Section 6
Local government borrowing as part of the system of local government finance in Tanzania

A brief synopsis of local government borrowing is provided in Section 1.2.4 of this report. Although borrowing currently only plays a very minor role in the system of local government finance, the question of local government borrowing is becoming increasingly important in Tanzania. Currently, the only approved borrowing mechanism for local authorities is the Local Government Loans Board, but by all accounts the Board is undercapitalized to meet all the (legitimate) borrowing needs of local governments in Tanzania. While one strong feature of Tanzania's (restrictive) approach to local government borrowing is that it provides local governments with a hard budget constraint (See Box 6.1), the current approach may actually be too restrictive and unnecessary prevent access to capital lending to some fiscally responsible and viable LGAs. Recently, a study was commissioned by LGRP to assess current LGA lending practices and to determine a new structure for the Local Government Loans Board (LGRP, 2005); their recommendations will be taken up later in this section.

Box 6.1
Providing local governments with a hard budget constraint and the "golden rule" of local government borrowing

The "golden rule" for (local) government borrowing states that it is proper for (local) governments to borrow for capital projects but prohibits the use of borrowing to fund recurrent spending (Musgrave, 1959). Instead, government spending on current goods and services should be met by revenue from taxes and other recurrent revenue sources. There is common agreement that borrowing to cover current expenditures is acceptable only in very rare, specific cases—usually for very short periods, to cover deficits arising from uneven cash flows within a budgetary year. (Dafflon, 2002; Swianiewicz, 2004).

Even in these exceptional cases, short-term local borrowing might provide local governments with a "soft budget constraint". The experience of many countries is that local government which receive short-term budget loans are unable to repay these credits at the end of the fiscal year, so that these budget loans end up being transformed into deficit grants. If local governments come to expect that their budget loans will be forgiven at year's end, this gives them a perverse incentive to engage in excessive spending and to reduce their revenue effort.

One on the constraints on the environment for local government lending is the limited degree of local revenue autonomy, which constrains the ability of LGAs to repay loans. While it is unlikely that borrowing will offer a solution for the financing needs of poor (predominantly rural) local authorities, access to borrowing may provide an avenue for wealthier (particularly urban) authorities to make greater investments in urban infrastructure. The reason why the borrowing mechanism may be more appropriate for (some) urban governments as opposed to rural governments is because urban governments have greater own resources and should be better able to repay their loans. Instead, most rural local governments likely have inadequate resources to repay their loans; alternative mechanisms (especially capital development grants) will have to be relied on to fund their capital development needs.

6.1 The rationale for borrowing to provide funding for capital development.

When local governments prioritize their recurrent expenditure needs and their budget decisions, this is accomplished by comparing the expected benefits from the various spending options: for instance, a community may judge the benefit of having additional schoolbooks during the coming year to be greater than the benefit of hiring a new teacher (or vice versa). However, the very nature of capital goods is different from regular recurrent budget items, which complicates the budgetary choices that need to be made.

In fact, if the local government finance system would require localities to fund capital goods from recurrent resources, this would lead to an under-provision of capital infrastructure. According to Petersen (1998), there are four major reasons why recurrent financing of capital development would be inefficient:

1. The amount of resources needed for capital projects is often too large to be raised from regular recurrent sources. Unlike most recurrent expenditures, capital infrastructure is “lumpy” in nature: all the spending must be done before there are any benefits, so that you could not simply decide to build half a bridge and receive half the benefits. If financed from recurrent revenues, taxpayers would be asked to bear the full cost of a capital project upfront, while the benefits from capital projects are spread out over a multi-year period: this concept is known as inter-temporal mismatch. Borrowing would restore the match over time between the costs and benefits of capital infrastructure. This argument is valid both for social types of infrastructure (school buildings, clinics, etc.) as well as productive types of infrastructure (markets, roads, and so on).

