CENTER FOR ECONOMIC INITIATIVES

Securing the Access of Municipalities to Credit Resources

BAKI – 2010

This document is a publication of the Project entitled "Strengthening Local Self-government in Azerbaijan" with financial support from Oxfam GB (Great Britain) and ICCO (Holland).

Authors:

Rovshen Agayev
Samir Aliyev

For more information, contact:

21 Zulfi Adıgozelov Street,
Bakı, Az1009, Azerbaycan
Tel: (99412) 5964459
Fax: (99412) 5964978
E-mail: **sei@azeronline.com**
Web site: **www.sei.az**

Introduction

Securing borrowing opportunities of local self-government institutions through the credit market is practiced in many countries. Before detailing such practices, there is a need to give an exact answer to this question: What necessitates the availability of municipalities' access to credit resources? In international practice, local tax sources cannot guarantee municipalities to adequately perform authorities. At the same time, the most ideal subsidized mechanisms (transfers to local budgets from upper level funds) applied to square or balance local budgets do not enable municipalities to access funds timely required for rendering adequate social services. So, the fact that local authorities have opportunity for access to the debt market does not mean they face large-size debt burden (risk too). On the contrary, this is a real and flexible financial mechanism promoting local authorities to undertake liabilities in a timely and qualitative manner, stimulate local social and economic development.

Although the rules for loans to local authorities are different in each country, there is a common feature: as a rule, they cannot take loans to compensate current outlays. Loans can be used to cover capital expenditure. Certainly, this approach causes a logic question: Why are local authorities barred from covering their current expenditure through loan funds? One reason is that financing of current expenditure through loans may result in the increase of uncontrolled debt burden. Another reason is that it may slake municipalities in terms of sufficiency utilization of their own revenue sources.

In Azerbaijan, local authorities cannot access credit resources, yet ten years have passed since local government institutions came into existence in the country. Although the existing legislation does not impose legal restrictions on credit resources, today's provisions within the credit market (lending rates in particular) are not absolutely favorable for local authorities. Since their activity is directly linked with social services. Much noteworthy is that their activity does not aim to make profit, but to meet public needs for social services. Therefore, local authorities cannot take the credit under commercial principles applied on private sector, but should benefit from concessional lending as governmental authorities. Besides, most countries have established specialized financial and credit institutions to facilitate municipal. Because unlike commercial banks, such institutions prioritize their activity as a key mission to provide soft and required loans to local authorities, while meaning they are committed to acting this way.

In Azerbaijan, the National Associations local authorities are consulted through should expand their scope of activities, performs duties subject to the statutory requirements.

The credit market access and forms of crediting for municipalities found in international practices have been studied while elaborating this document. The document also contains a series of case studies based on practices in neighboring countries – Turkey and Poland, as well as in developed countries.

The policy document builds upon a survey conducted among 50 municipalities in 12 regions throughout the republic. It has been sought to study municipal needs for credit resources, their attitude to the forms of credit. 10% of the respondents were from Şamaxı, 8% - Deveçi, 10% - Göyçay, 4% - Astara, 6% - Şeki, 2% - Ağdam, 12% - Quba, 8% - Barda, 10% - Hacıqabul, 10% - Lenkeran, 16% - Bakı, 2% - Abşeron. Also 68% of the respondents represented village municipalities, 24% settlement municipalities, 8% city municipalities.

The document consists of 4 parts. Part I – **"Problem Statement"** highlights existing problems regarding the credit market access for local authorities in Azerbaijan. Part II – **"Alternative Options"** mirrors three Alternatives (Alternative options) to ensure the credit market access for local authorities presented by SEI experts, as well as provides their explanation, possible realization, advantages and disadvantages. Part III – **"Evaluation of Alternative Options"** contains expert assessment of the three Alternative mechanisms on the basis of assessment criteria. Each Alternative is assessed according to these criteria. Part IV – **"Outcomes and Recommendations"** summarizes the study and lists recommendations for decision makers.

The aim of this document prepared with financial support from Oxfam (Great Britain) and ICCO (Holland) is to help local authorities to gain sufficient access to the local financial and credit markets. The authors believe that this policy document will contribute to the activity of structures responsible for improving the financial system of local authorities.

PROBLEM STATEMENT

Under paragraphs 1 and 4 of Article 9 (Financial resources of local authorities) of the European Charter of Local Self-Government, local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers and the financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks. The essence of this approach is that part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate. Since under Paragraph 8 of the same article, for the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law. In foreign practice, local authorities' access to the loan market is provided through: ***(1)*** credit financing by means of issuing municipal bonds**;** ***(2)*** taking credits directly from financial institutions.

None of the financial mechanisms introduced in the past 10 years since the establishment of municipalities in Azerbaijan have been applicable. Lack of issuing municipal bonds is coped with delayed expansion of the domestic securities market. At present, the ratio of stock market capitalization (AZN 457.3 million) to GDP is around 2 percent. This is several ten times less compared to developed countries. In addition, restricted power of municipalities in rendering public services, in particular the fact that the network of utilities services is beyond municipal competence, remain obstacles to the issue of municipal bonds. At the same time, municipal bonds can be effective in an environment, where municipalities have exclusive authority in introducing and amending local tax rates. Namely, unless the liability of municipal bond issues results in bond yield, their expenses can be covered through tax increases. In developed countries, a competent executing entity is created to secure municipal access to the debt market through securities and the process is regulated by this entity.

Given existing economic realities, it is rather easier and more applicable to provide municipal access to credit resources through financial and credit institutions.

