FINANCING OPTIONS FOR PARAGUAYAN MUNICIPALITIES

PARAGUAY MUNICIPAL AND RURAL FINANCE (PMRF) PROJECT

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Introduction

The initial objective of this assignment was to collaborate with local legal consultant in the drafting of a trust agreement that satisfies local law, municipalities and Paraguayan financial institutions. After reviewing local counsel's legal analysis and, more importantly, the primary purposes for which the trust initially considered necessary, consideration was given to options that any municipality being assisted under the Paraguay Municipal And Rural Finance Project to improve its financial management, total revenues, and overall financial condition facilitating financing of long term capital projects, such as road construction, road maintenance, and major infrastructure equipment purchases. Your preliminary work in assessing the municipalities' current financial condition has been very helpful and instructive. As a group, municipalities have a very poor grasp of their respective financial conditions. More importantly, their declining revenues and burgeoning deficits are as much benign neglect in collecting taxes owing and payable as with increasing operating expenses.

Thought was given, therefore to practical approaches. First and foremost is tax collection. This can be improved through simple concentration on collection efforts and having professional agents do so. Next, consideration was given to having a bank, fiduciaria or a finance company provide financial services to the municipality helping it to manage its overall financial, budgetary, and treasury functions better to improve its financial management and financial strength to be a more attractive and creditworthy borrower to financial institutions. Then, municipal equipment leases, a very popular method in the US for municipalities to finance 100% of their equipment needs, were reviewed for their applicability in Paraguay. Finally, consideration was given to your simple suggestion to the municipalities to establish a long term capital fund from a percentage of their annual revenues to be able eventually to finance their capital projects.

This memorandum briefly looks at each of these areas. Draft model agreements were prepared to give guidance on the legal structures that may be used for each. A draft Trust Agreement was prepared to fulfill the initial assignment goal, though subsequent project information suggests that this is not the most appropriate vehicle for the municipalities to use in improving their financial status. Finally, a separate memo was prepared to discuss the purposes and merits of each of the draft agreements.

I. Tax Receipt Collection Agents

A municipality can transfer certain tax receipts to suppliers, contractors, or other third parties, and have them collect their payment for goods and services through these collections.

- A 1908 law that provide contractors on property and receipts related to their work and enables them to collect payment from the property owners, demonstrating an early recognition of third party involvement in collection for services provided to the community by the municipality;
- Contractors have done some tax receipt collection to get paid for work in the past and have collection capabilities to do so; and
- Municipalities can and have engaged collection agencies, banks and law firms to collect past due taxes.

The municipality must enter into an agreement with the collection entity (contractor, supplier, bank, collection agency, or law firm) for collection of past due tax receipts on real or personal property or other tax receipts. The mayor and municipality board must approve such agreements. The municipality must provide the collection agency with documentation to show taxpayers of their status as an official tax collection agent.

While municipalities can engage third parties for tax collection, interest of various entities for collection of past due taxes must be explored. Many businesses are reluctant to do business with municipalities due to their inability to collect their fees. Suits against municipalities for collection are ineffective. Taxes by law must be paid into the municipality's bank account, though fees may be taken from any penalties or interest thereon. Therefore, the collection agent cannot easily collect fees simply from the tax collections themselves. Also, the collection agent cannot stop the taxpayer from paying the past due taxes directly to the municipality, nor prevent the municipality from accepting payment.

Banks have a right of offset of any funds owing them against any funds held by them for the account of the debtor, in this case a municipality. Banks often improve their fee collection by requiring the mayor and President of the Municipal Board sign any agreement in their personal capacity. While these officials are not personally liable for their official act (Const. Art. 106), signing in their personal capacity would make them liable for the unpaid obligations of the municipality under the agreement. Law firms have set fees for undertaking this work provided that a suit is file against the property owner for collection. Suits to collect taxes must be in the name of the municipality, though it must be filed by a lawyer, enabling due collection for work provided.

All of these issues must be covered in an appropriate agreement between the municipality and the collecting agent engaged. As using an outside entity to collect past due taxes is a step in a long term process to improve the financial standing and credit of the municipality, it behooves the municipality to present a fair agreement intending on honoring payment of fees earned in the collection and receipt of past due taxes.

Benefits: Collection of past due taxes benefits a municipality in numerous ways as part of a larger effort to:

- Increase its total revenues;
- Improve its financial management;
- Improve its relationship with contractors and suppliers, which provide it goods and services; and
- Enable it to provide better and more timely services and public infrastructure improvement to serve its citizens.