2. The absence of certain types of infrastructure may be limiting economic growth: while building a market or a rural road may generate economic activity, the fiscal resources to build the market or road only become available once the investment is in place. As such, the infrastructure that is needed to accommodate future growth is needed today; to delay providing the infrastructure would mean to slow

economic growth. In addition, if user fees or increased economic activity are expected to generate additional local revenues once the capital is in place, the absence of the capital infrastructure would also influence a locality's ability to repay the debt. Of course, this argument is only valid if borrowed resources are invested in economically productive uses.

3. It is more equitable (fair) to have those residents that will receive the benefits of the capital project over time to also contribute to the cost. The equity issue is particularly relevant when considering major capital projects with long-term benefits, where in the absence of borrowing we would possibly ask one generation to pay for the infrastructure used by another generation (intergenerational equity).

4. For countries with high inflation volatility, future increase in construction and acquisition cost can be avoided by building the project now. If loans can be locked in a reasonable, fixed rate, future inflation could also reduce the cost of borrowing, as the future payment would be worth less than the value of the sum that was borrowed.

6.2 Local government borrowing and moral hazard: the lack of incentives for repayment and the risk of a soft budget constraint

If local government borrowing has so many conceptual benefits over funding capital development from recurrent resources, why then is borrowing not widely used for this purpose in local governments around the world? There are in effect two parts to this question's answer. First, in order to borrow money, local governments need to have adequate revenues to repay their debt. Thus if local governments lack own resources (either in the form of own revenue collections or in the form of unconditional transfers), then it would be impossible for them to credibly borrow funds. Second, even if local governments have adequate resources, local government borrowing raises a problem with moral hazard.[1]

The moral hazard problem in subnational borrowing is the following: although a loan between a responsible local government and a (public or private financial institution) could bring benefits to both, once the loan is made, what is the incentive for the local government to repay this debt? In highly developed market economies with an established tradition of local autonomy, the reason that the local government will repay its debt is two-fold. First, in the absence of a solid repayment record on existing loans, local governments know that banks and other financial institutions would refuse to lend to them in the future. Second, in the case of loan defaults by local officials, legal action by their creditors or administrative action by the central government would give financial and political incentives for local governments to respect the loan agreement.

[1] Moral hazard is a situation in which one of the parties to an agreement has an incentive -after the agreement is made- to act in a manner that brings additional benefits to himself or herself at the expense of the other party.

However, conditions in most countries do not provide for such a tight accountability framework. In fact, in most countries the central government is (either implicitly or explicitly) regarded as the guarantor of all subnational government borrowing, so that there is an expectation that if a local government defaults on a debt; it will be repaid (in one way or another) by central authorities.[2] This expectation provides two perverse incentives: first, it gives an incentive to lending institutions to loan resources to local authorities even if these localities are not expected to repay their debts. Second, local governments have an incentive to excessively borrow and spend with the expectation that they will be bailed out by the central government, either by a one-time bailout or by a systematic increase in grants.

This threat of soft budget constraint is one of the most pressing local government finance issues in countries around the world. A review of empirical evidence and international practices reveals regular episodes of severe local debt, fiscal crises, and ultimate central government bail outs of regional and local governments in developed and developing countries alike (Rodden, 1999). Depending on the degree to which subnational governments are able to indebt themselves, the consequences of this problem could be very severe. Subnational fiscal crises caused by excessive subnational borrowing and payment arrears have the potential to snowball into national financial crises and macroeconomic instability.

In order to put into place a viable local government borrowing framework, the risks of moral hazard and soft budget constraints have to be overcome. Very broadly, there are three mechanisms that could contribute to fiscal discipline and responsible borrowing behavior by local governments:

1. Hierarchical constraints. Unless it is absolutely clear to all stakeholders involved (including local officials, local communities and financial institutions) that the central government does not guarantee local government debt and will not bail out defaulting local authorities, the potential for moral hazard arises. This situation motivates central governments to implement rules and administrative controls that constrain and limit local borrowing. Rodden (1999) refers to this set of limitations and rules as a *hierarchical* hard budget constraint. The ultimate hierarchical constraint is the legal enactment of local government "bankruptcy" or financial emergency procedures, which define the central government's response if a local government does default on its loan obligations (see Box 6.2).
2. Horizontal constraints. In addition to central government regulations, local fiscal decisions regarding borrowing are also dictated by local political considerations. If the local borrowing framework is unambiguously clear, any claims that other government levels are responsible for repaying local debt would not be credible. In that case, local government officials who attract excessively high levels of debt risk being punished by local voters who would hold their local officials responsible for failing to assure local fiscal health.