Azerbaijan's existing banking law imposes no restriction on municipal crediting. Ice-versa, under the law commercial banks are free to adopt decisions on this issue. Pursuant to the Central Bank's Regulations on Credit Allocations in Banks, each bank shall develop a strategy on credit granting depending on the characteristics and scope of its activity, as well as inetrbank regulations on risk management, including but not limited to, risk definition, assessment and control. Under the document, the criteria assessing credit orders placed with the bank are determined according to the credit volume, its length, related risk level, the debtor's activity, and other factors. Key factors here are as following:

- purpose of credits and source of payments;

- risk level related to the debtor and its credit order;
- sensitivity of credit and its instrument in the market and economic changes;
- subject to debtor's credit history, including historical sources and various scenarios, the debtor's current credit payment capacity based on cash flow forecasts;
- debtor's skills and background in commercial credit services;
- the state of market sector in terms of credit types and the debtor's state in this sector;
- Credit provisions and length including the opportunity to amend credit contract or agreement during credit period;
- Guarantee adequacy and its realization and use if need be.

When credit is granted to the debtor for the first time, the bank must take into consideration the debtor's reputation and greater capacity in the provision of credit guarantees.

The banks also take into account the customer's corporate management system when assessing credit orders and its adequacy while measuring credit risks.

Under the law in force, the state is not responsible for municipalities' instruments before the banks. According to the Central Bank's (CBA) requirements, financial statements must be presented before and after granting credits in order to determine the debtor's credit repayment capacity.

When ordering credits, the municipality shall fill out and submit a Credit Memorandum blank (the blank is available with banks)that contains the credit purpose, length, repayment mechanism, commitment, etc. Once local self-government authorities have established close contacts with banks and taken and repaid credits for several times within a certain period of time (say within a year), it may be possible to simplify document requirements (for example: simple credit can be replaced with credit line, which is a more convenient instrument). In line with the existing law and modern experience, municipalities' property, their capital issues (such as bonds, bills, shares of their enterprises, etc), their cash flows, income, assets purchased through credits (equipment, technological lines, transportation means, immovables, etc) may act in the capacity of guarantee and collateral. However, the reality is that for local authorities it is more appropriate to obtain concessional loans due to limited incomes.

So, local authorities in Azerbaijan now have no access to financial institutions, yet there are no legal obstacles for municipal crediting. One of the reasons for such situation is the fact that municipalities possess no pledged property required for credit access. Another important reason is lack of terms and conditions for concessional loans. It is known that as municipalities are not commercial institutions and their objective in most countries is to render public services to residents within their catchment area (such as drinkable water supplies, etc), they gain no profit. Ice-versa they are provided with subsidies through various funds (including local and government funds) formed on public funds. Or municipalities sometimes need short-or mid-term loans to implement locally social investment projects (road-construction and repair, park renovation and development, etc). so municipal crediting under commercial conditions to this end would be correct neither logically, nor in respects of economically profit and efficiency as well as of social interests.

Finally, a reason for failure to have access to the loan market is lack of skills and habits, in particular lack of their strategy required for addressing credit instruments. Key is to develop a strategy program for financing of municipalities' capital expenditures. The program should highlight real needs for capital expenditures in short-, mid- and long-terms, investment priorities, various alternative options for financing of planned projects.

ALTERNATIVES

Based on the research, including surveys and expert debates, three options have been defined as part of the policy development, in order to ensure municipal access to credit resources. These alternative options are as following:

1. Relevant amendments to the law to secure granting of concessional loans to local *(status-quo)*
2. *Municipal credit financing through creating a specialized municipal bank*
3. *Improvement of the crediting mechanism by creating a Municipal Development Fund*

Below is the detailed analysis of each option.

4. **Alternative 1: <u>Relevant amendments to the law to secure granting of concessional loans to local *(status-quo)*</u>**

Under the law on financial sources of municipalities there are no legal restrictions to grant credits to municipalities from resident banks and other lending organizations. Local self-government institutions can obtain short- and long-term credits from the said financial establishments. So lack of municipal crediting in Azerbaijan over the past 11 years can be due to the facts listed below:

1) ***Municipalities had had no need for credit resources.*** *Nevertheless, the survey among municipality representatives in different provinces across the republic conducted as part of this document showed that this version cannot be justified. Since all of the 50 municipality chiefs involved in the survey said they wanted to access credit resources, 40% of whom saw it expedient to use credit resources for establishment of municipal entities engaged in production, 60% - for the implementation of various infrastructure projects as well as creation of municipal services providing public services (**Annex 1**).*
2) ***Although law envisages municipal financing, there are no mechanisms to execute crediting.*** *In most countries, the purpose and maturities of municipal financing is restricted by the law. For example, municipal borrowing for operating expenditure is prohibited, as a rule. It may be permissible to borrow funds for investment projects. Or in some countries, the maturities of most municipal credits can be short-term (up to 3 years) and mid-term (up to 10 years). And in some counties, the volume of loans is restricted in a certain proportion to local budget expenditures.*
3) ***Existing crediting conditions meet no municipalities' interests and are not favorable in economic terms.*** *Local governments in Azerbaijan have much less financial opportunity. In 2009 overall revenues of local budgets accounted for less than 0.5% of the country's public funds. Under such conditions local governments cannot own or administer property with much value. Given that there are only commercial banks in Azerbaijan, it is impossible to provide loans to any entity, including local governments, without having real*

collateral. Namely, unlike other organizations (for example, business structures), the law does not envisage concessional lending for *local governments.*

In order to facilitate local governments to have sufficient access to credit resources through legislation improvement, it is necessary to amend some legal norms to the law on financial sources of municipalities. ***First,*** the law must set out that municipal borrowing can be permissible for capital expenditures only. ***Secondly,*** the volume of municipal borrowing must be restricted. For example, the volume of loans granted should not exceed 30 % the debtor's annual budget revenues, while debt service expenditure - 10% of annual budget expenditures. ***Thirdly,*** municipal borrowing must be recognized in the domestic market only. ***Finally***, the maturity of municipal loans must be restricted, say, at a maximum repayment period of 10-15 years.

