Municipal and Regional Finance Assessment: the Potential of Credit as a Development Tool in Morocco

Final Report

December 1998

Submitted to:

USAID/Morocco

Presented by:

Michèle Olivier Laird

Abt Associates Inc.

Contract: PCE-I-00-6007-00, Work Order OUT-803

MUNICIPAL AND REGIONAL FINANCE ASSESSMENT: THE POTENTIAL OF CREDIT AS A DEVELOPMENT TOOL

FINAL REPORT
DECEMBER 1998

By Michèle Olivier Laird
Abt Associates Inc.

Preface

This report was prepared by Abt Associates Inc. under USAID Contract PCE-I-00-8007-00. The purpose of the study is to assess Moroccan public and private financial markets, the potential for local government finance and regional development, and the further potential of credit as a development tool in Morocco. In particular, it looks at the potential of the Development Credit Authority as a potential tool for financing USAID projects in Morocco.

Field work was undertaken by Michèle Laird from September 28 through October 17. During this time, assistance was provided by USAID/Morocco personnel and numerous Moroccan public and private sector officials working in the areas of economic development, infrastructure development, government administration, and finance.

Thanks are due in particular to Mr. Tahar Berrada and Ms. Tina Dooley-Jones of USAID, as well as to those listed in Annex 5.

TABLE OF CONTENTS

Executive Summary

The Government of Morocco (GOM) is currently undertaking a series of policy reforms which will result in the decentralization and deconcentration of powers (decision making, budgetary, etc.) from the central level to the level of the sixteen administrative regions which make up the country. This decentralization opens up the potential for new and innovative relationships between the public and private sectors in the realm of project development and finance. Historically, USAID has worked across sectors to support GOM decentralization policies. USAID is interested in the potential of municipal or regional finance mechanisms for a number of development objectives including infrastructure development, health service provision, increased access to credit and microfinance for enterprise development, etc.

Local Government Structure and Finance

In order to assess the potential of credit as a tool to meet Morocco's development needs on a regional and local level, one must first examine the structure of regional and local government. The key components of local government are the province and prefecture and the commune.[1] The Communal Charter of 1960 basically prepared the way for decentralization and a greater focus on local administration. Three years later, decentralization was extended to the provincial level. The communal reform of 1976 attempted to open up the political process and to revise the technical one, establishing new local administrative units that were to be able to take charge of the economic and social development process.

Meanwhile, municipalities and communes in Morocco have always been managed as traditional administrative structures. Little improvement or modernization has been made in the way that they function. Most of them remain very poorly equipped in terms of modern office machines and materials. More recent difficulties include the fact the many large cities now include more than one municipality. At the other end of the scale, very small urban communes do not have the institutional structure required to fulfill their responsibilities.

Local governments throughout Morocco have a rather low level of autonomy, due to the considerable amount of central government supervision built into the administrative system. Even though recent laws have opened up significant areas for local initiatives, most municipalities lack the experience to act on them and have not accepted a more dynamic role in their own development.

[1] The urban communities are important as well, but these are governed by law rather than constitution and only apply in the largest urban areas: Casablanca, Rabat, Fes, Marrakech, Meknes, Skhirat-Temara, Tangiers, Oujda, Safi, Tetoune, Agadir, Taza, Kenitra, and Sale.

Furthermore, both current decentralization efforts and the application of the electoral system at the municipal level have frequently weakened the role of municipalities. The members of the municipal council are not elected by lists, but according to districts and on an individual basis. Because of this electoral approach, municipal solidarity is weak and often creates difficulties when attempting to adopt the budget. Narrow visions of elected officials frequently take precedence over community solidarity and concerns, a situation that effectively freezes the municipal council's ability to act. The lack of solidarity within municipal councils also makes it more difficult to apply and administer available tax measures in order to generate necessary revenues.

In general, while the decentralization trend in Morocco attempts to reinforce financial and budgeting capacities at the municipal level, there are a number of obstacles that essentially prevent any serious advance. These include limited institutional capacities; insufficient human resources, management, and materials; over-dependence by elected officials on the central government to define development programs; and inability of the municipality to make use of local, private sector expertise.

Other common problems that prevent municipalities from expanding or improving their performance include poorly defined boundaries for intervention; budgeting and accounting systems that are overly constrained by poorly understood and applied administrative procedures; limited means to influence the mobilization of locally generated financing through the collection of taxes; and opacity of the legal system.

USAID has been supporting institutional strengthening efforts within municipalities, including improvements in accounting systems. This support must be continued and expanded in order to equip officials and municipal staff with the needed skills and tools to take advantage of decentralization efforts.

While municipalities can identify their needs for urban services and facilities (health, education, housing, etc.) and transmit them to the regional or national levels, they are not directly responsible for the actual provision of many of these services, such as the construction of schools, hiring of teachers, building of hospitals, etc. The provision of these services is the responsibility of the offices and agencies of the central government, which have their own priorities and programs, and often work through their provincial or prefectural divisions. Meanwhile, water and sanitation (including wastewater treatment) are the responsibility of the communes. For some of the communes (generally the larger ones), these services are developed, delivered, and maintained at a district level by district water and electric authorities, or *Regies*.

With regard to planning for municipal development, government leaders generally recognize the usefulness of multiyear programs. While central authorities would basically favor such a planning approach, the level of solidarity between elected officials in the same municipality is often too inadequate to allow for any medium-term programming. As could be expected, each elected official is interested in obtaining the maximum amount of benefits for his or her area during the period of his or her electoral mandate. The unavoidable result is a series of small, local projects that follow a patchwork approach rather than any overall structuring of the municipality.

Currently the state-owned Fonds d'Equipement Communal (FEC) is the only bank lending to the communes. It does so without state guarantees. Private banks are currently not lending to communes due to the perceived risk -- possibility of default, no collateral which they can seize, no state guarantee. In looking at the FEC loans to the communes, it seems the greatest problem is late payment rather than non-payment. Nevertheless, late payment makes the communes less attractive clients than others that are available to private banks.

As was mentioned above, USAID has been working with municipalities to improve their structures, impart needed skills, and update their financial systems, as well as to support the passage of fiscal reform. This assistance is crucial given the trends of decentralization and deconcentration. Local governments are not yet equipped to handle the financial and development responsibilities that have been bestowed upon them; thus, continued strengthening efforts are needed.

Currently some communes do have the capacity to borrow -- they are relatively well-managed and transparent, with a solid source of revenue from shared and local taxes, etc. The majority of the communes, do not have borrowing capacity, though -- they lack sufficient human resources and have yet to establish sound management practices.

Furthermore, the newly established regional councils do not yet have the structure or procedures in place to safely manage a loan.

In general the district utility companies, Regies, are capable of borrowing -- as they are autonomous entities focusing entirely on utility services, clear cashflows and transparency are easier to come by. Nevertheless, the Regies' creditworthiness needs to be determined on a case by case basis. Tariff and fee structures in many Regies are complicated and thus make projecting revenue streams a difficult task.

Because decentralization is placing much of Morocco's development on the shoulders of local and regional governments, efforts must be made to strengthen these administrative units. As the regional councils are so new, their strengthening and growth may take some time, but guidance at these early stages could better ensure appropriate development. The municipal governments, in the meantime, clearly need training in public administration and management, restructuring of personnel functions, and assistance in modernizing computer systems, accounting methods, record keeping and the like. Even stronger municipalities, such as Rabat, have asked for technical assistance in the area of management and for a business course for their personnel. All municipalities could use such courses.

As the local governments increase their management ability, the central government should give them greater authority in the determination and collection of local taxes as well as the ability to charge true costs for local goods and services. This will allow the municipalities to better provide for the public and plan and implement much needed projects and programs.

Donor Financing Comparison

With regard to financing by other donor countries and organizations, the rates and terms vary. However, it is clear that FEC, ONEP, and other such borrowers favor concessional loans and grants. Indeed, for some projects, such as wastewater treatment, very low interest rates or grants are necessary in order to make the resulting service affordable to the people.

Germany lends at an extremely low interest rate, the Islamic Development Bank and France follow. Loans by the BEI[2] and World Bank, at rates around 6 percent, are considered expensive as donor loans go. The loans guaranteed by USAID (HG loans) are often the most expensive. Nevertheless, all of these loans are cheaper than local market rates (either through bond offerings or through bank loans).

None of the multilateral or bilateral lenders researched will lend to public entities in Morocco without a state guarantee. Therefore, they do not lend to municipal governments since they have no access to such guarantees.

Development Credit Authority Financing

Depending on US Treasury rates at the time, the USAID Development Credit Authority (DCA) loan mechanism could be attractive to certain borrowers, particularly those who find the demand for their funds greater than their supply. Municipal governments would certainly find such financing attractive; however, there is a question as to whether these entities would be deemed appropriate by the DCA Committee. Certainly lending to well-managed municipalities would fill a gap which is currently unmet. However, it is more likely that borrowers such as Regies, National Public Utilities, or state-owned and private financial institutions would be easily approved at this time.

A question or concern for all of these potential borrowers, however, is that of currency risk. Any entity in Morocco that borrows in dollars must institute procedures or a mechanism to cover the exchange rate risk unless they are operating in dollars. If the loan is short-term, then there are hedging facilities provided by the market. For longer-term loans, though, borrowers must be prepared to set aside sufficient reserves (thus effectively increasing the cost of the loan for the loan’s duration) or to swap the funds with another borrower/lender for local currency. For example, BMCE has in principle agreed to swap dirhams for dollars with the FEC if the dollar loan terms are favorable.

---

[2] Interest rates for loans by BEI vary widely, and in certain cases are around 4 percent, but range up to slightly over 6 percent.

The aspect of DCA direct loans that will make them attractive compared to loans offered by other international lenders is the fact that loans, in theory, can be offered without a state guarantee. This type of lending would fall under the DCA non-sovereign category. By not having to pay the extra two to three percent for a state guarantee, the effective interest rate will be more in line with those of concessional lenders and will be more attractive than the World Bank rates.

The DCA guarantee mechanism is also a possibility for increasing the flow of funds directed to regional and local development. Currently the potential users of DCA in Morocco that might find the DCA guarantee mechanism attractive are private banks that are interested in lending to Regies for infrastructure development projects, private banks that might lend to micro or small borrowers, and microfinance institutions (NGOs) that might borrow from private banks and onlend to small borrowers.

Credit financing possibilities are discussed by SO below.

Potential Projects for DCA or MSED Financing

When the Mission develops a DCA project idea (or Micro and Small Enterprise Development, MSED, for that matter), it should contact the Global Bureau to let them know of the Mission's interest, and then prepare a brief description of the project idea (see the DCA Annex for a suggested outline). The Mission should also indicate to the Washington DCA Team the amount of Mission resources (OYB) it is willing to commit to the project and should request preliminary subsidy cost estimates. Once this is complete, the Mission should further develop the project idea, contracting financial/credit expertise if necessary or calling in AID/W expertise. The Mission must prepare a detailed feasibility analysis with an emphasis on determining if there is a positive financial rate of return. If the results of the feasibility analysis are negative, the project is abandoned at this stage. If the results are positive, the project moves on to the next phase.

The next steps include detailed project development, optional subsidy cost verification, preparation of project approval documentation, final subsidy determination, budget authority transfer under DCA, preparation of project agreements, and financial closing.

In examining the Morocco Mission, there are two key areas of development in which the SOs are working that are prime candidates for DCA financing (loans or guarantees) – microfinance projects for private business, housing and health, and infrastructure development projects. Both of these types of projects generate revenue streams and thus are potentially financable through loans. The education sector is currently less attractive for this type of financing because of the slower rate of decentralization in this area. Potential DCA projects are described in further detail below.

Education

In the education sector, projects generate little if any revenue and subsequently in general are currently relying on grants or very low-interest loans. Communes or urban communities are a possible end-receiver of funds; however, disbursement may be difficult.

If decentralization in this sector comes about, then the regional authorities or provinces could borrow directly. However, this may take some time.

Private sector education would also be a good target for financing through loans, particularly local loans guaranteed by DCA. They can construct schools, improve schools, etc. with the funds and repay with revenue received from tuition (even low tuition). However, private schools are outside of the Morocco Mission Education SO goals.

Health

In the health sector, a possible use of a loan to the central government is contraceptive procurement. The SO1 has estimated that after 2001, the Moroccan government will need $7 million a year to finance contraceptive procurement. The Ministry of Finance could take a loan (DCA) of $35 million over 5 years, which it would transfer to the Ministry of Health to purchase contraceptives. It should be noted, though, that currently the DCA Credit Review Board favors non-sovereign loans over sovereign loans, and favors guarantees over direct loans in general.

To pursue this option, the Health SO should undertake a small study to assess: 1) the financial resources needed to continue the contraceptive procurement program; 2) what the Ministry of Health's other options are for financing contraceptive purchase – the potential availability of other grant funds from other donors or highly subsidized loans; and 3) whether loan financing for this activity fits within the budget "envelope" for the Ministry of Health (fits within the MOF's intended allocation to the MOH). The Health SO should also contact the Credit and Investment Office in Washington's Global Bureau (G/EG/CI) to discuss the potential project and get a read on the likelihood of its being approved for DCA financing.

Another option for DCA or MSED financing in the health sector is a microfinance program that would assist private sector doctors in establishing offices in small towns. Two alternatives exist here – 1) a loan portfolio guarantee to a local bank that would lend to doctors, perhaps through a medical association or with that association's technical assistance, or 2) a loan to a bank which would then lend to doctors, although currency risk would then become an issue.

A local currency loan portfolio guarantee to a bank for onlending to private sector doctors fits well with both MSED and DCA objectives. In order to pursue this, SO1 should meet with well-positioned local banks to discuss their interest in making loans to doctors wishing to establish or expand private practices in Morocco. SO1 should also contact the Credit and Investment Office in Washington to discuss the project idea and obtain assistance in the early stages. If the loans to be made to doctors are small, the project will be appropriate for an MSED guarantee (the current benefit of MSED is that it is now operational); if the loans are larger, DCA would be appropriate.

Economic Growth – Microfinance and Agribusiness

The Economic Growth SO currently has an ongoing microfinance project for entrepreneurs. This project has, to date, been supported solely through grant funding. However, as the NGO originating and servicing the loans (Al Amana) builds its track record, the project can be weaned from grant financing. A number of possibilities exist – Al Amana can obtain a local currency loan from a local bank or banks, and DCA or MSED can guarantee that loan(s); Al Amana, if approved as an institution allowed to raise funds on the local capital markets, can issue a bond, and DCA or MSED can guarantee that bond; or a DCA or MSED loan can be made directly to Al Amana (although it would then take on the currency risk).

In the economic growth as well as the housing sector, a potential use of DCA financing is a pilot housing finance project. An NGO (perhaps Al Amana since it has microfinance lending experience) or a state-owned enterprise such as ANHI would borrow DCA funds (either a direct credit or a local loan with a US guarantee) and would onlend to people wishing to improve or expand their houses. The loans made by the housing microfinance institution would be small, approximately 3 years in term in amounts ranging from $5,000 to $10,000. The idea would be to start the project, as a pilot, in one or two cities, perhaps Tetouane, Fes, or Taza (Al Amana is currently operating in Tetouane and Fes).

Initially, an an NGO or consulting firm experienced in microfinance housing lending would provide personnel to work with Al Amana or ANHI. They would work through field agents of the local organization (Al Amana or ANHI) and would develop loan forms in Arabic.

A housing microfinance project would be a new component of an ongoing project of the Economic Growth SO. The SO would incorporate this new activity within their overall microfinance project.

Another potential DCA project within SO3 is the establishment of an agribusiness export credit line in a local bank. A DCA direct loan, in dollars, could be made to a local bank which would then onlend in dollars to agribusiness exporters. This would be a good test case for using DCA loans, rather than guarantees, since there would be no currency risk issues involved.

For each of these project possibilities, the Mission should contact the Credit and Investment Office in the Global Bureau and follow the preliminary design steps described in the report and in the DCA Annex.

Municipal and Infrastructure Finance

The six main possibilities for DCA financing in the areas of municipal and infrastructure finance, are loans to the FEC, to a private bank, to ONEP or to RAMSA, a guarantee on a bond issue by ONEP, or a guarantee of a private bank's loan to a Regie.

The FEC borrows on the local market and from international lenders/donors and onlends to communes, urban communities and Regies. Currently the demand from their clients outweighs the FEC's supply of funds. One problem with a DCA direct loan to the FEC, however, is currency risk. Because it currently lacks an adequate mechanism to manage exchange rate risk, the FEC is wary of borrowing funds for medium or long terms unless the loan carries an extremely low interest rate. Furthermore, there is no need for the FEC to receive a DCA guarantee for a loan from a local bank since it itself is a bank and can borrow easily enough. Except for through the capital markets, it avoids borrowing locally since the rates are high.

One possibility is for the FEC to accept a US dollar DCA loan and swap with a private bank for local currency. The local private bank would use the dollars for dollar loans for export financing. The FEC would then onlend dirhams to the municipalities. The private bank would be responsible for repaying its loan and interest in dollars, while the FEC's repayments would be in dirhams. BMCE has indicated an interest in such a scheme if the dollar loan carries an attractive interest rate (less than 1 or 1.25 points over market). If the interest rate is good, then BMCE says it can reduce its margin for its clients. BMCE indicated that such a swap would be possible for short, medium or long-terms.

A private bank is also a candidate to receive a DCA loan or guarantee. BMCE, for example, has analyzed some Regies and their infrastructure projects and is very interested in lending if they can get a guarantee. In particular, they have said that the Regie of Tetouane, which handles water and electricity, is well-managed and a strong candidate for a loan. With a US guarantee, they would be more than willing to make such a loan.

Another option for DCA financing in the municipal infrastructure sector is a loan to ONEP. They have indicated that they would be interested in working with the US. Given the nature of the projects they work on, ONEP has said that DCA financing could more easily be used for potable water projects than for sewerage. However, a loan at US market rates would be appropriate for water projects. There would, however, be an issue of currency risk that ONEP would have to cover. Another option for ONEP would be a DCA guarantee on a local bond issue by ONEP. ONEP would raise funds on the local capital market, and with the DCA guarantee could likely offer a lower rate than it would have to otherwise, and/or attract more potential investors.

Finally, another option for DCA financing in this sector would be a loan to RAMSA, the Regie Autonome of Greater Agadir. RAMSA is currently undertaking a large waste project, involving the construction of collection canals, the installation of stormwater drains, and the construction of a wastewater treatment plant. The first phase of this project is to be financed by CFD and BEI. However, there remain outside towns that will not be serviced by this system; a DCA loan can be used to finance wastewater removal systems for these towns. RAMSA is developing projections for the costs of these smaller projects. It would also be feasible for RAMSA to issue bonds on the local market with a DCA guarantee.