[2] If local governments borrow from an intermediary financial institution such as the LGLB, the mechanism remains essentially the same. Unless the Board has the institutional credibility or legal means to enforce repayment discipline, local governments will lack an incentive to repay their debts.

3. Market pressures. Finally, if local governments borrowing directly from capital markets through bonds or banks (instead of an intermediary financial institution such as a loans board), the fiscal actions of local governments serve as signals to the financial market about their creditworthiness, as the market evaluates local governments based on their capacity and willingness to honor their debts. In a well-functioning capital market, local authorities that have established a greater creditworthiness pose less risk to financial institutions and are able to borrow at lower interest rates. This is known as *market-enforced* hard budget constraint. Tanzania is still quite a ways off from having an appropriate market-based local government borrowing framework.

Box 6.2
Local Government Bankruptcy or Emergency Procedures

Like individuals and businesses, subnational governments sometimes face financial difficulties. Subnational governments can get into financial problems in various ways, sometimes through economic or social misfortune; sometimes through incompetence or malevolence; sometimes through stubborn unwillingness to make tough budgetary choices; and often through a combination of these causes. However, the difference between businesses and subnational governments is that an insolvent business can be declared bankrupt and dissolved (in which case the assets are sold off to repay the firm's debts). This is generally not an appropriate response for local government authorities.

Although the occurrence of occasional local fiscal problems may be inevitable, a sound local government fiscal framework should at a minimum (1) remove any perverse incentive that would reward poor financial management, and (2) provide a clear framework for resolving local fiscal crises when they occur. Many countries have introduced municipal bankruptcy laws or local financial emergency procedures to assure a hard budget constraint in subnational financial management. Municipal bankruptcy laws generally have several components:

- Local bankruptcy laws or financial emergency procedures are generally triggered when a locality meets one or more specific criteria of insolvency (indicating that it is unable to repay its existing financial obligations). It is important to rely on objective, rules-based criteria, to prevent the central government from abusing such emergency provisions to intervene in subnational fiscal issues for political reasons.
- When the statute or regulation is triggered, local control over its finances is limited. In some cases, the local treasurer is subjected to external oversight, either by a centrally-appointed administrator, a supervisory board, or by a court-appointed specialist. In other cases (especially when the crisis is due to inadequate local oversight or malfeasance on the part of the local council), the local council or treasurer may be dismissed. The latter would send a strong signal to ensure local political accountability, and would discourage local politicians from trying to create budget deficits in order to attract supplementary funding from the central government.
- The externally appointed supervisor is given final authority over local budget decisions. It is his or her job to ensure that the local government is returned to financial solvency. In order to do so, the supervisor or emergency manager has the authority to reduce specific local spending items, terminate local staff as needed, require increases in local taxes, and renegotiate the local government's debt.

- Once the local financial crisis is resolved and the locality is returned to fiscal health, control over local fiscal decisions is returned to the local elected council and the local treasurer.

Source: Mikesell (2002)

6.3 International approaches and limitations

Ter-Minassian and Craig (1997) document international practices with respect to subnational borrowing. They group country approaches to the control of subnational borrowing into five broad categories, although some countries use mixed methods. At the extremes, a country could base its borrowing framework on exclusive reliance on market discipline on one extreme, and on a complete prohibition against subnational government debt on the other extreme. Other categories lie between those two extremes: cooperation by different levels of government in the design and implementation of debt controls, rule-based controls for subnational borrowing, and administrative controls on subnational debt.