In addition, it is possible to include provisions for the concessional lending regime for *local governments in the existing bank-lending legislation*. Here, the higher interest limits may be fixed for non-commercial municipal debts, especially for creation of public services and infrastructure. For example, it can be mentioned that credits granted to local governments for this purpose can be 2% (or 3%) than the centralized interest rate determined by the Central Bank (CBA). In this case, however, the credit resources must be provided at the expense of the government.

The law should also envisage credit loans with no collateral. In this case, credit projects of social importance recommended by the appropriate executive power (of the Central Bank or Finance ministry, for example) can be secured or covered by the government. Then local governments will not think about collateral.

By amending the law on budget system, it is possible to create a mechanism aimed at granting budgetary credits to local budget out of the state budget. It is appropriate to grant budgetary credits for the period at a length of one year and at lower rates. Such credits could be provided to fund budget deficit causing problems to the execution of the receipts item.

Municipalities' opportunity to gain sufficient access to credit resources are different in each country[1].

In **Belgium**, local governments obtain loans mainly through The bank, called Crédit Communal de Belgique. Although there are no limits in the volume of loans, they are provided for concrete purposes. Local governments use loans for capital expenditures only. The Interior Ministry announces the credit rates once a year depending on the repayment period.

In **Bulgaria**, municipal borrowing for operating expenditure is prohibited. Local governments do not need to obtain official permission from a body for credit market

[1] «Dünyada mahalli idareler». Ankara- 1999

access, but they cannot use foreign financial institutions as a debt instrument. However, in practice the government uses part of external loans to handle local problems (basically, drinkable water supplies and road operations) and local governments act in the capacity of implementing partners. Local governments can borrow from two sources: one-year credits from the state budget and credits provided by local lending institutions and firms.

In **France**, there are no restrictions to municipal borrowing and there is no need for permission from official bodies. They borrow credits mainly from the bank called Credit local de France. Credit resources cannot be disbursed to repay old credits and cover running expenditures. Such loans can be used to cover capital expenditure. About 10% of local budgets comes from loans in late years in France. The share of local taxes in local budgets is slightly more than 40%, while transfers from upper budget chains hardly touch 30%[2].

In **Spain**, there some restrictions for municipal borrowing. Since local governments must ask permission from the Finance Ministry to get access to the domestic credit market, while from the Central Bank for external borrowing. But unless the planned loans exceed 25% of budget revenue forecasts as well as 5% of of the project value to be financed through the planned loans, there is no need for official permission.

Similar restrictions are applied in **Portugal**. Under the Portuguese law, the amount of annual debt interests cannot exceed 20% of investment funds to be spent during the year.

In **Macedonia**, local governments can obtain credits not exceeding 20% of the annual operating budget and Such loans can be used to cover investment purposes. In this country, the share of municipal credits in GDP has averaged 1.4% (EUR 43 million) in late years[3].

The main purpose of the Alternative is to recognize by the law local governments as entities having access to concessional loans*, to ensure budgetary credits to local governments from the sate budget.*

To this end, the government must make sure that low-interest loans are granted to local governments through the Central Bank and this is marked as a separate item in the state budget. The loan interest can be fixed at about 2-3% compared to centralized loan interests. The Central Bank shall directly control crediting through authorized banks.

This Alternative has some advantages and disadvantages.

Advantages:

- Commercial banks will stimulate local governments to grant credits
- There is no need to make broader amendments to the law.

[2] "Report on Local and Regional Democracy in France". Explanatory Memorandum www.coe.int

[3] Децентрализация фискальной политики в условиях экономики переходного периода, кейс стади (анализ конкретных примеров) стран Балканского и Кавказского регионов. Братислава 2005 www.undp.org/europeandcis

Disadvantages:

- Lack of documents certifying the property owned or administered by some local governments may hamper credits granted with collateral.
- Potential stagnation in the credit market may restrict municipal access to credit resources
- Local governments' current economic conditions prevent them from accessing credit resources.

Alternative 2 "Municipal credit financing through creating a specialized municipal bank"

Specialized municipal banks in the world are directly created with the state's support. At present, such entities exist in over 50 countries around the world. In the most countries where the municipal banks are being operating, the local authorities are only entitled to obtain credit from those financial establishments. The said banks release the municipalities to seek resources in local and foreign markets, to pass exhausting and bureaucratic procedures in credit financing. They undertake these functions instead of them. First of all, if there is shortage of resources, the central government finances the municipal bank non-repayable loan or reimbursable loan bearing no interest. In some cases the banks involve long-term loans at lowest interest from foreign partners under the state guarantee. Merely, in the world practice for protection of municipal banks from bankruptcy the government uses the opportunities of separate insurance and guarantee funds to insure the funds and credit resources of those banks. As a rule, the government also undertakes insurance funds for that guarantee.

The functions of the municipal banks are not limited only to meeting the needs of their clients for credit, but also they provide different services. For instance, management of local budget, planning of capital costs and substantiation of the projects is directly implemented by advice of bank tellers. If required, bank tellers conduct trainings to municipal personnel in relation to those problems[4].

There are a number of countries around the world qualified in the sphere of establishment and activity of municipal banks. For instance, ***Netherlands Municipal Bank*** has 86-year history. At present, 50 percent of the bank's shares holding assets in the amount of 50 billion USD belong to central government and 50 percent to municipalities. CommuneCredit – a specialized Denmark cooperative bank (it was founded in 1898) has also been established on the basis of the similar principles.