The report which follows describes in further detail the conditions in which the USAID/Morocco Mission is working, the state of the financial markets and public finance system, regulatory changes that affect the financial system and municipal finance, and the possibilities of credit financing as a development tool in Morocco.

1. Introduction

The Government of Morocco (GOM) is currently undertaking a series of policy reforms which will result in the decentralization and deconcentration of powers (decision making, budgetary, etc.) from the central level to the level of the sixteen administrative regions which make up the country. This decentralization opens up the potential for new and innovative relationships between the public and private sectors in the realm of project development and finance. Historically, USAID has worked across sectors to support GOM decentralization policies. USAID is interested in the potential of municipal or regional finance mechanisms for a number of development objectives including infrastructure development, health service provision, increased access to credit and microfinance for enterprise development, etc. This report assesses Moroccan public and private financial markets, the potential for local government finance and regional development, and the further potential of credit as a development tool in Morocco.[3]

2. Assessment of Local Government Entities

In order to assess the potential of credit as a tool to meet Morocco's development needs on a regional and local level, one must first examine the structure of regional and local government.

2.1 Levels of Government

The Kingdom of Morocco, a sovereign Muslim state, is a democratic, social and constitutional monarchy. Successive Moroccan Constitutions, of 1961, 1970, 1972 and 1996 have retained the same constitutional institutions: the Monarchy, the Parliament, and the Government.

The King is the Head of State and the Constitution grants him significant powers. The Dahir, or Royal Decree, is the legal instrument that enables the King to carry out his functions; Dahirs are countersigned by the Prime Minister, with the exception of certain special cases (appointments of the Regency Council, the Prime Minister, the Constitutional Council, dissolution of Parliament, etc.).

The King appoints the Prime Minister and, on the basis of the proposals from the latter, appoints the other members of the Government. The King chairs the Council of Ministers and makes civil and military appointments.

---

[3] Much of the information on municipal finance resources and the structure and management of municipalities was obtained from the October 1997 TSS Kleimo and Sbihi report "Improved Municipal Financial Management: Current Practices and Lessons Learned" and the September 1998 draft UDA report by PADCO. Much of the information on USAID and other donor activities was obtained from the February 1998 Soos report "Donor Coordination and USAID Assistance in Morocco."

The 1996 Constitution set up a bicameral parliamentary system. Several additional measures were taken in 1997 to put these initiatives into reality. Parliament adopted an enabling Law (32-97) for regional representation and formation of the Chamber of Councilors. Thus, the Parliament is made up, under this Constitution, of two chambers -- the Chamber of Representatives and the Chamber of Councilors. The 333 members of the Chamber of Representatives are elected for a period of five years by direct universal suffrage. The 270 members of the Chamber of Councilors are elected for nine years, renewable in thirds every three years. This Chamber comprises:

- three-fifths members elected in each region by an electoral college made up of representatives of local communities, thereby giving regional officials decision-making powers with which to participate in general country policies at the national level;
- one-fifth members elected in each region by electoral colleges made up of people elected by chambers representing trades/professions;
- one-fifth members elected on a national scale by an electoral college made up of representatives of wage-earners (Art. 38).

The Government is the second branch of the executive power. It is the supreme executive and administrative authority of the State, and meets under the chairmanship of the King. The Government consists of the Prime Minister and the ministers and is answerable to the King and to Parliament.

The Prime Minister is responsible for the execution of laws, their proper application and the due operation of the civil service, and for co-ordination of ministerial business. He is the initiator of laws, which he has to submit to the Council of Ministers and to the two Chambers of the Parliament. He chairs the Government Council and is appointed by the King.

Until recently, the structure of government organization in Morocco functioned as a highly centralized system of decision making by the central government and execution by local governments under the supervision of central ministries operating through their local agents. Since 1976, and particularly more recently, this structure has gradually decentralized greater authority to local units of government.

2.1.1 Regions

A regional approach to territorial administration and development was first introduced by the Law of June 16, 1971. Seven economic regions were initially established that attempted to group together provinces with clear geographic, economic, and social relationships. The intention of these groupings was to stimulate greater and more equitable development among provinces. The actual boundaries of the economic regions, however, often reinforced rather than diminished provincial differences. The lack of genuine regional institutions also meant that the regional implications of the law were not well understood or applied. Work at the regional level continued to be done through central government initiatives and decisions.

While successive national development plans emphasized a range of important policies and programs to strengthen the regional approach (reduction of inequalities between regions, rural development, decentralization and deconcentration, regional development, promotion of development poles, etc.), the regional assemblies and their elected representatives remained too institutionally weak to follow up, evaluate, examine, or provide any real input into the management and development of their region.

After a period of relative inactivity, serious focus is now once again being placed on establishing regional authorities. The new process really began when the regional authorities were written into the Constitution by the referendum of September 4, 1992 and given the same legal status as local authorities. Regional authorities were then further strengthened by the referendum of September 13, 1996, which approved a bicameral Parliament and Chamber of Councilors, as was discussed earlier. The establishment of this second chamber has significantly advanced the process of decentralization by providing a means for regions to present their points of view at the highest levels of government.

The Law (1-97-84) of April 2, 1997 amended the Law of 1971 and made several important changes in regional organization. While it reinforced the role of Regional Councils, it also kept in place the executive power of the governor located in the regional capital. A subsequent decree on August 17, 1997 fixed the number of regions at 16, their capitals, their boundaries, and the number of representatives to be elected. Members of the regional councils were elected in October 1997 and provisional budgets established for the first six months of 1998 to get their activities under way.

The actions of 1997 make it clear that the long and rather tentative first phase of the regionalization process has ended and that a second, more serious and active phase has begun. Regionalization is likely to accelerate as these new regional councilors begin to impose their ideas in parliament.

A regional development department has also been created under the Prime Minister’s office in order to promote and coordinate the works, studies, and actions that concern the new regions and, in general, to assist them in promoting their economic development.

As was touched upon above, regional administration now has two essential components: the regional council with deliberating and decision making powers and the regional executive headed by the governor of the province or prefecture that headquarters the region. The president of the regional council has considerably more power in the functioning of the regional system than does the president of the provincial council who is subject to the role of the governor.

The regional council consists of presidents of the different prefectoral and provincial councils, as well as representatives from professional organizations within the region. At the same time, governors from the prefectures and provinces are responsible for ensuring the position of general secretary and the linkages between the regional council and local and central authorities.

The regional council includes at least seven permanent committees that oversee: 1) finance and budget, 2) planning and regional development, 3) economy, employment and social development, 4) health and hygiene, 5) agriculture and rural development, 6) town planning and environment, 7) education and culture. The council has been given three areas of authority:

- Tasks and functions specifically assigned to it: responsibilities relate to two main categories -- public finance and budget for the region; and economic and social development. The regional council is responsible for the elaboration of an economic and social development plan for the region that conforms to national development plans, regional development plans, and actions to generate employment, professional development, sport and private investment.

- Tasks and functions transferred to it: functions that can be transferred to the regional council include public facilities of regional interest, realization and maintenance of hospitals, secondary schools, training of local staff within the region and other actions agreed upon through a signed contract.

- Areas in which it is allows to make suggestions: the regional council can also make recommendations concerning broader regional development actions, service management and organization, government investments in the region, regional planning policies and the location of universities and hospitals.

A number of drawbacks are inherent in the basic constitution of these regional councils. First, the council meets only three times a year for only for a few days at a time. The council has only very limited staff for its own administration and its financial resources remain very uncertain and insufficient given the existing deficits to be addressed in each of the regions. All of these conditions make it difficult for the regional council to seriously consider the major economic, social, and environmental development issues facing the region.

Deliberations also continue to be made under the governor, which may have a dampening effect on the establishment of a regional identity given the governor's role as representative of the central government. While this situation may have been acceptable when the regional council was merely a consultative body with only minor involvement by elected officials, it is likely to change as the new councils begin to develop real decision-making powers. Little regionalization will take place as long as there are no changes in the administration responsible for executing services and its relationship to central government administration.

The region is a third level of territorial management above those of the province and communes. Whereas the province and communes have established working relationships over a period of many years, the region is a new administrative unit that will have to define its own relationships with other levels of administration. One of the advantages of working at the regional level, however, is that it allows for a more productive integration of economic, social and environmental policies. Other advantages exist in terms of planning, economic development, addressing social issues and equity.

The regional council needs to work with the municipalities and local authorities involved in urban development without reducing their respective areas of influence. A framework of mutual responsibility and dynamic partnership is required.

2.1.2 Municipalities and communes[4]

At present, under the 16 regions, there are 44 provinces, 24 prefectures, and 1,547 communes of which over three-fourths are rural (249 municipalities or urban communes and 1298 rural communes). Everyone resides within the boundaries of a commune; therefore, the boundaries of all communes are contiguous. A rural commune is one without a defined commercial center. An urban commune is one which has a defined urban center; however, it may also include small clusters of residences or lone dwellings which lack an urban character on their own. In the case of the larger urban centers or cities, these may comprise several urban and rural communes, each with a defined population as well as its own local government; these are termed urban communities or "*syndicat des communes*" and are a level of government between the prefectures and provinces and the communes. While the regions, prefectures, provinces and communes ("territorial collectivities") are defined by the October 1996 Constitution, the urban communities are determined by a Decree issued by the Ministry of Interior and governed by the same law as the commune -- "La Charte Communale" of 1976. Currently there are 14 urban communities in Morocco[5].

Urban communities report directly to the Wali of the region. For example, the city of Meknes is actually formed by six communes and the urban community includes the six communes. There are are two prefectures in the region that includes Meknes -- Prefecture Ismailia which has a governor, and Prefecture Hamrya whose governor is also the Wali for the region. All correspondence to the MOI from the urban community's president must go through the Wali.

Urban communities' resources derive from the taxe d'edilité, 50percent of which is contributed by the member communes, and from other taxes or fees that are generated by inter-communal services.

[4] Note that although strictly speaking, "municipal" refers to issues related to municipalities/urban communes, for ease of reading, the word "municipal" in this report is often applied to both urban and rural communes when describing administrative issues or finance.

[5] The urban communities and the number of communes they comprise are as follows: Casablanca (27), Rabat (5), Fes (5), Marrakech (5), Meknes (6), Skhirat-Temara (2), Tangiers (3), Oujda (4), Safi (3), Tetouane (2), Agadir (4), Taza (2), Kenitra (3), Sale (5).

Each commune has an elected president and council which serve six-year terms of office. The size of the council is based on the commune's population, with a maximum of seven. Municipal responsibilities are determined by the Ministry of the Interior and may be communicated in a proclamation of the King that is known as a *dahir* or through administrative circulars issued by a Ministry. Following the 1976 decision to convey greater responsibilities to municipal governments, a dahir was issued which delineates the responsibilities and powers of the communes. The dahir notes that communes have both a "moral personality" and "financial autonomy" in their management.

The president and council must meet in public sessions, with their actions posted for public access. They are charged with deciding on measures that lead to economic, social, and cultural development and for the formulation of local development plans which are oriented to the achievement of national development objectives. This includes the expectation that the local council will propose to the central administration those measures which they define as necessary to contribute to development but which exceed the capacity and resources of the municipal government. The council is responsible for the identification of projects and services needed as well as for their planning, implementation, and management.

The relationship between the central administration and the local municipalities continues to evolve. Major responsibilities have been transferred to the municipalities in diverse areas, notably the management of human and financial resources and the development and maintenance of infrastructure. The majority of functions exercised by the municipalities report to responsible central government officials in the Ministry of the Interior. This supervision is inscribed in the system of *tutelle*. The objective of this administrative supervision by the Ministry is one of checks on municipal provision of basic local needs with regard to essential services. This is particularly important with respect to the establishment of priorities by municipalities in light of tax reform (discussed later) and its financial consequences.

2.2 Structure and Problems

As was discussed in the previous section, the key components of local government are the province and prefecture and the commune.[6] The Communal Charter of 1960 basically prepared the way for decentralization and a greater focus on local administration. Three years later, decentralization was extended to the provincial level. The communal reform of 1976 attempted to open up the political process and to revise the technical one, establishing new local administrative units that were to be able to take charge of the economic and social development process.

[6] The urban communities are important as well, but these are governed by law rather than constitution and only apply in the largest urban areas: Casablanca, Rabat, Fes, Marrakech, Meknes, Skhirat-Temara, Tangiers, Oujda, Safi, Tetoune, Agadir, Taza, Kenitra, and Sale.

Meanwhile, municipalities and communes in Morocco have always been managed as traditional administrative structures. Little improvement or modernization has been made in the way that they function. Most of them remain very poorly equipped in terms of modern office machines and materials. More recent difficulties include the fact the many large cities now include more than one municipality. At the other end of the scale, very small urban communes do not have the institutional structure required to fulfill their responsibilities.

The existing organizational structure for local government is weak at best. The means by which responsibilities, powers and means are distributed is not very stable nor sustainable. This applies not only to political changes but also to internal conditions.

Although a standardized organization chart for municipalities has been proposed by the Ministry of Interior, both the official and actual organization of municipality staff differ greatly from the proposed arrangements. The administrative organization of municipalities and rural communes tends to be very flat, with little sense of hierarchy or chain of command due to very limited staff. Most services consist of several agents working in the same office and undertaking the same or very similar tasks.

The imbalances in municipal organization and staff produce very unequal distributions in terms of means and resources, municipal activities that take place at different rates, poor use of personnel, and frequent conflicts and animosities among staff members within the same overall administration. For this reason, official organization charts never reflect the real manner in which municipalities are organized or perform. The restructuring and reorganization of these municipalities also occurs on a continual basis, with elected officials frequently intervening and attempting to orient the manner in which municipalities function.

Furthermore, current municipal accounting systems involve only simple ledgers of expenses and revenues. They do not include any real financial planning, evaluation or control of the actions taken. Local governments need to change financial management practices from the simple accounting of expenses and incomes to more advance financial planning and subsequent evaluation.

Municipal systems currently face a number of problems that include the:

- over-involvement of elected officials in the day-to-day operations and management of the municipality, with a tendency to intervene at will in the normal operations of the municipality, rather than focus on broader development issues for the city;

- absence of a clear definition of respective roles and rules, duplication in responsibilities and tasks, individuals with multiple roles that result in conflicts of interest, a waste of human resources and the under-utilization of existing executive capacities;

- poor communication and lack of computerized records that lead to insufficient circulation of information between municipal entities and the tendency for each department or office to try to resolve problems in their own way or to redo tasks that have already been done elsewhere;

- lack of administrative checks, leading to delays in work; for example, contracts sometimes come through without the required signatures and must be reprocessed;

- poor recovery rate (for example, Rabat, a large, relatively well-managed municipality has a 25percent global rate of recovery). There are concessions that don't pay their fee and yet the concessions are regranted. There are too few employees engaged in collection, and those that are assigned that role are not necessarily appropriate;

- poor execution of projects, with approximately a 50 percent rate of realization, due to lack of trained professionals and poorly conceptualized projects;

- decision-making processes that are largely centered around the president and vice-presidents of the municipal councils, but that lack the technical support of the relevant offices, thus leading to decisions that do not fully consider the context of their application or the coordination required either within the municipality or with other local partners;

- general lack of any future vision or planning in the provision of infrastructure and public services, but rather quick-fix solutions undertaken by elected officials to obtain short-term results.

Certain reforms that can be undertaken in municipalities include the following:

- improving managerial capacities among the staff of municipalities, training them in the technical aspects of operating a local government;

- developing managerial capacities among elected officials that would include exercising their prescribed roles as elected officials, sensitizing them to the proper operation of municipal institutions, and ensuring their access to sound management information about their city's needs and potentials;

- re-sizing municipal structures to make better use of available human resources. There are generally too few staff to maintain effective working units based on standard organization charts (although some municipalities, like Rabat, have too many personnel -- approximately 1,200 when they feel perhaps 25 percent of that could do the job);

- modernizing municipal office infrastructure and operations – computerization, record-keeping, accounting;

- improving communication both within the municipality and with potential partners. This would include greater outreach to population groups with whom the municipality intends to work, NGOs and other development groups, as well as surrounding municipalities or communes;

- modernizing administrative structures to suit the size and activities of municipalities.

USAID has been working with municipalities to improve their structures, impart needed skills, and update their financial systems. This assistance is crucial given the trends of decentralization and deconcentration. As is discussed in further detail later, local governments are not yet equipped to handle the financial and development responsibilities that have been bestowed upon them; thus, continued strengthening efforts are needed.

3. USAID Strategic Objective (SO) Structure and Programs

USAID’s program in Morocco focuses on four development areas: population and health with a focus on preventative health care and family planning (SO1); environment through water resources management in the agricultural, urban and industrial sectors (SO2); expanding economic opportunities for poorer Moroccans through small business development and employment generation for the poor (SO3); and expanded primary educational attainment for girls in rural areas (SO4). These SOs, as well as the potential for using credit as a tool to further their goals, are discussed below.

3.1 SO1

USAID has been the predominant donor in family planning and maternal child health for nearly 30 years in Morocco. USAID’s approach in SO1 has been to integrate family planning into health service delivery, and to focus on access, quality and sustainability of integrated health services. The evolution of national public and private systems for family planning, reproductive health, safe motherhood, AIDS/STD and child survival have been heavily influenced by USAID.

USAID has provided leading-edge models, best practices and strategic direction in numerous aspects of family planning and maternal child health service delivery. For example, USAID has been the lead donor to finance and to shape and influence the family planning program in Morocco. This includes a wide variety of aspects relating to the design of the program as it evolved over the years, including integration with maternal child health services, and the creation and support for an NGO, the Moroccan Family Planning Association, to address public awareness and to provide private service delivery. USAID has also been the key donor to identify, shape and influence child survival as a priority health focus, including preventative programs. Furthermore, through USAID efforts over the years, service delivery has been effectively integrated even at the periphery, with notable progress over the past five years. The integrated approach has succeeded despite the persistence of vertical programs at the central level. Thus, while vaccinations, diarrhea, respiratory diseases, pregnancy, prenatal/neonatal counseling and family planning may be vertically segregated at the central level, public health clinics more effectively integrate these areas when addressing their clients.

USAID has been instrumental in encouraging deconcentration and decentralization of health services to strengthen local capacity and problem solving. However, although provinces are now implementing a number of activities, financing still is determined at the central government level.

By the year 2000, USAID’s Population and Health program will phase out of bilateral assistance, while continuing support from the Global Bureau through central programs. Currently, the program is in a transition phase. The transition focuses on GOM and private sustainability interventions, and on assuring appropriate support for important activities through other donors. Financial sustainability represents an immediate challenge, since donors provide over half (and some estimate up to 80 percent) of family planning program costs, compared to donor support of 3 percent for the overall Moroccan health budget. USAID has been the predominant donor for family planning, and is the only donor to provide assistance directly to the Directorate of Family Planning within the Ministry of Public Health.