Reliance on market discipline. As suggested by Lane (1993), there are a number of conditions that need to be satisfied for financial markets to create discipline on subnational government borrowing behavior:

- Markets should be free and open from regulations that place government in a privileged borrowing position
- Availability of adequate information on borrower's outstanding debt status and repayment capacity
- There should be no perceived chance of bailout of the lenders in the case of impending default
- The borrower should have institutional structures that ensure adequate policy responsiveness to market signals before reaching the point of exclusion from new borrowing

These stringent assumptions on market conditions are unlikely to be realized, especially in developing countries. Even some industrial countries place various forms of interventions into financial markets to put government securities at privileged positions. Because of those necessary conditions, exclusive reliance on market disciple as a method to control subnational borrowing is not widely used.

Cooperative approach to subnational debt. Closest to reliance on market discipline is the cooperative approach to debt control. In this approach, the limits on the local indebtedness are not set by law or determined by the central government, but arrived at through a negotiation process between the federal and lower level governments. Under this approach, subnational governments actively participate by formulating macroeconomic objectives and the key fiscal parameters necessary to attain those objectives. Central and local governments then agree on specific limits for financing requirements of individual jurisdictions. This approach has advantages in promoting dialogue between different levels of government, and is especially common in federal or quasi-federal countries. It also raises consciousness to macroeconomic impacts of subnational governments' borrowing decisions. But this approach works better in the environment of relative fiscal discipline and conservatism, as it may not be effective to prevent debt buildup in countries with weak market discipline, fiscal discipline or central government leadership.

Rule-based approaches to controlling subnational borrowing. A progressively more restrictive approach to local government borrowing is a rule based approach, which puts limitations to local borrowing in the constitution or in the laws. Some of these rules may set limits on the absolute level of indebtedness of a specific local jurisdiction; others specify that credit is to be used only for specific purposes; other rules may determine a maximum allowed debt service relative to total expenditures in order to limit the new borrowing; and others severely restrict certain types of borrowing associated with greater macroeconomic risks (such as borrowing from foreign sources). Many countries use a combination of these rules. In general, a rule-based framework for local government borrowing provides transparency and avoids a bargaining process between local and central governments.

However, a rule-based approach lacks flexibility and may end up encouraging practices aimed to circumventing the rules. To ensure its effectiveness, it needs to be supported by clear and uniform accounting standards for government entities, elimination of off-budget operations, a clear and comprehensive definition of what constitutes debt, and a modern government financial management information system.

Direct central government control over subnational borrowing. The opposite extreme of the market discipline approach –short of an outright prohibition of subnational borrowing- is direct controls by central governments over subnational borrowing. This control may mean that every local borrowing transaction from a private lender needs to be reviewed and authorized by the center, and/or the centralization of all government borrowing with on-lending to subnational governments for special purposes.[3]

In reality, direct administrative control comprises a range of centralized approaches, from complete central discretion over local borrowing decisions (where a central government body decides on local government loans on a case-by-case basis), to a centrally-organized financial intermediary for local governments. Direct administrative control is commonly used in unitary states than in federations. It has some advantages such as a close relationship between debt policy and other macroeconomic policies; better terms and conditions of international debts; avoiding the risk of contagious effect of one subnational's credit rating to other borrowers; and central government's commitment to bear the responsibility of subnational foreign debt. At the same time, excessive central discretion over local borrowing decisions may result in inefficiencies, particularly if the central government is not able to identify the most valuable local government investments or if the review process is subjected to political pressures.

[3] On-lending is a practice where a central government engages in lending, only to "on-lend" the proceeds of the loan to the local government level.

Although a central-government run local financial intermediary (such as a local government bank or loans board) officially provides direct central government control, the approach could nonetheless accommodate an impartial borrowing framework that gives a high degree of discretion to local authorities. This would be the case if all local governments borrowing is required to go through the loans board, but the board would use a rule-based mechanism to determine local eligibility for access to loan funds. Such a mechanism would provide a high degree of central government administrative control over local borrowing, without the inefficient discretionary intervention of the center in local government budgetary decisions.