Neighboring Turkey has very rich and interesting practice in the field of municipal banking. Municipal Bank was established in this country in 1933 (June 11th) and the bank's name was changed and called "Eller Banki". At present, the value of its total assets is 3

[4] Развитие бюджетного федерализма: международый опыт и Российксая практика. Москва- 2006.

billion YTL (approximately 2,1 billion USD). The bank offers to municipalities 5 percent credit resources. The volume of the bank's total investment in 2003-2007 was 5,2 billion YTL (approximately 3,7 billion USD) on 1231 projects. The significant part of those investments (5,0 billion YTL or 3,5 billion USD) was spent for implementation of the projects concerning potable water supple and sewerage system. "Eller Bank" has 18 regional divisions. Furthermore, in general the Bank composed 1170 technicians, 1389 administrative personnel and 3249 employees. Head office of the bank composed 9 main departments, 4 consulting structures and divisions. "Eller Bank" has developed its strategic plan for 2006-2010. The bank's mission is defined in that plan as follows: to take part in sustainable urbanization by meeting the local needs, developing the projects complying with international standards, meeting the credit demands, giving consultation and providing technical support[5].

As regards Azerbaijan, shortage of access to credit resources of the municipalities relates directly to weakness of financial potential of local authorities, i.e. insolvency of the municipalities, inability of nearly all municipalities to pay their current expenses on the one hand abstains the municipalities from obtaining credit, and on the other hand, financial establishments also do not show interest in financing credit to the bodies having such weak potential. That is why, the state authorities should show interest in improvement of inter-budgets transfers system and local taxation mechanisms. The government should take account that municipalities will gradually become reliable institution for financial establishments in the future, and municipalities' access to the credit funds in the medium-term period (approximately in 5-10 years) will minimize a little the state's financial burden. On the other hand, municipalities are not business corporations and credit financing under commercial conditions is impossible. As those credits are considered to be used for providing public services, for crediting the state municipalities under favorable terms the following mechanisms may be created:

a) for regulating financial-credit relations of the municipalities, municipal bank which authorized capital would be formed on the basis of state finance shall be created. Ownership of the bank's shares is divided equally between the government and municipalities. The accounts of all municipalities in the country are deposited with this bank. The entity fully transfers to the municipalities' administration. All municipalities are automatically considered as the bank's shareholders. The entity is managed by the Board of Chairmen elected by the municipalities and composed the members of local authorities. In case of establishing such kind of bank, there will not be any problem to obtain credit by the municipalities. Because, the best guarantee for disbursing those credits on time will be the municipality's bank account: if it is time for debt repayment, the funds entered to the account will be deducted. The high level of credit interest is defined by the National Bank; **b**) credits financed to the municipalities should be addressed only to the investment projects, and the directions of usage of those credit funds should be prescribed by legislation; **c**) interest of credits granted by Municipal Bank should be insignificant (for instance, 2-3% high compared to centralized accounting rate of the Central Bank),and

[5] http://www.ilbank.gov.tr

should only ensure to compensate the expenses for maintenance of the bank; d)training center regularly assisting the improvement of financial-credit administration of the municipalities should operate within the Bank.

The main purpose of the Alternative is to create a specialized municipal bank with financial assistance of the state and share participation of the municipalities, and this bank provides only banking services to municipalities.

This Alternative has some advantages and disadvantages.

<u>Advantages</u>
- Local governments have sufficient access to credit resources
- Sufficient credit financing for municipalities, restricted access to municipal bank accounts by local executive bodies
- Fund raising from foreign banks
- It ensures stable creditworthiness of local governments.

<u>Disadvantages:</u>
- Demand for opening of its branches in each region
- Demand for qualified specialists.

<u>Alternative 3: Improvement of the crediting mechanism by creating a Municipal Development Fund</u>

One of the main institutions providing financial services to local authorities in different countries around the world is Municipal Development Funds. The main purpose of these funds is to ensure socio-economic development at local level and to regulate the municipalities' financial administration. In the world practice, Municipal Development Funds realize the provision of the services such as giving grants, financing credit for solving the local problems, developing guarantee and insurance mechanisms for municipal credits, etc. 2 characteristic features of similar funds of separate countries attract attention: 1) credits obtained either from the funds allocated directly from state budget or international financial establishments under the state guarantee at the initial formation level, but to be repaid by the government are used; 2)these funds mainly play mediatory role – though they provide grants to the municipalities directly themselves, they use the services of different banks to deliver the credits.[6]

Consider practices from various countries to focus on the said financial institutions: in neighboring ***Georgia***, The Municipal Development Fund of Georgia (MDFG) was established in 1997. The World Bank is one of the main donors[7]**.** Under the Municipal Development and Decentralization Project with the World Bank financing and support the Fund has implemented 99 investment projects in the municipal infrastructure with the

[6] «Razvitie stranı: Üentrı i Periferii». Moskva -2009. O.R.Xasbulatov
[7] The Fund's website: www.mdf.org.ge

total cost of GEL 39.2 million. Of this, GEL 24, 9 million were allocated for the purpose of improving road infrastructure, 4.7 million for school building construction and repair, 1.1 million for sanitation and solid waste management[8]. Between 2002-2007 the World Bank allocated an additional US$ 19.4 million in loan.

The Fund provides the local authorities both with credits and grants. The main expenses priorities of the MDF are local investment projects. It is talked of waste discharging and reconstruction of water supply infrastructure, upgrading of local highway network and maintaining of existing equipment of the municipal infrastructure. Financial mechanism on the fund's specific projects is: 40 percent credit, 40 percent grant, the remaining 20 percent should be provided by the municipality submitting the project. However, grants are not always given, it depends on the conditions (the project's scope, potential opportunities of the municipality submitting the project, etc.). Municipalities are entitled to obtain credit from the central government under the guarantee of the fund or multiply partners. The crediting conditions of the MDF are as follows:

- *promptly submission of 20 percent contribution to the fund;*
- *annual interest rate is 15%;*
- *credit should be repaid within 10 years;*
- *debt for credit is not repaid within the first one year;*
- *real financial opportunities of the municipalities are reviewed*
- *and limitation is applied to the credit amount by taking into account the solvency;*
- *At the same time, limitation is applied to high level of crediting*
- *in order not allow rich municipalities to obtain more credits and not divide credit resources unfairly.*

In ***Poland***, The Municipal Investments Development Fund is functioning[9]. Preferential credits granted from The Municipal Investments Development Fund have a purpose of enabling the municipalities and their unions to finance costs of municipal investment project preparation, assigned for co-financing from the European Union Funds. The credit amount cannot exceed PLN 550,000 (USD 181,500) for one project, as well as 80% of net planned costs. Such projects cover a study of investment feasibility, cost analysis and benefits as well as the remaining project documentation, analysis, expertise and studies necessary for the preparation of investment realization.

