Chapter 20

Middle East and North Africa
Morocco

In a developing financial market with good potential, private investors are reluctant to lend to local governments that have little fiscal autonomy.

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Lessons

In Morocco, a unitary state with highly centralized governance, a national lending agency has dominated local government borrowing. The country is working to decentralize its governance and is still developing its domestic financial markets, which have had little experience in lending to subnational governments. Municipalities depend heavily on centrally collected and administered revenues and have little flexibility in setting local rates. Even so, local governments are important service providers, with large capital spending needs.

Morocco relies on a municipal development fund, the Communal Infrastructure Fund, as a vehicle for ensuring access to credit for municipalities that are too small or too heavily dependent on the central government to tap credit markets directly. The country's experience with its lending program has been fairly positive, but resource constraints threaten to crimp future

growth. The Communal Infrastructure Fund, almost the only source for long-term credit to subnational governments, has relied for resources largely on government funding and on lines of credit from official bilateral sources and multilateral institutions. Now diversifying its funding sources, it has been tapping domestic financial markets for long-term credit. The fund has issued medium- and long-term securities on domestic markets without government guarantee and has been steadily improving its management of financial risks and conforming with prudential regulations.

Deficiencies in financial management and reporting by subnational governments hamper their access to private credit, and centrally provided credit has limitations. Prescriptions of ways to address these shortcomings and limitations provide insight into the choices policymakers need to confront to make subnational access to credit more feasible.

In the more than 20 years since Morocco introduced the basic laws for municipalities—the Law on Municipal Organization and the Law on Organization of the Finances of Local Governments—it has experimented with and gradually extended the fiscal and administrative framework of decentralization. During this period the country has strengthened decentralization by reforming local revenues, adopting formula-based intergovernmental transfers, and establishing a stable system of credit financing. Decentralization both poses great challenges and offers great potential—because of tight budgets, disparities in access to basic services, and the increased demand for basic services that has arisen with Morocco's rapid urbanization. The challenges of development require a good framework for budgetary processes, intergovernmental fiscal relations, the assignment of expenditures and revenues, and the development of subnational credit markets.

In Morocco urban municipalities depend for 40 percent of their revenues on three centrally administered taxes: two shared taxes—an urban tax and a business tax—and a local property-based tax. They derive another third of their revenues from intergovernmental transfers, and the rest from

local fees and taxes. The share of revenues from own sources for local governments in Morocco appears to be comparable to that in many OECD countries. Local governments in Morocco depend less on central transfers than do municipalities in Latin America, for example, where transfers account for more than half of revenues on average. However, these governments have limited fiscal autonomy, with little discretion in determining the base or rate for shared and local taxes or even for user charges and fees for municipal services. An estimated 70 percent of local government revenues are subject to centrally set rates.

If local governments are to meet their financing needs, they will have to rely more on local revenues. Most own-source revenues are fees and charges for services or for periodic activities (such as annual fairs), and motor vehicle taxes generally accrue to the central level. Thus the most immediate prospect for increasing local revenues appears to be raising existing property taxes. Local governments also need greater freedom to determine local fees and charges for services.

Morocco has recently reformed its intergovernmental transfer system to remove the perverse incentives for deficit spending and unwise borrowing. By eliminating the budget deficit subsidy, the reforms have imposed a hard budget constraint on local governments and ensured that they would bear the full cost of borrowing. The reforms have also introduced a formula for distributing value added tax revenue that has improved the equity of fiscal transfers to local governments as well as the predictability and transparency of local revenues.

Subnational Government Borrowing

While Morocco has been liberalizing its financial sector and reforming its local government sector, the ability of subnational governments to access private credit remains largely untested. That ability depends on the quality of the fiscal and financial management, the budgetary and control systems, and the planning and implementation of their investment programs. One of the main determinants of subnational governments' creditworthiness and access to private funding under market conditions, however, is the legal and regulatory framework in which they generate revenues, manage assets, and finance and provide services.