Regardless of the borrowing policy chosen, there are important requirements from a financial management point of view. The central government needs to pay attention to the flows of borrowing, the source of credit and forms of borrowing (Potter, 1997). Many countries put close monitoring to the flows of borrowing of individual jurisdictions. It serves the purpose of preventing subnational governments from incurring the level of debt that would threaten their solvency. It also enables the central government to check on the aggregate national borrowing position. But even for the developed countries, this information on debt flows may not be sufficient. First, reported data might not be credible due to "creative accounting" and off-budget financing practices. Second, when subnational entities are the major holders of financial assets, market volatility and unwise investments could result in large arrears, like the case of Orange County in the United States and the Western Isles authority in the United Kingdom.

International practices and experiences. Table 6.1 provides an overview of selected international practices with respect to subnational borrowing and borrowing controls.

Table 6.1 separates international experiences into industrialized countries and developing countries. Industrialized countries tend to rely on a combination of market discipline, cooperative, rule-based and administrative controls (Ter-Minassian and Craig, 1997). Dafflon 2002; OECD (2004). As for the forms of borrowing, there has been a tendency for central governments to increasingly define the acceptable forms of local borrowing mechanisms or instruments, enabling the central government to more closely monitor local government borrowing. This development has been driven by the need to prevent "creative" accounting practices that are outside the normal borrowing controls. Such rules-based frameworks also aim to discourage long term borrowing to meet current short-term expenditure needs. (Swianiewicz, 2004)

Most transition countries in Eastern Europe and the former Soviet Union (not shown in the table) have an outright prohibition of local governments borrowing from the private sector, although in most transition economies' cases short-term budget loans from the Ministry of Finance are allowed. Indeed, many former Soviet republics are still in the habit of providing intergovernmental transfers on a negotiated gap-filling basis (as under the Soviet regime), in which short-term budget credits regularly turn into transfers at the end of each year. (As noted, this is a bad budgetary practice that perpetuates a soft budget constraint and encourages poor local fiscal decisions). Within the former Soviet Union, the Baltic states do allow local governments to borrow through financial intermediaries (Local Government Banks).

Table 6.1
Subnational Borrowing Controls on Domestic Borrowing in Selected Countries

	Market discipline	Cooperative control	Rule-based control	Direct Administrative control	Borrowing prohibited
Industrial countries					
Australia		•			
Austria				•	
Belgium		•			
Canada	•				
Denmark		•			
Finland	•				
France	•				
Germany			•		
Greece				•	
Ireland				•	
Italy			•		
Japan				•	
Netherlands			•		
Norway				•	
Portugal	•				
Spain				•	
Sweden	•				
Switzerland			•		
United Kingdom				•	
United States	•		•		
Developing Countries					
Argentine		•			
Bolivia		•			
Brazil		•			
Chile		•			
Columbia		•			
Ethiopia				•	
India				•	
Indonesia				•	
Korea, Rep. Of				•	
Mexico				•	
Peru				•	
South Africa		•			
Thailand					•

Source: Ter-Minassian and Craig (1997).

In the absence of well-functioning capital markets, relying on market discipline is simply not an option as a borrowing control for developing economies. Within Latin America, cooperative control mechanisms are widely practiced. However, excessive subnational control over the extent of subnational public borrowing can cause substantial fiscal instability. This could result if local governments were able to effectively dictate the terms of borrowing, which could cause local governments to borrow excessively.

In the remainder of the developing world, direct administrative control is the most widely practiced approach. This approach gives the central government the greatest degree of control over subnational borrowing (short of an outright prohibition of subnational borrowing). The fact that no developing countries rely on rule-based borrowing is not surprising, given the challenges that this would cause for the central government to monitor and control subnational borrowing and debt. As such, Tanzania's current practice follows the pattern of most developing countries. While this approach provides the center with a high degree of discretion and fiscal control, the flip-side of this coin is that the current approach greatly limits the ability and discretion of local government authorities to access loans, even in cases where this is economically justifiable and efficient.

