Chapter 21

Middle East and North Africa
Tunisia

Meeting most local government capital needs, the municipal development fund starts to borrow in the domestic capital markets.

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Lessons

A unitary and highly centralized state, Tunisia is making efforts to decentralize its governance and to develop its domestic financial markets. Private financial institutions have had little experience in lending to subnational governments, which have relied for credit finance almost exclusively on a municipal development fund. Local governments rely heavily on centrally collected and administered revenues and have little freedom to set local rates.

The municipal development fund in Tunisia is the cornerstone of the system for financing subnational investment, carried out as part of national planning. Combining loans and grants, the fund executes the central government's policy on financing subnational capital investment. Although the fund has little experience in raising capital, it recently has issued bonds on the domestic market.

The fund's sustainability would be enhanced by diversifying capital sources, broadening the range of services to local borrowers, and expanding its client base. Transforming the fund into an autonomous, commercially viable specialized financial institution may offer the best prospects for sustainability. Properly done, the development of the fund into a market-based institution—able to mobilize long-term resources on behalf of subnational borrowers—could catalyze the emergence and growth of a local government bond market in Tunisia.

In Tunisia subnational governments have relatively limited responsibilities for financing and providing services and so have relatively limited needs for long-term borrowing. The main urban services—such as water, transport, sanitation, and electricity—are provided by national agencies. Investments in health and education are also a national responsibility. Subnational governments are responsible mainly for roads, drainage, public order, pollution control, solid waste collection, and street cleaning and lighting. Their capital expenditures represent about 50 percent of their current revenues on average, though the share varies depending on the jurisdiction, with large urban centers devoting a bigger part of their budgets to investment spending than small rural entities.

The central government plays a major role in allocating resources and credit to subnational governments. Borrowing by subnational governments has occurred almost exclusively through a specialized financial intermediary wholly owned by the government, the Fund for Loans and Support to Local Communities (Caisse de Prêts et Soutien aux Collectivités Locales, or CPSCL). The CPSCL is also the main channel through which the central government transfers resources to subnational governments to finance their capital expenditures. Tunisia has no local government bond market in which subnational governments can issue debt, although it does have long-term credit markets for central government and corporate debt. The CPSCL's resources consist of a relatively large equity base provided by the government and external local government lines of credit provided by bilateral and multilateral financial institutions.

Tunisia has 256 local governments, representing about 60 percent of the country's population; the other 40 percent live in unincorporated areas. Local governments are managed by governing councils that elect a president. The governments have inadequate financial management capacity, with accounting systems that need to be improved. For example, while tax registers have been computerized in local governments, tax receipts are still processed manually.

Local governments depend on direct taxes for 32 percent of their resources. These include the hotel tax; the real estate tax; the undeveloped real estate tax; and the industrial, commercial, and professional establishments taxes. The taxes on real estate and undeveloped real estate were recently reformed, improving collections. Legislative and administrative changes in assessment values and improvements in accounting and computerization would also boost collections. Indirect taxes, mainly license fees for several types of small businesses, account for 8 percent of local government revenue. Many of these local levies are of little value and could be eliminated to allow local governments to focus on those with the greatest revenue potential. As in Morocco, local governments need greater freedom to fix rates in accordance with local ability to pay. Fees for public services, such as a surtax on electricity and a tax for removal of industrial waste, account for 24 percent of local government revenue.

In addition, subnational governments receive two types of financial transfers from the state. Transfers for operating expenditures are made through a dedicated fund, the Common Fund for Local Communities, which provided 27 percent of local government revenue in 2000. The formula for distributing these transfers includes an incentive for improved tax collections and an element of cross-subsidy to aid the poorer local governments. Transfers for investment financing come through one of two channels: the sectoral ministries, which deposit funds directly with local governments for financing certain types of equipment, or the CPSCL, which provides both grant financing and loans.