Documentation: Form agreement with third parties (suppliers, contractors, banks, law firms, collection agencies and the like) engaging the entity to collect identified past due tax receipts of a certain total value. The agreement could be renewed or terminated following collection of the receipts. Where contractors or suppliers are involved, this arrangement may be combined with a sale of goods or services whereby the entity would be provide past due tax receipts having a net value of at least the value of the goods or services with the remainder to be provided to the municipality less a commission for the tax receipt collection.

II. Fiduciaria/Banco Servicing Arrangement

Municipalities can enter into a multi-purpose arrangement with a *fiduciaria/banco* or financial services firm that would provide a number of credit and financial services. Engaging one financial service group to provide all services, if available, may prove less costly and provide better service. Banks and fiduciarias may be more attracted to providing the services if the total fee package for all services is high enough to warrant their participation. As one comprehensive package, all details could be set forth in one master agreement with separate auxiliary agreements specially covering the details of the separate function. Each of these credit and financial services can be developed individually and independently of each other. In fact, the municipality may want to start step by step with each service initially to develop the capacity of the municipal staff to gain full value of the services provided.

While there are Paraguayan banks and finance companies that can provide these services, it is not yet clear whether any are interested in developing the municipal market due to their low financial standing, limited adherence to sound financial management practices, and poor history for tax collection. Paraguay currently has only three fiduciarias and the trust and financial management service clients they service are few. In addition, they have a limited branch network and may not have a presence in or near the municipality to be able to provide timely and effective services. While these services could theoretically be provided via the Internet, this would largely lose the value of the municipal staff gaining greater experience directly from the firm through periodic interaction with the firm staff on various issues related to the services provided. Finally, the current Paraguayan economy, especially relative to the world economy, is very weak, encouraging banks to earn their income through placing the required amount of reserves with the Central Bank for 30 plus percent annually and placing the remainder of their loanable funds in overseas investments.

These negatives combine to require the municipality to try to attract quality firms to provide the municipality with quality services. One approach is to make agreements attractive to banks and fiduciarias such that they are likely to make good and reasonable fees if they undertake the work and are more likely to collect their fees for services rendered. Another is develop an attractive presentation of the services needed, the approach that the municipality would like to take, the safeguards for payment of fees, and the benefits to the bank or fiduciaria's image for servicing the municipality.

A. Bank Revolving Credit Line

The municipality may establish a bank revolving line of credit having a balance that fluctuates during the year. Possible terms would have interest charged on the outstanding daily balance and posted monthly. The line of credit could be secured by past due tax receipts having a value of some percentage of the outstanding balance. The bank could be engaged in connection with the credit line to collect the tax receipts and pay the funds into the municipality's current account with the bank. Collected tax funds from this account could make periodic or pay down payments on the credit line. The municipality could use the line of credit by drawing drafts of pre-determined amount for transfer to its current account for use as needed for municipal purposes to pay for goods and services. Alternatively, the line of credit could be restricted for special municipal purposes, such as road construction from the Municipal Development Fund detailed below. The revolving line of credit supported by identified past due tax receipts could be the funding source of the Municipal Development Fund, for example. The *fiduciaria* could manage the line of credit and draw drafts based on authorized instructions from the municipality. Internal controls, such as double official signatures, could be required on every authorized instruction to the services firm.

Credit Line Terms (Suggestion)

- Interest rate in Guarani at 2 to 3% per month calculated on a daily basis of outstanding debt balances and accrued monthly;
- Funds from the Municipal account, if the service is available, could automatically be swept into the revolving fund account at the end of any day that there are collected funds available to disburse to cover any outstanding balances of the revolving credit;

- Disbursements could be conducted by the services firm or bank through its trust department as fiduciaria in accordance with pre-determined instructions: signature of mayor and one other senior official and probably transmitted by fax. Instructions could eventually be delivered securely by way of the Internet.
- Certain Municipal real or personal property, not used for government operations, or past due tax receipts may be pledged to the revolving loan and secure repayment.

B. *Fiduciaria* Accounting/Disbursement Administration

A bank that also serves as a *fiduciaria* can provide accounting and funds administration services to the municipality through a special contract—*mandato fiduciaria*. Under this contractual arrangement, the fiduciaria would manage the municipality's bank account with the bank, the bank revolving line of credit, accept deposits, issue disbursements in accordance with instructions from the municipality, provide monthly management information to the municipality based on a pre-determined template to facilitate municipal decisionmaking. A financial services agreement could provide the same services to a non-*fiduciaria*.