6.4 Use of transfer system as a potential guaranteeing mechanism

The possibility for local government defaults on their debt obligations creates a problem of a soft budget constraint. This is particularly true when the local borrowing framework is not integrated well into the rest of the local government financing framework. For instance, when grants and borrowing are taken independently (which is almost always the case), they often provide conflicting and poor incentives for local fiscal behavior. First, heavy use of grants and subsidized loans provides local governments with incentives to undervalue capital when making investment decisions. Second, government distortions of the price of capital can generate inefficiencies and inequities across local governments. Third, indiscriminate grant allocation and other subsidies weaken the correspondence between costs and benefits, and this weakens the incentives for cost recovery and cost efficiency. Lastly, poor repayment creates a sustainable revolving fund to finance development in future infrastructure, as the local government is not pressed with loan payment while still enjoying the flow of grant money.

There are two main ways in which closer integration of the borrowing and transfer framework would result in an overall improvement in the system of local government finances. From a local fiscal administrative viewpoint, linking the borrowing framework to the transfer system could improve the overall effectiveness of local finances by creating proper incentives for debt repayment. If the borrowing framework would be linked to the transfer system in such a way that local authorities which default on their loan obligations would automatically be penalized by the transfer system (for instance, by having the loan repayment plus penalties recovered as a first charge from their unconditional grant, and/or by losing access to certain capital grants), this could go a long way in avoiding the moral hazard often encountered in local government borrowing schemes (Smoke, 1999).[4]

[4] Note that it is only possible for the central government to use unconditional grants to guarantee local government loans, since sectoral loans are earmarked for specific purposes.

More closely integrating the transfer system into the capital financing system might allow the development of a hybrid system where well-off governments and revenue-generating projects would rely more heavily on loans, while poorer local governments and projects that cannot recover costs would be subsidized (Smoke, 1999). As such, the integration of intergovernmental transfers and the loan system within a consistent financing framework would be consistent with the pursuit of a more equal allocation of subnational resources while, at the same time, supporting the gradual development of a municipal credit system (Weist, 2004). Such a hybrid system can institutionally evolve by either introducing a grant component into local government borrowing operations, or by including a component of borrowing into a grant program. For instance, the World Bank-supported Municipal Development Fund in the Republic of Georgia provides local governments with capital development funding on the basis of a 20% local matching share, a 40% grant, and a 40% loan component against concessionary conditions (www.mdf.org.ge). Of course, greater equalization could be achieved by varying the matching rate and the size of the grant component based on local fiscal conditions.

6.5 Recommendations for Tanzania

Based on this review on borrowing, the study team believes that there is a need to cast a wider role for LGA borrowing in Tanzania than is currently available. The Local Government Loans Board views its own role in a very narrow manner; the Board is too much a part of the central government; the Board's capitalization is inadequate (both the amount as well as the manner); its current mode of operations gives the Board substantial discretion in selecting local projects to be funded, and is viewed by many to favor poorer, rural districts in its funding decisions. As such, the current lending mechanism is substantially biased against wealthier urban areas, who –despite their greater need for capital development and their greater resource potential for repaying loans- do not have systematic access to loans to finance capital development projects. Box 6.3 provides an illustration of how such an alternative lending mechanism could possibly function.

Box 6.3
An illustrative design of an alternative loan mechanism

We do not believe that the current, single lending window will adequately accommodate the borrowing needs of all local government authorities in Tanzania. As such, we recommend that instead of (or in parallel to) the current loan mechanism operated by the LGLB, a separate on-lending window is established (hereafter referred to as the Alternative or Supplementary Loan mechanism) with the purpose of providing loans to wealthier local governments. In order to prevent administrative duplication, if administratively feasible, it would be desirable to have the LGLB's Secretariat administer this new loan window. However, this would require a further reorientation and strengthening of the LGLB, and closer cooperation with the Ministry of Finance.