The fiscal situation of subnational governments remains precarious, reflecting their weak savings and borrowing capacity. Their current expenditures rose faster than their current revenues in 1992–2002. Their investments, though relatively small in volume, also increased more rapidly than their current revenues, with estimates suggesting that they doubled in current value in the same period. Moreover, a decline in the savings capacity of subnational governments has undermined their finances. Even so, the outlook for growth in subnational investment—and thus in subnational

borrowing—remains good. Progress, however, will depend on further institutional reforms addressing such aspects as decentralizing authority and involving the private sector in the provision of services through concessions, management contracts with capital expenditures, and other arrangements.

Framework for Subnational Finance

The capital investment projects of subnational governments and unincorporated rural areas are listed in the Communal Investment Plan as part of a national five-year economic development plan. Once the projects of subnational governments are included in the Communal Investment Plan, they are entitled to receive financing from the program. The financing plan for capital investment projects is based on a formula that outlines the following:

- The share to come from self-financing or a subnational government's own resources (about 30 percent).
- The share to come from grants or the central government's contribution (30 to 40 percent).
- The loan component granted by the CPSCL (30 to 40 percent).

Local projects outside the framework of the Communal Investment Plan are revenue-generating (commercial) schemes, such as slaughterhouses or public markets.

The Role of Credit in Financing Subnational Investment

At 30 to 40 percent, borrowing represents a significant share of the financing of subnational investment projects. Debt service accounts for some 15 to 20 percent of current revenues for subnational governments. Given limited savings capacity, repayments of principal need to be spread out over six years on average, so as not to undermine budgets.

Credit is allocated to subnational governments according to their size, a distribution policy intended to provide small subnational governments with the basic equipment needed even at the risk of increasing their debt relative to their own resources. Large cities have more room for maneuver but nevertheless are hampered by the rigidity of their resources from local taxes and intergovernmental transfers. The capacity of subnational governments to finance their capital projects in line with the investment plans set out in the Communal Investment Plan, and to repay their debt, will depend on a real increase in their revenue receipts. In turn, that will require

increasing central government transfers and subsidies, widening tax bases, and improving tax collection.

Constraints on Subnational Governments' Access to Investment Finance

The great diversity among Tunisia's subnational governments—in population size, economic resources, and the range of public services provided to residents—is mirrored in disparities in the capital bases and solvency. As a result, some subnational governments are better able than others to access credit, and a small number might be deemed creditworthy by potential creditors. However, the needs of these potentially creditworthy entities are large relative to the total demand for credit by subnational governments.

For subnational governments with a substantial capital base, the central government could conceivably decide not to finance investments in projects that have a strong potential of attracting private financing, such as solid waste treatment projects. In this case such projects might be financed by the CPSCL through arrangements involving private concessionaires and delegated service providers, although reforms would be needed to lay the groundwork for such private participation.

Indeed, the government is considering possible changes in the way subnational investments are financed. One option might be to progressively reduce, for a given period, the volume of CPSCL lending in a way congruent with the currently weak borrowing capacity of some subnational governments. An assessment should be made of the extent to which large subnational governments might be able to take advantage of more flexible financing plans than those provided for under the Communal Investment Plan—and greater freedom in the choice of investments.

For the subnational sector as a whole, the main constraint on investment financing relates to the financial situation of governments. Substantial financial adjustments will be crucial to enable subnational governments to carry out their investment programs.

The Role of the Municipal Development Fund

As Tunisia's municipal development fund, the CPSCL is the cornerstone of the system for financing subnational investment. Combining credit and grants, the CPSCL carries out the government policy on financing subnational capital investment under a set of procedures aimed at ensuring efficient distribution of investment credits. Since the CPSCL was created in 1975, the institutional framework governing its operations (legal status,

procedures manual, investment guide) has been amended twice, in 1992 and 1997. These amendments increased the resources available to the CPSCL but failed to endow it with sufficient autonomy in decisionmaking. Its mandate is still part of the relatively rigid framework under which the Communal Investment Plan is implemented. As the partner of subnational governments in financing their capital investments, the CPSCL ought to have greater autonomy.