As USAID phases out its large bilateral mode of operation, the EU, World Bank and African Development Bank remain the key donors on a comparable scale. The World Bank and AfDB are likely to provide support for infrastructure and equipment on a large scale. Overall health policy and strategy will continue as the domain of the World Bank and EU. The UNFPA may replace USAID’s role in family planning policy, strategy and demography/census areas.

However, in preparing for the cut-off of bilateral support, USAID’s SO1 might want to consider replacing some of its grant operations with direct lending or loan guarantee facilities. In particular, a loan to the Directorate of Family Planning, through the Ministry of Finance, is a possible source of financing for the purchase and distribution of contraceptives and other family planning efforts. Furthermore, loan guarantees for local currency loans can be used to support lending to private sector physicians establishing practices.

The FY1998 Appropriations Act gives USAID the general authority to provide credit assistance for any of the development purposes of the FAA. The Development Credit Authority (DCA) is a financing authority that enables USAID managers to choose financing tools such as direct loans and loan guarantees when developing programs and projects. Furthermore, USAID currently has a Micro and Small Enterprise Development (MSED) program which authorizes microfinance loans to non-sovereign borrowers. Options for using credit by SO1 are discussed in further detail in the USAID Credit Financing section of this report.

3.2 SO2

USAID has been active in water resources management for decades, initially through agricultural development programs, and subsequently through urban housing and energy demand/clean technology. When SO2 was formulated in Morocco in 1994, USAID drew on considerable experience to leverage its resources and to promote “best practices” through GOM and donor activities.

USAID’s water resources management program has a cross-sectoral and integrated water resources management approach that focuses on sound water resources management. With declining resources, USAID has sought to leverage its resources with the GOM, Moroccan beneficiaries and donors. USAID’s pilot approach for interventions focuses on demonstrating successful technologies which can be replicated by others.

USAID’s program views water as a unitary resource which must be managed across the rural, agricultural, urban, residential, commercial and industrial sectors. Water quality and water quantity are viewed in an integrated fashion, with pollution contributing to scarcity and to health problems. Sustainable water resources management in Morocco requires first, an improved policy, regulatory and institutional framework; second, improved environmental technologies; and third, broadened public participation.

With regard to urban environment improvement and development, USAID was the first donor to work in municipal urban infrastructure with the state-owned municipal infrastructure bank, Fonds d’Equipement Communal (FEC) and was instrumental in creating the National Shelter Upgrading Agency (ANHI). USAID’s support for ANHI and FEC has resulted in impressive work in the urban sector. Indeed, the “best practices” gleaned from this collaboration are being integrated into government policy, and factored into other donors’ programs.

Furthermore, USAID has been working with urban communities, such as Meknes, to prepare them for partial privatization of municipal infrastructure services. The trend in Morocco is for such services to switch from local government hands to the private sector, generally through a public-private partnership (PPP) which can take the form of a management or service contract, a concession, a build-operate-transfer (BOT) or a build-own-operate-transfer (BOOT), depending on the infrastructure service in question. In Meknes, USAID worked with the urban community to prepare and issue the terms of reference for a management contract (“gestion deleguée”) for solid waste collection and disposal, and also assisted in the preparation of an agreement executed between the urban community and the comprising six communes. The work done by USAID with Meknes is now being used as a model for other cities undergoing the same process.

As the financing of water and urban development projects continues to be deconcentrated/decentralized by the central government going forward, new project design and financing mechanisms will need to be created by USAID. This sector may be particularly appropriate for credit financing, through US loans or local loans with international guarantees. Options for such financing, for example loans to FEC or a regional utility authority or guarantees to private sector banks for lending to regional utility authorities or municipalities, are discussed in the section on USAID Credit Financing.

3.3 SO3

USAID has been a key donor in the private sector for over a decade. USAID achievement has been characterized by a series of innovative private sector programs that have marked the evolution of Morocco's private sector. Although U.S. assistance levels are declining, USAID has managed existing pipelines in accordance with a strategy that maximizes the impact on each area of focus. USAID continues to innovate and to test pilot approaches in areas such as microenterprise.

USAID has provided innovative approaches, viable institutional models and strategic direction for numerous private sector activities. Most of these activities were innovative and risky, embarking in areas where there was little or no prior experience within Morocco. For example, USAID has put microenterprise finance on the map in Morocco through a number of studies, culminating in a pilot project.

Also, USAID has worked to strengthen agribusiness export promotion in an effort to render Moroccan agribusiness companies more competitive and more capable of maintaining a competitive edge as they face increasingly open competition from Europe.

In order to further leverage USAID funds directed towards these efforts, the Mission may want to consider supporting a DCA or MSED guarantee of a local bank loan to a microfinance institution(s) to continue the microenterprise/finance project already underway, to add a housing improvement loan component, or to work with SO1 to help finance entrepreneurial private doctors. A DCA loan directly to a microfinance organization is also a possibility, given that the institution could potentially onlend at a rate high enough to cover exchange rate risk. Also, the Mission may want to consider a DCA direct loan to a local bank who could then onlend in dollars to agribusiness companies for export financing.

3.4 SO4

USAID is the Government of Morocco's newest partner to support a renewed commitment to increase access to and attainment of basic education for rural girls. Since the initiation of a Target of Opportunity in USAID/Morocco's 1995 Country Strategy, USAID has collaborated closely with the GOM, donors and other partners to assure an appropriate role for each participant.

During the brief time in which USAID has been focusing on education for girls, the Mission has had some influence in coordinating and working with a number of donors on this initiative. It has also identified NGOs for joint development of action plans to address constraints in pilot provinces.

USAID is working collaboratively with the Moroccan and donor partners to develop a model for rural girls' education. The basic model has gained broad acceptance as a sound approach that will evolve and be refined over time. This model is expected to become the Moroccan model and to be replicated by other donors, as well as integrated into national education policy.

USAID/Morocco's goals and programs in education do not currently lend themselves to credit financing. If, however, under the new Mission strategy SO4 begins to focus on private education as well, there may be some appropriate uses for DCA financing. Furthermore, if the central government is unable to fully fund its education programs through grants, the Ministry of Finance may be interested in obtaining a US loan.

4. Financial System and Reforms

To further assess the Moroccan financial system's capacity for financing development projects that have been targeted by USAID, and in particular to finance the needs of regions and municipalities, this report reviews the Moroccan private and public financial system, the reforms that may affect these systems, and the capacity of the local governments to borrow.

4.1 Financial Markets

For some years, Morocco has been engaged in a broad program of liberalization and modernization of the banking and financial system. Measures have included the abolition in 1991 of credit ceilings, the strengthening in 1992 of monitoring of the solvency of banks (including the application of Cooke ratios), the introduction of a new banking law in July 1993, reinforcing the status and independence of the monitoring authority of Bank Al-Maghrib, the abolition in February 1996 of the restriction of interest rates on loans and the creation of an inter-bank market in foreign currencies in June 1996 (the interest rates applied to bank deposits are still controlled by Bank Al-Maghrib and by the Groupement Professionel des Banques du Maroc, GPBM), and reduction of mandatory holdings of public sector bonds to 10 percent of deposits (to be eliminated in 1998).

The measures taken to strengthen prudential control focused on capital adequacy and stringent loan classification and provisioning for non-performing loans, exceeding the Basle Code requirements. A system of deposit insurance was created. In addition, the cooperative banking network created an internal insurance fund for unforeseen losses. The share of non-performing loans in the total has remained broadly stable in recent years, at about 10 percent, and they are provisioned to about two-thirds of their face value. Foreign exchange risk exposure is restrained by tight limits on net open positions of banks.

The law of 1993 allowed the development of a legal framework applicable to all credit institutions and the extension of their activities to new fields such as goods and property leasing, factoring operations, asset management and the provision of services to facilitate the creation and development of enterprises.

Three laws regarding the securities markets were also passed in 1993. They served to restructure the legal framework of the capital market and in particular, the Casablanca stock exchange. The exchange has been privatized, a securities commission has been created, the laws regulating brokerage firms have been strengthened and new rules have been introduced to permit the creation of collective investment schemes (OPCVM).

The law of July 1993 also reallocates the responsibilities formerly held by the Conseil du Crédit et du Marché Financier with the creation of:

- Conseil National de la Monnaie et de l'Epargne (national monetary and savings council) which is consulted on monetary and fiscal policy;
- Comité des Etablissements de Crédit (credit establishments committee) aimed at managing the rules for credit establishments; and
- Commission de Discipline des Etablissements de Crédit (disciplinary commission for credit establishments).

With the goal of improving the relationship between credit establishments and their clientele, the law consolidates prudential measures and fosters the notion of greater transparency.

As in many countries, bank lending is the primary source of finance in Morocco for the private sector, but a corporate bond market is emerging. There are 19 banks and 54 finance companies, mostly owned by banks. The largest four banks hold about 70 percent of total assets. Improvements in accounting and disclosure standards, staff training, and adoption of international banking practices have been implemented, and foreign banks play a significant role, mostly through participation. Short-term credit is dominant and longer-term facilities and funding instruments are only now being developed, while foreign exchange credit has little importance. Intermediation margins are high, as average interest rates on credits are about 9 percent compared with the average cost of funds at 4 percent; there is no interest on sight deposits and competition is weak.

Five banks are still controlled by the State:

- BNDE, Banque Nationale pour le Développement Economique, which grants long-term loans to industry;
- CIH, Crédit Immobilier et Hôtelier, which finances investments in the building and tourist sector;
- CNCA, Caisse Nationale de Crédit Agricole, which extends loans to the agricultural sector;
- CPM, Crédit Populaire Marocain, which offers financing for small and medium-sized companies; and
- FEC, Fonds d'Equipement Communal, which grants medium to long-term loans to municipal governments and authorities for infrastructure development.

The four specialized financial organizations, i.e. BNDE, CIH, CNCA, and FEC, are now subject to the new banking law, which affords them "commercial banking status."

Three state-owned financial services companies are slated for privatization. They are:

- Banque Central Populaire (BCP) -- legal restructuring is currently in progress; a law is required to clarify its relations with the regional affiliates owned by independent cooperatives;

- BNDE -- currently quoted on the stock exchange; a further sell-off in several tranches is planned on the stock exchange, one to an anchor shareholder and another to the employees, the legal treatment of existing state guarantees for its foreign debt is still pending;

- CIH -- also quoted on the stock exchange, is restructuring its portfolio of property loans in preparation for privatization.

Bank Al Maghrib (Central Bank of Morocco) is a public entity established in 1959, which has been granted legal status and financial autonomy. Bank Al Maghrib has several roles. It is responsible for credit distribution, limitation and refinancing mechanisms. The bank's primary responsibility is the regulation of monetary policy. It is also a financial and management agent for the country's exchange reserves, and able to carry out all the transactions of a commercial bank. At the same time, Bank Al Maghrib carries out the control of banking activities; it monitors specialist financial organizations, and in terms of control, constitutes the only effective authority to which banks are subject. As the central bank, it issues paper money which it has the authority to print.

Most of the capital of the commercial banks in Morocco is held by private sector shareholders, of which foreign shareholders make up a significant proportion.

In addition to banks, Morocco has several specialized financial institutions. These include the following:

- Caisse Marocaine des Marchés (CMM) is a limited liability company. It authorizes banks to make loans to finance public or quasi-public contracts.

- Caisse de Dépôts et de Gestion (CDG) manages certain deposits from public or private sources, and also from provident societies. CDG collects and directs savings, grants and loans and makes advances to local authorities.

- Bank Al Amal finances investment projects for Moroccan nationals who are resident or have resided abroad.

In addition to financial institutions, there are other financial intermediary institutions such as the Treasury, Caisse Centrale de Garantie, Caisse Nationale de Sécurité Sociale, insurance companies, and leasing companies.

With regard to insurance, current insurance regulations are based on two basic texts: a) the Decree of September 6, 1941 relating to State unification with respect to insurance, reinsurance and capitalization operations; b) the Decree of November 28, 1934 relating to the insurance contract. Other texts also structure the activities of this sector, including the Decree relating to the law of October 9, 1977 on the presentation of insurance operations and on the practice of the profession of insurance agents. A new insurance law is currently being drafted.

As discussed above, Morocco's financial system has benefited over the past several years from substantial liberalization coupled with the implementation of strengthened prudential control of banks. Overall, the banking system appears to be sound and well prepared to play a more active role in the future. Problems pertaining to nonperforming loans of state specialized banks (agriculture, tourism, housing) are being addressed forcefully by the authorities. The banking system would benefit from greater competition. In this respect, the planned privatizations may be beneficial, as would be the modernization of the national savings bank and postal checking system. Important remaining issues for reform are: completing the accounting (and disclosure) reform; strengthening the secondary market for liquid assets, including an interbank market; improving the judicial system for loan collection procedures; and reforming the regulatory framework for the insurance industry. Furthermore, it would benefit the financial markets to promote private savings through the development of medium and long-term lending instruments such as housing loans.

4.2 Public Finance

In discussing public finance, this report focuses primarily on municipal finance, and the sources of funds available to municipalities and regions for project development.

In brief, though, on the national level, the investment budget has reached 23 percent of state expenses. The state expended an average of 2,500DH per inhabitant in 1996, of which an average of 625DH were committed to investment. The respective amounts in U.S. dollars were $253 and $71. Within the investment budget itself, 35 percent goes to the ministries and other agencies that are responsible for development and the provision of facilities across the country, while 13.4 percent goes to ministries involved in social development. To these sums are added the gross savings of local governments, roughly 5 billion DH in 1996, or about 190 DH per person.

Taxes are levied both by the central government and by municipalities, with national income tax, company tax, and the TVA (value-added tax) the principal sources of state revenue. A Ministry of Finance representative collects the municipal urban, sanitation, and business taxes that are shared with the state, while an additional 37 local taxes are charged to provide additional revenue for the operation of local government.

4.2.1 Management of Municipal Finance

Local governments throughout Morocco have a rather low level of autonomy, due to the considerable amount of central government supervision built into the administrative system. Even though recent laws have opened up significant areas for local initiatives, most municipalities lack the experience to act on them and have not accepted a more dynamic role in their own development.

Furthermore, both current decentralization efforts and the application of the electoral system at the municipal level have frequently weakened the role of municipalities. The members of the municipal council are not elected by lists, but according to districts and on an individual basis. Because of this electoral approach, municipal solidarity is weak and often creates difficulties when attempting to adopt the budget. Narrow visions of elected officials frequently take precedence over community solidarity and concerns, a situation that effectively freezes the municipal council's ability to act. The lack of solidarity within municipal councils also makes it more difficult to apply and administer available tax measures in order to generate necessary revenues.

In general, while the decentralization trend in Morocco attempts to reinforce financial and budgeting capacities at the municipal level, there are a number of obstacles that essentially prevent any serious advance. These include limited institutional capacities; insufficient human resources, management, and materials; over-dependence by elected officials on the central government to define development programs; and inability of the municipality to make use of local, private sector expertise.

Other common problems that prevent municipalities from expanding or improving their performance include poorly defined boundaries for intervention; budgeting and accounting systems that are overly constrained by poorly understood and applied administrative procedures; limited means to influence the mobilization of locally generated financing through the collection of taxes; and opacity of the legal system.

USAID has been supporting institutional strengthening efforts within municipalities, including improvements in accounting systems. This support must be continued and expanded in order to equip officials and municipal staff with the needed skills and tools to take advantage of decentralization efforts.

With regard to planning for municipal development, government leaders generally recognize the usefulness of multiyear programs. While central authorities would basically favor such a planning approach, the level of solidarity between elected officials in the same municipality is often too inadequate to allow for any medium-term programming. As could be expected, each elected official is interested in obtaining the maximum amount of benefits for his or her area during the period of his or her electoral mandate. The unavoidable result is a series of small, local projects that follow a patchwork approach rather than any overall structuring of the municipality.

Municipalities can use special accounts for specific projects spanning more than one budgeting period or having a rather permanent character (utility companies, housing, commercial centers, bus stations, etc.). The creation of such accounts requires authorizations from the overseeing central authorities.

While municipalities can identify their needs for urban services and facilities (health, education, housing, etc.) and transmit them to the regional or national levels, they are not directly responsible for the actual provision of many of these services, such as the construction of schools, hiring of teachers, building of hospitals, etc. The provision of these services is the responsibility of the offices and agencies of the central government, which have their own priorities and programs, and often work through their provincial or prefectural divisions.

Meanwhile, water and sanitation (including wastewater treatment) are the responsibility of the communes. For some of the communes (generally the larger ones), these services are developed, delivered, and maintained at a district level by district water and electric authorities, or *Regies*. Typically, a single authority will provide service to all residential, commercial, and industrial consumers within a group of neighboring communes. Although the communes are ultimately responsible for the provision of these services, when a Regie exists, it is not necessary for municipal governments to have a role in the provision of these services or in the collection of their fees. Rather, the Regies determine service charges and collection policies and may cut off service in response to nonpayment. They may also borrow funds from FEC or other lenders.

4.2.2 Local Government Resources

It is argued that the local government finance system is subordinated to that of the national system. Just four to five percent of municipal revenues come from their own production of goods. For services, their withholding is estimated at 19 percent. The price paid for services fails to recover costs fully. Municipalities cannot determine their own tax base or the rates to charge and must conform to the centrally designed system. Overall, this system is poorly adapted to local governments playing a major development role.

Current sources of local government revenue may be grouped into four categories, each of which will be discussed in turn. These include:

- VAT/Transfers
- Taxes shared with central government
- Local taxes
- Income from goods and services.

4.2.2.1 VAT/Transfers

In 1996, the government replaced the previous central government system of subsidizing the amounts needed to balance municipal budgets by a more transparent system involving the assignment of up-front revenues from the Value Added Tax (VAT). This provides municipalities with a regular source of revenue and helps them meet the new balanced budget requirement.

The VAT represents 20 percent of all government resources. Roughly 30 percent of the funds obtained from the VAT are transferred to municipalities and used for local government finance. This amount provides close to 45 percent of local government resources. It is distributed at the municipality level as follows: 70 percent is to be used to support project budgets or procurements; 15 percent is dedicated to investment expenses; 10 percent is dedicated to projects between communes; and 5 percent is to be used for unforeseen and extraordinary expenses.

This change in central government financial support to municipalities is extremely important in terms of creating a predictable stream of financial resources that will allow them to borrow and finance their investments.