In ***Brazil***, 48% of similar development funds constitute World Bank loans, while 52% are State contributions. In **Ecuador**, 73% of fund sources belong to World Bank & Inter-American Development Bank loans[10].

The government undertakes to establish Municipal Development Fund in Azerbaijan and it is able to found local financial establishment with initial capital in the amount of 30-50

[8] Municipal Development Fund of Georgia (http://www.developmentfunds.org/pubs/Victor%20Metreveli%20bio.doc)
[9] Poland The Municipal Investments Development Fund http://www.bgk.com.pl/index.php?module=site&catId=438&ru
[10] «Using municipal development funds to build municipal credit markets». George E. Peterson

million manats. The Azerbaijani government has certain practice in establishment of such development and support funds (Mortgage Fund, the funds related to development of NGOs, mass media, etc.). The said fund can operate in two directions:

1) Grant project may be announced at least twice a year. Grants may be allocated in relation to socio-economic development of municipalities. The funds for those grants may be obtained both from the state budget and donors as well. It should be taken into account that depending directly on the municipalities, the international donors will allocate large sums to the Municipal Development Fund which is supported by the state.
2) The Fund is entitled to grant short-term and long-term credits at low interest via authorized banks for implementation of the projects. As is seen from the different countries' practice, limitation may be imposed on maximum amount of the credits, and certain contribution may be required to be made as key conditions by the municipalities.

Expert services may be provided within the Fund for the municipalities to develop strategic plans and development programs, and to prepare projects. Those services may provide assistance and consultation not only for entities wishing to obtain funds from the said fund, but also for all entities seeking access to international donors.

The main purpose of the Alternative is to establish Municipal Development Fund within the Central Bank with support of government and international financial establishments (for instance, the World Bank). This fund grants the municipalities short-term and medium-term credits at low interest, and also allocates grants for funding different local projects.

This Alternative has some advantages and disadvantages.

Advantages:

- Local governments have sufficient access to credit resources
- There are similar practices in the country
- The Fund requires less expenses for functioning
- Credits are granted through authorized banks, there is no need to create a new bank
- The government disposes adequate financial resources
- Local governments have sufficient access to targeted financial aids
- The Fund can raise funds from international financial institutions.

Disadvantages:

- Local governments have no sufficient practices and experiences to explore projects.

EVALUATION OF POLICY OPTIONS

In order to evaluate alternative policy options and choose the best one, the expert group thought of a special set of criteria and built their evaluation on these criteria.

Assessment methodology. The assessment methodology encompasses expert assessment based on the criteria. Criteria that impact on the increase of municipalities' financial opportunities have been selected during the assessment. The selection has sought to measure the increase level of municipalities' financial opportunities through improving credit market access for them.
Each of the alternatives has been evaluated by the experts through the criteria and points given to them were added.

The evaluation took account of the following criteria:

- Enhanced level of municipal credit accessibility;
- Enhanced level of municipal budget revenues;
- Increased level of state financing backing;
- Dependence of municipalities on State Budget;
- Skill level of municipalities in financial management
- Increase level of opportunities in providing local public services.

Definition of the criteria:

Enhanced level of municipal credit accessibility – indicates enhanced level of local budget revenues through increasing municipalities' opportunity to gain sufficient access to credit resources.

Enhanced level of municipal budget revenues - indicates enhanced level of local budget revenues through raising credit resources.

Increased level of state financing backing – characterizes enhanced level of funds allocated to local budgets out of State Budget.

Dependence of municipalities on State Budget - shows dependence of municipalities on State Budget due to increased share of state funds in local budget revenues.

Skill level of municipalities in financial management – shows the influence of funds financed out of State Budget on the skill level of municipalities in financial management.

Increase level of opportunities in providing local public services – shows the increase level of opportunities in providing local public services at the expense of increase in municipalities' financial opportunity.

Explanation of evaluation points

Three levels are identified for the evaluation of alternatives – low, middle and high - and each level is given a conditional point with low given 1, middle 2 and high 3. The evaluation is based on comparative analysis and assumptions. Due to the unavailability of necessary statistical data, it is more likely to be difficult to define the boundaries of changes that may occur in the implementation of alternatives. Therefore, the points given are based on the comparative view of alternatives and experts' assumptions.

The evaluation of alternatives through the criteria is illustrated in Tables 1-5:

Evaluation of Alternatives through criteria

Table 1.

Alternative 1: Relevant amendments to the law to secure granting of concessional loans to local governments *(status-quo)*

Criteria	**Level**			**Points**
	Low	**Middle**	**High**	
	1	**2**	**3**	
1. Enhanced level of municipal budget revenues		2		**2**
2. Enhanced level of municipal credit accessibility		2		**2**
3. Increased level of state financing backing	1			**1**
4. Dependence of municipalities on State Budget	1			**1**
5. Skill level of municipalities in financial management	1			**1**
6. Increase level of opportunities in providing local public services		2		**2**
Total points				**9**

Table 2.

Alternative 2: Municipal credit financing through creating a specialized municipal bank

Criteria	**Level**			**Bal**
	Low	**Middle**	**High**	
	1	**2**	**3**	
1. Enhancement level of municipal budget revenues		2		**2**

2. Enhanced level of municipal credit accessibility			3	**3**
3. Increased level of state financing backing	1			**1**
4. Dependence of municipalities on State Budget		2		**2**
5. Skill level of municipalities in financial management		2		**2**
6. Increase level of opportunities in providing local public services		2		**2**
Total points				**12**

Table 3.