The CPSCL's activities remain relatively modest in scope because large infrastructure investments are outside the purview of subnational governments and do not receive CPSCL financing. The policy on subnational capital investment under the Communal Investment Plans has been giving priority to bringing infrastructure and basic equipment up to a common level across subnational governments. The CPSCL distributes its financing among the 256 subnational governments in accordance with the government policy on financing subnational capital investment. Tunis alone accounts for 12 percent of debt outstanding, and the country's 10 next largest towns for another 35 percent. With the investment effort by subnational governments exceeding 40 percent of their current revenues, it can be realized only by combining loans and grants to achieve a high average rate of subsidy.

The CPSCL's financial prospects are linked to the resources and solvency of the subnational governments that are its customers. A recent strategic study commissioned by the CPSCL from expert consultants in local government finance looked at the CPSCL's prospects for change and sustainability. The study led to proposals for redistributing tax revenue and charges between the central and subnational levels of government (with an increase in financial transfers from the central government) and between subnational governments and other institutions or authorities providing public services at the local level. Strengthening the borrowing capacity of subnational governments—and the growth potential of the CPSCL—also would require increasing their tax revenue and tax collection levels. Without such measures, the CPSCL's activities could expand only very slowly or even decline, with serious repercussions for its profit margins and financial equilibrium.

An Expanded Framework for the Operations of the Municipal Development Fund

A review of the financial situation of subnational governments, particularly their debt ratios and their capacity to self-finance investments, suggests that

the CPSCL needs to move beyond the uniform method of financing that it has been using. Introducing several different financing "windows" would allow the CPSCL to adapt its assistance to the varied financial situations of subnational governments. It would also enable the CPSCL to identify new opportunities and to broaden the range of its activities, products, and clients.

The CPSCL, for example, might have two windows:

- One window, providing financing under the Communal Investment Plan, involving all transfers or subsidies provided on an off–balance sheet basis and for which the CPSCL would be acting as an agent for the government against a management fee.
- A second window for more commercial financial operations, for financing investments outside the Communal Investment Plan, on terms reflecting the cost of resources mobilized by the CPSCL on private credit markets.

In addition, the CPSCL might consider introducing instruments and products enabling it to offer its clientele a broader range of financial engineering and technical assistance services. As the CPSCL evolves, there might be a possibility of a third line of activities for financing operations by other categories of borrowers or clients, such as private entities to which subnational services are subcontracted. Such financing could occur only after reforms allowing private concessionaires and subcontracted service providers to participate in subnational investment programs.

By ensuring a reliable channel for credit for priority projects, the CPSCL has brought about significant improvements in the financing of subnational investments, often in difficult circumstances arising from the weak technical capabilities and financial and institutional constraints of subnational governments. For the CPSCL to be sustainable, however, it will need to boost its capacity to mobilize long-term financing and broaden its capital base by diversifying the resources on which it draws. If the CPSCL is to take on an enhanced role as a specialized financial institution and gain access to other types of resources, subnational finances must undergo adjustments. The capacity of subnational governments to finance their capital investments and repay their debts depends on a significant increase in subnational receipts.

Diversification of Activities, Products, and Clients

Under the proposed strategy for making the CPSCL financially sustainable, efforts should be made to strengthen the CPSCL's authority in com-

mitting resources. Requests by subnational governments for financing investments outside the Communal Investment Plan should be eligible for loans from the CPSCL to the extent that they meet its eligibility criteria, particularly the criteria relating to economic and financial returns (some of the projects now under the Communal Investment Plan might not fully comply with the CPSCL's standards). Moreover, these loans should be granted on terms reflecting the true cost of borrowing by the CPSCL on private credit markets.

The prospects for diversifying the CPSCL's clientele are limited in the short term. Consideration should be given to making CPSCL loans available to private concessionaires providing local public services, subject to limits on the share of such loans in the CPSCL's activities. This financing of concessionaires would be unlikely to crowd out other options for subnational governments if it were limited to resources that the CPSCL could borrow on private credit markets.