The central government expects municipal governments to leverage FEC loans with the VAT resources they receive. While the notion of leveraging is not explicit and could be made a stronger component of local government financial planning, it is nevertheless clear that the central government's tightening of borrowing patterns is made possible by this VAT allocation, which can be used to meet the 20 percent local contribution required for investment in each project submitted to FEC. Nevertheless, despite the VAT contribution, many communes do not have sufficient resources to cover the 20 precent required by FEC for loans which could finance infrastructure projects.

The VAT stream forms the base of local resources to which other revenues are added.

4.2.2.2 Shared Taxes

These other revenues mainly include taxes that are shared with the central government. They include 75 percent of the product of the urban tax (which represents 2.5 percent of resources) which is based on property values or rents, 90 percent of the business tax/license fee (10.5 percent of their resources), and rental value tax (10.5 percent of their resources).

The business tax represents a concern for the wealthier municipalities. Since 1992, the share of business tax resources is allocated on a *pro rata* share based on population, with a certain inequality affecting municipalities endowed with important resources. Local officials and analysts argue that there are cases in which one municipality generates considerable business tax revenue, only to have to share it with the other municipalities in the same city, with the result that local officials have little incentive to create and administer taxable revenues.

4.2.2.3 Local Taxes

There are approximately 37 different local taxes (20 percent of the municipalities' resources), many of which have average or minimum and maximum rates fixed at the national level and do not allow municipalities to take full charge of their application and collection. If a municipality wishes to charge more or less than the rates set by the central government, it must obtain approval from the Ministry of Interior and Ministry of Finance. Furthermore, it should be kept in the mind that a large number of these taxes are quite old and outdated. The simplification of this fiscal system and the elimination of a whole series of sufficiently small taxes that provide little revenue but are costly to collect should be pursued. Many of these small taxes are also very unpopular, and, for that reason, municipalities make very little effort to collect them. Currently USAID is supporting fiscal reforms that are being considered that would consolidate the 37 taxes and review and potentially revise the law that sets the minimum and maximum rates for specific local taxes.

In the meantime, penalties are, in theory, charged for late taxes at the rate of 10percent per month on outstanding balances. Reasons for nonpayment of local taxes include the unavailability of funds to pay on the part of taxpayers, change of residence from one municipality to another (without an adequate system of keeping track of these movements), inadequate effort on the part of local tax collectors, and taxpayer resistance to taxes that they view as too high.

4.2.2.4 Income from Goods and Services

While current local sales account for only a small share of revenues, these are likely to offer among the greatest opportunities for change and expansion in the area of revenue generation. Currently, when selling public land or developing public markets, the municipal government is permitted to recover its costs but is prohibited from making a profit. Therefore, these goods are delivered or sold at less than market price.

Furthermore, there is no cost accounting performed at the local government level; therefore, prices charged for goods and services that result from local government effort are unlikely to account for all costs. Specifically, with accounting systems that record only current outlays, it is unlikely that the base of information exists for the determination of indirect costs and their assignment to the prices charged by local governments for goods, such as developed land, or services. Cash outlays, including the recorded price of land, actual construction costs, and the installation and operation of water, electrical, and other services may be fairly assessed and incorporated into the prices charged. Time spent by municipal personnel and the depreciation and operating expenses related to municipal equipment is most likely not included, though.

The introduction of cost accounting is likely to enhance local determination of true cost recovery rates for municipal services such as sanitation as well as better assessment of comprehensive capital costs for investment projects. Charges are required for services provided by the municipality and the utility authorities; however, rates are set by the commune, approved by the Ministry of the Interior, and are not always sufficient for cost recovery.

Municipalities have very little power over their resources. Although they can charge new fees for new services rendered, they do not have full control over the modification of rates, the level of recovery, or the monitoring of potential contributions. They also cannot launch a large program of urban improvement, unless it can generate sufficient resources. Once again, this leads to greater concentration by elected officials on small facilities, such as markets and bus stations, giving them as much attention and importance as the municipal components of national programs for water, electricity, and sanitation.

4.2.3 The Budgetary Process

Local governments are required to present balanced operating and investment budgets for approval by the Ministry of Interior and the Ministry of Finance. The operating budget is approved and adopted by the municipality in April, then transmitted to the prefecture and subsequently to the Ministries of Finance and Interior for approval. Prior to recent legislation, municipalities were permitted to run a deficit. However, budgets are now required to balance or exhibit a surplus that can be used for investment or future activities. The Ministry of the Interior controls certain components or line items of the operating budget to ensure that sufficient resources are allocated to pay for municipal personnel and other non-discretionary items. Municipal budgets are also required to obey the numerous circulars that are issued by the Ministries of Finance and Interior. While these circulars may be less constraining since the reform of 1996 (TVA reform), they continue to place limits on the budget.

Between September and November, those municipalities with operating budgets approved by the Ministries of Finance and Interior prepare their investment budgets by using the balance from the operating budget, the unconsumed resources from the previous budget exercise, and any resources that can be obtained from loans.

In addition to daily operational expenses, the operating budget covers the current portion of the capital budget (principal and interest payments). During the review process by the Ministry of the Interior, the FEC has the right to ensure that an appropriate level of funds have been allocated for debt service for FEC loans. In fact, for each loan recipient, the FEC communicates the debt repayment schedule to the municipality, province, prefecture and MOI/DGCL prior to operating budget preparation, thereby ensuring that FEC debt service is included as a “depense obligatoire.” Private lenders do not have this right of review.

The operating budget is developed and approved on an annual basis; any expenses not consumed at the end of the fiscal year are canceled, but can be carried over to the investment budget for the following year. This procedure has numerous consequences, given that the canceled credits often include very real municipal debts that will either have to be regularized in the following budget exercise or the remainders mandated.

In order to avoid the risk of having certain maintenance expenses, such as those for roads and parks, cancelled at the end of the year, municipalities often leave them out of their operating budget and instead include them in the investment budget.

Municipal operating expenses do not leave much room for dynamic management. An average of 64 percent of the budget is used for salaries and charges while 18 percent is used for everyday consumption.

The Ministry of Finance designates a collector of local government revenues who plays a dual role. This person controls the local budget and certifies each expense before it is made. Although the control is quite rigorous, the Ministry of Finance intends to continue this practice until it is convinced that local governments are in position to assume this function themselves and to take charge of their own budgetary control.

4.3 Financial Institutions and Municipal Finance

4.3.1 FEC

Other than their own revenues and the TVA allocation, municipalities' main source of financing for projects is the FEC.

FEC, a state-owned intermediary for *collectivités locales* or communes, became a bank in 1996. Communes in need of financing present projects to the FEC for loan approval and in many cases, design assistance. The FEC, although a bank, provides technical assistance as well as funds.

Currently, FEC remains the only specialized state-owned financial institution. The other state-owned financial institutions are no longer fully specialized. For example, BND used to lend long-term; however, now 20percent of their portfolio is long-term and 80percent is short-term. The Agriculture Bank also has diversified its products. The FEC is expecting that its mandate may be broadened in the future as well.

FEC goes to the local capital market to raise funds – issuing short-term instruments, and more recently, medium-term bonds (FEC has 5 to 7 year bonds outstanding). It also borrows from multilateral development banks and bilateral donors. The FEC then onlends to communes, incorporating its cost of funds plus a risk factor into the rate. The resulting cost to the communes is about 12percent, not necessarily expensive in absolute terms, but quite expensive in relative terms. The FEC also requires that the municipalities contribute to a project 20percent of the cost. Unfortunately, many municipalities do not have the 20percent necessary to obtain FEC financing.

Another problem in the virtually exclusive relationship communes have with the FEC is the volume of funds needed: 1 to 1.2 billion dirhams a year. The FEC alone cannot satisfy this need. Other financial institutions are needed to enter the sector to satisfy the demand.

Although communes are now free to borrow from private banks, these financial institutions remain wary of lending to the sector without a state guarantee. In part this is due to the banks' lack of familiarity with lending to municipalities and in part is due to the generally held, and perhaps well-founded, opinion that the communes do not yet have the financial nor human resource capacity to properly prepare and implement projects and support loans. This is a serious problem. Due to the ongoing decentralization effort, communes are now responsible for the provision of most public goods, and development relies on them.

Some sectors can be financed and serviced through concessions. For this to work, the district covered and the concessionaire need to find a balance between the recovery of costs and charging tariffs that are not too high for poorest residents. The packaging of services (electricity, water, sewerage) can sometimes result in better tariffs.

Communes can form a syndicate to bring in a private investor (PPP) for water services, souks, etc; however, if the comprising communes are all weak few if any private investors will be interested.

For more information on FEC and its lending practices, see Annex 1.

4.3.2 ONEP

Although not a financial institution, ONEP plays a large part in the financing of water, and more recently wastewater, infrastructure at the local and regional level.

4.3.2.1 Water

ONEP intervenes at a national level for water production. Financing is based on a combination of self-financing and outside financing from development banks. In 1995, the government provided ONEP with a transfer or subsidy of approximately 300MM DH. However this subsidy has been eliminated. ONEP is currently using 50percent autofinancing and 50percent financing from development banks, which lend at their cost plus a small margin. This mix may change, though, as ONEP determines what it can afford given the changing environment with regard to exchange rate risk. ONEP’s self-financing comes from the sale of water. These funds are applied against costs and debts; any excess is for investment. The tariffs for the sale of water vary. The tariffs reflect the cost of development, construction details of the water network, etc.

Casablanca produces some water, as do some of the Regies; however the amount they produce relative to the amount the covered districts consume will decrease as time passes.

ONEP intervenes at a local level for water distribution, when asked to do so by communes. For some communes, the cost is relatively high, and small communes find it difficult to subsidize the tariffs. Therefore, ONEP charges a surtax on the tariff in the richer areas to pay for the poorer ones. Also, ONEP receives concessional financing from bilateral donors (France, Belgium, etc). ONEP’s agreements for water distribution with the communes, “conventions de gerence,” are outdated, and are structured assuming that the money was originally going to come from the communes; however it does not, The funds come from the surtax and exterior financing (often grants or very subsidized loans).

The very tiny rural villages have a different arrangement for water distribution. ONEP builds conduits or canals into which the households along the route tap in. Financing includes external financing (grants, subsidized loans), a fee from the beneficiary, 15percent of the cost paid by the commune, and as of July 1, 1998 a surtax is also applied in the closest city. The cost of these conduits across Morocco is about 10 billion DH. The state has provided approximately 100 million DH.

4.3.2.2 Wastewater

ONEP is also beginning to intervene in sewerage projects. Sewerage infrastructure and wastewater treatment are the responsibility of communes; however, communes can choose to delegate their operation to others. ONEP has agreements -- “convention de cogestion” -- with some communes. This agreement fixes the conditions and modalities of financing. ONEP generally provides 70percent of the financing. It searches for donor funds to do so. The communes are responsible for 30 percent of the financing -- either from their own resources or from FEC.

If communes cannot provide the 30 percent and projects cannot be reduced in complexity or scope to the degree where communes can provide the resulting reduced 30 percent, then the project is not undertaken. The DGCL has been providing technical assistance in designing the wastewater projects and tariffs, trying to find middle grounds that both the communes and ONEP can afford. Although it has been asked by ONEP, the DGCL and the communes themselves, the state refuses to contribute funds in those cases where the communes do not have sufficient resources to provide the 30 percent contribution. Rather, the state says it already provides 30 percent of the TVA to the communes. Unfortunately, for small communes, the TVA amount is small as well.

The tariff for sewerage is set by ONEP, DCGL, and Ministry of Interior. The ceiling is not fixed, but rather is one of economic reality. The tariff can basically go no higher than 1.5DH per cubic meter.

4.3.2.3 Financing

ONEP must provide a state guarantee in order to borrow from the multilateral development banks and bilateral donors. ONEP’s guarantees from the state generally cost 2.5 percent of the total loan amount (before disbursement).

In the past ONEP has taken loans from private international banks, but their funds are currently more expensive than other funds available. Local banks do not offer loans with long enough terms; furthermore, their rates are expensive relative to the international funds available.

ONEP can issue bonds on the local market but does not do so. They say they would need permission from the Ministry of Finance and a guarantee. It is interesting to note that FEC must fulfill the same requirements and has done so without any difficulty.

4.3.3 Private Banks

Private banks are allowed, legally, to lend to municipalities and Regies; however, without a state or similar guarantee, they are reluctant to do so. The banks are looking for new clients and are interested in lending for infrastructure development, but they believe that with the current structure and resulting lack of transparency, lending is too risky. They recognize that there are profitable and viable infrastructure projects currently being planned, or undertaken, by Regies and municipalities; however, they feel that a guarantee of repayment from the municipality is insufficient – if the president of a municipality changes, then the guarantee will no longer hold under the new administration.

Private banks have indicated that if they could put a lien on the TVA resources of a municipality, then they would be willing to lend. However, currently the Ministry of Finance will not allow this. Furthermore, they have said that a guarantee from the Caisse Centrale de Garantie (CCG) would be sufficient credit enhancement, but the CCG has refused to issue such a guarantee for Regies or municipalities who wish to borrow to finance infrastructure projects.

At least one private bank has investigated the possibility of obtaining a guarantee from the World Bank and/or IFC to cover a loan to a Regie. However, the World Bank and IFC currently disagree on this issue, and no decision has been made as to whether they will offer a guarantee.

On the other hand, private banks have said they would lend and indeed are lending to private firms for infrastructure development. For example, some Moroccan banks are lending to Lyonnaisse Eaux Casablanca, which has the equivalent of an AA rating.

Furthermore, some banks have indicated a willingness to lend to the FEC, which would then onlend to the municipalities. In general, the private sector – both institutional investors buying bonds and potential bank lenders – have confidence in FEC and its ability to assist municipalities in developing projects and to manage loans to those municipalities. One bank quoted a possible lending rate that was above the interbank rate, but well below market.

Private banks do borrow from international lenders for some of their resources. For example, BMCE has loans from PROPARCO (France) which are to be used for export financing, a loan from World Bank, a loan from BEI and a loan from BID. Of concern, however, is the central government's new policy of no longer arranging for coverage of exchange rate risk. BMCE has indicated that it would only accept loans in foreign currency and onlend in local currency if the difference in the rates were 5 to 6 percent, thus allowing for a reasonable reserve. BMCE does, however, borrow in foreign currency and onlend in that same currency for export financing.

4.4 Assessment of Changes in Regulatory Framework

Changes in regulations which affect the financing of municipal and regional projects include decentralization and deconcentration efforts in general, the transformation of FEC into a bank, the decision by the central government to no longer issue state guarantees (except for a fee in some cases), and the decision by the central government to no longer accept exchange rate risk on loans to municipal or regional institutions from the exterior.

4.4.1 Decentralization and Deconcentration

The long-term plan for decentralizing, giving greater autonomy and responsibility to municipal governments, continues. This plan has been gradual, with various degrees of decentralization authorized and promoted by the central government in 1976, in 1986, 1996 and again in 1997. Certain recent changes are important to understand both for their impact on budget preparation and management at present and as indications of the philosophy and extent of the State's efforts to relinquish a measure of its control to local governments.

Until recently, municipalities could propose budgets that presented a net deficit but that accurately reflected the expenditures necessary to sustain essential operations of the municipality. The result was likely to be a transfer of resources from the central government out of its receipts of the TVA nationwide. In essence, this practice provided subsidies to both less viable municipalities and to those that had not increased local revenue collections at a rate sufficient to keep pace with expenditures. The Ministries of Finance and Interior ended this hidden subsidy in 1996 through the adoption of more stringent budget requirements for municipalities and through a more transparent and objective allocation of TVA resources.

Nevertheless, the central government continues to control the determination of taxes at the local level, thereby preventing municipalities from eliminating certain taxes, instating others, or changing rates. It can be argued that the Ministries of Interior and Finance viewed the common appearance of deficits in the local budgets as an indication of a lack of fiscal strength and responsibility among municipal governments as a whole and therefore maintained policies that restrained the accordance of full autonomy to the municipalities. According to the Ministry of the Interior/DGCL, local government revenues provide only five percent of total public sector earnings, while municipal expenditures account for ten percent of all public sector expenditures. Given that local governments have little control over their revenues, though, and are unable to reassess tax rates or consolidate taxes, the statement by the DGCL does not necessarily indicate mismanagement on the part of the municipalities.

The current view among officials in the central government is that the budget development process must be strengthened at the local level, along with the improvement of revenue sources which will permit greater outlays for both operating and capital expenditures. Many in government recognize that this is a period of major transition for municipal governments and, in turn, for their *tutelle*.

This transition period exists for regional authorities as well. Prior to 1986, there were seven economic regions in the country. With the introduction of the 1986 reforms, this number was doubled to 14, and in 1997 it was increased again, with the 16 new economic regions having greater autonomy for economic and social planning as well as finances. Each region has an assembly to decide on economic and social matters and a budget provided by the state. Responsibilities include the establishment and operation of universities, health, and the promotion of generation economic development. Resources for this budget come from a share of the central government's revenues from income tax, company tax, and TVA. As yet, there does not appear to be a clear, established system of economic planning at the regional level. As with many aspects of recent laws affecting decentralization, this one appears to be stronger in design than in implementation, with the law reflecting direction and desire for change rather than what local decision makers are capable of carrying out at present.

In the future, regional authorities may be able to raise additional funds through bond issues or loans. However, at the moment they do not have the structure in place nor the track record to be considered credit-worthy. Technical assistance efforts aimed at establishing sound operational systems and financial controls within the regional authorities during this period when they are just starting up would be very beneficial.

4.4.1.1 Housing and Infrastructure

Along with the decentralization and deconcentration efforts of the central government on a broad level, the Ministry of Housing and the Ministry of Equipment have been disengaging from direct intervention in housing and infrastructure projects. The policies regarding the central government's and Ministries' participation in these projects continues to change.

Recently, in the area of housing, the Ministry of Finance and Ministry of Housing have embarked upon a new approach – that of financing and using a state-owned operator to develop the offsite infrastructure and split land into large packages that will then be developed for social housing by private or public operators and sold to individuals. In general, this can be viewed as a public-private partnership. The Ministry of Housing plans on using public-private partnership arrangements more in the future. In the current project using this method, FADES and Kuwait are lending the funds through the Ministry of Finance to the Ministry of Housing for the development; the state is using publicly owned land, and the chosen state-operator that will supervise the development of the offsite infrastructure is SNEC. Currently, though, there is no established plan for the recovery of costs; that is, the funds are basically a transfer from the state. The government is looking into cost recovery for the future. For the moment, the Ministry of Finance and Ministry of Housing are disengaging purely on an operational level, not on a financial one. As they shift more fully to public-private partnerships, the private sector will take on certain financial responsibilities as well.