Alternative 3: Improvement of the crediting mechanism by creating a Municipal Development Fund

Criteria	**Level**			**Bal**
	Low	**Middle**	**High**	
	1	**2**	**3**	
1. Enhancement level of municipal budget revenues			3	**3**
2. Enhanced level of municipal credit accessibility			3	**3**
3. Increased level of state financing backing		2		**2**
4. Dependence of municipalities on State Budget		2		**2**
5. Skill level of municipalities in financial management		2		**2**
6. Increase level of opportunities in providing local public services		2		**2**
Total points				**14**

Each alternative is evaluated through the criteria and the results are presented in Table 4.

Table 4.

Results of evaluation by criteria

Criteria	**Alternatives**		
	1st alternative	**2nd alternative**	**3rd Alternative**
1. Enhancement level of municipal budget revenues	2	2	3

2. Enhanced level of municipal credit accessibility	2	3	3
3. Increased level of state financing backing	1	1	2
4. Dependence of municipalities on State Budget	1	2	2
5. Skill level of municipalities in financial management	1	2	2
6. Increase level of opportunities in providing local public services	2	2	2
Total:	**9**	**12**	**14**

Each of the alternatives has been evaluated by the experts through the criteria and points given to them were added. The third alternative "Improvement of the crediting mechanism by creating a Municipal Development Fund" has been chosen as the best one (**Tables 1-4**).

This option is ahead of the two other ones (14 points), as creation of such Fund is more favorable in terms of increasing municipal accessibility to credit resources.

Now, let's visualize the implications of alternatives based on the multi-purpose analysis. This analysis describes the goals of the implementation of the alternative and potential factors that may influence these goals.

Table 6.

Projecting outcomes of the alternative policies that aim to strengthen municipalities in Azerbaijan

Goals	Outcome category	Alternatives		
		1st alternative	2nd alternative	3rd alternative
1. Enhanced financial capacity	1.1. Availability of borrowing opportunity	Limited	Unlimited	Unlimited
	1.2. Budget revenue increase	Limited	Unlimited	Unlimited
	1.3. Increased state financing backing	Slight	Middle	High
2. Enhanced transparency and accountability in the utilization of financial means	2.1. Enhanced accountability before the government	Does not happen	Happens	Happens
	2.2. Limited opportunity in using credits for illegal (unauthorized) purposes	Low	High	High
	2.3. Public accountability for utilizations of credit resources	Low	Low	Low
3. Enhanced	3.1. Municipal reliance on State Budget	Unchangeable	Slight increase	Increase
	3.2. Local tax collection	No increase	Does not	Does not

municipal decentralization	encouragement		happen	happen
	3.3. Increased interest in local public services	Slight increase	Increase	Increase
4. More efficient financial administration	4.1. Structural development for financial management	Does not happen	Happens	Happens
	4.2. Personnel development	Does not happen	Happens	Happens

The multi-purpose analysis showed that Alternative II out of the three ones offered to enhance municipal accessibility to credit resources is a much more relevant and realistic tool in reaching out these goals. Both creating a specialized municipal bank or Municipal Development Fund could help local authorities gain sufficient access to credit resources. However, experts consider the Alternative III (Improvement of the crediting mechanism by creating a Municipal Development Fund) is much more relevant.

Outcomes and recommendations

The case study conducted as part of the policy preparation revealed the following outcomes:

1. Municipalities have gained no access to the credit market so far.
2. Although law envisages municipal financing, there are no mechanisms to execute crediting.
3. Existing crediting conditions meet no municipalities' interests and are not favorable in economic terms.

The survey showed that The third alternative "Improvement of the crediting mechanism by creating a Municipal Development Fund is ahead of the 4 possible options. It is possible to implement each Alternative. However, disadvantages in these mechanisms necessitate selection of the best option.

According to the authors, the Alternative "*Municipal credit financing through creating a specialized municipal bank*" is one of the possible options in helping municipalities gain access to credit resources. Since sufficient credit financing for municipalities, restricted access to municipal bank accounts by local executive bodies, fund raising from foreign banks, durability of municipal credit financing manifest advantages of this. However, sufficient number of domestic banks against the background of creating a new bank, with an extensive branch network and personnel reduces the implementation potential of this alternative.

Both the evaluation of the policy options and analysis of their possible implementation did necessitate the creation of a Municipal Development Fund under the Central Bank as an efficient way to help municipalities gain sufficient access to credit resources. The Government of Azerbaijan has already had an experience to create such development and assistance funds (Mortgage Fund, assistance funds for NGOs, the media, science, etc).

The aim of the Municipal Development Fund is to ensure social and economic development at local level, regulate financial administration of local authorities. In international practice, municipal development funds are engaged in rendering services, such as providing grants, granting loans to solve problems, developing guarantee and insurance mechanisms for municipal credits.

The creation of the Municipal Development Fund in Azerbaijan must be based on the principles below:

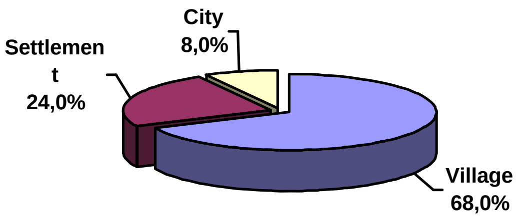
1. To establish a Municipal Development Fund with the first capital amount of AZN 30-35 million with government participation. The Fund shall be subordinated to the Central Bank of Azerbaijan (CBA).
2. The Fund could run in two directions:
   - announcement of grant projects at least twice a year. Grants may be provided for the best projects targeting social and economic development of municipalities. The funds may be financed out of State Budget and by donors. It should be noted that international funders or donors will provide large-size loans the Municipal Development Bank at the request of local authorities.
   - the Fund may grant low-rate shortterm and longterm credits through its representative (authorized) banks. Like any other foreign country, maximum amounts may be limited in Azerbaijan, municipalities may make certain contributions as well.
3. To shape and expert service center within the Fund, with a view to developing strategy and development plans, projects for for municipalities. In addition to assistance for loan raising, the service center may render methodological and consultation services for all organizations seeking channels to gain access to lending channels.

