Bond financing for local authorities

By
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A major thrust of economic policies under the new administration is to further strengthen the role of transparency and good governance in economic activities. Local authorities have been identified as one of the focus points for this purpose. Although this move certainly will reduce malpractices in local councils, the main reason behind this is to improve professionalism and the efficiency of local authorities. This is important because local councils are an intermediary body between the government and public.

Improving transparency and good governance at the level of local councils will improve the image of the government. It will certainly improve the public sector delivery system, and create better relations between the private and public sector. It will also pave the way for sustainable economic growth.

High economic growth and higher education have improved the quality of life across the Asia-Pacific region. This new phenomenon puts strong pressure on the structure and role of local authorities. The population is no longer perceived by the local authorities simply as a body whose daily social activities they should cater to. Increasingly, the population is viewed as an integral part of the whole governmental system and national development process.

It is expected that the challenges to the local authorities will continue to increase with the rise in economic performance and with the improved lifestyle of the population. But the limited financial resources of the local authorities have often hampered and constrained their efforts to rise to the challenges and expectations of their clients. However, much as the local authorities may want to innovate and revive their activities within specific areas, they always encounter inadequate resources.

Lack of money has generated other problems such as lack of skilled personnel, low use of computerisation, low standards of reporting, weak management and poor monitoring. All these place the local authorities low in the public eye. Today, the nation's vision of a developed country in the year 2020 leaves little doubt that the local authorities have to expand their range of services and encourage growth and development in their areas of jurisdiction. In this web of financial constraints, the local governments have no choice but generate revenue in order to perform.

Except for 2001 and 2002, the financial position of the local authorities was in the red since 1998. In 2003, the revenue growth was -1.9 per cent, while the current expenditure and development expenditure grew by 11.6 per cent and 8.0 per cent, respectively. This trend caused a deficit of around RM 495 million last year.

The revenue structure of the local authorities remains more or less unchanged, with more than 60 percent of its revenue coming from assessment tax and the rest coming from federal/state grants. This static revenue structure continues to exist, given the limited freedom and flexibility accorded to the local authorities in generating their own sources of revenue.

The financial burden of the local authorities can be reduced, to a certain extent, if they have sufficient capital or access to market financing, to carry out certain profitable activities within their localities.

Some local governments choose a method of deferred payments to carry out important projects. However, it is quite difficult to get a contractor who is willing to spend his money and to wait long for returns. If they agree, it is very likely that they will incorporate the waiting period into the cost of the project, hiking the total cost of the project eventually.

The issuance of bonds has long been identified as a potential solution to improve the financial performance of the local government. However there are economic, constitutional and operational issues and limitations surrounding the proposal.

One major setback of this proposal is the difficulties encountered in streamlining local government and federal government budgetary policies. In addition, there is the need for proper monitoring in terms of project selection and over borrowing. The local authorities also face the problem of insufficient qualified personnel to carry out proper investment analyses for their investment.

Although all these should not be seen as obstacles, they certainly shed some light on the importance of clear planning, regulations and guidelines, to bring local government financing in line with national economic objectives. Possibly, the federal government should determine/allocate the amount of borrowing for each state in line with national budget objectives. The allocation process needs a clear formula.

It is stipulated, under part 5, Section 39 of the Local Government Act 1976 for Peninsular Malaysia, under Section 55 Local Government Ordinance 1961 for the state of Sabah, and in Chapter 117 of the Local Authority Ordinance 1948 for the state of Sarawak, that the local authority/local government may raise loans from the market with the approval of the state government.

These Acts do not pevent the local government from raising market loans or issuing bonds, because the planning, development programmes and operation of local government activities have been carried out under state advice and supervision, with the President of local government being directly answerable to the State Assembly. Indeed, the state governments always wish to support local government efforts to raise capital, as it is tantamount to implementing their own development plans as well.

There is a need for a close cooperation among federal, state and local governments, to iron out constitutional and legislative problems professionally by leaving out any aspect of the political economy for the purpose of maximising the benefits to the country as a whole. The federal government, possibly the treasury, should be given the task of monitoring and supervising the whole process of bond financing.

This programme, if implemented, will increase the number and volume of quality bonds and will be in line with the government's serious efforts in developing the Malaysian capital market. Furthermore, the opening up of doors to rating agencies, which require greater transparency on information disclosure, will definitely bring a positive impact on the efficiency of services provided by the local governments.

The Asian financial crisis has highlighted the problems of excessive reliance on bank financing on the part of corporations in this region. The aftermath of the crisis has raised the critical need for a more balanced mix of equity and bonds as financing and investment choices in the capital market. Since then it has been acknowledged that a key priority for the region is to develop deeper, longer-maturity, more stable and more transparent debt markets in Asia.

Like other Asian countries, the Malaysian capital market, particularly its private debt securities' market is still young. However, it is developing fast and equipping itself with the necessary institutional and regulatory infrastructure. Thus, there will be no market inadequacy in accommodating the issuance of bonds by local governments. Although there are common problems for developing countries such as the lack of benchmark yield curves, inefficient secondary markets and rating processes, they are disappearing rapidly in Malaysia.

Some immediate problems which need to be resolved before the implementation of bond financing by the local governments relate to accounting practices and transparency issues. Local governments have up-to-date data on their activities since they are required to submit their audited financial statements to the state governments every year. However, bond financing will require a lot more detailed information.

While some weakness in the accounting standards of local governments are technical in nature and can be easily rectified, full information disclosure, as required by rating agencies, may be difficult for the local authorities to fulfill, given the social and political sensitivities.

To enable rating agencies to execute their jobs successfully, they need to be allowed to explore, examine and analyse all information and data related to local government activities. Thus, the whole transparency issue relating to the adequacy of accounting, auditing and disclosure standards will need to be addressed prior to the implementation of bond financing for the local governments.

Clearly, bond financing is an appropriate option to consider as it could go a long way towards improving and increasing local government finance in Malaysia, enabling the local governments to pursue their goals and aspirations of economic development in consonance with the country's economic vision, particularly in its quest to attain industrialised status by the year 2020.

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