With regard to infrastructure development, the central government differentiates between sectors. For certain large infrastructure projects, the state develops a financing scheme and undertakes the work. For other projects, such as autoroutes, it delegates the construction and operation to the private sector (PPPs). The Ministry of Equipment has completely disengaged itself from the operation of ports, which are now handled fully by the private sector.

Furthermore, the government created ONE, a state-owned entity, to develop an electrification plan and to act as an electricity operator. It created ONEP to handle the production of water and in many cases to handle the distribution as well. The Ministry of

Equipment continues to handle hydraulic projects. However, the government has placed no Ministry or state-owned enterprise in charge of sewerage and wastewater treatment. Both water distribution and sewerage are now the responsibility of communes, but there is no entity to take responsibility for the creation of a national or regional sewerage plan. Thus works are done in a piecemeal fashion, and only if the communes can afford it. ONEP has recently begun to intervene in the area of sewerage, but they have no mandate to develop regional plans and receive no assistance from the central government for these projects; furthermore, many communes cannot afford to “hire” ONEP as an operator for sewerage. Some kind of entity with central or even regional government authority must be established to determine sewerage needs, develop a plan, and obtain financing. Despite the central government’s insistence that sewerage is a top priority, it is doing nothing in that area.

4.4.1.2 Education and Health

In the areas of education and health, central government Ministries continue to execute the primary role in the financing of projects, whether at the national or local level. Provinces submit their budgets to the Ministry of Education and Ministry of Health, indicating their needs, including any proposals for the construction of schools or hospitals. The Ministries analyze the budgets of all of the provinces and then submit their consolidated budgets to the Ministry of Finance. The Ministry of Finance then determines how much it can provide each of the Ministries, either with the government’s own funds or from loans or grants from the exterior. Generally 65 percent is financed with government funds and 35 percent is financed with loans and grants.

With the advent of regionalization, the Ministry of Health has indicated that it may in the future turn to the regions to champion some of its current programs, particularly in educating people about health issues.

Currently, though, the responsibility for financing of education and health projects is not being decentralized. Unlike the budget of the Ministry of Housing for example, the budgets of the Ministry of Education and of Health remain more or less unchanged.

4.4.2 Other Reforms

As was discussed above, the 1993 Banking Law redefined operations on the financial market. Two categories of institution arose: 1) banks (given clear role), 2) *sociétés de financement* (very limited in functions -- can only do what is in their statutes; cannot go to market for funds beyond two years). In 1996, FEC was transformed into a bank, conforming to the 1993 law. The transformation increased financial supervision of the FEC, but also enabled it to access funds at a lower cost. Before this point they were lending at about 14 percent because their funds cost about 12 percent. Afterwards, their costs lowered to about 10 percent.

In 1997, more competitive as a bank, the FEC began to attract additional exterior funds. Multilateral development banks and bilateral donors looked favorably upon the increased supervision and regulatory controls placed upon FEC as a bank. Furthermore, FEC's new status allowed it to finance via the interbank market, and issue short and medium to long-term paper. To date, the FEC has issued 350MM Dh in bonds.

As a bank, the FEC will need to compete more with private sector banks. To do so, it wishes to cease some of the non-bank activities it has been undertaking. In the past, a large part of FEC's work included advising municipalities on developing bankable projects and helping them to manage their finances. In general, banks do not provide this handholding service. In addition, the municipalities are requesting that FEC take on a research bureau function as well. Services such as these are more social in nature and take away from the profitability of FEC; nevertheless, the municipalities need services such as these. Therefore, the question remains whether the FEC will provide these services, thus keeping its spreads higher or profitability lower, will they be taken over by another institution, or will they fall by the wayside?

Other reforms the government has passed place certain institutions in a difficult position. The central government has desisted the granting of state guarantees, except to some institutions in exchange for a fee, and it has stopped offering a mechanism for managing exchange rate risk.

State-owned entities continue to obtain state guarantees for exterior loans by paying a fee, generally 2.5 percent to 3 percent of the loan amount, depending on the borrower. The state has also agreed to give guarantees to certain *Regies*, for a fee. However, communes and urban communities are unable to access such guarantees, and thus cannot borrow from organizations such as the World Bank or CFD that require such a guarantee.

The lack of a mechanism to manage exchange rate risk poses an even greater problem. Because the dirham is not fully convertible, the market does not offer currency risk hedging mechanisms for longer than a year. Formerly, the Treasury offered certain financial institutions a scheme in which for exterior loans, the Treasury would accept the currency risk and in exchange, the borrower would pay to the Treasury and gain from the currency fluctuation, a flat commission on each loan that was onlent from the funds, and the differential in interest between the cost of funds from the exterior and the lending rate to downstream borrowers less the financial institution's minimum margin. The Treasury no longer offers this option, and borrowers of exterior funds, such as the FEC, ONEP, private banks and Regies, are currently grappling with the issue of exchange rate risk. Some have decided to no longer borrow these funds, some have decided to establish currency risk reserves for each foreign loan, and others are searching for alternate solutions.

5. Assessment of Other Donor Financing

Morocco receives development assistance from many donors. In 1996, the country received US$889 million in official development assistance (ODA), of which USAID contributed US$35 million or less than 3 percent. About two-thirds of total ODA to Morocco in 1996 were grants.

Donor assistance for Morocco is fairly evenly divided between bilateral and multilateral sources. France is the largest bilateral donor, followed by Germany, Belgium, Spain, Netherlands, Italy and Portugal. The main multilateral donors are the World Bank, the European Union, the United Nations, the African Development Bank, and Arab funds.

5.1 Donor Activity

The World Bank is considered a preeminent donor in Morocco. The Bank's four focus areas are 1) Economic growth and competitiveness; 2) Social and rural development; 3) Natural resources and environment; and 4) Role of the State in the economy. Other multilateral donors include the European Union (EU) and European Investment Bank (EIB) The EU provides $165 million annually, including EIB assistance to support three main areas: structural adjustment, private sector and socioeconomic activities. The EU provides substantial assistance for the development of the North, which is supplemented through bilateral assistance programs, especially those of Spain. The African Development Bank (AfDB) has operated in Morocco for over 20 years, and has committed about $3.5 billion for nearly 60 projects. About 60 percent of this amount has been disbursed on large infrastructure activities for utilities, irrigation, transport, telecommunications, housing, and social sectors of health and education.

The United Nations has nine active entities in Morocco. The United Nations Development Program (UNDP) has three priority areas of concentration: 1) Fight against poverty and to generate sustainable human development; 2) Protection of the environment, natural resources management, and promotion of renewable energies; and 3) Modernization of public administration and governance. Three UN agencies, WHO, UNFPA and UNICEF, explicitly focus on health, population/family planning and children's health. The World Food Program (WFP), UNESCO, and International Labor Organization (ILO) also support girls' basic education. The UN Economic Commission for Africa has a sub-regional office in Morocco.

France is Morocco's largest bilateral donor, and Morocco is the largest recipient of French aid in the world, benefitting from an estimated $325 million per year. The *Caisse Francaise de Developpement* (CFD) soon to be renamed the *Agence Francaise de Developpement* (AFD) provides about $125 million in loans (3 percent annual interest) for capital and financial investments. The Cultural, Scientific and Cooperation Service (CSCS) provides about $200 million of grants for economic and cultural cooperation. About $45-$50 million or 35 percent of (CFD) assistance is provided through PROPARCO, a public French finance company and (CFD) affiliate which funds French business ventures through investment loans, technical experts, equity participation and feasibility studies.

Other bilateral donors include Germany, which provided $32 million to Morocco in 1997, mainly in the environment, for national parks, integrated watershed development, sand dune stabilization, protection of endangered species, sanitation and water supply, and irrigated agriculture at Loukos and several small and medium irrigated perimeters. German assistance is provided through the KfW and GTZ, for loans and grants respectively, and through five German foundations. Japan provides about $30-$40 million annually in capital loan funds as well as grants to grassroots organizations and technical assistance. Japanese assistance is flexible within a broad strategic framework, responding to GOM and NGO/community requests for assistance. The Japan International Cooperation Agency (JICA) implements Japanese assistance for technical studies, capital investments and purchases, and oversight for grassroots grants. Spain provides commercial credits, development credits, and grants. Spanish assistance focuses primarily on the North, which was a Spanish protectorate prior to independence.

Spain provides about $200 million annually ($1 billion is programmed from 1996-2000) in commercial and development credits. Canada provides about $5 million (Canadian $7 million per year, of which about 85 percent supports bilateral development assistance, and the balance of 15 percent supports commercial partnerships. Canada's development assistance strategy emphasizes private sector development for both social and economic growth objectives. About 50 percent of Canadian assistance is provided through Canada's private sector to conduct feasibility studies or investments.

5.2 Donor Terms

Interest rates and conditions vary among donors. They all, however, seem to require a state guarantee (which under the new reforms, borrowers must now pay for).

5.2.1 France

The Caisse Francaise de Developpement (CFD) finances non-profit sectors. They cannot lend to profitable enterprises. For example, the Regie of Casablanca is considered to be a profitable enterprise, and thus the CFD cannot lend to it. There is, however, another French organization that lends to private sector, generally at 6 to 7 percent in francs.

The CFD finances its loans through the French market (65 percent) with a grant component (35 percent). Loan terms are generally 3 percent interest (in francs), 22 year term, with 8 years of deferred payment (interest paid, no principal).

The CFD does not lend directly to microfinance activities (to NGOs, small enterprises, etc). They think it’s too expensive. They would, however, lend to a bank that then does microfinance loans. The CDF also does not lend to communes directly – they feel the communes do not have sufficient transparency in their finances. They would, however, lend to a private bank if that bank wanted to onlend to the communes, stipulating for example, that the line of credit was for 10 year loans for water or sewerage. The CFD also cannot lend to small Regies, since they often do not have balanced budgets. However, the World Bank and CFD have issued a loan directly to Regie Fez -- there’s a state guarantee for default, and Fez takes currency risk.

The CFD is also lending jointly for an Agadir wastewater treatment plant (the borrower is RAMSA). The CFD is lending at 3 percent, BUI is lending at 4 percent (will go down to 1 percent after 1998), and FEC is lending at 11 1/2 percent. The project has not yet started due to environmental problems.

5.2.2 Germany

Kredistandstalt Fur Wiederanfban (KFW) lends to Ministries and state-owned enterprises at a very concessional rate – generally 0.75 percent -- in Deutsche Marks. This seems to be the lowest interest rate offered by bilateral donors (excluding grants). Because the rate is so low, borrowers can more easily support exchange rate risk, even though the Treasury is no longer offering this service.

KFW generally lends for environmental projects, but lending includes funds to FEC which onlends to municipalities for a variety of projects (including wastewater projects and other environmental infrastructure).

5.2.3 FADES

FADES lends to Morocco for a variety of infrastructure projects. It is currently lending to the Ministry of Housing (through the Ministry of Finance) for a housing development project that will use state-owned and private developers (50 percent of the 1.2 billion DH will come from FADES, 50 percent from Kuwait). This loan is for approximately 15 years, at 4.5 percent, with a 6 year grace period (that begins following the completion of work) during which interest is paid but no principal repayments are made. The first tranche, for 1998-99 is for 109 MM DH. There is a 0.5 percent fee if the funds are not used.

FADES has also lent for projects such as a fishing port in Agadir (80 percent of the required 310 MM DH from FADES, and 20 percent from Spain). The initial 40MM DH tranche from FADES carries a 2 percent interest rate, over 25 years, with an 8 year grace period.

5.2.4 BEI

The rates at which the European Investment Bank lends vary widely, depending on the client and the project. For example, BEI’s loan to RAMSA for a wastewater treatment facility will carry a 0.9 percent rate, while BEI loans to FEC and BMCE carry rates closer to 6 percent. As do the loans of other international lenders, BEI’s loans have a grace period (which varies by borrower) during which only interest must be repaid.

5.2.5 World Bank

The World Bank lends to the central government, the FEC, ONEP and other state-owned institutions at its cost plus a ½ to 1 point. Some of its loans are variable and some are fixed. Loans are in dollars and carry interest rates that generally range from 6 to 7 percent. State guarantees are required .

Although the World Bank lends a great deal to Morocco, Morocco has the lowest rate of use (percent of loans drawn down) of World Bank loans in the world. It has a rate of use of only 11 percent.

The government thinks that World Bank funds are expensive relative to other funds, and they accept them as a backup in case other funds are not made available. If the government does find cheaper funds, they pay World Bank a 0.75 percent penalty for not drawing down. Because of Morocco's low usage rate, the World Bank has recently increased its local office representation to see if they can increase Morocco's drawdown rate.

6. USAID Credit Financing

6.1 Development Credit Authority (DCA)

The FY1998 Appropriations Act gives USAID the general authority to provide credit assistance (direct loans and loan guarantees) for any of the development purposes of the FAA. The DCA is a broad authority to be used where: 1) USAID development goals and SOs can be achieved with credit assistance, 2) where the credit subsidy (explained later) of each proposed activity can be reasonably estimated and financed, and 3) where the borrowers (soverign or non-sovereign) are deemed reasonably creditworthy. DCA is a financing authority, not a program, that gives managers the flexibility to make more rational choices about the appropriate financing tools: loans, guarantees or grants, or a combination thereof.

6.1.1 DCA Overview

DCA is designed to be Mission-driven; Missions and other operating units will identify, design and implement DCA activities. Missions are responsible for the "development soundness" of their own credit activities. However, to ensure financial soundness, the "credit subsidy" for such activities will be determined by the USAID CFO based on advice of an independent subcommittee of the Agency's Credit Review Board. Having been advised of the credit subsidy estimate for a proposed activity, the Mission is free to use its own funds for the credit activity (using DCA transfer authority within statutory ceilings). In the future, DCA may be funded by a combination of transfer authority plus direct appropriations. The Global Bureau, under its Mission Support mandate, is able, upon request, to assist Missions in making credit subsidy projections and in otherwise structuring credit activities. Presumably, most credit activities will support existing Mission SOs and build upon grant-financed policy and institutional reforms. Loans are expected to be at or near market rates.

While USAID is and will remain essentially a grant agency, credit assistance under DCA is expected to have two advantages: a) greater sustainable development impact and "results" impact, and b) budget leverage. Budget leverage results from budget rules under the Credit Reform Act of 1990 that require an institution (in this case, USAID/Morocco) to finance from its own resources only the estimated true cost of a credit activity ("credit subsidy") and not the principal amount of the direct loans or loan guarantees issued. Credit assistance is expected to be particularly useful in areas such as micro and small enterprise, privatization of public services, infrastructure, efficient and renewable energy, and climate change.

6.1.2 The Mechanics of DCA

Under the DCA, USAID is authorized to provide both direct loans and loan guarantees. Any credit provided must be designed to achieve development goals determined by the Agency. A DCA direct loan is a contract to provide U.S. Government money to a borrower; the borrower agrees to repay the U.S. Government both principal and interest on the loan at predetermined intervals. A DCA loan guarantee is a contract between the U.S. Government and a lender whereby the former provides assurance of repayment in the case of default by the borrower. Loan guarantees do not require disbursement of funds by the U.S. Government to the borrower. The Government will only disburse funds to the lender if, and when, a borrower is unable or unwilling to repay the underlying loan.

6.1.2.1 Guarantees

According to the guiding principles applicable to DCA assistance, where the goals of an activity can be achieved with either direct loans or loan guarantees, the preferred mechanism for the delivery of assistance will be loan guarantees. DCA guarantees may be for dollar or non-dollar denominated debt. However, in the latter case, the total USAID contingent liability for principal will be capped or limited in dollar terms in order to assist in financial record keeping and risk management.

Beneficiaries of a USAID DCA loan guarantee will be required to pay a semi-annual guarantee fee based on the outstanding principal of the guarantee loan. The fee will be set by USAID between .25 percent and 1 percent per year, depending on the relative creditworthiness of the transaction and the development objectives associated with the project. In addition, a one-time activity origination fee of up to a maximum of 1.5 percent may be charged by USAID if justified by the activity analysis.

A DCA guarantee may be a guarantee of payment or of collection, depending on the needs of the activity.

DCA requires true risk sharing. For loan guarantee transactions, USAID will not cover more than 50 percent of a lender's risk unless USAID's Credit Review Board (CRB) otherwise approves.

6.1.2.2 Credit Subsidy

The Credit Subsidy is defined as the expected cost of a credit transaction to the U.S. Government. It is determined by the net present value of all credit related cash outflows and inflows to the U.S. Government. The subsidy concept was introduced in the Federal Credit Reform Act (FCRA) of 1990. This legislation requires that agencies issuing Federal credit (guarantees or direct loans) determine the cost of the credit in current units of value (net present value).

Determination of the subsidy includes: (i) assessing the risk of the credit transaction; (ii) estimating scheduled cash flows; and (iii) adjusting the cash flows ("expected") based on credit risk. The system allows the Government to price the expected liability of credit transactions under Federal credit programs.

USAID has worked to develop a risk model that complies with Government requirements for international credit issuing agencies and the appropriations language for the DCA. The system developed by USAID incorporates many of the practices used by the private sector and other agencies, such as the Export-Import Bank of the United States, the Overseas Private Investment Corporation and the Department of Agriculture, as well as requirements contained in the Office of Management and Budget's circulars and bulletins. The credit model is used to identify, score and price the risk of credit transactions.

6.1.2.3 Types of Projects

There are two types of credit projects: *Sovereign* and *Non-sovereign.* The style of the transaction will dictate the type of risk analysis and method for pricing credit risk.

A Sovereign transaction is one where the host government provides a full faith pledge to make payment under a loan or loan guarantee. *As* such, the risk of a sovereign transaction is derived from the Inter-Agency Country Risk Assessment System (ICRAS).

A *Non-sovereign* transaction is one where a private or non-central government entity pledges payment for a loan or loan guarantee. Non-sovereigns may include private financial institutions and businesses, municipal governments or other entities not explicitly guaranteed by the central government. The non-sovereign transaction does not benefit from a host government full faith pledge of repayment and therefore, a detailed credit risk assessment of the project is required.

As shown in the following table, sovereign projects will either be direct loans or loan guarantees, while non-sovereign projects can be direct loans, loan guarantees or loan portfolio guarantees (guarantee covers portfolio of loans, leases or other assets).

Table: DCA Financing Options

	Direct Loan	**Loan Guarantee**	**Loan Portfolio Guarantee**
Sovereign	Yes	Yes	No
Non-Sovereign	Yes	Yes	Yes

6.2 Micro and Small Enterprise Development (MSED)

To date, the Housing Guarantee Program (now called Urban Environment loans) and the Micro and Small Enterprise Development (MSED) Program are the only groups in USAID using credit.