If the Supplementary Loan mechanism could be funded from loan proceeds from international financial agencies or donor agencies,[5] the relative size of this borrowing mechanism would not be restricted by the limited capitalization of the Tradition Loan mechanism, but instead be determined by the demand for loans from qualifying councils, which in turn would be guided by their ability to repay these loans. Qualification for Supplementary Loans would be rule-based: one set of rules would determine which councils would have access to loan funds, and a second set of rules would curtail the amount and use of these funds. In the presence of such an appropriately capitalized Supplementary Loans mechanism (at concessionary rates), local governments would have no need to borrow from the private sector.

Although the exact design of a Supplementary Loan mechanism goes beyond the scope of the current study, it might be useful to illustrate what such a lending window could look like. The following only provides an *illustration* for a Supplementary Loan mechanism.

Based on the illustrative access criteria and limitations provided below, a rough estimate of the maximum capitalization requirement of the supplementary loan window would be approximately TSh 7.5 billion. For comparison, a total of TSh 317 million in loans was issued under LGLB's Traditional Loan mechanism in 2003.

Qualification for Access

In order for local government authorities to qualify for access to the Supplementary Loan mechanism, it would have to meet the following criteria:

- The council has to have a minimum level of local revenue collections of at least TSh 2,000 per person.[6]
- The council has to be current on all obligations to LGLB's Traditional Loan mechanism.
- The council meets the same Minimum Access Conditions applicable to the Local Government Capital Development Grant
- The council has a capital development plan in place, and budgets in the context of a unified local budget.

Restriction on the amount and use of loan proceeds

- Loan proceeds may only be used for capital investment purposes, for either infrastructure investments in the social sector (schools, clinics, etc.) or for public investment in economic activities (markets, roads, and so forth).
- Maximum borrowing limit: a council's outstanding debt may not exceed 25% of general-purpose resources (own revenue collections plus general-purpose grants)
- Maximum limit on interest payment: projected interest payments may not exceed 20% of a local authority's discretionary general-purpose resources.
- The central government (PO-RALG and MOF) will guarantee that if the LGA defaults on its loan repayment, the loan repayment will be withheld as a first charge from the unconditional grant and paid directly by the Treasury. This would constitute a violation of the minimum

[5] Since local authorities are liable to repay these resources, it may be possible to attract loan funds through the World Bank, African Development Bank, or other more specialized agencies, such as the German KfW Development Bank or Japanese Development Bank.

[6] This recommended minimum level (TSh 2,000) is approximately twice the average level of local collections, assuring that qualifying councils have a minimum ability to repay loans under the Supplementary Loan mechanism. Based on preliminary revenue data for the first half of 2004, 18 councils would meet this criterion. The level may be adjusted upward over time to provide an incentive for local governments to increase own source revenues in order to maintain access to the Supplementary Loans window.

access conditions.

<u>Loan conditions</u>
Qualifying loans could be issued against a concessionary interest rate of X % per annum, with a maturity of 3-5 years and a one-year grace period for the principal.

A recent study commissioned by LGRP (2005) recommends that the LGLB and its operations be significantly transformed. The LGLB study recommends the following key reforms:

- Transformation of the LGLB into an autonomous Local Government Finance Corporation (Limited)
- Modifying the composition of the Board to reflect ownership of the capital (resulting in greater autonomy and greater ownership outside central government)
- Capitalizing of the loans board through the issuance of shares, supplemented by capital obtained from development partners (including on-lending). The study envisions an initial capitalization of TSh 1.51 billion through the issuance of shares.
- Modifying the lending operations in line with international best practices, including expansion of the staff to encompass 55 professional and support staff.

In principle, the recommended transformation of the LGLB into a Local Government Finance Corporation (LGFC) fits well within the overall local government finance framework, as is developed and recommended by the Strategic Framework for Local Government Finance. However, the study team has a number of concerns and reservations about certain details of the recommendations made in the LGLB study. Our concerns include the following:

- <u>The absence of an inherent hard budget constraint</u>. The LGLB study acknowledges that there is a “culture of non-repayment” by local governments. Despite the fact that the LGLB document provides great detail on the reform of lending operations under the new Corporation, relatively little attention is paid to mechanisms to assure repayment of loans by LGAs and provide a hard budget constraint.

