bond issue from the Prvá Komunálna Banka (PKB). A second bank, Istrobanka, is about to issue a municipal bond. The development of a viable loan finance system for Slovak municipalities will depend on the evolution of the PKB, the involvement of commercial banks in municipal lending or municipal bond underwriting and perhaps, on the development of a commercially oriented revolving loan fund by the State Environmental Fund, to replace part of the current environmental loan system.

The PKB was created by municipalities to provide loan funds and other services for their specific investment finance needs. Since 1993, over 160 municipal investment projects have been financed by the bank. At mid-April 1994, two-thirds of the share in capital was dominated by one municipality, the city of Žilina, and the remaining third split among over 200 other Slovak municipalities. The funds available to the bank are likewise dominated by local government deposits. Although local governments who are not shareholders of the bank may request loans, it would appear that almost all the loans granted to municipalities were to shareholders.

The case of PKB poses the question of a potential conflict of interest between the activities of the bank and the shareholders in the bank, as the latter have received the majority of loan funds distributed. To maintain its financial position, PKB will have to be able to make loans to and collect loans from, share-holding municipalities on a commercial basis. In addition, the first municipal bond issued was underwritten by PKB for the city of Žilina. In order for the PKB to ensure its financial viability, credit decisions need to be free from political pressure which may be exercised by the shareholders. The bank's management appears to recognize this risk and has made efforts to receive technical assistance and training in loan evaluation and financial analysis from the Financial Services Volunteer Corps and perhaps the Crédit Local de France.

The Government of Slovakia, EBRD and other donors are currently preparing a proposal for the creation of a revolving loan fund, the State Environmental Revolving Investment Fund (SERIF), to replace very low-interest loans currently awarded by the State Environmental Fund. The SERIF would channel donor monies to commercial banks in Slovakia for on-lending to municipalities, at maturities which are longer than currently available (and more appropriate to municipal infrastructure finance needs). Under the proposed SERIF structure, the commercial banks would be direct lenders to municipalities, would analyze the financial feasibility of the projects and would take part of the credit risk. The creation of a Guarantee Fund would help to protect the lenders from part of the municipal risk. Commercial sources of funds would be combined with low cost of capital funds from the Environment Fund, to be provided to municipalities at blended, subsidized rates. However, the subsidy would be much shallower than that now provided.

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