USAID's MSED uses direct loan and guarantee authority to promote sustainable micro and small business development, and has been referred to by USAID Credit and Investment staff as "DCA-lite." MSED uses loans and guarantees to encourage financial institutions – commercial banks, finance companies, insurance companies, leasing companies, and other specialized financial intermediaries – to extend and expand credit to microentrepreneurs and small businesses. Constraints on MSED funds include the following: recipients must be micro or small enterprises, the largest credit available is $3 million, MSED funds are only directed to non-sovereign entities, and the loans cannot exceed five years (there have been very few exceptions). MSED is fully run and managed from USAID/Washington.

MSED's primary financial instrument is the Micro and Small Business Loan Portfolio Guarantee (LPG). LPG provides loan guarantees of up to 50 percent of the principal loss on a portfolio of small business loans, and up to 70 percent of the principal loss for micro-loans (MSED has not exceeded guarantees of 50 percent to date), made by financial institutions in developing countries. The guarantees are combined with training to give banks needed skills in assessing small business and microbusiness credits, and to assist borrowers in preparing business plans to present to the banks.

In issuing an LPG, MSED approves the financial institution itself; it does not preapprove the loans the institution makes. When approving a financial institution for a loan portfolio guarantee, the MSED investment officer considers the institution's risk (does CAMEL risk rating), the country risk, and other risk (such as market risk, etc.).

MSED has made many fewer direct loans, primarily due to a limited budget. The loans that MSED has made have been directed to organizations with a global or regional focus, such as ACCION, FINCA and WinRock.

Working closely with USAID field missions, the Credit and Investment Staff have catalyzed lending by banks to small and micro businesses in more than 33 countries, leading to over $150 million in new credit to micro and small business borrowers; trained over 500 bankers in small business lending techniques in 16 countries; supported the needs of entrepreneurs in South Africa by operating a $12 million LPG program designed to mobilize credit for South Africans disadvantaged by apartheid; and managed an $8 million LPG program in the West Bank/Gaza structured to mobilize credit and other types of financial support for Palestinian-owned businesses as part of the U.S. Government's overall effort to provide targeted support for the Middle East peace process.

MSED would be an appropriate program for USAID/Morocco to access for its microfinance programs, both the existing activity and new ones planned. The MSED Credit and Investment Staff have indicated a willingness to work with the Morocco Mission on such initiatives, if requested.

6.3 Potential Projects for DCA or MSED Financing

As the Mission considers projects to be financed by DCA, it should keep in mind the overall Agency ceiling of DCA transfer authority appropriated by Congress, and realize that the Mission will most likely be able to access only a portion of this total amount. As it moves forward in designing such projects, the Mission will need to request an allocation of DCA transfer authority, either formally through the annual budget process or informally through a specific request through its Bureau.

When the Mission develops a DCA project idea (or MSED for that matter), it should contact the Global Bureau to let them know of the Mission's interest, and then prepare a brief description of the project idea (see the DCA Annex for a suggested outline). The Mission should also indicate to the Washington DCA Team the amount of Mission resources (OYB) it is willing to commit to the project and should request preliminary subsidy cost estimates. Once this is complete, the Mission should further develop the project idea, contracting financial/credit expertise if necessary or calling in AID/W expertise. The Mission must prepare a detailed feasibility analysis with an emphasis on determining if there is a positive financial rate of return. If the results of the feasibility analysis are negative, the project is abandoned at this stage. If the results are positive, the project moves on to the next phase.

The next steps include detailed project development, optional subsidy cost verification, preparation of project approval documentation, final subsidy determination, budget authority transfer under DCA, preparation of project agreements, and financial closing.

In examining the Morocco Mission, there are two key areas of development in which the SOs are working that are prime candidates for DCA financing – microfinance projects for private business, housing and health, and infrastructure development projects. Both of these types of projects generate revenue streams and thus are potentially financable through loans. The education sector is currently less attractive for this type of financing because of the slower rate of decentralization in this area. Potential DCA projects are described in further detail below.

6.3.1 Education

In the education sector, projects generate little if any revenue and subsequently in general are currently relying on grants or very low-interest loans. Communes or urban communities are a possible end-receiver of funds; however, disbursement may be difficult. The World Bank lent $55 million for schools (construction etc.) through the Ministry of Finance. However, the funds have not been disbursed by the Ministry of Education. The mechanisms for disbursement to the local governments are not in place, and over the past 2 years, since the loan was signed, little if any has been disbursed.

If decentralization in this sector comes about, then the regional authorities or provinces could borrow directly. However, this may take some time.

Private sector education would be a good target for financing through loans, particularly local loans guaranteed by DCA. They can construct schools, improve schools, etc. with the funds and repay with revenue received from tuition (even low tuition). However, private schools are outside of the Morocco Mission Education SO goals.

6.3.2 Health

As was discussed earlier in this report, in the health sector, a possible use of a loan to the central government is contraceptive procurement. USAID/Morocco has been providing contraceptives to Morocco with grant money for several years. In 1997, Morocco was the second largest recipient of population funds from USAID in the world. However, with the revision of its strategy, the Mission is pulling out of this program and in 3 years time there will be no grant financing. The SO1 has estimated that after 2001, the Moroccan government will need $7 million a year to finance contraceptive procurement. The Ministry of Finance could take a loan (DCA) of $35 million over 5 years, which it would transfer to the Ministry of Health to purchase contraceptives. It may be difficult to convince the central government to accept loan financing in place of grant funds, though, and the government may seek grant funds elsewhere, such as UNFP. However, if the Ministry of Finance cannot access grant funds, then a DCA direct loan may be a feasible alternative, depending on how the terms compare to other loan possibilities from organizations such as World Bank. It should be noted also, though, that currently the DCA Credit Review Board favors non-sovereign loans over sovereign loans, and favors guarantees over direct loans in general.

To pursue this option, the Health SO should undertake a small study to assess: 1) the financial resources needed to continue the contraceptive procurement program; 2) what the Ministry of Health’s other options are for financing contraceptive purchase – the potential availability of other grant funds from other donors or highly subsidized loans; and 3) whether loan financing for this activity fits within the budget “envelope” for the Ministry of Health (fits within the MOF’s intended allocation to the MOH). The Health SO should also contact the Credit and Investment Office in Washington’s Global Bureau (G/EG/CI) to discuss the potential project and get a read on the likelihood of its being approved for DCA financing.

Another option for DCA or MSED financing in the health sector is a microfinance program that would assist private sector doctors in establishing offices in small towns. Two alternatives exist here – 1) a loan portfolio guarantee to a local bank that would lend to doctors, perhaps through a medical association or with that association’s technical assistance, or 2) a loan to a bank which would then lend to doctors, although currency risk would then become an issue. A microfinance program fits into the health SO’s new special objective. The new Results Framework will have a private sector health component.

A local currency loan portfolio guarantee to a bank for onlending to private sector doctors fits well with both MSED and DCA objectives. In order to pursue this, SO1 should meet with well-positioned local banks to discuss their interest in making loans to doctors wishing to establish or expand private practices in Morocco. SO1 should also contact the Credit and Investment Office in Washington to discuss the project idea and obtain assistance in the early stages. If the loans to be made to doctors are small, the project will be appropriate for an MSED guarantee (the current benefit of MSED is that it is now operational); if the loans are larger, DCA would be appropriate.

6.3.3 Economic Growth – Microfinance and Agribusiness

The Economic Growth SO currently has an ongoing microfinance project for entrepreneurs. This project has, to date, been supported solely through grant funding. However, as the NGO originating and servicing the loans (Al Amana) builds its track record (to date it has a very high repayment rate – 97 percent), the project can be weaned from grant financing. A number of possibilities exist – Al Amana can obtain a local currency loan from a local bank or banks, and DCA or MSED can guarantee that loan(s); Al Amana, if approved as an institution allowed to raise funds on the local capital markets, can issue a bond, and DCA or MSED can guarantee that bond; or a DCA or MSED loan can be made directly to Al Amana (although it would then take on the currency risk).

In the economic growth as well as the housing sector, a potential use of DCA financing is a pilot housing finance project. An NGO (perhaps Al Amana since it has microfinance lending experience) or a state-owned enterprise such as ANHI would borrow DCA funds (either a direct credit or a local loan with a US guarantee) and would onlend to people wishing to improve or expand their houses. The loans made by the housing microfinance institution would be small, approximately 3 years in term in amounts ranging from $5,000 to $10,000. The idea would be to start the project, as a pilot, in one or two cities, perhaps Tetouane, Fes, or Taza (Al Amana is currently operating in Tetouane and Fes).

Initially, an organization such as Cooperative Housing Foundation (CHF) would provide personnel to work with Al Amana or ANHI. They would work through field agents of the local organization (Al Amana or ANHI) and would develop loan forms in Arabic.

The effective lending rate to small borrowers would be higher than the general market rate, as is common with microfinance programs. Administrative costs would eventually decrease, though, lowering rates. In the Morocco Economic Growth SO's current microfinance project, they charge a 40 percent annual interest rate, and have a 97 percent repayment rate.

A housing microfinance project would be a new component of an ongoing project of the Economic Growth SO. The SO would incorporate this new activity within their overall microfinance project.

Another potential DCA project within SO3 is the establishment of an agribusiness export credit line in a local bank. A DCA direct loan, in dollars, could be made to a local bank which would then onlend in dollars to agribusiness exporters. This would be a good test case for using DCA loans, rather than guarantees, since there would be no currency risk issues involved.

For each of these project possibilities, the Mission should contact the Credit and Investment Office in the Global Bureau and follow the preliminary design steps described earlier and in the DCA Annex.

6.3.4 Municipal and Infrastructure Finance

The six main possibilities for DCA financing in the areas of municipal and infrastructure finance, are loans to the FEC, to a private bank, to ONEP or to RAMSA, a guarantee on a bond issue by ONEP, or a guarantee of a private bank's loan to a Regie.

As was described above, the FEC borrows on the local market and from international lenders/donors and onlends to communes, urban communities and Regies. Projects that these loans finance include market installations, equipment purchases, municipal infrastructure rehabilitation, wastewater removal, solid waste removal, roads and electrification. Currently the demand from their clients outweighs the FEC's supply of funds.

One problem with a DCA direct loan to the FEC, however, is currency risk. Because it currently lacks an adequate mechanism to manage exchange rate risk, the FEC is wary of borrowing funds for medium or long terms unless the loan carries an extremely low interest rate. Furthermore, there is no need for the FEC to receive a DCA guarantee for a loan from a local bank since it itself is a bank and can borrow easily enough. Except for though the capital markets, it avoids borrowing locally since the rates are high.

One possibility is for the FEC to accept a US dollar DCA loan and swap with a private bank for local currency. The local private bank would use the dollars for dollar loans for export financing. The FEC would then onlend dirhams to the municipalities. The private bank would be responsible for repaying its loan and interest in dollars, while the FEC's repayments would be in dirhams. BMCE has indicated an interest in such a scheme if the dollar loan carries an attractive interest rate (less than 1 or 1.25 points over market). If the interest rate is good, then BMCE says it can reduce its margin for its clients. BMCE indicated that such a swap would be possible for short, medium or long-terms.

A private bank is also a candidate to receive a DCA loan or guarantee. BMCE, for example, has analyzed some Regies and their infrastructure projects and is very interested in lending if they can get a guarantee. In particular, they have said that the Regie of Tetouane, which handles water and electricity, is well-managed and a strong candidate for a loan. With a US guarantee, they would be more than willing to make such a loan.

Another option for DCA financing in the municipal infrastructure sector is a loan to ONEP. They have indicated that they would be interested in working with the US. Given the nature of the projects they work on, ONEP has said that DCA financing could more easily be used for potable water projects than for sewerage. They prefer grants or very concessional loans for sewerage since the recovery of costs is more difficult and tariffs would have to be set too high to cover investment expenditures. However, a loan at US market rates would be appropriate for water projects. There would, however, be an issue of currency risk that ONEP would have to cover. Another option for ONEP would be a DCA guarantee on a local bond issue by ONEP. ONEP would raise funds on the local capital market, and with the DCA guarantee could likely offer a lower rate than it would have to otherwise, and/or attract more potential investors.

Finally, another option for DCA financing in this sector would be a loan to RAMSA, the Regie Autonome of Greater Agadir. RAMSA is currently undertaking a large waste project, involving the construction of collection canals, the installation of stormwater drains, and the construction of a wastewater treatment plant. The first phase of this project is to be financed by CFD and BEI. However, there remain outlier towns that will not be serviced by this system; a DCA loan can be used to finance wastewater removal systems for these towns. RAMSA is developing projections for the costs of these smaller projects. Another possibility is for RAMSA to issue a bond on the local market with a DCA guarantee.

7. Conclusions

Although Morocco has made great strides towards decentralization, weaknesses remain in the system which prevent municipalities from taking advantage of their newly-gained authority and from providing the services which are now their responsibility.

7.1 Decentralization Reforms

As part of the decentralization effort, the central government is now providing state guarantees only to those public entities it deems financially well-managed and only for a fee. It will not provide a state guarantee for any loan to a municipality. Furthermore, borrowers of external financing are now responsible for exchange rate risk.

Unfortunately, although various responsibilities have been delegated to municipalities, no provisions have been made for alternate financing solutions in the short-term. Thus, the municipalities, which are still considered weak administratively and financially non-transparent, have little if any means of obtaining a loan from the private sector or from foreign multilateral development banks since they do not have access to state guarantees and in some cases cannot afford to absorb the currency risk of foreign loans. Indeed, some donors and multilateral development banks have encouraged if not insisted on decentralization, but then have not trusted the decentralized entities enough to lend to them. Instead they turn back to the state entities they worked with before. No “safety nets” or other mechanisms have been put in place to handle the transition.

7.2 Municipal Infrastructure Services

The state has determined that municipal infrastructure services, such as water and wastewater treatment, are the responsibility of the communes. Therefore, the government expects the communes to finance these and other municipal services from their own resources, from the 30 percent VAT transfer and from FEC loans. However, this pool of funds is often not sufficient to pay for the development of infrastructure. Wastewater treatment facilities in particular are extremely expensive and beyond the reach of most communes.

Furthermore, communes may not borrow from multilateral development banks or bilateral development institutions since for these kinds of loans, the lenders require state guarantees. The state refuses to provide guarantees to communes, even if the communes are well-managed and are willing to pay the customary fee for such a guarantee. Thus the communes lack access to an important potential source of financing.

For a fee, the state will, though, provide its guarantee to Regies when they borrow from multilateral development banks and bilateral donors and lenders. If the state is willing to give a guarantee to a Regie, which is essentially a public utility established by a commune or group of communes, then it should seriously consider providing such guarantees to well-managed communes.

Furthermore, the state has indicated that sewerage and wastewater treatment is a top priority. However, it expects municipalities to handle the investment themselves, either through FEC loans or through ONEP. However, FEC loans are too small (as well as expensive), and ONEP requires a 30 percent contribution from the municipality. Therefore, small communes are generally left without the funds to finance sewerage facilities. When the commune or ONEP requests that the state assist with the 30 percent contribution, they refuse. If wastewater treatment is truly a priority for the government, then they must dedicate the resources necessary to fund it.

In many countries around the world, the central government helps in the construction of sewerage treatment facilities (investment, not operations). The construction of wastewater treatment plants is notoriously expensive, and the initial investments are much too onerous for the majority of the communes or Regies. Furthermore, concessions or other public-private partnerships cannot be viewed as the solution for all infrastructure development or infrastructure service provision, especially for projects involving large investments. If the State does not contribute in the investment for large projects, and the private sector handles it all, then the private developers and operators will need to raise tariffs above what people are able to pay -- especially in poor cities.

7.3 Local Government Capacity to Borrow

Currently FEC is the only bank lending to the communes. It does so without state guarantees. Private banks are currently not lending to communes due to the perceived risk -- possibility of default, no collateral which they can seize, no state guarantee. In looking at the FEC loans to the communes, it seems the greatest problem is late payment rather than non-payment. Nevertheless, late payment makes the communes less attractive clients than others that are available to private banks.

Currently some communes do have the capacity to borrow -- they are relatively well-managed and transparent, with a solid source of revenue from shared and local taxes, etc.

The majority of the communes, do not have borrowing capacity, though -- they lack sufficient human resources and have yet to establish sound management practices.

Furthermore, the newly established regional councils do not yet have the structure or procedures in place to safely manage a loan.

In general the Regies are capable of borrowing -- as they are autonomous entities focusing entirely on utility services, clear cashflows and transparency are easier to come by. Nevertheless, the Regies' creditworthiness needs to be determined on a case by case basis. Some, such as RAMSA, have proven capable of collecting sufficient revenues to cover their expenses; others, however, such as the former RAD in Casablanca, accrued a great deal of debt (overdue payables) before its services were taken over by Lyonnaise des Eaux. Furthermore, tariff and fee structures in many Regies are complicated and thus make projecting revenue streams a difficult task.

Because decentralization is placing much of Morocco's development on the shoulders of local and regional governments, efforts must be made to strengthen these administrative units. As the regional councils are so new, their strengthening and growth may take some time, but guidance at these early stages could better ensure appropriate development. The municipal governments, in the meantime, clearly need training in public administration and management, restructuring of personnel functions, and assistance in modernizing computer systems, accounting methods, record keeping and the like. Even stronger municipalities, such as Rabat, have asked for technical assistance in the area of management and for a business course for their personnel. All municipalities could use such courses.

As the local governments increase their management ability, the central government should give them greater authority in the determination and collection of local taxes as well as the ability to charge true costs for local goods and services. This will allow the municipalities to better provide for the public and plan and implement much needed projects and programs.

7.4 Donor Financing Comparison

With regard to financing by other donor countries and organizations, the rates and terms vary. However, it is clear that FEC, ONEP, and other such borrowers favor concessional loans and grants. Indeed, for some projects, such as wastewater treatment, very low interest rates or grants are necessary in order to make the resulting service affordable to the people.

Germany lends at an extremely low interest rate, the Islamic Development Bank and France follow. Loans by the BEI[7] and World Bank, at rates around 6 percent, are considered expensive as donor loans go. The loans guaranteed by USAID (HG loans) are

[7] Interest rates for loans by BEI vary widely, and in certain cases are around 4 percent, but range up to slightly over 6 percent.

often the most expensive. Nevertheless, all of these loans are cheaper than local market rates (either through bond offerings or through bank loans).

None of the multilateral or bilateral lenders researched will lend to public entities in Morocco without a state guarantee. Therefore, they do not lend to municipal governments since they have no access to such guarantees.

7.5 DCA Financing

Depending on US Treasury rates at the time, the DCA loan mechanism could be attractive to certain borrowers, particularly those who find the demand for their funds greater than their supply. Municipal governments would certainly find such financing attractive; however, there is a question as to whether these entities would be deemed appropriate by the DCA Committee. Certainly lending to well-managed municipalities would fill a gap which is currently unmet. However, it is more likely that borrowers such as Regies, National Public Utilities, or state-owned and private financial institutions would be easily approved at this time.