1. Accounts Management and Administration

- Management of Municipal accounts with the bank including demand account or cuenta corriente and revolving loan account;
- Disbursement from current or loan account based on authorized instructions from the Municipality;
- Mayor and one other—accountant—could sign all instructions to be faxed to the fiduciaria in accordance with pre-determined procedures;
- Fiduciaria could provide monthly statements of all accounts as well as reports in a format and providing MIS as required by the municipality;
- Fiduciaria could receive fees for administration of account and other related relationships—tax collection, revolving fund management, equal to .5 to 1% of the balance of the average annual outstanding balance of the Municipal current account plus the average outstanding balance of the revolving loan account.

2. Tax Receipt Collection

- Either the fiduciaria, a banking subsidiary, or a third party could be authorized by the municipality to collect tax receipts after the municipality had properly gone through all notice and initial collection procedures;
- All tax receipt collections could be deposited into the Municipal account at the bank and be used for the purposes as authorized in accordance with pre-determined procedures;

- The Municipality could provide the fiduciaria a sum certain in value of tax receipts that are past due and duly noticed and initial collections begun by the Municipality;
- As these tax receipts are collected, the Municipality can provide the fiduciaria with additional tax receipts ready for collection.
- If no banking sub or fiduciaria can undertake tax collections, then subcontracted to collection agency or law firm.
- The fiduciaria can provide for accounting of all tax receipts in collection with detailed information on each receipt, including without limitation, taxpayer's name, amount of tax for collection, description of taxes and if property tax, a description and address of the property, dates and actions taken by the Municipality, dates and actions taken by the collection agent, amount collected, amount compromised.
- The fiduciaria can receive commissions for tax receipt collections, which commissions should be 2% to 5% for the value of the receipts.

Documentation: Agreements for these services can be prepared in a couple of ways—individually or as a comprehensive service package. A comprehensive approach involves a master or umbrella agreement between Municipality, Bank and, if a separate legal entity, the *fiduciaria,* detailing the general services that each entity is going to provide for the Municipality as well as what the Municipality is going to do to facilitate the ability of the bank and *fiduciaria* to provide their services. Separate agreements could be prepared for current account with the bank; revolving loan agreement and account with the bank; tax receipts collection; and *fiduciaria* administration or financial services agreement setting forth its authorities to manage the current account, revolving loan, and tax receipt collection.

III. Municipal Equipment Leases

A. Municipal Tax Exempt Lease Purchase Agreement.

A municipal equipment lease or a tax exempt lease purchase agreement is a financial technique that enables a municipality to gain the use of equipment easily without having to wait for a bond issue or tax or other revenues to be available for the equipment purchase. The municipality leases the desired piece of equipment from a lessor (manufacturer, equipment dealer, bank, finance, or leasing company) and makes monthly lease payments for the term of the lease (36, 48, or 60 months). Often municipal leases are set up in one-year increments renewable annually to avoid some municipal statutory or regulatory limitations on long-term debt or voter approval. These lease payments are a current operating expense of the municipality, not a capital expenditure. If payments are not made timely, then the municipality forfeits the equipment to the lessor. The equipment is often titled in the name of the lessor enabling swift repossession in the event of default; not requiring a legal court proceeding in most jurisdictions, provided repossession is obtained peacefully. Some jurisdictions may require titling in the name of the municipality in order to obtain full tax benefits. Depending upon the rules of the jurisdiction, the interest component on the lease payment to the lessor may be tax exempt for financing a municipality, often lowering the municipality's financing costs.

At the end of the lease term, provided all payments are made, all title, possession, and ownership of the equipment is turned over to the municipality or the equipment can be purchased for a nominal amount or fair market value depending upon the lease terms. Various leasing firms have variations on these basic terms depending on the municipality, jurisdiction in which the municipality is located, and the creditworthiness of the municipality. Some firms offer master municipal equipment leasing arrangements whereby the lessor provides the municipality with a line of credit for leasing multiple pieces of equipment. Draws are made under the line for payment to the manufacturer or dealer for the equipment, which is then delivered to the municipality. The details of the equipment are added to the equipment leasing schedule of the master agreement and thereby subject to the same terms and conditions of the first leased piece of equipment. This approach streamlines leasing time and expense when the municipality has multiple equipment needs in any one year. Lease payments are calculated based on the entire amount of equipment leased.