Morocco's relatively developed financial markets provide a potentially good base of long-term funding for subnational governments. Total bank credit in the country averaged around $15 billion, or about 50 percent of

GDP, over the past five years. However, with the exception of a small number of direct bond issues by Casablanca,[1] local government borrowing has taken place predominantly through loans from the publicly owned, specialized financial intermediary, the Communal Infrastructure Fund. Although no legal restrictions prevent subnational governments from borrowing from other financial institutions, borrowings from commercial banks have been limited, mainly because of regulatory and institutional impediments affecting the risk associated with subnational borrowers. Foremost among these impediments are the limited autonomy and authority of subnational governments in mobilizing revenues and managing expenditures.

To foster a more efficient subnational finance system, the central government has embarked on reforms to help expand the bankable demand for private credit and increase the participation of private financial institutions in subnational investment funding. Success in these reforms will be critical given the pressing need to reach beyond budgetary resources to meet the large investment funding requirements. The hope is that, in an appropriate enabling environment, commercial banks would be interested in the potentially growing subnational finance market—previously too fragmented and unknown to justify large commitments and investments in systems development and know-how.

Main Issues in Subnational Borrowing

In Morocco credit financing accounted for about 8 percent of the total resources of subnational governments, and debt service for 19 percent of their current expenditures, over the five-year period from 1996–2000. While there is both potential and scope for further expansion of subnational credit markets, this expansion would need to be supported by regulations and instruments adapted to the investment financing needs of subnational governments. It also would require easing the demand-side constraints that impede their access to credit. These constraints relate mainly to the following:

- Subnational governments' lack of autonomy in fiscal decisionmaking coupled with poor planning and operating capabilities.
- Inadequate, ad hoc, or inconsistent economic selection criteria and benchmarks used by the central government in its review of subnational investment programs.
- The inefficiency of asset management by subnational governments.

- The absence of performance standards for locally provided monopoly services, which has resulted in poor quality of service delivery.
- The inadequacy of cost recovery practices and their lack of differentiation between revenue-generating services and public goods.
- Inadequate collection levels for user fees.

In addition, mobilizing private resources for subnational infrastructure in Morocco is likely to require a greater role for private providers of services—through greater use of concession arrangements, for example. The provision of services remains too centralized and uncompetitive.

Reforms aimed at improving local revenue mobilization and financial management focus on accounting, payment, financial control, and audit systems and on the incentives needed for timely collection of resources and reduced payment delays. Particularly important is greater capacity to generate own-source revenues through rational bases and rates for local taxes and adequate collection levels. The recently approved formula-based distribution of value added tax revenue has improved the predictability of part of the revenues of local governments, though more needs to be done for other sources of shared revenues. In addition, the central government has been working to improve the efficiency and transparency of its extensive administrative, financial, and budgetary controls, with a view particularly to reducing perceptions among potential private lenders that the government implicitly guarantees subnational borrowings.

Regulatory Environment for Subnational Borrowing

On the supply side an increase in subnational borrowing in the domestic financial markets will depend on adjustments to laws and regulations related to borrowing authority and the issuance, registration, and servicing of debt. The governance and transparency of financial markets need to be improved through rules that avoid creating distortions by remaining neutral between market participants and between instruments (such as between loans and bonds). Moreover, the regulatory and supervisory framework for subnational borrowing needs to be strengthened through sound bankruptcy laws and prudential regulations.

Bankruptcy of subnational governments needs to be governed by regulations on debt adjustments, bankruptcy initiation, debt workout plans, and allowed expenditures during bankruptcy proceedings. The protection of creditors' rights needs to be clarified by addressing such things as the authority to pledge assets as security for borrowing, to set up independent

trusts to handle the recurrent revenues of projects, and to establish sinking funds to amortize repayments of principal. In particular, the authority to pledge assets needs to be defined by regulations that differentiate between categories of subnational assets, such as core assets that may not be sold or used as debt collateral and noncore assets that may be used as collateral. In addition, measures are needed to improve the reliability of asset registration and valuation.

In the area of prudential regulations the central government has imposed limits and controls on subnational government borrowing, primarily through regulations relating to the receipt of loans from the Communal Infrastructure Fund. Debt service payments associated with subnational government borrowing must be treated as obligatory expenditures recorded in local budgets. Funds are not sequestered, but the local government must approve the budget, and debt service is a priority expenditure. Although this budgetary commitment does not guarantee against default—since expenditures related to debt service still need to be authorized by the local government—it does make default less likely. Moreover, regardless of the implied comfort, private creditors can set their own exposure limits. The prudential rules of the Communal Infrastructure Fund, for example, limit eligibility for borrowing to subnational governments whose debt service does not exceed 40 percent of their combined own-source and value added tax revenues. Debt service is estimated to be in the range of 20 to 25 percent of total local budgets.