A question or concern for all of these potential borrowers, however, is that of currency risk. Any entity in Morocco that borrows in dollars must institute procedures or a mechanism to cover the exchange rate risk. If the loan is short-term, then there are hedging facilities provided by the market. For longer-term loans, though, borrowers must be prepared to set aside sufficient reserves (thus effectively increasing the cost of the loan for the loan’s duration) or to swap the funds with another borrower/lender for local currency. For example, BMCE has in principle agreed to swap dirhams for dollars with the FEC if the dollar loan terms are favorable.

The aspect of DCA direct loans that will make them attractive compared to loans offered by other international lenders is the fact that loans, in theory, can be offered without a state guarantee. This type of lending would fall under the DCA non-sovereign category. By not having to pay the extra two to three percent for a state guarantee, the effective interest rate will be more in line with those of concessional lenders and will be more attractive than the World Bank rates.

Currently the potential users of DCA that might find the DCA Guarantee mechanism attractive are private banks that are interested in lending to Regies for infrastructure development projects or to small borrowers, microfinance institutions (NGOs) that might borrow from private banks and onlend to small borrowers, and institutions such as ONEP or a Regie that might wish to issue a bond on the local market with a DCA guarantee.

With regard to USAID projects that could be financed by DCA, there are a few. Health, microfinance and infrastructure development are the most likely targets. It is less likely that the Education Division will use DCA under its current rubric than the other SOs. Currently they focus on rural education, giving grants to institutions which have few other sources of of funds (and no cost recovery mechanisms).

Annex 1: FEC and Its Role as a Source of Municipal Finance

Project identification and analysis

As has been discussed in other reports, FEC emphasizes the municipal governments' primary role in the identification and formulation of projects for which FEC credit may be extended. FEC's concern is that the borrower understand its own financial situation as well as its potential for debt and the obligations it incurs once borrowing takes place. Currently, municipal governments must limit their borrowing to 40 percent of their total annual budget. Borrowing has been permitted to sustain operating deficits as well as to finance capital expenditures. The amount or share borrowed for current expenditures compared with capital expenditures must be examined on a case-by-case basis with respect to each municipality, as there does not appear to be a limit imposed with regard to the proportion of debt applied to deficit financing. The rate of loan repayment is a primary concern and is critical to decisions by the FEC regarding the extension of future loans to a particular municipality.

New requirements were introduced by FEC to increase the share of self-financing of projects by municipal governments. During 1996, FEC's expectation was that 10 percent of the financing of each project would come from municipal resources. This share increased to 15 percent in 1997 and to 20 percent in 1998.

In addition, FEC now requires that applications from borrowers include approved administrative accounts for the past two years as well as the current budget. Loans in excess of forty million dirham (over approximately US$4 million) require submission of a balance sheet and audit.

FEC undertakes its own evaluation of loans with regard to their impact on the achievement of project objectives. In advance of lending, it examines parameters established for the municipality in terms of its budget, required expenditures, and areas defined for its development, as well as recent assessment or reassessment of its tax base. In addition to its past experience with loan repayment, the identification of taxes available for collection and its "fiscal potential" are considered. With regard to the assessment of borrowing capacity, the FEC also assesses local capacity to exert control over expenditures and the potential to save from within normal municipal operations. It is particularly concerned about the ability of local governments to devise systems of budgetary control, which will give priority to outlays necessary for loan repayment. In many municipalities, costs that are not paid during the fiscal year are carried over to the next year. Clearly, the FEC seeks to avoid such practices on the part of its borrowers -- at least with respect to the share of the budget required for debt service.

The FEC recognizes that there are weaknesses in the technical and financial analysis of projects proposed by municipalities for borrowing, and understands that borrowing and investment decisions are strongly influenced by political considerations at the local level.

In FEC's experience, there are many weak administrative personnel in the municipalities, while others have clear objectives and strong capacity for decision making.

Resources

Meanwhile, as communes, regional authorities and Regies increase their demand for funds, and the financial markets continue to open, FEC must find ways to raise additional funds, lend more effectively, and become more effective.

The FEC has met with success in issuing bonds on the market. A variety of institutional investors have bought the bonds, and both issues were oversubscribed. However, the FEC cannot rely on such demand persisting. Currently the market is very liquid, and investors are searching for instruments in which they can invest. If the FEC bonds do not perform well for some reason, or if other investment opportunities become available, investors may turn elsewhere. What may be helpful is for the FEC to be rated; a rating agency is currently in the process of being established and FEC management have indicated their willingness for FEC to be rated when the agency is operational.

Current rates on bonds (dirham bonds) are approximately 8 percent for 5 year bonds, 8.5 percent for 10 year bonds, and ~ 9 percent for 15 year bonds (there currently are no private 15 year bonds on the market).

The FEC also borrows from foreign donors and banks. Currently, the FEC's World Bank loans are for about 6 percent (World Bank cost plus ½ point), with a grace period of 4 years during which interest is repaid but there are no principal repayments. FEC's World Bank loans are for 20 years. Loans from some countries (e.g., Germany) are a mix of public and private funds, with very low resulting interest rates (0.75 percent in the case of Germany). The FEC's most expensive loans are USAID Housing Guarantee loans, with rates ranging from 7.29 percent to 9.28 percent. All of FEC's loans are currently open (no requirements for specific project uses etc).

Of note is the fact that the FEC is now searching for a mechanism to cover currency risk, since the Treasury will no longer offer one. Before, the FEC relied on the Treasury to manage the risk, and in return, paid any gain of exchange, paid a flat 1 percent commission that was added to each downstream loan, and paid any difference in interest between their cost of funds from the exterior lender and the lending rate they charged less their 2 percent margin.

Currently, the FEC is accepting the currency risk on a loan from Germany. They are borrowing the funds at 0.75 percent and lending at 12 percent. Taking out their 2 percent margin, they are left with 9.25 percent, which they keep in a reserve for exchange rate risk. These funds stay in the reserve for the length of the loan, at which point the FEC offers to return the reserve funds to Germany who may accept them or decide to reinvest or relend them to the FEC.

Although the market only offers currency risk hedging for one year, the FEC has said that it may possibly be able to work something out with the banks to cover the risk of a loan for up to five years. Anything beyond that would be out of the question.

Some suggestions that have been made for the FEC include issuing municipal bonds on behalf of the municipalities, securitizing and selling a portion of its loan portfolio, and creating a leasing subsidiary.

Unfortunately, although they present opportunities for raising additional funds and diversifying the FEC's risk, these options are not possible at this point. There is a demand for new financial instruments, and recently authorized corporate bonds have proven to be popular. Furthermore, the Casablanca Stock Exchange has indicated initial interest in the concept of municipal bonds; however, there is not yet enough confidence in the market with regard to municipalities' being able to properly structure and implement projects to carry a bond based on those projects' revenues. Municipal finances are not yet transparent enough (nor sufficiently independent of the central government's control) for investors to feel comfortable with municipal bonds. Furthermore, the market currently offers credit insurance for certain small loans, but the rates remain high and it is unlikely that the municipalities could enhance their bonds with such insurance. Some potential investors, however, have indicated that they would feel comfortable if the municipal bonds carried a state guarantee (which is unlikely) or a guarantee from FEC.

As for securitizing a portion of the FEC's loan portfolio, this is also a good option for the future. Legislation has just been passed that enables the securitization of mortgages. Nevertheless, due to various difficulties (problems with collateral laws, foreclosure procedures, etc. still need to be worked out), no mortgage-backed securities have yet been issued. The securitization of mortgages will be the first step, or trial, in Morocco; following their issuance, it is more likely that legislation will be passed allowing for the securitization of other kinds of loans. With regard to the creation of a leasing subsidiary, although leasing equipment rather than lending to municipalities to buy equipment might reduce or at least diversify the FEC's risk, it does not seem feasible at this point. In theory, banks are allowed to establish leasing companies; however, the Ministry of Finance currently says that the FEC is not allowed to do so. This may change in the future.

Loans

In 1997, FEC approved loans of 1,040 million DH for the financing of 160 projects, at a cost of 1,807 million DH. During the year 946 million DH were drawn down from FEC loans by borrowers. This compares to 1,179 million DH in loans approved in 1996 for 166 project, with 931 million DH being drawn down during the year.

In 1996 and 1997, FEC loans were approved for the following types of borrowers:

Table A1-1: FEC Loans Approved

Type of Borrower	**1996**	**1997**

	MDH	%	MDH	%
Urban Communities	194	16.45	177	17.02
Urban Communes	753	63.91	665	63.94
Rural Communes	112	9.47	124	11.92
Provinces and Prefectures	3	0.27	60	5.77
Intercommunal Syndicates	4	0.32	14	1.35
Regies	55	4.65	-	-
Other	58	4.92	-	-
Total	1,179	100	1,040	100

Most of the loans to urban communities were for projects establishing markets, or for commercial equipment. Loans to urban communes were generally for wastewater and solid waste projects and urban rehabilitation/repair. Meanwhile, most of the loans to rural communes were for electrification projects and roads.

An example of a loan issued by the FEC is one given to the Provincial Council of Tata in 1997 for 3,240,000 dirhams. The loan was for the purchase of equipment for the execution of a variety of works, broken out as follows:

Table A1-2:: Example FEC Loan Use (loan to Tata)

Items	Cost (tax included) in dirhams
2 pickup trucks	420,000
1 dumptruck (5 m3) for contractors	495,000
1 tanker truck (5,000 liters)	490,000
1 flatbed truck with slatted sides	600,000
2 Land Rover utility vehicles	728,000
1 loader/excavator on wheels	700,000
Revision of prices and unforeseen expenses	167,000
Total Cost	3,600,000

Towards this total cost, the FEC’s loan provides 3,240,000 DH and the Provincial Council of Tata must contribute 360,000 DH.

The loan is for five years, with an annual interest rate of 12 percent. Here is also a .75 percent fee on funds that have not yet been drawn down, which will be paid at the time of each disbursement.

The Provincial Council of Tata was required to begin drawing down funds within a maximum of 6 months from the signing of the contract and required to draw down the entire loan amount within 12 months of the signing of the contract.

The Council cannot modify the project without previous consent from FEC, and must provide FEC with copies of all documentation relative to the execution of the project.

The loan, or the amount drawn down, must be repaid yearly for five years. Amounts not paid in time incur additional interest (one point plus the loan interest rate). Prepayment of principal is allowed.

FEC has not had a problem with default on its loans; the non-payment rate is very low. However, there are often delays in payments of 1 to 3 months, and in some cases longer. Few if any borrowers prepay principal.

Currently the FEC cannot lend to the private sector. However, with the expectation of a further opening in the market, the FEC has said that in the future it will begin to lend to the private sector for project finance.

Annex 2: Water and Sanitation in Agadir, RAMSA and ONEP

Souss-Massa Basin

The Souss-Massa river basin is a well-defined area that exhibits many of the recent urbanization and urban development trends and issues found throughout Morocco. The region comprises the major seaport and tourism area of Agadir, industrial and agro-processing industries in the plains of the Souss and Massa rivers, and remote mountain and resource-poor marginal areas that serve as the major sources of rural-urban migration.

The pattern of urbanization includes large-scale modern investment and development along the coast, major rural-urban migration and displacement of the population toward this development, rapid uncontrolled urban growth and agricultural change in the hinterland around the coastal area, and stagnation and/or deterioration of traditional cities and rural areas in the interior.

The number of cities in the region increased from 9 to 20 between 1971 and 1994. During this same period, cities with more than 50,000 inhabitants grew in number from one (Agadir) to five (Agadir-Anza, Inezgane, Aït Melloul, Dcheira, and Taroudannt), all of which but Taroudannt are located in the Agadir area. The number and sizes of smaller cities located along national highways and the Souss River have also increased. Good roads and adequate transportation facilities allow many of the people living in these newly emerging urban areas to commute to work in the Greater Agadir area.

The Souss-Massa river basin has historically had a very mobile population with high levels of both temporary and permanent migration to other parts of Morocco and foreign countries. Possibilities for migration out of the region, however, have diminished, resulting in greater internal migration within the region itself. Remittances provide one source of funds to facilitate the move from rural to urban or semi-urban areas and to acquire a rudimentary dwelling unit on a very small, inexpensive plot of unserviced land. As rural areas on the urban fringe begin to urbanize, the urban population becomes increasing rural in its basic characteristics and behavior. The result is a part-urban, part-rural transitional environment that suffers from the lack of coherent development and coordination. Overall land use in these semi-urban areas is rather poor and inefficient with a noticeable negative impact on the human and physical environment. The lower land values, good road access, and potential for combining part-time agricultural work with some paid informal or seasonal work continue to make these areas very attractive to low-income migrants.

Urban Development

Despite the discouraging results, urban development within the region has followed a very logical course. Significant investments in the reconstruction of Agadir and tourism development following the earthquake of 1961 created the need for manual workers and started a strong process of rural-urban migration within the region. The very planned and controlled development of Agadir, and the high land and housing prices that accompanied this approach, made it very difficult for low-income workers to find housing within the city of Agadir itself. Most of them were obliged to settle in smaller and much weaker municipalities located on the periphery of Agadir. A pattern of urban development and growth was created that was common to other Moroccan cities as well. Uncontrolled urban growth on the peripheries of even these smaller municipalities was essentially out of any legal jurisdiction and/or capacity to control. The small communes and municipalities on the periphery of major cities have generally been more concerned about increasing their population and economic activity than with the quality or type of development that takes place. In any case, most of these areas are eventually incorporated into the larger city and put under its responsibility.

Urban facilities and services have not been able to keep up with the pace of urban growth and expansion, particularly in areas that are not formally and legally recognized. Only when public pressure becomes significant are these areas incorporated within the city boundaries. At this time, it is often too late to reserve the necessary land for future roads and facilities. The government has experienced considerable difficulty in applying its powers of eminent domain, and its various Ministries have not had the financial resources to purchase necessary land on the private market.

In addition, institutional organization within the region has not been able to cope with the area's overall development. Part of the problem has been due to overlapping but different jurisdictions and lines of authority of government administration. The lack of financial resources for urban development has also led to a process of "decentralization by default" and greater participation by local community groups and/or associations in providing their own much-needed infrastructure and services. While the government's official position toward these associations has been ambivalent, local community provision of infrastructure and services is increasingly being viewed as a necessary, if not entirely desirable, contribution to urban development. While government remains worried about its loss of control over urban growth, its various agencies have generally been willing to allow the community to invest its own resources in infrastructure and service development. Since there is no agency specifically devoted to the overall development of the region, most urban development activities have been ad hoc and opportunistic in nature, with little concern about the broader or "downstream" effects of the decisions and actions being taken. Even the highly controlled development and use of resources in Agadir have provoked unforeseen and basically unintended development around the city due to the lack of a broader, more regional perspective.

Because of the region's size, economic activity, and rapid population growth, there is a very strong relationship between agriculture and urban development. The urban population in the river basin has increased 6.5 times over the 26-year period between 1971 and 1997. With a current growth rate of 6.5 percent, this population is likely to grow by another 3 to 4 times over the next 20 years. At this rate of growth, close to 130,000 new urban households would be created during this period. Considerable increases in agricultural productivity and commercialized farming will be required in order to feed this population. Population increases are also likely to offset economic gains.

Water is an obvious concern to both agricultural and urban development. The current situation is one of rising demand for water in the face of relatively static supply. Not much can be done to increase the supply of water in the region. Competition for water between agriculture and urban/industrial uses will therefore intensify. This situation will become increasingly important as the population more than doubles over the next 20 years and the need for irrigated agriculture significantly increases. It should be noted that the extraction of groundwater has exceeded recharge for several decades. Recently, this has been calculated as 630 millions of cubic meters (Mm$^{3)}$ used compared to 414 Mm^3 recharged, with the annual deficit being 216 Mm^3. The result of this situation has been a drop in the water table of some 1.5 meters during 1990s. Demand for potable water will more than double, from 50 Mm^3 to 120 Mm^3 by 2020, while the need for water for agricultural use will increase from 915 Mm^3 to a projected 1,075 Mm^3.

Meanwhile, sewage treatment lags far behind water provision and is an important concern for cities along the Souss River and other surface water. While increased efforts are being made to connect urban neighborhoods to sewage networks, a great deal remains to be done in terms of treatment. The same can be said for solid waste removal, which is generally unsatisfactory. Greater consideration is now being given to the potential of composting and using some of these products in greenhouses. The entire question of urban throughputs needs to be examined and reconsidered.

Water, Wastewater, and Solidwaste

According to the *Direction Régionale de l'Hydraulique* in Agadir, estimates of annual surface water resources in the Souss-Massa basin vary from 341 Mm^3 to 635 Mm^3. Groundwater resources are about 450 Mm^3 annually. Estimates of total average water resources therefore range from 794 Mm^3 to 1,085 Mm^3 per year.

Variations in both types of resources from year to year are great. The recorded minimum for surface water is 35 Mm^3 in 1960/61, while the maximum is 2,160 Mm^3 in 1962/63. Inflow of groundwater was estimated at only 250 Mm^3 in 1992/93.

Surface water is mobilized through four major dams: Abdelmoumem, Youssef Ben Tachfine, Aoulouz, and Imi El Kheng, with a total combined capacity of 642 Mm^3.

Total water consumption in the river basin is approximately 965 Mm^3 annually, or 120 liters per person. Six hundred fifty Mm^3 of groundwater and 315 Mm^3 of surface water are consumed. Of the total, 915 Mm^3 (95 percent) are used for irrigation, while 50 Mm^3 (5 percent) are consumed by urban and industrial users.

Extraction of groundwater has exceeded annual recharge for decades. Over the 1968-1986 period, annual average consumption was 630 Mm^3, while recharge (inflow from rain and surface water) was only 414 Mm^3. This produced an average annual deficit of 216 Mm^3. Over the 1986-1994 period, the annual deficit averaged 260 Mm^3, resulting in a lowering of the aquifer by an average of 1.5 meters a year during the 1990s.

Demand for potable water (including industrial uses) is projected to rise to 56 Mm^3 in 2000 and 120 Mm^3 in 2020, a 240 percent increase over 22 years, or 4.1 percent annually. Demand for water for irrigation is projected to increase to 1,000 Mm^3 in 2000 and 1,075 Mm^3 in 2020. This 160 Mm^3 increase represents only a 17 percent rise over current consumption, or a 0.7 percent annual increase over the period. At the regional level as at the national level, although absolute increases in water requirements for irrigation will be greater, the urban sector will, in relative terms, put more pressure on existing water supplies than any other sector in the decades to come.