- <u>The need for limitations on borrowing to assure repayment</u>. In fact, the study asserts that the reformed lending mechanism will be able to serve urban, rural, and even village authorities. However, we believe it to be highly unlikely that most district authorities or village authorities (and even some urban authorities) would have the fiscal capacity to viably access and repay local government loans. The imposition of conditions and limits on LGA borrowing will likely reduce the ability of LGAs to absorb loan funding below the amounts envisioned by the LGLB study. This would be especially true for poorer (predominantly rural) LGAs.

- <u>Concern about the issuance of loan guarantees</u>. The issuance of loan guarantees by the Local Government Finance Corporation without a credible and viable way for the Corporation to assure repayment by LGAs (e.g., through bankruptcy legislation) presents a major risk for moral hazard. We suggest the issuance of loan guarantees is a risk that would unnecessarily complicate and compromise the integrity of the proposed mechanism.

- The absence of linkages with the Capital Development Grant System. The lending mechanism developed by the LGLB study seems to be developed almost independently from other potential sources of capital development funding, especially the Capital Development Grant mechanism. The worst thing that could happen is for these mechanisms be uncoordinated and to “compete” between each other. For instance, we would want to avoid unaccountable local governments that fail to qualify for the LGCDG to be able to access capital resources through the lending mechanism. As such, it will be critical that Minimum Access Conditions are cross-referenced between the LGCDG and the LGA lending mechanism.

- The implications for human resource capacity. The proposed transformation of the LGLB has significant implications for the human resource requirement to manage the operation. Two concerns here are, first, whether the LGLB has the human resource capacity to transform itself into the corporate entity envisioned by the LGLB study, and second, whether the scope of the proposed professional and administrative staff for the Local Government Finance Corporation is justified given the relative minor role played by borrowing in the local government finance framework and the scarcity of available experts in the area of local government finance issues in Tanzania.[7]

- The source of capitalization. It is not clear whether the source of funding for the initial capitalization of the LGFC would interfere with the funding of the LGCDG. This should obviously be avoided. Given the current funding constraints at the local level, it would be illogical to expect (and it is unlikely that LGAs would have the own revenue sources) to substantially buy into the LGFC.

- The speed of the reform. The LGLB study seems to suggest moving forward rapidly with the transformation of LGLB into a Corporation (in fact, the study provides draft languages for implementing legislation). While local government borrowing is an important pillar of fiscal decentralization, the reform of the LGLB may not be sufficiently high of a priority within the realm of local government finance. It also appears that key stakeholders (e.g., within the Ministry of Finance) still need to be sensitized to the appropriateness of this reform.

[7] By comparison, less than a dozen budget officers are available in the Ministry of Finance to administer and oversee the portfolio of TSh 474 billion in local government grants. The central government currently does not provide a single expert on local government revenues to support LGAs in revenue collections, which accounts for TSh 35-50 billion annually. Similarly, the proposed staffing for the LGLB would exceed the staffing for the entire LGRP Finance Component, including all ZRT Finance and Finance Management Experts.

- Ability to proceed with many of the recommendations under the current legal framework. We note that if the political will is present to pursue the recommended reforms, many of the recommendations made by the LGLB study could be implemented by the LGLB in its current incarnation without major legislative and institutional reforms.

In other words, we suggest that the Government of Tanzania in principle should move forward with the reforms that are recommended by the LGLB study, with the specific caveats as noted above. While the overall direction of the proposals for the transformation of the LGLB into a Local Government Finance Corporation is sound, there is no major reason to rush the introduction of these reforms. Instead, a more gradual transformation of the LGLB into an LGFC would be appropriate given the prominence of other ongoing reforms in the field of local government finance.