Several reforms are needed to encourage private participation in subnational borrowing. An important focus of the regulatory reforms should be information to prospective creditors about the financial situation of subnational borrowers, particularly their indebtedness—whether direct liabilities or contingent liabilities such as guarantees. Disclosure rules should distinguish between publicly and privately placed offerings, with private placements subject to less stringent disclosure. Disclosure also would provide a useful basis for credit rating, which in time might become a statutory requirement to allow creditors to assess their exposure to local governments. Audits are required, but they should be conducted by a government agency rather than an independent party.

Types of Subnational Borrowing

Most subnational borrowings in Morocco have been earmarked for specific infrastructure investments. Even so, the financial industry has not sought to develop specific infrastructure finance instruments that would entail a dis-

tinction between tax-supported (general obligation) and revenue-based (limited obligation) borrowing schemes. Tax-supported borrowings allow subnational governments to service debt out of general revenues. They are often used to finance "public-good" projects that indirectly produce tax revenue (such as by increasing real estate values or stimulating economic growth and business investments) that can help meet debt service. In Morocco the prospects for effective tax-based funding schemes are not promising. Because subnational governments lack the authority to determine the bases and rates for locally collected taxes and to ensure adequate collection levels, they are unlikely to capture the benefits of many public-good projects.

Revenue-based borrowing, not yet used in Morocco, allows the borrower to meet debt service obligations from the revenues of the project financed by the debt. As a means of credit enhancement, these revenues are pledged to creditors as senior debt collateral. This requires segregating the revenues in an account out of which debt holders would be paid on a priority basis. Under existing laws, however, it is unclear whether subnational governments in Morocco can pledge future revenues as security for borrowing.

Revenue-based borrowings can be structured on a nonrecourse basis, in which creditors' claims are limited to the project's revenues or, at most, the project entity's assets. Because these revenues and assets can be segregated from other subnational government assets, nonrecourse finance can shield the central government from implicit contingent liabilities associated with subnational debt.

Communal Infrastructure Fund: Intermediary for Subnational Borrowing

Using a financial intermediary that can tap credit markets on behalf of subnational borrowers is one way to foster market access for small and medium-size municipalities that still cannot directly access Morocco's long-term credit markets. The Communal Infrastructure Fund, which has been almost the only source of long-term credit for subnational governments, has relied for resources largely on government funding and on lines of credit from official bilateral sources and multilateral institutions. Recently it has sought to diversify its funding sources, and as part of its strategy it has been tapping the domestic financial markets for long-term credit.

The Communal Infrastructure Fund has issued medium- and long-term securities (variable rate notes and certificates of deposit), without government guarantee, at small spreads over government debt issues. It has been steadily

improving its management of financial risks, conforming with the prudential regulations of the banking authorities. Its issues, amounting to a dozen so far, have been relatively evenly spaced. In the 1990s the fund's lending accounted for some 20 to 25 percent of total investment outlays by subnational (principally municipal) governments. In the past few years subnational credit has declined somewhat in real terms (as has subnational investment), despite expectations that the volume of credit would grow as a result of the reforms in the intergovernmental transfer and local revenue schemes.

The subnational credit market in Morocco remains relatively small, with the Communal Infrastructure Fund's portfolio of $500 million representing about 3 percent of outstanding bank credit. Its annual loan commitments range between $100 million and $200 million. Most of the fund's lending has gone to urban municipalities, which account for about 70 percent of outstanding credit. Rural communes, with small projects and limited debt service capacity, account for about 25 percent of outstanding credit. (The balance of the fund's lending goes to municipal corporations.) However, rural communes hold more than half the outstanding loans by number.

The loans extended by the Communal Infrastructure Fund in the 1990s were largely for non-revenue-generating projects—roads (32 percent of total loans), electricity (16 percent, mainly to rural communes participating in national electrification programs), solid waste management (10 percent), sewerage (9 percent), sports facilities (6 percent), urban transport (3 percent), and water supply (2 percent). This sectoral distribution shows that the fund has been a relatively important source of financing for sewerage and solid waste projects. The small share of financing for water supply reflects the fact that water investments are the responsibility of the national water authority, which does not borrow from the fund. Loans for commercial infrastructure (such as local markets) have accounted for some 15 percent of the total.