The main problem in the water sector is therefore rising demand in the face of relatively static supply. Since the flow of the Souss is irregular and that of Atlas mountain water courses relatively weak, little additional supply can be mobilized by new investments. The key to maintaining equilibrium will therefore be demand management.

Water distribution and financing

In the potable water sector, the main distributors are the *Régie Autonome* of Greater Agadir (RAMSA), ONEP, and the municipalities. RAMSA is responsible for water and wastewater services throughout Greater Agadir, which, with an estimated population of 500,000 in 1994, includes the Municipalities of Agadir, Anza, Bensergao, Dcheira, Inezgane, Tikiouine, and Aït Melloul. Eighty-five percent of households in the RAMSA service area have a private or shared connection to the piped water supply network. Thirteen percent are served by standpipes, while 2 percent have no potable water service. The total length of the network is 1,074 kilometers. In 1996, 21.37 million Mm^3 of water entered the network; of this amount, 17.7 million Mm^3 was consumed by RAMSA clients, leaving 17.5 percent unaccounted for. Annual consumption is projected to rise to 23.4 Mm^3 by 2000 and to 38.0 Mm^3 by 2010.

RAMSA's major sources of income in the water sector include user fees and connection charges. Domestic and hotel user fees range from 2.62 DH to 6.13 DH to 7.81 DH per cubic meter for monthly consumption in the 0-24 m^3, 24-60 m^3, and more than 60 m^3 ranges, respectively. "Preferential" users, such as public baths, pay 5.08 DH per cubic meter. Industrial users pay 5.30 DH per cubic meter. Base charges are 33 .20 DH per year for domestic and hotel users, 79.20 DH per year for industrial and preferential users. In general, connection charges are 3,800 DH per dwelling unit. RAMSA reduces charges to cover the costs of studies in the case of some low-income housing projects. Other sources of revenue include developer fees for off-site infrastructure, such as distribution mains, pumping stations, reservoirs, etc. These are levied at 13.51 DH per square meter of gross development area.

Income that RAMSA collects from these sources is sufficient to cover its costs. As shown in the table below, revenues from connection charges, user fees, and other levies, such as special fees for off-site mains, were slightly above expenditures in 1997, including investment and debt service. This held true for 1995 and 1996 as well. This level of cost recovery is a key element in RAMSA's ability to meet metropolitan water needs over the medium and long term. Debt service is fairly small in relation to total expenditures, indicating that the agency is able to use own-source revenue to finance most of its operations.

Table: RAMSA Financial Summary in the Water Sector, 1997 (000s DH)

Line Item	**1997**
Expenditures	
Investment (connections)	27,398
Purchase of water (from ONEP)	67,141
Purchase of material and equipment	10,721
Cost of fuel, water and other consumables	3,365
Studies	2,845
Other costs (rental, transportation, etc.)	1,585
Personnel	20,007
Debt Service	
Interest	813
Capital	2,235
Subtotal	136,110
Revenues	
Connection Charges	30,114
Sales of water	95,097
Fixed user fees	2,015
Fees from “Peines et soins”	1,910
Other	1,066
Subtotal	130,202
Revenues/Expenditures	96%

The other major institutional player in the potable water sector in the basin is ONEP. Consistent with its mission to provide water distribution services in small and medium-sized towns, ONEP serves about one-half of the population of the built-up area between Greater Agadir and Taroudannt. ONEP intervenes as a *maître d’ouvrage délégué*, or concessionaire, responsible for providing water services and authorized to collect fees directly from end users. The municipality retains overall responsibility for service provision as the owner of the network.

ONEP began its regional water distribution role in Taroudannt in the 1970s. Since then, ONEP has taken over Oulad Teima, Taroudannt, Taliouine, Oulad Berrehil, Aït Iazza, and Biougra in the Souss basin. ONEP towns in the Massa basin include Sis Ifra, Massa, Ras Muka, and Mirlift. Coverage levels in ONEP are typical of those in small and medium towns throughout Morocco and are generally in the 65 percent to 75 percent range.

Towns in which neither RAMSA nor ONEP is active provide their own drinking water. These towns generally include the smaller urban municipalities and many of the rural municipalities. The coverage levels of municipal networks are generally lower than those of ONEP-managed networks, typically reaching only 50 to 70 percent of households. The majority of the remainder are served by standpipes. Extensions to the piped system are often done by neighborhood associations, then tied into the network by the municipality.

Investment levels in municipally managed water systems are generally very low on a per capita basis. Concerned about their electorate’s negative perceptions of raising water tariffs, municipal administrations are reluctant to bring rates up to a level where self-financed investments could begin to keep up with rates of urbanization. Municipal reluctance to mobilize additional financial resources, either through borrowing or increased user charges, has also led many towns to elect not to ask ONEP to take over their water systems, since a degree of municipal participation in investment costs is required. As a result, after an initial surge in the 1970s, the rate of municipal participation in the ONEP program declined during the 1980s, leading to a slowdown in water service improvement throughout the region.

Wastewater collection and treatment

As in other regions in Morocco, wastewater collection and treatment lags way behind drinking water provision. Collection levels are relatively good in Greater Agadir, but drop quickly with decrease in city size outside the RAMSA service area. Almost none of the collected wastewater is treated. Although the depth of the aquifer tends to limit groundwater pollution, discharge of untreated wastewater in river beds poses a threat to the health of local residents.

RAMSA reports that 75 percent of the population of Greater Agadir is connected to the piped sewerage system. Another 13 percent have private on-plot or local collective facilities, while 12 percent have no waste disposal system at all. Total length of the piped network is 750 kilometers, or just under three-quarters the length of the water system. The network is combined, except in the tourist area adjacent to the beach in Agadir, where stormwater and wastewater are separated.

Of the 15.3 million cubic meters of wastewater collected yearly, only a very small portion is treated by the experimental Ben Sergao wastewater treatment plant. The remainder is discharged into the Atlantic (Agadir and Anza) or the Souss River (Inezgane, Dcheira, Aït Melloul, and Tikiouine). The Agadir outfall is located between the two ports, less than one kilometer upstream from the main tourist bathing area. Almost 5,000 tons of BOD (biological oxygen demand) are discharged into the natural environment yearly. Average increases of 150 percent in the southern zone and almost 300 percent in the northern zone are expected over the next several years.

RAMSA began preparation of the Greater Agadir Sewerage Master Plan in 1988, but because of opposition to planned construction of a wastewater treatment plant in the Mzar dunes, approval was not obtained until 1995. The first phase of the plan is now under implementation. The Agadir-Souss collector is currently under construction, as are other segments that are tying together the sub-networks in different parts of the metropolitan area. Construction of the treatment plant is scheduled to begin in early 1999 and be complete by the end of 2001.

The new Mzar plant will employ a sand filtration method similar to that of the existing Ben Sergao experimental plant. Ben Sergao treats 750 cubic meters of wastewater daily. Initial separation of sludge and water takes place in a lagoon (two days). The outflow then passes to five filtration ponds, where it is filtered through deep sand pits. The assessment of the Ben Sergao plant carried out by RAMSA confirmed a strong performance in reduction of biological pollution. Moreover, the sand filtration method requires one-third the surface area of traditional lagoons and is cheaper where sand is readily available. Hence the location of the Mzar plant in the dunes near the mouth of the Souss River.

Although the city of Drarga, with USAID assistance, is planning to build treatment facilities, Ben Sergao is currently the only wastewater treatment plant in the Souss-Massa river basin, and it treats only 0.5 percent of the wastewater collected in the region. The remaining 50 million cubic meters annually is discharged directly into the surface water system (interior towns) or the ocean (coastal towns).

RAMSA’s major sources of income in the wastewater sector include user fees and connection charges. Domestic user fees range from 0.2 DH to 0.78 DH to 1.36 DH per cubic meter of wastewater transported monthly in the 0-24 m^3, 24-60 m^3, and more than 60 m^3 ranges, respectively. “Preferential” users, such as public baths, pay 0.78 DH per cubic meter. Industrial and hotel users pay 2.73 DH per cubic meter. Base charges are 36 DH per year for domestic users, 180 DH per year for hotel, industrial and preferential users, and 72 DH per year for administration users and public fountains. In general, connection charges are 1,100 DH per dwelling unit. RAMSA reduces charges to cover the costs of studies in the case of some low-income housing projects. Other sources of revenue include developer fees for off-site infrastructure. These are levied at 35 DH per square meter of gross development area.

RAMSA’s financial performance in the wastewater sector is summarized in the table below. RAMSA includes the total estimated cost of all new networks hooked up to the system in both the “investment” line item and the “connection charges” line item. Most of these local networks are built by developers; some are built by neighborhood associations. In neither case does RAMSA pay for the investment. The two corresponding line items in the balance sheet do not therefore provide an accurate account of actual income from services provided to customers. Nevertheless, the table shows that developer fees and other charges levied by RAMSA are mobilizing substantial amounts of additional capital, which can be used to pay for new investments.

Table: RAMSA Financial Summary in the Wastewater Sector, 1997

(000s DH)

Line Item	**1997**
Expenditures	
Investment	10,446
Purchase of material	1,764
Overhead	785
Studies	1,207
Other (rent, transport, telephone)	1,092
Personnel	8,411
Operation and Maintenance	26,420
Debt Service	
Interest	553
Capital	781
Subtotal	46,609
Revenues	
Connection Charges	37,311
User Fees	19,980
Other	14,559
Subtotal	71,850
Revenues/Expenditures	154%

Reuse of wastewater is not widespread in the region. This practice is illegal for untreated wastewater. The height of the banks of the Souss makes it difficult for farmers to extract river water for irrigation, both because the cost of a pump would be prohibitive and because the pump would be easily visible to the authorities. Nevertheless, illegal reuse of wastewater for irrigation is known to take place in certain areas of the basin, including Oulad Teima. While some of this wastewater is used to irrigate food crops, much of it is also used on non-food crops, such as reeds.

ONEP began to be active in the wastewater sector in Souss-Massa in 1993. To date, only two towns, Oulad Teima and Biougra, have concluded agreements with ONEP to provide wastewater services. ONEP will assume the role of concessionaire, as it does in the water sector, with responsibility for making required improvements and managing the system and authority to collect fees and charges directly from end users. The municipalities remain owners of the system.

In Oulad Teima and Biougra, initial technical and financial studies have been carried out. Investments are now being planned and programmed. Although progress has been slow to date, ONEP reports that demand for intervention in the wastewater sector is stronger than in the water sector, mostly because the potential clientele is limited to towns where ONEP is already providing water services and ONEP and the local administration therefore already have a working relationship.

Under the ONEP formula, local governments must cover 30 percent of the cost of liquid waste improvements. The balance is funded by ONEP through its revenues from tariffs or through international assistance programs. The wastewater tariff is designed to cover, at a minimum, the cost of system operation and maintenance.

ONEP requires that some form of treatment be designed and implemented in all districts receiving a piped wastewater collection system. However, ONEP does not require that wastewater services be provided in all districts receiving potable water hook-ups. There is no systematic linking of water and wastewater services. This isolated treatment of the two sectors allows the urban water provision to continue to make strong advances in coverage and service level without corresponding improvements in the area of wastewater collection and treatment.

Given RAMSA's limited geographical scope and the slow pace of ONEP's urban wastewater program, most liquid waste services in the Souss-Massa basin continue to be delivered by local governments. In the larger towns, old combined piped systems often serve the urban core, while peripheral areas rely on on-plot solutions or have no wastewater services. No basin-wide coverage figures are available, but interviews with ONEP personnel and municipal technical staff indicate that coverages in small and medium-sized towns, including those located along the Souss between Agadir and Taroudannt, are in the 30-50 percent range.

Many of the networks are subject to blocking in the dry season (sand penetration through street drains) and overflow during the wet season (underdimensioned combined networks dating from the colonial period). None of the collected wastewater is treated. Wastewater is generally dumped in river or stream beds in the interior and into the ocean along the coast.

Solid waste

Solid waste collection in urban areas is carried out by local governments in core areas of large and medium-sized towns and by private hand-drawn cart operators in most peripheral neighborhoods and small towns. No region-wide collection figures are available, but conversations with municipal technical departments indicate that, on average, between 70 and 90 percent of the population is served, of which two-thirds benefit from municipally provided service. Coverage varies greatly between the larger urban municipalities (where 50-80 percent of the population receives municipal collection service) and the rural municipalities, in which service is often provided by private hand-drawn carts.

Greater Agadir has the only "sanitary landfill" in the Souss-Massa basin. Although designed as such, the facility as constructed and operated fails to live up to the term. The site is not fenced, and the waste is not systematically covered with earth. Garbage burning is common, and the site is home to a large scavenger population. A large regional compost facility was built with European bilateral assistance, but the unit is experiencing start-up problems, including poor product quality. Some specialists have observed that the equipment is unnecessarily complex for a solid waste chain in which most sorting takes place upstream in response to the strong recycling market.

A smaller pilot compost operation has been proposed under the USAID-financed Water Resources Sustainability project. The pilot operation will combine domestic waste and agricultural waste to make an agricultural grade compost. The feasibility study concluded that, in the greenhouse vegetable sector, demand for compost is on the rise as more and more farmers shift away from local manure and chemical fertilizers.

With the exception of the Greater Agadir landfill, all solid waste collected in the Souss-Massa is deposited in uncontrolled dumpsites. Dumping in river beds is common and has been observed in Oulad Teima and other towns along the Souss. While the depth of the aquifer in the Souss valley (generally in the 50-200 meter range) limits groundwater contamination from leachate, dumping in the river beds clearly poses a surface water pollution problem. It is also an aesthetic problem for down-river towns and for Agadir, where refuse washes up on the beach.

RAMSA Resources

In addition to autofinancing, RAMSA borrows from international and local institutions. For water distribution, RAMSA has both World Bank and FEC loans. For sewerage, in particular for the wastewater treatment facility in Mzar dunes, RAMSA has loans (which have yet to be discbursed) from BEI and CFD. The BEI loan is for 200 MM DH (paid in ECUs) for 15 years, with an interest rate of 0.9 percent, with a 5 year grace period during which only interest must be repaid. The CFD loan is for 160 MM DH (paid in francs) for 20 years, with and interest rate of 3 percent, with a grace period of 9 years during which only interest must be paid. RAMSA is paying 3 percent of the loan amount (paid per tranche) for a state guarantee for each of these loans. To handle exchange rate risk, RAMSA is planning on establishing a reserve of 0.5 percent of the loan amount, to cover slippage. The details of this reserve account have not yet been worked out. RAMSA is contributing 100 MM DH itself for the wastewater treatment project.

Annex 3: Details of Using the Direct Credit Authority

Annex 4: MSED Loan Portfolio Guarantee Documentation

Annex 5: Meetings Held

<u>USAID/Morocco</u>

Mr. Tahar Berrada, RHUDO, USAID/Morocco

Monique Bidaoui-Nooren, Chief, Office of Education, USAID/Morocco

Abderrahim Bouazza, Economist, USAID/Morocco

Gerald Cashion, Chief, Office of Economic Growth, USAID/Morocco

Jamal Dadi, Microfinance Specialist, Office of Economic Growth, USAID/Morocco

Ms. Tina Dooley-Jones, RHUDO, USAID/Morocco

Nina Etyemezian, Office of Education, USAID/Morocco

Alan Hurdes, Natural Resources, ENR SO Team Leader, USAID/Morocco

Michele Moloney-Kitts, Director, Office of Population and Health, USAID/Morocco

Kamal Sebti, Office of Economic Growth, USAID/Morocco

<u>USAID/Washington</u>

Mr. John Wasielewski, Director, Office of Credit and Investment, USAID/Washington

Mr. Gil Rosenthal, Investment Officer, Office of Credit and Investment, USAID/Washington

<u>FEC</u>

Mr. Oudor, Director of Credit, FEC

Abdelrhani Guezzar, Director of Finance, FEC

<u>Agadir</u>

Mr. Mohammed Ghrrabi, Wali of Agadir and of the Region

Mr. Watiq, President of the Urban Community of Agadir

Mr. Ben Ali, ANHI Regional Director (Agadir)

Mr. Bajalate, Member of Agadir Communal Council

<u>R.A.M.S.A.</u>

Mohammed Moussa, General Director, R.A.M.S.A.

Mr. Hanafi, Director of Potable Water, R.A.M.S.A.

Mme. Nbou, Director of Finance, R.A.M.S.A.

Director of Water Treatment, R.A.M.S.A.

<u>Other</u>

Bedrane, Board of FEC, Ministry of Finance

Mr. Mohammed Belbachir, Engineering Projects, Ministry of Housing

Mr. Filali, General Director of ANHI

Jean Yves Grosclaude, Caisse Francaise de Developpement

Najib Guedira, Vice President of the Commune of Hassan/Rabat, President of the Commission des Finances

Ahmed Kawni, DCGL

Mahamed Laaziri, Director of Planning and Financial Resources, Ministry of Health

Mr. Lahlou, Director of Finance, ONEP

Mr. Lahlou, Ministry of Housing

Mr. Marcil, Treasury, Ministry of Finance

Annex 6: Documents used

“Structure des Ressources et des Charges des Budgets des Collectivities Publiques au Maroc,” Mr. ES-SKALI Mohamed Tijani, Direction Generale des Collectivites Locales, Mars 1990.

“Maroc: Etude sur les Finances Locales,” September 1987.

“Decentralisation et Politiques Sectorielles: Etude d’Evaluation et Perspectives de Developpement Local Entrouvertes par la Regionalisation,” Septembre 1998, USAID/Maroc (Boazza).

“Morocco Urban Development Assessment,” PADCO, Inc., September 1998.

“Cahier des conditions tarifaires pour le service de l’assaainissement liquide,” Commune Urbaine de Khenifra, Commune Rurale de Moha Ou Hammou Zayani, gere par l’Office National de l’Eau Potable (ONEP).

“Cahier des Charges pour l’Exploitation du Service de l’Assainissement Liquide,” Commune Urbaine de Khenifra, Commune Rurale de Moha Ou Hammou Zayani, par l’Office National de l’Eau Potable (ONEP).

“CDIE Capital Markets Case Study: Morocco,” Draft of September 1998, Frank Martin and Jim Elliott, USAID.

“Partnerships for Urban Land Production: FEC-ANHI-Municipalities,” June 1998, Samir Kanoun and Larbi Rharbi, Technical Support Services Inc.

Improved Municipal Financial Management: Current Practices and Lessons Learned”, Jeanine Kleimo and Mohamed Sbihi, Technical Support Services, Inc., October 1997

“Donor Coordination and USAID Assistance in Morocco,” Helen E. Soos, February 1998.

“Market Financing and Other Factors Affecting Risk Management of the Fonds d’Equipement Communal,” Priscilla Phelps, PADCO, Inc., August 1998.