Financing requests from the most solvent subnational governments are expected to attract the interest of commercial banks and other sources of capital market financing over the next few years. Even so, the development of lending activity directed at the subnational sector remains a commitment that few domestic financial institutions are inclined to undertake. For this reason the CPSCL is still the agency best placed to respond to the financing needs of subnational governments, even if its skills in subnational financing may still need improvement.

The CPSCL has yet to acquire all the characteristics and assets of an effective specialized financial institution. Its lending activities and debt outstanding with subnational governments remain modest, reflecting the small share of subnational capital spending in the national investment effort. Moreover, its portfolio is subject to credit risks arising from the precarious financial situation of many of its borrowers. While its activities are now governed by centralized administrative procedures and financing policies under the Communal Investment Plan, under a new market-oriented regime the CPSCL would need to enhance its skills in the analysis of subnational finances, the evaluation of credit risk, and financial engineering, particularly in project structuring.

The continued importance of the policy of state subsidy of subnational investments means that the CPSCL would have to continue to finance subnational investments through a combination of loans and grants. However, this role should not preclude the diversification of its financial products. The CPSCL should aim at steady growth in its turnover, by offering a wider

range of options to subnational governments and by expanding its clientele to include private concessionaires and larger projects.

Diversification of Resources

The CPSCL needs to diversify its financing sources in domestic markets not only to finance its loans to subnational governments and respond to growing demand from clients but also to ensure its sustainability in Tunisia's evolving financial sector. Because the CPSCL cannot rely indefinitely or exclusively on lines of credit from external donors, developing the ability in the medium term to tap the bond market appears to be essential for continuing and sustaining its activity. The way in which the CPSCL finances its operations has not yet required specific skills for capital mobilization; if the institution is to grow and change, however, it will need to acquire these skills.

The CPSCL, as part of its efforts to diversify its resources, is seeking to mobilize credit through bond issues on the domestic financial market. It recently floated its first public bond issue in the local currency, with a maturity of seven years. For this purpose it obtained a credit rating from the Maghreb Rating Agency. The favorable rating of AA will permit the CPSCL to launch future bond issues under attractive terms. Nonetheless, the quality of its credit, as perceived by potential investors, will depend largely on the quality of its clients and their solvency.

Transformation into a Market-Based Specialized Financial Institution

The strategic study commissioned by the CPSCL concluded that the best path was to transform the institution into a market-based specialized financial intermediary for subnational governments. In this scenario a possible strategic alliance could be considered between the CPSCL and another financial institution interested in financing subnational governments' programs and projects, especially if the CPSCL were to broaden its activities to include other categories of borrowers and clients. As a specialized market-based institution, the CPSCL could envisage forming such an alliance on the basis of its comparative and competitive advantages in financing subnational investments—potentially attractive factors for banking institutions. This approach would avoid the prohibitive costs involved in setting up a bank while still affording the CPSCL access to an attractive source of funds, the deposits of the allied banking institution. The alliance would also allow the CPSCL to participate with its partner in loan syndications, for example, expanding the range of its activities to include operations of a scope and risk profile that would preclude the CPSCL from being the sole creditor.

The transformation of the CPSCL into an autonomous, commercially viable specialized financial institution should be accompanied by institutional and regulatory strengthening. Changes are needed in the CPSCL's statutes, for example, to progressively transform the CPSCL into a limited liability company, allowing it to strengthen its capital base by attracting new partners that would shore up its position in the financial sector. The CPSCL's capital market skills need to be enhanced in anticipation of the diversification of its resources and access to private credit markets. Also needed is the development of policies, guidelines, and procedures reflecting the CPSCL's current method of financing and expected changes (for example, addressing issues relating to project financing and financial engineering, including financial restructuring plans for subnational governments in difficulty). Done properly, the development of the CPSCL into a market-based institution—able to mobilize long-term resources on behalf of subnational borrowers—could serve as a catalyst for the emergence and growth of a local government bond market in Tunisia.