For equipment leasing arrangements to be attractive to purchasers, a number of accounting and tax issues need to be considered. If the lease is considered an operating lease, then the lessor will be able to depreciate the equipment on its books for the life of the equipment. Operating leases require the lessor to maintain ownership throughout the life of the lease and sell the equipment to the lessee at the end of the term only at the lessee's option and for fair market value. All other leases are financial leases offering limited tax benefits to the lessor. As the municipality is tax exempt, depreciation has no tax benefits for it, but the availability of tax benefits to the lessor effectively lowers the price of the equipment to the municipality. Some municipalities are exempt from some import duties or value added taxes depending upon the equipment leased.

Benefits: A municipal equipment lease offers municipalities a number of financing advantages over alternative approaches:

- Gain equipment use immediately at today's prices but avoids large lump sum expenditures;
- Municipality is able generally to finance 100 percent of the equipment cost from general revenues without a down payment or security deposit;
- The expense and time consumption of a bond issue, or the unpopularity of a tax increase is avoided;

- Only requires the lease payments for a single year to be budgeted in the annual municipal budget, is treated as an operating expense, and is not public debt that often requires voter approval;
- Often municipal equipment leases include pre-payment options to enable early payment for financing savings should municipal revenues suddenly increase, an important consideration due to high effective imputed interest rates; and

Documentation: A standard municipal equipment lease agreement with the general provisions for covering relevant issues of most jurisdictions. Tax and accounting treatments must be reviewed in order to make sure that a leasing arrangement is attractive to equipment manufacturers or dealers or financial institutions. While equipment leasing appears within the laws of Paraguay, equipment leasing is not a widely used financial arrangement in Paraguay for commercial firms and is not known for municipal equipment procurement or use. Efforts will have to be made to encourage both municipalities and potential equipment lessors to understand and be attracted to the benefits of equipment leasing in order for this mechanism to be adopted and readily used by both.

IV. Municipal Development Fund

A municipal development fund offers a very sound initial approach for improving a municipality's ability to budget for and purchase, lease or otherwise obtain the equipment and machinery that it needs to construct and maintain road and other municipal infrastructure or contract service for such infrastructure. This fund is a budgetary account and a policy decision or directive for the municipality to segregate or transfer a certain portion of its annual revenues to this fund.

The Municipal Development Fund is not a legal entity but a policy of the municipality adopted by the Municipal Board and the Mayor to dedicate revenues toward the long-term capital expenditure needs of the municipality. First and foremost among these expenditures is for the construction and maintenance of roads. Having quality paved, graveled and permanent surface roads is fundamental infrastructure that all municipalities should provide its citizens. Unfortunately, the capital cost of road construction and the purchase price of road graders and other maintenance equipment is beyond the tax and other revenues of most municipalities based on an annual budget. If a municipality has not established a history of being creditworthy to enable bank borrowing or public debt issuance, then it must adopt a program of saving municipal revenues until sufficient funds are available to purchase needed equipment or contract for road construction. Establishing a Municipal Development Fund is the setting up of a municipal capital account designating its funds for the priority capital projects of the municipality, most frequently road construction and maintenance. Typically, municipalities designate around 15% of their annual revenues to be transfer to the Fund.

Municipalities without the ability to borrow must have large lump sums to pay for needed equipment or large road construction projects. The Municipal Fund enables it essentially to save money until it reaches these capital expenditure goals. If a municipality properly develop its Fund, saves for the needed equipment or capital project, and successfully purchases the equipment or implements the project when the Fund reaches the needed amount of funds, then the municipality will have given financial institutions valuable information on the municipality's commitment to make and reach goals. It will have a track record of responsible budgetary management in order to serve its community better.

While the Fund is not a legal entity, the municipality can still establish a special Fund account with its bank that is interest bearing to enable Fund buildup. This limits the temptation of using the funds for general municipal purposes. Special signatory procedures, such as Mayor and Board President signatures required for any fund transfers from the account, establish a seriousness of intention and commitment to the purposes of the Fund. Annual budgetary proposals and reports can include the long-range municipal plan for the projects and equipment that the municipality intends to finance using the Fund including time tables and actions plans to effect the overall plan.

Benefits: Establishing a Municipal Development Fund has a number of benefits to the municipality.

- Municipality has a clearer plan for improving municipal infrastructure, including a timetable and funding.
- Expensive equipment that must be purchased over a multiyear period is attainable;
- Municipal staff gain important experience in providing for both short term operations and long term capital expenditures;
- The municipality improves its financial management history giving greater comfort to potential lenders for financing the municipality's future needs.

Documentation: Establishing a Municipal Development Fund requires only the Municipal Board to adopt a resolution setting forth the purpose of the Fund, the amount of annual revenues to go into the Fund, and the restrictions on how the Fund should be managed. The Board then directs the Mayor to establish the Fund in accordance with the resolution.