Annex 1

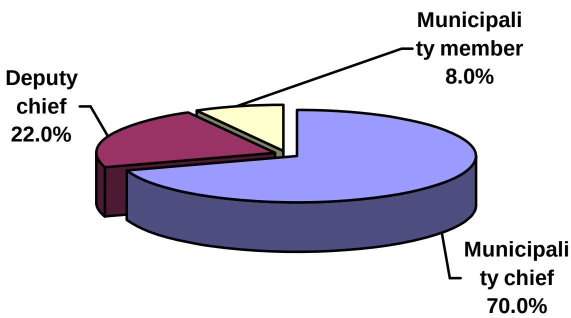
Survey analysis

The aim of the survey is to assess the potential factors and needs for municipalities' access to credit resources.

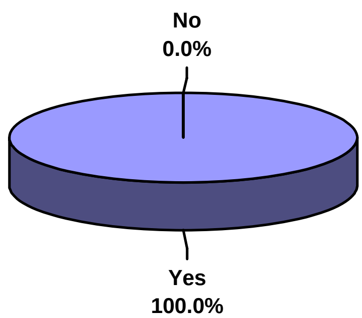
The survey was conducted among 50 municipalities in 12 regions throughout the republic. 10% of the respondents were from Şamaxı, 8% - Deveçi, 10% - Göyçay, 4% - Astara, 6% - Şeki, 2% - Ağdam, 12% - Quba, 8% - Barda, 10% - Hacıqabul, 10% - Lenkeran, 16% - Bakı, 2% - Abşeron. Also 68% of the respondents (34) represented village municipalities, 24% (12) settlement municipalities, 8% (4) city municipalities.



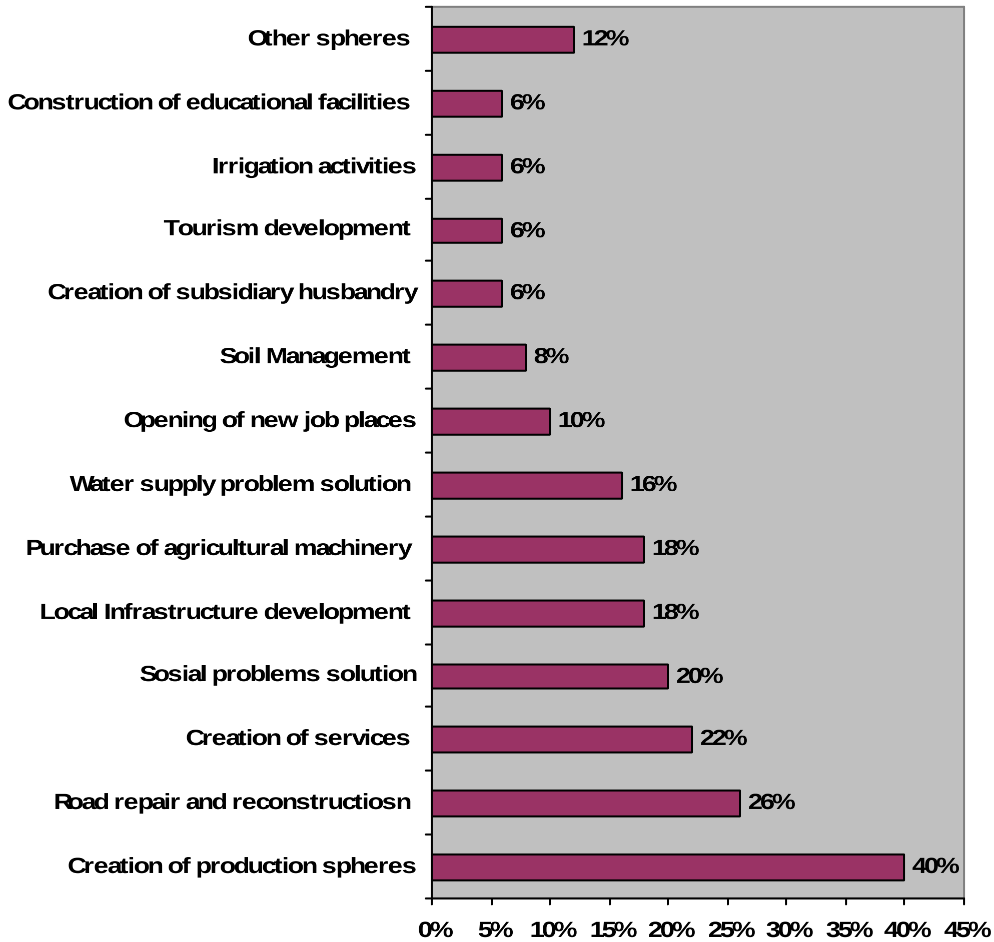
Municipality chiefs, deputy municipality chiefs and municipality members were impacted by the survey. 70% of the respondents (35 persons) constituted, 22% (11 persons) deputy chiefs, 8% (11 persons) municipality members.



In response to the question, regarding the municipalities' need for credit, all of the respondents answered "positively".