The Communal Infrastructure Fund has the potential to take on an increasingly important role in subnational finance. It has a valuable franchise with subnational governments, specialized knowledge, a strong equity base, and a broad and diversified project portfolio. It has been the preferred lending vehicle for subnational governments and can continue to mobilize funds on behalf of local governments, mainly from official bilateral and multilateral sources. Financial measures have been taken to strengthen its autonomy, financial viability, and capital base. Government guarantees are no longer provided for its domestic bond issues, and its provisions on loan arrears are now in line with the prudential requirements for the banking sector. Its repayment experience is good, with few loans in arrears.

With further reforms, the Communal Infrastructure Fund might be able to play more of a developmental role in subnational finance in the context of an open, competitive financial sector. The fund is expected to make its operations increasingly sustainable and to leverage its capital by issuing debt in private credit markets and lending the proceeds to subnational governments. It could expand its menu of services to include nonlending products, such as fee-based financial advisory services and technical assistance to larger municipalities. In time it could expand its range of borrowers beyond subnational governments to other providers of local services, whether public entities or private concessionaires.

As a provider of long-term credit to subnational governments, the Communal Infrastructure Fund could participate in and sometimes lead banking syndicates for larger loans to subnational governments and concessions for local infrastructure and possibly help in underwriting subnational bond issues. In pooling the credit demand of subnational borrowers, the fund could act as a bridge between subnational governments and institutional investors. This would be especially useful where subnational governments have little potential for directly accessing private credit markets and where institutional investors are in no position to assess the risk of individual subnational governments but might be willing to assume, through the Communal Infrastructure Fund, a diversified exposure to the subnational government sector.

Private Financial Institutions in Subnational Borrowing

Commercial banks have shown little interest in lending to local governments in Morocco. Among the main factors inhibiting such lending are the limited autonomy of subnational governments, the weak institutional and management capacity, the lack of transparency and weak auditing standards, and the lack of access to timely and reliable information on subnational governments' financial and operational performance. Added to these are the generic difficulties of perfecting collateral interests through cumbersome and uncertain recourse to the judicial system. Accordingly, despite the banks' large liquidity and their financial advantages over the Communal Infrastructure Fund (which lacks access to lower-cost deposits and cannot finance private concessions), the few attempts by banks to enter the subnational finance market have been inconclusive. Most commercial bank term lending for infrastructure has been restricted to private concessions and, occasionally, municipal corporations. As a result, banks still lack

familiarity with the legal, institutional, and regulatory framework in which subnational governments operate.

Yet commercial banks' interest and involvement in the subnational finance market could grow in line with demand if the demand is at a scale sufficient to sustain the business development costs involved for banks entering and competing in the infrastructure sector (particularly in water, sewerage, and solid waste, where future investments by subnational governments are expected to be substantial). Depending on the depth and effectiveness of reforms in the subnational government sector, banks also could be attracted by prospects for increased profitability resulting from the expectation of greater credit demand, lower operational costs, and more manageable credit risks.

Potential Role for the Bond Markets in Subnational Borrowing

The institutional savings in Morocco could potentially provide a substantial funding pool for investments in subnational government projects. Indeed, given the shortage of attractive fixed income securities for pension funds, insurance companies, and mutual funds, debt securities issued by subnational governments could be appealing, particularly those issued by large urban municipalities with sufficient and stable resources. First, however, obstacles to issuing public debt must be removed and regulations governing financial transactions by subnational governments introduced (in such areas as financial disclosure, registration, underwriting, distribution, instruments). The capital market regulations now in effect do not respond to the needs of subnational issuers, particularly with respect to procedures and disclosure requirements.

Because of limited technical capabilities and high transaction costs, only a few subnational governments in Morocco—the largest urban municipalities—would be likely to access the bond markets directly. Nonetheless, the development of a subnational securities market could foster the broader reforms—in disclosure, financial transparency, management quality, auditing, asset collateralization, and credit rating capabilities—that are needed for independent assessment of the creditworthiness of local governments.

Note

1. These bonds are not listed on an exchange and were distributed solely domestically.