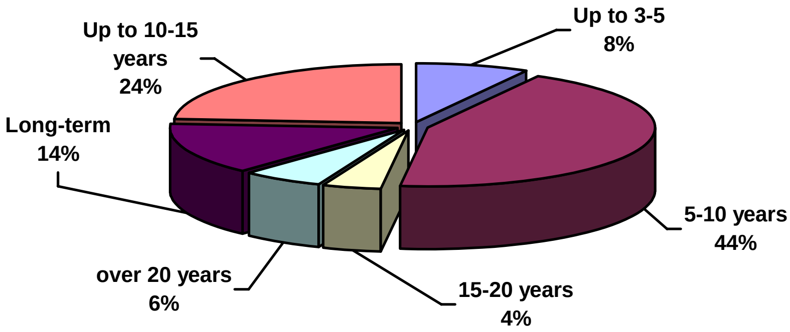
In response to the question **"What problems would you like to sort out through the use of credits?"**, 40% of the respondents (40 persons) preferred to create production spheres; 26% (13 persons) to reconstruct and repair roads; 22%(11 persons) to create multi-type spheres, 20% (10 persons) repair social problems in the catchment area, 18% (9 persons) to develop local infrastructure, 18% (9 persons) to manage soil and purchase agricultural equipment and machinery to cultivate unused land, 16% (8 persons) to solve water supply problems, 10% (5 persons) to generate new job places, 8% (4 persons) to need credits for soil development.



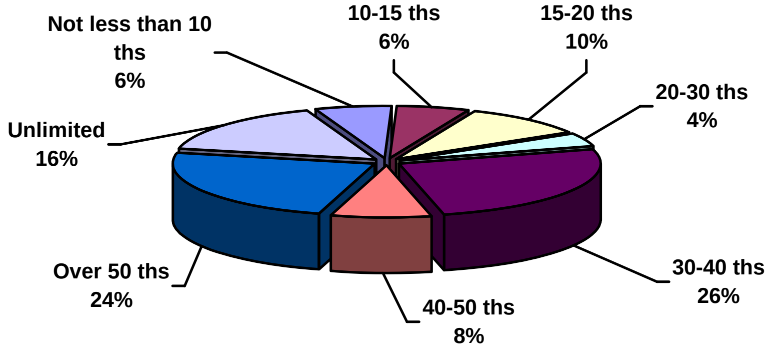
Out of the total respondents, 6% welcomed creation of auxiliary husbandry, 6% - tourism development, 6% - irrigation activities, 6% - construction of educational facilities, while 12% of them offered that credits must be directed to other spheres, including construction of administrative buildings for buildings and houses for roofless people.

In response to the question **"Under what conditions would you like to take the credit?"**, the respondents offered long-term, low-rate and large-size credit financing.

Regarding credit **length**, almost half of respondents (44%) said the best period is 5-10 years, while 24% offered 10-15 years, 4% - 15-20 years, 6% - over 20 years. And 14% of the respondents offered longterm credits, yet failed to name any concrete length. 8% of them reported the period of 3-5 years would be sufficient for them.



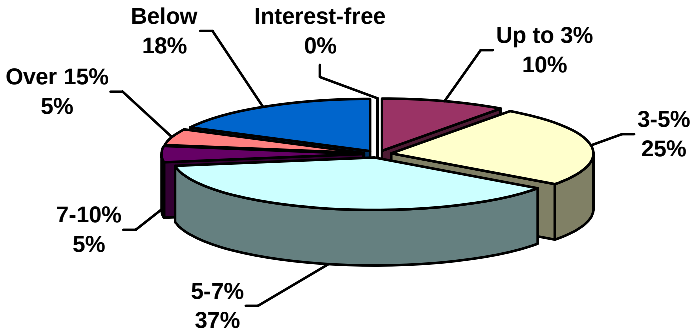
As to loan value, the majority of respondents reported AZN 30,000-AZN 40,000. As much as 26% of respondents claim that such amount could help them solve own problems. 24% of respondents reported to obtain over AZN 50,000 in loan, while 6% named AZN 10,000, another 6% AZN 10,000- AZN 15,000, 10% AZN 15,000 –AZN 20,000, 4% AZN 20,000 AZN 30,000, 8% AZN 40,000 – AZN 50,000. Also 16 of respondents did not call an exact amount, but welcomed unlimited credit financing.



In addition, municipalities in their responses mentioned that they want credit repayments for the period of 2-3 years and the compliance of credit terms and conditions with those the government has granted to private businesses.

Regarding the question related to credit rates, 30% of respondents reported respondent that 5-7% annual rate would be all right for them, while 20% of them expressed readiness to obtain credits at 3-5%, another 20% pointed to interest-free credits. And 8% of respondents said they can afford 3% annual rate, 4% about 7-10%, while 4% reported 10%

and higher; 14% of respondents did not name a concrete figure, only saying that they want to access credits at low rates.



In response to the question **"What mechanisms would you favor for municipal credit financing?"**, half of respondents (50%) offered creation of a specialized municipal bank to grant credits, which exists in some countries, while 42% of respondents pointed to the mechanism of granting of credits through municipal development funds, 2% saw no difference between.

Survey outcomes

Survey analysis highlight the outcomes below:

1. All municipalities need credit funds and they are ready to appeal for obtaining such credits in case credit terms are softened (in a form of low-rate credits).
2. Municipalities willing to obtain credits prefer to use the funds for creation of production spheres.
3. Municipalities prefer long term, low-rate, and considerable credits.
4. Regarding credit length, almost half of respondents (445) said the best period is 5-10 years.
5. Municipalities maintain that credit length should take nearly three years at most.
6. The question regarding the credit amount showed that over one-third (26%) of respondents need AZN 30,000 – AZN 40,000, while 24 percent need more than AZN 50,000.
7. Municipalities in their responses mentioned that they want credit repayments for the period of 2-3 years and the compliance of credit terms and conditions with those the government has granted to private businesses.
8. Half of respondents (50%) prefer rates at 3-7% per year, while 20 percent of them prefer interest-free loans.
9. Municipalities with a slight difference prefer to access credit means through municipal banks.